

THE LAW SOCIETY OF SCOTLAND EXAMINATIONS

BUSINESS ORGANISATIONS

Friday 29 July 2022

**1300 – 1600
(Three hours)**

You are required to answer **THREE** questions.

You are expected to provide legal authority for all your assertions.

You are expected to write your own answers, and you must neither share your answers with any other candidate nor copy another candidate's work. Use your own words in your answers, not merely transcribing what you may find in textbooks, solicitors' blogs or other law-related websites.

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Question One

Keith, Lachlan and Mark are scaffolders who run a scaffolding business, KLM Scaffolding, as a partnership. The three partners have a rudimentary partnership agreement which reflects the fact that Keith has contributed 60% of the partnership capital, and Lachlan and Mark have contributed 20% each. Keith's mother, Joan, has lent some money to the partnership, the rate of interest varying according to the profitability of the partnership, according to an oral agreement between Keith and Joan, and to which Lachlan and Mark have not objected. On one occasion, some scaffolding is not properly erected, causing loss to the contractor who had hired KLM Scaffolding. When KLM Scaffolding initially could not reimburse the contractor's loss, the contractor, knowing Joan was wealthy, proposed to claim from her on the grounds that she was a partner – something she stoutly denied.

Some time later, Keith, Lachlan, and Mark decide to incorporate the partnership business. Joan's loan is repaid to her. The partnership transfers the scaffolding business to a new company, called KLM Scaffolding Ltd, of which Keith, Lachlan and Mark are directors. They each take shareholdings in the company in the same proportions as their interests in the partnership. Joan then lends the company the same amount that she had previously lent to the partnership. This time her interest rate varies according to the current rate of inflation. A meeting of the board of directors briefly records the loan but does not record the fact that Mark objected to the loan because of the high rate of interest. The minute of the meeting does not reveal how the decision to accept the loan was made. A year later, Joan announces that she would like to have the benefit of a floating charge to secure her loan to the company. The other directors agree with this, but Mark does not. Again, there is no record of how the decision to grant the floating charge was made.

As a result of Mark's apparent disloyalty, Keith decides to convene a general meeting at short notice, at which he proposes to use his and Lachlan's votes to remove Mark as a director. At the meeting, which takes place the following day, Mark objects to the short notice, and objects to being dismissed. His objections are ignored and the others vote to remove him as director. He then asks for the return of his capital, but they refuse to give it to him. This is on the grounds that the company does not at that time have any distributable profits.

At this point, Lachlan receives a letter from the British subsidiary of the Dutch airline company, KLM, objecting to the use of the letters K, L and M in that order in the company

name, KLM Scaffolders Ltd. Lachlan replies to the effect that on registration of the name KLM Scaffolders, the Registrar of Companies had made no objection, so it must be legal.

Consider the points of law arising from the above and, where relevant and possible, explain what should have been done had proper procedures been followed.

Question Two

John owns a castle on the west coast of Scotland. It has been in his family for years, but he needs to sell it, now that he lives far away from the castle. He hires a firm of estate agents to market the castle. The terms of the agency agreement state that John will pay a fee of 1.5% of the contracted sale price of the castle to the estate agents. This fee does not all the marketing material, the advertising and any other expenses which must be borne for John. The marketing materials say that all bids must be submitted to the estate agents, by a day yet to be decided. The estate agents ask a self-employed local representative, Alec, for a fee, to show prospective purchasers round the castle. Ben, a millionaire, wishes to buy the castle, but does not wish to have to submit a competitive bid. He wants to do a quick private deal. Ben explains to Alec what he wants and what he would offer John. He also tells Alec that if the deal goes ahead, there will be commission for Alec from Ben. Alec says that he will get back to him. Alec, instead of going back to the estate agents, tells John directly about the offer. Alec does not reveal the possibility of Ben's commission to John or to the estate agents. John decides that the offer from Ben is a good one. John tells Alec to tell Ben to get Ben's solicitors to put in an offer to John's solicitors. John sends an email to the estate agents to stop acting for him, as he has already received a good offer. The email goes into the estate agent's junk mail and is not noticed. The estate agents therefore continue to market the castle. John's solicitors are surprised when John tells them that he no longer wishes to bother with the estate agents, but the solicitors do what John wants them to do, and conclude missives quickly with Ben's solicitors for the purchase of the castle. Ben is not actually buying the castle himself: he is using a Scottish-incorporated company, of which he is the sole shareholder and director, to buy the castle. The company's name is Darkcastle Ltd. The entry date and the date of payment ("the date of settlement") is agreed between John's solicitors and Ben's solicitors as being in seven days' time. The date of settlement comes round and John's solicitors await the purchase price from Ben's solicitors. By 4.30 pm it still has not arrived in John's solicitors' bank account. Ben's solicitors are concerned as they have not heard from Ben for some days, despite the imminence of the day of entry. In the meantime the estate agents have heard what is going on, and are most indignant at John's behaviour. By 5 p.m. it is clear that the money has not been paid. Nevertheless, the estate agents, having stated that they no longer wish to deal with John, next morning send in their fee-note to John, demanding that it be paid promptly. John refuses to pay it on the grounds that (a) he and Ben had done the deal privately without the help of the estate agents and (b) that neither Ben nor Darkcastle Ltd had produced the purchase price, so he could hardly be expected to pay commission to the estate agents on a transaction that had not taken place.

Meanwhile Ben's solicitors find Ben, who is by now on a yacht in the Aegean Sea. The solicitors ask what is happening, and why the money was not paid. Ben says that he has

changed his mind about the castle, and that if this is inconvenient for others, it is too bad; and if they don't like it, it isn't his problem, but they are welcome to sue Darkcastle Ltd. On investigation it is discovered that Darkcastle Ltd has £100 of share capital and no other assets. The estate agents refuse to pay Alec his fee or expenses for showing the castle, so Alec boldly writes to Ben to ask for them. Ben replies to him saying that while it is true that Ben and Alec did agree that if the deal went ahead, Alec would get commission, both Ben and Darkcastle Ltd were both acting for another purchaser whose name Ben, and by extension Darkcastle Ltd, are not at liberty to reveal. Ben asserts he is under no obligation to pay Alec's fee or expenses.

Discuss the points of law arising in the above, indicating in particular the rights available to, or liabilities incurred by, John, the estate agents, Ben, Darkcastle Ltd, the unnamed purchaser, and Alec.

Question Three

Mildew Consulting Ltd ("Mildew") specialises in the restoration of damp properties, by stripping out rotten materials and preventing future deterioration. It is run as a partnership by a surveyor, Alice, and a former all-trades contractor, Barry. They each are directors: Alice puts £40,000 capital into the company while Bernard puts in £20,000. Mildew has the standard articles for a private limited company. Alice believes she is entitled to 2/3rds of the company's profits. Mildew picks up a good deal of consultancy work.

After some years' successful trading, Bernard asks Alice if his son, Carlo, could be a member of the company, particularly if he contributes £20,000 capital and works for the company. She initially refuses, mainly on the unspoken grounds that she does not trust the young man. Bernard is not happy about this, but he does recognise that he and Alice do make a good professional team. He then suggests that Carlo could be allotted 20,000 new special non-voting ordinary shares (again of £1.00 nominal value). Alice agrees to this, and says she will attend to the paperwork.

Sometime later, having noticed that he does not seem to be receiving any dividends, or received a share certificate, Carlo discovers that although he is supposed to have been issued his shares, he can find no record in the company's books about this. He asks to see the accounts but Alice tells him he is not allowed to see the accounts as he is only a non-voting shareholder. Carlo is not happy about this. He complains to Alice, and she says that if he works hard, and carries out certain tasks well, Alice might consider making him a director. Some time later, having done what Alice had asked, he approaches her and tells her what he has done, and whether he might now become a director. Alice laughs at him and tells him that she was never serious about the matter. Carlo thinks he has been treated very badly by his fellow shareholder. Carlo also discovers that Alice is proposing to sack the company's auditor.

Carlo approaches you as a friend who knows about business law. Explain to Carlo what should have been done to ensure that he received his shares, and what rights or remedies

there may be for Alice's treatment of him or the dismissal of the auditor. You may assume you were able to access the company's registered documentation through the Companies House website.

Question Four

Verdant Ltd is a wholly-owned subsidiary of United Bauxite plc, a Scottish-registered company specialising in quarrying bauxite and making products (mostly semi-conductors) from one of the metals found in bauxite, gallium. The directors of Verdant Ltd are appointed by the directors of United Bauxite Ltd. Verdant Ltd operates a mine in Scotland from which gallium has been extracted over the last forty years. The Scottish mine is nearing the end of its operational life as the cost of quarrying the bauxite is greater than the available supply of bauxite. Quarrying the bauxite comes at a considerable environmental cost. Verdant Ltd has the benefit of insurance policies that should cover the cost of dealing with these environmental costs if for some reason Verdant Ltd is unable to meet those costs. The proceeds of these policies would amount to £30 million. Verdant Ltd owns other quarries elsewhere in the world.

Verdant Ltd has been lent £15 million by United Bauxite plc. Verdant Ltd's share capital is £20 million. Verdant Ltd has undistributed profits of £10 million. As a result of a rise in the cost of processing bauxite to extract gallium, the directors of United Bauxite plc now wish to dispose of Verdant Ltd on terms that preclude United Bauxite plc being liable for any of Verdant Ltd's debts. Verdant Ltd's directors wish to reduce its share capital to £5 million. They then propose to declare a dividend of £25 million to be paid to United Bauxite plc. At the time the directors decide to do this, the cost of clearing up the Scottish mine is £25 million. Following the reduction of capital, the dividend is duly paid. Shortly afterwards, Verdant Ltd goes into what is initially a members' voluntary liquidation. Once the liquidator is appointed, it is apparent that even after the disposal of Verdant Ltd's other mines, the company's assets are less than its liabilities, while the cost of clearing up the Scottish mine turns out not to be £25 million but £35 million, mainly because of inflation and recent extra environmental requirements imposed by the Government. When confronted by the sceptical liquidator with the information about the extra cost of clearing up the Scottish mine, the directors appear surprised and taken aback.

Explain the requirements for the reduction of the capital of Verdant Ltd and for the payment of the dividend. In the light of the reduction of capital and the payment of the dividend, followed by the company's insolvency, consider the liability, if any, of the members and the directors of Verdant Ltd.

Question Five

Gumshoe Ltd is a private detective agency run as a company by four retired detective policemen. Ahmed investigates financial fraud. Bithro investigates blackmail threats and dog-napping. Clem investigates on-line scams. David investigates adulterous spouses. Each of them is a director and they each have 25 shares in the company. Gumshoe Ltd is initially quite successful, but not long after it has taken a lease of office premises in Dundee, there is a down-turn in business and the company cannot pay the rent. Rather than wait for the company to be wound up in the courts, there is a creditors' voluntary winding up. The liquidator finds the following matters of concern:

- (a) Ahmed, who had lent the company £20,000 when it was going through a slightly sticky patch, had arranged for his loan to be repaid to him six weeks before the resolution for the winding-up; he did this knowing that Gumshoe Ltd would have difficulty paying the rent.
- (b) Bithro had secretly encouraged one of the company's clients not to use Gumshoe but to take his concerns about blackmail to another private detective agency, which, said Blithro, would better resolve the client's difficulties. The other agency was one with which Bithro was secretly connected. Gumshoe Ltd lost otherwise valuable business as a result of Birthro's actions
- (c) Clem had received information about a listed company, information that was only available on the dark web. The information related to new developments in products that the listed company was making, and suggested that the company's products were not as reliable as the listed company was suggesting. Through Gumshoe Ltd, Clem borrowed shares from another investor, transferred those shares to Gumshoe Ltd, sold those shares, and then, a week later, by which time the information about the listed company's products was being published in the newspapers, and the listed company's share price had fallen, Gumshoe Ltd bought the shares back and returned the shares to the original investor. Clem paid the profit made on the transaction to Gumshoe Ltd.
- (d) Part of David's job was to produce evidence of adulterous relationships for divorce proceedings. Following a tip-off to the liquidator, it appeared that David had been accepting money from people whom David had caught having adulterous relationships. David was effectively being paid not to reveal his findings to Gumshoe Ltd. The money he received was not disclosed to Gumshoe Ltd.
- (e) Notwithstanding the winding-up, Ahmed is considering starting a new company in the same line of business, but known as "Humshoe Ltd".

The liquidator seeks your legal advice on these five matters.

Question Six

To what extent is the dissenting judgment of Lord Sales in *Sevillja v Marex Financial Ltd* an accurate view of the principle of reflective loss in company law?

Note for candidates: it is appreciated that there is much information on the internet and elsewhere on this particular matter. Candidates are expressly reminded that their answers must be in their own words and demonstrate their own understanding of the law. Any evidence of plagiarism will result in a fail.

END OF QUESTION PAPER