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THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2009 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC12: COMPANY LAW

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TIME ALLOWED: 3 HOURS

SUGGESTED SOLUTIONS

1. (a) The documents to be delivered to the registrar when registering a company and their contents are memorandum of association and the articles of association if any – section 14(1) of the Companies Act.

Section 14(2) of the Companies Act further provides that with every memorandum registered, there shall be delivered to the registrar for registration a statement in the prescribed form containing:

(i) the full name (together with any former or other names) residential and postal address, and occupation of each of the first directors of the company.
(ii) the full name (together with any other names) residential and postal address, and other occupation of the first secretary.

(iii) the situation of the company's registered office, and its postal address; and
(iv) Such further particulars as may be prescribed.

(b) The legal effect of the certification of incorporation are:

Section 15(1) states that on the registration of the memorandum of a company the registrar shall issue a certificate of incorporation in the prescribed form.

From the date of incorporation mentioned in the certificate the subscribers of the memorandum together with such other persons as may from time to time become members of the company shall be a body corporate by the name contained in the memorandum capable forthwith of exercising all the functions of an incorporated company, having perpetual succession and power to hold land – S15(2) of the Companies Act and also ***Salomon vs Salomon & Co. Ltd***.

(c) The rule in ***Foss vs Harbottle*** is a logical result of the principle that a company is a separate legal person from the members who compose it. From this, it follows that if a wrong is done to it, the company is the proper person to bring an action. This is the essence of the rule in ***Foss v Harbottle*** which states that the proper plaintiff for the wrongs done to the company is the company itself and the company can act only through its majority shareholders.

There are two main advantages to the rule in ***Foss vs Harbottle*** of a purely practical nature.

(i) If every individual member were permitted to sue anyone who had injured the company there would be as many actions as there are shareholders. Legal proceedings would never cease and there would be enormous wastage of time and money.
(ii) If an individual member could sue a person who had caused loss to the company and the company then ratified that person's act at a general meeting, the legal proceedings would be quite useless for a court will naturally hold that the will of the majority prevails

(iii) It reinforces the principle that a company is a legal entity with rights and duties.

(d) The statutory provisions regarding pre-incorporation contracts are that any person who purports to enter into a contract on behalf of a company before it comes into existence shall be personally bound by the contract and entitled to the benefits thereof. Section 20(1) of the Companies Act.

However, permits the following exceptions:

(i) A company may, within a reasonable time after it comes into existence, expressly or by any action or conduct signify its intention to be bound thereby adopt a written contract made before it came into existence in its name or on its behalf. Upon this being done, the company shall be bound by the contract and entitled to the benefits thereof and the person who purported to act on behalf of the company shall cease to be bound by or entitled to the benefits of the contract.

(ii) If the contract is written the person who purported to act on behalf of the company shall neither be bound by it nor be entitled to the benefits thereof if there is an express provision to that effect – Section 20(4).

(iii) Whether or not such a contract is adopted by the company, the other party to the contract may make an application to the court for an order fixing obligations under the contract as joint and several or apportioning liability between the company and the person who purported to act on behalf of the company.

2. (a) An incorporated company may be limited or unlimited. According to Section 5(1)(c) of the Companies Act, an unlimited company has no limit on the liability of its members. If the company is wound up with debts its members will be personally responsible to discharge those debts without any limit on their liability.

A limited company is one where the amount of capital to be contributed to the company by a member on winding up of the company is fixed by the agreement between him and the company. The member will only pay what he had agreed to pay or balance thereof towards the company's debts at the time of winding up.

(b) The limit on the liability of company members may take two forms, depending on whether or not the company members have actually contributed capital.

Section 5(1)(a) of the Companies Act provides that a company limited by shares is one whose liability of its members is limited to the amount, if any unpaid on the shares held by them. Each share is assigned a nominal value which members may pay in full or in part. Where a company is limited by shares, the liability of its members will be limited to the amount not paid on their shares.

On the other hand where instead of a share capital a company simply gets a promise from each member to contribute a fixed amount if necessary to pay its debts on winding up, such a company will be a Company Limited by guarantee and cannot create shares. The liability of Members of such company will be limited to the amount that they have respectively undertaken to contribute.

(c) Under Section 5(5) of the Companies Act a public company is defined as any company other than a private company. According to Section 5(3) a private company is one which by its memorandum or articles restricts the right to transfer its shares; limits the total number of its members to 50 and is prohibited from inviting the public to acquire shares and debentures.

(d) Under Section 2 of the Companies Act a company is a holding company of another company or body corporate where the later is a subsidiary. In other words a holding company is a company that has another company or body corporate as sits subsidiary.
Under the 7th Schedule to the Companies Act the Holding-Subsidiary Company relationship exist mainly where a company (holding company) is a member of another company (subsidiary company) and has power to appoint, remove, or procure the appointment or removal of or to prevent such appointment or removal of at least half of the latters directors for the time being. Alternatively, a company will be holding company of another if it holds more than half in norminal value of the latter equity share capital.

3. (a) (i) Reduction of capital is the decrease in the amount of issued share capital.

(ii) Cancellation of capital is the decrease in the nominal capital of the company, i.e. unissued shares are cancelled. It is also known as diminution of capital.

(b) The company must be authorized by its articles of association to reduce its capital.

(i) If so authorized, it must pass a special resolution.

(ii) Section 67 and soon afterward obtain a confirming order of the court to reduce its capital and alter its memorandum accordingly (Sections 67 and 68 respectively).

(iii) This must not relate to cancellation of capital, or variation of class rights which is governed by Section 48.

(c) (i) To extinguish or reduce liability on share capital not paid e.g. where a company has shares with a nominal value of K1.00 and only K0.50 has been paid. If the company is doing well and does not anticipate calling-up the other K0.50, it can pass a resolution that will regard K0.50 shares as being fully paid. The company must convert them to shares with a nominal value of K0.50 Section 67(1)(a) of the Companies Act.

(ii) To cancel paid up capital which is lost or is no longer represented by assets e.g. where a company has a share capital of K100,000 divided into 100,000 fully paid shares of K1.00 each, yet its assets are worth only K50,000. Provided the company is doing badly and that the networth of assets is a permanent loss and not merely a short term fluctuation, the company may reduce the capital to 100,000 shares of K0.50 each fully paid. Section 67(1)(b) of the Companies Act.

(iii) To repay share capital in excess of the company's needs e.g. where a company is doing well or where a company has sold part of its undertaking. For instance if a company has 100,000 full paid up shares, K100-00 each but does not need this amount of capital, it may reduce its capital to 100,000 fully paid up shares of K50.00 each and return K50-00 per share to the members. Section 67 of the Companies Act.

(d) If the reduction of share capital affects creditors, especially in circumstances enumerated in Section 67(1) paragraphs (a) and (c), the court will not give its confirming order or the order confirming the special resolution for reduction of capital unless the court first settles the list of creditors who are objecting or are entitled to object Section 68(2)(a) and (b). The court will not make the confirmation order unless the creditors:

(i) agree or consent to the reduction of capital
(ii) are paid off, or
(iii) are given adequate or acceptable security Section 68(2)(c).

4. (a) The term share is not defined or properly described in the Companies Act. A share was defined by Farewell in ***<u>Borland's Trustee v Steel (1901)</u>*** as: The interest of the shareholder in the company measured by a sum of money, for the purpose of 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.

(b) (i) Ordinary shares – sometimes described as a residuary class i.e. they consist of rights that remain after the rights of the other classes of shareholders (if any) have been satisfied. Ordinary shareholders control resolutions at general meetings.

(ii) Preference shares – confer on holders preferences over other classes of shareholder in respect of dividends, repayment of capital or both. Preference shares are designed to appeal to investors who want a steady return on their capital combined with a high level of safety. The shareholders' right to vote is usually restricted except in class meetings.

(c) (i) It is usual to issue shares at a price above their nominal value, i.e. at a premium. This may be because the net assets of the company exceed the nominal value of the shares, or because previously issued shares of the same class have a market value in excess of their nominal value.

Whatever is the situation, it is evident that the market value of the shares in Union Foods Ltd exceed the nominal value. The difference between the market value and the nominal value (in this situation) is called a premium. Selling of shares at a premium is permitted by the Companies Act.

(ii) Under Section 61(1) where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called "the share premium account".

(d) The share premium account may be applied by the company – Section 61(2)

(i) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.
(ii) in writing off preliminary expenses.
(iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or of any debentures of the company.
(iv) in providing for the premium payable on redemption of any redeemable preference shares or if any debentures of the company.

(v) where redeemable shares are issued at a premium, to provide the premium payable on redemption.

5. (a) Interim dividends are those dividends which are paid between annual general meetings. Usually the payment is made in respect of the first half of the financial year. The time for making payment will allow for the consideration of the half-year results. The amount will be less than the final dividend as a matter of prudence should the latter half of the year not come up to the expectations. In the case of a public company, interim accounts will be necessary to support an interim dividend. The Companies Act is silent on interim payments but the position in practice would be that, like in the UK, directors may pay an interim dividend without reference to their shareholders.

(b) The company declared the dividend by ordinary resolution, but the declaration cannot exceed the amount recommended by the directors, although the directors can reduce the recommended amount. The dividends are paid in proportion to the amount paid up on shares and normally a cheque will be sent by post to the registered address of the shareholder.

Neither ordinary shareholders nor preference share holders have an automatic right to a dividend, even if profits are available. It is up to the directors to decide whether or not to recommend a dividend. The dividend is then declared by the company in a General Meeting. Only when it has been declared does a dividend become payable and enforceable as a debt against the company.

Even then, on liquidation, it is not payable until after the debenture holders and creditors have been paid.

(c) (i) A director can only be liable if the distribution was unlawful. As such it must be proved first that the distribution was in fact unlawful. Any director who was knowingly a party to the unlawful distribution is liable to pay to the company the amount lost plus interest. In the present case there is a clear indication that the distribution may be unlawful because it was paid out of undistributable reserves.

The liability of directors can arise in three ways: First, the directors recommend to declare a dividend which they know is paid out of capital. Second, without preparing any account they declare or recommend a dividend which proves to be paid out of capital, since it is their duty to ensure that profits are available; Third, they make some mistake of law or interpretation of the memorandum or articles which leads them to declare an unlawful dividend. However, in the third case the directors may be entitled to relief if they acted honestly and reasonably. Table A).

(ii) Only an unlawful distribution is subject to recovery, even then not all unlawful distributions may be recovered. WDC Ltd may recover an unlawful dividend from its members if at the time of receipt they knew, or had reasonable grounds for knowing, that it was unlawful. If only part of the dividend is unlawful, i.e. it exceeds the distributable profits by a margin, then only the excess can be recovered.

6. (a) Irregularity in the appointment of a director does not excuse the company from liability for the director's acts which are within his actual or ostensible authority in terms of Section 126 of the Companies Act which provides that a director's acts will be valid and binding on the company notwithstanding any defect which is discovered after his appointment or qualification.

However, since this provision applies where the director was actually appointed, it will not apply where the irregularity consists in the fact that no such appointment was made ***Morris v Kansen*.**

Even where there has not been an appointment, a company may still be bound by the acts of a person who purports to act on the company's behalf as director if the company holds him out as having authority to act in its name: Section 140(2) Companies Act, ***Hely Hutchnson v brayhead Ltd***.

(b) The rule set out in the case of ***Royal British Bank v Turquand*** underscores the liability of a company for the acts of its directors. The rule states that a company will still be liable for the acts of its directors even if the appointment of the director or his authority is questionable or did not exist. The rule states that the absence of appointment or authority will not affect an outsider who deals with such person unless the outsider actually knew that the person was not a director and that he did not have the authority to bind the company. The outsiders' position is strengthened by the fact that he is not bound to enquire into the rules governing the company's internal management before he enters into any transaction with a person purporting to act on its behalf.

(c) The insider exception is one exception to the rule in ***Royal British Bank v Turquand.*** It is entrenched under Section 140(4) of the Companies Act which makes limitations to the directors' authority binding only on a third party who is aware of it: ***Howard v Palent Ivory Manufacturing Co***. The exception is to the effect that the rule in ***Turquand's Case*** shall not apply if the person dealing with the company knew or ought to have known of the non compliance of the company's rules of internal management. The exception covers or affects only insiders or those who hold positions in the company. The exception excludes shareholders and even director not responsible for or who does not take part in the conclusion of the transaction: ***Hely Hutchnson v Bayhead Ltd.***

7. (a) A debenture is a document issued b y a company that creates or acknowledges indebtedness on the part of the company. Examples are bonds, charges/ mortgages, debenture stock, bills of sale a farmer's stop order.

(b) Differences and similarities between debentures and shares:

(i) A debenture is a loan to the company and its holder becomes a creditor of the company while a share is a unit of ownership in a company and the holder of a share becomes a debtor of the company and may be liable for the companies liabilities depending on the nature of the company.

(ii) A shareholder is entitled to vote at meetings and during decision making while a debenture holder does not have the right to vote.

(iii) A share entitles its holder to dividend payments declared by the company while a debenture only entitles its holder to interest payments.

(iv) Both shares and debentures are means of raising capital for a company.

(c) The following are different classes of debentures

(i) Redeemable Debentures this is a debenture whereby the holder is entitled to payment of the principal sum on a specific date or on the occurrence of a particular event or any other condition being fulfilled.

(ii) Irredeemable Debenture is a debenture where the holder is only entitled to repayment of his principal sum at winding up of the company.

(iii) debentures are debentures which do not show the name of the owner of the debenture and all interest payments and principal sum are payable to the holder of the bearer debenture.

(iv) Convertible debentures are debentures which can be exchanged by the debenture holder for fully paid-up shares of the equivalent value of the debentures.

(d) In terms of Section 203 (1) of the Companies Act, a member of a company who feels that the company

(i) the creditor to whom the company is indebted in a sum exceeding one thousand Kwacha then due has served on the company a written demand under his hand requiring the company to pay the sum so due and the company has for twenty-one days thereafter neglected to pay the sum or to secure or compound it to the reasonable satisfaction of the creditor.

(ii) execution or other process issued on a judgement, decree or order of any court in favour of a creditor of the company is wholly or partly unsatisfied.

(iii) if it is proved to the satisfaction of the court that the company is unable to pay its debts.

(c) The court's power under Section 213(1)(f) to wind up a company on the ground that it is just and equitable so to do is properly discretionary. There is therefore no definite number of occasions on which the court will exercise its power, but it has done so in the following cases:

(i) where the substratum or the main object of the company has failed ***Re : German Date Coffee Co.***

(ii) where there is deadlock in management ***Re:Yenidje Tobacco Co***.

(iii) where the company was formed for a fraudulent purpose.

(iv) where the company never in fact has any business or property.

(v) where a director has voting control and refuses to hold meeting, produce accounts or pay dividends ***Lock vs John Blackwood***.

(d) The powers of a liquidator outlined in Section 230 of the Companies Act and include:

(i) to carry on the business of the company so far as is necessary for the beneficial winding up thereof. This is done with the authority of the court or of the committee of inspection except where such carrying on of business is done during the four weeks next after the date of the winding up order.

(ii) to make any compromise or arrangement with creditors or those who have claims, to pay any class of debtor in full, to compromise any debts and liabilities to take any security for the discharge of any debt, liability or claim and give a complete discharge in respect thereof. These too are done with the authority of the court or if the committee of inspection.

(iii) to bring or defend legal proceedings in the name and on behalf of the company.

(iv) to compromise any debt due to the company with the exception of debts due from members and those where the amount claimed by the company exceeds five hundred kwacha.

(v) to sell the real and personal property and things in action of the company.

(vi) to raise on the security of the assets of the company and money requisite.

vii) to appoint a legal practitioner to assist him in his duties.

(viii) to appoint an agent to do any business which he is unable to do himself.

(ix) to do all such things as are necessary for winding up the affairs of the company and distributing its assets.

8. (a) The duties and powers of auditors are authorized in Section 194 of the Companies Act and these are:

(i) to act in such a manner as faithful, diligent, careful and ordinary skilful auditors would act in the circumstances (see Section 194(1). Subsection 2 of this section states that no provision whether contained in the memorandum or articles shall exempt the auditors from this duty.

(ii) auditors have a right of access to the places of business and the books of accounts and vouchers of the company and are entitled to enquire from the officers of the company such information as is necessary for the performance of their duties.

(iii) auditors are entitled to attend any general meeting of the company to receive all notices and other communications relating to any general meeting and to be heard at any general meeting on any part of the business of the meeting which concerns them as auditors (Section 194(4) of the Companies Act.

(iv) the auditors may apply to court for directions in any matter arising in connection with the performance of their functions under the Act.

(b) Section 194(1) of the Companies Act imposes a duty on the auditors to act in the performance of their duties as faithful, diligent, careful and ordinary skilful auditors would act in the circumstances. The section clearly imposes a duty on the auditors not to act negligently in the performance of their duties.

For an auditor not to investigate a fraud when such has been reported to him is clearly a violation of the provisions of Section 194(1) of the Companies Act. No careful, skilful, faithful and diligent auditor would act in such a manner. An auditor is naturally liable to the company for loss occasioned by breach of his duty of care.

Thus in ***Re : Thomas Gerald's and Sons*** a director of a company falsified the company's accounts by fraudulent entries. The auditors were suspicious and asked him for an explanation, but made no further investigation. As a result, their estimate of the company's profits was wrong and the company declared dividends which it could not otherwise have
+done, paying tax which would not otherwise have been payable. The company went into liquidation and the liquidator took proceedings against the auditors. It was held that damages recoverable included the dividend, the costs of recovering the tax and any tax not recoverable.

(c) (i) A person qualified to be an auditor is supposed to be one entitled to act as such under the Public Accountants and Auditors Act – Section 192(1).

(iii) Under Section 193(1) a resolution to remove an auditor is only effective if it is passed at a general meeting of the company of the intention to move such a resolution thirty five days before the general meeting and the company should send a copy of the notice to the Auditor concerned. The period of notice is reduced to 14 days if the auditor was appointed by subscribers to the memorandum or the directors or the resolution is to replace the auditor concerned. Further, the resolution shall not be effective unless notice thereof has been given to the members by the company not less than twenty one days before the meeting. This period is reduced to 7 days in the same circumstances referred to above.
The auditor concerned is under Sub-section 2 of Section 193 entitled to be heard on the resolution and to send to the company a written statement copies of which shall together with the notice of the general meeting be sent by the company to persons entitled to receive notice of the meeting. If the statement is received too late, it shall be circulated to the persons entitled to receive the notice.

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