2023
EDITION

Business & Company LAW

STUDY TEXTBOOK

CPA (U)

PAPER 5

BUSINESS & COMPANY LAW

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This study textbook has been designed to help students pass their CPA(U) Paper 5 exams. It has been published in close consultation with lecturers and tutors who have extensive experience in teaching this subject. Additionally, the content has been updated to reflect the new changes in the CPA(U) Syllabus that took effect on 1st January 2023. This book contains all the essential information needed to help you pass your exams with flying colours.

The study text therefore;

- Highlights the most important elements in the CPA(U) Syllabus and the key skills you need.
- Emphasizes how each chapter links to the CPA(U) Syllabus and the study guide.
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Sixth Edition 2023
Printed by Harvest Uganda Ltd
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THIS STUDY TEXT INCLUDES THE FULL CPA(U) BUSINESS & COMPANY LAW SYLLABUS

This book has been specially written and designed to help students preparing for their CPA(U) BUSINESS AND COMPANY LAW Paper 5 professional examinations and those undertaking a BUSINESS STUDIES and BSC ACCOUNTING AND FINANCE course at the University. It is also useful for lecturers preparing students for those examinations.

This book covers a variety of contents, exercises, model questions, test papers, mixed exercises and answers to equip and prepare students for their examinations.

This book contains

- ✓ Progressive notes targeted to the entire Financial Accounting Syllabus and study Guide.
- ✓ Review exercises and Questions to check your understanding
- ✓ Clear layout and style designed to save your time
- ✓ Plenty of examination Questions from a variety of past papers.

We are grateful to all the examination councils for their permission to reproduce past examination questions.
The suggested solutions to the Illustrative questions have been prepared by the whole entire author Team.

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- Structure of Courts and administration.
- Hierarchy of the Court system.

1.1 KEY DEFINITION - *LAW*

Law may be defined as a body of rules and regulations governing or regulating society, the enforcement of which is effected by way of sanctions. However, some laws especially procedural laws may not be backed by sanctions.

1.2 PURPOSE OF LAW IN SOCIETY

The rule of law requires that people should be governed by accepted rules, rather than by the arbitrary decisions of rulers. These rules should be general and abstract, known and certain, and apply equally to all individuals.

Constitutional governments are based on a previous commitment to freedom under the rule of law. The essential attribute of constitutionalism is a legal limitation on government. Under constitutionalism, rulers are not above the law, government power is divided with laws enacted by one body and administered by another, and an independent judiciary exists to ensure laws are administered objectively. An efficient and effective constitution allows government to function to protect the lives and liberties of citizens without violating the rights of some to provide gains to others.

Non-statist customary and privately produced laws continue to exist today. Members of many voluntary associations prefer to operate under rules of their own choice and making rather than relying on those of a coercive government.

Law demarcates what is right and wrong in society and defines the manner in which human activity is to be conducted for harmonious life. Some laws are intended to preserve the environment (e.g. environmental law); Law ensures that people perform their undertakings in transactions (e.g. law of contract); Law is also used to punish offenders and control crime in society (e.g. criminal law); Law is used to compensate people who are injured by the acts of others (e.g. the law of torts); Law stipulates the manner in which public affairs are to be run (e.g. administrative law); Law regulates the relations between or among states (e.g. international law). Etc.

1.3 CLASSIFICATION OF LAW

Laws are classified into a variety of forms

- *Criminal law Vs. Civil law*
- *Public law Vs Private law*
- *Substantive law Vs Procedural law*
- *Municipal law Vs International law*

1.4 CRIMINAL LAW

This branch characterizes certain conduct, acts or omissions/wrongdoing as offences against the state. Criminal law emanates from the term 'crime' that signifies an act of disobedience to the law and such disobedience is normally punishable by sanctions ranging from death, imprisonment, fine or even a caution etc. [*However, consider sins, immoral acts, unethical conduct and social evils*].

Criminal law is normally enforced by police and the Directorate of Public Prosecutions (DPP) currently headed by Mr. Richard Buteera although in some cases a private person can also commence criminal proceedings by complaint on oath before a Magistrate as per the Magistrates Courts Act, Cap 16 (MCA). (also Private prosecution e.g. by the National Drug Authority). Where private prosecution has been commenced, the DPP has powers under the Constitution and the MCA to take over the conduct of the proceedings. Under Criminal law, a person is innocent until proved guilty or until he pleads guilty and the burden of proof lies on the prosecution, except in a few cases where the burden may shift to the accused especially in strict liability offences.

NB. Cases involving abuse of office and corruption by public officers are prosecuted by the IGG before the Anti-Corruption Court (a division of the High Court of Uganda).

Civil law- concerns itself with rights and duties of individuals towards each other e.g. law of contract – obligations & consequences of parties to agreements, the law of tort which concerns civil wrongs for which a remedy lies in damages e.g. motor accidents, accidents at work places – duty of care owed by one party to another. The law of property which involves land rights, ownership, and transfer, the law of succession which involves devolution of property on death etc. The sanctions are in form of remedies like damages, specific performance, injunction, rescission, rectification etc.

Distinction between Civil and Criminal law

In civil law, legal action is commenced by a private person, or entity called the Plaintiff (or Applicant in an application) against another who has violated the right called the Defendant (or Respondent in an application).

Criminal law is enforced on behalf of the state and in the name of the state e.g. R v James, The Queen v John. In Uganda, the Constitution provides that the Prosecutor should be designated as Uganda e.g. Uganda v Hussein Akbar Godi. The person against whom criminal proceedings are brought is called the accused.

In criminal law, the standard of proof is one beyond reasonable doubt while in civil matters; it is based on preponderance of evidence /or balance of probability.

In both criminal and civil law, a party who appeals is called the appellant and the party against whom the appeal is made is called the respondent.

Concurrency of criminal and civil wrongs

Sometimes a case may fall under both criminal and civil law e.g. civil suit in negligence versus a criminal case for negligent or reckless driving, Malicious damages to property, Trespass. There is no bar against bringing a case in criminal and civil law.

1.5 PUBLIC LAW

This law deals with the relationship between the state and individuals or between states *inter se.* It includes international law, administrative law, constitutional law and criminal law.

(i) **Constitutional law** is a body of rules regulating the structure of the principal organs of government, their relation to each other and also forms the basis for validity of the laws.

(ii) **Administrative law** regulates rights and duties arising from exercise of powers and functions conferred on those with statutory powers [powers granted under written law] e.g. local authorities and institutions.

1.6 SUBSTANTIVE LAW

This is a branch of law that spells out the legal rights, duties, obligations and liabilities of parties *inter se* and government. Examples include contract law, the Companies Act etc

1.7 PROCEDURAL LAW

This branch of law entails rules governing the manner in which a right is enforced under the law or a crime is prosecuted under criminal law for example the law of civil procedure, evidence, and criminal procedure.

1.8 MUNICIPAL LAW

Municipal law is the national law. It is law which has its application to one state while **International law** is the law that governs relation of states *inter se* i.e. it applies to more than one state. International law may be sourced from international treaties and conventions e.g. the Convention against Torture, the EA Treaty etc. International law applies to Uganda if a particular instrument has been ratified or domesticated in its laws.

1.9 STEPS TO BE FOLLOWED IN ENFORCING LEGAL ACTION

- Civil matters: notice of intention to sue should be communicated to the other party, a plaint should be filed and served on the Defendant together with Summons, and the defendant in turn files a written statement of defence and serves it on the Plaintiff. The Plaintiff may file a reply to the written statement of defence. When the pleadings have been filed, the Court sets a hearing date and both the Plaintiff and the Defendant adduce their evidence assisted by the witnesses. When all evidence has been heard, the lawyers make their submissions and the Judge/Magistrate makes his/her judgment/ruling based on the law, facts and the evidence.

- Criminal matters: a victim files a complaint with the police, investigations are carried out by the police, accused is arrested, a charge sheet or indictment is prepared [in respect of offences triable by a Magistrates Court and the High Court respectively], the prosecution and defence adduce their evidence, submissions are made by lawyers if parties are represented and the Courts makes a judgment.

- In the Magistrates Court, the accused is formally charged by reading out the offence to him to which he pleads either guilty, not guilty or he may keep quiet implying not guilty. In the High Court, the process is called arraignment. Where the accused pleads not guilty, he is remanded, brought from time to time for hearing, till judgment and sentencing. If found not guilty, he is acquitted. During the trial, the accused person is entitled to apply for bail which may be granted or refused at the Court's discretion.

1.10 THE STRUCTURE OF THE COURTS & ADMINISTRATION OF JUSTICE IN THE UGANDAN LEGAL SYSTEM

1.10.1 Important Terminologies

- **Jurisdiction.** This refers to scope of powers vested in a particular Court relating to what kind of cases it can handle and is determined on the basis of subject matter, value, location and nature of offence or claim.

- **Pecuniary jurisdiction** connotes the monetary value of the subject matter which a Court is allowed to handle for example under the **Magistrates' Court Amendment Act** a Chief Magistrates Court can hear cases the value of whose subject matter is of up to a maximum of 50,000,000/= while a Magistrate grade one can handle case of up to 20,000,000/=. Magistrates Grade II hear claims of up to 5,000,000/=. Magistrate Grade III have been phased out.

- **Geographical or territorial jurisdiction** means the Court exercises power over cases that arise within the local area where the Court is situate.

- **Criminal Jurisdiction** refers to the power of court to handle a particular criminal offence. For example under S.**161** of **the Magistrates' Court Act** a Magistrate's Court presided over by a Chief Magistrate may try any offence other than an offence carrying a death penalty e.g. rape, murder….

  A Magistrate Grade I may try any offence other than an offence carrying a death penalty or life imprisonment.

- **Courts of first instance** are courts where an action is originally commenced and heard. In that case, the court will be said to be exercising its original jurisdiction [or trial court].

- **Appellate Court:** This is the higher court [normally in hierarchy] to which an aggrieved party may seek remedy by way of challenging the decision, ruling or sentence made or passed against him by a lower Court [trial court].

- **Appellate Jurisdiction T**he appellate court after considering an appeal may reverse the decision of the lower court on a successful appeal in which case it is said to allow the appeal or it may affirm/ uphold the decision of the lower in the event of an unsuccessful appeal in which case it is said to dismiss the appeal. In doing so, it is exercising its powers/jurisdiction as an appellate court.

- **Distinguishing cases** – when court's attention is drawn to a previous case with almost similar facts, it seeks out material differences in the facts, reasoning or approach and will not follow that case.

- **Over ruling** occurs when a higher court decides a similar case on the basis of a different legal principle. The previous rule of a lower court is said to be overruled/ceases to have legal effect.

- **Facts** are the circumstances that give rise to a claim; only material facts are relevant. Facts must be distinguished from evidence; facts are allegations and evidence is proof that may be from oral testimonies or documents.

- **Issues**: These are points of contention e.g.

  (i) Whether the there was a contract between the plaintiff and the defendant
  (ii) If so, whether the defendant breached the contract
  (iii) Whether the plaintiff is entitled to the remedies applied for.

- **Law Applicable** refers to the relevant Act, delegated legislation, case, common law, equity, custom or texts to be relied upon in resolving the dispute.

- **Decision of Court**. The refers to the conclusion that Court draws from the summing up of the facts, evidence and the law e.g. a judge may say: *"on the basis of the law and evidence as analyzed above, I find that the Plaintiff has proved negligence and the Defendant is thus liable [in civil cases] or that the accused is guilty [in criminal matters].*

- ***Ratio Decidendi.*** This refers to the reasoning of the court, the justification for reaching a particular conclusion. It is also referred to as the statement or principal of law e.g. *In Donoghue V Stevenson Lord Atkin* stated the famous 'my neighbour principle' thus';

  "*Every person who stands in a direct relationship with another in such a way that his actions or omissions are foreseeably likely to cause injury to that other [a neighbour] owes a duty of care to that person and will be held liable if such acts or omission are the proximate cause of the other's injury".*

- **Suit** means a claim that has been duly filed in court by whatever means. The process of filing is commonly referred to as suing or commencing proceedings. Different claims may be instituted through various procedures.

- **Reversal of a decision**

This happens where an appellate court reverses the decision of a lower court from which the appeal emanated.

- **Disapproval**

This is where a superior court in the course of its judgment expresses doubt as to the validity of some previous rule/decision or principle but does not expressly over rule it.

1.11 THE HIERARCHY OF THE COURT SYSTEM

The civil / criminal justice system is structured in form of a hierarchy of courts with specific jurisdiction/power/limits to handle specified cases.

Under Article 129 of the Constitution, it is provided that judicial power shall be exercised by the courts of judicature which shall consist of the Supreme Court, the Court of Appeal [COA], the High Court and such subordinate courts as Parliament may by law establish. Article 128 provides that in the exercise of judicial power, the courts shall be independent and shall not be subject to control or direction of any person or authority

1.11.1 The Supreme Court

The Supreme Court is the highest court of appeal under Article 132 (1) of the Constitution. It has original jurisdiction in matters of presidential election petitions. An appeal can lie to the Supreme Court from the decisions of the Court of Appeal as may be prescribed by law. The SC consists of the Chief Justice and other Justices of the Supreme Court. The CJ is the head of the judiciary and is responsible for the administration and supervision of all courts in Uganda (Art 133(1)(a)).

1.11.2 The Court of Appeal (COA)

The Court of Appeal consists of the Deputy Chief Justice and other Justices of Appeal (Article 134). An appeal can lie to the Court of appeal from the decisions of the High Court as may be prescribed by law. It can also sit as a constitutional court to determine questions regarding the interpretation of the constitution (Article 137 (1). The court is headed by the Deputy Chief Justice whose role is to assist the Chief Justice in its administration (Article 136 (1(b)).

1.11.3 The High Court

The High Court is established under Article 138 of the Constitution. Subject to the provisions of the Constitution, the High Court has unlimited original jurisdiction in all matters and such appellate jurisdiction and other jurisdiction as may be conferred on it by the Constitution **(Article 139(1)).** The decisions of courts lower than the High Court are appealable to the High Court as provided by the law. The High Court is headed by the Principal Judge (Article 141 (1(a) currently Justice James Ogoola. The PJ assists the Deputy Chief Justice in the administration of the High Court and subordinate courts.

The High Court has divisions ranging from the commercial, criminal, family, land, Anti-Corruption, War Crimes, and civil divisions each with a registry and a registrar. On top of the criminal division of the High Court, there is now a specialized court to handle criminal cases of corruption and abuse of office i.e. the Anti-Corruption court.

The High Court holds sessions in various parts of Uganda called High Court Circuits for the trial of civil and criminal cases. Currently sessions are held in Nakawa, Masaka, Jinja, Gulu, Arua, Fort Portal, Mbarara, Mbale, etc.

1.11.4 The Magistrate's Courts

These are established under S. 3 of the Magistrates Court Act and the High Court is empowered by the Judicature Act to supervise them. They consist of grades ranging from Chief Magistrate, Grade II, II while grade III was phased out. A Chief Magistrate is empowered to supervise all Magistrates' Courts within the area of his jurisdiction.

The powers and jurisdiction of a particular magistrate are determined by the grade of his or her appointment and the powers and jurisdiction conferred upon that grade by the Magistrates Courts Act. **(S.4(3).**

An appeal lies to the High Court from the Chief Magistrate or Magistrate Grade I. There are various Magisterial areas each headed by a Chief Magistrate.

1.11.5 The Family and Children Court

S.13 of the Children Act provides that there shall be a Family and Children Court in every district which shall be presided over by a magistrate. The jurisdiction of the court extends to power to hear and determine applications relating to child care and protection (e.g. custody and maintenance, parentage) as well as criminal charges against a child except any offence punishable by death or any offence for which a child is jointly charged with a person over eighteen years of age;

NB. The Children Act provides that unless otherwise provided, matters of a civil nature concerning children are dealt with by the village Local Council Courts where the child resides or where the root of the complaint arises.

1.11.6 Local Council Courts

These are established under S.3 of the Local Council Courts Act 2006 for the administration of justice at every village, parish town division and sub-county. They are supervised by the High Court although the Chief Magistrate may exercise this function on its behalf. The territorial jurisdiction of LC Courts extends only to matters arising in the territory of the council where the court is established or to matters arising elsewhere if the defendant or accused ordinarily resides in that territorial area except where the law provides otherwise.

The language of the court is the language widely spoken in the area of jurisdiction of the court. LCCs can give remedies including compensation, restitution, attachment and sale.

Appeals lie from village LCC to Parish LCC; from Parish LCC to town, division or Sub County; from town, division or Sub County to the Chief Magistrates Court; from Chief Magistrates Court to High Court with leave of the Chief Magistrates Court or the High Court.

1.11.7 The Military courts

These are established under the UPDF Act to try all those persons subject to military law e.g. every officer and militant of the reserve forces when he is in uniform, on duty, on active service, present at any training of a unit of the Defence forces etc.

They include the Division Court Martial, the Unit Disciplinary Committee, the General Court Martial, the Court Martial Appeal Court and the Field Court Martial.

1.12 THE NATURE OF THE UGANDAN LEGAL SYSTEM

The 1995 Constitution is the supreme law of Uganda from which all other laws derive their validity. Accordingly any law or custom which is inconsistent with it is void to the extent of the inconsistency. The constitution regulates the relations between the state and its citizens as well as between state organs.

1.12.1 Sources of Law

This includes primary and delegated legislation, Common law and Equity, case law and customary law.

Legislation **refers to law enacted/made by parliament and other bodies or authorities vested with such powers by law. The cardinal forms of legislation are Acts of Parliament and delegated legislation.**

1.12.2 Acts of Parliament/ Statutes

These are the supreme source of legislation, over and above the common law and equity. Acts are written law enacted by Parliament as primary legislation. An Act arises from a Bill. **A Bill** is the first draft and proposed law which has been formally tabled before Parliament for consideration. The Bill becomes an Act (law) when Parliament has approved it and the President had assented to it. Statutes/Acts of Parliament are divided into sections, subsections, paragraphs and sometimes schedules.

1.12.3 Delegated Legislation

This is often times called subordinate legislation or secondary legislation. Parliament normally passes an Act setting out the general laws without details hence leaving it to bodies, authorities or persons to make rules to give effect to the law.

However, ordinarily the power to make secondary legislation is usually vested in the specific authority by the Parent Act meaning that such legislation should conform to the Parent Act or other related Acts lest it will be rendered null and void to the extent of its inconsistency

- ***Types of Delegated Legislation***

  (i) **Statutory Instruments.** Normally called rules, regulations or orders, Statutory Instruments are laws made by authorized persons upon whom such power has been vested by the Parent Act. In other words, there must be a provision in the Parent Act authorizing such legislation. **Statutory Instruments** normally relate to commencement date of Parent Acts, rules of procedure, alteration of monetary and other limits. Statutory Instruments/Rules/Regulations are divided into rules, subrules, paragraphs and sometimes schedules.

  (ii) **Ordinances.** These are laws passed by the District Council. S.38 (l) of the Local Government Act provides that a District Council shall have power to pass local bills into ordinances signed by the Chairperson. However the bill is required to be first forwarded to the AG through the Minister to ensure that it is not inconsistent with the Constitution and any other Act of Parliament before the Chairperson signs it. Once the chairperson signs it, it becomes an ordinance and is published in the gazette and in the local media. An ordinance may be made to apply to the whole district, any part of the district, a particular section or profession of the people.

An ordinance is made for matters which are not adequately provided for by the constitution or Act of Parliament. Examples include The Wakiso Revenue Ordinance, Kiruhura Diary and Cooling Ordinance, Pader District Education Ordinance etc.

(iii) **Bye- Laws.** These are made by local authorities or other authorized bodies and are only binding on persons or entities coming within their scope [limited geographical scope].The law making entities derive their authority for an enabling provision in the Parent Act.

Under the Cooperative Societies' Act, cooperative Societies are empowered to make bye laws as a condition for registration.

Under the Local Governments Act, an urban, sub county, division or village council is empowered to make bye law which must not be inconsistent with the constitution, or any Act of Parliament, or ordinance passed by a District Council, or a bye law passed by a higher council. The bye law has to be sent first to the relevant authority to certify that it is not so inconsistent.

- **Advantages of delegated legislation**

a. Parliament is busy analyzing policy issues and therefore it requires time off for this purpose.

b. Some matters are so urgent that they require immediate attention to be addressed. This situation may require that a law be passed immediately for which Parliament may not have time

c. Matters to be legislated on may be so technical that they may require technical persons to handle. Not all parliamentarians are technical enough to handle all matters and so expert knowledge can be got by delegating the power to legislate e.g. nurses and midwives regulations.

d. Future difficulties are better handled with delegated legislation especially where service charges are involved e.g. payment of fees like stamp duty.

e. Delegated legislation addresses the detailed aspects of the law which may have been overlooked by parliament.

f. Delegated legislation ensures flexibility as it is simpler and in case of impracticability or unfairness, it can easily be revoked or amended.

- **Disadvantages of delegated legislation**

- Delegated authorities are at times given powers to legislate on matters of principle which should only be dealt with by Parliament.
- Parliament, the supreme law making organ of the state, may lack control over delegated legislation and this may lead to passing of dangerous laws.
- Delegated powers may be so wide and this may create uncertainty about the prevailing laws as well as leading to a multiplicity of laws that may be contradictory.

- There is a risk of an authority to which power is delegated to exercise those powers beyond the permitted limits in which case any law thereby passed will be void (*ultra vires*)

❑ ***Controlling Delegated Legislation***

There are mechanisms put in place to control delegated legislation.

A. **Parliamentary Veto.** Parliament reserves the power to withdraw authority to the delegated person or institution if such authority is misused. Parliament normally subjects any subsidiary legislation to scrutiny before it comes into force.

B. **The consultative Process.** Before a proposed statutory instrument is concluded, the interested parties are normally consulted for views and comments.

C. **Judicial Scrutiny.** Courts are normally invited to scrutinise the validity of statutory instruments on grounds relating to:

(i) The content falling outside the scope of the Parent Act.
(ii) Failure to comply with the requisite procedure.
(iii) Incompatibility with convention rights. For example in Raymond V Honey (1983), whilst the Home secretary had powers to make rules for the management of prisons, he was not permitted to deny prisoners the right to access to the Courts.
(iv) Also see the mechanisms under ordinances and bye/laws above.

1.12.4 Common Law and Equity

Common law refers to a body of rules that have over time been developed by English judges from English customs which became on the basis of fundamental legal principles.

Equity refers to a body of discretionary rules and remedies devised by the courts of chancery on the basis of fairness, rules of natural justice and good conscience to remedy the lacuna/gap/ defects created by the common law. They are laid down in form of maxims/doctrines.

What were the defects in the common law?

- **The procedural technicalities**. Common law required claimants to commence their actions by way of a writ/claim form setting out the terms of the claim and failure to comply [however minor the non-compliance] therewith rendered the action bad in law and therefore unsustainable. Form was much emphasized than substance. The writ provided for specific claims that could be commenced by such method and any claim not provided for therein was untenable in law.

- **A limited number of remedies** were available at common law; basically damages/ monetary compensation for loss or damage. If a claim required some form of remedy other than damages, it would fail.

- Equity therefore has its genesis embedded in the cumbersome nature of the common-law. The rules were first developed by the King through petitions and later the Lord Chancellor. Subsequently a court of Chancery was established to administer equity and its rulings are the foundation of the multiplicity of equitable rules/doctrines applied today. Examples include; equity helps the vigilant and not the indolent, he who seeks equity must do equity, equity looks at substance rather than form; he who comes before equity must come with clean hands.

- The common law and doctrines of equity are today concurrently administered in all courts but are all subject to and cannot prevail over written law.

1.12.5 Case law or judicial precedent

Being a common law country, Uganda applies precedent as a source of law. Precedent means earlier decisions of the courts of record that are relied upon by courts in deciding cases of similar facts. In Uganda, courts of record are the Supreme Court, Court of Appeal and High Court. Case law is therefore referred to as judge-made law. Precedent is based on the legal principle of *stare decisis* which requires subordinate courts to stand by earlier decisions with similar facts.

Under the system, decisions are recorded in law reports so as to facilitate a degree of continuity and predictability.

Law reports in Uganda include Uganda Law Reports (ULR), Kampala Law Reports (KALR), High Court Bulletins (HCB), Uganda Commercial Law Reports and Uganda Law Society Reports (ULSR). English reports include the Weekly Law Reports (WLR), Kings Bench Division (KBD), Queens Bench Division (QBD), Chancery Reports (ChD), Probate Division, All England Law Reports (ALL ER) etc. Cases are also now available online. E.g via www.ulii.org. www.judicature.go.ug, etc.

- **Advantages of case law:**

a. Precedent creates certainty in the law once judges make a decision on a particular matter. The law thus becomes predictable as a party can predict the likely outcome of a case basing on its facts and an earlier decision on a similar case.

b. Precedents allow the growth and development of the law so that it does not remain static. This arises from the aspect of overruling and distinguishing precedents.

c. Precedent supplements parliament in its law making function. Since Parliament cannot make provision for everything, judge-made law can fill in the gaps.

d. Case law is based on real/ factual situations. It is therefore more practicable unlike statutes which are not easily ascertainable. For example whereas unnatural offenses are criminalized, no lesbian has ever been tried in the courts of law.

- **Disadvantages of case law:**

Case law is rigid. Once a rule has been laid down by a court of record, it is binding on the lower courts even if it is thought to be wrong.

Case law is bulky and complex. It is found scattered in so may law reports that one has to widely research if he seeks to rely on a particular precedent till he comes up with the current legal position on the matter.

1.12.6 Customary law

This is an unwritten source of law. The Judicature Act permits the High Court to apply customary law as long as it is not inconsistent with natural justice, equity and good conscience. Customary law is limited to civil matters and does not apply to criminal matters since the constitution provides that except for contempt of court, no person shall be convicted of a criminal offence unless the offence is defined and the penalty for it is prescribed by law. Customary law should also be compatible with written law.

For a custom to qualify to be applied as customary law:
It must be in existence with uninterrupted and harmonious application which should have dated from time immemorial. This is the antiquity test which has been fixed way back to 1198 BC. The courts must take judicial notice of the custom because of its notoriety.

PART B

COMMERCIAL LAW

2.0 LAW OF CONTRACT

UNIT 2 OVERVIEW:

- Key Definition.
- Contract Formation.
- Types of Contracts.
- Essentials of a Valid Contract.
- Offer, Acceptance and Consideration.

2.1 KEY DEFINITION - *CONTRACT*

A contract is a legally binding agreement or relationship that exists between two or more parties to do or abstain from performing certain acts. The parties can be natural persons or artificial persons e.g. a company.

The parties to the agreement must have a final agreement, that is, their minds must meet. This is what is called consensus and idem. A party to a contract is said to be in breach if it/he or she has failed to fulfil the terms of the contract. When the parties' minds divert then there is no contract.

2.2 CONTRACT FORMATION

Those are certain necessary legal formalities in the formation of a binding contract. These include:

1. The intention to be legally bound by the contact
2. Offer and acceptance
3. The parties must have legal capacity to enter into the contract
4. The subject matter of the contract must be lawful.
5. The promise must furnish consideration
6. There are certain contracts which require certain formalities before they are entertained by courts of law and such formalities must be followed.
7. It should be possible to perform
8. It must be entered into freely (Genuine consent).

The consent of the parties must be genuine and not induced by fraud, duress, mistake or misinterpretation.

2.3 What is the relevancy of the law of contract in a modern business world?

The law of contract presuppose an exchange economy. Commodities cannot go to market and make exchange of their own count. We must therefore have the interaction of the owners in order for these subjects to inter into relation with one another as commodities. Their owners must place themselves into relation with one another as persons whose will resides in these objects. We must behave in such a way that each doesn't appropriate a commodity of another for that reason except by means of an act done by mutual consent. They must therefore, usually recognise each other's right of private ownership. This legal relation will thus express itself in a contract. Whether such a contract is part of a developed legal system or not it is the relation between two wills and the reflex of the real economic relation between the two. A commodity is of a nonuse value to the owner and of a use value to the non-owner. This therefore raises a need for exchange.

In the early stages of man, production was for use values other that exchange value. However, with modernisation of society and improved means of production there was surplus production and law of contract became increasingly important.

2.4 TYPES OF CONTRACT

1. *Simple Contracts*

These are also referred to as parol contracts. A simple contract doesn't need to be in any specific form. It can be oral [by word of mouth] or written, party oral and party written or merely implied by conduct.

2. *Specialty Contracts*

These are contracts under seal. They must be executed in a specific form. They include gratuitous promises, conveyances of leases and land etc. Usually such contract are in writing and must be properly signed if they are to be enforceable. Other contracts that must supported by written evidence include contracts of guarantee (special promise to answer for the debt, discourage or an omission of another person) contracts of employment for more than six months, hire purchase contracts/agreements and money lending contracts.

Contracts can also be classified in terms of their validity as valid contract, void and voidable.
A valid contract is an agreement which is binding and enforceable. Such contract must have the following essential elements;

i. An intention to create a legal relationship
ii. Consideration
iii. The parties involved must have capacity
iv. There must be genuine consent
v. Possibility of performance
vi. Legality of the subject matter
vii. Sufficient certainty of terms and the contract must be in a prescribed form.

3 *Avoidable contract*

Is an agreement that is binding and enforceable but because of lack of one or more of the essentials of a valid contract, it may be set aside or avoided at the option of the aggrieved.
If a party entitled to such right fails to exercise it within a reasonable time, then the contract shall be binding, such contracts include: contracts of a continuing nature entered into by minors (infants), contracts affected by duress, undue influence etc.

4 *Void Contracts*

There are not contracts at all. If a contract is void, then it is of no legal effect, void contract include those which are prohibited by the law or are against public policy

5 *Illegal Contracts*

These are contracts that involve a criminal element. They cannot be enforced in a court of law. E.g. contracts to commit a crime.

6 Bilateral
This is a contract that creates binding obligations on both parties to the contract.

7 Unilateral
This is a contract that creates binding obligations on one of the parties only e.g. promising a reward to whoever finds your lost item. Nobody is under obligation to look for the item but if the item is found there is an obligation to give the promised reward.

2.5 THE ESSENTIALS OF A VALID CONTRACT

(i) Offer
An offer is an expression of readiness to contract on terms by the offer which if accepted by the offeree or accepter will rise to binding contract.
An offer may be made expressly in so many words or by conduct. It may be made to an individual, a group of persons or public at large. The essential characteristics of an offer is that it must intend to be bound without further negotiations. The offeror must not merely have been feeling his way towards an agreement, not merely initiating negotiation from which an agreement may or may not result. He must be prepared to implement his/her promise if such is the wish of the result. He must be prepared to implement his/her promise if such is the wish of the other party. An offer must be conclusive in nature and must leave no room for further negotiations. It can be made to an individual, a group of persons or the public at large.

The leading authority on these points is Carill Vs Carbolic Smoke Ball Company (1893).
The defendant company advertised in the Newspaper that it had manufactured a drug free smoke ball and that it was a prevention against influenza. The defendant promised that it would offer 100 pounds to any user who caught influenza after using it in accordance with stipulated conditions. The defendant also stated that a sum of 1000 pounds had been deposited with the bank to show seriousness in the matter. Relying on the advert, the plaintiff bought the drug and used it as directed and yet she succumbed to the cold. She sued the defendant for 1000 pounds.

The defendant argued that;

i. There was no offer but a mere statement of intention
ii. Even if there was an offer, it wouldn't be binding since it was not made to a particular person.
iii. There was no acceptance held.

1. The defendant's act of depositing 1000 pounds with the bank was to show their seriousness in the matter and as such the advert could not be referred to as a mere puff but it was an offer intended to be acted upon and as such creating binding obligations on the defendant.
2. The defendant could not deny liability because this was a general offer. An offer can be made to the whole and accepted by anyone who comes forward and performs the conditions even without prior notification or acceptance.

Invitation for Offer
An offer should be distinguished from an invitation to treat/invitation for offers. As already seen, the major characteristics of an offer is that if accepted will result into a contract. For example in an institution where a buyer intends to buy an item leaving the seller to fix a price is not an offer but an invitation to treat. Such phenomenon doesn't give rise to contractual relationship.

An invitation to treat is merely an invitation to make an offer and no contract can result from it alone. The best examples are; display of goods in a shop or supermarket, an auction, ordinary advertisements on radio, television and news treat and not an offer. It is the customer to decide cases, these situations amount to invitation to an offer to the shop keeper by picking up the items and tendering money. This is illustrated in a number of cases.

Granger Vs Gough
In this case, it was observer that the issue of the catalogue containing goods for sale at a specific price is not its self an offer. The prospective buyer by offering that price is himself an offeror and if his offer is accepted creates a binding agreement. Therefore, the issue of a catalogue would amount to an invitation for offers.

Spencer Vs Harding [1870]
Court observed that display of goods in windows with prices indicated thereon is not an offer to the person who produces an indicated amount of money. Willies J. observed that circular is a mere attempt to ascertain whether an offer can be obtained in such a margin, as the seller is willing to accept.

In Fisher Vs Bell
The respondents shop keeper displayed a knife with price attached. He was charged with offering a flick knife contrary to the provisions of Act that prohibited the sale of certain weapons in England.

The issue before court was whether the display of the knife constituted an offer for sale within the meaning of the Act. It was held by court of appeal that the display of the knife was a mere invitation to treat and the shop keeper was not liable. Relating this position to super markets or self-service shops, it is a settled principle of law that a contract is made at the counter, in Pharmaceutical society of Great Britain against Boots Chemists (1953). The defendant had a self-service store in which certain listed drugs were displayed on the shelves. It was an offence to sell such drugs unless the sale was done under supervision of a registered pharmacist. A customer made a selection of some of the drugs from the shelves. The defendants had placed the pharmacists at the cash desk near the exit but not near the shelves. The defendants were charged with an offence of selling such drugs without the supervision of a registered pharmacist.

The issue before court was, if the sale took place when the customer picked the drugs from the shelves, the defendants would be liable but if the sale took place at the cash desk where the registered pharmacist was stationed, then the defendants would not be liable. Court therefore, had to determine where the sale took place. Court held that the defendants were not liable because the display of goods on the shelves was merely an invitation to treat and not an offer.
It should be noted the declaration of intention and mere statement of information doesn't constitute an offer. This position is illustrated in Harris Vs Nickerson {1873}.

An auctioneer advertised that there would be a sale of office furniture. The plaintiff a prospective buyer travelled to London to attend to sale but all the furniture was withdrawn. He sued for loss of time and travelling expenses. It was held that the auctioneer was not bound to sell the furniture as he was merely stating intentions to sell and not making an offer which by acceptance would be transformed into a contract. The advertisement for bids in an auction is mere invitation to treat. The sale is complete when the hammer falls and until that time the bid may be withdrawn. Mayanja-Nkangi –Vs- National Housing Corporation [1972]1 ULR 37. The Plaintiff on becoming a member of Parliament and subsequently a minister, received a letter from the minister of Housing and Labour offering him an opportunity to purchase a house. He sent a cheque and was given a receipt after he had been <u>un officially shown the main terms of the purchase</u>. The Minister of Housing and Labour ordered National Housing Corporation to the transfer of the property which wasn't affected. The plaintiff sued for specific performance following the down payment of 20% of the purchase price. Court held that the initial letter from the ministry was an invitation to treat and there was no contract as the transaction relied upon by plaintiff was still in the process of negotiations and that no concluded contract was made between the parties.

A communication which the merely initiates negotiations from which an agreement might or might not result is not an offer but merely an invitation to treat.

2.6 COMMUNICATION OF OFFER

An offer becomes effective when it is communicated to the offeree e.g. if B found A's lost dog and not having seen the advertisement by A offering a reward for its return, returns it out of goodness of heart, B will not be able to claim the reward.

Fitch Vs Snadakar
A two hundred US Dollar reward was offered for the arrest of a criminal. The plaintiff not aware of the reward apprehended the criminal and later claimed the reward.
Court held that the claim must fall as he was not aware of the offer when he arrested the criminal.

2.7 TERMINATION OF OFFER

1. **Lapse of time.**
   An offer cannot remain open for acceptance longer than the time if any prescribed in the offer or if not time is indicated, longer than a reasonable time. What amounts to a reasonable time depends on the nature of the contract and circumstances of each case for example.

Ramsgate Victoria Hotel Company –Vs- Montefiore (1866)
M applied for the purchase of shares in the plaintiff company on June 8th. His offer was not accepted until Nov. 23rd when he received a letter of allotment. He refused to take the shares as by the time the price of the shares had fallen. It was held that M was entitled to refuse as his offer had lapsed Nov. 23rd and couldn't be accepted.

2. **Revocation**

An offer may be revoked or withdrawn by the person who made it at any time before it has been accepted. This rule also applies where the offer has specified the time within which the offer should be taken or accepted. This position is illustrated in Routledge Vs Grant (1982).
Grant offered to buy a house. He gave six weeks within which there was to be accepted. The offer was withdrawn before the end of 6 weeks and the plaintiff went to court since the 6 weeks hadn't lapsed. It was held that the defendant was entitled to revoke the offer before 6 weeks if the offer had not been accepted. An offer becomes irrevocable if the offeree starts to meet or comply with conditions of performance or if he has given some consideration for the option. If the offer attempts to revoke the offer where the offeree has given some consideration for the option or has stated meeting the conditions of performance he will be held liable in damages.
Once the offer is revoked, it must be communicated to the offeree. In a situation where it is not communicated, it cannot amount to effective revocation if from the case of Dickson Vs Dodds (1876). On a Wed, the defendant gave the plaintiff a written offer to sell to him his house. The offer was to remain open until Friday 9:00am, On Thursday he sold it to someone else. The plaintiff was informed of the sale by a 3rd party. It was held that there was proper revocation of the offer.

Communication by post office

It is also a rule of law that revocation by post office will not come into effect until it is actually received by the offeree. It should be noted however that acceptance by post office becomes effective as soon as acceptance is posted. It doesn't matter whether the letter is lost or received. This principle was laid down in Household fire insurance company Vs Grant (1879). The only expectation is where the parties have expressly indicated that it will only be effective when the letter is received.

3. An offer lapses if not accepted in a manner prescribed.

Ellason Vs Henshaw (1819)
The plaintiff offered to buy flour from the defendant requesting the reply to be sent with the Wagon driver who communicated the offer. The defendant communicated the acceptance by post office. The driver reached before the letter was received. Court held that there was no contract between the two parties.

4. Death or insanity of the one of the parties
If the contract envisaged or contemplated by the offer involves personal relationships e.g. an offer to act as an agent, then death or insanity of the offeror prevents acceptance. Death after acceptance normally has no effect on the contract for example if X sells his car to Y and before the car is delivered, X dies, it is possible for Y to sue the legal representatives of X for breach of contract if they refuse to deliver the car.

5. Counter offer/Cross
An offer is terminated by a counter offer and the original offer cannot be revived by the person to whom it was originally made even if he is prepared to accept the original offer unconditionally. This position is illustrated in Hyde Vs Wretch (1840). The defendant offered in writing to sell his firm to the plaintiff for 100 pounds. The plaintiff made an offer of 950 pounds. The defendant refused too accept the counter offer. Later, the plaintiff agreed to pay 1000 pounds which the defendant refused to accept. The plaintiff sued for an order of specific performance. It was held that there was no acceptance and the order could not be granted.

2.8 ACCEPTANCE

This is an indication to enter into and the will to be bound by the contract. It is a positive response to an offer. Once the existence of an offer has been proved, court must be satisfied that the offeree has accepted the offer otherwise, there is no contract concluded. Acceptance can be:

i. In Writing
ii. Oral form
iii. By conduct. Where there is no express acceptance, the conduct of the parties must be looked at in order to establish whether there is anything to infer (imply) an acceptance on part of the offeree. This can be seen from the case of Carill Vs Carbolic Smoke ball Company [supra]. In this case there was no express acceptance as such but the performance by the plaintiff of the condition set by the defendant leading to the reward of 100 pounds was held to constitute an acceptance of the defendant offer.

Conditions of acceptance

1. In order to make a contract binding the acceptance must be communicated and mere intentional to accept is not sufficient. This position of the illustrated in Filthouse –Vs- Bindley (1862). The plaintiff wrote to his nephew offering to buy one of his horses adding " if I hear no more about him I will consider that horse in mine at 30 pounds and 15 pence. The nephew did not reply but told the defendant who was and auctioneer to keep the horse out of the sale of his farm stock as it was sold to the plaintiff. The defendant sold the horse by mistake and the plaintiff sued him for damages (compensation got as a result of loss suffered). It was held that since the nephew had not communicated his acceptance to the plaintiff, there was no contract of sale and the auctioneer was not liable.

2. Acceptance of offer must be absolute and an unqualified. Where the acceptor varies the terms of the offer it amounts to the counter offer and invalidates the original offer. Neal Vs Merret (1930). The defendant offered his land for sale to the plaintiff at 280 pounds. The plaintiff replied accepting and enclosing 80 pounds with a promise to pay the balance by instalments of 50 pounds each. It was held that the defendant was not liable for refusing to sell his land as there was no unqualified acceptance.

3. Acceptance must be communicated to the offer in a manner prescribed by him.

4. If there is time prescribed then acceptance must be within that time. It should be noted that once acceptance is made, it became irrevocable. An offer may be revoked by express notice before it is accepted by the moment the person expresses his acceptance for an offer that very the contract is concluded and doesn't matter whether acceptance is by word of mouth or letter. Where acceptance is made by post office then it becomes effective after posting it. Immediately the letter of acceptance is dropped in the postal box, a contract is created between the parties. This is illustrated further in Adams Vs Lindsell where Lord Denning observed that "when a contract is made by post it is clear law throughout the common law countries that acceptance in complete as soon as the letter of acceptance is put in the postal box and it is the place where the contract is made.

2.9 CONSIDERATION

The term consideration has been defined in a number of cases Currie Vs Misa (1875). It was defined as an interest, a profit or benefit interest, accruing to one party or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other party in concluding a contract. In Dunlop-Vs-Selfridge (1915) consideration was defined as a price for which the promise of the other party is bought. Consideration is essential for the formation of a contract. Every simple contract isn't legally binding unless it is supported by consideration. There must be a quid-proquo (something for something).

Consideration can take three basic forms.

a) Executed Consideration

This is the value already given by the promise to the promisor. E.g. where goods are purchased on credit, the seller has performed his obligation in delivering the goods to the purchaser.

b) Executory Consideration

It is Executory consideration when it is yet to change hands. It is a promise to perform acts in future. Executory consideration of contract is where the parties exchange promises to perform their obligation at a later date.

c) Past consideration (See rules governing consideration)
There are certain rules that govern consideration.

1. Consideration must be real (sufficient) although there is need for it to be adequate.

Generally court will not enforce a promise unless some value has been given for it. Courts do not inquire in to its adequacy as long as it has some economic value. Even ac act or omission of some small value can constitute consideration. This position is illustrated in Thomas Vs Thomas. In this case the plaintiff's deceased husband expressed a desire that the plaintiff should make use of his house if she survived him on payment of one pound per year. The plaintiff survived the husband but the executors declined to enforce the arrangement. The plaintiff sued for breach of contract. Court observed that although the husband wishes were not sufficient consideration, the payment of one pound per year was good consideration of the husband's promise it was further observed that courts will not mind about adequacy of consideration and are always reluctant to interfere in the bargain on contract concluded between the parties.

2. **Consideration must not be past.** This means that a part act or forbearance which took place before or after the promise was made can't be good consideration of the promise for example, if A voluntarily returns B's lost property and after the returns B promises a reward which later declines to give, A cannot enforce B's promise because it is based on past consideration. Once negotiations are over and the parties have concluded a bargain/contract any subsequent or fresh promise made by either party in contract is known as past consideration.

The law is that for a promise to constitute valid consideration, it must have been made during negotiations and such past consideration isn't valid consideration for the bargain in respect of which and is no consideration at all.

Roscorla Vs Thomas (1842)
The plaintiff bought a horse and after the contract for sale was complete, the defendant affirmed that the horse was free from any vice, so the horse later proved vicious and plaintiff sued on this promise. It was held that any vice wasn't supported by any free consideration and therefore was unenforceable.

Re M'cardle (1951)
In this case a number of children were entitled to a house by their fathers will after the death of their mother. One of the children together with his wife has lived with the mother in the same house. The wife carried out extensive renovations and improvements on the house. Later all the other children executed documents to repay her for these improvements. They finally declined to pay and the matter came up in court. It was observed that the promise could not be enforced as it was based on past consideration. It should be noted however, that this is a general rule and there are certain exceptions to this rule.

1. Where services are rendered at the expense or implied request of the promisor in circumstances which raise an implication of a promise to pay.

   Lampleigh Vs Baithawaite (1615), In this case, the defendant while under a death sentence requested the plaintiff to obtain the kings pardon for him. The plaintiff successfully did it and the defendant subsequently promised to pay 100 pounds which he eventually failed to pay. The defendant argued that this promise was based on past consideration. Court observed that the plaintiff performed services on the express request of B and the subsequent request to pay though based on past consideration was binding on him.

2. When a bill of exchange e.g. a cheque is paid for a past act, such consideration will be regarded as good consideration. The logic behind this exception is that some commercial practice allows negotiation of a cheque and if a past act was to be regarded as non-consideration then, negotiability of cheques would be minimised and this would have adverse effect on economic activities. Further, the law relating false cheques does not take into consideration the purpose for which it was issued.

3. Consideration must move from the promise

This implies that if A wishes to sue successfully upon a promise made by B, it is essential for A as a receipt of the promise and therefore a promise to show that he gave consideration to B, the promisor. This is what has been expressed as the doctrine of privity of contract. See Tweddle Vs Atkinson [1861]. The plaintiff intended to marry the defendant's daughter. His father agreed with the defendant father to pay money to the plaintiff if the marriage took place. The defendant failed to pay. Held the plaintiff was a stranger and could not enforce the contract. The concept is based on the fundamental assumption of English law that a contract is a bargain such that he who takes no part in the bargain takes no part in the contract. In effect this means that one can enforce another person's promise unless he has been a party to the contract and that a stranger to consideration or to the contract cannot sue on that contract even if it is made for his own benefit. This expression is further illustrated in Dunlop Vs Selfridge [1915].

The plaintiff sold tyres below to Dew Company where by Dew and company agreed not to sell the tyres below the price list provided and it was also agreed that Dew and company would obtain similar arrangements with other dealers. Dew and company sold the tyresto Selfridge and it was agreed that they would not sell the goods below the price provided. Selfridge breaching this arrangement and Dunlop sued for breach of contract. Court observed that the plaintiff had no right of action because no consideration moved from Selfridge to them. This decision Dunlop Vs Selfridges derives its basis of an earlier case Price Vs Easton (1833).
The defendant promised a one X that if he did some work for the plaintiff, the defendant would pay sum of money to the plaintiff. The obligations were performed as agreed but the defendant declined to pay the plaintiff. The plaintiff sued for breach of contract. It was held that no consideration had moved from the plaintiff to the defendant and such the action would not be maintained.

It should be noted however that this is a general rule and there are some exceptions to this rule.

1. Agency

A principal may sue on a contract made by his agent. This appears more apparent because the principal is the contracting party who merely acted through the instrumentality of the agent.

2. A holder for values of a bill of exchange (cheque) can sue prior parties on that endorsed or negotiations in favour of C for value, C acquires a right to sue A if the cheque is dishonoured although no consideration moved from him to A.

3. The assignee of the debt can sue a debtor in his own name.

4. The Law of trusts.

The law of trusts forms an expression in that a beneficiary (people entitled to benefit from the trust) acquires a right to use the trustee if he intermeddles/interferes with the trust property for his personal benefit. Although the arrangement is between the settler and the trustee, the beneficiaries though strangers to the arrangement can successfully sue on such contracts.

5. Statutory exceptions e.g. insurance contracts. In a life assurance and third party insurance policies, the beneficiaries can sue the insurance company.

6. Restrictive covenants. These are rights or conditions that passed on with land. This is a negative term of the stopping one of the parties from doing something. They are common in land transactions where a person buys land from another and it is agreed that the restrictions on the use of land will run with the land.

4. Consideration must be in excess of an existing obligation

In discussing this rule the following situations must be considered:

i. Discharge of an obligation imposed by law

In circumstances where there is a legal obligation already imposed on a person and such a person enters into contract cannot be enforced. This position of the law delivers its basis from the decision in Collins Vs Godfrey 1831. Collins was called upon to give evidence on behalf of the defendant.

The defendant promised payment. It was later proved that Collins was under legal obligations to give evidence on behalf of the defendant. Court observed that if it is an obligation imposed upon a party by law to give evidence from time to time such attendance does not constitute consideration or payment.

ii. Performance of contractual duty already owned to the defendant.

Where a party performs a contractual duty already imposed by the terms of the contract, it does not amount to consideration. This is explained in Stick Vs Myrick (1809).

A sea captain being unable to find two substitutes for two sailors who had deserted, promised to divide the wage of the deserters among the rest of the crew if the crew would sail the ship home. They performed this obligation but the promise was not enforced.
Court observed that the promise was not enforceable because of absence of consideration. It further observed that in sailing the ship home, the crew had done nothing more than it was already bound to do. Their original contact obliged them to meet the normal emergencies of the voyage of which minor desertions was one of them. This principle is further explained in Pinnels case.

Pinnel sued Cole (defendant) for a debt of 8 pounds due on 11th Nov. 1600. The defendant, at Pinnel's request (plaintiff) had paid him 5 pounds on October 1st and Pinnel had accepted this payment in full satisfaction of the original debt. A judgement was given in favour of the plaintiff on a technical point of pleading but court made it clear that where a creditor pays a lesser sum than what is due to him and promises not to sue the balance, the promise is not binding. The reason for this is to found in the fact that the buyer is already bound in the existing contractual obligation to pay and payment of part of the debt cannot be considered for the creditors promise not to sue on the balance. The same observation was meant in Foakes Vs Beers. The only exceptional circumstance where payment of a lesser sum may discharge the debt in full not withstanding that the debtor was already under an obligation to pay the whole debt are the following:

1. Payment by a 3rd party

Where the creditor accepts in full satisfaction of the debt owned by his

(iv) Legality

To support a contract consideration must be lawful. For a contract to be binding on both parties the subject matter of the contract must be lawful. This implies that it must not be prohibited by the law or against public policy. If the subject matter of the contract is illegal the contract is illegal then the contract is invalid, unlawful and enforceable. This position of the law derives its basis from the case of Foster Vs Driscoll (1929). A contract was entered into for the shipment of whisky from England to the U.S.A during the time when a prohibition was in force. The plaintiff sued when the contract was breached. It was held that the contract couldn't be enforced owing to its illegal nature. Illegal contracts involve some degree of moral wrong and an element of crime or fraud. Such contracts include the following:

1. Contracts to commit a crime, a torts or fraud on a third party. This is explained in the case of Dann vs Curson (1911) An agreement was entered into a cause a disruption at a theatre. The plaintiff who agreed to create the disturbance and in fact did so sued for the remuneration due to him under the agreement. Court held that the action could not succeed as it was an agreement to commit a crime and against Public Policy. An agreement to defraud or deceive is also illegal. This is explained in the case of Waldo v Martin (1825). In this case an agreement was concluded to the effect that the plaintiff would secure a job for the commission. The defendant failed to pay. Court held that the agreement was illegal and could not be enforced. Court further observed that the fruits of a crime are irrevocable.

2. Contracts involving sexual immorality. If a man promises to pay money to a woman as recompose for sexual pleasure, such illicit intercourse is illegal and the contract is enforceable. The law in Uganda makes prostitution and living on earnings of prostitution as an offence. This explanation was made in case of Peace Vs Brooks (1866). The plaintiff owned a carriage which was of an attractive design intended to assist her obtain clients. The defendant hired the carriage and defaulted in Payment. The evidence produced in court indicated that the carriage was basically intended and actually used for purpose of soliciting clients. Court held that the plaintiff claim of the sum due couldn't be enforced due to its illegal nature.

3. Contracts prejudicial to public safety. Furtado V Rogers (1802). In this case Lord Alvanley observed "we are all of the opinion that it is not competent for any subject to enter into any arrangement which may be detrimental to the interests of his own country and such that a contract is as much prohibited as if it had been expressly prohibited by the Acts of either to benefit an enemy country or to disturb the good relations of the state with a friendly country.

4. Contracts prejudicial to the administration of justice. It is a well-established rule that courts will never enforce nor recognise.

3.0 AGENCY LAW

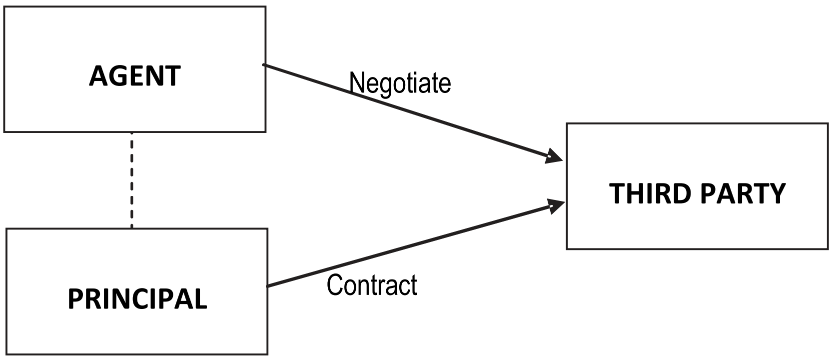
UNIT 3 OVERVIEW:

- Role of Agency and Agency relationship.
- Formation of Agency.
- Authority of the Agent.
- Agents and Third Parties.
- Other Considerations.

1 ROLE OF AGENCY AND AGENCY RELATIONSHIPS

Agency is a relationship which exists between two legal persons (the principal and the agent) in which the function of the agent is to form a contract between their principal and a third party. Partners, company directors, factors, brokers and commercial agents are all acting as agents.

Agency is a very important feature of modern commercial life. It can be represented diagrammatically as follows:



For instance Pendo may ask Alan to take Pendo's shoes to be repaired. Pendo and Alan expressly agree that Alan is to do this on Pendo's behalf. In other words, Alan becomes her agent in making a contract between Pendo and Thierry, the shoe repairer, for her shoes to be mended.

1.1 Types of agent

In practice, there are many examples of agency relationships, to which you are probably aware of in everyday life, although you might not know that they illustrate the law of agency. The most important agency relationships for the Business Law syllabus are those of partners and company directors.

TYPES OF AGENT	DESCRIPTION
Partners	This is a particularly important example of agents in your syllabus as accountants who own and run an accountancy practice together are partners, and are therefore agents of each other.
Company Directors	This is another important example of agency in your syllabus. Company directors act as agents of their company.
Promoters	A promoter is someone (except professionals acting in their professional capacity) who undertakes to form a company.
Factors	A factor, sometimes called a mercantile agent, is a person whose job is to sell or buy goods on behalf of another person. For example, motor dealers are often factors.
Brokers	A broker may operate in many trades. They are essentially an intermediary who arranges contracts in return for commission. For example, an insurance broker.
Auctioneers	Auctioneers are agents authorised to sell property at auction on behalf of the seller. When an auctioneer accepts a bid from a buyer, they become the agent of the buyer for the purpose of making a record of the sale.
Commercial Agents	A commercial agent is an independent agent who has continuing authority in connection with the sale or purchase of goods.

2 Formation of agency

The relationship of principal and agent is created by mutual consent in the vast majority of cases. This agreement does not have to be formal or written.

The mutual consent comes about usually by express agreement, even if it is informal. However, it may also be implied agreement, due to the relationship or conduct of the parties.

2.1 Express agreement

This is where the agent is expressly appointed by the principal. This may be orally, or in writing. In most commercial situations, the appointment would be made in writing to ensure that everything was clear. An agent expressly appointed by the principal has actual authority of the principal to act on their behalf.

2.2 Implied agreement

An agency relationship between two people may be implied by their relationship or by their conduct.

For example if an employee's duties include making contracts for their employer, say by ordering goods on their account, then they are, by implied agreement, the agent of the employer for this purpose. An agent authorised in this way is said to have implied authority.

2.3 Ratification of an agent's act: retrospective agreement

A principal may subsequently ratify an act of an agent retrospectively.

An agency relationship may be created retrospectively, by the 'principal' ratifying the act of the 'agent'. Therefore it is created after the 'agent' has formed a contract on behalf of the 'principal'. If the principal agrees to the acts of the agent after the event, they may approve the acts of the agent and make it as if they had been principal and agent at the time of the contract.

The conditions for ratification are:

- *The principal must have existed at the time of the contract made by the agent*
- *The principal must have had legal capacity at the time the contract was made*
- *The ratification must take place within reasonable time*
- *They ratify the contract in its entirety*
- *They communicate their ratification to the third party sufficiently clearly*

Once a contract has been ratified by the principal, the effect is that it is as if the agency relationship had been expressly formed before the contract made by the agent took place.

2.4 Formation of agency agreement without consent

An agency may be created, or an agent's authority may be extended, without express consent. This happens by estoppel, when the principal 'holds out' a person to be their agent, and when there is an agent of necessity.

2.4.1 Implied agreement

In some cases, an agency created by implied agreement might result in the agent having more implied authority than the principal might have consented to.

2.4.2 Agent by estoppel

An agency relationship may be formed by implication when the principal holds out to third parties that a person is their agent, even if the principal and the 'agent' do not agree to form such a relationship. In such a case, the principal is estopped from denying the agent's apparent/ostensible authority, hence the name 'agent by estoppel'. An agency relationship is not so formed if it is the 'agent' who creates the impression that they are in an agency relationship with a 'principal'.

2.4.3 Agent by necessity

In some rare situations, it may be necessary for a person to take action in respect of someone else's goods in an emergency situation. That person can become an agent of necessity of the owner of the goods, as they take steps in respect of the goods.

Illustration

A seller is shipping frozen goods to a buyer in another country. While the ship is docked, the freezers in the ship break down and the relevant part required to fix them cannot be obtained. If the ship's captain (acting as the agent of necessity) cannot make contact with the owner of the goods, they might, of necessity, sell the goods while they are still frozen, rather than allow them to spoil by defrosting.

This is particularly rare, because it would only occur when the 'agent' could not make contact with the 'principal', which in the modern world is extremely unlikely.

This principle is a historic part of English shipping and merchant law and you should be aware that it might be possible, but do not worry about the other details of the doctrine.

3 Authority of the agent

If an agent acts within the limits of their authority, any contract they make on the principal's behalf is binding on both principal and third party. The extent of the agent's authority may be express, implied or ostensible. Express and implied authorities are both forms of actual authority.

A principal does not give the agent unlimited authority to act on their behalf. A contract made by the agent is binding on the principal and the other party only if the agent was acting within the limits of their authority from their principal.

In analysing the limits of an agent's authority, three distinct sources of authority can be identified:

- *Express authority*
- *Implied authority*
- *Ostensible authority*

3.1 Express authority

Express authority is a matter between principal and agent. This is authority explicitly given by the principal to the agent to perform particular tasks, along with the powers necessary to perform those tasks.

The extent of the agent's express authority will depend on the construction of the words used on their appointment. If the appointment is in writing, then the document will need to be examined. If it is oral, then the scope of the agent's authority will be a matter of evidence. If the agent contracts outside the scope of their express (actual) authority, they may be liable to the principal and the third party for breach of warranty of authority.

Illustration

A board of directors may give an individual direct express authority to enter the company into a specific contract. The company would be bound to this contract, but not to one made by the individual director outside the express authority.

3.2 Implied authority

Where there is no express authority, authority may be implied from the nature of the agent's activities or from what is usual or customary in the circumstances. Between principal and agent the latter's express authority is paramount. The agent cannot contravene the principal's express instructions by claiming that they had implied authority for acting in the way they did. As far as third parties are concerned, they are entitled to assume that the agent has implied usual authority unless they know to the contrary.

Watteau v Fenwick 1893

The facts: The owner of a hotel (F) employed the previous owner (H) to manage it. F forbade H to buy cigars on credit but H did buy cigars from W. W sued F for payment but F argued that he was not bound by the contract, since H had no actual authority to make it, and that W believed that H still owned the hotel.

Decision: It was within the usual authority of a manager of a hotel to buy cigars on credit and F was bound by the contract (although W did not even know that H was the agent of F) since his restriction of usual authority had not been communicated.

Hely-Hutchinson v Brayhead Ltd 1968

The facts: The chairman and chief executive of a company acted as its de facto managing director, but he had never been formally appointed to that position. Nevertheless, he purported to bind the company to a particular transaction. When the other party to the agreement sought to enforce it, the company claimed that the chairman had no authority to bind it.

Decision: Although the director derived no authority from his position as chairman of the board, he did acquire authority from his position as chief executive. Therefore the company was bound by the contract as it was within the implied authority of a person holding such a position.

Illustration

A principal employs a stockbroker to sell shares. It is an implied term of the arrangement between them that the broker shall have actual authority to do what is usual in practice for a broker selling shares for a client. Any person dealing with the broker is entitled to assume (unless informed to the contrary) that the broker has the usual authority of a broker acting for a client.

3.3 Actual authority

Express and implied authorities are sometimes referred to together as actual authority. This distinguishes them from ostensible or apparent authority.

Actual authority is a legal relationship between principal and agent created by a consensual agreement between them.

3.4 Apparent/ostensible authority

An agent's apparent or ostensible authority may be greater than their express or implied authority. This occurs where a principal holds it out to be so to a third party, who relied on the representation and altered their position as a result. It may be more extensive than what is usual or incidental.

The ostensible (or apparent) authority of an agent is what a principal represents to other persons that they have given to the agent (authority by 'holding out'). As a result, an agent with express or implied authority which are limited can be held in practice to have a more extensive authority.

Apparent/ostensible authority usually arises either

(a) Where the principal has represented the agent as having authority even though they have not actually been appointed

(b) Where the principal has revoked the agent's authority but the third party has not had notice of this.

3.4.1 The extent of ostensible authority

Ostensible authority is not restricted to what is usual and incidental. The principal may expressly or by inference from their conduct confer on the agent any amount of ostensible authority.

3.4.2 Example: partnership

A partner has considerable but limited implied authority by virtue of being a partner. If, however, the other partners allow them to exercise greater authority than is implied, they have represented that they have wider authority. They will be bound by the contracts which they make within the limits of this ostensible authority.

Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd 1964

The facts: K and H carried on business as property developers through a company which they owned in equal shares. Each appointed another director, making four in all. H lived abroad and the business of the company was left entirely under the control of K. As a director K had no actual or apparent authority to enter into contracts as agent of the company, but he did make contracts as if he were a managing director without authority to do so. The other directors were aware of these activities but had not authorised them.

The claimants sued the company for work done on K's instructions.

Decision: There had been a representation by the company through its board of directors that K was the authorised agent of the company. The board had authority to make such contracts and also had power to delegate authority to K by appointing him to be Managing Director. Although there had been no actual delegation to K, the company had by its acquiescence led the claimants to believe that K was an authorized agent and the claimants had relied on it. The company was bound by the contract made by K under the principle of 'holding out' (or estoppel). The company was estopped from denying (that is, not permitted to deny) that K was its agent although K had no actual authority from the company.

It can be seen that it is the conduct of the 'principal' which creates ostensible authority. It does not matter whether there is a pre-existing agency relationship or not.

This is important – ostensible authority arises in two distinct ways. It may arise where a person makes a representation to third parties that a particular person has the authority to act as their agent without actually appointing them as their agent. Alternatively, it may arise where a principal has previously represented to a third party that an agent has authority to act on their behalf.

3.4.4 Representations creating ostensible authority

The representation must be made by the principal or an agent acting on their behalf. It cannot be made by the agent who is claiming ostensible authority.

It must be a representation of fact, not law, and must be made to the third party. This distinguishes ostensible authority from actual authority, where the third party need know nothing of the agent's authority.

3.4.5 Reliance on representations

It must be shown that the third party relied on the representation. If there is no causal link between the third party's loss and the representation, the third party will not be able to hold the principal as liable.

Illustration
If the third party did not believe that the agent had authority, or if they positively knew they did not, then ostensible authority cannot be claimed. This is true even if the agent appeared to have authority.

3.4.6 Alteration of position following a representation

It is enough that the third party alters their position as a result of reliance on the representation. They do not have to suffer any detriment as a result, but damages would in such an event be minimal.

3.5 Revocation of authority

Where a principal has represented to a third party that an agent has authority to act, and has subsequently revoked the agent's authority, this may be insufficient to escape liability. The principal should inform third parties who have previously dealt with the agent of the change in circumstances. This is particularly relevant to partnerships and the position when a partner leaves a partnership.

3.6 Termination of agency

Agency is terminated by agreement or by operation of law (death, insanity, insolvency). Agency is terminated when the parties agree that the relationship should end.

It may also be terminated by operation of law in the following situations:

- *Principal or agent dies*
- *Principal or agent becomes insane*
- *Principal becomes bankrupt, or the agent becomes bankrupt and this interferes with their position as agent*

Termination brings the actual authority of the agent to an end. However, third parties are allowed to enforce contracts made later by the 'agent' until they are actively or constructively informed of the termination of the agency relationship.

4 Relations between agents and third parties

An agent usually has no liability for a contract entered into as an agent, nor any right to enforce it.
Exceptions to this: when an agent is intended to have liability; where it is usual business practice to have liability; when the agent is actually acting on their own behalf; where agent and principal have joint liability.

A third party to a contract entered into with an agent acting outside their ostensible authority can sue for breach of warranty of authority.

4.1 Liability of the agent for contracts formed

An agent contracting for their principal within their actual and/or apparent authority generally has no liability on the contract and is not entitled to enforce it. However, there are circumstances when the agent will be personally liable and can enforce it.

(b) When they intended to undertake personal liability – for example where they sign a contract as party to it without signifying that they are an agent.
(c) Where it is usual business practice or trade custom for an agent to be liable and entitled.
(d) Where the agent is acting on their own behalf even though they purport to act for a principal. Where an agent enters into a collateral contract with the third party with whom they have contracted on the principal's behalf, there is separate liability and entitlement to enforcement on that collateral contract.

It can happen that there is joint liability of agent and principal. This is usually the case where an agent did not disclose that they acted for a principal.

4.2 Breach of warranty of authority

An agent who exceeds their ostensible authority will generally have no liability to their principal, since the latter will not be bound by the unauthorised contract made for him. But the agent will be liable in such a case to the third party for breach of warranty of authority.

4.0
TRUST LAW

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UNIT 4 OVERVIEW

- Definition and types of Trusts
- Parties of a Trust
- Creation of a Trust
- Legal aspects of Trusts
- Termination of a Trust

4.1 KEY DEFINITION - *TRUST*

A trust is a **fiduciary arrangement** that allows a third party, or trustee, to hold assets on behalf of a beneficiary or beneficiaries. Trusts can be arranged in many ways and can specify exactly how and when the assets pass to the beneficiaries.

Since trusts usually avoid probate, your beneficiaries may gain access to these assets more quickly than they might to assets that are transferred using a will. Additionally, if it is an irrevocable trust, it may not be considered part of the taxable estate, so fewer taxes may be due upon your death.
A trust exists when the titleholder of property is obliged to deal with that property for the benefit of another person.

4.2 PARTIES OF A TRUST

1. *the trustee* — a legal person who holds a vested legal title (or a vested equitable title) in the property, subject to fiduciary duties;

2. *trust property* — property in real or personal form which is identified or ascertainable and capable of being held on trust. The trust property can be legal or equitable property; and

3. *the beneficiary* (sometimes referred to as the *cestui que trust* in older cases, or the *object* of the trust in modern cases) — a person, or group of persons, who hold a beneficial equitable estate in the property and on whose behalf the trustee must act.

It should be noted that the person who creates the trust during their lifetime is usually referred to as a *settlor*. Such a trust is often described as an *inter vivos* trust or a *settlement*. When the trust has been created in a will, the creator is the author of the will, namely *the testator* (if male), or *testatrix* (if female). A trust created in a will is referred to as a *post mortem* trust. In this and following chapters, the word *creator* will be used as a collective term to cover both settlors and testators / testatrixs.

4.3 ACTORS IN THE TRUST

There are three major actors in a Trust, these include;

1. **Creator-**

This is the individual or an incorporated body such as a company that sets up the Trust.

2. Trustee

This is the individual or an incorporated body such as a company that is charged with the duty of managing and controlling the Trust created by the creator.

3. Beneficiary

This is the individual or an incorporated body such as a company that is aimed at benefiting from the Trust.

The three legal actors need not always be different legal persons. It is possible for a creator and a trustee to be the same person, for example, when a trust is created by declaration of trust similarly it is possible for a creator to be a beneficiary, in cases where the creator instructs the trustee to hold the property for his or her benefit.

A trustee might also be a beneficiary, but only in situations where the trustee is one of a number of beneficiaries. It is impossible to be the sole trustee and sole beneficiary because once a person owns complete legal and equitable estates they are said to merge together, leaving no distinction between the legal and equitable estates

4.4 THE SPICIES OF A TRUST

There 3 major species of a trust, namely;

1. *Express trusts;*
2. *Resulting (or sometimes referred to as implied) trusts; and*
3. *Constructive trusts.*

Examples of express trusts include;

- *(i) Fixed*
- *(ii) Discretionary*
- *(iii) Bare*

4.5 IMPORTANCE OF TRUSTS

Assets in a trust may also be able to pass outside of probate, saving time, court fees, and potentially reducing estate taxes as well.

Other benefits of trusts include:

a. **Control of your wealth.** You can specify the terms of a trust precisely, controlling when and to whom distributions may be made. You may also, for example, set up a revocable trust so that the trust assets remain accessible to you during your lifetime while designating to whom the remaining assets will pass thereafter, even when there are complex situations such as children from more than one marriage.

b. **Protection of your legacy.** A properly constructed trust can help protect your estate from your heirs' creditors or from beneficiaries who may not be adept at money management.

c. **Privacy and probate savings.** Probate is a matter of public record; a trust may allow assets to pass outside of probate and remain private, in addition to possibly reducing the amount lost to court fees and taxes in the process.

4.6 BASIC TYPES OF TRUSTS

Marital or "A" trust	Designed to provide benefits to a surviving spouse; generally included in the taxable estate of the surviving spouse
Bypass or "B" trust	Also known as **credit shelter trust**, established to bypass the surviving spouse's estate in order to make full use of any federal estate tax exemption for each spouse
Testamentary trust	Outlined in a will and created through the will after the death, with funds subject to probate and transfer taxes; often continues to be subject to probate court supervision thereafter
Irrevocable life insurance trust (ILIT)	Irrevocable trust designed to exclude life insurance proceeds from the deceased's taxable estate while providing liquidity to the estate and/or the trusts' beneficiaries
Charitable lead trust	Allows certain benefits to go to a charity and the remainder to your beneficiaries
Charitable remainder trust	Allows you to receive an income stream for a defined period of time and stipulate that any remainder go to a charity
Generation-skipping trust	Using the generation-skipping tax exemption, permits trust assets to be distributed to grandchildren or later generations without incurring either a generation-skipping tax or estate taxes on the subsequent death of your children
Qualified Terminable Interest Property (QTIP) trust	Used to provide income for a surviving spouse. Upon the spouse's death, the assets then go to additional beneficiaries named by the deceased. Often used in second marriage situations, as well as to maximize estate and generation-skipping tax or estate tax planning flexibility
Grantor Retained Annuity Trust (GRAT)	Irrevocable trust funded by gifts by its grantor; designed to shift future appreciation on quickly appreciating assets to the next generation during the grantor's lifetime

4.7 THE LAGAL ASPECTS OF TRUSTS:

4.7.1 Contracts and Trusts

Gosper v Sawyer (1985) 160 CLR 548 at 568–9; 58 ALR 13 at 26, Mason and Deane JJ stated:
The origins and nature of contract and trust are, of course, quite different. There is however no dichotomy between the two. The contractual relationship provides one of the most common bases for the establishment or implication and for the definition of a trust.

- if A makes a promise to B for the benefit of C, the promise could then be enforced against A by C, if B can be considered the trustee of A's promise: *Winterton Constructions Pty Ltd v Hambros Australia Ltd* (1991) 101 ALR 363.

- The question of whether contractual rights are held on trust is answered by examining the words of the agreement: *McLellan v Sharantelli Pty Ltd* [2000] VSC 174.

- The intention must be to create a trust, and not just an intention to benefit a third party: *Dalton v Ellis; Estate of Bristow* [2005] NSWSC 1252. If it is clear that there was no intention to create a trust of the promise, or if there is no intention to benefit the third party, then no trust will be found: *Marks v CCH Australia Ltd* [1999] 3 VR 513. However, if there is an intention to benefit a third party and a trust is an effective mechanism then a trust can be implied: *Re Emilco Pty Ltd* (2002) 20 ACLC 388. In that sense, in *Kowalski v MMAL Staff Superannuation Fund Pty Ltd (ACN 064 829 616) (No 3)* [2009] FCA 53, Finn J, at [92], said that it is:
  …not necessary that the contracting parties know and understand that they are creating a trust. It is sufficient that they intend to create a relationship which, in equity, conforms to that of a trust

4.7.2 Fiduciary Relationships and Trusts

- Trusts are a subset of fiduciary relationships and the duties owed by trustees to their beneficiaries are fiduciary in character.

- Fiduciary duties and obligations of trust are not mutually exclusive. A person can owe separate and co-existing fiduciary and trustee obligations

4.7.3 Deceased Estates and Trusts

Executors of deceased estates occupy a similar function to trustees. Executors, like trustees, are fiduciaries. However, an executor's duties exist in relation to the proper administration of the deceased's estate.

4.7.4 Bailments and Trust

- A bailment only confers a weak possessory title on the bailee. It does not create a trust as the bailee does not take a vested title in the property: **Case:** *Olma v Amendola* [2004] SASC 274

- An agency exists where one person (the principal) authorises another person (the agent) to act as the principal's representative. The actions of an agent bind the principal. Like bailments, agency agreements are based in contract. **Case**: *Loughran v Perpetual Trustees WA Ltd* [2007] VSC 50

4.7.5 Debts and Trusts

- The position of creditors is very different from that of beneficiaries. Beneficiaries have equitable interests in the property held by the trustee. Creditors do not have an interest in their creditor's property. A creditor only has access to common law remedies to pursue the debt

- The institutions of debt and trust can co-exist in the one transaction if there is a common intention that funds will be held for specific purposes eg *Quistclose.*

In Barclays Bank Ltd v Quistclose Investments Ltd [1970] AC 567
Rolls Razor Pty Ltd (Rolls Razor) borrowed a large amount of money from Quistclose Investments Ltd (Quistclose). Quistclose lent the money on the basis that it was to be used for the specific purpose of paying Rolls Razor's shareholders their dividends. Rolls Razor deposited the money in a special account with Barclays Bank. Barclays were informed that the money was only to be used to pay the dividend. Before the dividend was paid Rolls Razor went into liquidation. The bank sought to use the

money in the account to set-off the debts which were owed to it by Rolls Razor. Quistclose sought to retrieve the money and claimed that the bank had no right to use the funds in a set-off.

Lord Wilberforce found that the agreement between Quistclose and Rolls Razor created a primary trust for the shareholders. When that trust could not proceed (due to Rolls Razor's insolvency) the loan became subject to a secondary trust in favour of Quistclose in the event of the money not being used for its dedicated purpose. Finally, given that the bank had notice of the mutual intention of the parties to create a trust, it was bound to respect that trust and could not use the funds to set-off debts owed to it by Rolls Razor.

- The mutual intention of the parties can be discerned from the language employed by the parties, the nature of the transaction and the relevant circumstances attending the relationship between them: *Re Australian Elizabethan Theatre Trust; Lord v Commonwealth Bank of Australia* (1991) 30 FCR 491 at 502–3

- *McManus RE Pty Ltd v Ward* [2009] NSWSC 440, a deposit for the purchase of a hotel was paid directly into the vendor's personal account. Absent any other indication that the money was to be held on trust, Palmer J found that the money was simply a debt and no trust had been created.

McKechnie J found similarly in *Smith v Western Australia* [2009] WASC 189, where the mother and sister of a drug dealer were unable to establish a mutual intention to create a trust for funds which they provided to the drug dealer to help him pay his legal costs and mortgage. The drug dealer's house was being confiscated as part of proceeds of crime legislation and the mother and sister claimed an interest in the house arising from their loans. This claim failed as there was no intention that they were to be given an interest in the house in response to their provision of funds.

4.7.6 Securities and Trusts

- Debts will often be secured. This means that the debtor has agreed to give the creditor a proprietary interest in one or more of his or her assets. Should the debtor not pay, the creditor can realise the security by taking possession of the secured property or by ordering that it be sold and the proceeds be used to satisfy the debt.

- The equitable charge is very similar to a trust. An equitable charge is a form of security that allows the creditor (chargee) to order the sale of the property, after a triggering event, like default of payment. The proceeds of sale can then be used to satisfy amounts due to the charge.

- If the transferor intends that the title be transferred, 'subject to' payments being made to another, then it will be construed as a charge. For example, property might be given 'to A subject to A paying B $1000'. This transfer evidences an intention that the obligation to pay is annexed to property as opposed to being a fiduciary obligation imposed on the transferee. The obligation is of a finite nature. It is satisfied after compliance. As such it is not of the same extent and duration as the trustee's fiduciary obligations to care for the beneficiaries' interest in a trust.

4.7.7 Conditional Dispositions and Trusts

- Transfers of property, which are subject to obligations being fulfilled to third parties, will ordinarily be viewed as equitable charges.

- If a transferor of property indicates a motive, hope or expectation that the property will be used in a particular way, the condition will be viewed as precatory and import no legal or equitable obligations. For example, gifts made in the belief that 'justice will be done to my relatives' will impose a moral obligation which has no force: *In the Will of Warren; Verga v Taylor* [1907] VLR 325

- However, if the transfer is made subject to a binding condition precedent, the transfer will not take place until the condition precedent is satisfied: *Re Gardiner (dec'd)* [1971] 2 NSWLR 494. If the condition is a condition subsequent the property will be forfeited if the condition is not fulfilled: Dal Pont and Chalmers (2004) at 434-5. If the disposition states that the obligation is to be fulfilled within a time period it is viewed as a condition precedent: *Re Gardiner (dec'd)* [1971] 2 NSWLR 494 at 498, per Helsham J.

- In cases where the conditional disposition is possibly a charge, condition precedent or condition subsequent, courts prefer to view the disposition as imposing a charge. It has been said that a conditional disposition will be treated as taking effect as a charge even where words of condition are used: *Re Gardiner (dec'd)* [1971] 2 NSWLR 494.

4.7.8 Retention of Title Clauses and Trusts

- Romalpa' clauses, are contractual clauses used in the sale of goods. They allow suppliers to retain title in delivered goods until such time as full payment has been made: *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 2 All ER 552

- Romalpa clauses operate very much like a bailment and are therefore quite distinguishable from a trust relationship. However, where the goods have been mixed with other goods or used in a manufacturing process or sold, Romalpa clauses can operate like a trust or a charge. **Associated Alloys Pty Limited v ACN 001 452 106 Pty Limited (in liq)**

4.7.9 Powers of Appointment and Trusts

- In a power of appointment, the titleholder of property (the *donor*) gives another person (the *donee*) the power to deal with, or dispose of, the property that is the subject of the power. Normally the power will allow the donee to transfer the property to a third party who can be chosen from a class of people specified in the power (the *objects* of the power). Unlike a trustee, the donee of a power is not usually given the title to the property.

  1. *general powers*, where the donee is empowered to appoint the property to anyone including himself or herself;

  2. *special powers*, which are powers to appoint the property to specific individuals or classes of objects, not including the donee;

  3. *hybrid powers*, where the donee can give the property to anyone in the world except for a particular group or class or individual; and

  4. *intermediate powers*, where the donee can add to the specified class of objects in the power.

Why does the distinction between trust powers and mere powers matter? Both mere and trust powers are required to describe their objects with sufficient certainty. It used to be the case that trust powers and mere powers were subjected to different tests of certainty.

4.8 TERMINATION OF A TRUST

4.8.1 Power of settlor to terminate or modify

Generally, if the settlor has not expressly reserved the power to terminate or modify a trust, the power to do so does not exist. e.g., Heifetz v. Bank of America, 147 Cal. App. 2d 776 (1977). The method of revocation or modification is specified in the trust instrument. The will is ineffective to modify or revoke an inter vivos trust, unless the trust instrument allows it. If the settlor retains any rights under the trust (e.g., income for life), the settlor's creditors can reach that income.

4.8.2 Power of trustee to terminate or modify

The trustee's power also comes from the trust agreement. As such, the agreement must expressly confer on the trustee the power to terminate or modify the trust, otherwise the trustee has no power to alter the terms of the trust. As a protection mechanism, where a trustee exercises a discretionary power, such as modifying or terminating the trust, his exercise of these functions is subject to judicial review. e.g., Corkery v. Dorsey, 111 N.E. 795 (Mass. 1916).

4.8.3 Power of beneficiaries to modify or revoke

Under the "Claflin doctrine," [Claflin v. Claflin, 20 N.E. 454 (Mass. 1889)], which is followed in the majority of jurisdictions today, the beneficiaries can compel termination or modification of a trust if and only if:

- All beneficiaries join in the request to the trustee or in the suit petitioning the court to modify or terminate the trust; and

- The proposed modification or the termination will not defeat a material purpose of the settlor in creating the trust.

The first requirement; of getting the consent of all beneficiaries, may be difficult to obtain because "all beneficiaries" consists of not only all existing but also all potential beneficiaries, some of which may not be born yet or otherwise ascertainable.

Example: Dale establishes a trust for the benefit of the issue of her sister Shana. This type of arrangement creates an indefinite class of potential beneficiaries. Thus, in this case it is impossible to obtain the consent of all beneficiaries to either modify or terminate the trust because some may be either minors or not born yet. e.g., Estate of Lewis, 79 A. 921 (Pa. 1911).

The second requirement of not defeating the settlor's "material purpose" in setting up the trust turns on the wording of the trust instrument and the circumstances around its execution. Additionally, courts allow parol evidence to evaluate the settlor's statements before and after the creation of the trust to flush out the settlor's original purpose behind the trust.

Certain purposes do not easily lead to termination. For instance, if the purpose was for support, the courts could infer that the settlor wanted to protect the beneficiary from his own imprudence, thereby defeating the beneficiary's request to terminate the trust early. In addition, if the trust is to terminate on its own at a certain age, this would likely be a barrier to early termination.

Example: Harlan established a trust for the benefit of his nephew, Drew. Under the terms of the trust, the trustee is authorized to spend amounts necessary for Drew's support until age 21. Between ages 21 and 31, Drew is to receive the net income of the trust. At age 31, Drew will receive the corpus of the trust and it will terminate. If Drew decided he wanted to terminate the trust at age 25, the court would probably deny the request, given the prearranged age restrictions in the trust agreement.

4.8.4 Power of courts to modify or revoke

The courts may step in to allow the trustee to deviate from administrative terms of a trust to perform acts otherwise forbidden. This may become necessary whenever changed circumstances unforeseen by the settlor impair the trust's ability to carry out the settlor's original purpose. Courts are less reluctant to alter the settlor's distributive provisions, especially when the change would alter the shares the beneficiaries are to receive. See, e.g., Stanley v. Ligon, 210 A.2d 384 (Md. 1965).

Example: In his will, Addison leaves his estate in trust. The income is to be paid to his wife, Gladys, for life. At her death the principal is to be divided among their two children, Evan and Kyle. When Gladys becomes ill, the income is not sufficient to support her. In an attempt to access the trust's principal, the trustee, joined by Evan and Kyle, petition the court to modify the trust. The court granted the request because the will did not forbid Gladys from having access to the principal. Besides, a strict reading of the trust—"income for life . . . principal to . . . Evan and Kyle"—would defeat Addison's material purpose for establishing the trust in the first place—to provide support for Gladys. See Petition of Wolcott, 56 A.2d 641 (N.H. 1948).

Certain circumstances lead to the trust terminating by operation of law. For instance, if the trust specifies a certain term, it will terminate at the end of that term. In addition, if the trust fulfills its purpose, such as providing support for a college education, the trust would end once that goal had been reached. Lastly, if the trust property ceases to exist, the trust also terminates.

5.0 EMPLOYMENT LAW

UNIT 5 OVERVIEW:
- The Legal Framework of employment
- Contract of employment
- Duties and obligations of employees
- Obligations of employers

5.1 INTRODUCTION

Employment Law is concerned with the relations existing between employers and their employees. The employment relationship is governed principally by the contract of employment between the employer and his employee. The rights and responsibilities of employees derive from this contract and also the various Acts which lay down employment standards.

5.2 THE EMPLOYMENT CONTRACT LEGAL FRAMEWORK

The following legal framework governs the employment contract law in Uganda;
- The 1995 Constitution of the Republic of Uganda
- Labour relations in Uganda are governed by the Employment Act, No. 6 of 2006, replacing The Employment Act Cap. 219,
- The Labour Unions Act No. 7 of 2006 replacing the Trade Unions Act Cap. 223 and providing for the right to form or belong to a Trade Union as enshrined in Article 29 of the Constitution,
- The Labour Disputes (Arbitrations and Settlement) Act No. 8 of 2006 which provides for the resolution of Labour disputes.
- The Occupational and Safety and Health Act replacing The Factories Act and providing for working conditions at work place and the Workers' Compensation Act which regulates compensation to workers for diseases and injuries sustained in the course of employment, the National Social Security Fund Act, that obliges employers to deduct 5% of salary of employee and 10% contributions towards the Employee's savings with NSSF;
- The Pensions Act that provides for Pension of civil servants, The Local Governments Act that provides for Pension of civil servants,
- The Public Service standing Orders, The Minimum Wages and Advisory Board Act, etc.

5.3 THE EMPLOYMENT ACT 2006

The Employment Act, which came in force in August 2006, has brought about the following changes in the Employment relationship:
- Scope: The Act applies to all employees including Government employees except members of UPDF.
- Prohibits forced labour;

- Prohibits discrimination in employment based on race, colour, sex, religion, political opinion, social origin, HIV status or disability;
- Prohibits sexual harassment at work place;
- Puts the administration of the Act entirely under the Ministry of Labour;
- Enhances powers of labour officers;
- Confines attestation of contracts to one instance, i.e. employees who are unable to read the language in which the contract is written and makes an unattested contract enforceable against the employer.
- Provides for effect of death of employer or insolvency on contract of service.
- Imposes ban on employment of children below 12 years;
- Requires consent of employee before one can travel with him or her outside Uganda;
- Confines repatriation allowance to persons employed at places beyond 100 kms from their home;
- Makes wages for a defined 26 weeks period preferential at bankruptcy and winding up;
- Provides for maternity leave of 60 working days from 1 month;
- Provides for paternity leave;
- Particulars of employment to be provided;
- Certificate of service at end of contract and entitlement;
- Disciplinary penalties;
- Hearing on any form of termination;
- Probationary period termination otherwise unfair unlawful termination;
- Compensation in case of unfair termination etc.;

5.4 TERMS OF A CONTRACT OF SERVICES

A contract of service means any contract whether oral or in writing where a person agrees in return for remuneration to work for an employer and includes a contract of apprenticeship

A contract of apprenticeship arises where there is an obligation on the employer to take all reasonable steps to ensure that the employee is taught, and acquires the knowledge and skills of that industry by means of practical training received in the course of the employee's employment.

The relationship of employee-employer is contractual hence the law of contract is central. The parties agree to the terms provided they are not less than what the Act provides or exclude the application of a provision of the Act to the detriment of the employee. The great majority of employment contracts are oral in the sense that there is no actual written contract; the employee agrees to work on certain terms that are explained verbally. Contracts for senior executive positions, which may impose certain elaborate duties and provide for complex remuneration arrangements, tend to take a written form, either the entire contract is a single document or it is a brief document which refers to terms and conditions that are set out in some detailed document.

5.4.1 Express Terms:

The express terms of the employment contract are the terms actually agreed on by the parties. Where the contract is written these terms will appear on the document, where it is oral, practical difficulties can arise in proving what was agreed.

A contract of service [if not required by law to be in writing] may be made orally or in writing. **[S.25].** If it is made with an illiterate person, it shall be attested to by means of a written document drawn up by a magistrate or labour officer who shall before attesting first ascertain that the employee has freely consented to it. [i.e. without undue influence, coercion, misrepresentation or mistake]., be satisfied that the employee has duly understood its terms, before accepting it, ensure that it is in conformity with the provisions of the Act. An agreement which excludes any provision of the Act shall be void except where permitted by the Act. **[S. 27]**

It is clearly of value that the terms of a contract be reduced in writing or evidenced in writing. In this way disputes can be averted more easily and evidence will be easier to obtain in the event of dispute. It is therefore a sensible step for the parties (or at least the employer who has the facilities) to be charged with the task of reducing the agreement in writing.

The duty to do so and the details relating to this are seen in **S. 59**. An employee is entitled to receive from his employer notice in writing of the particulars of employment. It should contain the full names and addresses of the parties to the contract, date of commencement of contract, job title, place where employees duties are to be performed, wages which the employee is entitled to, employee's normal hours of work, etc. **[S. 59].** Where there is any dispute between the employer and employee as regards the terms and conditions of employment, these particulars shall serve as evidence **[S.60].**

The general aim of the provision is to encourage the development of explicit and clear terms about the most important elements of the employee's contract. It is intended to be a mirror of that agreement but is not the contract itself.

The most widely cited statements of the effects of the written statements is found in **Systems Floors (UK) Ltd Vs Daniel (1982) 1 CR 54,** where **Brown Wilkson J.** said that: *"it provides very strong prima facie evidence of what were the terms of the contract between the parties but does not constitute a written contract between the parties. Nor are the statements of the terms finally conclusive; at most they place a heavy burden on the employer to show that the actual terms of the contract are different from those which he has set out in the statutory statement".*

5.4.2 Implied Terms

Frequently differences will arise about a matter on which the parties never reached actual agreement. When the contract was being made, they may never even have considered the matter or they may have done so briefly without reaching any firm conclusion. Court will not readily imply terms; generally the parties themselves and not judges should decide what terms they are contracting under. (Refer to the doctrine of freedom of contract)

5.4.3 Methods/Basis of Implying Terms:

Implied by facts/officious bystander test. A common form of implied term is one which is implied by virtue of the particular facts of the case. In deciding whether to fill a gap in the contract by implying a term, the test usually adopted is, if at the time they made their contract, would they almost certainly have agreed to the suggested term. The Courts attempt to guess what the parties would have decided had they faced up to the matter at that time. In **Skiilas V Southern Foundries (1926) Ltd [1939] 2KB 206** at 227, Mackinnon L.J. gave a classic exposition of their process.

"*prima facie (*on the face of it*) that which in any contract is left to be implied and need not be expressed is something so obvious that it goes without saying; so that, if, while the parties were making their bargain, an officious bystander were to suggest some express provision for it in their agreement, they would answer him with a common 'oh, of course".*

5.4.4 Business Efficacy:

Perhaps a more exhaustive formulation of the test is that of Lord Simon in **B. P. Refinery (Western Port) Pty Ltd Vs. Shire of Hastings (1978) 52 A. J. LR 20.**

"For a term to be implied, the following conditions (which may overlap) must be satisfied:-

- *it must be reasonable and equitable (fair);*
- *it must be necessary to give business efficacy (value) to the contract;*
- *it must be so obvious that it goes without saying;*
- *it must be capable of clear expression;*
- *It must not contradict any express term of the contract".*

Unless the existence of a term is practically compelled by these tests, it will not be implied by the Court. Merely because the term in question is a quite reasonable one is not sufficient. Because employment contracts establish a somewhat unique continuing relationship, the courts tend to imply some terms in circumstances where these terms might not be implied in ordinary commercial transactions. When determining whether a particular term should be implied, the courts take account of various factors. One of them is the subsequent conduct of the parties; what they did after the employment commenced is a very useful indication of what term they would have agreed upon when the contract was being made.

5.4.5 Custom and Practice:

Some customs and practices prevailing at the workplace may be implied as terms of the employment contract, in order to attain contractual status in this manner, the alleged custom must satisfy four requirements:

- it must be notorious;
- Certain;
- Reasonable;
- And is a custom that is regarded as obligatory.

If the custom is not notorious, then it is impossible to say that the employee in question could have not been aware of it on being hired. As in the case of work rules, it is essential to demonstrate that employees should have been fully aware of the custom or rule. In **Devonald v Rosser & Sons (1906)** it was said that "a custom cannot be read into a written contract unless it is so universal that no workman could be supposed to have entered into the service without looking to it as part of the contract. But it has been held that it is not essential that the employee in question was actually aware of the custom; that it is immaterial whether he knew of it or not.

Secondly, the custom must be certain, thus in **Devonald's case**, where it was contended that a custom existed whereby employers could temporarily close the work place without paying their employees any remuneration, it was held "there was no element of certainty about the alleged custom". Thirdly, before it will be implied into the contract, the custom must be a reasonable one. Thus in **Devonald's case**, the alleged custom just referred to was rejected for being "eminently unreasonable".

The custom must be one that was regarded as imposing obligations. In **Meek v Port of London Authority (1918),** the Court refused to imply into a contract an alleged custom whereby the employer paid the employee's income tax. Even if this practice had satisfied the requirement of notoriety, the court characterized it as a windfall, observing that, it would require a very strong case indeed to turn a practice apparently of bounty into a usage of obligation.

5.5 TERMS IMPLIED BY COMMON LAW

These are more or less duties imposed by common law on the parties to a contract of employment. The common law duties on the part of the employer are to pay wages, to provide work, exercise care, to cooperate and to provide access to a grievance procedure. On the part of the employee, the debate is whether there is a duty to obey reasonable orders, exercise reasonable care and competence, maintain fidelity i.e. be honest, not compete, not misuse confidential information, not impede the employer's business and duty to account. Most of these duties have been incorporated in written law.

5.6 THE DUTIES OF THE EMPLOYER

- **Obligation to Provide Work**

Generally, while the employee is contractually obliged to attend at the work place during the agreed times for working, the employer is not obliged to furnish actual work to be done. All that usually is required of the employer is to pay the agreed remuneration for the period during which the employee is at work. Although having no actual work to do may deprive the employee of job satisfaction is always regrettable but by itself provide no cause of action. **Cresswell Vs. Sawdon & Co. (1901) 2 KB 653,** the Plaintiff was hired for 4 years as a salesman at a fixed salary. Before the contract expired, his employer refused to provide him with any more work to do, although the employer was content to continue paying his salary. It was held that the employer was not thereby in breach of his obligation.

This general principle does not apply where the employee's remuneration depends entirely on being provided with tasks to perform, for instance where remuneration is based on piece rate or on commission. In those circumstances, in the absence of an express stipulation to the contrary, it is an implied term that the employee will be supplied with sufficient work to earn such remuneration as could reasonably be anticipated. Where parts of the agreed earnings are to be reckoned on a piece rate or a commission basis, the circumstances may warrant implying a similar term. Such a term was held to exist in **Re Rubel Bronze & Mental Co. (1918) 1 KB 315,** where the plaintiff was the company's general manager for three years at a fixed salary together with a commission based on the company's profit. Because he could have earned a very large commission on the profits, if made, it was held that he had therefore the right to ask that he should have a full opportunity to earning such commission.

- **Obligation to Pay Wages**

In **Orman Vs. Saville Sportwear Ltd,** Justice Pilcher said that the authorities which had been cited to him
*"establish the following proposition, where the written terms of the contract of service are silent as to what is to happen in regard to the employee's right to be paid whilst he is absent from work due to sickness, the employer remains liable to continue paying so long as the contract is not determined (*terminated*) by proper notice, except where a condition to the contrary can properly be inferred from all the facts and the evidence in the case. If the employer seeks to establish an implied condition that no wages are payable, it is for him to make it out.*

- **Indemnity**

The employer must indemnify his employee where the employee has incurred a liability while acting on the employer's behalf except where the employee knew that he was doing an unlawful act.

In **Burrows v Rhodes**, D were the organizers of the Jameson raid. They induced P to re-enlist in the armed forces of the British South African Co. which they did by means of a fraudulent statement. P believed that the venture in which he was to take part was lawful. It was held that he was entitled to damages from his employers for injuries suffered.

- **Safety**

The employee must take reasonable care to ensure that his premises are safe. He will therefore be in breach of his duties if he provides defective safety equipment knowingly or which he should have known on reasonable examination. The burden is on him to examine the equipment. He will also be in breach if he fails to remedy breaches that have been brought to his attention.

5.7 DUTIES OF AN EMPLOYEE

- **Loyalty and good faith**

The employee must not accept bribes or make secret profits. In **Boston Deep Sea Fishing C v Ansell**, while employed as a managing director with the Plaintiff Co., Ansell contracted with a shipbuilding company for supply of ships taking a secret commission. It was held that Ansell's action was a breach of his duty to his employer.

- **Misconduct**

The employer must not misconduct himself. The term misconduct includes persistent laziness, immorality, dishonesty; drunkenness etc. misconduct will justify summary dismissal if it goes to the root of the contract.

In **Pepper v Webb**, a gardener who behaved in a surly manner, showed disinterest in the garden, refused to perform certain tasks in the garden and was disobedient to the employer was held to have been summarily dismissed justifiably.

But in **Wilson v Racher**, a gardener was dismissed for swearing at his employer on one occasion. It was held that this was an exceptional outburst from an otherwise competent and diligent employee who had been provoked by his employer. Therefore there were no grounds for dismissal.

- **Account for property and gain**

And employee must account for any money or property belonging to his employer and any gains made thereon.

- **Trade secrecy**

The employee must maintain secrecy over his employer's affairs during the time of his employment. If the employer wishes to extend this beyond the period of employment, it would be advisable to insert a suitable clause in the contract of employment (restraint of trade clause)

The employee is under an obligation to his employers not to disclose confidential information obtained by him in the course of, and as a result of his employment. The duty applies both during employment and afterwards if the employee seeks to use such information to the detriment of his employer.

In **Rob v Green**, an employee who copied down a list of customers intending to use it after leaving employment was retrained from doing so.

- **Competence and Care**

An employee must be reasonably competent to perform the job for which he was hired. Extreme incompetence will warrant instant dismissal; it was been held in **Harmer Vs Cornelius (1958)** to be *'very unreasonable that an employer should be compelled to go on employing a man who, having represented himself, competent, turns out to be incompetent'*. Many employments have elaborate disciplinary procedures aimed at ensuring that the work is done with a reasonable degree of competence.

- **Indemnity**

Since it is an implied term of the employment contract that employees will exercise a reasonable degree of care and skill in the performance of their work, consequently, it was held in **Lister Vs Ramford Ice cold storage Co. Ltd,** that where an employer suffered financial loss as a result of his employees breach of his duty, the employee is under an obligation to indemnify the loss. In that case an employee negligently drove a van in the course of his work and injured a fellow employee. On the basis of vicarious liability, the employers had to compensate that fellow employee for his injuries. It was held that the van driver was under an implied contractual duty to indemnify the employer in respect of that sum.

Employers are subject to an extensive duty of care which is based on an implied term in the Employment Contract, which is also founded in the law of Torts and is the subject of elaborate statutory regulation, notably, the Occupational Safety and Health Act and the Workers' Compensation Act.

The employers' common law duty is owed to each individual employee and employers must take due account of the different physiques and other attributes of their various employees. For instance, in **Paris v Stepney Borough Council,** it was held that an employer owes a greater duty to take care of a one eyed man than a normal man in respect of risk of injuries to the eye.

- **Obedience to reasonable orders:**

It depends on the circumstances of the case whether an employer's lawful orders are reasonable and accordingly, must be obeyed by the employee. Generally, employers are not entitled to give orders regarding what employees do outside their working hours but there are some jobs which warrant giving certain instructions about what an employee should or should not do while not actually at work, orders regarding what an employee should do outside work will usually be regarded as unreasonable, unless the contract clearly envisaged giving those orders.

But the Courts would be most reluctant to strike down instructions given about how a particular task should be performed since, by the nature of the employment relationship, it is for the employer to determine how the work is to be done. An order would have to be wholly unconnected with the employee's job or be manifestly unreasonable before it would be rejected by the courts.

An example of orders which were held unreasonable is **Ottoman Bank v Chaharin (1930) AC 227,** involving a bank employee who had been based in London. Under his contract, he could be posted abroad to any branch in Turkey. He was ordered to go and work at a branch there where, to the employer's knowledge, his personal safety was at risk, the order there was unreasonable.

Even where a contract expressly authorizes the employer to give certain directions, ordinarily, those must still take due account of the employee's health and safety, (**Johnstone Vs Bloomesbury Health Authority (1991).** In **Cresswell Vs Board of Inland Revenue 1984,** the employer introduced a new computerized system (COP) which replaced the traditional manual method of tax coding. The employees unsuccessfully sought a declaration that the employers were acting in breach of contract in requiring them to operate the computerized system. Walton J. held that:

"there can really be no doubt as to the fact that an employee is expected to adopt himself to new methods and techniques introduced in the course of employment….., in an age when computer has forced its way into the school room and where electronic games are played by school children in their own homes as a matter of everyday occurrence, it can hardly be considered that to ask an employee to acquire basic skills as to retrieving information from a computer or feeding such information into a computer is something in the lightest esoteric or even now days unusual."

- **Co-operation**

Over and above the question of obeying specific orders, employees are subject to an overriding duty to co-operate with their employers in the performance of their work. Because the employment contract envisages a continuing relationship between employers and employees, it would seem that the employee must perform the various contractual obligations with a degree of good faith. It is an implied term that the contract should be performed in such a way as not to undermine its commercial objective.

5.8 OTHER TERMS OF EMPLOYMENT

A) **The Employment Act:**

The Employment Act is the principal law regulating the employment relationship. Most of its provisions on employee rights provide the minimum. Under **S.27(2)**, the Employer may offer terms that are more favorable to the employee than what the Act provides for. Other terms to a contract of Employment prescribed by the Employment Act include weekly rest and length of working hours, leave (Annual, Sick, Maternity, Paternity leave etc), notice of termination periods, disciplinary Procedures, etc.

Under **S.51** an employee shall not be required to work for an employer for more than 6 consecutive days without a day's rest. The maximum working hours for employees shall be 48 hours per week except that the employer and employee may agree that maximum working hours shall not be less than or shall be more than 48 hours. An employee shall be entitled to maternity leave, sick pay, annual leave and public holidays, paternity leave in accordance with **S. 54**.

These terms will be implied in every contract even if the parties did not expressly agree upon them.

WAGES

Under **S. 41**, wages shall be paid in legal tender to the employee entitled to payment but may also be paid with the prior written agreement of the employee by cheque etc,. No person other than the employee is allowed to receive wages on his/her behalf without the written permission of the employee. **[S.44]**

The Act further prohibits deductions from the employee's wages except where permitted by law **[S.45].** The Act permits deductions in respect of any tax rate, subscription or contribution imposed by law, labour union dues, [i.e. any regular or periodic subscription required to be paid by a union member to any labour union of which he is a member], contributions to a pension fund established by the employer

which deduction the employee has in writing consented to; deduction by way of reasonable rent or other reasonable charge for accommodation provided by the employer **[S. 46]**
Under the **NSSF Act S. 12**, a contributing employer is allowed to deduct from the monthly wage payment of his or her employee the employee's share of a standard contribution of 5 percent calculated on the total wages paid during that month to that employee. Under **S. 116** of the **Income Tax Act,** every employer shall withhold tax from a payment of employment income to an employee.

B) **Workers' Compensation Act**:

This Act was intended to ensure that workers injured in the course of the employment receive compensation from their employers. The Act defines an employer as the Government of Uganda, any person incorporated or unincorporated, association or partnership, which directly engages a worker or which, in respect of any worker, carries on the business of hiring out his or her services.

The Act applies to all employment within Uganda and to workers employed by or under the Uganda Government in the same way and to the same extent as if the employer were a private person, but not to active members of the armed forces.

5.9 EMPLOYER'S LIABILITY.

If personal injury by accident arises **out of and in the course of a worker's employment**, the injured worker's employer shall be liable to pay compensation in accordance with this Act **[S. 3].**

An act shall be deemed to be done out of and in the course of employment when a worker acts to protect any person on the employer's premises whom the worker believes to be injured or imperiled, or when a worker acts to protect property on the employer's premises.

Any personal injury by accident arising while the employee is traveling directly to or from his or her place of work for the purpose of employment shall be deemed to be an accident arising out of and in the course of his or her employment. It shall be for the employee who suffers injury by accident arising while traveling to or from his or her place of work to show that such travel was direct. Compensation shall be payable under this section whether or not the incapacity or death of the worker was due to the recklessness or negligence of the worker or otherwise.

Any accident arising in the course of employment shall, unless the contrary is proved, be presumed to arise out of employment. Because of this liability, the Act requires every employer to insure and keep himself or herself insured in respect of any liability which he or she may incur under the Act to any worker employed by him or her.

5.10 COMPUTATION OF COMPENSATION

The Act details the method of computation of the amount to be compensated. The basis of the computation is the nature of the injury alongside monthly earnings of the affected worker and whether or not the deceased worker has left behind family members who are dependent on his earnings. The word injury is defined to include an accident and a disease mentioned under the Act; the injury may be a fatal one or it may be one of a temporary or permanent nature, which incapacitates a worker for any employment which he or she was capable of undertaking at the time when the accident occurred. The word earnings is defined to include wages and any allowances paid by the employer to the worker, including the value of any food, accommodation or benefit in kind.

If the worker is killed as a result of an accident for which the employer has liability under this Act, the dependants (if any) of the deceased may recover from the employer the expenses of medical treatment of the deceased, burial of the deceased and expenses incidental to the medical treatment and burial of the deceased

The Act further allows a worker to bring legal proceedings against the employer to recover damages from him in respect of the injury notwithstanding the fact that he has been compensated in accordance with the provisions of the Act. However, the amount of compensation which he or she has been awarded under this Act shall be taken into account in the assessment of his or her loss. **[S.17].** This provision was meant to prevent double compensation and therefore unjust enrichment on the part of the injured worker.

C) **National Social Security Fund Act:**

The NSSF Act obliges every employer to deduct and remit to the Fund 5% of the employee's wages per month and also to contribute 10% of the employee's salary to the Fund.

D) **Labour Unions Act and Freedom of Association**

This freedom is guaranteed both under the **Constitution** and the **Labour Unions Act.** Article **29 (e)** of the Constitution provides that every person shall have the right to freedom of association which includes freedom to form or join trade unions.
S. 3 of the Labour Unions Act also provides that employees shall have a right to organize themselves in any labour union and may assist in running the labour union, bargain collectively through a representative of their own choice, withdraw their labour and take industrial action. Meanwhile, under **S. 4** the employer is barred by the Act from interfering with this right to associate otherwise if he does, he commits an offence under **S.5** for which he is criminally liable.

5.11 OCCUPATIONAL HEALTH AND SAFETY ACT

Article 39 of the Constitution provides for the right to a clean and healthy environment.
The **Occupational Safety and Health Act** imposes an obligation on employers to ensure the safety of employees at work. They are thus required to put in place measures for the achievement of this purpose e.g. provision of protective gear against the effect of pollution, to monitor and control the release of dangerous substances into the environment, to supervise the health of workers who are exposed to dangerous hazards due to pollution and other harmful agents e.g. through periodic medial examination, keeping medical records of workers, ensuring that work premises remain safe and without risk to health, displaying safety precautions etc.

The Act requires workplaces to be kept in a clean state to have suitable lighting to ensure that buildings at a work place are of sound construction, to have adequate supply of wholesome drinking water accessible to by all workers, adequate facilities for taking meals, a first aid room etc.
The administration and enforcement of the provisions of the Act is entrusted to the Commissioner for Occupational Health and Safety and inspectors. Their role is, with the assistance and cooperation of the occupier of the work place to enter into work premises to ensure that employers are implementing the requirements of the Act.

5.12 EMPLOYMENT OF NON CITIZENS

This is governed by The Uganda Citizenship and Immigration Control Act Cap 66 and The Uganda Citizenship and Immigration Control Regulations No 16/04
No person shall enter or remain in Uganda unless that person is in possession of a valid entry permit, certificate of permanent residence or pass issued under the Act. A non-citizen shall not be issued with the above documents unless he possesses a passport, a certificate of identity, a convention travel document or any other valid travel document**. [S.53]**
A non-citizen shall not unless he posses the above documents be employed in a parastatal or private body, public service, by a private person, engage in private business in Uganda **[S.59]**
There are classes of entry permits specified in the Act **[S.54]. Class G** covers employees. The person must satisfy the immigration board that he has been offered and has accepted employment in Uganda.

5.13 VICARIOUS LIABILITY OF THE EMPLOYER

When a person is injured by another, the rule at common law is that the injured party may sue the actual wrong doer. Where the wrong doer is an employee, the injured party may also have an action against the employer under the principal of vicarious liability. Although the employer did not personally commit the wrong, he may be responsible for all those who are employed by him. The third party will usually sue the employer as he is usually in a better financial position to meet the claim for damages.
Government is liable for the civil wrongs committed by its servants **(S. 3(1)(a) of the Government Proceeding Act)**, but not generally to wrongs committed by a member of the UPDF **(S. 4 of the Law Reform Miscellaneous Provisions Act)**

The view is taken that, by employing a person, the employer makes it possible for him to commit a wrong. It is regarded as a normal business risk for which he would be wise to take out insurance.
The rule is that the employer is vicariously liable for the torts (civil wrongs) of the employer that are committed within the course of his employment.

In **Limbus v London General Ominbus Co**, a bus driver whilst racing a bus caused an accident. His employers were held liable because he was doing what he was employed to do ie to drive a bus, although in an improper way.

In contrast, in **Beard v London General Ominbus Co**, a bus conductor attempted to turn a bus around at the end of its route and in doing so he caused an accident. His employers were not liable since he was only employed to collect fairs and not to drive buses.
Sometimes, a prohibition imposed by an employer on an employee will limit the scope of employment. Thus in **Twine v Beans express**, a driver employed by the defendants gave a lift to a person who was killed due to the employer's negligent driving. The employer had been expressly forbidden to give lifts and a notice to this effect was displayed in the vehicle. It was held that the employer was not vicariously liable as the driver's action was outside the scope of his employment and the injured person was deemed to be a trespasser.

Where an employee who is on a journey deviates from the authorized route, it is a question of degree whether he has started on afresh journey (a frolic of his own) which relives the employer from liability.

5.14 EMPLOYMENT OF CHILDREN

Children under 16yeas of age are entitled to be protected from social or economic exploitation and shall not be employed in or required to perform work that is likely to be hazardous or to interfere with their education or to be harmful to their health or physical, moral, metal, spiritual or social development [**Article 34** of the constitution]

A child under the age of 12 years shall not be employed in any business, undertaking or work place. **[S.32].** A child under the age of 14 is only allowed to be employed for light work carried out under the supervision of an adult aged over 18 years and which work does not affect the child's education. A child shall not be employed between the hours of 7 pm and 7 am. Any person including a labour union or employer's organization may complain to a labour officer if he or it considers that the child is being employed in breach of these provisions of the law.

5.15 DISMISSAL OF EMPLOYEES AND TERMINATION OF CONTRACT OF EMPLOYMENT

In recognition of the frequent dismissals of employers from work especially in the Ugandan private sector, the framers of the Employment Act came up with major safeguards against both unlawful or unfair termination and unlawful dismissal. The Act provides for certain requirements that must be complied with before a contract of service can be terminated. The one loophole in the Act is failure to make a clear distinction between termination and dismissal, the Act appears to use the two words interchangeably.

"Termination of Employment" means the discharge of an employee from an employment at the initiative of the employer for justifiable reasons other than misconduct, such as, expiry of contract, attainment of retirement age. On the other hand, Dismissal from Employment" means the discharge of an employee from employment at the initiative of his or her employer when the said employee has committed verifiable misconduct."

An employment contract can be terminated in a number of ways which include the following **[S.65].**

- The contract can be terminated by the employer with notice
- Where it is a contract of service, being a contract for a fixed term of task, ends with the expiry of the specified term or the completion of the specific task [unless it is renewed]
- Where the contract is ended with or without notice on the part of the employee as a consequence of unreasonable conduct on the part of the employer towards him
- Where the contract is ended by the employee in circumstances where the employee has received notice from the employer but before the expiry of that notice.

A contract of service shall not be terminated by an employer unless he or she gives notice to the employee except, where the contract of employment is summarily terminated in accordance with **S. 69** [below] or where the reason for termination is attainment of retirement age, **[S.58].** The notice must be in writing and shall be in a form and language that the employee to whom it relates can reasonably be expected to understand. The period of notice depends on the period for which the worker has been employed and the notice periods are specified under the Act. No employer has the right to terminate a contract of service with less notice than that to which the employee is entitled by any statutory provision or contractual term [**S.69 (2)].** However, nothing shall prevent an employee from accepting payment in lieu of notice.

An employer shall before reaching a decision to dismiss an employee on grounds of misconduct or poor performance explain to him the reason for dismissal in a language the employee may reasonably be expected to understand. The employee is entitled to have another person of his or her choice present during the explanation. The employer shall in turn give the employee a hearing and consider any representations which the employee and the person if any chosen by him may make. Whether the dismissal is a summary dismissal which is justified or whether it is a fair dismissal, the employer must have given the employee a reasonable time within which to prepare these representations. Where these requirements are not complied with, the employee may lodge a complaint with the labour officer for redress **[S. 66]**.

Irrespective of whether any dismissal which is a summary dismissal is justified or whether it is fair an employer who fails to comply with this section is liable to pay the employee a sum equivalent to four weeks net pay. **(S.66(4))**

5.16 UNFAIR REASONS FOR TERMINATION

Notwithstanding the above, it is vital to note that not all reasons that the employer may give are fair reasons to justify termination of a contract. Thus under **S. 75** of the Act, a list of reasons which may be considered as unfair is given i.e.

- A female employee's pregnancy or any reason connected with her pregnancy
- The fact that an employee took, or proposed to take, any leave to which he was entitled to under the law or a contract
- An employee's membership or proposed membership of a labour union
- Participation or proposed participation in the activities of a labour union outside working hours, or with the consent of the employer within working hours
- An employee's refusal or proposed refusal to join or withdraw from a labour union
- An employee's race, sex, colour, religion, political union or affiliation, nationality, social origin, marital status, HIV status or disability.
- An employee's temporary absence from work for any period up to 3 months or reliable grounds including illness or injury
- An employee's initiation or proposed initiation of a complaint or other legal proceedings against his employer
- The organization or intended organization of a strike or other form of industrial action where the strike of industrial action is lawful. **[S.76]**

5.17 SUMMARY DISMISSAL

An employer is entitled to dismiss summarily and the dismissal shall be termed justified where the employee has by his or her conduct indicated that he has fundamentally broken his obligations under the contract of service **[S. 69].** This would arise from serious misconduct being manifested by the employee.

Summary dismissal is deemed to have taken place when the employer terminates the service of an employee without notice or with less notice than that to which the employee is entitled by any statutory provision or by a contractual term. This is a new provision because formerly summary dismissal meant only dismissal without notice.

Where the employment contract does not specify the grounds for summary dismissal what constitutes serious misconduct for these purposes depends on the nature of the job in question and the terms of the contract. Certain actions almost invariably would be regarded as a serious misconduct, like deliberately destroying the employer's property, stealing from the employer and gross insubordination.

In **Eletu v Uganda Airlines Corporation [1989],** it was held that at common law, to justify such dismissal, a breach of duty must be serious one, a breach amounting in effect to repudiation by the servant of his obligations under the contract of employment such as disobedience of lawful orders, drunkenness, immorality, assaulting fellow workers, incompetence and neglect

It was held further that there is no fixed rule of law defining the degree of misconduct which would justify summary dismissal. However summary dismissal is a strong measure to be justified only in exceptional circumstances. The test to be applied in determining whether a summary dismissal was justified is whether misconduct leading to summary dismissal goes to the root of the contract so as to indicate unwillingness to continue to be bound by the original terms of the contract.

5.18TERMINATION OF CONTRACT UNDER COMMON LAW

Most of the common law rules of termination of contract of employment have been modified by Statute in Uganda. The Common Law principles of termination of a contract of Employment are as follows:

An employer's right to hire and fire is unlimited. He need not assign any reason for the dismissal. See **Jabi Vs Mbale Municipal Council. In Ridge Vs Baldwin, Lord Reid** said, *"It may be exercised for any reason or for none".*

In **Wilson Nuwemuguzi Vs National Water and Sewerage Corporation,** the Supreme Court, speaking through Platt JSC held that it is not necessary that the master, dismissing a servant for good cause, should state the grounds for such dismissal; and provided that good ground existed in fact, it is immaterial whether or not it was known to the employer at the time of dismissal, justification of dismissal can accordingly be shown by proof of facts ascertainable subsequent to the dismissal or on grounds differing from those of the time. The purpose of notice is to give the employee an opportunity to look for alternative employment

Notice: one of the features which distinguish a contract of employment from other contractual situations is that a contract of employment is one of continuous obligation, with generally speaking no specified time for its ending. Thus apart from certain exceptions (e.g. fixed term contracts, summary dismissal, retirement age, project termination) if either the employer or employee wishes to terminate the contract, notice of such termination must be given.

Under common law, the length of notice must be specified in default of which the law would imply a reasonable notice. What is reasonable depends on the circumstances of each case. Factors taken into account include the employee's position, the industry, nature of work and period of payment (i.e. monthly or weekly). In **Grundy Vs Sun Printing and Publishing Association [1916],** a year was held to be reasonable notice for a steamers chief officer and a newspaper editor. In **Adams Vs Union Cinemas Ltd [1939],** six months for a manager of 120 cinemas was held reasonable. Six months was also held reasonable for a journalist **(Bauman Vs. Houlton Press Ltd [1952]** and in **Nicholls Vs Falcon Airways Ltd [1962],** an airline pilot was held to be entitled to three month's notice. In **Hill Vs CA Parsons & Co. Ltd,** the Court of Appeal expressed the view that a senior engineer would have been entitled to be between six months to one year's notice. Further, persons in well paid jobs are entitled to relatively lengthy notice. In **Carvill Vs Irish Industrial Bank Ltd,** a managing director of a small bank was held to be entitled to six months. **MsDonnell Vs Ministry of Education [1940]** allowed six months to a teacher.

If a contract of employment came to an end because of the operation of the doctrine of frustration, no notice will be given. Notice may be given by either side orally or in writing. In either case, apart from summary dismissal, it will run from the day after it is given unless a later date is specified, but it cannot operate unless the recipient has had an opportunity to know of it.

The general common law rule is that once notice has been given, it cannot be unilaterally withdrawn either by the employer or the employee. Riordan Vs War Office [1959] and Brennan Vs C Lindley & Co. Ltd [1874], although it can be withdrawn by mutual agreement between the parties – **Harris & Russel Ltd [1973]** and the period can be extended by mutual agreement. **Mowlem Northern Ltd Vs Watson [1990]**.

The right to be heard. In **Jabi Vs Mbale Municipal Council,** it was held that it was a fundamental requirement of natural justice that a person properly employed was entitled to a fair hearing before being dismissed on charges involving breach of disciplinary regulations or misconduct. Where this was not done it would be properly said that the dismissal was wrongful. Where there has been gross misconduct on the part of the employee, the employer may dismiss the employee summarily. Under common law, an employee dismissed summarily is not entitled to a hearing or to notice. See **Barclays Bank Vs Mubiru.**

An employee who is dismissed wrongly is only entitled to damages for wrongful dismissal. In Jabi Vs Mbale Municipal Council, it was held that where the dismissal was wrongful by whatever reason, the appropriate reparation for such dismissal was compensation and not reinstatement on the job for an employer has an unfettered right to dispense with the services of his employee. **In Ushillini Gullbhai Vs Kampala Pharmaceuticals,** it was held that an employee whose contract has been repudiated cannot insist that the contract is subsisting. He has to accept the termination and sue for damages.

Students must consider the extent to which the common law rules of termination of a contract of service have been modified or reversed by the Employment Act No. 6 of 2006 and how future disputes are likely to be decided.

5.19 REMEDIES FOR BREACH OF A CONTRACT OF EMPLOYMENT:

Where a person claims that there has been an infringement of any of the rights provided for under the Act, the remedy given under the Act is lodging a complaint with the Labour officer who has authority to hear and settle complaints brought before him [**S.93].** A person dissatisfied with the decision of the Labour Officer has the right to appeal to the Industrial Court. **[S.94]**

The Act provides in **S.71** that upon hearing a labour complaint, the Court may make an order of reinstatement or an order of compensation. The fact that a court is empowered to make the order of reinstatement as a preferred order means that authorities which provided that specific performance as a remedy is not available in employment contracts, no longer represent good law in this country.
Regarding damages, the Act provides for basic and additional compensatory awards. It is not clear whether these represent the minimum or maximum. Under the common law, damages were the most appropriate remedy for breach of a contract of employment subject to a duty to mitigate the damages.
Read about other ways in which a contract of service can be terminated
Consider frustration, winding up, and death of the employer……..

6.0
PARTNERSHIP LAW

UNIT 6 OVERVIEW

- Definition and types of partnerships
- Formation and termination of partnerships
- The relationship of partners
- Partnerships and third parties

6.1 GENERAL INTRODUCTION

The major law regulating partnerships in Uganda is the partnership Act 2010, Act 2 of 2010. This Act repealed the partnership Act, Cap 114 and came into force on 27th February 2010. Some of the principles of partnership law are embodied in rules of equity and common law.

6.2 KEY DEFINITION – *Partnership*

Partnerships are a form of business structure. According to section 1 of the partnership act, 2010, partnership means a partnership referred to in section 2 and a limited liability partnership referred to in section 47. There are broadly two types of partnership: General partnership and limited liability partnerships. Under section 56 of the partnership Ac, a limited partnership may convert into a general partnership by surrendering the certificate of registration to the registrar for cancellation.

A partnership is a relationship which subsists between or among persons, not exceeding twenty in number, who carry on a business in common with a view to making profit. If the partnership is formed for the purpose of carrying on a profession, the number of professionals, which constitutes the partnership shall not exceed fifty. (See section 2 (1) & (2) partnership Act, 2010). However, the relation between members of any company or association which is registered under the companies Act or any other Act for the time being in force and relating to the registration of joint stock companies or formed or incorporated by or in pursuance of any other written law, is not a partnership within the meaning of the partnership Act.
According to section 47(5) of the partnership Act, even a body corporate may be a limited liability partner.

Section 4 of the partnership Act, 2010 requires mandatory registration of a firm carrying on business in Uganda under a business name which does not consist of the true surname of all partner who are individuals and the corporate names of all partners which are corporations without any addition other than the true names of individual partners or initials of the first names; and the corporate names of all partner which are corporations. Such registration shall be under the Business Names Registration Act, Cap 109.

A person could choose to do business as a sole proprietor or by incorporating a company. Unlike registered companies which are distinct legal entities, a partnership does not have separate legal personality. The company is considered separate from its shareholder and can own property in its own name, sue and be sued in its own capacity. However, a partnership is not regarded as separate from its partners (Except in the case of limited liability partnership). As such the obligations of the firm become the obligations of the partners. There could be limited liability partnerships where the liability of some of the partners can be limited just like for registered companies with limited liability. This is a new innovation in Uganda's business law.

Section 3 of the partnership Act contains rules for determining the existence of a partnership. Whether or not a partnership exists is normally a question of fact. In the case of **Stekel; v Ellice (1973) ALL ER 465,** it was held that an agreement to enter into a partnership[on certain terms might constitute a partnership forthwith, or from an agreed date, even though the agreement provided for some formal agreement which was never in fact executed . it was further held that the fact that a person was described as a salaried partner was not conclusive one way of the other of the question whether he was a partner in the true sense; the question whether there was a partnership depends on the true nature of the relationship and not on the label attached to it . In **Davis v Davis (1894) 1 Ch 393,** the court noted that though the receipt by a person of a share of the profit of a business is prima facie evidence that he is a partner in the business, but all this is not to be registered as a presumption which has to be rebutted by other circumstances; but all the circumstances must be considered, and an inference drawn from them as a whole. Without attributing undue weight to any one of them.

According to section 1 of the partnership Act, persons who have entered into partnership with one another are, for the purpose of this Act, called collectively a firm, and the name under which their business is carried on is called the firm name.

6.3 RELATIONS OF PARTNER TO PERSONS DEALING WITH THEM

These are regulated by section 5 – 20 of the partnership Act. Generally, every partner is considered as an agent of the firm and his other partner for the purpose of the business of the partnership. The acts of every partner who does any act for carrying on in usual way business of the kind carried on by the firm of which he is a member bind the firm and his other partner unless the partner so acting has in fact no authority to act for the firm in the particular matter, and the person with whom the partner is dealing either knows that the partner has no authority, or does not know or believe him to be a partner. See **Geoffrey Gatete & Angella Maria Nakigonya v William Kyobe SCCA No. 7 of 2005.** In **Lai Chand Sharma trading as regal provision stores v Bush Mills (1957) EA 404,** it was noted that the action of the managing partner in pledging the credit of the firm for the supply of provisions to employees of the firm was in the usual course of business and the firm and its partners were liable for his actions. That what is done in carrying on the partnership business in the usual way in which business of a like kind are carried on, is made the test of authority or ratification can be proved. This probably means the same thing as saying that what is necessary to carry on the partnership business in the usual way is the test of a partner's implied authority to bind the firm. "The question whether a given act can or cannot be said to be done in carrying on business in the way in which it is usually carried on must evidently be determined by the nature of the business, and by the practice of persons engaged in it. Evidently on both of these points is therefore necessarily admissible, and, as may readily be conceived, an act which is common in the prosecution of one kind of business in the ordinary way may be required for carrying on another business of a different character. Consequently no answer of any value can be given to the abstract question – can one partner bind his firm by such and such an act? Unless, having regard to what is usual in business, it can be predicated of the act in question either that it is one without which business can be carried on, or that is one which is not necessary for carrying on any business whatever."

All partners are bound by acts on behalf of the firm. However, where the partner uses the credit of the firm for his private purpose, the firm will generally not be bound unless that partner is in fact specifically authorized by the other partners. In such circumstances, the partner would be personally liable.

The liability of the partner for the debts and obligation of the firm is joint and several meaning that the firm creditor can pursue payment from the firm or from the partners jointly of from any of the partners alone. However, in **Sarwan singh v Karam sigh Lai Puran Singh (1963) 423**, it was held, inter alia, that there is no obligation for a plaintiff who seeks to enforce a claim against a partnership to join all the partnership as defendants.
Special rules apply to the liability of minor partners. (See section) 10 & 11 of the partnership Act)

A person may become liable for the debts or obligations of a firm if he held out or allowed himself to be held out as a partner in a firm. (See Section 18 partnership Act).

Notice to any partner who habitually acts in the partnership business of any matter relating to the affairs of the partnership operates as a notice to the firm except in cases of fraud committed by or with the consent of the partner .(See section 18 partnership Act)

The partners are liable only for debts incurred by the firm while they are still partners. As such an incoming partner does not thereby become liable to the creditors of the firm for anything done before he was a partner. A partner who retires from the firm does not thereby cease to be liable for partnership debts before his retirement. See section 19 of the partnership Act. In **Ranbhai & Co. (Uganda) Ltd. V Laji Ratna and Anothr (1970) EA 106,** it was held that as the second defendant had been introduced to the plaintiff as a partner in the firm express notice of his withdrawal was necessary and as this was never the second defendant was liable.

6.4 RELATION OF PARTNERS TO ONE ANOTHER

Section 21 – 33 of the partnership Act, contains provisions that regulate the relations among the partners. Generally, the rights and duties of the partners arise out of consent of the partner. Some of the rights and duties are imposed by law but these may be varied by the consent of the partner.

All property and rights and interests in property originally brought into the partnership stock or acquired on account of the firm or for the purpose and in the course of partnership business are called partnership property. The said property is to be held and applied by the partner exclusively for the purpose of the partnership and in accordance with the partnership agreement.

Normally, property bought with money belonging to the firm is deemed to have been brought on account of the firm. Execution of a decree shall not issue against any partnership property except on a judgment against the firm. This means that a partner cannot pledge the partnership property may be charged for his personal debts. However, a partner's interest in the partnership property may be charged in favour of judgment but only upon application to the court. The other partners always have the first option to redeem the interest charged or to purchase it where necessary.

Except as otherwise agreed, all the partners are entitled to share equally in the capital and profits of the business and must contribute equally towards the losses whether of capital or otherwise sustained by the firm. The firm must indemnify every partner in respect of payments made and personal liabilities incurred by the partner in the ordinary and proper conduct of the business of the firm. Every partner may take part in the management of the partnership business. No person may be introduced as a partner without the consent of all the existing partners. Every partner may at all reasonable times have access to and inspect and copy the partnership books of accounts. No majority of the partners can expel any partner unless a power to do so has been conferred by express agreement between the partners.

Where no fixed term has been agreed upon for the duration of the partnership, any partner may terminate the partnership at any time on giving reasonable notice of his intention so to do all the other partners. The partner seeking retirement has to seek consent of the other partners regarding the dissolution of the partnership but where the other partner decline to give their consent to the dissolution, that partner has the option of retiring from the partnership. Where a partnership entered into for a fixed term is continued after has expired, and without any express new agreement, the rights and duties of the partner remain the same as they were at the expiration of the term.

Every partner is bound to render the true accounts and full information of all things affecting the partnership to any partner or his legal representatives. Every partner must account to the firm for any benefit delivered by him without the consent of the other partners from any transaction concerning partnership, or from any use by him of the partnership property, name or business connections. It is the duty of a partner not to compete with the firm. If a partner without the consent of the other partners carries on any business of the same nature as and competing with that of the firm, the partner must account for and pay over to the firm all profits he made in that business.

6.5 DISSOLUTION OF PARTNERSHIP AND ITS CONSEQUENCES

Unlike an incorporated company which unless it is would up can exist perpetually in its own name, a partnership does not exist perpetually. It may be dissolved in various instances. Section 34 – 46 of the partnership Act contains provisions that regulate the dissolution of partnership and the consequences that arise from such dissolution.

Under Section 34 (1), subject to any agreement between the partners, a partnership is dissolved if entered into foe a fixed term, by the expiration of the term; if entered into for a single adventure or dissolved if any partner suffers his or her share of the partnership property to be charged under this act for his or her separate date. (See section 35 of the partnership Act).

Under section 36 of the partnership Act, a partnership is, in every case, dissolved by the happening of any event that makes it unlawful for the business of the firm to be carried on or for the members of the firm to carry it on in partnership.

According to section 37, there can be dissolution by court order in case of lunacy, incapacity, etc. where a partner becomes permanently of unsound mind, the partners can apply to court for an order of dissolution of the partnership. Also when a partner other than the partner suing becomes in any way permanently incapable of performing his part of the partnership contract. Where a partnership can only be carried on at a loss and whenever it is just and equitable, the court can issue an order for the dissolution of the partnership.

Upon dissolution of the partnership, the rights of the partners and the people dealing with the firm might be affected. Dissolution thus has a number of consequences.

Where a person deals with a firm a change in its constitution, he is entitled to treat all apparent members of the old firm as still being members of the firm until he has notice of the change. An advertisement in the Gazette shall be notice as to persons who had no dealing with the firm before the date of the dissolution or change so advertised. In **Rambhai & Co. (Uganda) Ltd. V Laiji Ranta and**

Another (1970) EA 106, It was held that as the second defendant had been introduced to the plaintiff as a partner in the firm express notice of his withdrawal was necessary and as this was never given the second defendant was liable. In the case, the words "apparent members" were interpreted to mean all members apparent to the person dealing with a firm. The Apparent member may be apparent by the fact that a person has had dealing with them before or by indirect information or by direct communication. The court further noted that No notice of retirement is necessary in order to prevent a partner, who not known to the person dealing with a firm to have been a partner, from becoming liable for debts contracted after his retirement. If a person dealing with a firm had not knowledge prior to the dissolution that the retiring partner had been a partner. The retiring partner is relieved from liability. See also **Tower Cabnet Co. Ltd v Ingram (1949) 1 ALL ER 1033.**

The estate of a partner who dies or who becomes bankrupt or of a partner, who, not having been known to the person dealing with the firm to be a partner, retires from the firm, is not liable for partnership debts contracted after the date of the death, bankruptcy or retirement respectively. See section 398 of the partnership Act. As such a partner is only liable for such obligations of the firm incurred while they are partners, unless otherwise agreed.

A partner may publicly notify the fact of dissolution or retirement to the other partners or the public after the dissolution of a partnership the authority for each partner to bind the firm and the other rights an obligations of the partner continue notwithstanding the dissolution so far as may be necessary to wind up the affairs of the partnership, and to complete transactions begun but unfinished at the time of the dissolution, but not otherwise. However, the firm is not bound by acts of a partner who has become bankrupt unless the other persons have represented themselves as partners of the bankrupt.

On the dissolution of a partnership, every partner is entitled as against the other partners in the firm and all persons claiming through them in respect of their interest as a partner, to have the property of the partnership applied in payment of the debts and liabilities of the firm, and to have the surplus assets after such payment applied in payment of what may be due to the partners respectively after deducting what may be due from them as partners to the firm.

Each partner is entitled at the time of dissolution to recover reasonably what they contributed towards the property of the partnership having to the terms of the partnership contract. In the event of dissolution of the partnership by reason of fraud of one partner, the partners not guilty of fraud are entitled by the person guilty of the fraud.

In some cases, the outgoing partner can share profits made after dissolution depending on the agreement between the partners.

Subject to any agreement between the parties, the amount due from surviving or continuing partners to an outgoing partner or the representatives of a deceased partner in respect of the outgoing or deceased partner's share is a debt accruing at the date of the dissolution or death.

Section 46 of the partnership Act contains rules for Distribution of assets on final settlement of accounts. In settling accounts between the partner after a dissolution of partnership, subject to any agreement, the losses, including losses and deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly, if necessary, by the persons individually in the proportion in which they were entitled to share profits. The assets of the firm, including the sum , if any, contributed by the partners to make up losses of deficiencies of capital, shall be applied in paying the debts and liabilities of the firm to the persons who are not partners; in paying each partner rateably what is due from the from to the partner for advances as distinguished from capital; In paying to each ratably what is due from the firm to the partner In respect of capital and ultimate residue, if any shall be divided among the partners in the proportion in which profits are divisible.

Read: Henry J, B Kendall & other v Peter Hamilton (1879) IV HL 504
Ram Rakha s/o Shandar Bootamal Horra v Shandar Bootamal Horra and others (1959) EA 981
Robinson v Geisel and others (1894) 2 Q. B. 685.

Limited Liability partnerships – see sections 47 – 59
Although limited liabilities partnerships have been introduced in Uganda by the partnership Act, 2010, Act 2 of 2010

Section 47 of the partnership Act, Provides, inter alia, that a limited liability partnership may be formed in the manner prescribed by this Act. A limited liability partnership shall consist of not more than twenty persons, and shall have one or more persons called general partners who shall be liable for all debts and obligation of the firm.
A limited liability partnership shall, in addition to general partners have one or more persons called limited liability partners who shall contribute a stated amount of capital to the firm, and shall not be liable for the debts or obligations of the firm beyond the amount of capital so contributed.

Under section 47(4) of the partnership Act, 2010 a limited liability partner shall not, during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his or her contributions to the partnership, and if a limited liability partner draw out or receives back any part of his or her contribution, He or she shall be liable for debts and obligation of the partnership up to the amount so drawn out or received back. In this respective, the liability of a limited liability partners is similar to that of a shareholder / member of a limited liability company.

Section 18 of the partnership Act, 2010requires a limited liability partnership to be registered with the registrar in accordance with section 50 and a limited liability partnership that is not registered shall be taken to be a general partnership and all it members general partners. A partnership registered as a limited liability partnership under section 50shall, at the end of its name; add the letters "LLP."

Pending registration of a limited liability, 2010 provides, the registrar of companies may on written application under the business Name Registration Act reserve a name for a period of thirty days and not exceeding sixty day. Such name should not be undesirable or deceptive. See section 49 partnerships Act, 2010.

Section 50 of the partnership Act, 2010 provides for particulars of registration of limited liability partnership. Under this section, the registration of a limited liability partnership shall be effected by delivering to the Registrar of companies a statement signed by the partners containing the name of the limited liability partnership; the general nature of the limited liability partnership's business ; the principle place of business of the limited liability partnership; the full names and address of each of the partners; the term, if any, for which the limited liability ; a description is entered into, and the date of its commencement; a statement that the partnership is limited; a description of the status of each partner, limited or general; and the sum contributed by each partner and the form in which it is so contributed upon receiving the above particulars and the prescribed fee for the registration, the registrar of companies then issue a certificate of registration of the limited liability partnership.

Section 51 of the partnership Act, 2010 requires that any changes in particulars of a limited liability partnership as specified in that section should be registers with the registrar. Such registration shall be by delivery of a statement signed but the firm specifying the nature of the change within ten days to the registrar and the registrar shall issue a certificate of change in particular to the firm. Contravention of this is an offence and each general partner shall, on conviction be liable to a fine not exceeding 0.5 currency points for each day during which the contravention continues.

The management of a limited liability partnership regulated by section 52 of the partnership Act, 2010 under this section, it is provided, inter alia, that a limited liability partner shall not take part in the management of the partnership business and shall not bind the firm. However, a limited liability partner may, upon fifty seven days' notice to the general partners, in person or by that partner's agent inspect the books of the firm and ascertain the state and prospects of the partnership business.

Where a limited liability partner takes part in the management of the partnership business, that partner shall be liable for all debts and obligations of the firm incurred while he or she takes part in the management as though he or she were a general partner.

Under section 52 (5) of the partnership Act, a limited liability partnership shall not be dissolved by the death or bankruptcy of a limited liability partner, and the mental incapacity of a limited partner shall not be a ground for dissolution of the partnership by the court unless the contribution of the limited liability partner who is mentally incapacitated cannot otherwise be ascertained and realized.

In case of the dissolution of a limited liability partnership. Its affairs shall not be wound up by the general partnership unless the court directs otherwise. See section 52 (6)

Under section 52 (7) of the partnership Act, 2010, subject to an agreement express or implied between or among the partners, any difference arising as to ordinary matter concerned with the partnership business may be decided by a majority of the general partners; a limited liability partner may, with the consent of the general partners , assigned his or her contribution in the partnership, and upon such assigned, the assignee shall become a limited partner with all the rights of the assignor; partners shall not be entitled; to dissolve the partnership by reason of any limited liability partner suffering his or her contribution to be charged for his or her separate debt; a general partner may be introduced as a limited liability partner without the consent of the of the existing limited liability partners; and a limited liability partner shall be entitled to dissolve the partnership by notice. This provision is in contract with aspects of a general partnership.

Under section 53 particular Act, 201, a limited liability partnership may be wound up under this Act, and all provision of this Act relating to winding up shall apply to a limited liability partnership with the exceptions and modifications provided for in this section. Subsection (2) therefore provided that a limited liability partnership shall not be thereof provides that a limited liability partnership shall not be wound up under this Act, Voluntarily or subject to the supervision of the court.

According to section 53 (3) of the partnership Act, 2010 the circumstances in which a limited liability partnership may be wound are – if the partnership is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs; if the partnership is unable to pay its debts; or if the court is of the opinion that it is just and equitable that the partnership should be wound up. Inability to pay debts is defined under section 53 (4) thereof.

Under section 54 of the partnership Act, Notice of any arrangement or transaction under which a general partner becomes a limited partner, or under which the contribution of a limited partner in the firm is assigned to any person shall immediately be advertised in the Gazette before any such arrangement or transaction comes into effect.

Statement filed by a limited liability partnership under this Act may be inspected by any person upon payment of a fee, not exceeding 0.5 of a currency point as the Minister may prescribe.

A limited liability partnership may be covered into a general partnership by surrendering the certificate of its registration to the registrar for cancellation. The registrar shall within fourteen days after the surrender of a certificate of registration publish the conversion in the *Gazette*. See section 56 (1) & (2) of the partnership Act, 2010. A limited partner who becomes a general partner after the conversion shall continue to be liable for any obligation incurred by the limited liability partnership before the conversion took effect; and shall be liable for any obligation of the general partnership that are incurred by the general partnership after the conversion.

Under section 56 (4) partnership Act, a general partnership may, subject to the provisions of the Act, Convert to a limited liability partnership under this Act by delivering to the Registrar a statement containing the particular specified in section 51. Upon receipt of the statement and upon payment of the prescribed fee, the registrar shall issue a certificate of registration to the person or firm delivering the statement. A general partner who becomes a limited liability partner shall, after the conversion to a limited liability partnership, continue to be liable for any obligations incurred by the general partnerships before the conversion.

According to section 57, conversion from one of the partnerships to another under this Act shall not affect any action or proceedings pending in court for or against the converting partnership; and the action or proceedings may be continued as if the conversion did not take place.

Section 58 of the partnership Act 2010 provided that the provisions of the law relating to winding up of the unregistered company under the companies Act shall apply, with necessary modifications, to the winding up of a partnership under this Act.

It should be noted that the applicant of the provision of the partnership Act, 2010, in relation to limited liability partnership is yet to be tested in the courts of law and general practice as they are still fairly new

7.0 LAW OF TORTS AND PROFESSIONAL NEGLIGENCE

UNIT 7 OVERVIEW

- Tort and other wrongs
- Types of Torts
- Other aspects of law of Torts

7.1 TORT AND OTHER WRONGS

The law gives various rights to persons. When such a right is infringed the wrongdoer is liable in tort.

7.1.1 Tort

Tort is distinguished from other legal wrongs.

(a) It is not a breach of contract, where the obligation which is alleged to have been breached arose under an agreement between two parties.

(b) It is not a crime, where the object of proceedings is to punish the offender rather than compensate the victim.

7.1.2 Key Terms:

A tort is a civil wrong and the person wronged sues in a civil court for compensation or an injunction. The claimant's claim generally is that they have suffered a loss such as personal injury at the hands of the defendant and the defendant should pay damages.

In tort no previous transaction or contractual relationship need exist: the parties may be complete strangers; such as when a motorist knocks down a pedestrian in the street. The claim in tort is based on the general law of duties and rights.

7.2 TYPES OF TORT

The two main types of tort that you need to understand for your exam are 'passing-off' and negligence.

1.2.1 'Passing-off'

Passing-off is the use of a name, mark or description by one business that misleads a consumer to believe that their business is that of another. This tort often occurs when expensive 'designer' products such as watches or clothing are copied and sold as 'originals' to unsuspecting customers.

The development of the Internet has seen the routine selling of domain names to those who wish to buy them. This has created the opportunity for individuals to set up a website that has the intention of mimicking an established brand and stealing their customers.

The issue of what is misleading under the tort of passing-off has been the subject of numerous cases, but it appears that the businesses do have to be very similar indeed. In Stringfellow v McCain Foods GB 1984 the owner of a famous nightclub failed to prevent a manufacturer of long, thin oven chips from calling their product by the same name. When Midland Bank in the UK rebranded as HSBC they were subject to a passing-off claim from the long established HFC Bank. The case failed on the grounds of there being insufficient chance of public confusion: HFC Bank v Midland Bank 2000.

7.2.1 Negligence

In simple terms, negligence is the carelessness of an individual or company which causes damage (physical or financial) to the claimant. Negligent acts tend to be inadvertent or reckless, but not normally intentional.

7.3 THE TORT OF NEGLIGENCE

Negligence is the most important modern tort. To succeed in an action for negligence the claimant must prove that:

- The defendant had a duty of care to avoid causing injury, damage or loss
- There was a breach of that duty by the defendant
- In consequence the claimant suffered injury, damage or loss

7.3.1 Definition

There is a distinct tort of negligence which is causing loss by a failure to take reasonable care when there is a duty to do so. This is the most important and far reaching modern tort.

The term negligence is used to describe carelessly carrying out an act and breaking a legal duty of care owed to another causing them loss or damage.

7.4 LIABILITY

Any legal person can commit and therefore be liable for a tort providing the three stage test is passed. This includes, for example, a car driver who injures a pedestrian, or a company that causes death or injury to a customer. Also, an employer can be vicariously liable for the acts of an employee. This means an employer may be liable for loss or damage caused by an employee, providing the acts were committed whilst the employee was performing the duties they were employed to do.

7.5 DUTY OF CARE

In the landmark case of Donoghue v Stevenson 1932 the House of Lords ruled that a person might owe a duty of care to another with whom they had no contractual relationship at all. The doctrine has been refined in subsequent rulings, but the principle is unchanged.

7.6 The basic rule

The question of whether or not a duty of care exists in any situation is generally decided by the courts on a case by case basis, with each new case setting a precedent based on its own particular facts.

In the case described below, the House of Lords was attempting to establish a general duty that could be applied to all subsequent cases and situations.

Donoghue v Stevenson 1932

The facts: A purchased a bottle of ginger beer for consumption by B. B drank part of the contents, which contained the remains of a decomposed snail, and became ill. The manufacturer argued that as there was no contract between himself and B he owed her no duty of care and so was not liable.

Decision: The House of Lords laid down the general principle that every person owes a duty of care to his 'neighbour', to 'persons so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected'.

7.7 DEVELOPMENT OF THE DOCTRINE

This narrow doctrine has been much refined over the years since the snail made its celebrated appearance. For any duty of care to exist, it was stated in Anns v Merton London Borough Council 1977 that two stages must be tested:

- Is there sufficient proximity between the parties, such that the harm suffered was reasonably foreseeable?
- Should the duty be restricted or limited for reasons of economic, social or public policy?

The latest stage in the doctrine's development came in Caparo Industries plc v Dickman 1990 that established a three stage test for establishing a duty of care that still stands:

- Was the harm reasonably foreseeable?
- Was there a relationship of proximity between the parties?
- Considering the circumstances, is it fair, just and reasonable to impose a duty of care?

7.8 BREACH OF DUTY OF CARE

The second element that must be proven by a claimant in an action for negligence is that there was a breach of the duty of care by the defendant.

7.9 The basic rule

Breach of duty of care is the second issue to be considered in a negligence claim. The standard of reasonable care requires that the person concerned should do what a reasonable man would do, and should not do what a reasonable man would not do: Blyth v Birmingham Water Works 1856. This will also mean the reasonable employer, or the reasonable adviser.

The following factors should be considered when deciding if a duty of care has been breached:

(a) Probability of injury

It is presumed that a reasonable man takes greater precautions when the risk of injury is high: Bolton v Stone 1951. Therefore when the risk is higher the defendant must do more to meet their duty. In Glasgow Corporation v Taylor 1992 a local authority was held to be negligent when children are poisonous berries in a park. A warning notice was not considered to be sufficient to protect children.

(b) Seriousness of the risk

The young, old or disabled may be prone to more serious injury than a fit able-bodied person. The **'egg-shell skull'** rule means that you must take your victim as they are. Where the risk to the vulnerable is high, the level of care required is raised: *Smith v Leech Brain & Co 1962.*

Paris v Stepney Borough Council 1951

The facts: P was employed by K on vehicle maintenance. P had already lost the sight of one eye. It was not the normal practice to issue protective goggles since the risk of eye injury was small. A chip of metal flew into P's good eye and blinded him.

Decision: There was a higher standard of care owed to P because an injury to his remaining good eye would blind him.

(c) Issues of practicality and cost
It is not always reasonable to ensure all possible precautions are taken. Where the **cost** or **disruption** caused to eliminate the danger far **exceeds the risk** of it occurring it is likely that defendants will be found not to have breached their duty if they do not implement them.

Latimer v AEC Ltd 1952

The facts: The defendants owned a factory that become flooded after a period of heavy rain. The water mixed with oil on the factory floor causing it to become very slippery. Sawdust was applied to the majority of the areas affected, but the claimant slipped on one of the few areas that was not treated.

Decision: The defendant did all that was necessary to reduce the risk to its employees and was not held liable. The only other option was to close the factory, however no evidence could be provided that would indicate a reasonable employer would have taken that course of action. Closing the factory would have outweighed the risk to the employees.

(d) Common practice

Where an individual can prove their actions were in line with **common practice** or **custom** it is likely that they would have met their duty of care. This is unless the common practice itself is found to be negligent.

(e) Social benefit

Where an action is of some benefit to society, defendants may be protected from liability even if their actions create risk. For example, a fire engine that speeds to a major disaster provides a social benefit that may outweigh the greater risk to the public.

(f) Professions and skill

Persons who hold themselves out to possess a particular skill should be judged on what a reasonable person possessing the same skill would do in the situation rather than that of a reasonable man. Professions are able to set their own standards of care for their members to meet and therefore members should be judged against these standards rather than those laid down by the courts.

4.2 Res ipsa loquitur

In some circumstances the claimant may argue that the **facts speak for themselves** (*res ipsa loquitur*) – want of care being the only possible explanation for what happened, negligence on the part of the defendant must be presumed.

Res ipsa loquitur can be defined as: 'The thing speaks for itself'. If an accident occurs which appears to be most likely caused by negligence, the court may apply this maxim and infer negligence from mere proof of the facts. The burden of proof is reversed and the defendant must prove that they were not negligent.

The **claimant must demonstrate** the following to rely on this principle:

(a) The thing which caused the injury was under the **management and control** of the defendant.
(b) The accident was such that it would not occur if those in control used **proper care**. Therefore in *Richley v Fould 1965* the fact that a car skidded to the wrong side of the road was enough to indicate careless driving.

Example

In *Mahon v Osborne 1939* a surgeon was required to prove that leaving a swab inside a patient after an operation was not negligent.

7.10 CAUSALITY AND REMOTENESS OF DAMAGE

Finally the claimant must demonstrate that they suffered injury or loss as a **result** of the breach.

7.10.1 Damage or loss

This is the third element of a negligence claim. A claim for compensation for negligence will not succeed if **damage** or **loss** is not proved. A person will only be compensated if they have suffered actual loss, injury, damage or harm **as a consequence** of another's actions. Examples of such loss may include:

- Personal injury
- Damage to property
- Financial loss which is directly connected to personal injury, for example, loss of earnings
- Pure financial loss is rarely recoverable

7.10.2 Pure financial loss

Pure financial loss, also known as **economic loss,** is loss which is **unconnected with physical damage**.
It is not usually recoverable. For example in *Spartan Steel and Alloys Ltd v Martin & Co Ltd 1973* it was held that general loss of profits due to interruption caused by a prolonged loss of power to a manufacturing plant as a whole was not recoverable. However, the claimants were able to recover losses from physical damage to a particular furnace, and loss of profit on the damaged products in the furnace, which occurred as a direct result of power being unexpectedly cut.

7.10.3 The 'But for' test

To satisfy the requirement that harm must be caused by another's actions, the **'But for' test** is applied. The claimant must prove that if it was not 'but for' the other's actions they would not have suffered damage. Therefore claimants are **unable** to claim for any harm that would have happened to them **anyway** irrespective of the defendant's actions.

Barnett v Chelsea and Kensington HMC 1969

The facts: A casualty doctor sent a patient home without treatment, referring him to his own doctor. The patient died of arsenic poisoning.

Decision: Whilst the doctor was held negligent, the negligence did not cause the patient's death because he would have died anyway.

7.10.4 Multiple causes

The courts often have difficulty in determining **causation** where there are a number of possible causes of injury including the negligent act. The courts must decide on the **facts** if the negligent act was the one that most likely caused the injury.

Wilsher v Essex AHA 1988

The facts: A premature baby suffered blindness after birth. It was claimed that a doctor failed to notice that the baby received high doses of oxygen and this caused the blindness.

Decision: Evidence was provided that there was six possible causes of the blindness including the one claimed. However, the court could not ascertain which of the six actually occurred and therefore could not create a direct causal link.

The case below indicates the court's flexibility when applying legal principles in exceptional cases.

Fairchild v Glenhaven Funeral Services Ltd & Others 2002

The facts: The claimants all contracted a disease caused by contact with asbestos over extended periods of time with several different employers. The defence claimed that the disease could be contracted by exposure to one asbestos fibre and as the claimants were employed by a number of employers it could not be established at which employer they contracted the disease.

Decision: The House of Lords held that all the employers (who had failed to take reasonable care), contributed to the cause and were all liable.

7.10.5 Novus actus interveniens

Courts will only impart liability where there is a cause of events that are a probable result of the defendant's actions. Defendant's will not be liable for damage when the chain of events is broken. There are three types of intervening act that will break the chain of causation.

7.10.6 Act of the claimant

The actions of the claimant themselves may break the chain of causation. The rule is that where the act is reasonable and in the ordinary course of things an act by the claimant will not break the chain.

McKew v Holland, Hannen and Cubbitts (Scotland) Ltd 1969

The facts: The claimant had a leg injury which was prone to causing his leg to give way from time to time. Whilst at work he failed to ask for assistance when negotiating a flight of stairs. He fell and was injured as a result.

Decision: The fact that the claimant failed to seek assistance was unreasonable and was sufficient to break the chain of causality.

7.10.7 Act of a third party

Where a third party intervenes in the course of events the defendant will normally only be liable for damage **until** the intervention. For example, in *Knightley v Johns 1982* the defendant caused a road traffic accident. A police inspector negligently handled traffic control following the accident. This negligence led to the claimant, a police officer, being killed. The defendant who caused the accident successfully argued that the negligent handling by the police inspector broke the chain of causation between his negligence and the death of the officer.

Lamb v Camden LBC 1981

The facts: The defendant negligently caused a house to be damaged, and as a result it had to be vacated until it could be repaired. During the vacant period, squatters took up residence and the property suffered further damage.

Decision: Intrusion by squatters was a possibility that the defendant should have considered, but it was not held to be a likely event. Therefore the defendant should not be liable for the additional damage caused by the intervening actions of the squatters.

7.10.8 Natural events

The chain of causality is not automatically broken due to an intervening natural event. In situations where the breach puts the claimant at risk of additional damage caused by a natural event the chain will not be broken. However, where the natural event is unforeseeable, the chain will be broken.

Carslogie Steamship Co Ltd v Royal Norwegian Government 1952

The facts: A ship owned by the claimants was damaged as a result of the defendant's negligence and required repair. During the trip to the repair site the ship was caught in severe weather conditions that resulted in additional damage being caused and therefore a longer repair time was required. The claimants claimed loss of charter revenue for the period the ship was out of action for repairs caused by the original incident.

Decision: The House of Lords held that the defendants were liable for loss of profit suffered as result of the defendants' wrongful act only. Whilst undergoing repairs, the ship ceased to be a profit-earning machine as the weather damage had rendered her unseaworthy. The weather conditions created an intervening act and the claimants had sustained no loss of profit due to the ship being out of action as it would have been unavailable for hire anyway due to the weather damage.

7.10.9 Remoteness of damage

Even where causation is proved, a negligence claim can still fail if the damage caused is *'too remote'*. The test of reasonable foresight developed out of *The Wagon Mound (1961)*. Liability is limited to damage that a reasonable man could have foreseen. This does not mean the exact event must be foreseeable in detail, just that the eventual outcome is foreseeable.

The Wagon Mound 1961

The facts: A ship was taking on oil in Sydney harbour. Oil was spilled onto the water and it drifted to a wharf 200 yards away where welding equipment was in use. The owner of the wharf carried on working because he was advised that the sparks were unlikely to set fire to furnace oil. Safety precautions were taken. A spark fell onto a piece of cotton waste floating in the oil, thereby starting a fire which damaged the wharf. The owner of the wharf sued the charterers of the Wagon Mound.

Decision: The claim must fail. Pollution was the foreseeable risk: fire was not.

The House of Lords decided in the case of *Jolley v London Borough of Sutton 2000* that the remoteness test can be passed if **some** harm is foreseeable even if the exact nature of the injuries could not be.

Jolley v London Borough of Sutton 2000

The facts: The defendants should have removed a boat which had been dumped two years previously. A teenage boy was injured while attempting to repair it.

Decision: Even though the precise incident was not foreseeable, the authority should have foreseen that some harm could be caused since they knew children regularly played on the abandoned boat.

7.11 DEFENCES TO NEGLIGENCE

The amount of damages awarded to the claimant can be reduced if it is shown that they contributed to their injury. The defendant can be exonerated from paying damages if it can be proved that the claimant expressly or impliedly consented to the risk. In employment situations, an employer may be held vicariously liable for the actions of their employee.

7.11.1 Contributory negligence

A court may **reduce** the amount of damages paid to the claimant if the defendant establishes that they contributed to their own injury or loss, this is known as contributory negligence.

Sayers v Harlow UDC 1958

The facts: The claimant was injured whilst trying to climb out of a public toilet cubicle that had a defective lock.

Decision: The court held that the claimant had contributed to her injuries by the method by which she had tried to climb out.

If the defendant proves that the claimant was at least **partially** at fault, courts will reduce the damages awarded to them by a **percentage** that is **just** and **reasonable**. This percentage is calculated according to what is established as the **claimant's share of the blame**. This is typically in the range of 10% to 75%, however it is possible to reduce the claim by up to 100%.

In ***Fitzgerald v Lane & Patel 1989*** the claimant crossed the road whilst the lights were at red for pedestrians. The first defendant driver collided with him and the claimant was thrown from the bonnet of that car into the road, where he was run over by a car driven by the second defendant. The claimant suffered severe spinal injuries that led to partial paralysis, but it could not be proven which impact caused the paralysis. In awarding damages the House of Lords attributed blame in the proportion of 50% against the claimant and 25% each against the two speeding drivers. Damages were thus awarded in those relative proportions.

7.11.2 Volenti non fit injuria

Where a defendant's actions carry the risk of a tort being committed they will have a defence if it can be proved that the claimant consented to the risk. *Volenti non fit injuria* literally means the voluntary acceptance of the risk of injury.

This defence is available to the defendant where both parties have expressly consented to the risk (such as waiver forms signed by those taking part in dangerous sports), or it may be implied by the conduct of the claimant.

ICI v Shatwell 1965

The facts: The claimant and his brother disregarded safety precautions whilst using detonators, resulting in injury to the claimant.

Decision: The court upheld the defence of *volenti non fit injuria*. The claimant disregarded his employer's statutory safety rules and consented to the reckless act willingly.

An awareness of the risk is not sufficient to establish consent. For this defence to be successful the defendant must prove that the claimant was fully informed of the risks and that they consented to them.

This point was made in *Dann v Hamilton 1939* where a girl passenger in a car driven by a drunk driver was injured. The defendant established that she was aware of the risk but could offer no evidence that she consented to it. As a result of this case the defence of *volenti* is unlikely to succeed in cases where consent is implied.

7.11.3 carious liability

In employment situations, an employee can avoid liability for negligence if they were acting on their employer's business at the time of the incident. For the employer to be vicariously liable, the employee must have been following their employer's instructions, even if the manner of how they were carrying them out was not how the employer told them to.

In *Limpus v London General Omnibus Co (1862)* a bus company was found vicariously liable for a bus driven negligently by a bus driver against their instructions. However, in *Beard v London General Omnibus Co (1900),* the bus company was not found vicariously liable where a bus conductor (who was not authorised to drive a bus) drove a bus negligently. In that case, the employee was held liable.

7.12 PROFESSIONAL ADVICE

Professional individuals and organisations have a special relationship with their clients and those who rely on their work. This is because they act in an expert capacity.

7.12.1 Development

We shall now turn our attention to how the law relating to negligent professional advice, and in particular auditors, has been developed through the operation of precedent, being refined and explained with each successive case that comes to court. It illustrates the often step-by-step development of English law, which has gradually refined the principles laid down in *Donoghue v Stevenson* and *Anns v Merton London Borough Council* to cover negligent misstatements which cause pure financial loss.

7.12.2 The special relationship

Before 1963, it was held that any liability for careless statements was limited in scope and depended upon the existence of a contractual or fiduciary relationship between the parties. Lord Denning's tests of a further (later termed 'special') relationship were laid down in the Court of Appeal in his dissenting judgement on *Candler v Crane, Christmas & Co 1951*.

According to Lord Denning, to establish a special relationship the person who made the statement must have done so in some professional or expert capacity which made it likely that others would rely on what they said. This is the position of an adviser such as an accountant, banker, solicitor or surveyor.

It follows that a duty could not be owed to complete strangers, but Lord Denning also stated at the time: 'Accountants owe a duty of care not only to their own clients, but also to all those whom they know will rely on their accounts in the transactions for which those accounts are prepared.' This was to prove a significant consideration in later cases.

However, Lord Denning's view was a dissenting voice in 1951 in the *Candler* case, where the Court of Appeal held that the defendants were not liable (for a bad investment based upon a set of negligently prepared accounts) because there was no direct contractual or fiduciary relationship with the claimant investor.

It was 12 years later that the special relationship was accepted as a valid test. Our starting point is a leading case (*Hedley*) on negligent misstatement which was the start of a new judicial approach to cases involving negligent misstatement. You must make sure that you are familiar with it.

Hedley Byrne & Co Ltd v Heller and Partners Ltd 1963

The facts: HB were advertising agents acting for a new client, Easipower Ltd. HB requested information from Easipower's bank (HP) on its financial position. HP returned non-committal replies, which expressly disclaimed legal responsibility, and which were held to be a negligent misstatement of Easipower's financial resources.

Decision: While HP were able to avoid liability by virtue of their disclaimer, the House of Lords went on to consider whether there ever could be a duty of care to avoid causing financial loss by negligent misstatement where there was no contractual or fiduciary relationship. It decided (as *obiter dicta*) that HP were guilty of negligence having breached the duty of care, because a special relationship did exist. Had it not been for the disclaimer, a claim for negligence would have succeeded.

As you already know, *obiter dicta* such as those made in 1963 do not form part of the *ratio decidendi*, and are not inding on future cases. They will, however, be **persuasive**.

Note that at the time liability did not extend to those who the advisor might merely **foresee as a possible user** of the statement.

However in a subsequent case, the courts extended potential liability, and started to take account of third parties not known to the adviser. The following case echoed the principles laid down in *Anns* and addressed the question of **reasonable foresight** being present to create a duty of care.

JEB Fasteners Ltd v Marks, Bloom & Co 1982

The facts: The defendants, a firm of accountants, prepared an audited set of accounts showing overvalued stock and hence inflated profit. The auditors knew there were liquidity problems and that the company was seeking outside finance. The claimants were shown the accounts; they took over the company for a nominal amount, since by that means they could obtain the services of the company's two directors. At no time did MB tell JEB that the stock value was inflated. With the investment's failure, JEB sued MB, with the following claims.

(a) The accounts had been prepared negligently.
(b) They had relied on those accounts.
(c) They would not have invested had they been aware of the company's true position.
(d) MB owed a duty of care to all persons whom they could reasonably foresee would rely on the accounts.

Decision: Even though JEB had relied on the accounts (b), they would not have acted differently if the true position had been known (c), since they had really wanted the directors and not the company.

Hence the accountants were not the cause of the consequential harm and were not liable. Significantly (although this did not affect the decision as to liability) it was the judge's view that MB did indeed owe a duty of care through foresight (d) and had been negligent in preparing the accounts (a).

Decisions since *JEB Fasteners* have, however, shied away from the foresight test and gone back to looking at whether the adviser has knowledge of the user and the use to which the statement will be put.

7.13 The Caparo decision

The Caparo case is fundamental to understanding professional negligence. It was decided that auditors do not owe a duty of care to the public at large or to shareholders increasing their stakes in the company in question.

This important and controversial case made considerable changes to the tort of negligence as a whole, and the negligence of professionals in particular. It set a precedent which forms the basis for courts when considering the liability of professional advisers.

Caparo Industries plc v Dickman and Others 1990

The facts: Caparo, which already held shares in Fidelity plc, bought more shares and later made a takeover bid, after seeing accounts prepared by the defendants that showed a profit of £1.3m. Caparo claimed against the directors and the auditors for the fact that the accounts should have shown a loss of £400,000.
The claimants argued that the auditors owed a duty of care to investors and potential investors in respect of the audit. They should have been aware that a press release stating that profits would fall significantly had made Fidelity vulnerable to a takeover bid and that bidders might well rely upon the accounts.

Decision: The auditor's duty did not extend to potential investors nor to existing shareholders increasing their stakes. It was a duty owed to the body of shareholders as whole.

In the *Caparo* case the House of Lords decided that there were **two** very different situations facing a person giving professional advice.

(a) Preparing information in the knowledge that a **particular person** was contemplating a transaction and would rely on the information in deciding whether or not to proceed with the transaction (the 'special relationship').

(b) Preparing a statement for **general circulation**, which could forseeably be relied upon by persons unknown to the professional for a variety of different purposes.

It was held therefore that a public company's auditors owe **no duty of care to the public at large** who rely on an audit report when deciding to invest – and, in purchasing additional shares, an existing shareholder is in no different position to the public at large.

In *MacNaughton (James) Papers Group Ltd v Hicks Anderson & Co 1991*, it was stated that it was necessary to examine each case in the light of the following.

- Foreseeability
- Proximity
- Fairness

This is because there could be no single overriding principle that could be applied to all individual cases. Lord Justice Neill set out the matters to be taken into account in considering this.

- The purpose for which the statement was made
- The purpose for which the statement was communicated
- The relationship between the maker of the statement, the recipient and any third party
- The size of any class to which the recipient belonged
- The state of knowledge of the maker
- Any reliance by the recipient

7.13.1 Non-audit role

The duty of care of accountants is held to be higher when advising on takeovers than when auditing. The directors and financial advisors of the target company in a contested takeover bid owe a duty of care to a known takeover bidder in respect of express representations made about financial statements prepared for the purpose of contesting the bid on which they knew the bidder would rely: *Morgan Crucible Co plc v Hill Samuel Bank Ltd and others 1991*.

7.13.2 The law since Caparo

A more recent case highlighted the need for a cautious approach and careful evaluation of the circumstances when giving financial advice, possibly with the need to issue a disclaimer.

ADT Ltd v BDO Binder Hamlyn 1995

The facts: Binder Hamlyn was the joint auditor of BSG. In October 1989, BSG's audited accounts for the year to 30 June 1989 were published. Binder Hamlyn signed off the audit as showing a true and fair view of BSG's position. ADT was thinking of buying BSG and, as a potential buyer, sought Binder Hamlyn's confirmation of the audited results. In January 1990, the Binder Hamlyn audit partner attended a meeting with a director of ADT. This meeting was described by the judge as the 'final hurdle' before ADT finalized its bid for BSG. At the meeting, the audit partner specifically confirmed that he 'stood by' the audit of October 1989. ADT proceeded to purchase BSG for £105m. It was subsequently alleged that BSG's true value was only £40m. ADT therefore sued Binder Hamlyn for the difference, £65m plus interest.

Decision: Binder Hamlyn assumed a responsibility for the statement that the audited accounts showed a true and fair view of BSG which ADT relied on to its detriment. Since the underlying audit work had been carried out negligently, Binder Hamlyn was held liable for £65m. The courts expect a higher standard of care from accountants when giving advice on company acquisitions since the losses can be so much greater.

This situation was different from *Caparo* since the court was specifically concerned with the **purpose of the statement made at the meeting**. Did Binder Hamlyn **assume any responsibility** as a result of the partner's comments? The court decided that it did. The court did not need to consider the question of duty to individual shareholders, because *Caparo* had already decided that there was none. Following the *ADT* case, another case tested the court's interpretation.

NRG v Bacon and Woodrow and Ernst & Young 1996

The facts: NRG alleged that the defendants had failed to suggest the possibility that certain companies it was targeting might suffer huge reinsurance losses. They had also failed to assess properly whether these losses could be protected against, because defective actuarial methods had been used. As a result, it overpaid for these companies by £255m.

Decision: The judge observed that accountants owe a higher standard of care when advising on company purchases, because the potential losses are so much greater, following *ADT*. However, applying this higher standard of care to the facts, it was decided that NRG had received the advice that any competent professional would have given, because the complex nature of the losses that the companies were exposed to were not fully understood at the time. In addition, the use of defective actuarial methods had not led directly to the losses, because NRG would have bought the companies anyway.

There have been some other **important clarifications** of the law affecting accountants' liability in the area of responsibility towards non-clients. The following two cases both concern auditors' liability to group companies.

Barings plc v Coopers & Lybrand 1997

The facts: Barings collapsed in 1995 after loss-making trading by the general manager of its Singapore subsidiary, BFS. BFS was audited by the defendant's Singapore firm, which provided Barings directors with consolidation schedules and a copy of the BFS audit report. The defendant tried to argue that there was no duty of care owed to Barings, only to BFS.

Decision: A duty of care was owed to Barings, as the defendants must have known that their audit report and consolidation schedules would be relied upon at group level.

BCCI (Overseas) Ltd v Ernst & Whinney 1997

The facts: In this case, the defendants audited the group holding company's accounts, but not those of the claimant subsidiary. The claimant tried to claim that the defendants had a duty of care to them.

Decision: No duty of care was owed to the subsidiary because no specific information is normally channelled down by a holding company's auditor to its subsidiaries.

An auditor’s responsibility can be extended to other parties in limited circumstances. In *Law Society v KPMG Peat Marwick 2000* it was held that an accountant who reported on a solicitor’s client accounts owed a duty to the solicitor’s regulator as well as to the solicitor. This is because a solicitor is legally and professionally required to obtain an accountant’s report on their client accounts by their regulator (then the Law Society, now the Solicitors Regulation Authority), and the regulator may be liable to pay compensation to clients of a solicitor who has mismanaged their accounts.

UK accountancy firms have been investigating ways of limiting liability in the face of increasing litigation. KPMG, for example, incorporated its audit practice in 1995.

In 2000, the Limited Liability Partnerships Act 2000 was passed, and limited liability partnerships have been permitted under law since 2001. This protects the partners of accountancy firms from the financial consequences of negligent actions as their liability to third parties (previously unlimited) can now be limited.

In Uganda, the partnership Act 2010, Act 2 of the Laws of Uganda has also tried to incorporate the same provisions to protect partners of accountancy firms in Uganda from the financial consequences of negligent actions of third parties.

PART C

COMPANY LAW

8.0 INCORPORATION AND CLASSIFICATION OF COMPANIES

UNIT 8 OVERVIEW:

- Introduction.
- Classification & distinction of companies.
- Procedure for registering a company.
- Certificate of Incorporation.
- Commencement of Business.

1 SOLE TRADERS' AND COMPANIES' LEGAL IDENTITIES

In a **sole tradership**, there is no legal distinction between the individual and the business.

1.1 Sole traders

A sole trader owns and runs a business. They contribute capital to start the enterprise, run it with or without employees, and earn the profits or stand the losses of the venture.

Sole traders are found mainly in the retail trades (local newsagents), small scale service industries (plumbers), and small manufacturing and craft industries. An accountant may operate as a sole trader.

1.2 Legal status of the sole trader

Whilst the business is a separate accounting entity the business is not legally distinct from the person who owns it. In law, the person and the business are viewed as the same entity.

The advantages of being a sole trader are as follows.

(a) No formal procedures are required to set up in business. However, for certain classes of business a licence may be required (eg retailing wines and spirits), and VAT registration is often necessary.

(b) Independence and self-accountability. A sole trader does not need consult anybody about business decisions and is not required to reveal the state of the business to anyone (other than the tax authorities each year).

(c) Personal supervision of the business by the sole trader should ensure its effective operation. Personal contact with customers may enhance commercial flexibility.

(d) All the profits of the business accrue to the sole trader. This can be a powerful motivator, and satisfying to the individual whose ability/energy results in reward.

The disadvantages of being a sole trader include the following.

(a) If the business gets into debt, a sole trader's personal wealth (for example, private house) might be lost if the debts are called in, as they are the same legal entity.

(b) Expansion of the business is usually only possible by ploughing back the profits of the business as further capital, although loans or overdraft finance may be available.

(c) The business has a high dependence on the individual which can mean long working hours and difficulties during sickness or holidays.

(d) The death of the proprietor may make it necessary to sell the business in order to pay the resulting tax liabilities, or family members may not wish to continue the business anyway.

(e) The individual may only have one skill. A sole trader may be, say, a good technical engineer or craftsman but may lack the skills to market effectively or to maintain accounting records to control the business effectively.

(f) Other disadvantages include lack of diversification, absence of economies of scale and problems of raising finance.

1.3 Companies

A company has a legal personality separate from its owners (known as members). It is a formal arrangement, surrounded by formality and publicity, but its chief advantage is that members' liability for the company's debts is typically limited.

A company is the most popular form of business association and by its nature, it is more formal than a partnership or a sole trader. There is often substantially more legislation on the formation and procedures of companies than any other business association.

The key reason why the company is a popular form of business association is that the liability of its members to contribute to the debts of the entity is significantly limited. For many people, this benefit outweighs the disadvantage of the formality surrounding companies, and encourages them not to trade as sole traders or (unlimited) partnerships.

1.4 Definition of a company

For the purposes of this Study Text, a company is an entity registered as such under the Companies Act Cap 110 of the Laws of Uganda.

The key feature of a company is that it has a legal personality (existence) distinct from its members and directors.

1.5 Legal personality

A person possesses legal rights and is subject to legal obligations. In law, the term 'person' is used to denote two categories of legal person.

- An individual human being is a natural person. A sole trader is a natural person, and there is legally no distinction between the individual and the business entity in sole tradership.
- The law also recognises artificial persons in the form of companies and limited partnerships. Unlimited partnerships are not artificial persons.

Corporate personality is a common law principle that grants a company a legal identity, separate from the members who comprise it. It follows that the property of a company belongs to that company, debts of the company must be satisfied from the assets of that company, and the company has perpetual succession until wound up.
A corporation is a legal entity separate from the natural persons connected with it, for example as members or directors.

2 Limited liability of members

The fact that a company's members – not the company itself – have limited liability for its debts protects the members from the company's creditors and ultimately from the full risk of business failure.

A key consequence of the fact that the company is distinct from its members is that its members have limited liability.

Limited liability is a protection offered to members of certain types of company. In the event of business failure, the members will only be asked to contribute identifiable amounts to the assets of the business.

2.1 Protection for members against creditors

The company itself is liable without limit for its own debts. If the company buys plastic from another company, for example, it owes the other company money.

Limited liability is a benefit to members. They own the business, so might be the people whom the creditors logically ask to pay the debts of the company if the company is unable to pay them itself.

Limited liability prevents this by stipulating the creditors of a limited company cannot demand payment of the company's debts from members of the company.

2.2 Protection from business failure

As the company is liable for all its own debts, limited liability only becomes an issue in the event of a business failure when the company is unable to pay its own debts.

This will result in the winding up of the company and enables the creditors to be paid from the proceeds of any assets remaining in the company. It is at winding up that limited liability becomes most relevant.

2.3 Members asked to contribute identifiable amounts

Although the creditors of the company cannot ask the members of the company to pay the debts of the company, there are some amounts that members are required to pay in the event of a winding up.

Type of company	Amount owed by member at winding up
Company limited by shares	Any outstanding amount from when they originally purchased their shares from the company If the member's shares are fully paid, they do not have to contribute anything in the event of a winding up.
Company limited by guarantee	The amount they guaranteed to pay in the event of a winding up

2.4 Liability of the company for tort and crime

As a company has a separate legal identity, it may also have liabilities in tort and crime. Criminal liability of companies in particular is a topical area but, is outside the scope of your syllabus.

3 Types of company

Most companies are those incorporated under the Companies Act. However there are other types of company such as corporations sole, chartered corporations, statutory corporations and community interest companies.

Corporations are classified in one of the following categories.

Categories	Description
Corporations sole	A corporation sole is an official position which is filled by one person who is replaced from time to time. The Public Trustee and the Treasury Solicitor are corporations sole.
Chartered corporations	These are usually charities or bodies such as the Institute of Certified Public Accountants of Uganda (ICPAU), formed by an Act of Parliament.
Statutory corporations	Statutory corporations are formed by special Acts of Parliament. This method is little used now, as it is slow and expensive. It was used in the nineteenth century to form railway and canal companies.
Registered companies	Registration under the Companies Act is the normal method of incorporating a commercial concern. Anybody of this type is properly called a company.
Community Interest Companies (CICs)	A special form of company for use by 'social' enterprises pursuing purposes that are beneficial to the community, rather than the maximisation of profit for the benefit of owners, created by the Companies (Audit, Investigation and Community Enterprise) Act 2012.

3.1 Limited companies

The meaning of limited liability has already been explained. It is the member, not the company, whose liability for the company's debts may be limited.

3.1.1 Liability limited by shares

Liability is usually limited by shares. This is the position when a company which has share capital states in its constitution that 'the liability of members is limited'.

3.1.2 Liability limited by guarantee

Alternatively a company may be limited by guarantee. Its constitution states the amount which each member undertakes to contribute in a winding up (also known as a liquidation). A creditor has no direct claim against a member under their guarantee, nor can the company require a member to pay up under their guarantee until the company goes into liquidation.

Companies limited by guarantee are appropriate to non-commercial activities, such as a charity or a trade association which is non-profit making but wishes to have a form of reserve capital if it becomes insolvent. They do not have share capital.

3.2 Unlimited liability companies

An unlimited liability company is a company in which members do not have limited liability. In the event of business failure, the liquidator can require members to contribute as much as may be required to pay the company's debts in full.

An unlimited company can only be a private company, by definition a public company is always limited.
An unlimited company need not file a copy of its annual accounts and reports with the Registrar, unless during the relevant accounting reference period:

a) It is (to its knowledge) a subsidiary of a limited company.
b) Two or more limited companies have exercised rights over the company, which (had they been exercised by only one of them) would have made the company a subsidiary of that one company.
c) It is the parent company of a limited liability company.

The unlimited company certainly has its uses. It provides a corporate body (a separate legal entity) which can conveniently hold assets to which liabilities do not attach.

3.3 Public and private companies

A company may be private or public. Only the latter may offer its share to the public.

A public company is a company whose constitution states that it is public and that it has complied with the registration procedures for such a company.

A private company is a company which has not been registered as a public company under the Companies Act. The major practical distinction between a private and public company is that the former may not offer its securities to the public.

A public company is a company registered as such under the Companies Act with the Registrar. Any company not registered as public is a private company. A public company may be one which was originally incorporated as a public company or one which re-registered as a public company having been previously a private company.

3.4 Conditions for being a public company

To trade, a public company must hold a Registrar's trading certificate having met the requirements.

3.4.1 Registrar's trading certificate

Before it can trade a company originally incorporated as a public company must have a trading certificate issued by the Registrar. The conditions for this are:

- The name of the company identifies it as a public company by ending with the words 'public limited company' or plc' or their Welsh equivalents, 'ccc', for a Welsh company.

- The constitution of the company states 'the company is a public company' or words to that effect.
- The allotted share capital of the company is at least the authorised minimum.
- It is a company limited by shares.

A company limited by guarantee which has no share capital, and an unlimited company, cannot be public companies.

3.4.2 Minimum membership and directors

A public company must have a minimum of one member. This is the same as a private company. However, unlike a private company it must have at least two directors. A private company must have just one. Directors do not usually have liability for the company's debts.

3.5 Private companies

A private company is the residual category and so does not need to satisfy any special conditions. They are generally small enterprises in which some if not all shareholders are also directors and vice versa. Ownership and management are combined in the same individuals.

Therefore, it is unnecessary to impose on the directors complicated restrictions to safeguard the interests of members and so the number of rules that apply to public companies are reduced for private companies.

3.6 Differences between private and public companies

The main differences between public and private companies relate to: capital; dealings in shares; accounts; commencement of business; general meetings; names; identification; and disclosure requirements.

The more important differences between public and private companies relate to the following factors.

3.6.1 Capital

The main differences are:

a) There is a minimum amount of shs. 2,000,000 for a public company, but no minimum for a private company.
b) A public company may raise capital by offering its shares or debentures to the public; a private company is prohibited from doing so.
c) Both public and private companies must generally offer to existing members first any ordinary shares to be allotted for cash. However a private company may permanently disapply this rule.

3.6.2 Dealings in shares

Only a public company can obtain a listing for its shares on the Stock Exchange or other investment exchange. To obtain the advantages of listing the company must agree to elaborate conditions contained in particulars in a listing agreement with The Stock Exchange. However, not all public companies are listed.

3.6.3 Accounts

(a) A public company has six months from the end of its accounting reference period in which to produce its statutory audited accounts. The period for a private company is nine months.

(b) A private company, if qualified by its size, may have partial exemption from various accounting provisions. These exemptions are not available to a public company or to its subsidiaries (even if they are private companies).

(c) A listed public company must publish its full accounts and reports on its website.

(d) Public companies must lay their accounts and reports before a general meeting annually. Private companies have no such requirement.

3.6.4 Commencement of business

A private company can commence business as soon as it is incorporated. A public company if incorporated as such must first obtain a trading certificate from the Registrar.

3.6.5 General meetings

Private companies are not required to hold annual general meetings, (AGMs). **Public companies** must hold one within six months of their financial year end.

3.6.6 Names and Identification

The **rules on identification** as public or private are as follows.

- The word **'limited'** or **'Ltd'** in the name denotes a private company; **'public limited company'** or **'plc'** must appear at the end of the name of a public company.
- The **constitution** of a **public** company must state that it is a public company. A **private company** should be identified as private.

3.6.7 Disclosure requirements

There are special disclosure and publicity requirements for public companies.

The main advantage of carrying on business through a public rather than a private company is that a public company, by the issue of listing particulars, may obtain a listing on The Stock Exchange and so mobilise capital from the investing public generally.

There is an important distinction between public companies and listed public companies. Listed (or quoted) companies are those which trade their shares (and other securities) on stock exchanges. Not all public companies sell their shares on stock exchanges (although, in law, they are entitled to sell their shares to the public). Private companies are not entitled to sell shares to the public in this way.

In practice, only public companies meeting certain criteria would be allowed to obtain such a listing by the Stock Exchange.

Private companies may be broadly classified into two groups: independent (also called free-standing) private companies and subsidiaries of other companies.

4 Additional classifications

There are a number of other ways in which companies can be classified.

4.1 Parent (holding) and subsidiary companies

There is a distinction between an 'accounting' definition of a parent company, and a 'legal' definition under the Companies Act. A company will be the parent (or holding) company of another company, its subsidiary company, according to the following rules.

Parent company

a) It holds a majority of the voting rights in the subsidiary.
b) It is a member of the subsidiary and has the right to appoint or remove a majority of its board of directors.
c) It has the right to exercise a dominant influence over the subsidiary:

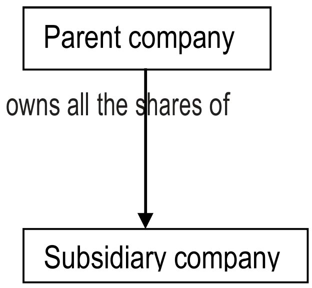
   (i) By virtue of provisions contained in the subsidiary's articles
   (ii) By virtue of a control contract

d) It is a member of the subsidiary and controls alone, under an agreement with other members, a majority of the voting rights in the company.
e) A company is also a parent if:

   (i) It has the power to exercise, or actually exercises, a dominant influence or control over the subsidiary
   (ii) It and the subsidiary are managed on a unified basis.

f) A company is also treated as the parent of the subsidiaries of its subsidiaries.

A company (A Ltd) is a wholly owned subsidiary of another company (B Ltd) if it has no other members except B Ltd and its wholly owned subsidiaries, or persons acting on B Ltd's or its subsidiaries' behalf.



The diagram illustrates a simple group. In practice, such groups might be much larger and much more complex.

The importance of the parent and subsidiary company relationship is recognised in company law in a number of rules.

(a) A parent company must generally prepare group accounts in which the financial situation of parent and subsidiary companies is consolidated as if they were one person.

(b) A subsidiary may not ordinarily be a member of its parent company.

(c) Since directors of a parent company can control its subsidiary, some rules designed to regulate the dealings of companies with directors also apply to its subsidiaries, particularly loans to directors.

4.2 Quoted companies

As we have seen public companies may seek a listing on a public exchange. This option is not open to private companies, who are not allowed to offer their shares for sale to the public. Listed companies are sometimes referred to as quoted companies (because their shares are quoted publicly).

4.3 Small companies regime

Small companies benefit from the small companies regime's reduced legal requirements in terms of filing accounts with the Registrar and obtaining an audit. The definitions of a small company for the purposes of accounting and auditing are almost identical.

4.4 Multinational companies

The vast majority of companies will simply operate in one country. However, some of the larger companies in the world will operate in more than one country. Such companies are multinational.
A multinational company is a company that produces and markets its products in more than one country.

4.4.1 Examples: multinational companies

Some examples of well-known multinational companies include; Wal-mart Stores, Royal Dutch Shell, Exxon Mobil and Toyota.

5 Effect of legal personality

The case of *Salomon v Salomon & Co Ltd 1897* clearly demonstrates the **separate legal personality** of companies.

Salomon v Salomon & Co Ltd 1897

The facts: The claimant, S, had carried on business for 30 years. He decided to form a limited company to purchase the business so he and six members of his family each subscribed for one share.

The company then purchased the business from S for £38,782, the purchase price being payable to the claimant by way of the issue of 20,000 £1 shares, the issue of debentures, £10,000 of debentures and £8,782 in cash.

The company did not prosper and was wound up a year later, at which point its liabilities exceeded its assets. The liquidator, representing unsecured trade creditors of the company, claimed that the company's business was in effect still the claimant's (he owned 20,001 of 20,007 shares). Therefore he should bear liability for its debts and that payment of the debenture debt to him should be postponed until the company's trade creditors were paid.

Decision: The House of Lords held that the business was owned by, and its debts were liabilities of, the company. The claimant was under no liability to the company or its creditors, his debentures were validly issued and the security created by them over the company's assets was effective. This was because the company was a legal entity separate and distinct from S.

The **principle of separate legal personality** was confirmed in the following case.

Lee v Lee's Air Farming Ltd 1960

The facts: Mr Lee, who owned the majority of the shares of an aerial crop-spraying business, and was the sole working director of the company, was killed while piloting the aircraft.

Decision: Although he was the majority shareholder and sole working director of the company, he and the company were separate legal persons. Therefore he could also be an employee with rights against it when killed in an accident in the course of his employment.

The following is a more **recent case** on separate legal personality which confirms the previous case law is still valid.

MacDonald v Costello 2011

The facts: Mr and Mrs Costello entered into an agreement with MacDonald (a firm of builders) to develop land which they owned. For tax purposes, the Costellos used a special purpose vehicle (Oakwood Residential Limited) to finance the work and the contract was between Oakwood and MacDonald.
Oakwood had been used in previous dealings between the parties. Oakwood failed to pay some invoices when there was disagreement about the work which had been done. MacDonald was awarded a payment order against Oakwood and an

award in restitution against the Costellos personally for unjust enrichment. The Costellos appealed the award for unjust enrichment.

Decision: Although the Costellos had been enriched by the work done by MacDonald, it was decided that the award against them should not be upheld. They were not party to the contract and, as shareholders of Oakwood, they were protected by the veil of incorporation.

5.1 Veil of incorporation

Incorporation 'veils' members from outsiders' view but this veil may be lifted in some circumstances, so creditors and others can seek redress directly from members. The veil may be lifted: by statute to enforce the law; to prevent the evasion of obligations; and in certain situations where companies trade as a group.

Because a company has separate legal personality from the people who own or run it (the members/shareholders/directors), people can look at a company and not know who or what owns or runs it.

The fact that members are 'hidden' in this way is sometimes referred to as the 'veil of incorporation'. Literally, the members are 'veiled' from view.

6. Ignoring separate personality

It is sometimes necessary by law to look at who the owners of a company are. This is referred to as 'lifting the veil'.

Separate personality can be ignored to:

- Identify the company with its members and/or directors.
- Treat a group of companies as a single commercial entity (if a company is owned by another company).

The more important of these two reasons is the first one, although the second reason can sometimes be more complex. The main instances for lifting the veil are to enforce the law, prevent evasion of obligations and in some group situations. However, with the establishment of the concept of corporate manslaughter it is likely that directors will increasingly face prosecution and custodial sentences where they are found personally accountable for a death where the death can be connected with how they ran their business. The veil of incorporation will no longer protect them: *R v OLL Ltd 1994*.

6.1 Lifting the veil by statute to enforce the law

Lifting of the veil is permitted under a number of statutes to enforce the law.

6.1.1 Liability for trading without trading certificate

A public company must obtain a trading certificate from the Registrar before it may commence to trade. Failure to do so leads to personal liability of the directors for any loss or damage suffered by a third party resulting from a transaction made in contravention of the trading certificate requirement. They are also liable for a fine.

6.1.2 Fraudulent and wrongful trading

When a company is wound up, it may appear that its business has been carried on with intent to defraud creditors or others. In this case the court may decide that the persons (usually the directors) who were knowingly parties to the fraudulent trading shall be personally responsible under civil law for debts and other liabilities of the company.

Fraudulent trading is also a criminal offence.

6.1.3 Disqualified directors

Directors who participate in the management of a company in contravention of an order under the Company Directors Disqualification Act will be jointly or severally liable along with the company for the company's debts.

6.1.4 Abuse of company names

In the past there were a number of instances where directors of companies which went into insolvent liquidation formed another company with an identical or similar name. This new company bought the original company's business and assets from its liquidator.

The Insolvency Act makes it a criminal offence and the directors personally liable where; they are a director of a company that goes into insolvent liquidation and; they become involved with the directing, managing or promoting of a business which has an identical name to the original company, or a name similar enough to suggest a connection.

Questions in this area may require the identification of circumstances where the veil of incorporation will be lifted.

6.2 Lifting the veil to prevent evasion of obligations

A company may be identified with those who control it, for instance to determine its residence for tax purposes. The courts may also ignore the distinction between a company and its members and managers if the latter use that distinction to evade their existing legal obligations.

Gilford Motor Co Ltd v Home 1933

The facts: The defendant had been employed by the claimant company under a contract which forbade him to solicit its customers after leaving its service. After the termination of his employment he formed a company of which his wife and an employee were the sole directors and shareholders. However he managed the company and through it evaded the covenant that prevented him from soliciting customers of his former employer.

Decision: An injunction requiring observance of the covenant would be made both against the defendant and the company which he had formed as a 'a mere cloak or sham'.

6.2.1 Public interest

In time of war a company is not permitted to trade with 'enemy aliens'. The courts may draw aside the veil if, despite a company being registered in the Uganda, it is suspected that it is controlled by aliens: *Daimler Co Ltd v Continental Tyre and Rubber Co (GB) Ltd 1917*. The question of nationality may also arise in peacetime, where it is convenient for a foreign entity to have a British facade on its operations.

Re F G Films Ltd 1953

The facts: An English company was formed by an American company to 'make' a film which would obtain certain marketing and other advantages from being called a British film. Staff and finance were American and there were neither premises nor employees in England. The film was produced in India.

Decision: The British company was the American company's agent and so the film did not qualify as British. Effectively, the corporate entity of the British company was swept away and it was exposed as a 'sham' company.

6.2.2 Evasion of liabilities

The veil of may also be lifted where directors ignore the separate legal personality of two companies and transfer assets from one to the other in disregard of their duties in order to avoid an existing liability.

Re H and Others 1996

The facts: The court was asked to rule that various companies within a group, together with the minority shareholders, should be treated as one entity in order to restrain assets prior to trial.

Decision: The order was granted. The court thought there was evidence that the companies had been used for the fraudulent evasion of excise duty.

6.2.3 Evasion of taxation

Courts may lift the veil of incorporation where it is being used to conceal the nationality of the company.

Unit Construction Co Ltd v Bullock 1960

The facts: Three companies, wholly owned by a UK company, were registered in Kenya. Although the companies' constitutions required board meetings to be held in Kenya, all three were in fact managed entirely by the holding company.

Decision: The companies were resident in the UK and liable to UK tax. The Kenyan connection was a sham, the question being not where they ought to have been managed, but where they were actually managed.

6.2.4 Quasi-partnership

An application to wind up a company on the 'just and equitable' ground under the Insolvency Act may involve the court lifting the veil to reveal the company as a quasi-partnership. This may happen where the company only has a few members, all of whom are actively involved in its affairs. Typically the individuals have operated contentedly as a company for years but then fall out, and one or more of them seeks to remove the others.

The courts are willing in such cases to treat the central relationship between the directors as being that of partners, and rule that it would be unfair therefore to allow the company to continue with only some of its original members. This is illustrated by the case of *Ebrahimi v Westbourne Galleries Ltd 1973.*

6.3 Lifting the veil in group situations

The principle of the veil of incorporation extends to the holding (parent) company/subsidiary relationship. Although holding companies and subsidiaries are part of a group under company law, they retain their separate legal personalities. There is also some precedent for treating separate companies as a group (*DHN Food Distributors v Tower Hamlets LBC 1976)* although doubt has since been cast on this by subsequent cases.

In *Adams v Cape Industries plc 1990*, three reasons were put forward for identifying the companies as one, and lifting the veil of incorporation. They are:

- The subsidiary is acting as agent for the holding company.
- The group is to be treated as a single economic entity because of statutory provision.
- The corporate structure is being used as a facade (or sham) to conceal the truth.

Adams v Cape Industries plc 1990

The facts: Cape, an English company, headed a group which included many wholly-owned subsidiaries.
Some of these mined asbestos in South Africa, and others marketed the asbestos in various countries including the USA.

Several hundred claimants had been awarded damages by a Texas court for personal injuries suffered as a result of exposure to asbestos dust. The defendants in Texas included one of Cape's subsidiaries, NAAC.
The courts also considered the position of AMC, another subsidiary, and CPC, a company linked to Cape Industries.

Decision: The judgement would not be enforced against the English holding company, either on the basis that Cape had been 'present' in the US through its local subsidiaries or because it had carried on business in the US through the agency of NAAC. Slade LJ commented in giving the judgement that English law 'for better or worse recognises the creation of subsidiary companies ... which would fail to be treated as separate legal entities, with all the rights and liabilities which would normally be attached to separate legal entities'.

Whether desirable or not, English law allowed a group structure to be used so that legal liability fell on an individual member of a group rather than the group as a whole.

Lifting the veil in group situations is easily forgotten. Ensure you know the *Cape Industries* case and the three reasons for lifting the veil in groups which it sets out.

6.4 Summary of situations in which the veil can be lifted

The instances in which the veil will be lifted are as follows.

Lifting the veil by statute to enforce the law	Liability for trading without a trading certificate Fraudulent and wrongful trading Disqualified directors Abuse of company names
Evasion of obligations	Evasion of legal obligations Public interest Evasion of liabilities Evasion of taxation Quasi-partnership
Group situations	Subsidiary acting as agent for the holding company The group is to be treated as a single economic entity The corporate structure is being used as a sham

6.5 Lifting the veil and limited liability

The above examples of lifting the veil include examples of where, if they have broken the law, directors can be made personally liable for a company's debts. This is very rare. If those directors are also members, then limited liability does not apply. This is the only time that limited liability is overridden and that the member becomes personally liable for the company's debts due to their actions as a director.

7. Comparison of companies and partnerships

Because it is a separate legal entity, a company has a number of features which are different from a partnership. The most important difference between a company and a traditional partnership is that a company has a separate legal personality from its members, while a traditional partnership does not.

7.1 The differences

The separate legal personality of a company gives rise to a number of characteristics which mark it out from a traditional partnership. Revise this table when you studied the rest of the book and know more of the details concerning the distinctive factors of companies.

Factor	Company	Traditional partnership
Entity	Is a legal entity separate from its members	Has no existence outside of its members

Liability	Members' liability can be limited	Partners' liability is usually unlimited
Size	May have any number of members (at least one)	Some partnerships are limited to 20 members (professional partnerships excluded)
Succession	Perpetual succession – change in ownership does not affect existence	Partnerships are dissolved when any of the partners leaves it
Owners' interest	Members own transferable shares	Partners cannot assign their interests in a partnership
Assets	Company owns the assets	Partners own assets jointly
Management	Company must have at least one director (two for a public company)	All partners can participate in management
Constitution	Company must have a written constitution	A partnership may have a written partnership agreement, but also may not
Accounts	A company must usually deliver accounts to the Registrar	Partners do not have to send their accounts to the Registrar
Security	A company may offer a floating charge over its assets	A partnership may not usually give a floating charge on assets
Withdrawal of capital	Strict rules concerning repayment of subscribed capital	More straightforward for a partner to withdraw capital
Taxation	Company pays tax on its profit Directors are taxed through PAYE system Shareholders receive dividends which are taxed ten months after the tax year	Partners extract 'drawings' weekly or monthly. No tax is deducted as income tax is payable on final profit for the year.
Management	Members elect directors to manage the company	All partners have a right to be involved in management

9.0 PROMOTION AND FORMATION OF COMPANIES

UNIT 9 OVERVIEW:

- Key Definitions.
- Promoters' duties.
- Memorandum of Association.
- Articles of Association.
- Other Considerations.

1. Promoters and pre-incorporation contracts

A promoter forms a company. They must act with reasonable skill and care, and if shares are to be allotted they are the agent of the prospective shareholders, with an agent's fiduciary duties.

A company cannot form itself. The person who forms it is called a 'promoter'. A promoter is an example of an agent.

A promoter is one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose.

In addition to the person who takes the procedural steps to get a company incorporated, the term 'promoter' includes anyone who makes business preparations for the company. However a person who acts merely in a professional capacity in company formation, such as a solicitor or an accountant, is not on that account a promoter.

1.1 Duties of promoters

Promoters have a general duty to exercise reasonable skill and care.

If the promoter is to be the owner of the company there is no conflict of interest and it does not matter if the promoter obtains some advantage from this position, for example, by selling their existing business to the company for 100% of its shares.

If, however, some or all the shares of the company when formed are to be allotted to other people, the promoter acts as their agent. This means they have the customary duties of an agent and the following fiduciary duties.

(a) A promoter must account for any benefits obtained through acting as a promoter.
(b) Promoters must not put themselves in a position where their own interests conflict with those of the company.
(c) A promoter must provide full information on their transactions and account for all monies arising from them. The promoter must therefore make proper disclosure of any personal advantage to existing and prospective company members or to an independent board of directors.

A promoter may make a profit as a result of their position.

(a) A legitimate profit is made by a promoter who acquires interest in property before promoting a company and then makes a profit when they sell the property to the promoted company, provided they disclose it.
(b) A wrongful profit is made by a promoter who enters into and makes a profit personally in a contract as a promoter. They are in breach of fiduciary duty.

A promoter of a public company makes their disclosure of legitimate profit through listing particulars or a prospectus. If they make proper disclosure of a legitimate profit, they may retain it.

1.1.1 Remedy for breach of promoter's fiduciary duty

If the promoter does not make a proper disclosure of legitimate profits or if they make wrongful profits the primary remedy of the company is to rescind the contract and recover its money: *Erlanger v New Sombrero Phosphate Co 1878*.

However sometimes it is too late to rescind because the property can no longer be returned or the company prefers to keep it. In such a case the company can only recover from the promoter their wrongful profit, unless some special circumstances dictate otherwise.

Where shares are sold under a prospectus offer, promoters have a statutory liability to compensate any person who acquires securities to which the prospectus relates and suffered loss as a result of any untrue or misleading statement, or omission. Statutory and listing regulations together with rigorous investigation by merchant banks have greatly lessened the problem of the dishonest promoter.

2. Pre-incorporation expenses and contracts

A promoter has no automatic right to be reimbursed pre-incorporation expenses by the company, though this can be expressly agreed.

2.1 Pre-incorporation expenses

A promoter usually incurs expenses in preparations, such as drafting legal documents, made before the company is formed. They have no automatic right to recover these 'pre-incorporation expenses' from the company. However they can generally arrange that the first directors, of whom they may be one, agree that the company shall pay the bills or refund to them their expenditure. They could also include a special article in the company's constitution containing an indemnity for the promoter.

2.2 Pre-incorporation contracts

Pre-incorporation contracts cannot be ratified by the company. A new contract on the same terms must be expressly created.

A pre-incorporation contract is a contract purported to be made by a company or its agent at a time before the company has been formed.

In agency law a principal may ratify a contract made by an agent retrospectively. However, a company can never ratify a contract made on its behalf before it was incorporated. This is because it did not exist when the pre-incorporation contract was made so one of the conditions for ratification fails.

A company may enter into a new contract on similar terms after it has been incorporated (novation). However there must be sufficient evidence that the company has made a new contract. Mere recognition of the pre-incorporation contract by performing it or accepting benefits under it is not the same as making a new contract.

2.3 Liability of promoters for pre-incorporation contracts

A company's promoter is liable on all contracts to which they are deemed to be a party. This means they may also be entitled to enforce such contracts against the other party and so they could transfer the right to enforce the contract to the company.

2.4 Other ways of avoiding liability as a promoter for pre-incorporation contracts

There are various other ways for promoters to avoid liability for a pre-incorporation contract.

(a) The contract remains as a draft (so not binding) until the company is formed. The promoters are the directors, and the company has the power to enter the contract. Once the company is formed, the directors take office and the company enters into the contract.
(b) If the contract has to be finalised before incorporation it should contain a clause that the personal liability of promoters is to cease if the company, when formed, enters a new contract on identical terms. This is known as novation.
(c) A common way to avoid the problem concerning pre-incorporation contracts is to buy a company 'off the shelf'. Even if a person contracts on behalf of the new company before it is bought the company should be able to ratify the contract since it existed 'on the shelf' at the time the contract was made.

You should consider the status of pre-incorporation contracts as a highly examinable topic.

3 Registration procedures

A company is formed and registered under the Companies Act 2012 when it is issued with a certificate of incorporation by the Registrar, after submission to the Registrar of a number of documents and a fee. Most companies are registered under the Companies Act 2012.

A company is formed under the Companies Act 2012 by one or more persons subscribing to a memorandum of association who comply with the requirements regarding registration. A company may not be formed for an unlawful purpose.

3.1 Documents to be delivered to the Registrar

To obtain registration of a company limited by shares, an application for registration, various documents and a fee must be sent to the Registrar.

3.1.1 Application for registration

The Companies Act requires an application for registration to be made and submitted to the Registrar. The application must contain:

- The company's proposed name
- The location of its registered office
- That the liability of members is to be limited by shares or guarantee
- Whether the company is to be private or public
- A statement of the intended address of the registered office

Documents to be delivered	Description
Memorandum of association	This is a prescribed form signed by the subscribers. The memorandum states that the subscribers wish to form a company and they agree to become members of it. If the

	company has share capital each subscriber agrees to subscribe for at least one share.
Articles of association (only required if the company does not adopt model articles)	Articles are signed by the same subscriber(s), dated and witnessed. Model articles are provided by statute and can be adopted by a new company if: • No other articles are registered, or • If the articles supplied do not exclude or modify the model articles.
Statement of proposed officers (company form 7)	The statement gives the particulars of the proposed director(s) and company secretary if applicable. The persons named as directors must consent to act in this capacity. When the company is incorporated they are deemed to be appointed.
Registration fee	A registration fee is also payable on registration.

Note: Questions on incorporation could require you to identify the documents which should be sent to the Registrar.

3.2 Certificate of incorporation

The Registrar considers whether the documents are formally in order. If satisfied, the company is given a 'registered number'. A certificate of incorporation is issued and notice of it is publicised.

A company is registered by the inclusion of the company in the register, and the issue of a certificate of incorporation by the Registrar. The certificate:

- Identifies the company by its name and registered number
- States that it is limited (if appropriate) and whether it is a private or public company
- States whether the registered office is in Kampala or any other district in Uganda like Mukono, Wakiso, Mbarara, Gulu, Arua etc.
- States the date of incorporation
- Is signed by the Registrar, or authenticated by the Registrar's official seal

A certificate of incorporation is a certificate issued by the Registrar which denotes the date of incorporation, 'the subscribers, together with any persons who from time to time become members, become a body corporate capable of exercising all the functions of an incorporated company'.

The certificate of incorporation is conclusive evidence that:

- All the requirements of the Companies Act have been followed.
- The company is a company authorised to be registered and has been duly registered.
- If the certificate states that the company is a public company it is conclusive.

If irregularities in formation procedure or an error in the certificate itself are later discovered, the certificate is nonetheless valid and conclusive: *Jubilee Cotton Mills Ltd v Lewes 1924*.

Upon incorporation persons named as directors and secretary in the statement of proposed officers automatically become such officers.

3.3 Companies 'off the shelf'

Buying a company 'off the shelf' avoids the administrative burden of registering a company.

Because the registration of a new company can be a lengthy business, it is often easiest for people wishing to operate as a company to purchase an 'off the shelf' company.

This is possible by contacting enterprises specialising in registering a stock of companies, ready for sale when a person comes along who needs the advantages of incorporation.

Normally the persons associated with the company formation enterprise are registered as the company's subscribers, and its first secretary and director. When the company is purchased, the shares are transferred to the buyer, and the Registrar is notified of the director's and the secretary's resignation.

The principal advantages for the purchaser of purchasing an off the shelf company are as follows.

(a) The following documents will not need to be filed with the Registrar by the purchaser:

- (i) Memorandum and articles (unless the articles are not model articles)
- (ii) Application for registration
- (iii) Statement of proposed officers
- (iv) Statement of compliance
- (v) Statement of capital and initial shareholdings
- (vi) Fee

This is because the specialist has already registered the company. It will therefore be a quicker, and very possibly cheaper, way of incorporating a business.

(b) There will be no risk of potential liability arising from pre-incorporation contracts. The company can trade without needing to worry about waiting for the Registrar's certificate of incorporation.

The disadvantages relate to the changes that will be required to the off-the-shelf company to make it compatible with the members' needs.

(a) The off-the-shelf company is likely to have model articles. The directors may wish to amend these.
(b) The directors may want to change the name of the company.
(c) The subscriber shares will need to be transferred, and the transfer recorded in the register of members. Stamp duty will be payable.

3.4 Re-registration procedures

A private company with share capital may be able to re-register as a public company if the share capital requirement is met. A public company may re-register as a private one.

Note. For a private company to re-register as a public company it must fulfill the share capital requirement of a public company: Its allotted share capital must be at least shs. 2,000,000 of which a quarter must be paid up, plus the whole of any premium.

	Re-registering as a public company	Re-registering as a private company
Resolution	The shareholders must agree to the company going public • Convene a general meeting • Pass a special resolution (75% majority) – Alters the constitution	The shareholders must agree to the company going private • Convene a general meeting • Pass a special resolution (75% majority of those present and voting) – Alters the constitution
Application	The company must then apply to the Registrar to go public • Send application to the Registrar • Send additional information to the Registrar, comprising - Copy of the special resolution - Copy of proposed new public company articles - Statement of the company's proposed name on re-registration - Statement of proposed company secretary - Balance sheet and related auditors' statement which states that at the balance sheet date the company's net assets are not less than its called-up share capital and undistributable reserves. - Statement of compliance - Valuation report regarding allotment of shares for non-cash consideration since the balance sheet date	The company must then apply to the Registrar to go private • Send the application to the Registrar • Send additional information to the Registrar, comprising - Copy of the special resolution - Copy of altered new private company articles - Statement of Compliance - Statement of the company's proposed name on re-registration
Approval	The Registrar must accept the statement of compliance as sufficient evidence that the company is entitled to be re-registered as public. A certificate of incorporation on re-registration is issued.	The Registrar issues a certificate of incorporation on re-registration.

3.5 Commencement of business rules

To trade or borrow, a public company needs a trading certificate. Private companies may commence business on registration.

3.5.1 Public companies

A public company incorporated as such may not do business or exercise any borrowing powers unless it has obtained a trading certificate from the Registrar. This is obtained by sending an application to the Registrar. A private company which is re-registered as a public company is not subject to this rule.
The application:

- States the nominal value of the allotted share capital is not less than minimum.
- States the particulars of preliminary expenses and payments or benefits to promoters
- Must be accompanied by a statement of compliance.

If a public company does business or borrows before obtaining a certificate the other party is protected since the transaction is valid. However the company and any officer in default have committed an offence punishable by a fine. They may also have to indemnify the third party.

Under the Insolvency Act a court may wind-up a public company which does not obtain a trading certificate within one year of incorporation.

3.5.2 Private company

A private company may do business and exercise its borrowing powers from the date of its incorporation. After registration the following procedures are important.

(a) A first meeting of the directors should be held at which the chairman, secretary and sometimes the auditors are appointed, shares are allotted to raise capital, authority is given to open a bank account and other commercial arrangements are made.
(b) A return of allotments should be made to the Registrar.
(c) The company may give notice to the Registrar of the accounting reference date on which its annual accounts will be made up. If no such notice is given within the prescribed period, companies are deemed to have an accounting reference date of the last day of the month in which the anniversary of incorporation falls.

4. Statutory books and records

4.1 The requirement for public accountability

The price of limited liability is greater public accountability via the Companies Registry, registers, the *Gazette* and company letterheads.

Under company law the privileges of trading through a separate corporate body are matched by the duty to provide information which is available to the public about the company.

The basic sources of information on Uganda companies are;

- The Registrar keeps a file which holds all documents delivered by the company for filing. Any member of the public, for example someone who intends to do business with the company, may inspect the file at the Registry.
- The registers and other documents which the company is required to hold at its registered office (or another registered address).
- The Ugandan *Gazette*, a specialist publication, in which the company itself or the Registrar is required to publish certain notices or publicise the receipt of certain documents.
- The company's letterheads and other forms which must give particulars of the company's place of registration, its identifying number and the address of its office.

4.2 The Registrar of Companies

The Registrar of Companies (the Registrar) and the Registrar's department within the Government is usually called Companies House (in full it is 'the Companies Registration Office').

The company is identified by its name and serial number which must be stated on every document sent to Companies House for filing.

On incorporation the company's file includes a copy of its certificate of incorporation and the original documents presented to secure its incorporation.

Once a company has been in existence for some time the file is likely to include the following.

- Certificate of incorporation
- Public company trading certificate
- Each year's annual accounts and return
- Copies of special and some ordinary resolutions
- A copy of the altered articles of association if relevant
- Notices of various events such as a change of directors or secretary
- If a company issues a prospectus, a signed copy with all annexed documents

4.3 Statutory books

A company must keep registers of certain aspects of its constitution, including the registers of members, charges and directors.

Various people are entitled to have access to registers and copies of records that the company must keep. To enable the documents to be found easily the company must keep them at its registered office or a single alternative inspection location (SAIL) which is registered with Companies House. All documents may be kept at either location or combination of the two. Companies are not permitted to have more than one single alternative inspection location.

Register/copies of records:-

- Register of members
- Register of charges
- Register of directors (and secretaries)
- Records of directors' service contracts and indemnities
- Records of resolutions and meetings of the company
- Register of debentureholders
- Register of disclosed interests in shares (public company ONLY)

4.4 Register of members

Every company must keep a register of members. It must contain:

(a) The name and address of each member
(b) The shareholder class (if more than one) to which they belong unless this is indicated in the particulars of their shareholding
(c) If the company has a share capital, the number of shares held by each member. In addition:

 (i) If the shares have distinguishing numbers, the member's shares must be identified in the register by those numbers
 (ii) If the company has more than one class of share the member's shares must be distinguished by their class, such as preference, ordinary, or non-voting shares

(d) The date on which each member became and eventually the date on which they ceased to be a member

Any member of the company can inspect the register of members of a company without charge. A member of the public must pay but has the right of inspection.

A company with more than 50 members must keep a separate index of those members, unless the register itself functions as an index.

4.5 Register of charges

The register of charges must contain:

- Details of fixed or floating charges affecting the company property or undertaking
- Brief descriptions of property charged
- The amount of the charge
- The name of the person entitled to the charge

A company must also keep copies of every instrument creating a charge. Any person may inspect the instruments and the charges register; members and creditors may inspect free of charge.

4.6 Register of directors

The register of directors must contain the following details for all directors who are natural persons.

- Present and former forenames and surnames
- A service address (may be the company's registered address rather than their home address)
- Residency and nationality
- Business occupation (if any)
- Date of birth

The register does not include shadow directors and it must be open to inspection by a member (free of charge), or by any other person (for a fee).

Note the company must keep a separate register of directors' residential addresses but this is not available to members or the general public.

4.6.1 Corporate directors

Where a legal person (such as a company) is a director, the register of directors must contain:

- The corporate or firm name
- Its registered or principal office

4.7 Records of directors' service contracts

The company should keep copies or written memoranda of all service contracts for its directors, including contracts for services which are not performed in the capacity of director. Members are entitled to view these copies for free, or request a copy on payment of a set fee.

A director’s service contract, means a contract under which:

(a) A director of the company undertakes personally to perform services (as director or otherwise) for a company, or for a subsidiary of the company, or

(b) Services (as director or otherwise) that a director of the company undertakes personally to perform are made available by a third party to the company, or to a subsidiary of the company.

4.8 Register of debentureholders

Companies with debentures issued nearly always keep a register of debentureholders but there is no statutory compulsion to do so.

4.9 Accounting records

Companies must keep sufficient accounting records to explain the company's transactions and its financial position, in other words so a profit and loss account and balance sheet can be prepared.

A company is required to keep accounting records sufficient to show and explain the company's transactions. At any time, it should be possible:

- To disclose with reasonable accuracy the company's financial position at intervals of not more than six months
- For the directors to ensure that any accounts required to be prepared comply with the Act and International Accounting Standards

Certain specific records are required by the Act.

(a) Daily entries of sums paid and received, with details of the source and nature of the transactions
(b) A record of assets and liabilities
(c) Statements of stock held by the company at the end of each financial year
(d) Statements of stocktaking to back up the records in (c)
(e) Statements of goods bought and sold (except retail sales), together with details of buyers and sellers sufficient to identify them

The requirements (c) to (e) above apply only to businesses involved in dealing in goods.
Accounting records must be kept for three years (in the case of a private company), and six years in that of a public one.

Accounting records should be kept at the company's registered office or at some other place thought fit by the directors. Accounting records should be open to inspection by the company's officers. Shareholders have no statutory rights to inspect the records, although they may be granted the right by the articles.

Failure in respect of these duties is an offence by the officers in default.

4.10 Annual accounts

A registered company must prepare annual accounts showing a true and fair view, lay them and various reports before members, and file them with the Registrar following directors' approval.

For each accounting reference period (usually 12 months) of the company the directors must prepare accounts. Where they are prepared in Companies Act format they must include a balance sheet and profit and loss account which give a true and fair view of the individual company's and the group's

- Assets
- Liabilities
- Financial position
- Profit or loss

The accounts can either be in Companies Act format or prepared in accordance with International Accounting Standards. Where international accounting standards are followed a note to this effect must be included in the notes to the accounts. Most private companies are permitted to file abbreviated accounts.

The company's board of directors must approve the annual accounts and they must be signed by a director on behalf of the board. When directors approve annual accounts that do not comply with the Act or IAS they are guilty of an offence.

A public company is required to lay its accounts, and the directors' report, before members in general meeting. A quoted company must also lay the directors' remuneration report before the general meeting.

A company must file its annual accounts and its report with the Registrar within a maximum period reckoned from the date to which the accounts are made up. The standard permitted interval between the end of the accounting period and the filing of accounts is six months for a public and nine months for a private company.

The accounts must be audited. The auditors' report must be attached to the copies issued to members, filed with the Registrar or published. Exemptions apply to small and dormant companies, though members may require an audit. The accounts must also be accompanied by a directors' report giving information on a number of prescribed matters. These include (where an audit was necessary) a statement that there is no relevant information of which the auditors are unaware, and another statement from the directors that they exercised due skill and care in the period. Quoted companies must submit the directors' remuneration report.

Each member and debentureholder is entitled to be sent a copy of the annual accounts, together with the directors' and auditor's reports. In the case of public companies, they should be sent at least 21 days before the meeting at which they shall be laid. In the case of private companies they should be sent at the same time as the documents are filed, if not earlier.

Anyone else entitled to receive notice of a general meeting, including the company's auditor, should also receive a copy. At any other time any member or debentureholder is entitled to a copy free of charge within seven days of requesting it.

All companies may prepare summary financial statements to be circulated to members instead of the full accounts, subject to various requirements as to form and content being met. However, members have the right to receive full accounts should they wish to.
Quoted companies must make their annual accounts and reports available on a website which identifies the company and is maintained on the company's behalf. The documents must be made available as soon as reasonably practicable and access should not be conditional on the payment of a fee or subject to other restrictions.

Where the company or its directors fail to comply with the Act, they may be subject to a fine.

5. Statutory returns

Every company must make an annual return to the Registrar.

Every company must make an annual return each year to the Registrar which is made up to a 'return date'. This date is either the anniversary of incorporation or the anniversary of the date of the previous return (if this differs).

The form of the annual return prescribed for a company which has share capital is:

- The address of the registered office of the company
- The address (if different) at which the register of members or debentureholders is kept

o The type of company and its principal business activities

o The total number of issued shares, their aggregate nominal value and the amounts paid and unpaid on each share

o For each class of share, the rights of those shares, the total number of shares in that class and their total nominal value

o Particulars of members of the company

o Particulars of those who have ceased to be members since the last return

o The number of shares of each class held by members at the return date, and transferred by members since incorporation or the last return date

o The particulars of directors, and secretary (if applicable)

1. Memorandum of Association

The memorandum is a simple document which states that the subscribers wish to form a company and become members of it.

Before the Companies Act 2006, the memorandum of association was an extremely important document containing information concerning the relationship between the company and the outside world – for example its aims and purpose (its objects).

The position changed with the 2006 Act and much of the information contained in the old memorandum is now to be found in the Articles of Association, which we will come to shortly. The essence of the memorandum has been retained, although it is now a very simple historical document which states that
the subscribers (the initial shareholders):

(a) Wish to form a company under the Act, and
(b) Agree to become members of the company and, to take at least one share each if the company is to have share capital.

The memorandum must be in the prescribed form and must be signed by each subscriber.

It has been deemed by the Companies Act 2006 that companies which were incorporated under a previous Act and whose memorandum contains provisions now found in the articles, shall have these provisions interpreted as if they are part of the articles.

2. A company's constitution

A company's constitution comprises the Articles of Association and any resolutions and agreements it makes which affect the constitution.

According to the Companies Act 2006, the constitution of a company consists of:

 The Articles of Association

- Resolutions and agreements that it makes that affects the constitution

We shall consider resolutions and agreements first. This will help explain how the Articles of Association are amended.

2.1 Resolutions and agreements

In addition to the main constitutional document (the Articles of Association), resolutions and agreements also form part of a company's constitution.

Resolutions are decisions passed by members which directly affect the company's constitution as they are used to introduce, amend or remove provisions in the articles. Agreements made, for example between the company and members, are also deemed as amending the constitution.

Copies of resolutions or agreements that amend the constitution must be sent to the Registrar within 15 days of being passed or agreed. If a company fails to do this then every officer who is in default commits an offence punishable by fine. Where a resolution or agreement which affects a company's constitution is not in writing, the company is required to send the registrar a written memorandum that sets out the terms of the resolution or agreement in question.

2.2 Articles of association

The articles of association consist of the internal rules that relate to the management and administration of the company. The articles contain detailed rules and regulations setting out how the company is to be managed and administered. The Act states that the registered articles should be contained in a single document which is divided into consecutively numbered paragraphs. Articles should contain rules on a number of areas, the most important being summarised in the table below.

CONTENTS OF ARTICLES	
Appointment and dismissal of directors	Communication with members
Powers, responsibilities and liabilities of directors	Class meetings
Directors' meetings	Issue of shares
General meetings; calling, conduct and voting	Transfer of shares
Members' rights	Documents and records
Dividends	Company secretary

2.2.1 Model articles

Rather than each company having to draft their own articles, and to allow companies to be set up quickly and easily, the Act allows the Secretary of State to provide model (or standard) articles that companies can adopt. Different models are available for different types of company; most companies would adopt model private or public company articles.

Companies are free to use any of the model articles that they wish to by registering them on incorporation. If no articles are registered then the company will be automatically incorporated with the default model articles which are relevant to the type of company being formed. Model articles can be amended by the members and therefore tailored to the specific needs of the company.

Model articles are effectively a 'safety net' which allow directors and members to take decisions if the company has failed to include suitable provisions in its registered articles or registered no articles at all.

The following summarises the model articles for a private limited company. Do not try to learn the contents but use it to understand the type of information contained in them. Model articles are also available for public limited companies. These articles are different to those of a private limited company as they are more appropriate to the needs of a plc.

Model articles for private companies limited by shares

Index to the articles

Part 1 Definitions and interpretation

Part 2 Directors

Directors' powers and responsibilities

Decision-making by directors

Appointment of directors

Part 3 Shares and distributions

Shares

2.2.2 Alteration of the articles

The articles may be altered by a special resolution. The basic test is whether the alteration is for the benefit of the company as a whole.

Any company has a statutory power to alter its articles by special resolution. A private company may pass a written resolution with a 75% majority. The alteration will be valid and binding on all members of the company. Copies of the amended articles must be sent to the Registrar, within 15 days of the amendment, taking effect.

2.2.3 Making the company's constitution unalterable

There are devices by which some provisions of the company's constitution can be made unalterable unless the member who wishes to prevent any alteration consents.

(a) The articles may give a member additional votes so that they can block a resolution to alter articles on particular points (including the removal of their weighted voting rights from the articles).
However, to be effective, the articles must also limit the powers of members to alter the articles that give extra votes.

(b) The articles may provide that when a meeting is held to vote on a proposed alteration of the articles the quorum present must include the member concerned. They can then deny the meeting a quorum by absenting themselves.

(c) The Act permits companies to 'entrench' provisions in their articles. This means specific provisions may only be amended or removed if certain conditions are met which are more restrictive than a special resolution such as agreement of all the members. However, such 'entrenched provisions' cannot be drafted so that the articles can never be amended or removed.

2.2.4 Restrictions on alteration

Even when it is possible to hold a meeting and pass a special resolution, alteration of the articles is restricted by the following principles.

(a) The alteration is void if it conflicts with the Companies Act or with general law.

(b) In various circumstances, such as to protect a minority, the court may order that an alteration be made or, alternatively, that an existing article shall not be altered.

(c) An existing member may not be compelled by alteration of the articles to subscribe for additional shares or to accept increased liability for the shares which they hold unless they have given their consent.

(d) An alteration of the articles which varies the rights attached to a class of shares may only be made if the correct rights variation procedure has been followed to obtain the consent of the class. A 15 per cent minority may apply to the court to cancel the variation.

(e) A person whose contract is contained in the articles cannot obtain an injunction to prevent the articles being altered, but they may be entitled to damages for breach of contract. Alteration cannot take away rights already acquired by performing the contract.

(f) An alteration may be void if the majority who approve it are not acting *bona fide* in what they deem to be the interests of the company as a whole.

The case law on the bona fide test is an effort to hold the balance between two principles:

(a) The majority are entitled to alter articles even though a minority considers that the alteration is prejudicial to its interests.
(b) A minority is entitled to protection against an alteration which is intended to benefit the majority rather than the company and which is unjustified discrimination against the minority.

Principle (b) tends to be restricted to cases where the majority seeks to expel the minority from the company.

The most elaborate analysis of this subject was made by the Court of Appeal in the case of *Greenhalgh v Arderne Cinemas Ltd 1950.* Two main propositions were laid down by the Judge.

(a) 'Bona fide for the benefit of the company as a whole' is a single test and also a subjective test (what did the majority believe?). The court will not substitute its own view.
(b) 'The company as a whole' means, in this context, the general body of shareholders. The test is whether every 'individual hypothetical member' would in the honest opinion of the majority benefit from the alteration.

If the purpose is to benefit the company as a whole the alteration is valid even though it can be shown that the minority does in fact suffer special detriment and that other members escape loss.

2.2.5 Expulsion of minorities

Expulsion cases are concerned with:

- Alteration of the articles for the purpose of removing a director from office
- Alteration of the articles to permit a majority of members to enforce a transfer to themselves of the shareholding of a minority

The action of the majority in altering the articles to achieve 'expulsion' will generally be treated as valid even though it is discriminatory, if the majority were concerned to benefit the company or to remove some detriment to its interests.

If on the other hand the majority was blatantly seeking to secure an advantage to themselves by their discrimination, the alteration made to the articles by their voting control of the company will be invalid. The cases below illustrate how the distinctions are applied in practice.

Sidebottom v Kershaw, Leese & Co Ltd 1920

The facts: The articles were altered to enable the directors to purchase at a fair price the shareholding of any member who competed with the company in its business. The minority against whom the new article was aimed did carry on a competing business. They challenged the validity of the alteration on the ground that it was an abuse of majority power to 'expel' a member.

Decision: There was no objection to a power of 'expulsion' by this means. It was a justifiable alteration if made *bona fide* in the interests of the company as a whole. On the facts this was justifiable.

Brown v British Abrasive Wheel Co 1919

The facts: The company needed further capital. The majority who held 98% of the existing shares were willing to provide more capital but only if they could buy up the 2% minority. As the minority refused to sell, the majority proposed to alter the articles to provide for compulsory acquisition on a fair value basis. The minority objected to the alteration.

Decision: The alteration was invalid since it was merely for the benefit of the majority. It was not an alteration 'directly concerned with the provision of further capital' and therefore not for the benefit of the company.

Dafen Tinplate Co Ltd v Llanelly Steel Co (1907) Ltd 1920

The facts: The claimant was a minority shareholder which had transferred its custom from the defendant company to another supplier. The majority shareholders of the defendant company sought to protect their interests by altering the articles to provide for compulsory acquisition of the claimant's shares.

The new article was not restricted (as it was in *Sidebottom's* case above) to acquisition of shares on specific grounds where benefit to the company would result. It was simply expressed as a power to acquire the shares of a member. The claimant objected that the alteration was invalid since it was not for the benefit of the company.

Decision: The alteration was invalid because it 'enables the majority of the shareholders to compel any shareholder to transfer his shares'. This wide power could not 'properly be said to be for the benefit of the company'. The mere unexpressed intention to use the power in a particular way was not enough.

Therefore if the majority intend that the power to acquire the shares of a minority is to be restricted to specific circumstances for the benefit of the company, they should ensure that this restriction is included in the new article.

Scenario questions on this area of law may concern a majority wishing to amend the company's articles to allow the expulsion of a minority. If this is the case, pay close attention to the resolution as it may be invalid under one of the cases above.

2.2.6 Filing of alteration

Whenever any alteration is made to the articles a copy of the altered articles must be delivered to the Registrar within 15 days, together with a signed copy of the special resolution making the alteration.

2.2.7 Interaction of statute and articles

There are two aspects to consider.

(a) The Companies Act may permit companies to do something if their articles also authorise it. For example a company may reduce its capital if its articles give power to do this. If, however, they do not, then the company must alter the articles to include the necessary power before it may exercise the statutory power.

(b) The Companies Act will override the articles:

  (i) If the Companies Act prohibits something
  (ii) If something is permitted by the Companies Act only by a special procedure (such as passing a special resolution in general meeting)

3. Company objects and capacity

A company's objects are its aims and purposes. If a company enters into a contract which is outside its objects, that contract is said to be ultra vires. However the rights of third parties to the contract are protected.

3.1 The objects

The objects are the 'aims' and 'purposes' of a company. Under previous companies legislation they were held in a specific clause within the memorandum of association. This clause set out everything the company could do, including being a 'general commercial company' which meant it could pretty much do anything.

The 2006 Act changed matters. The objects could now be found in the articles but most articles will not mention any objects. This is because under the Act a company's objects are completely unrestricted (ie it can carry out any lawful activity). Only where the company wishes to restrict its activities is there an inclusion of those restrictions in the articles.

3.1.1 Alteration of the objects

As a company's objects are located in its articles, it may alter its objects by special resolution for any reason. The procedure is the same as for any other type of alteration.

3.2 Contractual capacity and *ultra vires*

Companies may only act in accordance with their objects. If the directors permit an act which is restricted by the company's objects then the act is *ultra vires*.

Ultra vires is where a company exceeds its objects and acts outside its capacity.

Companies which have unrestricted objects are highly unlikely to act *ultra vires* since their constitution permits them to do anything. Where a company has restrictions placed on its objects and it breaches these restrictions then it would be acting *ultra vires*.

The approach taken by the Companies Act 2006 is to give security to commercial transactions for third parties, whilst preserving the rights of shareholders to restrain directors from entering an *ultra vires* action.

There are two important sections of the Companies Act 2006 concerning *ultra vires* contracts:

S 39 provides as follows:

'the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.'

S 40 provides as follows:

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

There are a number of points to note about s 40.

(a) The section applies in favour of the person dealing with the company, it does not apply to the members.

(b) In contrast with s 39 good faith is required on the part of the third party. The company has, however, to prove lack of good faith in the third party and this may turn out to be quite difficult.

(c) The third party is not required to enquire whether or not there are any restrictions placed on the power of directors. They are free to assume the directors have any power they profess to have.

(d) The section covers not only acts beyond the capacity of the company, but acts beyond 'any limitation under the company's constitution'.

Whilst sections 39 and 40 deal with the company's transactions with third parties, the members may take action against the directors for permitting *ultra vires* acts. Their action will be based on the fact that the objects specifically restricted the particular act and directors have a statutory duty to abide by the company's constitution.

The main problem for members is that they are most likely to be aware of the *ultra vires* act only after it has occurred. Therefore they are not normally in a position to prevent it, although in theory they could seek an injunction if they found out about the potential *ultra vires* act before it took place.

3.3 Transactions with directors

The Companies Act 2006 also applies when the company enters into a contract with one of its directors, or its holding company, or any person connected with such a director. Contracts made between the company and these parties are voidable by the company if the director acts outside their capacity.

Whether or not the contract is avoided, the party and any authorising director is liable to repay any profit they made or make good any losses that result from such a contract.

4. The constitution as a contract

The articles constitute a contract between:

- Company and members
- Members and the company
- Members and members

The articles do not constitute a contract between the company and third parties, or members in a capacity other than as members (the *Eley* case).

4.1 Effect

A company's constitution bind:

- Members to company
- Company to members
- Members to members

The company's constitution does not bind the company to third parties.

This principle applies only to rights and obligations which affect members in their capacity as members.

Hickman v Kent or Romney Marsh Sheepbreeders Association 1915

The facts: The claimant (H) was in dispute with the company which had threatened to expel him from membership. The articles provided that disputes between the company and its members should be submitted to arbitration. H, in breach of that article, began an action in court against the company.

Decision: The proceedings would be stayed since the dispute (which related to matters affecting H as a member) must, in conformity with the articles, be submitted to arbitration.

The principle that only rights and obligations of members are covered applies when an outsider who is also a member seeks to rely on the articles in support of a claim made as an **outsider**.

Eley v Positive Government Security Life Assurance Co 1876

The facts: E, a solicitor, drafted the original articles and included a provision that the company must always employ him as its solicitor. E became a member of the company some months after its incorporation. He later sued the company for breach of contract in not employing him as its solicitor.

Decision: E could not rely on the article since it was a contract between the company and its members and he was not asserting any claim as a member.

The members are able to compel the company to obey the Articles: *Pender v Lushington 1877*.

4.2 Constitution as a contract between members

The Companies Act gives to the constitution contractual effect between (a) the company and (b) its members individually. It can also impose a contract on the members in their dealings with each other.

Rayfield v Hands 1958

The facts: The articles required that (a) every director should be a shareholder and (b) the directors must purchase the shares of any member who gave them notice of his wish to dispose of them. The directors, however, denied that a member could enforce the obligation on them to acquire his shares.

Decision: There was 'a contract ... between a member and member-directors in relation to their holdings of the company's shares in its articles' and the directors were bound by it.

Articles and resolutions are usually **drafted** so that each stage is a dealing between the company and the members, so that:

(a) A member who intends to transfer their shares must, if the articles so require, give notice of their intention to the company.
(b) The company must then give notice to other members that they have an option to take up their shares.

4.3 Constitution as a supplement to contracts

The constitution can be used to establish the terms of a contract existing elsewhere.

If an outsider makes a separate contract with the company and that contract contains no specific term on a particular point but the constitution does, then the contract is deemed to incorporate the constitution to that extent.

If a contract incorporates terms of the articles it is subject to the company's right to alter its articles. However a company's articles cannot be altered to deprive another person of a right already earned, say for services rendered prior to the alteration.

4.4 Shareholder agreements

Shareholders' agreements sometimes supplement a company's constitution.

Shareholder agreements are concerned with the running of the company; in particular they often contain terms by which the shareholders agree how they will vote on various issues.

They offer more protection to the interests of shareholders than do the articles of association. Individuals have a power of veto over any proposal which is contrary to the terms of the agreement. This enables a minority shareholder to protect their interests against unfavourable decisions of the majority.

5. Company name and registered office

Except in certain circumstances a company's name must end with the words limited (Ltd), public limited company (plc) or the Welsh equivalents.

A company's name is its identity. There are a number of rules which restrict the choice of name that a company may adopt.

5.1 Statutory rules on the choice of company name

No company may use a name which is:

- The same as an existing company on the Registrar's index of company names
- A criminal offence, offensive, or 'sensitive'
- Suggest a connection with the government or local authority (unless approved)

The choice of name of a limited company must conform to the following rules.

(a) The name must end with the word(s):

   (i) Public limited company (abbreviated plc) if it is a public company
   (ii) Limited (or Ltd) if it is a private limited company, unless permitted to omit 'limited' from its name
   (iii) The Welsh equivalents of either (i) or (ii) may be used by a Welsh company

(b) No company may have a name which is the same as any other company appearing in the statutory index at Companies House. For this purpose two names are treated as 'the same' in spite of minor or non-essential differences. For instance the word 'the' as the first word in the name is ignored. 'John Smith Limited' is treated the same as 'John Smith' (an unlimited company) or 'John Smith & Company Ltd'. Where a company has a name which is the same or too similar to another, the Secretary of State may direct the company to change its name.

(c) No company may have a name the use of which would be a criminal offence or which is considered offensive or 'sensitive' (as defined by the Secretary of State).

(d) Official approval is required for a name which in the Registrar's opinion suggests a connection with the government or a local authority or which is subject to control.

A name which suggests some professional expertise such as 'optician' will only be permitted if the appropriate representative association has been consulted and raises no objection.
The general purpose of the rule is to prevent a company misleading the public as to its real circumstances or activities. Certain names may be approved by the Secretary of State on written application.

5.2 Omission of the word 'limited'

A private company which is a charity or a company limited by shares or guarantee and licensed to do so before 25 February 1982 may omit the word 'limited' from its name if the following conditions are satisfied.

(a) The objects of the company must be the promotion of either commerce, art, science, education, religion, charity or any profession (or anything incidental or conducive to such objects).
(b) The memorandum or articles must require that the profits or other income of the company are to be applied to promoting its objects and no dividends or return of capital may be paid to its members. Also on liquidation the assets (otherwise distributable to members) are to be transferred to another body with similar objects. The articles must not then be altered so that the company's status to omit 'Limited' is lost.

5.3 Change of name

A company may decide to change its name by:

(a) Passing a special resolution
(b) By any other means provided for in the articles (in other words the company can specify its own procedure for changing its name).

Where a special resolution has been passed, the Registrar should be notified and a copy of the resolution sent. If the change was made by any other procedure covered by (b), the Registrar should be notified and
a statement provided which states that the change has been made in accordance with the articles.

The change is effective from when a new incorporation certificate is issued, although the company is still treated as the same legal entity as before. The same limitations as above apply to adoption of a name by change of name as by incorporation of a new company.

5.4 Passing-off action

A person who considers that their rights have been infringed can apply for an injunction to restrain a company from using a name (**even if** the name has been duly registered). It can do this if the name suggests that the latter company is carrying on the business of the complainant or is otherwise connected with it.

A company can be prevented by an injunction issued by the court in a passing-off action from using its registered name, if in doing so it causes its goods to be confused with those of the claimant.

Ewing v Buttercup Margarine Co Ltd 1917
The facts: The claimant had since 1904 run a chain of 150 shops in Scotland and the north of England through which he sold margarine and tea. He traded as 'The Buttercup Dairy Co'. The defendant was a registered company formed in 1916 with the name above. It sold margarine as a wholesaler in the London area. The defendant contended that there was unlikely to be confusion between the goods sold by the two concerns.
Decision: An injunction would be granted to restrain the defendants from the use of its name since the claimant had the established connection under the Buttercup name. He planned to open shops in the south of England and if the defendants sold margarine retail, there could be confusion between the two businesses.

If, however, the two companies' businesses are different, confusion is unlikely to occur, and hence the courts will refuse to grant an injunction. The complaint will also not succeed if the claimant lays claim to the exclusive use of a word which has a general use.

5.5 Appeal to the Company Names Adjudicators

A company which feels that another company's name which is too similar to its own may object to the Company Names Adjudicator under the Companies Act. The Adjudicator will review the case and, within 90 days, make their decision and provide their reasons for it in public. In most cases the Adjudicator will require the offending company to change its name to one which does not breach the rules. In some cases the Adjudicator may determine the new name.
An appeal against the decision may be made in Court. The Court may reverse the Adjudicator's decision, affirm it and may even determine a new name.

5.6 Publication of the company's name

The company's name must appear legibly and conspicuously:

- Outside the registered office and all places of business
- On all business letters, order forms, notices and official publications
- On all receipts and invoices issued on the company's behalf
- On all bills of exchange, letters of credit, promissory notes, cheques and orders for money or goods purporting to be signed by, or on behalf, of the company
- On its website

5.7 Business names other than the corporate name

A business name is a name used by a company which is different from the company's corporate name or by a firm which is different from the name(s) of the proprietor or the partners.

Most companies trade under their own registered names. However a company may prefer to use some other name.

The rules require any person (company, partnership or sole trader) who carries on business under a different name from their own:

(a) To state its name, registered number and registered address on all business letters (including emails), invoices, receipts, written orders for goods or services and written demands for payment of debts.
(b) To display its name and address in a prominent position in any business premises to which its customers and suppliers have access.
(c) On request from any person with whom it does business to give notice of its name and address.

5.8 Registered office

The Companies Act 2006 provides that a company must at all times have a registered office to which all communications and notices can be sent. Its location in England and Wales or just in Wales or Scotland determines its domicile. A company may change its registered office (but not its domicile), but for a period of 14 days after notice is served any person may validly present documents to the previous address.

10.0 SHARE CAPITAL

UNIT 10 OVERVIEW:

- Introduction & Key definitions
- Raising share capital
- Prospectus
- Allotment of shares

1. Members

A member of a company is a person who has agreed to become a member, and whose name has been entered in the register of members. This may occur by: subscription to the memorandum; applying for shares; the presentation to the company of a transfer of shares to the prospective member; applying as personal representative of a deceased member or a trustee of a bankrupt.

1.1 Becoming a member

A member of a company is a person who has agreed to be a member and whose name has been entered in the register of members.

Entry in the register is essential. Mere delivery to the company of a transfer of shares does not make the transferor a member – until the transfer is entered in the register.

1.2 Subscriber shares

Subscribers to the memorandum are deemed to have agreed to become members of the company. As soon as the company is formed their names should be entered in the register of members.

Other persons may acquire shares and become members:

- By applying and being allotted shares
- By presenting to the company for registration a transfer of shares to them
- By applying as personal representative or trustee of a
  - Deceased member
  - Bankrupt member

1.3 Ceasing to be a member

There are eight ways in which a member ceases to be so.

A member ceases to be a member in any of the following circumstances.

- They transfer all their shares to another person and the transfer is registered

- The member dies
- The shares of a bankrupt member are registered in the name of their trustee.
- A member who is a minor repudiates their shares.
- The trustee of a bankrupt member disclaims their shares.
- The company forfeits or accepts the surrender of shares.
- The company sells them in exercise of a lien
- The company is dissolved and ceases to exist.

1.4 The number of members

Public and private companies must have a minimum of one member. There is no maximum number.

Public and private companies must have a minimum of one member. There is no maximum number. Where a company has a sole member, the following rules will apply.

(a) The register of members must contain a statement that there is only one member and give their address.

(b) Quorum. The Act automatically permits a quorum of one for general meetings.

2. The nature of shares and capital

A **share** is a transferable form of property, carrying rights and obligations, by which the interest of a member of a company limited by shares is measured.

2.1 Shares

A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of a liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*.

The key points in this definition are:

- The share must be paid for ('liability'). The nominal value of the share fixes this liability, it is the base price of the share eg a shs1 ordinary share.
- It gives a proportionate entitlement to dividends, votes and any return of capital ('interest').
- It is a form of bargain ('mutual covenants') between shareholders which underlies such principles as majority control and minority protection.

A share's nominal value is its face value. So a shs1 ordinary share for instance, has a nominal value of shs1.
No share can be issued at a value below its nominal value.

A share is a form of personal property, carrying rights and obligations. It is by its nature transferable.

A member who holds one or more shares is a shareholder. However some companies (such as most companies limited by guarantee) do not have a share capital. So they have members who are not also shareholders.

Information about any special rights attached to shares is obtainable from one of the following documents which are on the file at Companies House:

- The articles, which are the normal context in which share rights are defined.

- A resolution or agreement incidental to the creation of a new class of shares (copies must be delivered to the Registrar).
- A statement of capital given to the Registrar within one month of allotment, together with the return of allotment.

2.2 Types of capital

The term 'capital' is used in several senses in company legislation, to mean issued, allotted or called up share capital or loan capital.

2.2.1 Authorised share capital

Under previous company legislation, companies had to specify a maximum authorised share capital that it could issue. Under the 2006 Act, the concept of authorised share capital was removed.

2.2.2 Issued and allotted share capital

Issued and allotted share capital is the type, class, number and amount of the shares issued and allotted to specific shareholders, including shares taken on formation by the subscribers to the memorandum.

A company need not issue all its share capital at once. If it retains a part, this is unissued share capital.

Issued share capital can be increased through the allotment of shares.

Rights issues and the issue of bonus shares will also increase the amount of a company's capital.

2.2.3 Called up and paid up share capital

Called up share capital is the amount which the company has required shareholders to pay now or in the future on the shares issued.

Paid up share capital is the amount which shareholders have actually paid on the shares issued and called up.

For example:
A company has issued and allotted 70 shs1 (nominal value) shares, has received 25p per share on application and has called on members for a second 25p. Therefore its issued and allotted share capital is shs70 and its called up share capital is shs35 (50p per share). When the members pay the call, the 'paid up' share capital is then shs35 also. Capital not yet called is 'uncalled capital'. Called capital which is not yet paid is termed 'partly paid'; the company therefore has an outstanding claim against its shareholders and this debt is transferred to the new shareholder if the share is transferred.

As we saw earlier, on allotment public companies must receive at least one quarter of the nominal value of the shares paid up, plus the whole of any premium.

2.2.4 Loan capital

Loan capital comprises debentures and other long-term loans to a business.

Loan capital, in contrast with the above, is the term used to describe borrowed money obtained usually by the issue of debentures. It is nothing to do with shares.

2.3 Market value

Shares of a public company are **freely transferable** (providing the appropriate procedures are followed) and therefore may be subsequently sold by some or all of the shareholders. The sale price will not necessarily be the nominal value, rather it will reflect the prospects of the company and therefore may be greater or less than the nominal value.

3 Types of share

If the constitution of a company states no differences between shares, it is assumed that they are all **ordinary** shares with parallel rights and obligations. There may, however, be other types, notably **preference shares**.

3.1 Ordinary shares (equity)

If no differences between shares are expressed then all shares are equity shares with the same rights, known as ordinary shares.

Equity is the residual interest in the assets of the company after deducting all its liabilities. It comprises issued share capital excluding any part of that does not carry any right to participate beyond a specified amount in a distribution.

Equity share capital is a company's issued share capital less capital which carries preferential rights.

Ordinary shares are shares which entitle the holders to the remaining divisible profits (and, in a liquidation, the assets) after prior interests, eg creditors and prior charge capital, have been satisfied.

3.2 Class rights

Class rights are rights which are attached to particular types of shares by the company's constitution.

A company may at its option attach special rights to different shares regarding:

- Dividends
- Return of capital
- Voting
- The right to appoint or remove a director

Shares which have different rights from others are grouped together with other shares carrying identical rights to form a class. The most common types of share capital with different rights are preference shares and ordinary shares. There may also be ordinary shares with voting rights and ordinary shares without voting rights.

3.3 Preference shares

The most common right of preference shareholders is a prior right to receive a fixed dividend. This right is not a right to compel payment of a dividend, but it is cumulative unless otherwise stated. Usually, preference shareholders cannot participate in a dividend over and above their fixed dividend and cease to be entitled to arrears of undeclared dividends when the company goes into liquidation.

Preference shares are shares carrying one or more rights such as a fixed rate of dividend or preferential claim to any company profits available for distribution.

A preference share may and generally will carry a prior right to receive an annual dividend of fixed amount, say 6% of the share's nominal value. Ordinary and preference shares are deemed to have identical rights. However, a company's articles or resolutions may create differences between them.

As regards the priority dividend entitlement, four points should be noted.

(a) The right is merely to receive a dividend at the specified rate before any other dividend may be paid or declared. It is not a right to compel the company to pay the dividend. The company can decline to pay the dividend if it decides to transfer available profits to reserves instead of using the profits to pay the preference dividend.

(b) The right to receive a preference dividend is deemed to be cumulative unless the contrary is stated. If, therefore, a 6% dividend is not paid in Year 1, the priority entitlement is normally carried forward to Year 2, increasing the priority right for that year to 12% – and so on.

    When arrears of cumulative dividend are paid, the holders of the shares at the time when the dividend is declared are entitled to the whole of it even though they did not hold the shares in the year to which the arrears relate. An intention that preference shares should not carry forward an entitlement to arrears is usually expressed by the word 'non-cumulative'.

(c) If a company which has arrears of unpaid cumulative preference dividends goes into liquidation, the preference shareholders cease to be entitled to the arrears unless:

    (i) A dividend has been declared though not yet paid when liquidation commences.
    (ii) The articles (or other terms of issue) expressly provide that in a liquidation arrears are to be paid in priority to return of capital to members.

(d) Holders of preference shares have no entitlement to participate in any additional dividend over and above their specified rate. If, for example, a 6% dividend is paid on 6% preference shares, the entire balance of available profit may then be distributed to the holders of ordinary shares.

This rule also may be expressly overridden by the terms of issue. For example, the articles may provide that the preference shares are to receive a priority 6% dividend and are also to participate equally in any dividends payable after the ordinary shares have received a 6% dividend. Preference shares with these rights are called participating preference shares.

In all other respects preference shares carry the same rights as ordinary shares unless otherwise stated.
If they do rank equally they carry the same rights, no more and no less, to return of capital, distribution of surplus assets and voting. In practice, it is unusual to issue preference shares on this basis. More usually, it is expressly provided that:

(a) The preference shares are to carry a priority right to return of capital.
(b) They are not to carry a right to vote, or voting is permitted in specified circumstances. For example failure to pay the preference dividend, variation of their rights or a resolution to wind up.

When preference shares carry a priority right to return of capital the result is that:

(a) The amount paid up on the preference shares, say shs1 on each shs1 share, is to be repaid in liquidation before anything is repaid to ordinary shareholders.
(b) Unless otherwise stated, the holders of the preference shares are not entitled to share in surplus assets when the ordinary share capital has been repaid.

3.3.1 Advantages and disadvantages of preference shares

The advantages of preference shares are greater security of income and (if they carry priority in repayment of capital) greater security of capital. However in a period of persistent inflation, the benefit of entitlement to fixed income and to capital fixed in money terms is an illusion.

A number of other drawbacks and pitfalls, such as loss of arrears, winding up and enforced payment, have been indicated above. Preference shares may be said to fall between the two stools of risk and reward (as seen in ordinary shares) and security (debentures).

3.4 Redeemable shares

Redeemable shares, which are shares issued on terms that they may be bought back by a company either at a future specific date or at the shareholder's or company's option.

3.5 Treasury shares

Treasury shares are created when a limited company legitimately purchases its own shares out of cash or distributable profit. The purchased shares are then held by the company 'in treasury' which means the company can re-issue them without the usual formalities. They can only be sold for cash and the company cannot exercise the voting rights which attach to them.

3.5.1 Variation of class rights

The holders of issued shares have vested rights which can only be varied by using a strict procedure. The standard procedure is by special resolution passed by at least three quarters of the votes cast at a separate class meeting or by written consent.

A variation of class rights is an alteration in the position of shareholders with regard to those rights or duties which they have by virtue of their shares.

Examples of rights that attach to shares (class rights) include voting rights, a right to dividends and a right to a return of capital when a company is wound-up. Rights attach to a particular class of shares if the holders of shares in that class enjoy rights that are not enjoyed by the holders of shares in another class

These class rights can only be varied by the company with the consent of all the shareholders in the class, or with such consent of a majority as is specified (usually) in the articles. The standard procedure for variation of class rights requires that a special resolution shall be passed by a three quarters majority cast either at a separate meeting of the class, or by written consent. If any other requirements are imposed by the company's articles then these must also be followed.

3.5.2 When variation rules apply

It is **not** a variation of class rights to issue shares to new members, to subdivide shares of another class, to return capital to preference shareholders, or to create a new class of preference shareholders.

It is only necessary to follow the variation of class rights procedure if what is proposed amounts to a variation of class rights. The following examples do not constitute a variation of class rights.

3.5.3 Examples: Not a variation of class rights

(a) To issue shares of the same class to allottees who are not already members of the class (unless the defined class rights prohibit this).

White v Bristol Aeroplane Co Ltd 1953

The facts: The company made a bonus issue of new ordinary and preference shares to the existing ordinary shareholders who alone were entitled under the articles to participate in bonus issues. The existing preference shareholders objected. They stated that reducing their proportion of the class of preference shares (by issuing the bonus of preference shares) was a variation of class rights to which they had not consented.

Decision: This was not a variation of class rights since the existing preference shareholders had the same number of shares (and votes at a class meeting) as before.

(b) To subdivide shares of another class with the incidental effect of increasing the voting strength of that other class

Greenhalgh v Arderne Cinemas Ltd 1946

The facts: The company had two classes of ordinary shares, 50p shares and 10p shares. Every share carried one vote. A resolution was passed to subdivide each 50p share into five 10p shares, thus multiplying the votes of that class by five.

Decision: The rights of the original 10p shares had not been varied since they still had one vote per share as before.

(c) To return capital to the holders of preference shares

(d) To create and issue a new class of preference shares with priority over an existing class of ordinary shares

The cases cited in the preceding paragraph illustrate the principle that without a 'literal variation' of class rights there is no alteration of rights to which the safeguards of proper procedure and appeal to the court apply. The fact that the value of existing rights may be affected will not concern the court if the rights are unchanged.

Knowledge of what does not constitute a variation of class rights is vital in this area.

3.5.4 Special situations

To deal with unusual situations which in the past caused some difficulty, the following rules apply.

(a) If the class rights are set by the articles and they provide a variation procedure, that procedure must be followed for any variation even if it is less onerous than the statutory procedure.

(b) If class rights are defined otherwise than by the articles and there is no variation procedure, consent of a three quarters majority of the class is both necessary and sufficient.

The rules on notice, voting, polls, circulation of resolutions and quorum relating to general meetings relate also to class meetings when voting on alteration of class rights.

3.5.5 Minority appeals to the court for unfair prejudice

A dissenting minority holding 15% or more of the issued shares may apply to the court within 21 days of class consent to have the variation cancelled as 'unfairly prejudicial'.

Whenever class rights are varied under a procedure contained in the constitution, a minority of holders of shares of the class may apply to the court to have the variation cancelled.

The objectors together must:

- Hold not less than 15% of the issued shares of the class in question
- Not themselves have consented to or voted in favour of the variation
- Apply to the court within 21 days of the consent being given by the class

The court can either approve the variation as made or cancel it as 'unfairly prejudicial'. It cannot, however, modify the terms of the variation. To establish that a variation is 'unfairly prejudicial' to the class, the minority must show that the majority was seeking some advantage to themselves as members of a different class instead of considering the interests of the class in which they were then voting.

3.6 Statement of capital and initial shareholdings

A return known as a statement of capital and initial shareholdings is required to be made to the Registrar when a company is registered, and therefore applies only to the shares of the subscribers. This statement must give the following details in respect of the company's share capital and be up to date as of the statement date.

(a) The total number of shares of the company

(b) The aggregate nominal value of the shares

(c) For each class of share:

(i) The prescribed particulars of any rights attached
(ii) The total number of shares in the class
(iii) The aggregate nominal value of shares in the class

(d) The amount paid up and the amount (if any) unpaid on each share, either on account of the nominal value of the share or by way of premium.
(e) Information that identifies the subscribers to the memorandum of association.

(f) In respect of each subscriber, the number, nominal value and class of shares taken by them on formation and the amount to be paid up.

4. Allotment of shares

Directors exercise the delegated power to allot shares, either by virtue of the articles or a resolution in general meeting.

4.1 Definition

Allotment of shares is the issue and allocation to a person of a certain number of shares under a contract of allotment. Once the shares are allotted and the holder is entered in the register of members, the holder becomes a member of the company. The member is issued with a share certificate.

The allotment of shares is a form of contract. The intending shareholder applies to the company for shares, and the company accepts the offer. The terms 'allotment' and 'issue' have different meanings.

(a) A share is allotted when the person to whom it is allotted acquires an unconditional right to be entered in the register of members as the holder of that share. That stage is reached when the board of directors (to whom the power to allot shares is usually given) considers the application and formally resolves to allot the shares.

However if the directors imposed a condition, for instance that the shares should be allotted only on receipt of the subscription money, the allotment would only take effect when payment was made.

(b) The issue of shares is not a defined term but is usually taken to be a later stage at which the allottee receives a letter of allotment or share certificate issued by the company.

The allotment of shares of a private company is a simple and immediate matter. The name of the allottee is entered in the register of members soon after the allotment of shares and they become a member.

4.2 Public company allotment of shares

There are various methods of selling shares to the public.

Public offer: where members of the public subscribe for shares directly to the company.
Offer for sale: an offer to members of the public to apply for shares based on information in a prospectus.
Placing: a method of raising share capital where shares are offered in a small number of large 'blocks', to persons or institutions who have previously agreed to purchase the shares at a predetermined price.

4.3 Private company allotment of shares

The allotment of shares in a private company is more straightforward. The rule to remember is that private companies cannot sell shares to the public. An application must be made to the directors directly. After that shares are allotted and issued, and a return of allotment made to the Registrar, as for a public company.

4.3.1 Directors' powers to allot shares

Directors of private companies with one class of share have the authority to allot shares unless restricted by the articles.

Directors of public companies or private companies with more than one class of share may not allot shares (except to subscribers to the memorandum and to employees' share schemes) without authority from the members. Any director who allots shares without authority commits an offence under the Companies Act 2006 and may be fined. However, the allotment remains valid.

4.4 Pre-emption rights

If the directors propose to allot 'equity securities' wholly for cash, there is a general requirement to offer these shares to holders of similar shares in proportion to their holdings.

Pre-emption rights are the rights of existing ordinary shareholders to be offered new shares issued by the company *pro rata* to their existing holding of that class of shares.

If a company proposes to allot ordinary shares wholly for cash, it has a statutory obligation to offer those shares first to holders of similar shares in proportion to their holdings and on the same or more favourable terms as the main allotment. This is known as a rights issue.

4.5 Rights issues

A rights issue is a right given to a shareholder to subscribe for further shares in the company, usually *prorata* to their existing holding in the company's shares.

A rights issue must be made in writing (hard copy or electronic) in the same manner as a notice of a general meeting is sent to members. It must specify a period of not less than 21 days during which the offer may be accepted but may not be withdrawn. If not accepted or renounced in favour of another person within that period the offer is deemed to be declined.

Equity securities which have been offered to members in this way but are not accepted may then be allotted on the same (or less favourable) terms to non-members. If equity securities are allotted in breach of these rules the members to whom the offer should have been made may within the ensuing two years recover compensation for their loss from those in default. The allotment will generally be valid.

4.5.1 Exclusion of pre-emption rights

A private company may by its articles permanently exclude these rules so that there is no statutory right of first refusal.

4.5.2 Disapplication of pre-emption rights

Any company may, by special resolution resolve that the statutory right of first refusal shall not apply. Such a resolution to 'disapply' the right may either:

(a) Be combined with the grant to directors of authority to allot shares, or

(b) Simply permit an offer of shares to be made for cash to a non-member (without first offering the shares to members) on a particular occasion

4.6 Bonus issues

A bonus issue is the capitalisation of the reserves of a company by the issue of additional shares to existing shareholders, in proportion to their holdings. Such shares are normally fully paid-up with no cash called for from the shareholders.
A bonus issue is more correctly but less often called a 'capitalisation issue' (also called a 'scrip' issue). The articles of a company usually give it power to apply its reserves to paying up unissued shares wholly or in part and then to allot these shares as a bonus issue to members.

5. Issuing shares at a premium or at a discount

In issuing shares, a company must fix a price which is equal to or more than the nominal value of the shares. It may not allot shares at a discount to the nominal value.

Every share has a nominal value and may not be allotted at a discount to that.

In allotting shares every company is required to obtain in money or money's worth, consideration of a value at least equal to the nominal value of the shares plus the whole of any premium. To issue shares 'at par' is to obtain equal value, say, shs1 for a shs1 share.

Ooregum Gold Mining Co of India v Roper 1892

The facts: Shares in the company, although nominally shs1, were trading at a market price of 12.5p. In an honest attempt to refinance the company, new shs1 preference shares were issued and credited with 75p already paid, so the purchasers of the shares were actually paying twice the market value of the ordinary shares. When, however, the company subsequently went into insolvent liquidation the holders of the new shares were required to pay a further 75p.

If shares are allotted at a discount to their nominal value, the allottee, if they agree to the issue, must nonetheless pay the full nominal value with interest at the appropriate rate. Any subsequent holder of such a share who knew of the underpayment must make good the shortfall.

Consideration for shares	
Partly-paid shares	The no-discount rule only requires that, in allotting its shares, a company shall not fix a price which is less than the nominal value of the shares. It may leave part of that price to be paid at some later time. Thus shs1 shares may be issued partly-paid – 75p on allotment and 25p when called for or by instalment. The unpaid capital passes with the shares. If transferred, they are a debt payable by the holder at the time when payment is demanded.
Underwriting fees	A company may pay underwriting or other commission in respect of an issue of shares if so permitted by its Articles. This means that, if shares are issued at par the net amount received will be below par value.
Bonus issue	The allotment of shares as a 'bonus issue' is for full consideration since reserves, which are shareholders' funds, are converted into fixed capital and are used to pay for the shares.
Money's worth	The price for the shares may be paid in money or 'money's worth', including goodwill and know-how. It need not be paid in cash and the company may agree to accept a 'non-cash' consideration of sufficient value. For instance, a company may issue shares in payment of the price agreed in the purchase of a property.

5.1 Private companies

Private companies may issue shares for inadequate consideration provided the directors are behaving reasonably and honestly.

A private company may allot shares for inadequate consideration by acceptance of goods or services at an over-value. This loophole has been allowed to exist because in some cases it is very much a matter of opinion whether an asset is or is not of a stated value.

The courts therefore have refused to overrule directors in their valuation of an asset acquired for shares if it appears reasonable and honest. However a blatant and unjustified overvaluation will be declared invalid.

5.2 Public companies

There are stringent rules on consideration for shares in public companies. More stringent rules apply to public companies.

(a) The company must, at the time of allotment, receive at least one quarter of the nominal value of the shares and the whole of any premium.
(b) Any non-cash consideration accepted must be independently valued.
(c) Non-cash consideration may not be accepted as payment for shares if an undertaking contained in such consideration is to be, or may be, performed more than five years after the allotment. This relates to, say, a property or business in return for shares. To enforce the five year rule the law requires that:

    (i) At the time of the allotment the allottee must undertake to perform their side of the agreement within a specified period which must not exceed five years. If no such undertaking is given the allottee becomes immediately liable to pay cash for their shares as soon as they are allotted.
    (ii) If the allottee later fails to perform their undertaking to transfer property at the due time they become liable to pay cash for their shares when they default.

(d) An undertaking to do work or perform services is not to be accepted as consideration. A public company may, however, allot shares to discharge a debt in respect of services already rendered.

If a public company does accept future services as consideration the holder must pay the company their nominal value plus any premium treated as paid-up, and interest at 5% on any such amount.

(e) Within two years of receiving its trading certificate, a public company may not receive a transfer of non-cash assets from a subscriber to the memorandum. This is unless its value is less than 10% of the issued nominal share capital and it has been independently valued and agreed by an ordinary resolution.

5.2.1 Valuation of non-cash assets

When a public company allots shares for a non-cash consideration the company must usually obtain a report on its value from an independent valuer.

The valuation report must be made to the company within the six months before the allotment. On receiving the report the company must send a copy to the proposed allottee and later to the Registrar.

The independent valuation rule does not apply to an allotment of shares made in the course of a takeover bid.

5.3 Allotment of shares at a premium

If shares are issued at a premium, the excess must be credited to a share premium account.

Share premium is the excess received, either in cash or other consideration, over the nominal value of the shares issued.
An established company may be able to obtain consideration for new shares in excess of their nominal value. The excess, called 'share premium', must be credited to a share premium account.

If a company obtains non-cash consideration for its shares which exceeds the nominal value of the shares the excess should also be credited to the share premium account.

5.3.1 Example: Using a share premium account

If a company allots its shs1 (nominal) shares for shs1.50 in cash, shs1 per share is credited to the share capital account, and 50p to the share premium account.

Example:
We will use the above example to illustrate the effects of the transaction on the balance sheet. The company has issued 100 shares.

	Before share issue	**After share issue**
	Shs.	Shs.
Cash	100	250
Share capital	100	200
Share premium	—	50
	100	250

The general rule is that reduction of the share premium account is subject to the same restrictions as reduction of share capital. You should learn the fact that a company cannot distribute any part of its share premium account as dividend.

5.4 Uses of the share premium account
Use of the share premium account is limited. It is most often used for bonus issues. Under the Companies Act, the permitted uses of share premium are to pay:

- Fully paid shares under a bonus issue since this operation merely converts one form of fixed capital (share premium) into another (share capital)
- Issue expenses and commission in respect of a new share issue

Additionally, the share premium account may be used to finance any premium due when redeemable shares are redeemed.

1. Members

A member of a company is a person who has agreed to become a member, and whose name has been entered in the register of members. This may occur by: subscription to the memorandum; applying for shares; the presentation to the company of a transfer of shares to the prospective member; applying as personal representative of a deceased member or a trustee of a bankrupt.

1.1 Becoming a member

A member of a company is a person who has agreed to be a member and whose name has been entered in the register of members.

Entry in the register is essential. Mere delivery to the company of a transfer of shares does not make the transferor a member – until the transfer is entered in the register.

1.2 Subscriber shares

Subscribers to the memorandum are deemed to have agreed to become members of the company. As soon as the company is formed their names should be entered in the register of members.

Other persons may acquire shares and become members:

- By applying and being allotted shares
- By presenting to the company for registration a transfer of shares to them
- By applying as personal representative or trustee of a
    - Deceased member
    - Bankrupt member

1.3 Ceasing to be a member

There are eight ways in which a member ceases to be so.

A member ceases to be a member in any of the following circumstances.

- They transfer all their shares to another person and the transfer is registered
- The member dies
- The shares of a bankrupt member are registered in the name of their trustee.
- A member who is a minor repudiates their shares.
- The trustee of a bankrupt member disclaims their shares.
- The company forfeits or accepts the surrender of shares.

- The company sells them in exercise of a lien
- The company is dissolved and ceases to exist.

1.4 The number of members

Public and private companies must have a minimum of one member. There is no maximum number.

Public and private companies must have a minimum of one member. There is no maximum number. Where a company has a sole member, the following rules will apply.

(a) The register of members must contain a statement that there is only one member and give their address.

(c) Quorum. The Act automatically permits a quorum of one for general meetings.

2. The nature of shares and capital

A **share** is a transferable form of property, carrying rights and obligations, by which the interest of a member of a company limited by shares is measured.

2.1 Shares

A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of a liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*.

The key points in this definition are:

- The share must be paid for ('liability'). The nominal value of the share fixes this liability, it is the base price of the share eg a shs1 ordinary share.
- It gives a proportionate entitlement to dividends, votes and any return of capital ('interest').
- It is a form of bargain ('mutual covenants') between shareholders which underlies such principles as majority control and minority protection.

A share's nominal value is its face value. So a shs1 ordinary share for instance, has a nominal value of shs1.
No share can be issued at a value below its nominal value.

A share is a form of personal property, carrying rights and obligations. It is by its nature transferable.

A member who holds one or more shares is a shareholder. However some companies (such as most companies limited by guarantee) do not have a share capital. So they have members who are not also shareholders.

Information about any special rights attached to shares is obtainable from one of the following documents which are on the file at Companies House:

- The articles, which are the normal context in which share rights are defined.
- A resolution or agreement incidental to the creation of a new class of shares (copies must be delivered to the Registrar).
- A statement of capital given to the Registrar within one month of allotment, together with the return of allotment.

2.2 Types of capital

The term 'capital' is used in several senses in company legislation, to mean issued, allotted or called up share capital or loan capital.

2.2.1 Authorised share capital

Under previous company legislation, companies had to specify a maximum authorised share capital that it could issue. Under the 2006 Act, the concept of authorised share capital was removed.

2.2.2 Issued and allotted share capital

Issued and allotted share capital is the type, class, number and amount of the shares issued and allotted to specific shareholders, including shares taken on formation by the subscribers to the memorandum.

A company need not issue all its share capital at once. If it retains a part, this is unissued share capital.

Issued share capital can be increased through the allotment of shares.

Rights issues and the issue of bonus shares will also increase the amount of a company's capital.

2.2.3 Called up and paid up share capital

Called up share capital is the amount which the company has required shareholders to pay now or in the future on the shares issued.

Paid up share capital is the amount which shareholders have actually paid on the shares issued and called up.

For example:
A company has issued and allotted 70 shs1 (nominal value) shares, has received 25p per share on application and has called on members for a second 25p. Therefore its issued and allotted share capital is shs70 and its called up share capital is shs35 (50p per share). When the members pay the call, the 'paid up' share capital is then shs35 also. Capital not yet called is 'uncalled capital'. Called capital which is not yet paid is termed 'partly paid'; the company therefore has an outstanding claim against its shareholders and this debt is transferred to the new shareholder if the share is transferred.

As we saw earlier, on allotment public companies must receive at least one quarter of the nominal value of the shares paid up, plus the whole of any premium.

2.2.4 Loan capital

Loan capital comprises debentures and other long-term loans to a business.

Loan capital, in contrast with the above, is the term used to describe borrowed money obtained usually by the issue of debentures. It is nothing to do with shares.

2.3 Market value
Shares of a public company are **freely transferable** (providing the appropriate procedures are followed) and therefore may be subsequently sold by some or all of the shareholders. The sale price will not necessarily be the nominal value, rather it will reflect the prospects of the company and therefore may be greater or less than the nominal value.

3 Types of share

If the constitution of a company states no differences between shares, it is assumed that they are all **ordinary** shares with parallel rights and obligations. There may, however, be other types, notably **preference shares**.

3.1 Ordinary shares (equity)

If no differences between shares are expressed then all shares are equity shares with the same rights, known as ordinary shares.

Equity is the residual interest in the assets of the company after deducting all its liabilities. It comprises issued share capital excluding any part of that does not carry any right to participate beyond a specified amount in a distribution.

Equity share capital is a company's issued share capital less capital which carries preferential rights.

Ordinary shares are shares which entitle the holders to the remaining divisible profits (and, in a liquidation, the assets) after prior interests, eg creditors and prior charge capital, have been satisfied.

3.2 Class rights

Class rights are rights which are attached to particular types of shares by the company's constitution.

A company may at its option attach special rights to different shares regarding:

- Dividends
- Return of capital
- Voting
- The right to appoint or remove a director

Shares which have different rights from others are grouped together with other shares carrying identical rights to form a class. The most common types of share capital with different rights are preference shares and ordinary shares. There may also be ordinary shares with voting rights and ordinary shares without voting rights.

3.3 Preference shares

The most common right of preference shareholders is a prior right to receive a fixed dividend. This right is not a right to compel payment of a dividend, but it is cumulative unless otherwise stated. Usually, preference shareholders cannot participate in a dividend over and above their fixed dividend and cease to be entitled to arrears of undeclared dividends when the company goes into liquidation.

Preference shares are shares carrying one or more rights such as a fixed rate of dividend or preferential claim to any company profits available for distribution.

A preference share may and generally will carry a prior right to receive an annual dividend of fixed amount, say 6% of the share's nominal value. Ordinary and preference shares are deemed to have identical rights. However, a company's articles or resolutions may create differences between them.

As regards the priority dividend entitlement, four points should be noted.

(e) The right is merely to receive a dividend at the specified rate before any other dividend may be paid or declared. It is not a right to compel the company to pay the dividend. The company can decline to pay the dividend if it decides to transfer available profits to reserves instead of using the profits to pay the preference dividend.

(f) The right to receive a preference dividend is deemed to be cumulative unless the contrary is stated. If, therefore, a 6% dividend is not paid in Year 1, the priority entitlement is normally carried forward to Year 2, increasing the priority right for that year to 12% – and so on.

When arrears of cumulative dividend are paid, the holders of the shares at the time when the dividend is declared are entitled to the whole of it even though they did not hold the shares in the year to which the arrears relate. An intention that preference shares should not carry forward an entitlement to arrears is usually expressed by the word 'non-cumulative'.

(g) If a company which has arrears of unpaid cumulative preference dividends goes into liquidation, the preference shareholders cease to be entitled to the arrears unless:

(iii) A dividend has been declared though not yet paid when liquidation commences.
(iv) The articles (or other terms of issue) expressly provide that in a liquidation arrears are to be paid in priority to return of capital to members.

(h) Holders of preference shares have no entitlement to participate in any additional dividend over and above their specified rate. If, for example, a 6% dividend is paid on 6% preference shares, the entire balance of available profit may then be distributed to the holders of ordinary shares.

This rule also may be expressly overridden by the terms of issue. For example, the articles may provide that the preference shares are to receive a priority 6% dividend and are also to participate equally in any dividends payable after the ordinary shares have received a 6% dividend. Preference shares with these rights are called participating preference shares.

In all other respects preference shares carry the same rights as ordinary shares unless otherwise stated.
If they do rank equally they carry the same rights, no more and no less, to return of capital, distribution of surplus assets and voting. In practice, it is unusual to issue preference shares on this basis. More usually, it is expressly provided that:

(c) The preference shares are to carry a priority right to return of capital.
(d) They are not to carry a right to vote, or voting is permitted in specified circumstances. For example failure to pay the preference dividend, variation of their rights or a resolution to wind up.

When preference shares carry a priority right to return of capital the result is that:

(c) The amount paid up on the preference shares, say shs1 on each shs1 share, is to be repaid in liquidation before anything is repaid to ordinary shareholders.
(d) Unless otherwise stated, the holders of the preference shares are not entitled to share in surplus assets when the ordinary share capital has been repaid.

3.3.1 Advantages and disadvantages of preference shares

The advantages of preference shares are greater security of income and (if they carry priority in repayment of capital) greater security of capital. However in a period of persistent inflation, the benefit of entitlement to fixed income and to capital fixed in money terms is an illusion.

A number of other drawbacks and pitfalls, such as loss of arrears, winding up and enforced payment, have been indicated above. Preference shares may be said to fall between the two stools of risk and reward (as seen in ordinary shares) and security (debentures).

3.4 Redeemable shares

Redeemable shares, which are shares issued on terms that they may be bought back by a company either at a future specific date or at the shareholder's or company's option.

3.5 Treasury shares

Treasury shares are created when a limited company legitimately purchases its own shares out of cash or distributable profit. The purchased shares are then held by the company 'in treasury' which means the company can re-issue them without the usual formalities. They can only be sold for cash and the company cannot exercise the voting rights which attach to them.

3.5.1 Variation of class rights

The holders of issued shares have vested rights which can only be varied by using a strict procedure. The standard procedure is by special resolution passed by at least three quarters of the votes cast at a separate class meeting or by written consent.

A variation of class rights is an alteration in the position of shareholders with regard to those rights or duties which they have by virtue of their shares.

Examples of rights that attach to shares (class rights) include voting rights, a right to dividends and a right to a return of capital when a company is wound-up. Rights attach to a particular class of shares if the holders of shares in that class enjoy rights that are not enjoyed by the holders of shares in another class

These class rights can only be varied by the company with the consent of all the shareholders in the class, or with such consent of a majority as is specified (usually) in the articles. The standard procedure for variation of class rights requires that a special resolution shall be passed by a three quarters majority cast either at a separate meeting of the class, or by written consent. If any other requirements are imposed by the company's articles then these must also be followed.

3.5.2 When variation rules apply

It is **not** a variation of class rights to issue shares to new members, to subdivide shares of another class, to return capital to preference shareholders, or to create a new class of preference shareholders.

It is only necessary to follow the variation of class rights procedure if what is proposed amounts to a variation of class rights. The following examples do not constitute a variation of class rights.

3.5.3 Examples: Not a variation of class rights

(c) To issue shares of the same class to allottees who are not already members of the class (unless the defined class rights prohibit this).

White v Bristol Aeroplane Co Ltd 1953

The facts: The company made a bonus issue of new ordinary and preference shares to the existing ordinary shareholders who alone were entitled under the articles to participate in bonus issues. The existing preference shareholders objected. They stated that reducing their proportion of the class of preference shares (by issuing the bonus of preference shares) was a variation of class rights to which they had not consented.

Decision: This was not a variation of class rights since the existing preference shareholders had the same number of shares (and votes at a class meeting) as before.

(d) To subdivide shares of another class with the incidental effect of increasing the voting strength of that other class

Greenhalgh v Arderne Cinemas Ltd 1946

The facts: The company had two classes of ordinary shares, 50p shares and 10p shares. Every share carried one vote. A resolution was passed to subdivide each 50p share into five 10p shares, thus multiplying the votes of that class by five.

Decision: The rights of the original 10p shares had not been varied since they still had one vote per share as before.

(c) To return capital to the holders of preference shares

(d) To create and issue a new class of preference shares with priority over an existing class of ordinary shares

The cases cited in the preceding paragraph illustrate the principle that without a 'literal variation' of class rights there is no alteration of rights to which the safeguards of proper procedure and appeal to the court apply. The fact that the value of existing rights may be affected will not concern the court if the rights are unchanged.

Knowledge of what does not constitute a variation of class rights is vital in this area.

3.5.4 Special situations

To deal with unusual situations which in the past caused some difficulty, the following rules apply.

(c) If the class rights are set by the articles and they provide a variation procedure, that procedure must be followed for any variation even if it is less onerous than the statutory procedure.

(d) If class rights are defined otherwise than by the articles and there is no variation procedure, consent of a three quarters majority of the class is both necessary and sufficient.

The rules on notice, voting, polls, circulation of resolutions and quorum relating to general meetings relate also to class meetings when voting on alteration of class rights.

3.5.5 Minority appeals to the court for unfair prejudice

A dissenting minority holding 15% or more of the issued shares may apply to the court within 21 days of class consent to have the variation cancelled as 'unfairly prejudicial'.

Whenever class rights are varied under a procedure contained in the constitution, a minority of holders of shares of the class may apply to the court to have the variation cancelled.

The objectors together must:

- Hold not less than 15% of the issued shares of the class in question
- Not themselves have consented to or voted in favour of the variation

- Apply to the court within 21 days of the consent being given by the class

The court can either approve the variation as made or cancel it as 'unfairly prejudicial'. It cannot, however, modify the terms of the variation. To establish that a variation is 'unfairly prejudicial' to the class, the minority must show that the majority was seeking some advantage to themselves as members of a different class instead of considering the interests of the class in which they were then voting.

3.6 Statement of capital and initial shareholdings

A return known as a statement of capital and initial shareholdings is required to be made to the Registrar when a company is registered, and therefore applies only to the shares of the subscribers. This statement must give the following details in respect of the company's share capital and be up to date as of the statement date.

(a) The total number of shares of the company
(b) The aggregate nominal value of the shares
(c) For each class of share:

(i) The prescribed particulars of any rights attached
(ii) The total number of shares in the class
(iii) The aggregate nominal value of shares in the class

(d) The amount paid up and the amount (if any) unpaid on each share, either on account of the nominal value of the share or by way of premium.
(e) Information that identifies the subscribers to the memorandum of association.

(f) In respect of each subscriber, the number, nominal value and class of shares taken by them on formation and the amount to be paid up.

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4.1 Definition

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4.5 Rights issues

A rights issue is a right given to a shareholder to subscribe for further shares in the company, usually *prorata* to their existing holding in the company's shares.

A rights issue must be made in writing (hard copy or electronic) in the same manner as a notice of a general meeting is sent to members. It must specify a period of not less than 21 days during which the offer may be accepted but may not be withdrawn. If not accepted or renounced in favour of another person within that period the offer is deemed to be declined.

Equity securities which have been offered to members in this way but are not accepted may then be allotted on the same (or less favourable) terms to non-members. If equity securities are allotted in breach of these rules the members to whom the offer should have been made may within the ensuing two years recover compensation for their loss from those in default. The allotment will generally be valid.

4.5.1 Exclusion of pre-emption rights

A private company may by its articles permanently exclude these rules so that there is no statutory right of first refusal.

4.5.2 Disapplication of pre-emption rights

Any company may, by special resolution resolve that the statutory right of first refusal shall not apply. Such a resolution to 'disapply' the right may either:

(d) Be combined with the grant to directors of authority to allot shares, or

(e) Simply permit an offer of shares to be made for cash to a non-member (without first offering the shares to members) on a particular occasion

4.6 Bonus issues

A bonus issue is the capitalisation of the reserves of a company by the issue of additional shares to existing shareholders, in proportion to their holdings. Such shares are normally fully paid-up with no cash called for from the shareholders.
A bonus issue is more correctly but less often called a 'capitalisation issue' (also called a 'scrip' issue). The articles of a company usually give it power to apply its reserves to paying up unissued shares wholly or in part and then to allot these shares as a bonus issue to members.

5. Issuing shares at a premium or at a discount

In issuing shares, a company must fix a price which is equal to or more than the nominal value of the shares. It may not allot shares at a discount to the nominal value.

Every share has a nominal value and may not be allotted at a discount to that.

In allotting shares every company is required to obtain in money or money's worth, consideration of a value at least equal to the nominal value of the shares plus the whole of any premium. To issue shares 'at par' is to obtain equal value, say, shs1 for a shs1 share.

Ooregum Gold Mining Co of India v Roper 1892

The facts: Shares in the company, although nominally shs1, were trading at a market price of 12.5p. In an honest attempt to refinance the company, new shs1 preference shares were issued and credited with 75p already paid, so the purchasers of the shares were actually paying twice the market value of the ordinary
shares. When, however, the company subsequently went into insolvent liquidation the holders of the new shares were required to pay a further 75p.

If shares are allotted at a discount to their nominal value, the allottee, if they agree to the issue, must nonetheless pay the full nominal value with interest at the appropriate rate. Any subsequent holder of such a share who knew of the underpayment must make good the shortfall.

Consideration for shares	
Partly-paid shares	The no-discount rule only requires that, in allotting its shares, a company shall not fix a price which is less than the nominal value of the shares. It may leave part of that price to be paid at some later time. Thus shs1 shares may be issued partly-paid – 75p on allotment and 25p when called for or by instalment. The unpaid capital passes with the shares. If transferred, they are a debt payable by the holder at the time when payment is demanded.
Underwriting fees	A company may pay underwriting or other commission in respect of an issue of shares if so permitted by its Articles. This means that, if shares are issued at par the net amount received will be below par value.
Bonus issue	The allotment of shares as a 'bonus issue' is for full consideration since reserves, which are shareholders' funds, are converted into fixed capital and are used to pay for the shares.
Money's worth	The price for the shares may be paid in money or 'money's worth', including goodwill and know-how. It need not be paid in cash and the company may agree to accept a 'non-cash' consideration of sufficient value. For instance, a company may issue shares in payment of the price agreed in the purchase of a property.

5.1 Private companies

Private companies may issue shares for inadequate consideration provided the directors are behaving reasonably and honestly.

A private company may allot shares for inadequate consideration by acceptance of goods or services at an over-value. This loophole has been allowed to exist because in some cases it is very much a matter of opinion whether an asset is or is not of a stated value.

The courts therefore have refused to overrule directors in their valuation of an asset acquired for shares if it appears reasonable and honest. However a blatant and unjustified overvaluation will be declared invalid.

5.2 Public companies

There are stringent rules on consideration for shares in public companies. More stringent rules apply to public companies.

(f) The company must, at the time of allotment, receive at least one quarter of the nominal value of the shares and the whole of any premium.
(g) Any non-cash consideration accepted must be independently valued.
(h) Non-cash consideration may not be accepted as payment for shares if an undertaking contained in such consideration is to be, or may be, performed more than five years after the allotment. This relates to, say, a property or business in return for shares. To enforce the five year rule the law requires that:

    (iii) At the time of the allotment the allottee must undertake to perform their side of the agreement within a specified period which must not exceed five years. If no such undertaking is given the allottee becomes immediately liable to pay cash for their shares as soon as they are allotted.
    (iv) If the allottee later fails to perform their undertaking to transfer property at the due time they become liable to pay cash for their shares when they default.

(i) An undertaking to do work or perform services is not to be accepted as consideration. A public company may, however, allot shares to discharge a debt in respect of services already rendered.

    If a public company does accept future services as consideration the holder must pay the company their nominal value plus any premium treated as paid-up, and interest at 5% on any such amount.

(j) Within two years of receiving its trading certificate, a public company may not receive a transfer of non-cash assets from a subscriber to the memorandum. This is unless its value is less than 10% of the issued nominal share capital and it has been independently valued and agreed by an ordinary resolution.

5.2.1 Valuation of non-cash assets

When a public company allots shares for a non-cash consideration the company must usually obtain a report on its value from an independent valuer.

The valuation report must be made to the company within the six months before the allotment. On receiving the report the company must send a copy to the proposed allottee and later to the Registrar.

The independent valuation rule does not apply to an allotment of shares made in the course of a takeover bid.

5.3 Allotment of shares at a premium

If shares are issued at a premium, the excess must be credited to a share premium account.

Share premium is the excess received, either in cash or other consideration, over the nominal value of the shares issued.

An established company may be able to obtain consideration for new shares in excess of their nominal value. The excess, called 'share premium', must be credited to a share premium account.

If a company obtains non-cash consideration for its shares which exceeds the nominal value of the shares the excess should also be credited to the share premium account.

5.3.1 Example: Using a share premium account

If a company allots its shs1 (nominal) shares for shs1.50 in cash, shs1 per share is credited to the share capital account, and 50p to the share premium account.

Example:
We will use the above example to illustrate the effects of the transaction on the balance sheet. The company has issued 100 shares.

	Before share issue	**After share issue**
	Shs.	Shs.
Cash	100	250
Share capital	100	200
Share premium	—	50
	100	250

The general rule is that reduction of the share premium account is subject to the same restrictions as reduction of share capital. You should learn the fact that a company cannot distribute any part of its share premium account as dividend.

5.4 Uses of the share premium account

Use of the share premium account is limited. It is most often used for bonus issues. Under the Companies Act, the permitted uses of share premium are to pay:

- Fully paid shares under a bonus issue since this operation merely converts one form of fixed capital (share

premium) into another (share capital)
- Issue expenses and commission in respect of a new share issue

Additionally, the share premium account may be used to finance any premium due when redeemable shares are redeemed.

11.0 DEBENTURES

UNIT 11 OVERVIEW

- Definition and classification of debentures
- Issue and transfer of debentures
- Trust deed
- Other legal issues

1. Borrowing

Companies have an implied power to borrow for purposes incidental to their trade or business.

All companies registered under the Companies Act 2006 have an implied power to borrow for purposes incidental to their trade or business. A company formed under earlier Acts will have an implied power to borrow if its object is to carry on a trade or business. In delegating the company's power to borrow to the directors it is usual, and essential in the case of a company whose shares are quoted on the Stock Exchange, to impose a maximum limit on the borrowing arranged by directors.

A contract to repay borrowed money may in principle be unenforceable if either:

- It is money borrowed for an ultra vires (or restricted) purpose, and this is known to the lender.
- The directors exceed their borrowing powers or have no powers to borrow.

However:

- In both cases the lender will probably be able to enforce the contract.
- If the contract is within the capacity of the company but beyond the delegated powers of the directors the company may ratify the loan contract.

Case law has determined that if a company has power to borrow, it also has power to create charges over the company's assets as security for the loan.

1.1 Personal guarantees

Some lenders may require directors and/or members to agree to repay a loan out of their personal wealth should the company default on the debt. This is known as requesting a personal guarantee, which is a promise by a person (the directors or shareholders) to assume a debt obligation in the event of non- payment by the borrower (the company). Personal guarantees are a means of protecting the lender by preventing the shareholders/members from hiding behind the protection of limited liability. It is commonly used where the lender is very powerful (such as a bank) and the borrower has no other source of funds available to it (such as a new or small company).

2 Debentures and loan capital

2.1 Loan capital

Loan capital comprises all the longer term borrowing of a company. It is distinguished from share capital by the fact that, at some point, borrowing must be repaid. Share capital on the other hand is only returned to shareholders when the company is wound up.

A company's loan capital comprises all amounts which it borrows for the long-term, such as, permanent overdrafts at the bank, unsecured loans, from a bank or other party and loans secured on assets, from a bank or other party. Companies often issue long-term loans as capital in the form of debentures.

2.2 Debentures

A debenture is a document stating the terms on which a company has borrowed money. There are three main types.

- A single debenture
- Debentures issued as a series and usually registered
- Debenture stock subscribed to by a large number of lenders. Only this form requires a debenture trust deed, although the others may often incorporate one

A debenture is the written acknowledgement of a debt by a company, normally containing provisions as to payment of interest and the terms of repayment of principal. A debenture may be secured on some or all of the assets of the company or its subsidiaries.
A debenture may create a charge over the company's assets as security for the loan. However a document relating to an unsecured loan is also a debenture in company law.

2.3 Types of debenture

A debenture is usually a formal legal document. Broadly, there are three main types.

(a) A single debenture

If, for example, a company obtains a secured loan or overdraft facility from its bank, the latter is likely to insist that the company seals the bank's standard form of debenture creating the charge and giving the bank various safeguards and powers.

(b) Debentures issued as a series and usually registered

Different lenders may provide different amounts on different dates. Although each transaction is a separate loan, the intention is that the lenders should rank equally *(pari passu)* in their right to repayment and in any security given to them. Each lender therefore receives a debenture in identical form in respect of their loan. The debentures are transferable securities.

(c) The issue of debenture stock subscribed to by a large number of lenders

Only a public company may use this method to offer its debentures to the public and any such offer is a prospectus; if it seeks a listing on The Stock Exchange then the rules on listing particulars must be followed. Each lender has a right to be repaid their capital at the due time (unless they are perpetual) and to receive interest on it until repayment. This form of borrowing is treated as a single loan 'stock' in which each debenture stockholder has a specified fraction (in money terms) which they or some previous holder contributed when the stock was issued. Debenture stock is transferable in multiples of, say, £1 or £10.

A company must maintain a register of all debenture holders and register an allotment within two months.

One advantage of debenture stock over debentures issued as single and indivisible loan transactions is that the holder of debenture stock can sell part of their holding, say £1,000 (nominal), out of a larger amount.

Debenture stock must be created using a debenture trust deed, though single and series debentures may also use a debenture trust deed.

2.4 Debenture trust deed

Major elements of a debentures trust deed for debenture stock:-

- The appointment usually of a trustee for prospective debenture stockholders. The trustee is usually a bank, insurance company or other institution but may be an individual.

- The nominal amount of the debenture stock is defined, which is the maximum amount which may be raised then or later. The date or period of repayment is specified, as is the rate of interest and half-yearly interest payment dates.

- If the debenture stock is secured the deed creates a charge or charges over the assets of the company.

- The trustee is authorised to enforce the security in case of default and, in particular, to appoint a receiver with suitable powers of management.

- The company enters into various covenants, for instance to keep its assets fully insured or to limit its total borrowings; breach is a default by the company.

  There may be elaborate provisions for transfer of stock and meetings of debenture stockholders.

Advantages of a debentures trust deed for debenture stock

- The trustee with appropriate powers can intervene promptly in case of default.

- Security for the debenture stock in the form of charges over property can be given to a single trustee.

- The company can contact a representative of the debentureholders with whom it can negotiate.

- By calling a meeting of debentureholders, the trustee can consult them and obtain a decision binding on them all.

- The debentureholders will be able to enjoy the benefit of a legal mortgage over the company's land.

2.5 Register of debentureholders

Company law does not specifically require a register of debentureholders be maintained. However, a company is normally required to maintain a register by the debenture or debenture trust deed when debentures are issued as a series or when debenture stock is issued.

When there is a register of debentureholders, the following regulations apply.

(a) The company is required by law to keep the register at its registered office, or at an address notified to the registrar.

(b) The register must be open to inspection by any person unless the constitution or trust deed provide otherwise. Any person may obtain a copy of the register or part of it for a fee. A holder of debentures issued under a trust deed may require the company (on payment) to supply them with a copy of the deed.

Under the Companies Act a company has five days to respond to an inspection request or seek exemption to do so from the court.

(c) The register should be properly kept in accordance with the requirements of the Companies Act.

2.6 Rights of debentureholders

The position of debentureholders is best described by comparison with that of shareholders. At first sight the two appear to have a great deal in common.

- Both own transferable company securities which are usually long-term investments in the company.
- The issue procedure is much the same. An offer of either shares or debentures to the public is a prospectus as defined by the Act.
- The procedure for transfer of registered shares and debentures is the same. But there are significant differences.

Differences	shareholder	Debentureholder
Role	Is a proprietor or owner of the company	Is a creditor of the company
Voting rights	May vote at general meetings	May not vote
Cost of investment	Shares may not be issued at a discount to nominal value	Debentures may be offered at a discount to nominal value
Return	Dividends are only paid • Out of distributable profits • When directors declare them	Interest must be paid when it is due
Redemption	Statutory restrictions on redeeming shares	No restriction on redeeming debentures
Liquidation	Shareholders are the last people to be paid in a winding up	Debentures must be paid back before shareholders are paid

From the investor's standpoint debenture stock is often **preferable to preference shares**. Although both yield a fixed income, debenture stock offers greater security.

2.6.1 Advantages and disadvantages of debentures (for the company)

Advantages	Disadvantages
Easily traded	May have to pay high interest rates to make them attractive
Terms clear and specific	Interest payments mandatory
Assets subject to a floating charge may be traded	Interest payments may upset shareholders if dividends fall
Popular due to guaranteed income	Debentureholder's remedies of liquidators or receivers may be disastrous for the company
Interest tax-deductible	
No restrictions on issue or purchase by a company	

3. Charges

A charge over the assets of a company gives a creditor a prior claim over other creditors to payment of their debt out of these assets.

Charges may be either fixed, which attach to the relevant asset on creation, or floating, which attach on 'crystallisation'. For this reason it is not possible to identify the assets to which a floating charge relates (until crystallisation).

3.1 Definition

A charge is an encumbrance upon real or personal property granting the holder certain rights over that property. They are often used as security for a debt owed to the charge holder. The most common form of charge is by way of legal mortgage, used to secure the indebtedness of borrowers in-house purchase transactions. In the case of companies, charges over assets are most frequently granted to persons who provide loan capital to the business.
A charge secured over a company's assets gives to the creditor (called the 'chargee') a prior claim (over other creditors) to payment of their debt out of those assets. Charges are of two kinds, fixed and floating.**3.2 Fixed charges**

A fixed charge is a form of protection given to secured creditors relating to specific assets of a company. The charge grants the holder the right of enforcement against the identified asset (in the event of default in repayment or some other matter) so that the creditor may realise the asset to meet the debt owed. Fixed charges rank first in order of priority in liquidation.Fixed (or specific) charges attach to the relevant asset as soon as the charge is created. By its nature a fixed charge is best suited to assets which the company is likely to retain for a long period. A mortgage is an example of a fixed charge.

If the company disposes of the charged asset it will either repay the secured debt out of the proceeds of sale so that the charge is discharged at the time of sale, or pass the asset over to the purchaser still subject to the charge.

3.3 Floating charges

A **floating charge** has been defined, in case law as:

(a) A charge on a class of assets of a company, present and future …
(b) Which class is, in the ordinary course of the company's business, changing from time to time and …
(c) Until the holders enforce the charge the company may carry on business and deal with the assets charged.

Floating charges do not attach to the relevant assets until the charge crystallises.

A floating charge is not restricted to assets such as receivables or inventory. A floating charge over 'the undertaking and assets' of a company (the most common type) applies to future as well as to current assets.

3.4 Identification of charges as fixed or floating

It is not always immediately apparent whether a charge is fixed or floating. Chargees often do not wish to identify a charge as being floating as it may get paid later than preferential debts in insolvency proceedings.

A charge contract may declare the charge as fixed, or fixed and floating, whether it is or not. The label attached by parties in this way is not a conclusive statement of the charge's legal nature.

The general rule is that a charge over assets will not be registered as fixed if it envisages that the company will still be able to deal with the charged assets without reference to the chargee.

R in Right of British Columbia v Federal Business Development Bank 1988

The facts: In this Canadian case the Bank had a charge over the company's entire property expressed as 'a fixed and specific mortgage and charge'. Another term allowed the company to continue making sales from stock in the ordinary course of business until notified in writing by the bank to stop doing so.

Decision: The charge was created as a floating, not a fixed, charge.

However, the courts have found **exceptions** to the general rule concerning permission to deal.

(a) In *Re GE Tunbridge Ltd 1995* it was held that the charge over certain fixed assets was a floating charge even though the company was required to obtain the chargee's permission before dealing with the assets.

(b) In *Re Cimex Ltd 1994* the court decided that the charge in dispute was a fixed charge. The assets did not in the ordinary course of business change from time to time. This was despite the company being able to deal with the assets without the chargee's permission.

3.4.1 Charges over receivables

Charges expressed to be fixed which cover present and future receivables (book debts) are particularly tricky.

Again the general rule applies. If the company is allowed to deal with money collected from customers without notifying the chargee, the courts have decided that the charge is floating. If the money collected must be paid to the chargee, say in reduction of an overdraft, the courts have determined that the charge is fixed: *Siebe Gorman & Co Ltd v Barclays Bank Ltd 1979.*

In 2005 the House of Lords held in *Re Spectrum Plus* that there can be no fixed charge over a company's book debts.

3.5 Creating a floating charge

A floating charge is often created by express words. However no special form of words is essential. If a company gives to a chargee rights over its assets while retaining freedom to deal with them in the ordinary course of business until the charge crystallises, that will be a charge which 'floats'. The particular assets subject to a floating charge cannot be identified until the charge attaches by crystallisation.

3.6 Crystallisation of a floating charge

Floating charges crystallise or harden (convert into a fixed charge) on the happening of certain relevant events.

Crystallisation of a floating charge occurs when it is converted into a fixed charge: that is, a fixed charge on the assets owned by the company at the time of crystallisation.

Events causing crystallisation
The liquidation of the company
Cessation of the company's business
Active intervention by the chargee, generally by way of appointing a receiver
If the charge contract so provides, when notice is given by the chargee that the charge is converted into a fixed charge (on whatever assets of the relevant class are owned by the company at the time of the giving of notice)
The crystallisation of another floating charge if it causes the company to cease business.

Floating charge contracts sometimes make provision for 'automatic crystallisation'. This is where the charge is to crystallise when a specified event – such as a breach of some term by the company – occurs, regardless of whether:

- The chargee learns of the event.
- The chargee wants to enforce the charge as a result of the event.

Such clauses have been accepted by the courts if they state that, on the event happening, the floating charge is converted to a fixed one. Clauses which provide only that a company is to cease to deal with charged assets on the occurrence of a particular event have been rejected.

3.7 Comparison of fixed and floating charges

Floating charges rank behind a number of other creditors on liquidation, in particular preferential creditors such as employees.

A fixed charge is normally the more satisfactory form of security since it confers immediate rights over identified assets. A floating charge has some advantage in being applicable to current assets which may be easier to realise than long term assets subject to a fixed charge. If for example a company becomes insolvent it may be easier to sell its inventory than its empty factory.

The principal disadvantages of floating charges:-

The holder of a floating charge cannot be certain until the charge crystallises which assets will form their security.

Even when a floating charge has crystallised over an identified pool of assets the chargeholder may find themself postponed to the claim of other creditors as follows.

(a) A judgement creditor or landlord who has seized goods and sold them may retain the proceeds if received before the appointment of the debentureholder's receiver.

(b) Preferential debts such as wages may be paid out of assets subject to a floating charge unless there are other uncharged assets available for this purpose.
(c) The holder of a fixed charge over the same assets will usually have priority over a floating charge on those assets even if that charge was created before the fixed charge.
(d) A creditor may have sold goods and delivered them to the company on condition that they are to retain legal

ownership until they have been paid (a Romalpa clause).

A floating charge may become invalid automatically if the company creates the charge to secure an existing debt and goes into liquidation within a year thereafter. The period is only six months with a fixed charge.

3.8 Priority of charges

If more than one charge exists over the same class of property then legal rules must be applied to see which takes priority in the event the company goes into liquidation.

Different charges over the same property may be given to different creditors. It will be necessary in such cases to determine which party's claim has priority.

Example:
If charges are created over the same property to secure a debt of £5,000 to X and £7,000 to Y and the property is sold yielding only £10,000, either X or Y is paid in full and the other receives only the balance remaining out of £10,000 realised from the security.

Priority of charges

- Fixed charges rank according to the order of their creation. If two successive fixed charges over the same factory are created on 1 January and 1 February the earlier takes priority over the later one.

- A floating charge created before a fixed charge will only take priority if, when the latter was created, the fixed chargee had notice of a clause in the floating charge that prevents a later prior charge.

- A fixed charge created before a floating one has priority.

- Two floating charges take priority according to the time of creation.

If a floating charge is existing and a fixed charge over the same property is created later the fixed charge has priority. This is unless the fixed chargeholder knew of the floating charge. The fixed charge ranks first since it attached to the property at the time of creation but the floating charge attaches at the time of crystallisation. Once a floating charge has crystallised it becomes a fixed charge and a fixed charge created subsequently ranks after it.

3.8.1 Negative pledge clauses

A floating chargeholder may seek to protect themselves against losing their priority by including in the terms of their floating charge a prohibition against the company creating a fixed charge over the same property (sometimes called a 'negative pledge clause').

If the company breaks that prohibition the creditor to whom the fixed charge is given nonetheless obtains priority, unless at the time when their charge is created they have actual knowledge of the prohibition.

3.8.2 Sale of charged assets

If a company sells a charged asset to a third party the following rules apply.

- A chargee with a fixed charge still has recourse to the property in the hands of the third party – the charge is automatically transferred with the property.
- Property only remains charged by a floating charge if the third party had notice of it when they acquired the

property.

You should be prepared to work out the priority of charges in a scenario.

4. Registration of charges

To be valid and enforceable, charges must be registered within 21 days of creation by the Registrar.

Certain types of charge created by a company should be registered within 21 days with the Registrar by either the company or a person interested in it (eg the debenture trustee). Charges securing a debenture issue and floating charges are specifically registrable.

Other charges that are registrable include charges on:

- Uncalled share capital or calls made but not paid
- Land or any interest in land, other than a charge for rent
- Receivables (book debts)
- Goodwill or any intellectual property
- Ships or aircraft or any share in a ship

4.1 The registration process

The company is responsible for registering the charge but the charge may also be registered as a result of an application by another person interested in the charge.

The Registrar should be sent the instrument by which the charge is created or evidenced. The Registrar also has to be sent prescribed particulars of the charge.

- The date when the charge was created
- The amount of the debt which it secures
- Short particulars of the property to which the charge applies
- The person entitled to it

The Registrar files the particulars in the companies 'charges' register and notes the date of delivery. They also issue a certificate which is conclusive evidence that the charge had been duly registered.
The 21 day period for registration runs from the creation of the charge, or the acquisition of property charged, and not from the making of the loan for which the charge is security. Creation of a charge is usually effected by execution of a document.

4.2 Rectification of register of changes

A mistake or omission in registered particulars can only be rectified by the court ordering an extension of the period for registration, and with the subsequent rectification of the register. The court will only make the order if the error or omission was accidental or if it is just and equitable to do so.

4.3 Failure to deliver particulars

The duty to deliver particulars falls upon the company creating the charge and if no one delivers particulars within 21 days, the company and its officers are liable to a fine.

Non-delivery in the time period results in the charge being void against an administrator, liquidator or any creditor of a company.

Non-delivery of a charge means that the sum secured by it is payable forthwith on demand.

4.3.1 Late delivery of particulars

The rules governing late delivery are the same as governing registration of further particulars, that is, a court order is required for registration.

A charge can only be registered late if it does not prejudice the creditors or shareholders of the company. Therefore a correctly registered fixed charge has priority over a fixed charge created earlier but registered after it, if that charge is registered late.

4.4 Register of charges

As you already know, every company is under an obligation to keep a copy of documents creating charges, and a register of charges, at its registered office or single alternative inspection location.

5. Debentureholders' remedies

5.1 Rights of unsecured debentureholders

A debentureholder without security has the same rights as any other creditor.

Any debentureholder is a creditor of the company with the normal remedies of an unsecured creditor. They could:

- Sue the company for debt and seize its property if their judgement for debt is unsatisfied
- Present a petition to the court for the compulsory liquidation of the company
- Apply to the court for an administration order, that is, a temporary reprieve to try and rescue a company

5.2 Rights of secured debentureholders

A secured debentureholder may enforce the security if the company defaults on payment of interest or repayment of capital. They may take possession of the asset subject to the charge and sell it or apply to the court for its transfer to their ownership by a foreclosure order. They may also appoint a receiver or administrator of it. A floating charge holder may place the company into administration.

A secured debentureholder (or the trustee of a debenture trust deed) may enforce the security. They may:

- Take possession of the asset subject to the charge if they have a fixed charge (if they have a floating charge they may only take possession if the contract allows)
- Sell it (provided the debenture is executed as a deed)
- Apply to the court for its transfer to their ownership by foreclosure order (rarely used and only available to a legal chargee)
- Appoint a receiver of it, provided an administration order is not in effect or (in the case of floating charge holders), appoint an administrator without needing to apply to the court.

12.0 MEMBERSHIP

UNIT 12 OVERVIEW

- Introduction
- The Shareholders
- Termination of Membership
- Register of members and annual return

12.1 INTRODUCTION

The Management of the company may include various officers such as the auditors, accountants, board of directors. Managing directors, and any other officer of a company. Two organs are basically responsible for the management of a company and these include:

1. The shareholders through company meetings
2. The Board of Directors through the Board of Directors meetings.

12.2 THE SHAREHOLDERS

Shares represent the interest of the members in the company. The membership contract creates contractual rights and obligations between the company and its members and between the members themselves. The main body of this contract is formed by the provisions laid down in the memorandum and articles of Association. Members are bound by these provisions. E.g. Shares are the shareholders' property and may be sold on. However, if the articles provide for pre-exemption rights, stipulating that shares must first be offered to the existing membership, the shareholders would then not be free simply to sell their shares on the open market. The membership contract extends to those who later have bought shares from the original shareholders. This is a departure from the usual rules of contract law, as the doctrine of privity of contract means that individuals do not have any right or obligations arising from a contract to which they were not original parties.

12.3 MINORITY SHAREHOLDERS

In effect it is the majority shareholders who make the company decisions. It is difficulty for minority shareholders to prevent a course of action sanctioned by the majority holding. In general, minority shareholders cannot look to the court for support if they are dissatisfied, as the courts will not interfere in matters of internal management. The general rule is that it is the company which should act as s claimant, not individual shareholders.

Sealy in his book" **cases and material in company law" (1971)** at page 452 – 453 stated that the minority shareholders of a company in principal must accept the decisions of the majority shareholders and must acknowledge that the powers enjoyed by their brethren/ brothers bring about changes in the company by persuasions, lobbying and publicity.
The frustrations of the majority shareholders in such situation can only be resolved by the protection of the law as provided under common law and the companies Act.

Accordingly, a shareholder who is aggrieved by the actions, omission s or decision of the majority shareholders has rights and remedies generally based on contract. This contract emanates from the companies Act which is to the effect that once the memorandum of |Association and Articles of Association have been signed, they constitute contract between a particular signatory and his co-signatory as well as between himself and the company. Thus, such a minority shareholder can sue in court basing on breach of this contract. However, one has to be a member or shareholder to sue or benefit from this contract in question (AOA),

The instance when such a contract may be treated are many and include among others:

(i) Where the directors involve the company in ultra- vires transactions
(ii) Where a shareholder is denied his dividend that has already been declared.
(iii) Where a director has embezzled and misappropriated the company's property and funds
(iv) Where it is obvious that the shareholders are expropriating a shareholder's share.
(v) Where the majority shareholders are varying the rights of a minority

Shareholders without the latter's consent or are infringing them in one way or another.

It should be noted that whether or not a minority shareholder will be able to maintain any of these actions in his name would depend on the procedure laid down by the law.

12.4 ENFORCEMENT OF MEMBERS' RIGHTS AT COMMON LAW

The issue as to whether or not a shareholder can maintain a personal action for wrongs in his company is in common law governed by the rule in Foss v Harbottle (1843). In this case, the plaintiff complained, inter alia, that the directors of the company had sold their own land to such company at a price quite in excess of the true value of the land i.e. they had benefited from the sale. The court found as a fact that even if the act of the director was wrong and true, it was not an injury to the plaintiff but to the company as a whole and the court dismissed the action observing that "*in such cases where the company has been injured it is the company to sue for such wrong unless factors exist to justify a departure from this procedure.*"
The court propounded the rule to the effect that
"in a case where something injurious has been done to the company, the proper plaintiff to sue for that wrong is not an individual or a group of shareholders but the company itself"

- **Rationale (reasons behind) of the rule in Foss v Harbottle**

The rule in Foss & Harbottle was an aid before courts to curb unnecessary potential litigation
In the case of **Mac Dough v Gardiner (1871) Ch 13,** the court pointed out if every dispute about internal management of companies had to be brought to courts, the courts would be overwhelmed with cases.
In the case of **Mayrille v whytley (1896), Ch 788,** court said that the rule serves the purpose of preventing the company from being torn to pieces by litigation.

In **CAREN V BRURY (1812)** the court stated in principle that *"this court is not to be required from every occasion to take the management of any play house and brew house in the kingdom"*

- **Exceptions to the Rule in Foss v Habottle**

There are various exceptions to this general principle at common law and under state. In certain circumstances, members can exercise control over the board of directors by taking actions on behalf of the company to prevent wrong doing or to enforce their personal rights. An action by a minority shareholder(s) is either a derivative action, if the shareholder is suing in the name of the company, or a representative action. If brought by a member to enforce their personal rights, For example, if a shareholder complains that the company intends to enter into contracts outside the scope of the objects clause, a minority action is usually permitted to restrain ultra vires transaction. Fraudulent transactions may also be the subject of a minority action. Nor may a company deny a member his personal rights attached to his shareholding. statute also stipulates that a member of a company may apply to the court by petition for an order on the grounds that the company's affairs are being or have been conducted in a manner unfairly prejudicial to the interest of the members generally or to some part of its members, for example, allotting shares in breach of pre- emption rights, failure to pay proper dividends, or the improper use of company assets for personal interest.

There are various order the court can make to remedy the situation. It can grant an order regulating the company's affairs for the future, or restructuring the company from acting in a certain way, the court can grant a compulsory purchase order, ordering that the company or its members to purchase the shareholder if it would be equitable to do so.

The above can be expounded as hereunder:
The case of Foss & Harbottle in providing for the rule also provides for a situation where one may depart from the general rule and this is where the court states in the holding *"…that unless factors exist to justify a departure from that procedure"*
The exceptions have been formulated with a view of bringing in line in Foss & Harbottle with the realities of changing times.

1. Infringement of a personal right of a shareholder

Once the individual rights of a shareholder have been infringed or are about to be infringed, the aggrieved shareholder can maintain a personal action notwithstanding the fact that his company may also have been infringed in the process. In the case of **Misango v Musingire(1966)EA 390**, the plaintiff argued that a meeting of his company by a resolution altered the articles of Association of the company to his detriment. He further argued that non – share holders attended the meeting and voted for such resolution. Sir udo – Udoma held that the suit was maintained in law by the plaintiff in his own right, since there had been an injury done to him personally by the directors and other members of the company.

2. Where the directors involve the company in illegal / ultra vires transactions

If there's a fraudulent act being carried out in the company and those committing the act are the people in control as majority shareholders, an individual shareholder can maintain a personal action notwithstanding the rule in Foss & Harbottle.

In the case of **Brown v British Apprehensive wheel co. (1919) Ch 290,** the defendant majority shareholders having failed to persuade the minority for the latter to sell to them their shares to transfer compulsorily his shares if required in writing by the a holder of at least 90% of the shares asked the plaintiff to transfer his shares to them upon which the plaintiff brought an application to court challenging this new article.
The court declared the resolution for the new article invalid as it amounted to expropriation of the plaintiff's shares.

The term "fraud on the minority" has been broadly interpreted to cover even instances where the company's property is being expropriated.

In the case of Edwards v Hamwen (1950), jenkin LJ laid down the tests where the rule in Foss & Harbottle may be departed from i.e.

(i) Where the company shareholders are acting or are about to act ultra vires
(ii) When the act complained of though not utravires is illegal and could be effectively resolved by a specials majority vote, usually where a special or extra ordinary resolution is required and it is alleged that it has not been validly passed.
(iii) Where its alleged that the person rights of the plaintiff shareholders have been fringed or are about to be infringed:
(iv) Where those who control the company are perpetuating a fraud on a minority shareholder;
(v) Where the interests of justice require that the general rule prescribing a suit by company be disregarded.

In **DANIELS V DANIELS (1972) 2 WLR 73;** court held that fraud on the minority covers more than fraud in the strict sense and action would be allowed in respect of any fault without fraud.

3. Breach of the Articles of Association

These articles constitute a contract between the shareholders and the company as between the shareholders themselves and therefore any shareholder can institute an n action in his name where the articles have been breached.

4. Need to by- pass the rule in Foss v Harbottle in the interest of justice

In the case of **HEYTING V DUPONT (1964), WLR 843** THE court held that the category of exception to the rule in Foss & Harbottle could not be closed since under certain instances the interest of justice may demand that the rule be by- passed by a minority shareholder.

In Daniel v Daniel a shareholder complained that the defendants who were the majority shareholders as well as the directors of the company acted negligently in selling the company property (land), to one of the directors for £4,250 and that directors resold the land four years later at £120,000.

The issue was whether the plaintiff's action could succeed in light of the rule in Foss & Harbottle in the absence of any fraud. Court held that there's no reason why it cannot succeed where the action of the majority and the directors although without fraud had conferred some direct benefits to themselves. The court said that *"to put up with directors is one thing and to put up with directors who are so foolish that they make a profit of that magnitude at the expression of the company's is something entirely different".*

5. Derivative Actions.

This is a relatively recently developed action which a shareholder cannot proceed under common law because of the rule in Foss & Harbottle or under statute can take a complaint to court for wrongs committed in his company. The plaintiff in such action is seen not to be suing on his own but on behalf of and for the company.

However, the court are not very ready to entertain such action and consequently, a number of limitations have been set up i.e.

(i) The plaintiff must have clean hands i.e. he must not have connived with the company members
(ii) It must be proved that it is impractical for the company to sue by itself.

A derivative action differs from a personal action in the sense that although a shareholder is allowed to sue, he is not suing on his own behalf but on behalf of the company because the company itself is unable to sue for that wrong.

The rationale behind the principle is that when people who have committed the wrong are the same people who are supposed to sue, they may not do it.

However, the courts have insisted that a derivative action should not be utilized as a means of side stepping the rule in Foss & Harbottle therefore the following conditions must be satisfied:

(i) The action must allege a fraud on the minority.
(ii) That the company is being controlled but those who have committed the wrong and therefore are unable to sue for it.
(iii) That the plaintiff is not suing on his own behalf or on behalf of the others but rather on behalf of the company

13.0 MEETINGS

UNIT 13 OVERVIEW

- Statutory Meetings
- Annual General Meeting
- Other general Meetings
- Notices of meetings & proceedings

13.1 SHAREHOLDERS' MEETINGS

The directors are responsible for the daily running of the company, but the most important matter that can affect the company must be presented to the shareholders in the general meeting. Arach- Amoko J in **Re Kibuye United Victual (U) Ltd (2002 – 2004) The Uganda Commercial Law Reports 296** noted that although the company's regulation normally empower the directors to manage its business, the ultimate control of the company lies with the general meeting. In this case, as the company had never held a meeting since its incorporation, the judge found that there was, therefore urgent need for the company to hold a meeting.

Ordinary shares usually carry voting rights. Every company must hold an annual general meetings. It is the duty of the general meeting to act for the benefits of the company as a whole. Extraordinary general meeting may also be called to vote on special business if required by a sufficient number of members. A class meeting is where a class of shareholders meet to decide matters which affect their particular class of shares.

A member can appoint a proxy, who needs not to be a member, to vote in his place at a general meeting. Voting can be by a show of hands, one vote per person, or by a poll vote, the voting rights of the member being in proportion to the number of voting shares held. Every company must keep minutes of the proceedings of its general meeting and directors' meeting.
The shareholders have an opportunity of influencing the company's management through the company meetings. There are various types of meetings through which the shareholder can participate in the affairs of the company and as above noted, these include

13.2 STATUTORY MEETINGS(SECTION 130)

Under section 130 of the companies Act, Cap 110, every public company is required to hold a statutory meeting within 1-3 months from the date of commencement of business. Private companies are not required to hold such a meeting. The meeting is held once by the public companies and must be held within the first months from the date of commencement of the business by the company. The members of the company are required under Section 130 (2) to send a statutory report to all the members of the company at least 14days before the day on which the meeting is held and such statutory report must be certified by not less than two directors of the company. The statutory report shall state-

a) The total number of shares allotted and whether they are fully paid up or not and the nature of consideration paid for the shares:
b) The total amount of cash received by the company in respect of all the shares allotted:

c) An abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the report:
d) The names, postal address and descriptions of the directors, auditors, if any , managers, if any and the secretary of the company : and
e) The particulars of and contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

The directors are to cause a copy of the statutory repot to be delivered to the registrar for registration forthwith after the sending thereof to the members of the company are required by Section 130 (5) of the companies Act, Cap110.
Under Section 130 (9), in the event of any default in complying with this section, every director of the company who is knowingly and wilfully guilty of the default, or, in the default by the company, every officer of the company who is in default, is liable to a fine not exceeding one thousand shillings. Failure to hold a statutory meeting or to file a report thereon is a ground for winding up by the court under Section 222 of the Companies Act.

13.3THE ANNUAL GENERAL MEETING (SECTION 131)

According to Section 131 (1) of the Companies Act, Cap 110, every company shall in each year hold a general meeting as its annual general meeting in addition to any other meeting in that year, and shall specify the meeting as such in the notices calling it; and not more than fifteen months shall elapse between the date of one annual general meeting of a company and that of the next ; except that so long as a company holds its first annual general meeting within eighteen months of its incorporation, it need not hold it in the year of its incorporation or in the following year. If default is made in holding an annual general meeting, under section 131 (2) the register of companies may, on the application of any member of the company, call or direct the calling of a general meeting of the company and give such ancillary or consequential directions as the registrar thinks expedient, including directions modifying of supplementing, in relation to the calling, holding and conducting of the meeting, The operation of the company's articles; and it is declared that the directions that may be given under this subsection include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting . Such a meeting held by only one member would be deemed to be an annual general meeting for that year.
If default is made is holding the AGM of the company in accordance with Section 131 (1), or in complying with any direction of the registrar under Section 131 (2), the company and every officer of the company who us un default are liable to a fine not exceeding two thousand shillings.

Normally, the matters to be discussed in the annual general meeting include:
i. Appointment of auditors and directors of the company
ii. Fixing their remuneration;
iii. Declaration of dividends;
iv. Consideration of the Accounts and balance sheets of the company;
v. Consideration of the report of the directors and auditors of the company;
vi. Election of new directors to replace those retiring;
vii. Any special or other business

The resolutions passed at this meeting are called **ordinary resolutions.**

13.4EXTRA-ORDINARY GENERAL MEETING (S.132)

This general meeting is required by Section 132 of the companies Act and Article 49 of table A. This meeting may be held in case of the emergence of some urgent or special matter which cannot wait until the next AGM.
The directors may whenever they think fit convene such meeting. However, such meeting may also be requisitioned by the shareholders themselves.
If at any time there are not within Uganda, sufficient directors capable of acting to form a quorum. Any director or any two members of the company may convene an extra Ordinary –general meeting in the same manner as nearly as possible as this meeting may be convened by the directors.

This meeting:

i. Is held as a result of a requisition by the shareholders or the instance of the directors upon the emergencies of an urgent or special matter:
ii. Not every shareholder can requisition for such meeting. In a company limited by shares, it is requisition by a member or members who hold not less than 10% of the paid up capital in a company and those requisitioning for the meeting must respect at least 10% of the total voting rights of all the members having to vote;
iii. The meeting must be held within 21 days after the requisition has been received.

If the directors refuse to convene the meeting, then 50% of the requisitionists can go ahead to convene that meeting provided they do so within 3 months after the expiry of the 21days. S. 132 (3).

13.5GENERAL MEETING CONVENED UNDER COURT ORDERS (SECTION135)

This type of meeting occurs as a result of an aggrieved shareholder applying to court for an Annual General meeting to be held in instances e.g. where the directors have hindered the meeting from taking place.
Where it is impractical to convene and hold a company's meeting, any aggrieved shareholder may apply to court for such a meeting to be convened and conducted in anyway as the court thinks fit. The court can also on its own motion order a meeting of the company to be called, held and conducted in such a manner as the court thinks fit; including an order that one member of the company present in person or by proxy shall be deemed to constitute a meeting . Section 135 (1).

A shareholder / person can convene the court that it has been impractical to convene such a meeting. This can be done by showing that the directors have bought up most of the share in the company.

In the case of **Re Sombrero Ltd (1958) Ch 980**, one member was allowed by court to constitute a meeting. The court pointed out that the circumstances of each particular case must be examined and that in the instant case, if the meeting was refused, it would be depriving the applicant of his statutory right which through the company he is entitled to exercise and remove the respondents as directors. That there is a clear statutory duty on directors to call this meeting whether or not the consideration which is only one of the matters to be dealt with at the Annual general meeting is ready or not.

In Uganda Eyeddembe Publications Ltd (1975) (High Court Companies Cause No.9 of 1979)
In this case there were three shareholders, two of whom were chased from Uganda in 1972. The third member became the sole director, signatory and used to constitute all general meetings and the court later allowed it.

In the case of Re Air RIP International Ltd (Companies Cause No.3 of 1984).
There were only two shareholders and one complained that his co- shareholder had never stepped into the companies premises for the previous two years. The court asked him to make an application requesting to be allowed to convene a general meeting which he duly did and it was granted.

13.6 NOTICE OF COMPANY MEETINGS

Directors must give shareholders full information and detailed disclosures of what is likely to be discussed in the meeting. In case of Henderson v Bank of Austra – asia (1890)45 Ch 330, court held that the shareholders must be given full and sufficient information as to what is likely to be discussed in the meeting.

The notices convening meeting must be sent to the members within the time presubscribed by the companies Act, that is, 21 days before the meeting and every notice must be in writing or otherwise the notice is void, (S.133(1) & (2) and S. 134)
However if a shorter notice is given and all the members attend the meeting is valid, See S.133 (4).

A number of cases have considered the issue of self-interests where the directors have not fully disclosed the matters of discussion. In the case of Kaye v Croydon Tramways Co. (1898) 1 Ch 358, one of the issues to be discussed at the company's meeting was whether or not to approve a particular agreement in which the directors stood to gain. The secretary sent out a vague circular for the meeting and the members asked the secretary to provide further information as to how the directors stood to benefit but was not complied with. The issue was whether the meeting and the agreement adopted were valid. Court held that the notice was insufficient and therefore the agreement adopted at the meeting could not be valid until sanctioned by a proper company's meeting duly convened for that purpose.
In the case of Tiesse v Anderson (1899) 1 Ch 86, the meeting of the company was to consider alternative schemes of reconstructing a company which in financial difficulties. The scheme adopted, was one in which one of the directors had a strong interest which was not disclosed in the notice.
One of the shareholders applied to court the have the resolution set aside Court held that "a shareholder after investing his money in a company which is now in financial difficulties has to consider whether not the scheme proposed is the best scheme"

The notice convening the meeting must thus be sufficient, full and specific to enable the shareholder receiving it to decide whether to attend or not. It must give fair warning and fair chance.
The court in this case concluded that it is not protecting decedents (a shareholder who isn't interested) but a shareholder who is absent as a result of having received a notice but concluded that he will not oppose the matter for discussion leaving if for the majority to decide.
According to TABLE A Article 50, the accidental omission to give notice of a meeting to a number or if a member fails to receive that notice do not necessarily invalidate the proceedings of the meeting unless it can be established that the failure to deliver or send the notice was due to fraud of the directors.

13.7 PROCEDURE, ATTENDANCE AND VOTING AT MEETINGS

Unless the company's articles provide otherwise, any two or more members holding at least 10% of the capital and paid up capital may call a company's meeting (Provided under S.134 (b) of the company's Act.)

Quorum
This term referes to the number of members of any body of persons whose presence at the meetings is required in order that business may be validly transacted. Where the articles of the company are silent, The companies Act under section 134 © provides that *"In the case of a private company, two members, and in the case of any other company three members, personally present shall be a Quorum."*

However, the articles may prescribe that presence by proxy is adequate. Table A provided in article 53that "No business shall be transacted at any general meeting unless a quorum of members is present at the time when the meeting proceeds to business." It would appear that this requirement is satisfied if a quorum is present at the beginning of the meeting even if it does not subsist to the end and only one member remains throughout to the end. However, one member may constitute a quorum where the registrar of companies under S. 131 (2) of the companies Act or the court under S.135 declares that a quorum of one person is sufficient for a meeting. See **RE: UGANDA EYEDDEMBE PUBLICATIONS LTD (1975)** Companies cause of No.9 of 1979.

The articles of Association usually stipulate who shall be the chairman at meetings, for instance table A under articles 55 – 56 indicates that the chairman of the Board of directors if present and willing shall be the chair and in case he is absent, or if the members so wish, a chair may be elected by the members present from among themselves.

Where the articles are silent as to who should be the chairman, the members present may themselves nominate one.

The chairman's duties include:
1. Ensuring proper and orderly conduct of the business at the meeting:
2. Regulating the proceedings ; and
3. Time keeping.

Article 60 of table A gives the chairman the casting vote at the meeting. In the case of national Dwelling Society (1894) 3 Ch 159 the court held that it is unquestionably the duty of the chairman to preserve order and to take care that the proceedings, are conducted in a proper manner and that the sense of the meeting is properly ascertained with regard to any question before meeting.

The court further said that the chairman has no power to take his own hands decision which the meeting has competence to decide.

13.8VOTING AT MEETINGS
Unless the articles of the company provide otherwise, each member has one vote and voting is by show of hands irrespective of the number of shares held by each and no proxies are allowed to vote on a poll where the company has share capital as provided under section 136 (1).

Under S. 137 a poll may be demanded for. Where the articles provide that voting shall be by poll, in a company with share capital. Each member has one vote in respect of his shares. Thus, a shareholder with a higher number of shares has a higher vote.
The AOA cannot exclude the right to demand a poll or require a specific percentage or members with a specified number of shares to demand foe it.
Under S.13, it is stated that either 5 members entitled to vote or shareholders with at least 10% of the voting rights, can demand a vote by poll. The rationale behind voting is the presumption that, those who are likely to demand the poll are the members with the highest stake in the company.

Accordingly, if an important matter relating to the company's policy is before the meeting, such people must be given a chance to direct the company.
Any provision in the AOA which tends to exclude the rights to demand a poll is void.
The courts may however sometimes invalidate a member's voting if it wasn't done in good faith **Re Clemens v Clemens Ltd (1976) 2 ALLER 268** an Auntie who framed resolution attempted to get the plaintiff out of any control of the company and the court set the resolutions aside on the ground that it wasn't done in good faith.

13.9VOTING AGREEMENTS

In a situation where the shareholder has entered into voting contracts, his right to vote is curtailed by that agreement. The rationale for this is that the court should not interfere with the freedom of competent parties to make their own contracts.

13.10 PROXIES

A proxy in company law is a person appointed to attend a meeting on behalf of a shareholder. The person appointed may or may not be a shareholder of the company.
Under S.136 a proxy can vote on a poll unless the AOA do not allow. A person appointed as a proxy has the same rights as the person appointing him.
The notice calling the meeting must specify that the member is free to appoint a proxy.

13.11TYPES OF RESOLUTIONS

Directors may pass directors' resolution at board meetings. Shareholders vote on the resolutions, which may be voted on in the annual general meetings. The shareholders vote on the resolution raised during the general meeting. There are various types of resolutions:

- **Extraordinary resolution**: This must be passed by majority of at least 75% and will be used e.g. as a resolution to wind up a company if it cannot pay its debts (although a special resolution could also be used in winding up under the order of court). Notice must be given to the shareholders.
- **Special resolution:** again a 75% majority is required as per section 141 of the companies ACT, CAP 110. Twenty one days' notice must be given. It would be used. E.g. to change a company's articles of association. A special resolution could be passed to lay down how directors should act with respect to a particular matter.
- **Ordinary resolution:** a simple majority vote is required. E.g. to remove a director before the end of his term.

Some resolutions must be registered as required under section 143 of the companies Act, Cap 110. Every company must also keep minutes of all proceedings of general meetings and of meetings of its directors in the minute book kept for that purpose as per section 145 companies Act.

14.0 DIRECTORS AND SECRETARY

UNIT 14 OVERVIEW

- o Appointment
- o The Board of Directors
- o The company Secretary
- o Other Aspects

14.1 INTRODUCTION

A company may have different officers entrusted with its management. The control of most modern registered companies is distributed among its principle organs: The general meeting, the managing director and the Board of directors.

14.2 THE BOARD OF DIRECTORS

Normally, the board of directors exercise general policy control and invariably leaves the detailed management and policy implementation to the managing director or chief executive of the company and his managerial staff. The board of directors has the ability to delegate its functions to a single managing director or director permitted by the company's Article of Association E.g. See Article 102, 107, 108 & 109 Table A

Section 1 of the companies Act defines a director to include any person occupying the position of director by whatever name called. A director is also defined to include any person in accordance with whose directions or instructions the directors of the company are accustomed to act. See Section 125 (4) & 201 (10) (a) companies Act. Such a person may be a majority shareholder. However, these definitions are quite unclear as to what exactly in the meaning of director.

Directors are viewed as agents and at times trustees of the company. They stand in a fiduciary position with the company. They are mandated to act in the interest of the company. But their powers will normally be conferred upon them by the general or the Articles of Association.

14.3 APPOINTMENT OF DIRECTORS

Every public company registered under the companies Act must have at least 2 directors. A private company must have at least 1 Director. However, a sole director cannot act as the sole secretary. See Section 177, 178 & 179 Companies Act, Cap 110.

Normally directors are appointed in accordance with the Articles of Association. The first directors are normally named by the Articles of Association and are appointed by the subscribers to the memorandum of association. The Articles of association will contain provisions regulating the mode of increase, reduction, retirement and other aspects relating to directorship of the company.
The annual General Meeting of the members of the company can also appoint directors by ordinary resolution. Every change in the particulars of directors have to be notified to the registrar of companies.

In the case of a public company, a person is not eligible for appointment unless they are at least 21 years and not over 70years except where the articles of association so allow, or where the appointment has been made or approved by a resolution with special notice stating his age having been given. See section 186 Companies Act, Cap 110.

A director should not be an undischarged bankrupt unless appointed with the leaves of court. See Section 188 Cap 110. He should not be a convict of offences related to the management of the company. See Section 189 Cap 110. The court will normally indicate the period of disqualification in this regard. Where a share qualification is required for appointment, the shares should be taken up within 2 months of assumption of office or such shorter period as may be prescribed by the articles. Failure to do so leads to vacation of office. See Section 183(3). For public companies with a share capital before a person can be appointed a director of a company, He must have signed and delivered for registration his consent to act as a director.
A director need not to be a natural person. A corporation can be a director especially to enable a holding company to maintain complete control of a subsidiary.

The articles of association may authorize a director to appoint an alternative director to act for him at any board meeting where he is unable to attend.

The acts of a director are valid notwithstanding any defects that may after wards be discovered in his appointment or qualification. See section 181 Companies Act. Also **R v Camps (1962) FA 403.** In **this** case the articles required every director to hold in his own right at least one fully paid up share in the capital of the company. Camps didn't satisfy this requirement but continued to act as a director. When he was charged with failing to keep proper books of accounts, and failing to hold an AGM and also failing to produce accounts and balance sheets, he argued his qualification shares, his appointment as invalid and the case was dismissed. The state appealed and the supreme court of Kenya agreed with the trial court and held that camps could not be held to be a director since with the enactment of the section which made it an offence to act as a director when unqualified, the legislature did not intend to appoint a director (that he wasn't a director as a matter of law) but he continued to act as a defect one (As if he was intact a director) and therefore he was liable. The court pointed out that any person who performs the functions of a director, though not duly qualified is occupying the position of the director that to hold otherwise would be to defeat the object of the penal sanction relating to liability of directors.

It should be noted that there are publicity requirements of directors and secretary. Upon appointment, the registrar of companies must be notified of any changes in the name, date of birth, other directorship, usual address of the person so appointed. This is done via company form 7.

14.4TERMINATION OF DIRECTORSHIP

The position of a director can be terminated in a number of ways:

(i) Retirement: This will normally be in accordance with the Articles of Association or in the case of a public company upon reaching the age of 70years. The articles of association may also require a certain number of directors to retire by rotation in each year.

(ii) Resignation: A director can resign at any time by giving notice in writing to the company. Once again, such notice cannot be withdrawn without the approval of the remaining directors. See Glossop v Glossop(1907)2 Ch 370 & Prichlick v Marsh (1961) WNLR 59. Verbal resignation could still be adopted depending on the circumstances of the case.

(iii) Removal: This will normally be by a resolution of the Annual General meeting. See Section 185 of the companies Act, Cap 110. However, this can be costly in case the removed director sued the company. At times the director could be a majority shareholder or having voting arrangements with shareholders taking his removal difficult. Also removal of a director in small companies which are more or less family business may not be that easy.

14.5 REMUNERATION

The remuneration of directors is normally determined in accordance with the articles of association or by a resolution of the Annual general meeting. The companies Act is silent about payments to directors. Under Article 76 of Table A, however, the remuneration of the directors from time to time be determined by the company in general meeting. Such remuneration shall be deemed to accrue from day to day. The directors may also be paid all travelling, Hotel and other expenses properly incurred by them in attending and returning from meetings of the director of any committee of the directors or general meetings of the company or in connection with the business of the company.
However, Lindley LJ, in **Re George Newman & Co. (1895)1 Ch 674 at 686** was of the view that directors are not entitled to remuneration except where there is provision to that effect in the company's articles of association. See also **Hutton v West cork Rail Co. (1883) 23 Ch. D. 654; Modikayo Oneka v Wines & spirit (U) Ltd. (1974) HCB 263.** Where the remuneration is foxed under the articles of Association, it may still be difficult for directors who are shareholders to enforce their rights as the articles of association can only be enforced by a member of the company. It may be wise for a director to insist that his remuneration be fixed by a separate resolution of the company.

14.6 POWER OF DIRECTORS

These will usually be stipulated in the Articles of Association., Some power could be derived from the General meeting. Directors are servants of the company and not of individual shareholders. However shareholders have the powers to control the actions of the directors through the decisions passed in the General Meetings. Directors have to act within what is stipulated in the memorandum and articles of association.

The powers will normally be exercised by the Board of Directors. The managing Director often has the responsibility of overseeing the daily running of the affairs of the company and can often assign particular directors to handle tasks. The company secretary and the Auditor too often have core responsibilities and powers conferred upon them by the company.

While the powers are to be exercised by the Board of Directors, it may occur that some authority will be exercised by corporate individual directors / officers of the company. As a primary organ of the company, the directors' collective exercise of power as a board binds the company, which in relation to the exercise of that power may be regarded as the principal.

As such, directors as a board bind the company. It is, however, debatable if individual directors also bind the company. Nonetheless, it is generally accepted that if acting within the scope of their authority, a director can bind the company just as much as the board would.

14.7 THE INDOOR MANAGEMENT RULE

An individual director may be able to bind the company in transactions with outsiders on the basis of the application of the constructive notice doctrine as modified by the indoor management rule. This rule is also referred to as the rule in **Royal British bank v Turquand (1856)6 E & 8327.**

In the **Turquard** Case, the constitution of the company stipulated that the director could borrow on bond such sums as should, from time to time by the general resolution of the company, be authorized to be borrowed. Without such resolution, two bonds for £2,000 were issued to the bank under the common seal of the company and were signed by two directors. In liquidation proceedings, the bank sued Turquard, the Liquidator on the security of the bonds. The defendant pleaded that since the borrowing had not been authorized by the requisite resolution, the bonds were not binding to the company. It was held that the bonds were binding on the company. It was indicated that while persona dealing with the company are fixed with notice of its public documents, in this case the deed and state of settlement, they are not bound to do more. In this case all that bank was required to do was to read the settlement. In so doing, it found that there was permission to borrow by the company on certain conditions. That is by resolution of the company. The bank then had a right to infer that a resolution authoring the borrowing had been passed.

The import/ essence of the indoor management rule is that persons dealing with the company are assumed to know the contents of its public documents, and that therefore any transaction they enter into with the company is authorized by those documents. However, they are not bound to do any more, i.e. they need not inquire into the regularity of internal proceedings and may assume internal regularity.

The relevant documents for the purpose of constructive notice include the Memorandum & Articles of Association, special & ordinary resolution and any other document filed by the company with the registrar of companies.
It should, however be noted that the application of the indoor management rule has been modified in its application by subsequent case law and the application of agency principles. As such there are various exception to the indoor management rule:

(i) Although an outsider who is dealing with a company is deemed to know the contents of its public documents, where the act proposed to be done is explicitly contrary to the documents, it cannot bind the company unless it has been ratifies See **Irvine v Union Bank of Australia (1877) 2 App Cas 266.** Also in **Obaseki v African Continental Bank 1966 NMLR 35,** It was held that an act done in excess of actual authority by an agent is not binding especially where he is dealing with persons who are aware of the excess of authority.

(ii) The indoor management rule will not apply where the relevant third party has knowledge that internal procedures required have not complied with or there are suspicious circumstances putting the third party on inquiry in that regard. See **Mahoy v Holyford mining Company (1875) LR7 HL 869.**

(iii) An officer of the company who is held out by it as having authority to represent it will bind the company irrespective of defective appointment or excess of authority except where the outsider knows that the officer has been irregularly appointed or is exceeding his authority or where circumstances are such as to put the outsider on inquiry or where it is clear from the public documents that the officer has no actual authority. See **Freedam & Lockyer v Buckhurst Park properties (Mangal) Ltd (1964) 2 QB 480.**

(iv) Where an officer purports to exercise authority which he does not usually have, an outsider is not protected if the officer exceeds his authority unless the company has held him out as having to act in the matter and the outsider has relied on the representation in which case the company is estopped. See **Mercantile Bank of India v Chartered Bank of India (1937) 1 ALL ER 231.**

(v) If a document purporting to be sealed or signed on the company's behalf turns out to be a forgery it does not bind the company. However may be stopped from disclaiming the document as a forgery if it has been put forward as genuine by an officer acting within his actual, usual or apparent authority.

A number of reforms have been advocated for the abolition of the constructive notice doctrine and it has also been suggested that actual knowledge of the contents of toe memorandum & articles of association should not prevent a third party from enforcing a contract with the company if he honestly and reasonably failed to appreciate that they had the effect of precluding the company or any of its officers from entering into the contract in question. It has also been proposed that a single director should be able to bind the company if he acts consistently with the usual authority of a single director. These proposed reforms would be good for Uganda given Uganda's level of literacy and the socio economic circumstances.

Nevertheless, until such reforms are effected, the Turquard and freeman & lockyer case remain applicable in Uganda.

14.8 LIABILITY OF A COMPANY FOR ACTS OF ITS OFFICERS

See **Lennard's Carrying Co. Ltd v Asiatic Petroleum Co. Ltd (1915) AC 705, HL** (On a person who is relay the directing mind and will of the corporation, the very ago of the personality of the corporation); See **Bolton (Engineering) Co. Ltd v Graham & Sons (1957) 1 Q. B 159**. See also **Meridian Global Fund management Asia Ltd v Securities Commission (1995) 2 A. C 500.**

More difficulties arise in the area of tortuous or criminal liability the question being whether the company can be held vicariously responsible for torts or criminal acts committed by its officers. While it is more clear that the company is vicariously liable for the torts committed by its officers in the course of their duties. It is less clear whether the company can also be held liable for the crimes committed by its officers as a company is incapable of having a mens rae which is necessary for criminal liability.

Duties of director s
Directors owe several duties to the company including among others the duty to lay proper accounts i.e. profit and loss to the general meeting.

Broadly, the duties of the directors can be divided into **fiduciary duties** and **the duty of care & skill.**

Fiduciary duties are owed only to the company only by directors as agents of the company. The duties not owed to the shareholders in their individual capacity. However, directors are also under a duty to disclose information to the shareholders as a group and not individually.

The fiduciary duty involves a duty to act bona fide in the interest of the company. This duty was discussed in the case of **Re Smith & Fawcett Ltd (1942) Ch 304.** A director must not act to the detriment of the company. As such, any malafides act by a director would lead him in breach of his duties. A director is also under a duty to exercise his powers for a proper purpose. A director will be in breach of this duty where he misuses s his powers. Directors are also required to avoid conflicts in breach of interests while executing their duties to the company. A director must not put his interests above those of the company. This duty extends to the use of company property, information or opportunity. See **Cook v Deeks (1916) AC 554.** A director should also avoid conflict of interest in contracts with the company. He should only engage in contracts with the company where the Articles of Association so allow or upon full disclosure of his interest. A director must disclose all direct or indirect interests in all such transactions at the meeting of directors and the affected director should abstain from proceeding where his conflict of interest is being discussed. Even in a company with only one director, he must disclose such interest by taking minutes to reveal such an interest. A director is also under a duty not to complete with the company is all transactions in which has an interest.

The duty of care and skill is owed by the directors to the company as trustees. See Re **City Equitable Fire Insurance Co (1925) Ch 407** Directors are under a duty to act with such care as can reasonably be expected of them, given their knowledge and experience. They must act negligently and they must act honestly for the benefit of the company. However, under the business judgment rule, directors may b excused for any negligent decision as long as they honestly believed that what they did was for their furtherance of the company's business.

Enforcement

The directors' duties may be enforced through a number of ways:

- **Litigation by the company:** The Company being a distinct legal person is empowered to bring suit to enforce directors' duties. Foss v Harbottle. However, where a director whose conduct is being complained of is a majority shareholder, a company may not find it easy to institute the proceedings as such a director is likely to vote against any proposal for litigation. Also directors may have voting arrangements with some shareholders leading to sabotage.
- Litigation by a member: In a limited number of instances, an individual member may be allowed to sue in place of the company. See **Edwards v Halliwell.** Such instances include
- When it is complained that the company is acting or proposing to act utra vires, since the matter is one which the members cannot ratify,
- Where the act complained of, though not utltra vires the company, could be effective only if resolved upon by a special majority vote, usually where a special or extra ordinary resolution is required and it is alleged that it has not been validly passed;
- Where those who control the company are perpetrating a fraud on the minority;
- Where the interests of justice require that the general rule prescribing suit by company be disregarded.
- There could also be a derivative action.

14.9 THE COMPANY SECRETARY

Every company must have a company secretary see Section 177 – 179 companies Act, Cap 110. The company secretary is responsible for various administration duties, including preparation and keeping.

The company in default

It may be the case that a company has failed to repay a loan, or the interest on a loan, to a creditor. This is an event of default. When a debenture holder wants to enforce the terms of a debenture when there has been default, the remedy is to appoint a receiver. Receivers are often lawyers or Accounts or managers. A receiver is appointed either by the court or under the terms of the debenture.

There are several different types of receivers. For example, there are administrative receivers, receivers and managers who manage the business of the company where a floating charge covers only a part of the company's undertaking, or a receiver appointed by a lender who has a fixed charge on property. A receiver may or may not be a qualified insolvency practitioner, although liquidator, administrators and administrative receiver must be. A receiver does not does not have to be a qualified insolvency practitioner to enforce a fixed charge, but must be one to enforce a floating charge. This requires an administrative receiver to announce the receivership, take control of the assets subject to the floating charge and realize those assets, paying off creditors in due course. When the receiver has done this, he may leave.

A company does not necessarily go into liquidation after the appointment of a receiver. If it does, the receiver may become the provisional liquidator on winding up. The creditors then meet to decide upon a permanent liquidator. An official receiver may also be appointed to act as an interim receiver until the liquidator has been appointed.

There is a distinction between a receiver and a liquidator. A receiver and a liquidator have separate functions, although physically they may be the same person. A receiver is appointed to help a creditor obtain payment. He is not there to wind up a company: This is the task of a liquidator.

15.0
COMPANY AUDITORS AND ACCOUNTS

UNIT 15 OVERVIEW

- General Introduction
- Appointment
- Other Aspects

1. The company auditor

Every company (apart from certain small companies) must appoint appropriately qualified **auditors**. An audit is a check on the stewardship of the directors.

Every company (except a dormant private company and certain small companies) must **appoint auditors** for each financial year.

1.1 Appointment

The **first auditors** may be appointed by the directors, to hold office until the **first general meeting** at which their appointment is considered. **Subsequent auditors** may not take office until the previous auditor has ceased to hold office. They will hold office until the end of the next financial period (private companies) or the next accounts meeting (public companies) unless re-appointed.

Appointment of auditors	
Members	▪ Usually appoint an auditor in general meeting by ordinary resolution. ▪ Auditors hold office from 28 days after the meeting in which the accounts are laid until the end of the corresponding period the next year. This is the case even if the auditors are appointed at the meeting where the accounts are laid. ▪ May appoint in general meeting to fill a casual vacancy.
Directors	• Appoint the first ever auditors. They hold office until the end of the first meeting at which the accounts are considered. ▪ May appoint to fill a casual vacancy.
Secretary of State	• May appoint auditors if members fail to. • Company must notify Secretary of State within 28 days of the general meeting where the accounts were laid.

2.1.1 Eligibility as auditor

Membership of a Recognised Supervisory Body is the main prerequisite for eligibility as an auditor. An audit firm may be either a body corporate, a partnership or a sole practitioner.

The Act requires an auditor to hold an 'appropriate qualification'. A person holds an 'appropriate qualification' if they:

- Have satisfied existing criteria for appointment as an auditor
- Hold a recognised qualification obtained in the UK
- Hold an approved overseas qualification

2.1.2 Ineligibility as auditor

Under the Companies Act 2006, a person may be ineligible on the grounds of 'lack of independence'.

A person is ineligible for appointment as a company auditor if they are:

- An officer or employee of the company being audited
- A partner or employee of such a person
- A partnership in which such a person is a partner
- Ineligible by virtue of the above for appointment as auditor of any parent or subsidiary undertaking where there exists a connection of any description as may be specified in regulations laid down by Secretary of State.

2.1.3 Effect of lack of independence or ineligibility

No person may act as auditor if they lack independence or become ineligible. If during their term of office an auditor loses their independence or eligibility they must resign with immediate effect, and notify their client of their resignation giving the reason.

A person continuing to act as auditor despite losing their independence or becoming ineligible is liable to a fine. However it is a defence if they can prove they were not aware that they lost independence or became ineligible.

The legislation does not disqualify the following from being an auditor of a limited company:

- A shareholder of the company
- A debtor or creditor of the company
- A close relative of an officer or employee of the company

However, the regulations of the accountancy bodies applying to their own members are stricter than statute in this respect.

2.2 Reappointing an auditor of a private company

The rules on appointment make reference to a meeting where the accounts are laid. This is not always relevant for private companies as under the Act they are not required to hold an AGM or lay the accounts before the members.

Therefore auditors of private companies are deemed automatically reappointed unless one of the following circumstances apply.

- The auditor was appointed by the directors (most likely when the first auditor was appointed).
- The articles require formal reappointment.
- Members holding 5% of the voting rights serve notice that the auditor should not be reappointed.

- A resolution (written or otherwise) has been passed that prevents reappointment.
- The directors have resolved that auditors should not be appointed for the forthcoming year as the company is likely to be exempt from audit.

2.3 Auditor remuneration

Whoever appoints the auditors has power to fix their remuneration for the period of their appointment. It is usual when the auditors are appointed by the general meeting to leave it to the directors to fix their remuneration (by agreement at a later stage). The auditors' remuneration must be disclosed in a note to the accounts.

2.4 Exemption from audit

Certain companies are exempt from audit provided the following conditions are fulfilled.

(a) A company is exempt from the annual audit requirement in a financial year if it meets the criteria for being a small company (two from, turnover being less than £6.5 million, balance sheet total not more than £3.26 million and having 50 or fewer employees).
(b) The exemptions do not apply to public companies, banking or insurance companies or those subject to a statute-based regulatory regime.
(c) The company is a non-commercial, non-profit making public sector body which is subject to audit by a public sector auditor.
(d) Members holding 10% or more of the capital of any company can veto the exemption.
(e) Dormant companies which qualify for exemption from an audit as a dormant company.

2.5 Duties of auditors

The statutory duty of auditors is to report to the members whether the accounts give a true and fair view and have been properly prepared in accordance with the Companies Act. They must also:

- State whether or not the directors' report is consistent with the accounts.
- For quoted companies, report to the members on the auditable part of the directors'
- Remuneration report including whether or not it has been properly prepared in accordance with the Act.
- Be signed by the auditor, stating their name, and date. Where the auditor is a firm, the senior auditor must sign in their own name for, and on behalf, of the auditor.

To fulfil their statutory duties, the auditors must carry out such investigations as are necessary to form an opinion as to whether:

(a) Proper accounting records have been kept and proper returns adequate for the audit have been received from branches.

(b) The accounts are in agreement with the accounting records.

(c) The information in the directors' remuneration report is consistent with the accounts.

The auditors' report must be read before any general meeting at which the accounts are considered and must be open to inspection by members. Auditors have to make disclosure of other services rendered to the company and the remuneration received.

Where an auditor knowingly or recklessly causes their report to be materially misleading, false or deceptive, they commit a criminal offence and may be liable to a fine.

2.6 Rights of auditors

The Companies Act provides statutory rights for auditors to enable them to carry out their duties.

The principal rights of auditors, excepting those dealing with resignation or removal, are set out in the table below, and the following are notes on more detailed points.

Access to records	A right of access at all times to the books, accounts and vouchers of the company.
Information and explanations	A right to require from the company's officers, employees or any other relevant person, such information and explanations as they think necessary for the performance of their duties as auditors.
Attendance at/notices of general meetings	A right to attend any general meetings of the company and to receive all notices of and communications relating to such meetings which any member of the company is entitled to receive.
Right to speak at general meetings	A right to be heard at general meetings which they attend on any part of the business that concerns them as auditors.
Rights in relation to written resolutions	A right to receive a copy of any written resolution proposed.

If auditors have not received all the information and explanations they consider necessary, they should state this fact in their audit report.

The Act makes it an offence for a company's officer knowingly or recklessly to make a statement in any form to an auditor which:

- Conveys or purports to convey any information or explanation required by the auditor and
- Is materially misleading, false or deceptive

The penalty is a maximum of two years' imprisonment, a fine or both.

2.7 Auditors' liability

Under the Companies Act any agreement between an auditor and a company that seeks to indemnify the auditor for their own negligence, default, or breach of duty or trust is void. However, an agreement can be made which limits the auditor's liability to the company.

Such liability limitation agreements can only stand for one financial year and must therefore be replaced annually.

Liability can only be limited to what is fair and reasonable having regard to the auditor's responsibilities, their contractual obligations and the professional standards expected of them.

Such agreements must be approved by the members and publicly disclosed in the accounts or directors' report.**2.8**

Termination of auditors' appointment

Auditors may leave office in the following ways: resignation; removal from office by an ordinary resolution with special notice passed before the end of their term; failing to offer themselves for re-election; and not being re-elected at the general meeting at which their term expires.Departure of auditors from office can occur in the following ways.

(a) Auditors may resign their appointment by giving notice in writing to the company delivered to the registered office.

(b) Auditors may decline reappointment.

(c) Auditors may be removed from office before the expiry of their appointment by the passing of an ordinary resolution in general meeting. Special notice is required and members and auditors must be notified. Private companies cannot remove an auditor by written resolution; a meeting must be held.

(d) Auditors do not have to be reappointed when their term of office expires, although in most cases they are. Special notice must be given of any resolution to appoint auditors who were not appointed on the last occasion of the resolution, and the members and auditor must be notified.

Where a private company resolves to appoint a replacement auditor by written resolution, copies of the resolution must be sent to the proposed and outgoing auditor. The outgoing auditor may circulate a statement of reasonable length to the members if they notify the company within 14 days of receiving the copy of the written resolution.

2.8.1 Resignation of auditors

However auditors leave office they must either: state there are no circumstances which should be brought to members' and creditors' attention; or list those circumstances. Auditors who are resigning can also: circulate a statement about their resignation to members; requisition a general meeting; or speak at a general meeting.

Procedures for resignation of auditors	
Statement of circumstances	Auditors must deposit a statement at the registered office with their resignation stating: • For quoted companies – the circumstances around their departure. • For non-quoted public companies and all private companies – there are no circumstances that the auditor believes should be brought to the attention of the members or creditors. • If there are such circumstances the statement should describe them. • Statements should also be submitted to the appropriate audit authority.
Company action	The company must send notice of the resignation to the Registrar. The company must send a copy of the statement of circumstances to every person entitled to receive a copy of the accounts.
Auditor rights	If the auditors have deposited a statement of circumstances, they may: • Circulate a statement of reasonable length to the members • Requisition a general meeting to explain their reasons • ttend and speak at any meeting where appointment of successors is to be discussed.

If the auditors decline to seek reappointment at an AGM, they must nevertheless fulfil the requirements of a statement of the circumstances just as if they had resigned. The reason for this provision is to prevent auditors who are unhappy with the company's affairs keeping their suspicions secret. The statement must be deposited not less than 14 days before the time allowed for next appointing auditors.

2.8.2 Removal of the auditor from office

Procedures for removal from office	
Auditor representations	If a resolution is proposed either to: • Remove the auditors before their term of office expires or • Change the auditors when their term of office is complete the auditors have the right to make representations of reasonable length to the company
Company action	The company must: • Notify members in the notice of the meeting of the representations • Send a copy of the representations in the notice • If it is not sent out, the auditors can require it is read at the meeting
Attendance at meeting	Auditors removed before expiry of their office may: • Attend the meeting at which their office would have expired • Attend any meeting at which the appointment of their successors is discussed
Statement of circumstances	If auditors are removed at a general meeting they must: • Make a statement of circumstances for members and creditors

16.0 DIVIDENDS

UNIT 16 OVERVIEW
- Declaration and payment
- Unlawful distributions
- Capitalisation of profits

Capital maintenance

The rules which dictate how a company is to manage and maintain its capital exist to maintain the delicate balance between the members' enjoyment of limited liability and the creditors' requirements that the company shall remain able to pay its debts.

Capital maintenance is a fundamental principle of company law that limited companies should not be allowed to make payments out of capital to the detriment of company creditors. Therefore the Companies Act contains many examples of control upon capital payments. These include provisions restricting dividend payments, and capital reduction schemes.

The rules affecting the possible threats to capital are complicated in certain areas. However, provided you know the rules, questions on capital maintenance tend to be straightforward.

2 Reduction of share capital

Reduction of capital can be achieved by: extinguishing/reducing liability on partly-paid shares; cancelling paid-up share capital; or paying off part of paid-up share capital. Court confirmation is required for public companies. The court considers the interests of creditors and different classes of shareholder. There must be power in the articles and a special resolution.

A limited company is permitted without restriction to cancel unissued shares as that change does not alter its financial position.

If a limited company with a share capital wishes to reduce its issued share capital it may do if:

- The power to do so has not been restricted by the company's articles (if it does not have power in the articles, these may be amended by a special resolution).
- It passes a special resolution. (If the articles have been amended, this is another special resolution)
- It obtains confirmation of the reduction from the court

2.1 Solvency statement

A private company need not apply to the court if it supports its special resolution with a solvency statement.

A solvency statement is a declaration by the directors, provided 15 days in advance of the meeting where the special resolution is to be voted on. It states there is no ground to suspect the company is currently unable or will be unlikely to be able to pay its debts for the next 12 months. All possible liabilities must be taken into account and the statement should be in the prescribed form, naming all the directors.

It is an offence for directors to deliver to the Registrar a solvency statement without having reasonable grounds for the opinions expressed in it.

2.2 Why reduce share capital?

A company may wish to reduce its capital for one or more of the following reasons.

- The company has suffered a loss in the value of its assets and it reduces its capital to reflect that fact.
- The company wishes to extinguish the interests of some members entirely.
- The capital reduction is part of a complicated arrangement of capital which may involve, for instance, replacing share capital with loan capital.

There are **three basic methods of reducing share capital** specified in the Companies Act.

Method	What happens	Effects
Extinguish or reduce liability on partly paid shares	Eg Company has nominal value £1 shares 75p paid up. Either (a) reduce nominal value to 75p; or (b) reduce nominal value to a figure between 75p and £1	Company gives up claim for amount not paid up (nothing is **returned** to shareholders)
Pay off part of paid-up share capital out of surplus assets	Eg Company reduces nominal value of fully paid shares from £1 to 70p and repays this amount to shareholders	Assets of company are reduced by 30p in £
Cancel paid-up share capital which has been lost or which is no longer represented by available assets	Eg Company has £1 nominal fully paid shares but net assets only worth 50p per share. Difference is a debit balance on reserves. Company reduces nominal value to 50p, and applies amount to write off debit balance	Company can resume dividend payments out of future profits without having to make good past losses

2.3 Role of the court in reduction of share capital

When the court receives an application for reduction of capital its first concern is the effect of the reduction on the company's ability to pay its debts, that is, that the creditors are protected.

If the reduction is by extinguishing liability or paying off part of paid-up share capital, the court requires that creditors shall be invited by advertisement to state their objections (if any) to the reduction. Where paid-up share capital is cancelled, the court may require an invitation to creditors.

Normally the company persuades the court to dispense with advertising for creditors' objections (which can be commercially damaging to the company).

Two possible approaches are:

- To pay off all creditors before application is made to the court; or, if that is not practicable
- To produce to the court a guarantee, say from the company's bank, that its existing debts will be paid in full

The second concern of the court, where there is more than one class of share, is whether the reduction is fair in its effect on different classes of shareholder.

If the reduction is, in the circumstances, a variation of class rights the consent of the class must be obtained under the variation of class rights procedure.

Within each class of share it is usual to make a uniform reduction of every share by the same amount per share, though this is not obligatory.

The court may also be concerned that the reduction should not confuse or mislead people who may deal with the company in future. It may insist that the company add 'and reduced' to its name or publish explanations of the reduction.

2.3.1 Confirmation by the court

If the court is satisfied that the reduction is in order, it confirms the reduction by making an order to that effect. A copy of the court order and a statement of capital, approved by the court, to show the altered share capital is delivered to the Registrar who issues a certificate of registration.

3. Distributing dividends

Various rules have been created to ensure that dividends are only paid out of available profits.

A dividend is an amount payable to shareholders from profits or other distributable reserves.

3.1 Power to declare dividends

A company may only pay dividends out of profits available for the purpose. The power to declare a dividend is given by the articles which often include the following rules.

Rules related to the power to declare a dividend
The company in general meeting may declare dividends.
No dividend may exceed the amount recommended by the directors who have an implied power in their discretion to set aside profits as reserves.
The directors may declare such interim dividends as they consider justified.
Dividends are normally declared payable on the paid up amount of share capital. For example a £1 share which is fully paid will carry entitlement to twice as much dividend as a £1 share 50p paid.
A dividend may be paid otherwise than in cash.

Dividends may be paid by cheque or warrant sent through the post to the shareholder at their registered address. If shares are held jointly, payment of dividend is made to the first-named joint holder on the register.

Listed companies generally pay two dividends a year; an interim dividend based on interim profit figures, and a final dividend based on the annual accounts and approved at the AGM.

A dividend becomes a debt when it is declared and due for payment. A shareholder is not entitled to a dividend unless it is declared in accordance with the procedure prescribed by the articles and the declared date for payment has arrived. This is so even if the member holds preference shares carrying a priority entitlement to receive a specified amount of dividend on a specified date in the year. The directors may decide to withhold profits and cannot be compelled to recommend a dividend.

If the articles refer to 'payment' of dividends this means payment in cash. A power to pay dividends in specie (otherwise than in cash) is not implied but may be expressly created. Scrip dividends are dividends paid by the issue of additional shares. Any provision of the articles for the declaration and payment of dividends is subject to the overriding rule that no dividend may be paid except out of profits distributable by law.

3.2 Distributable profit

Distributable profits may be defined as 'accumulated realised profits ... less accumulated realised losses'. 'Accumulated' means that any losses of previous years must be included in reckoning the current distributable surplus. 'Realised' profits are determined in accordance with generally accepted accounting principles.

Profits available for distribution are accumulated realised profits (which have not been distributed or capitalised) less accumulated realised losses (which have not been previously written off in a reduction or reorganisation of capital).

The word 'accumulated' requires that any losses of previous years must be included in reckoning the current distributable surplus. A profit or loss is deemed to be realised if it is treated as realised in accordance with generally accepted accounting principles. Hence, financial reporting and accounting standards in issue, plus generally accepted accounting principles (GAAP), should be taken into account when determining realised profits and losses.

Depreciation must be treated as a realised loss, and debited against profit, in determining the amount of distributable profit remaining.

However, a revalued asset will have deprecation charged on its historical cost and the increase in the value in the asset. The Companies Act allows the depreciation provision on the valuation increase to be treated also as a realised profit. Effectively there is a cancelling out, and at the end only depreciation that relates to historical cost will affect dividends.

Example:
Suppose that an asset purchased for £20,000 has a ten year life. Provision is made for depreciation on a straight line basis. This means an annual depreciation charge of £2,000 (£20,000/10 years) must be deducted in reckoning the company's realised profit less realised loss.

After five years the asset is written down value is £10,000 (£20,000 less £2,000 × 5 years). Suppose that the asset is then revalued to £50,000. The increase in the value of the asset (£40,000) is credited to the revaluation reserve.

The consequences of this revaluation are that the annual depreciation charge is raised to £10,000(£50,000/5 remaining years of the asset's life) and £8,000 (£40,000/5 years) is transferred from the revaluation reserve to realised profit each year for the remaining life of the asset

If, on a general revaluation of all fixed assets, it appears that there is a diminution in value of any one or more assets, then any related provision(s) need not be treated as a realised loss. The Act states that if a company shows development expenditure as an asset in its accounts it must usually be treated as a realised loss in the year it occurs. However it can be carried forward in special circumstances (generally taken to mean in accordance with accounting standards).

3.3 Dividends of public companies

A public company may only make a distribution if its net assets are, at the time, not less than the aggregate of its called-up share capital and undistributable reserves. It may only pay a dividend which will leave its net assets at not less than that aggregate amount.

A public company may only make a distribution if its net assets are, at the time, not less than the aggregate of its called-up share capital and undistributable reserves. The dividend which it may pay is limited to such amount as will leave its net assets at not less than that aggregate amount.

Undistributable reserves are defined as:

(a) Share premium account
(b) Capital redemption reserve
(c) Any surplus of accumulated unrealised profits over accumulated unrealised losses (known as a revaluation reserve). However a deficit of accumulated unrealised profits compared with accumulated unrealised losses must be treated as a realised loss
(d) Any reserve which the company is prohibited from distributing by statute, its constitution or law.

Example:
Suppose that a public company has an issued share capital (fully paid) of £800,000 and £200,000 on share premium account (which is an undistributable reserve). If its assets less liabilities are less than £1 million it may not pay a dividend. If however its net assets are say £1,250,000 it may pay a dividend but only of such amount as will leave net assets of £1 million or more, so its maximum permissible dividend is £250,000.

The dividend rules apply to every form of distribution of assets except the following

- The issue of bonus shares whether fully or partly paid
- The redemption or purchase of the company's shares out of capital or profits
- A reduction of share capital
- A distribution of assets to members in a winding up

You must appreciate how the rules relating to public companies in this area are more stringent than the rules for private companies.

3.4 Relevant accounts

The profits available for distribution are generally determined from the last annual accounts to be prepared. Whether a company has profits from which to pay a dividend is determined by reference to its 'relevant accounts', which are generally the last annual accounts to be prepared.

If the auditor has qualified their report on the accounts they must also state in writing whether, in their opinion, the subject matter of their qualification is material in determining whether the dividend may be paid. This statement must have been circulated to the members (for a private company) or considered at a general meeting (for a public company).

A company may produce interim accounts if the latest annual accounts do not disclose a sufficient distributable profit to cover the proposed dividend. It may also produce initial accounts if it proposes to pay a dividend during its first accounting reference period or before its first accounts are laid before the company in general meeting. These accounts may be unaudited, but they must suffice to permit a proper judgement to be made of amounts of any of the relevant items.

If a public company produces initial or interim accounts they must be full accounts such as the company is required to produce as final accounts at the end of the year. They need not be audited. However the auditors must, in the case of initial accounts, satisfy themselves that the accounts have been 'properly prepared' to comply with the Act. A copy of any such accounts of a public company (with any auditors' statement) must be delivered to the Registrar for filing.

3.5 Infringement of dividend rules

In certain situations the directors and members may be liable to make good to the company the amount of an unlawful dividend.

If a dividend is paid otherwise than out of distributable profits the company, the directors and the shareholders may be involved in making good the unlawful distribution.

The directors are held responsible since they either recommend to members in general meeting that a dividend should be declared or they declare interim dividends.

(a) The directors are liable if they declare a dividend which they know is paid out of capital.

(b) The directors are liable if, without preparing any accounts, they declare or recommend a dividend which proves to be paid out of capital. It is their duty to satisfy themselves that profits are available.

(c) The directors are liable if they make some mistake of law or interpretation of the constitution which leads them to recommend or declare an unlawful dividend. However in such cases the directors may well be entitled to relief as their acts were performed 'honestly and reasonably'.

The directors may however honestly rely on proper accounts which disclose an apparent distributable profit out of which the dividend can properly be paid. They are not liable if it later appears that the assumptions or estimates used in preparing the accounts, although reasonable at the time, were in fact unsound.

The position of members is as follows.

- A member may obtain an injunction to restrain a company from paying an unlawful dividend.
- Members voting in general meeting cannot authorise the payment of an unlawful dividend nor release the directors from their liability to pay it back.
- The company can recover from members an unlawful dividend if the members knew or had
- Reasonable grounds to believe that it was unlawful.
- If the directors have to make good to the company an unlawful dividend they may claim indemnity from members who at the time of receipt knew of the irregularity.
- Members knowingly receiving an unlawful dividend may not bring an action against the directors.

If an unlawful dividend is paid by reason of error in the accounts the company may be unable to claim against either the directors or the members. The company might then have a claim against its auditors if the undiscovered mistake was due to negligence on their part.

17.0 CORPORATE INSOLVENCY

UNIT 17 OVERVIEW

- Dissolution and Insolvency
- Winding up
- The Liquidator

17.1 DISSOLUTION AND INSOLVENCY

The term dissolution refers to bring a company to an end. This may be for various reasons: E.g. It may be that the purpose for which the business was set up has been achieved. The most usual reason for dissolution is because the company's business is insolvent. As a legal person, a company is wound up and remains in existence only until the process of liquidation is complete. The term insolvent is generally used to describe a company that cannot pay its debts.

17.2 DISSOLUTION OF REGISTERED COMPANIES

There are various ways in which a registered company may be dissolved:

- Cancellation of the registration. On the ground that the company's objectives are illegal e.g. the company was set up for the purpose of prostitution;

- By and order of the court where the company is transferring its undertaking to another company under recognition. This can at times be by agreement of the companies involved in the reconstruction or amalgamation either under a merger, a takeover, an acquisition, division scheme of arrangement. See section 207, 208, 209, 210, 285, 304 companies Act, Cap 110. In many instances, the process of reconstruction, reorganization or amalgamation of companies will involve complex transactions that may result into the disappearance of one or more companies involved in transactions or at times the formation of new entities. The shareholders/ members of all the affected companies would have to agree on the nature of the transaction. The general meetings of the concerned companies must approve the merger/ takeover etc. This may have consequences for the members, Management, employees and even the creditors of the affected companies. As a result, it is vital that the transaction must be well arranged to cater for the interests of all the stake holders.
- By the registrar of companies if the company is defunct, see section 343 companies Act, Cap 110;
- By winding up.

17.3 WINDING UP

The liquidation of a company is achieved by the process known as winding up. Section 212 (1) of the companies Act provides that the winding up of a company may be either

(a) By the court;
(b) Voluntary; or
(c) Subject to the supervision of the court.

As such there are two broad sorts of winding up:
Voluntary winding up and involuntary (compulsory) winding up. See section 212 companies Act, Cap110.

1. **Voluntary winding up** is initiated by the members of the company or the creditors. Section 276 of the companies Act, Cap 110 provides circumstances in which a company may be wound up voluntarily. Subsection (1) thereof provides that a company may be wound up by voluntarily-
   a. When the period, if any fixed for the duration of the company by the articles expires, or even, If any, occurs, on the occurrence of which the articles provide that the company is to be dissolved and the company in general meeting has passed a resolution requiring the company to be wound up voluntarily;
   b. If the company resolves by special resolution that the company be wound voluntarily
   c. If the company resolves by special resolution to the effect that it cannot by reasons of its liabilities continue its business, and that it is advisable to wind up;

In a voluntary winding up, the shareholder can resolve to end the company. If the majority of the directors swear a statutory declaration of solvency then the company members can manage the winding up themselves (Section 281 Companies Act). This is called a **Members' voluntary winding up.** The members can appoint a liquidator in general meeting. In the case of a **Creditors'' voluntary winding up,** the directors have failed to swear a voluntary declaration of insolvency. A meeting of creditor must be called. See section 276 – 312 companies Act.

2. **Compulsory (Voluntary) winding up** is by court order. A winding up petition is submitted to the court by the company itself, or a creditor who establishes a prima facie case- See **Re olathe silver Mining Company. (1884) 27 Ch. D. 278; Re Dunderland Iron Ore Co. Ltd (1909) 1 Ch 446.** Or by a contributory - See **Re Rica Gold Washing Co. (1879) 11 Ch. D 36; Re chesterfield catering (1976) 3 ALL ER 294.** See Section 222 & 224 companies Act. Under section 222 of the companies Act, cap 110, a company may be wound up by the court if-
   a. The company has by special resolution resolved that the company be wound up by the court;
   b. Default is made in delivering the statutory report to the register or in holding the statutory meeting;
   c. The company does not commence business within a year from its incorporation or suspend its business for a whole year;
   d. The number of members is reduced, in the cases of a private company, Below two, or, in the case of any other company, below seven;
   e. The company is unable to pay its debts; See **Re Mastermind Tobacco (U) Limited Tobacco & Commodity Traders International Incorporated (2002 – 2004) Uganda commercial law reports 414; TranAfrica Assurance Co. Ltd v Cimbria (EA) Ltd (1997 – 2001) Uganda Commercial Law Report 139.**
   f. The court is of the opinion that it is just and Equitable that the company should wound up;(e.g. Due to rivalry among shareholders or officers of the company and generally internal strife within company);
   g. In the case of a company incorporated outside Uganda and carrying on business in Uganda, winding up proceedings have been commenced in respect t of it in the country or territory of its incorporation or in any other country or territory in which it has established a place of business.

A contributory is someone who is liable to contribute to the assets of the company on winding up. See Section 214 Companies Act & Re: Industrial and Commercial Bank (1933) 10 NLR 85. There are various situations in which there will be a compulsory winding up. E.g. the company has passed a special resolution that it is to be wound up by court, the number of Members has fallen below the inability to pay debts. One the petition has been presented, the company may not dispose of its property or transfer any of its shares.

17.4 WINDING UP UNDER THE SUPERVISION OF COURT

Under section 308 – 312 of the companies Act, Winding up may be subject to the supervision of court .according to section 308, Where a company has passed a resolution for voluntary winding up, the court may make an order that the voluntary winding up shall continue but subject to such supervision of the court, and with such liberty for creditors, contributories or others to apply to the court and generally on such terms and conditions, as the court thinks just. Under section 309 thereof, a petition for the continuance of winding up subject to the supervision of the court shall, for the purpose of giving jurisdiction to the court over actions, be deemed to be a petition for winding up by the court.

A winding up order has a number of consequences. See section 226 – 228, 230 – 238, 261 etc. Once a winding up order has been made, no legal processing can be brought up against the company except with the leave of court – Nevertheless, a party sued by the company under liquidation may counterclaim as was held **In Langley construction (Brixham) Ltd v Weills (1969) 1 WLR 503**; If no liquidator has been appointed, the official receiver becomes a provisional liquidator; The directors' power of management cease upon appointment of a liquidator – **Flowler v broads patent night light Co. (1983) 1 Ch 724** – but they can appeal in the company's name against the order of winding up and can have some residual powers e.g. to instruct legal counsel; there can be no transaction with the company's assets except with power of the liquidator – **Re Muddu Awulira Enterprises Limited (2002 -2004) Uganda commercial Law reports 418;** all company employees and directors are deemed dismissed but can be reemployed by the liquidator.

17.5 THE ROLE OF A LIQUIDATOR

A liquidator is an insolvency practitioner who is appointed to wind up a company. Once appointed, only the liquidator may deal with the assets of a company. His role is to take control of the company, gather in the assets that belong to the company, realize them and pay off the creditors in order of priority. There is a fixed order of priority in a liquidator, with each category being paid in full before moving on to the next category. See section 315 companies Act.

Creditors with fixed charges may realize their charges on the company property. Traditionally, the first category in the order of priority has been the liquidator's fees (although this has been altered I jurisdiction such as England). Then preferential creditors such as the URA taxes and wages of the employees are paid off, fixed charges and floating charges holders and unsecured trade creditors. Only when creditors have been paid out, will any surplus been distributed to the shareholders. The members rank according to their rights, usually with preference shareholders being paid before ordinary shareholders.

As can be seen from this order of priority, creditors with security are in a better position than unsecured creditors. Most charges on property are registrable, but they must have been registered properly otherwise they may fail. With respect to fixed charges anthem same property, the first in time has priority. Floating charges normally rank behind fixed charges in priority, unless there is a negative pledge clause in the floating charge stating that a company is not allowed to create a subsequent charge that has priority over a floating charge.

The liquidator may set aside transitions that were intended to defraud the creditors, He can apply to the court to recover assets that were disposed of by the company within two years if undervalued, e.g. a gift made by the company at a time that was already unable to pay its debts. Some charges may be invalid, e.g. If the charge was made in favour of a connected person. A charge will constitute a preference if it unfairly prefers some creditors to others.

In certain circumstances, director of the company may be contributories. A director can be held liable for fraudulent or wrongful trading. Fraudulent trading is where a company knows it will not be able to pay its debts when due, or is reckless as to whether it can pay them. Wrongful trading is where a director ought to have realized that the company could not pay its debts. Again, the director could be required to contribute to the assets of the company in winding up.

17.6 SPECIAL CREDITOR RIGHTS

That the liquidator pays out creditors according to an order of priorities can be very unfavorable to some creditors. Certain legal constructions have been developed to circumvent the order of priorities and give protection to those who would otherwise find themselves low down on the list.

- **Retention of title** or reservation of title clause **(Romalpa clause);** this is a clause inserted into a contract of sale stipulating that the seller remains the legal owner of the goods he sells until the buyer has paid for the goods in full. Only then will the title pass. The purpose of this clause is to affect priority, as a supplier of goods with a valid retention of title clause will rank above a creditor secured by means of a registered charge in the event of receivership or liquidation.

- **Lien:** Here the lien acts as a charge on the property of another as security for the performance of an obligation, E. g. a lien can exist where a person has carried out work on another person\s property, such as carrying out repairs. The person carrying out the work has a lien over the property until he is paid for his work. The liquidator cannot take the property until the holder of the lien has been paid off.

- **Trust device**: the trust is a legal construction usual in common law countries. Funds that have been given to the company for a specific purpose may be held on trust, creating a relationship of trustee / beneficiary rather than that of creditor / debtor. This means that the funds are not part of the assets that the liquidator may fail upon to distribute to the creditors.

17.7 ALTERNATIVES TO WINDING UP

There are circumstances in which winding up the company would not be the best option for the creditors. The company could attempt to reach an understanding with the creditors. In some cases, the best option for all concerned may be to rescue the company and get it up and running again.

- Voluntary arrangement: this is a legally binding, voluntary between the company and its creditors. Any such arrangements should be supervised by a qualified insolvency practitioner. Voluntary arrangements may be inform of a composition or a scheme of arrangement. In a **composition**, an arrangement made with the creditors to settle a debt immediately by repaying only part of it. In a **scheme of arrangement**, a plan is drawn up to offer a way of paying debts and avoiding insolvency.

- **Administration order:** it may be possible to rescue a company by putting its management in the hands of an administrator, who again must be a qualified insolvency practitioner. The purpose of an administration order is the survival of the company as a going concern, as a whole or in part. Any petition for winding up would then be dismissed, as would a receiver if the order is granted. The order creates a **moratorium,** or **suspension of payments**, for a fixed period so that on – one can deal with the assets in that specified period. The administrator then runs the business.