Examiner's report

F4 Corporate and Business Law (LSO)
June 2012

General Comments

The performance of candidates overall continued to be unsatisfactory with a large number appearing to be unprepared for the examination. However, there is clear evidence of a growing number of candidates performing satisfactorily.

As usual, the examination was sufficiently testing to reveal those candidates who did not prepare well for the examination. However it did provide considerable opportunity to candidates to score high marks.

It has to be repeated again that candidates did not prepare for the format. The format does not help candidates who do topic spotting or question spotting. It demands that all candidates have to look at the syllabus, keeping in mind that all topics in syllabus have to be mastered. The old practice of selecting few topics and ignoring others simply cannot work. It also requires them to practise time management. The questions were clear in their demands and in line with the familiar pattern of the past examination papers. Many answers showed very superficial familiarity with the content of the course and the prescribed textbook.

The law examination is a technical examination and requires a good knowledge and understanding of the technical rules at the very least; problem scenario questions also require skills to analyse facts and then to apply the rules to the facts. Candidates and teachers should note that the problem scenario questions require much more in the way of analysis and application.

The overall result would have been considerably higher had candidates paid sufficient attention to the suggested answers to the past examination questions to get a feel of what is expected of them. The answers are available on the ACCA website; your course lecturer too could acquire them for you. Pay special attention to problem scenario questions. Candidates would do considerably better if they are asked to do mock examinations based on past question papers. Two or three such mock examinations would reveal where they have to improve upon and go a long way to improve their marks in the examination. Another suggestion is to ask the candidates to summarise the suggested answers to past examination papers in not more than 2 to 2 ½ pages. This should help them learn the quality of time management and to focus on what is asked in the question.

The key to marks lies in the breadth of knowledge of the leading cases. They are not many in any case. Candidates must also practise writing out the answers to questions; their prescribed textbook has many to choose from. This would give them the confidence and the ability to organise their thoughts. It was clear to the marker that the candidates on the whole did not prepare for the examination well, did not revise the syllabus and chose to ignore leading cases, as well as, key statutory provisions of the Companies Act. Too much guesswork and commonsense were used to answer the questions. There is no substitute for hard work and thorough preparation.

Specific Comments

Question One

This question asked candidates to explain the main rules the courts use to interpret statutes. These are the literal rule, golden rule and the mischief rule. Except for a few, most candidates answered this question reasonably well. Explanation of the mischief rule was brief in very many cases. It shows that if candidates practise to revise their learning materials in preparation for the examination, they would certainly score high marks comfortably.

Question Two

This question required the candidates to discuss the concept of *cession* and the circumstances when the consent of the debtor is necessary to validate *cession.*

Cession involves the substitution of a new creditor (the *cessionary*) for the original creditor (the *cedent*), the debtor remaining the same. *Cession* is a transfer of rights and not obligations. On both these points, many did not do well.

There are just four exceptions. Rights of personal nature where debtor has a *substantial interest* in making performance to *cedent* only (*delectus personae*), *cession* cannot take place without debtor's consent: *Isaacson v. Walsh* & *Walsh (1903)*. Except a very few, no candidate explained it properly and just a couple of them made any reference to the case. The second exception is that the contract may expressly forbid the cession of rights under it without debtor's consent. But notwithstanding such an express prohibition, the creditor may *still* cede his rights unless the debtor can show that the restraint on *cession* serves a useful purpose to the debtor. Again, the latter part was not indicated by any of the candidates. The third concerning the part of the debt and fourth concerning the statutes were discussed correctly.

Furthermore, some candidates confused cession with delegation and some others with set off. Candidates should remember that it is the correct, sufficient and adequate answers that secure good marks.

Question Three

This question required candidates to explain and distinguish between a contract *of* service and a contract *for* services. Since the distinction has legal consequences, courts have developed three tests for distinguishing the two. The three tests are control test, organisation test and the multiple, or economic reality test.

Almost all candidates answered the question reasonably well. However, many candidates chose not to discuss the three tests and simply discussed some of the legal consequences that flow from placing a person in one or the other category. Discussing the tests was an integral part of the correct answer. Those who did not do so scored less as a result.

Question Four

This question dealt with the creation of an agency relationship. It was in three parts: appointment by agreement, appointment by ratification and appointment by holding out.

Most candidates did reasonably well as regards creation of an agency relationship by agreement.

As regards creation of an agency relationship by ratification, someone purports to act as an agent of a certain principal in a certain transaction — although the principal never authorised the agent to do so — then the principal may subsequently ratify or adopt what the agent has done. In such a case, the agent is deemed to have been acting as an authorised agent when he effected the transaction. However, ratification validates only past acts of the 'agent' and gives no authority for the future. Ratification does not require any special form and can be express, implied or even inferred from the conduct. Several candidates chose not to answer this part of the question at all. Others answered it partly.

Agency by holding out is created when the principal), by words or conduct, allows another to appear to the outside world as his agent, with the result that third parties deal with him as an agent, and would suffer prejudice, were the principal to repudiate this apparent agency. In such cases, the 'principal' is said to 'hold out' as his agent someone as having authority to act on his behalf: see *Freeman and Lockyer v Buckhurst Park Properties Ltd* (1964). Several candidates chose not to answer this part of the question as well. Others answered it partly or inadequately. Only a minority answered this part adequately. Candidates did not prepare this part of the syllabus well.

Question Five
This question asked candidates to explain and distinguish between the three types of share capital listed. It also required candidates to explain the difference between the nominal value of shares and their market value.

Authorised capital is also called the nominal capital. Nominal value of a share is the face value of a share. The amount of nominal capital is not an indication of shares issued or paid for. The only significance of the figure is that it is used as a gauge to determine the stamp duty which has to be paid on registration. A company may alter its memorandum to increase its nominal capital if authorised by its articles by passing an ordinary resolution [s 63 Companies Act 1967]. If articles do not authorise an increase, then they would have to be altered first. The increase enables the company to issue more shares if it has already reached the maximum allowed by the nominal capital. On the whole, candidates explained the concept of authorised capital reasonably well.

Issued capital represents the nominal value of the shares actually issued by the company in return for cash or some other consideration as may have been agreed by the company. It may consist partly of paid-up capital and partly of uncalled capital. The uncalled capital is akin to a guarantee fund the creditors of a company can look up to. The sum total of paid-up and uncalled capital constitutes the issued capital of a company. It is more important than authorised capital as a true measure of the substance of the company. Most candidates did not include uncalled capital as constituting a part of the issued capital.

Paid-up capital is the proportion of the nominal value of the issued capital actually paid by the shareholder. It may be the full nominal value, in which case it fulfils the shareholder's responsibility to outsiders; or it can be a mere part payment, in which case the company has an outstanding claim against the shareholder. The Companies Act 1967 requires that the authorised, paid- up and issued capital must be at least R1,000 [s 10(1)(iv) Companies Act 1967]. In Lesotho, law does not require the directors to certify that the company's issued capital is adequate. None of the candidates discussed the R1,000 requirement in the context of paid-up capital. Indeed, most stated that the authorised capital alone must be at least R1,000.

The answer to these three parts of the question in a very large majority of cases consisted of just a few lines each. Many wrote no more than two or three sentences. This cost them marks.

The nominal value of the share remains fixed and does not normally change. However, the value of the shares in the stock market may be subject to daily fluctuation depending on a number of interrelated factors, such as the profitability of the company, the prevailing rate of interest or prospective take-over bids, among others. Thus the market value of a share of R1 nominal value may be as much as R5 or higher, or as low as 1 cent. Several candidates discussed only a part of this question. Many stated that the market value can never be lower than the nominal value of a share.

Question Six
This question required candidates to explain what is meant by the veil of incorporation of a company and when can it be lifted by the courts.
Salomon v Salomon & Co Ltd (1897) cast a veil between a company and its members. Most of the time the veil is opaque through which one cannot see who the members are. The corporate veil does not conceal the internal affairs of the company from view. On the contrary, the legislature has always made it an essential condition of the recognition of corporate personality that it should be accompanied by the widest publicity. The third parties may not have a recourse against its members but they are nevertheless entitled to see who these members are, what shares they hold, who the directors are, what its constitution is, what its capital is and how it has been obtained, and its profit and loss account. What essentially the corporate veil does is to shield members from personal liability for the debts of their company.

Many candidates confused the veil of incorporation with lifting the veil of corporation. The former is merely an affirmation that a company once duly registered is separate from its members. None pointed out that the corporate veil does not conceal the internal affairs of the company from being viewed.

As regards the instances when the veil may be lifted by the courts, a large number of candidates chose to discuss when the veil may be lifted under the Companies Act 1967 and mixed this with when it can be lifted by the courts. Apparently, this could be a result of not paying attention to the language of a question. Very few candidates referred to cases in answering this part of the question.

Question Seven

This question asked candidates to explain the concept of corporate governance. Most scholars agree that corporate governance consists of systems by which companies are directed and controlled. Modern corporations can be described as a link where the rights and interests of the various stakeholders are brought into play. Indeed, society now expects greater accountability from companies in regard to their non-financial affairs like the environment within which a company operates. Corporate governance requires rules and principles that accommodate the interface between the company and its operational environment. There is an ongoing debate on the role and function of stakeholders like employees, creditors, consumers and the community at large. In this wide sense, corporate governance could perhaps be defined as the process of controlling management and of balancing the interests of all internal stakeholders and other parties who can be affected by the corporation's conduct in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation.

Once a company totters and nears insolvency, accountability to the creditors of the company supercedes accountability to other stakeholders like the employees, the wider community and the consumers. It is argued that if a company desires to encourage 'other stakeholders' to make long-term commitments to the well-being of the company, then those commitments may need protection from subsequent opportunistic behaviour of the company. Contractual mechanisms may be inadequate to offer proper protection and perhaps incorporation of such groups into a company's governance structure may be a solution. Lesotho's Companies Act 1967 is silent on such matters.

King's Reports of 1994, 2002 and 2009 in South Africa deal with this and other questions in some depth. They led to the formulation of The Code of Corporate Practices and Conduct for companies listed on Johannesburg Stock Exchange. The Code attempts to deal with questions such as: Should directors' duties be formulated on a pluralistic or an enlightened shareholder basis? It provides that a director must act to promote the success of the company for the benefit of the members as a whole and in doing so must take into account in good faith all the material factors that it is practicable to identify. These material factors may include the company's need to foster its business relationships with its employees, suppliers, customers and even wider community.

In Lesotho, Companies Act 1967 gives brief attention to the notion of corporate governance. Lesotho does not have a stock exchange either. Private, rather than public, companies dominate the corporate scene. It is expected that companies shall voluntarily embrace wholesome rules on corporate governance.
Candidates generally discussed the duties of directors and some the duties of a secretary as well. Nothing else was discussed. Many chose not to answer this question at all. This was definitely the worst performed question by the candidates. Candidates probably omitted to prepare this topic altogether.

Question Eight

This question asked the candidates to explain the legal significance of the three matters set out in the question. Nana Laundry's advertisement is an invitation to the potential suppliers to submit tenders for the supply of a second-hand laundry machine. Such an advertisement is regarded as an invitation to treat. It is not an offer and its 'acceptance' does not result in a legally binding contract. Except for a small number of candidates, this part of the question was answered correctly.

Maluti Equipment's tender was an offer submitted in response to Nana Laundry's advertisement. Again except for a small number of candidates, this part of the question too was answered correctly.

Maluti Equipment admitted that they are in breach of contract and so are liable to pay damages to Nana Laundry, which are not remote. Candidates were expected to use *Hadley v. Baxendale* (1854) to determine which of the claimed damages were remote and hence, not recoverable. Since Maluti Equipment knew that Nana Laundry was likely to suffer a business loss if the delivery of the machine was delayed, such losses fell under the first rule of *Hadley v. Baxendale* (1854) as they could be said to arise naturally from the breach and hence, recoverable.

Maluti Equipment would not be liable for the R100,000 loss of profits on the army contract because this damage was remote under *Hadley v. Baxendale*'s second rule since it was not foreseen by the Maluti Equipment when they made the contract.

Only a small minority of candidates answered this part of the question properly. This part of the problem was based on *Victoria Laundry (Windsor) Ltd v. Newman Industries* (1949), which excepting one or two candidates, no one referred to. A large number chose to answer this part of the question by deploying common sense and not referring to, or basing their answer on, *Hadley v. Baxendale* (1854). Candidates would score higher marks if they pay more attention to answering problem scenario questions. They pose a different kind of challenge as compared to a knowledge based question.

Question Nine
This question required the candidates to discuss the legal validity of certain measures under the Companies Act 1967.

The first tested the understanding of the candidates regarding the payment of dividend out of the share capital. The established practice based on common law is that dividends may only be paid out of divisible profits and not out of share capital. Excepting a few candidates, all candidates answered the question correctly.

In the second part of the problem, the assets of the company were proposed to be used to secure a loan; that loan then was to be used by an intermediary to buy the shares of the company to boost its market price. This would infringe section 58 Companies Act 1967 and the directors authorising it would be liable to criminal penalties including imprisonment. Moreover, the purpose for which the loan was to be used may be *ultra vires* the objects clause of the memorandum of association of the company. As a result, directors and other officers responsible for pursuing such a strategy would be liable in damages for breach of their fiduciary duties to the company as well. Only a small minority of candidates answered this part correctly. Most gave their own opinion that it would be difficult for the company to repay the loan and so it must not obtain the loan. Many wrote just one or two lines that such loans would be *ultra vires* or they could not be used for buying shares. No one referred to section 58 Companies Act 1967.

By virtue of section 154 Companies Act 1967, a director cannot, without the approval of the company in a general meeting, issue, allot or reserve any shares for himself or his nominee without offering them to all the shareholders of the company in proportion to their existing holdings on the same terms and conditions. Any resolution sanctioning a differential issue of shares to directors and their friends must be approved specifically for this purpose by the general meeting. Therefore, the first step would be to obtain the approval of shareholders in a general meeting to allot additional shares to the directors and their friends. Once this has been done, such shares can be issued. Except very, very few, no candidate answered this part correctly.

Weighting such shares worth 10 votes each required alteration of the articles by passing a special resolution to authorise the issue of such additional shares to the directors and their friends. In addition, the alteration has to be *bona fide* for the benefit of the company as a whole. In the *Greenhalgh* case, it was held that an alteration would be invalid if its purpose was to discriminate between the majority and the minority shareholders so as to give to the former an advantage of which the latter were deprived. It is, therefore, not certain that if the alteration is challenged in the court, it would be found to be for the benefit of the company as a whole.

Lastly, in law, the directors are given power to issue additional shares to raise fresh capital for the company, not to prevent take-overs. In *Hogg v. Cramphorn Ltd* (1966), it was held to be irregular. However, the company could ratify it and make it regular. In the problem, it would appear that it is the directors, not the shareholders, who are opposed to a take-over. Under the circumstances, the proposed course of action may not be possible.

Not a single candidate discussed any of this in their answers.

Question Ten
This question required candidates to discuss the financial aspects of the dissolution including the distribution of the assets of the registered partnership.

The first step, under the Partnership Proclamation 1957, is for the partners to publish in a local newspaper a 30-day notice of their intention to dissolve their partnership and the date upon which such dissolution would take place. [section 7(2) Partnership Proclamation 1957]. The second step would be to realise the partnership assets. The value of partnership assets was worth R20,000. The partnership owes the financial institution R7,000 and they must be paid in full first. The third step would be to repay Sam his advance of R3,000. The amount left for distribution between the partners would be R10,000. This would be distributed in proportion to the capital contribution. Thus Sam will receive R5,000, Peter R3,000 and Peter R2,000.

Last, Sam, Peter and Thabo must record the dissolution of their partnership including the details of the distribution of the value of the assets of their partnership (R20,000), as stated above, in a deed as required by the Partnership Proclamation 1957. Under section 7(1) Partnership Proclamation 1957, this deed has to be signed by all the partners, notarised and registered within 60 days in the office of the Registrar.

Not one candidate discussed this question satisfactorily. Only a few were able to discuss the correct proportion of the residue. Partnership is a very important topic of the syllabus. There was a lack of preparation of an important topic.