

STUDY MANUAL



Foundation level

# Fundamentals of Business Law

2012



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# Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

<b>Learning objectives</b>	Show the referenced CPA Australia learning objectives.
<b>Topic list</b>	Tells you what you will be studying in this chapter.
<b>Introduction</b>	Presents a general idea of what is covered in this chapter.
<b>Chapter summary diagram</b>	Summarises the content of the chapter, helping to set the scene so that you can understand the bigger picture.
<b>Before you begin</b>	This is a small bank of questions to test any pre-existing knowledge that you may have of the chapter content. If you get them all correct then you <i>may</i> be able to reduce the time you need to spend on the particular chapter. There is a commentary section at the end of the Study Manual called <i>Before you begin: answers and commentary</i> .
<b>Section overview</b>	This summarises the key content of the particular section that you are about to start.
	
<b>Learning objective reference</b>	This box indicates the learning objective covered by the section or paragraph to which it relates.
	
<b>Definition</b>	Definitions of important concepts. You really need to know and understand these before the exam.
	
<b>Exam comments</b>	These highlight points that are likely to be particularly important or relevant to the exam. (Please note that this feature does not apply in every Foundation Level study manual.)
	
<b>Worked example</b>	These highlight points that are likely to be particularly important or relevant to the exam. (Please note that this feature does not apply in every Foundation Level study manual.)
	
<b>Question</b>	This is a question that enables <b>you</b> to practise a technique or test your understanding. You will find the solution at the end of the chapter.
	
<b>Key chapter points</b>	Review the key areas covered in the chapter.

### Quick revision questions

A quick test of your knowledge of the main topics in this chapter.

The quick revision questions are not a representation of the difficulty of the questions which will be in the examination. The quick revision Multiple Choice Questions (MCQs) provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. Use these questions as a means to reflect on key concepts and not as the sole revision for the examination.

### Revision questions

The revision questions are not a representation of the difficulty of the questions which will be in the examination. The revision MCQs provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. Use these questions as a means to reflect on key concepts and not as the sole revision for the examination.

### Case study



This is a practical example or illustration, usually involving a real world scenario.

### Formula to learn



These are formulae or equations that you need to learn as you may need to apply them in the exam.

### Bold text

Throughout the Study Manual you will see that some of the text is in **bold type**. This is to add emphasis and to help you to grasp the key elements within a sentence and paragraph.

## Chapter summary

This summary provides a snapshot of each of the chapters, to help you to put the syllabus as a whole and the Study Manual itself into perspective.

### Chapter 1 – Sources of law and types of legal system

Chapter 1 identifies various sources of law and introduces the concepts of national and international law. It then explores the three most common national legal systems operating worldwide, namely the common, civil and Sharia legal systems.

### Chapter 2 – Common law and legislation

This chapter outlines the creation and interpretation of law by the courts under the common law and explores the doctrine of precedent. It then goes on to define legislation, list common forms of legislation and outline the procedure for the creation of legislation. The last section examines the rules of statutory interpretation.

### Chapter 3 – The legal framework

Chapter 3 outlines the Australian court systems and discusses the advantages and disadvantages of court-based adjudication. It then explores methods of alternative dispute resolution to court settlement, namely arbitration, conciliation and mediation.

### Chapter 4 – Formation of contracts

This is the first of three chapters examining the development and principles of contract law. This chapter defines a contract and outlines the three essential elements which make up any valid contract – offer and acceptance, consideration, and intention to create legal relations.

### Chapter 5 – Contractual terms

Chapter 5 delves deeper into the details of contract law. It examines the case law and statutory interpretation of express and implied terms, contract conditions, contract warranties and exclusion clauses.

### Chapter 6 – Breach of contract and its associated remedies

The last of the three chapters on contract law, Chapter 6 examines the end of a contract. It defines the various forms of breach of contract and explores the payment of damages to the injured party.

### Chapter 7 – International commercial contracts

This chapter presents contracts for the international sale of goods. The two chief legal instruments in this area are the UN Convention on Contracts for the International Sale of Goods (UNCISG) and the standardised ICC Incoterms.

### Chapter 8 – Torts

Chapter 8 introduces the law of torts and specifically the tort of negligence. It discusses the factors required to succeed in a tort claim and rules surrounding payment of damages. Lastly, the chapter outlines Australian, Singaporean and Malaysian consumer protection legislation.

### Chapter 9 – Incorporation and agency theory

Chapter 9 is first of five chapters focusing on company law, with the primary focus on the Australian jurisdictions. Secondary examples are taken from the UK, Singapore and Malaysia. The chapter examines



the concepts of separate legal personality and limited liability, as well as outlining various company structures. The chapter concludes with a detailed discussion on agency and agency relationships.

## **Chapter 10 – Company formation and constitution**

Chapter 10 outlines the procedures for the formation of a company under Australian law. It examines requirements pertaining to promoters, pre-registration contracts, company registration and the company constitution.

## **Chapter 11 – Company directors and other company officers**

Chapter 11 examines the roles and responsibilities of company directors, company auditors and company secretaries. It outlines appointment, termination, duties and powers for all these functions.

## **Chapter 12 – Membership and dividends**

This chapter turns its attention to the role of members within a company structure. It discusses the nature and types of shares as well as members' roles, responsibilities and rights. It concludes with a detailed discussion on dividend payments.

## **Chapter 13 – Corporate insolvency**

This final chapter explores rules and procedures pertaining to corporate insolvency of both companies and partnerships with a primary focus on Australia. It outlines voluntary winding up, compulsory winding up, receivership and administration.

# Answering multiple choice questions (MCQs)

The questions in your exam will each contain four possible answers. You have to **choose the option that best answers the question**. The three incorrect options are called distractors. There is a skill in answering MCQs quickly and correctly. By practising MCQs you can develop this skill, giving you a better chance of passing the exam.

You may wish to follow the approach outlined below, or you may prefer to adapt it.

- Step 1** Attempt each question. Read the question thoroughly. You may prefer to work out the answer before looking at the options, or you may prefer to look at the options at the beginning. Adopt the method that works best for you.
- Step 2** Read the four options and see if one matches your own answer. Be careful with numerical questions, as the distractors are designed to match answers that incorporate common errors. Check that your calculation is correct. Have you followed the requirement exactly? Have you included every stage of the calculation?
- Step 3** You may find that none of the options matches your answer.
- Re-read the question to ensure that you understand it and are answering the requirement
  - Eliminate any obviously wrong answers
  - Consider which of the remaining answers is the most likely to be correct and select the option
- Step 4** If you are still unsure make a note and continue to the next question. Some questions will take you longer to answer than others. Try to reduce the average time per question, to allow yourself to revisit problem questions at the end of the exam.
- Step 5** Revisit unanswered questions. When you come back to a question after a break you often find you are able to answer it correctly straight away. If you are still unsure have a guess. You are not penalised for incorrect answers, so **never leave a question unanswered!**

# Learning objectives

CPA Australia's learning objectives for this Study Manual are set out below. They are cross-referenced to the chapter in the Study Manual where they are covered.

## Fundamentals of Business Law

### General overview

This exam covers general legal knowledge relating to the business environment, a basic knowledge of the law of contracts, and an understanding of the responsibilities and risks that arise in business, with particular regard to the law relating to corporate entities.

These are the topics that will be covered in the exam.

### Topics

		Chapter where covered
<b>LO1. Sources of law</b>		
LO1.1	Identify the sources of different types of law	1
LO1.2	Identify the features of the different legal systems	1
	1.2.1 common law	1
	1.2.2 civil law	1
	1.2.3 Sharia law	1
<b>LO2. Common law and legislation: precedent and stare decisis and statutory interpretation</b>		
LO2.1	Identify how common law and relevant legislation are applied	2
LO2.2	Analyse and explain legal cases and principles in setting precedents	2
LO2.3	Specify how legal cases and principles set precedents	2
LO2.4	Identify how to deal with the doctrine of stare decisis (legal precedent)	2
LO2.5	Specify the rules and models for statutory interpretation	2
<b>LO3. Legal framework</b>		
LO3.1	Describe the legal framework of statute law (legislation) and common law	3
LO3.2	Explain the court system	3
LO3.3	Explain different methods of alternative dispute resolution	3
<b>LO4. Fundamental aspects of contracts and contract law</b>		
LO4.1	Describe the fundamental features and essential requirements (terms) of contracts	4
LO4.2	Describe the law of contract	4
LO4.3	Describe the necessary elements in the formulation of a contract	4
LO4.4	Explain the importance of conditions and essential terms of contracts	5
LO4.5	Identify the nature and status of pre-contract representations	5
LO4.6	Explain the effect of valid exclusion clauses	5

		Chapter where covered
<b>LO5. Breaches of contract law</b>		
LO5.1	Recognise the different types of breach of contract and their effects	6
LO5.2	Specify relevant and available remedies for breach of contract	6
	5.2.1 damages	6
	5.2.2 specific performance	6
<b>LO6. Specialised commercial contracts</b>		
LO6.1	Identify the characteristics of commercial contracts used in international trade	7
	6.1.1 international sales of goods	7
	6.1.2 international transportation of goods	7
<b>LO7. Torts</b>		
LO7.1	Explain that the law of torts concerns a civil wrong which may mean a civil action for compensation arises	8
LO7.2	Explain the tort of negligence	8
LO7.3	Explain that tort law provides legal remedies for damages caused by negligence	8
LO7.4	Explain that negligence means failure to exercise reasonable care	8
LO7.5	Explain consumer protection law and negligence	8
LO7.6	Explain the implications under common law in relation to pre-registration contracts	10
<b>LO8. Agency theory</b>		
LO8.1	Explain that agency is the relationship between principal and agent	9
LO8.2	Explain how agency theory underlies the principles of corporate governance	9
LO8.3	Explain that partnership is an agency relationship	9
LO8.4	Explain the application of agency theory to companies	9
<b>LO9. Incorporation and its effects</b>		
LO9.1	Recognise the nature and effect of a company having a separate legal personality	9 and 10
LO9.2	Explain the effects of incorporation	9
	9.2.1 limited liability	9
	9.2.2 perpetual succession	9
LO9.3	Distinguish the differences between public and proprietary companies	9
LO9.4	Identify the processes necessary in forming a company	10
LO9.5	Specify the elements of the constitution of a company	10
LO9.6	Describe the role of promoters in forming a company	10
LO9.7	Recognise the difficulties and implications of pre-registration contracts	10
<b>LO10. Management of companies</b>		
LO10.1	Identify the key legal issues that arise in the management and governance of companies	11
	10.1.1 Identify the impact of key business decisions on shareholder interests	11
	10.1.2 Identify the impact of key business decisions on the public	11

		Chapter where covered
LO10.2	Specify the nature and role of company directors and other officers as agents of the company	11
LO10.3	Specify the nature, role and powers of the board of directors	11
	10.3.1 Specify the relationship between the board and the company in a general meeting	11
LO10.4	Identify the rules on directors' remuneration and financial benefits to directors and other related parties	11
LO10.5	Identify the rules on appointment and removal of directors from office	11
LO10.6	Specify the extent of directors' duties and powers	11
LO10.7	Recognise the issue that arises when there are related party transactions	11
LO10.8	Specify the rules on transfer of shares and refusal to register a transfer of shares	12
LO10.9	Identify the role and powers of the company secretary	11
LO10.10	Identify the role and powers of the registered company auditor	11
<b>LO11. Membership and dividends</b>		
LO11.1	Identify the significance of the register of members	12
LO11.2	Identify the significance of the requirement for disclosure of interests in shares	12
LO11.3	Recognise the role of the general meeting of shareholders including voting and resolutions	12
LO11.4	Distinguish the rights and remedies of members of companies including:	11
	11.4.1 appointing a registered company auditor	11
	11.4.2 inspection of the books of the company	12
	11.4.3 protection of the minority and the treatment for unfair or oppressive company practices	12
LO11.5	Specify the procedure for payment of dividends	12
LO11.6	Specify the rights of shareholders regarding dividends	12
LO11.7	Specify the company formalities in determining when dividends are payable to shareholders	12
LO11.8	Identify the rules governing the maximum amount for dividend distribution	12
<b>LO12. Corporate insolvency</b>		
LO12.1	Specify the grounds relating to the dissolution and winding up of companies and partnerships	13
LO12.2	Specify the procedures for dissolution and winding up of companies and partnerships	13
LO12.3	Specify the procedures for addressing corporate insolvency, including stakeholders and the rights of claimants	13
LO12.4	Identify the powers and duties of receivers and liquidators	13
LO12.5	Recognise administration as an appropriate alternative to winding up when a company is in financial difficulties	13

Topic exam weightings		
1	Sources of law	5%
2	Common law and legislation	5%
3	Legal framework	5%
4	Fundamental aspects of contracts and contract law	10%
5	Breaches of contract law	6%
6	Specialised commercial contracts	5%
7	Torts	10%
8	Agency theory	10%
9	Incorporation and its effects	10%
10	Management of companies	12%
11	Membership and dividends	10%
12	Corporate insolvency	12%
TOTAL		100%



# Chapter 1

## Sources of law and types of legal system

Learning objectives	Reference
<b>Sources of law</b>	<b>LO1</b>
Identify the sources of different types of law	LO1.1
Identify features of the different legal systems	LO1.2
common law	LO1.2.1
civil law	LO1.2.2
Sharia law	LO1.2.3

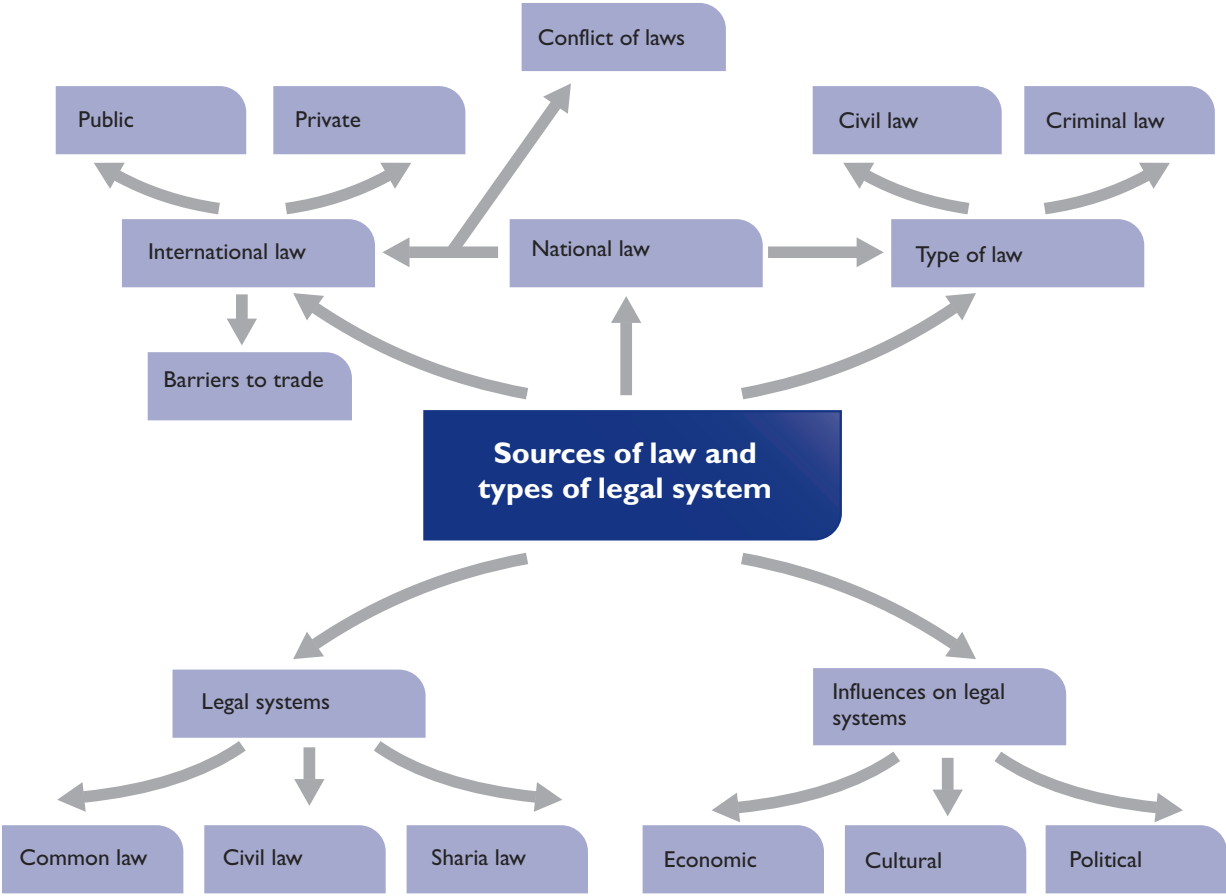
### Topic list

- 1 The concepts of national and international law
- 2 Legal systems
- 3 Criminal law
- 4 Civil law
- 5 Common law systems
- 6 Civil law systems
- 7 Sharia law systems

# Introduction

In this chapter we will be looking at the overall **context** in which national and international law exists. There is no all-encompassing international law as such; instead there are **national legal systems** which have varying **sources of law** (of three kinds: **common law, civil law or Sharia law**). These may be contradictory (creating the problem of **conflict of laws**), therefore some **model international laws** and **conventions** have been put together by international organisations such as the United Nations to help resolve the problem. In these ways the relations between **sovereign states**, and between individuals in different states, are regulated.

The kind of legal system used by a sovereign state depends on historical and cultural factors, and to some extent on economic and political factors. Whatever the legal system, we will be looking in particular at: **principles of law, sources of law and the role of judges.**





## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Broadly, what is a legal system? (Section 2.1)
- 2 What are the main differences between the common law system and the civil law system?  
(Section 1.1, Section 5, Section 6)
- 3 Explain federalism. (Section 1.5)
- 4 What is the separation of powers? (Section 1.8.2)
- 5 Define public and private international law. (Section 2.4)
- 6 Explain the concept of 'conflict of laws'. (Section 2.6)
- 7 Define criminal law and civil law. (Section 3, Section 4)
- 8 What is equity? (Section 5.2.2)
- 9 Define the core principle of Sharia law. (Section 7.1)
- 10 Explain the role of judges in the Sharia legal system. (Section 7.3)

# 1 The concepts of national and international law



## Section overview

- There are various **model international laws** that regulate the relationship of **sovereign states** and their rights and duties with respect to each other. Most law, however, consists of the **national laws** of sovereign states which nevertheless follow certain **common methodologies**.



## Exam comment

Exam questions on the topics in this chapter are most likely aimed at testing your knowledge and understanding of distinctions, and so are unlikely to contain a scenario element.

## 1.1 Model international laws and exemplar national laws

LO  
1.1

Although 'law' is a global concept, it is **usually organised on national lines**, and there is only a **limited amount of truly international law**. In this Study Manual we shall consider some **national laws that have been examples** for various countries developing their legal systems, namely Australia and the United Kingdom, both common law countries, France, a civil law country, and Pakistan and Iran, both Sharia law countries. These may therefore indicate the practice of law in many countries worldwide. We shall also examine **model laws and conventions that have been developed by international bodies** and which have been adopted by various countries so that nations may interact with one another more easily.

First of all we shall look in general terms at **how nations have ordered their own legal systems**. We shall give examples of a number of nations, but we shall by no means be comprehensive in world terms.



## Exam comment

If you are studying in a country to which we do not make reference, find out the origins of your nation's legal system so that you can compare it to the ones we discuss here. Remember that you are not going to be examined on any one nation's legal system, rather you will be examined on **principles of law that have international significance**.



## Section overview

- There are **three key legal systems** or **underlying methodologies of law** operating in the world that have been adopted by different countries for different reasons: common law, civil law and Sharia law.

## 1.2 Common law

LOs  
1.1  
1.2.1

**Common law** is a **historic system of laws formulated in England** between 1066 and 1400. The terminology associated with this system can be confusing. You will find that the legal system is named after one distinctive source of law within itself, but that the system comprises several sources of law. Common law systems developed in **England**, but have been **exported to many former British colonies**, including **Australia, Singapore, Malaysia, India** and the **United States of America**.

## 1.3 Civil law

LOs  
1.1  
1.2.2

**Civil law** systems originated in **continental Europe** and have developed from the Ancient Roman legal system. Like English common law, civil law systems were widely exported during the colonial era and so are equally prominent in other world areas, for example **Japan, China, Indonesia** and **Brazil**. Codes of law are a common feature of civil law, however they are not a compulsory feature. Civil law systems are much

younger than common law ones, although they come from equally old legal heritages. We shall use **France** as an exemplar of these systems. Increasingly in modern times, civil and common law systems share common elements, but historic differences have a conceptual impact.

## 1.4 Sharia law

LOs  
1.1  
1.2.3

**Sharia law** is significantly **different in both purpose and practice** from common and civil law systems as it is **bound up in the religion of Islam**. It has influence on the interpretation of law in many Islamic countries worldwide, and has been adopted as a comprehensive legal system in some. We shall look at two exemplar countries where such adoption has taken place: **Pakistan** and **Iran**.

## 1.5 Legal pluralism

In fact most countries have multiple legal systems:

- **Australia** has a uniform common law system based on English common law, but of primary importance is the **Australian Constitution**. Australia is a **federation** of previously autonomous **states and territories** combined under the Commonwealth of Australia. The **United States of America** (the US) is another example of a federation of states. In Australia, the federation of states means there are two co-existing systems of government in each state or territory and the Australian Constitution clearly outlines the **division of powers** between the state/territory governments and the federal (also known as the Commonwealth) government. Further, there are **federal** statutes enacted by the **Parliament of Australia** which apply to the whole of Australia, and laws enacted by the self-governing **Parliaments of the Australian states and territories**. These are separate **jurisdictions** with their own systems of **courts** and **parliaments**; the legal systems in the self-governing states and territories influence each other, but do not bind each other.
- In **India** legal pluralism takes the form of different laws governing different groups within the country; there are special Muslim courts that address concerns in Muslim communities by following Sharia law principles. Secular courts (based on **English common law**) deal with the issues of other communities.
- **Malaysia** operates a dual legal system similar to India and is a federation of various states, like **Australia**. There are separate state Sharia court systems (Syariah courts) which have jurisdiction over all Muslims and hear all matters pertaining to Islamic law. These run alongside the federal common law court system.
- **Canada** has multiple legal systems within one geographic area, namely a common law system in the majority of the country, but a civil law system in Quebec.
- In **South Africa** there is a mix of a civil law system (e.g. for the law of tort), a common law system (e.g. for the law of contract), and African customary law. Though South Africa has elements of a civil law system it does not have codified law.

## 1.6 The effects of economic and political contexts on legal systems

**Business activity** takes place within a particular **economic, political and legal context**, and each of these areas will affect each other to an extent. The economic and political context of each nation is not the same, although many groups of nations are similar, and therefore nations' legal systems vary considerably from one another.

The **differences** between nations in terms of economics, politics and, most importantly for this syllabus, legal context, can present **problems** for **international trade**. We shall cover some of the difficulties presented and the solutions created by various international bodies, particularly the **United Nations** (UN).

## 1.7 Economic systems



### Section overview

- Economics can be described as the ways in which society decides **what to produce, how to produce it** and **who to produce it for**. There are three basic kinds of economic system – planned, market and mixed economies.

Each **individual** is involved in economics, in 'providing' by salary or labour for themselves and their family. On a wider scale, **governments** are involved in economics for the whole country. There are various types of economic system that might exist in a country: **planned, market** and **mixed**.

### 1.7.1 Planned economy

A **planned economy** exists where the decisions and choices about resource allocation are made by the government. Money values are attached to resources and to goods and services, but it is the government that decides what resources should be used, how much should be paid for them, what goods should be made and what their price should be. Although the individual might be allowed to own some personal possessions, most kinds of wealth would not be available for ownership by individuals.

### 1.7.2 Market economy

A **market economy** exists where the decisions and choices about resource allocation are left to **market forces of supply and demand**, and the workings of the price mechanism. In the market economy, most wealth is owned by individuals, with a minimum being collectively owned.

### 1.7.3 Mixed economy

In a **mixed economy**, decisions and choices are made partly by free market forces of supply and demand, and partly by government decisions. Economic wealth is divided between the private sector and the public sector. In practice, all modern national economies are mixed economies, although with differing proportions of free market and centrally planned decision-making from one country to the next.

## 1.8 Political systems: separation of powers



### Section overview

- Political systems affect legal systems. There may be a democracy or a dictatorship, which generally influences the nature of the rule of law in the nation. In democratic systems there is usually separation of powers between the head of state, the executive, the legislature and the judiciary. In dictatorial systems some or all of these powers may be combined so that one person or party has total power.

We have already referred to the role of government in national economics. Governments, as we shall see, are also heavily involved in law-making. Politics, the process of how nations are governed and by whom, is clearly relevant to how law is developed.

Law-making can be a **democratic** process, where law is developed by citizens, or a more **dictatorial** process, where law is developed by a government put in place by another method, for example a military coup.

What process is in force in a nation also affects two very important factors: the **rule of law**, and the **separation of powers**.

### 1.8.1 The rule of law

How and what laws are made and enforced in a country depends to a large extent on the emphasis that the country's political system places on the nature of the **rule of law**. This is the degree to which individual behaviour is regulated by law and to distinguish the law from the arbitrariness of the rule of man.

In **dictatorial** systems there tends to be an emphasis on state or government regulation and control of resources. This means individual freedom is heavily subject to the rule of state-made law, and the behaviour of individuals is to a large extent dictated by the state by means of law.

In more **democratic** or *laissez-faire* political systems, the emphasis is on the law being a means of sorting problems out where they arise. Provided individuals act within the letter and spirit of the law, they are free to choose for themselves how they regulate their lives and how they relate to other people and groups.

### 1.8.2 Separation of powers

The concept of the 'rule of law' is closely bound up with that of the **separation of powers**. Most clearly democratic nations in the world have power held in different places, so that no part of the political process holds too much influence. They usually have:

- An elected **legislature**, a body which decides on what laws should be passed to ensure that the people's wishes – for example, freedom or wealth – are met.
- An elected **executive**, or government body, which makes the decisions that put the laws into action.
- A **judiciary**, which may or may not be elected, that rules on any disputes about laws, whether between the government and the people (**criminal law**) or between individuals (**civil law**).

In some nations the **legislature**, the **executive** and the **judiciary** are completely separate, therefore each is accountable to, and can operate as a 'check and balance' on, the others. In most states however there is a **complex relationship** between the three sets of powers. This means that a balance is struck between control and accountability, on the one hand, and actually 'getting things done' on the other.

The other separation of powers that frequently exists is where the person who is **head of the executive** is **not** the same person as the **head of state**. In most nations the two persons are separate. **Australia** is an example of a **constitutional monarchy** tied to the **United Kingdom**. The head of state is the reigning monarch of the United Kingdom as represented by the Australian executive-appointed Governor-General, while the head of the executive is the Prime Minister. **Malaysia** is also a constitutional monarchy, and the head of state is an elected monarch selected by, and from, the nine Royal rulers of nine Malay states. The term of office is five years and it is largely a ceremonial role. The head of the executive is the Prime Minister. Malaysia is one of the few elected monarchies in the world. In comparison, the US operates a **presidential republic** where the President is both head of state and head of the executive, while **India** is a **parliamentary republic** where the President is head of state and the Prime Minister head of the executive.

## 2 Legal systems



### Section overview

- 'Legal systems' can be used in two senses: to describe the body of laws and mechanisms for their enforcement in a country, and to describe the underlying nature of a country's law.

### 2.1 What is a legal system?

A legal system in a country embodies both the **laws** of that country and the **mechanisms** the country has in place for regulating and enforcing those laws. Therefore a legal system incorporates:

- The country's **laws**.
- The **legislature**: the law-making body.
- The **judiciary** (or **judicature**): the body that sits in judgment on disputes about laws.
- The **prosecution system**: the system that seeks to ensure the criminal law is enforced and that people who break the law are prosecuted.
- The **police**: the body that seeks to enforce the law and to protect the public.
- The **prison system**: the system that ensures that people who have broken the criminal law are detained in accordance with their sentence.

The term '**legal system**' is also used to describe the **underlying nature of the country's laws**. It is in this sense that we shall be using the term later in this chapter.

Before embarking on the rest of this Study Manual and sitting the exam, it is vital that you have an understanding of what **international law** is, and how the various aspects of the learning objectives fit together. In order to do so, it will be necessary first to consider what law itself is, and to understand some key terms taken from the Oxford Dictionary of Law.

## 2.2 What is law?



### Section overview

- **Law** is the enforceable body of rules that govern any society. **Positive law** is the body of law imposed by the state.

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Law is a body of rules that enables society to operate. As such, it **does not have to be written down**, but can be simply rules that everyone in the society knows. Given the sheer size of the world, then, **law has not historically been seen in global terms**, but rather in manageable 'societies'.

Both far back in human history and today in some societies, law has been seen in terms of **families and tribes**. More recently in much of the world, it has been seen in terms of **nation states** or **sovereign states**. Many states have **written constitutions** outlining citizens' basic legal rights, and a body of **national law**, or rules, which governs how the state operates. This is known as **positive law**.

## 2.3 Types of law



### Section overview

- The main distinctions to be made between types of law are between **national** and **international** law, and between **criminal** and **civil** law.

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Each sovereign state has a set of laws which regulate how entities relate to each other and to the state, in their own country, known as **national law**. This is distinct from **international law**, which reflects the interrelationship of sovereign states, and which attempts to resolve the problem of **conflict of national laws**.

Within each state, and increasingly across national boundaries, there is also a distinction between **civil law** and **criminal law**. We shall come back to this shortly.

## 2.4 International law



### Section overview

- **Public international law** is the system of law regulating the interrelationship of sovereign states and their rights and duties with regard to one another. **Private international law** regulates cases where there is a conflict of national laws. **Sources of international law** are **treaties, custom and general legal principles**.

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In addition to the existence of positive national law, sovereign states, individuals and corporations interact with one another globally and that has led to **conflict of laws**. Conflict of laws can occur when there is interaction between sovereign states, organisations, or individuals from different jurisdictions.

While nations have interacted happily with one another over many years, improved **communication systems** resulting in increased **international trade** and other **relationships** has prompted moves by various bodies to develop international legal systems and understandings with each other.

**Public international law** is the system of law regulating the relations between sovereign states, and the rights and duties they have with regard to each other. It deals with matters such as:

- The formation and recognition of states.
- Acquisitions of territory.
- War.
- The law of the sea and of space.

- Treaties.
- Treatment of aliens – a person in a country who is not a citizen of that country.
- Human rights.
- International crimes and international judicial settlement of disputes.

Certain international organisations, such as the **United Nations, companies** and sometimes **individuals** for example, in the area of human rights, may have **rights or duties under international law**.

**Private international law** regulates cases which involve the national laws of two or more states where a different result will ensue depending on which state's law is applied. To address our *Fundamentals of Business Law* learning objectives we are concerned with situations where individuals or corporations interact or act on the basis of international commerce, that is private international law.

There are various **sources of international law**:

- Conventions and treaties, for example, double taxation agreements.
- International custom, for example, aspects of international trade law.
- The general principles of law recognised by civilised nations.

We have seen that economics, politics and law all affect **international trade**. Given the differences between economic and political systems in nations, there are therefore significant barriers to free international trade.

## 2.5 Barriers to free international trade



### Section overview

- Barriers to free trade exist to **protect** markets from outside competition. They include: tariffs or customs duties; import quotas; embargoes; hidden subsidies for exporters and domestic producers; import restrictions, as well as the barriers created by differences in laws.

In practice many barriers to free trade exist because the governments of sovereign states try to protect home industries against foreign competition. **Protectionism** can be practised by a government in several ways.

### 2.5.1 Tariffs or customs duties

Tariffs or customs duties are taxes on **imported goods**. The effect of a tariff is to raise the price paid for the imported goods by domestic consumers, while leaving the price paid to foreign producers the same, or even lower. The difference is transferred to the government sector.

### 2.5.2 Import quotas

**Import quotas** are restrictions on the **quantity** of a product that is allowed to be imported into the country. The quota has a similar effect on consumer welfare to that of import tariffs, but the overall effects are more complicated:

- Both domestic and foreign suppliers enjoy a higher price, while consumers buy less at the higher price.
- Domestic producers supply more.
- There are fewer imports in volume.
- The government collects no revenue.

### 2.5.3 Embargo

An **embargo** on imports from one particular country is a total ban, which is effectively a zero quota.



## 2.5.4 Hidden export subsidies and import restrictions

There has been an enormous range of government subsidies and assistance for exports and deterrents against imports. Some examples are given below:

- **For exports** – export credit guarantees, insurance against bad debts for overseas sales; financial help, such as government grants to the aircraft or shipbuilding industry; and general state assistance.
- **For imports** – complex import regulations and documentation, or special safety standards demanded from imported goods.

## 2.5.5 Differences in law

In addition to the economic problems above, there are legal barriers to trading between nations. For instance, take a moment to try and define what a contract is. A contract is something **defined by the law**, and so, as the law varies from country to country, it may be one thing in one country and a different thing in the other. It may have different legal consequences in different parts of the world.

For example, the following definition of a contract could be given.



### Definition

A **contract** is a legally binding agreement.

However, **what makes an agreement legally binding is likely to vary** from country to country. In one country, a legally binding agreement may be formed by two people making an agreement and shaking hands on it. In another, the agreement may have to be committed to writing and evidenced by witnesses.

In some countries, it may be the case that an agreement does not become legally binding unless **other conditions** are fulfilled. For example, in common law systems, there is a legal doctrine known as consideration. Under this doctrine parties have to exchange promises, acts or forfeitures of value to create a contract. Such a legal doctrine is unknown in civil law systems.

This raises a problem. People wanting to engage in international trade, say person A (from country Z) wants to trade with person B (from country Y). If the relationship breaks down, the following issues arise:

- A could claim that under Z's law, no contract was ever formed.
- B could claim that under Y's law, no contract was ever formed.
- Both parties could claim that the contract is not legally enforceable in their country.
- The remedies available for broken contracts in the different countries may differ.
- The parties might disagree on which country to seek legal resolution in.
- They might seek legal resolutions in their countries and be unable to enforce them.

The list above summarises some of the issues arising from **conflict of laws**.

## 2.6 Conflict of laws



### Section overview

- **Conflict of laws** is where parties from different nations have a legal dispute, and it is necessary to determine which national law governs the validity of the legal situation.

### 2.6.1 Example: Conflict of laws



A contract is made in Australia, but the contract is to be fulfilled in Japan. The relationship between the parties breaks down and legal resolution is sought. But should this be under Australian law or Japanese law?

### 2.6.2 International conventions, treaties and model laws

When problems such as the above arise, **international co-operation** is required to ensure that solutions can be found. Otherwise, the parties may be able to avoid each other and any solutions sought may not be enforceable.



Countries have sought solutions to these problems by coming to **agreements** with each other and by enacting various **conventions** and **treaties** that **regulate international practice**. UN Conventions are binding under international law on states and other entities.

For instance, the **Rome Convention 1980** set out policy on what law should govern the validity of international contracts. It sets down the general principle that if the parties have a **written contract** and have **expressed preference** for a particular law in that written contract, that law should govern the contract. This is known as **choice of laws**.

The **New York Convention 1958** set out the agreement of countries relating to referring cases to arbitration.

However, the conventions have not necessarily solved all the problems presented by conflict of laws completely. The United Nations has also developed **Model Laws** that countries may adopt into their own national laws. These make practices uniform on an international basis and iron out any remaining problems.

Later in the Study Manual we shall look briefly at the UN's Model Laws on arbitration and insolvency. We shall also examine the UN Convention on Contracts for the International Sale of Goods (UNCISG).

The best way to access all UN conventions, treaties and bodies such as the International Court of Justice (ICJ) as discussed in Chapter 3 is to go to the UN parent website at [www.un.org](http://www.un.org) and select International Law. From there you will see the headings International Courts and Tribunals and Legal Resources and Training. You will find all treaties and conventions under Legal Resources and Training.

### 3 Criminal law



#### Section overview

- A **crime** is conduct prohibited by the law. It is usually **punished** by the State, which **prosecutes** the case, by means of **fines** or **imprisonment**. There is usually a **heavy burden of proof**.

In a criminal case, the State is the prosecutor because it is the community as a whole which suffers as a result of the law being broken. **Persons guilty of crime may be punished by fines payable to the State or imprisonment**. In some circumstances the court may make a compensation order, by which the criminal must pay some compensation to the victim or their family.

In a criminal trial, the **burden of proof** to convict the **accused** rests with the **prosecution**, which must prove its case **beyond reasonable doubt**. In the United States, reported cases are usually cited with the prosecutor's name first then that of the accused, for example *The State v Smith* or, in **Australia** for instance, *R v Reid*. In this instance, 'R' denotes Regina or Rex meaning Queen or King, the head of state, acting as the prosecutor.

What is actually considered a **crime** will vary from jurisdiction to jurisdiction. Other differences include the types of punishments delivered to guilty parties, the degree of evidence required to convict someone of an offence, and the extent to which the court may order the guilty criminal to compensate the victim.

In resolving criminal issues, the outcome is usually punishment of the wrongdoer, although a compensation order may be made in some circumstances. Some legal systems based on Sharia or Islamic law contain the concept of **qisas**, or **retribution**. This is covered in more detail shortly. In certain cases these give a legal right to inflict on the wrongdoer the same hurt as he has perpetrated on the victim, or to accept **diyat**, or **compensation**, instead.

This provides some **compensation** to the victim of criminal activity, who is not necessarily considered in common and civil law systems. In these systems, the focus of the law is mainly to punish the wrongdoer, so victims might have to undertake a personal action under the civil law to receive significant compensation.

## 4 Civil law



### Section overview

- **Civil law** exists to regulate disputes about the rights and obligations of persons when dealing with each other. The State is not party to a civil case, and there is a lighter burden of proof.

In civil proceedings, the case must usually be proven on the **balance of probability**, to convince the court that it is **more probable than not that the assertions are true**. This is a lighter burden of proof than in criminal law cases, which is **beyond reasonable doubt**.

Terminology in civil cases is different from that in criminal cases. The **plaintiff** (claimant) sues the **defendant**. A civil case would therefore be referred to as, for example, *Smith v Megacorp Co*.

One of the most important areas of civil liability for business, and accountants in particular, is the law of **trade and contract**.

We shall be discussing the international laws relating to trade in later chapters of this Study Manual. It is therefore important for you to understand the nature of civil law, as opposed to criminal law, as it is a type of law existing in all legal systems.

### 4.1 Distinction between criminal and civil cases

It is not an act or event which creates the distinction between criminal and civil cases, but the **legal consequences**. A single event might give rise to criminal and civil proceedings.

A broken leg caused to a pedestrian by a drunken driver is a single event which may give rise to:

- A **criminal case** – prosecution by the State for the offence of driving with excess alcohol, and
- A **civil case** – the pedestrian sues for compensation for pain and suffering.

The two sorts of proceedings are usually easily distinguished because three vital factors are different:

- The **courts** where the case is heard (explained further Chapter 3).
- The **procedures**.
- The **terminology**.

In criminal cases the **rules of evidence** are usually very strict. For example, a confession will be carefully examined to see if any pressure was brought to bear upon the accused. An admission in a civil case will not usually be subjected to such scrutiny.



### Question 1: Criminal and civil law

While on a sales trip, one of your employees is involved in a car accident. The other vehicle involved is damaged and it is alleged that your employee is to blame. What legal proceedings may arise as a result of this incident?

(The answer is at the end of the chapter)

## 5 Common law systems



### Section overview

- Common law forms the foundation of the law in many jurisdictions throughout the world.

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**Common law systems** derive from, and are named after, the **law developed in England** between **1066 AD** and about **1400 AD**.

Although the law was developed in England, it has been exported globally as a result of the British Empire. It is the basis of the legal system of Australia, Singapore, Malaysia and the US. We shall use **Australia, England, the US, Singapore and Malaysia** as exemplar of the system throughout this section.

You should note that England has been part of what is now the United Kingdom (UK) for over three hundred years. Some of England's legal system remains peculiar to itself within that kingdom, but many of the modern aspects are common to all the nations in the kingdom (England, Scotland, Northern Ireland and Wales), and you will find both England and the UK referred to in this Study Manual.

### 5.1 Principles of common law



#### Section overview

- **Common law builds up over time**, added to by the legislature (statutes are presumed to add to, not alter, existing law) and by **precedent**.

In common law, **principles of law** do **not become inoperative** through the **lapse of time**. In other words, law does not become irrelevant and invalid just because it is old. This applies to all sources of the law. Also, **new laws developed by the legislature are presumed not to alter**, merely to add to, **the existing law**, unless they specifically state that they do.

Another important principle of common law is the concept of **precedent**, which we shall look at in more detail below, when we discuss judge-made law, and in Chapter 2.



#### Definitions

A **precedent** is a previous court decision or **case** which another court is bound to follow by deciding a subsequent case in the same way. Hence the type of law is often known as **case law**.

The **doctrine of precedent** means that a judge is bound to apply a decision from an earlier case to the facts of the case before them provided, among other conditions, that there is no material difference between the cases.

### 5.2 Sources of law in common law systems

There are various sources of law in common law systems:

- Common law (from which the legal system derived its name) – based on case law.
- Equity – based on case law.
- Statute.
- Custom – still important in **Australia** where, since 1992, customary laws of indigenous people have been held to co-exist with mainstream common law.
- Constitutional law –Australia has a significant additional source of law, the **Australian Constitution**. **Malaysia** and **Singapore** both have written constitutions which are primary sources of law, as does the **US** in the **American Constitution**. The UK does not have a written constitution.

**Case law** is a significant difference between common law and civil law systems. We shall consider it later on in connection with the role of judges, and in detail in Chapter 2.

### 5.2.1 Common (case) law

At the time of the Norman Conquest of England in 1066 there was no system of law common to the whole country. Rules of local custom were applied by local manorial courts. To improve the system, the King sent **royal commissioners** on tour to deal with crimes and civil disputes. At first, these commissioners applied the local customary law of the neighbourhood. On their return from circuit they sat in the royal (known as **common law**) courts in London to try cases there.

In time the commissioners in their judicial capacity developed rules of law. These (known as common law) were selected from the differing local customs which they had encountered, and which they applied uniformly in all trials (before the King's courts) throughout the kingdom.

There were a number of problems with the system of common law on its own:

- (i) Common law was often **inflexible**. Before he could bring an action, a claimant or plaintiff had to obtain a **writ** which was an order issued under the King's authority. Writs covered only a limited number of matters. If there was no appropriate writ form, an action could not be brought.
- (ii) Only a **limited remedy**, damages (compensation), was available. Common law could not stop a person doing something or compel them to do something.
- (iii) There was **too much emphasis on procedure**. A claimant or plaintiff might lose their case because of a minor technicality or wording. The system was open to bribery and corruption.

### 5.2.2 Equity

As a result of these problems with the common law, a parallel system of **complementary law** was developed. Citizens who could not obtain redress for grievances in the King's common law courts petitioned the King to obtain relief by **direct royal intervention**. These petitions came before the King in Council and by custom were referred to the principal civil minister – the Chancellor.

In dealing with each petition the Chancellor's concern was to establish the truth of the matter and then to impose a **just solution** without undue regard for technicalities or procedural points. Because the principles on which the Chancellor decided points were based on fair dealing between two individuals as equals, it became known as **equity**. The courts of equity developed legal principles which still underpin common law such as the concepts of a **fiduciary** relationship (discussed in Chapter 10 ) and **unconscionable conduct**.

The system of equity was **not a complete alternative** to the common law. It was a **method of adding to and improving on the common law**. Both sources of law are now administered in the same courts and by the same personnel. Together, these two historic sources of law form **case law** which is law made by judges.

### 5.2.3 Statute



#### Definition

**Statute law** is made either by the legislature as primary legislation, or by some other body in exercise of law-making powers delegated by the legislature, known then as delegated or subordinate legislation.

In common law systems statute is now the primary source of new law, but as stated above it does not automatically override common law. In **Australia** the emphasis is on making sure that the people who are most likely to use the statutes, namely administrative decision makers, can interpret what is meant. Conversely, **UK** tradition is to draft statutes in comprehensive detail to attempt to cover all eventualities that the statute is designed to cover.

From time to time, the legislature may produce a **codifying statute**, which puts common law in an area on a statutory footing. In that respect, codifying statutes are similar to civil law codes, which we shall consider later. However, codification is not common in the **either Australia** or the **UK** for example, and many areas of law – for example, contract and property law – still largely derive from common law with equitable principles applied as well.

### 5.2.4 Constitutional law

The **Australian Constitution** is made up of the Constitution of the Commonwealth of Australia from 1901, together with the Statute of Westminster Adoption Act of 1942 and the Australia Act of 1986. The **High Court of Australia** (which we shall refer to in Chapter 3) has the authority to interpret constitutional provisions.

You can access it on the Internet, for example at [www.australianpolitics.com/articles/constitution](http://www.australianpolitics.com/articles/constitution)

The American Constitution, mentioned earlier, is the ultimate source of law in the **US**. Any statute passed by the American Senate, by the federal government or in individual states may be challenged by a citizen on the grounds that it is unconstitutional.

The American Constitution sets out the basic rights of US citizens and the systems of government for them. You can access it on the Internet, for example at [www.usconstitution.net](http://www.usconstitution.net)

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## 5.3 Role of judges in common law systems



### Section overview

- Judges play two roles in building up **case law** in common law systems – by setting and applying **precedent** and by **interpreting statutes**, via which they also perform the important function of **judicial review**.

### 5.3.1 Precedent in case law

It is generally accepted that **consistency** is an important feature of a good decision-making process. Judges are required to treat similar cases in the same way.

A judge's decision is expected to be **consistent with previous decisions**. It should provide an opinion which the parties, and others, can use to direct their future relationships as it creates law. This is the basis of the system of **precedent**, which we introduced above, and which we shall look at in more detail in Chapter 2.



### Question 2: Case law

What do you think are the advantages of case law as a source of law in common law systems?

**(The answer is at the end of the chapter)**

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### 5.3.2 Statutory interpretation in case law

When deciding cases based on statute law, **judges will be required to interpret the statutes that the legislature has enacted**. There are various models, rules and presumptions associated with the interpretation of statute, which we shall look at in Chapter 2.

### 5.3.3 Judicial review in common law systems

Where **judicial review** is an aspect of a country's constitution – as it is in many common law systems, including **Australia** and the **US** – it is possible for judges to review legislation or case law to establish whether it conflicts with the country's constitution. A US citizen has the right to challenge law which appears to be unconstitutional. The role of **determining whether created law conflicts with the Constitution falls to judges** in the courts, notably the US Supreme Court. In Australia, the **High Court of Australia** has the power of judicial review over laws passed by the Parliament of Australia and the parliaments of the States, and it interprets the Constitution of Australia.

## 6 Civil law systems



### Section overview

- Civil law systems seek to ensure comprehensibility and certainty by means of codification via statutes and administrative regulations. In simple terms, this is so that common law and custom do not apply.

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Civil law developed in Continental Europe, during a period of revolutionary change and creation of new nation states. It spread to other areas of the world during the era of European colonial expansion. We shall use **France** as exemplar.

### 6.1 Principles of civil law

Two key principles in civil law are **comprehensibility** and **certainty**. This can be seen in the Codes that provide the hallmark of civil law, and the different role allocated to judges in the civil law system compared with the common law systems.

### 6.2 Codification in civil law

Civil law tradition historically owes much to the **law of the Roman Empire**, and is sometimes given a date of origin as early as 450 BC.

In more recent times, a key period in the development of civil law was the era of **revolution** in Western Europe in the late eighteenth and early nineteenth centuries. It was after these revolutions that **emerging nations** decided to **codify their law**, abolishing the mixture of common law and custom remaining from Roman times, and establish a **national law**.

In France, the process of law-making can be seen in the period after the French Revolution in the years following 1789. The French Civil Code, the **Code Napoleon**, published in 1804 is the key example. France now has a large number of such codes of law. The German Civil Code was published in 1896.

Where law is **codified** in civil law systems, it is generally codified so as to provide a comprehensive code of the enacted law in a certain area. Codes of law are a common feature of civil law, although they are not a compulsory feature. While France has the **Code Napoleon** other civil law countries, such as **South Africa**, do not have codified law.

### 6.3 Sources of civil law

There are various sources of law in France:

- The Constitution,
- European Union (EU) law,
- Statutes,
- Administrative regulations, and
- Custom (of limited importance, so we shall not consider this further).

The key source of law is **statute**, much of which is **codified**. Administrative regulations are also codified. Statute law is usually **drafted** as **general principles** and in **simple language** as far as possible, so as to ensure that the law is accessible. This is in stark contrast to English statutes, which are complex and drafted to cover many eventualities.

## 6.4 The role of judges in civil law



### Section overview

- In civil law systems, **judges simply apply the law** – they do not make law via precedent, although they may perform a **judicial review** to ensure that statutes and other parliamentary laws are in line with the **constitution**.

The role of judges in a civil law system is significantly different in theory from the role of a common law judge. In **France**, there is a **distinct division** between those who **draft the law** and those who **apply the law**, judges being the latter.

There is no such thing in France as judge-made law. While previous decisions of other judges will be **persuasive** to judges making decisions, they do not create precedent in the same way as in the common law system.

### 6.4.1 The Court of Cassation

The top court of appeal in France is the **Court of Cassation**. Cassation comes from the French word meaning 'to quash'. When the Court of Cassation was originally formed, it was a government department set up to quash any court decisions where the legislators felt that the law had been incorrectly interpreted.

The history of the Court of Cassation is therefore not as a court. Originally it was manned not by judges, but by legislators, whose role was to **quash** the original decision and return the case to the court system to be retried.

In practice, the Court became a **court of appeal**, where the people determining that the law had been incorrectly interpreted also set out what the correct interpretation should have been, so that the case was not returned to the judicial system. In time, then, the Court of Cassation has been subsumed into the judicial system.

### 6.4.2 Statutory interpretation in civil law

There is no general principle in French law on how judges should interpret statute. This is probably due to the historic feeling that judges should not interpret the law but merely apply it to the letter. However, some **general principles** of statutory interpretation have developed.

#### Statutory interpretation

'Quand la loi est claire, il faut la suivre'	Where the meaning of the law is clear, it must be followed. French judges will not extend or restrict the scope of a statute that is unambiguous.
'Quand elle est obscure, il faut approfondir les dispositions pour en pénétrer l'esprit'	Where the statute is obscure or ambiguous, one should construe it in accordance with the spirit of it, rather than to the letter, in order to determine its legal meaning.
'Si l'on manque de loi, il faut consulter l'usage ou l'équité'	If there is a gap in the law, judges must resort to custom and equity. However, as stated above, custom is only of limited application in France.

There are also the following alternative methods of statutory interpretation:

- **Teleological method.** This is where a judge seeks to identify the social purpose of the legislation and apply it in a manner that achieves it.
- **Historical method.** This is where the judge looks at the intention of the legislator and then tries to envisage what the intention would be if the law was being drafted in modern times. The judge then applies that intention.



### 6.4.3 Judicial review in civil law

Although in the civil law tradition judges do not have a key role interpreting statute, a system of **judicial review** has grown in certain civil law countries. This role is to comment on whether statute law is in accordance with the country's constitution. This is the case in **Japan**, where the **Supreme Court** has the power of judicial review. However, the Japanese Supreme Court is extremely conservative in exercising its powers and has overruled only eight statutes in over 50 years.

In **Germany** separate **constitutional courts** have been set up for the purpose of judicial review. However, the judges in constitutional courts are not the same as in the normal court system. In other words, special judges are created to comment on whether legislation is constitutional. The specialist German courts are very active - over 600 statutes have been overruled in roughly 50 years.



#### Question 3: Codification

What is the difference between codification in a common law system and codification in a civil law system?

(The answer is at the end of the chapter)

## 7 Sharia law systems



### Section overview

- Sharia law is based on the religion of Islam. This means that the law extends into **areas of belief and religious practice** and that the **law is God-given** and so has **wider significance than social order**.

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The major difference between Sharia law and the other legal systems we have introduced in this chapter is that **Sharia law is explicitly based on**, and connected with, **the religion of Islam**. We shall describe Sharia law in general terms, but also use Pakistan and Iran as exemplars of countries that have adopted Sharia.

**Sharia** is 'a way to a watering place', in other words, a path to be followed. **Sharia law** is ordained by Allah as guidance for mankind.

### 7.1 Principle of Sharia law

As can be seen above, the main principle of Sharia law is that it is **the divine way** ordained for man to follow by Allah. The law, therefore, is **sourced directly from Allah** and this has a significant impact on how it is interpreted by judges. In true Sharia tradition, judges are clerics, known as Imam.

### 7.2 Sources of Sharia law



### Section overview

- The main sources of **Sharia** law are the **Quran** and the **Sunnah**. The secondary sources of law are the **Madhab**.

The **key source of law** in Sharia is the **Quran**, which contains various injunctions of a legal nature.



### Definition

The **Quran** is Allah's divine revelation to his Prophet, Muhammad.



The Quran was revealed to the **Prophet Muhammad** during the last years of his life, around 619–632 AD. It was written down piecemeal during his lifetime but not fully collated until after his death.

The Muslim calendar is different from the Western systems of years BC and AD. However, for the purposes of comparability with common and civil law systems, the AD dates are being used here.

The Quran includes various injunctions of a legal nature, but it does not cover every detail, so **another primary source of law** in Sharia is the **Sunnah**.



## Definition

The **Sunnah** is 'the beaten track', in other words, what has come to be the acceptable course of conduct. It is derived from the sayings of the Prophet, known as **Ahadith** (known in the singular as Hadith).

There are also five **major secondary sources** of law in the Muslim world, known as **Madhab**. These are schools of thought based on **writings and thoughts of major jurists** formed in the years immediately following the death of the Prophet and are named after those jurists:

- The Shia school.
- The Hanafi school (Imam Abu Hanifa).
- The Maliki school (Imam Malik).
- The Hanbali school (Imam Ahmad Ibn Hanbal).
- The Shafii school (Imam As-Shafii).

These schools of law are given more prominence in certain parts of the world, so, for example, parts of Iraq and parts of **Iran** follow the Shia school ('Shia Muslims'). The majority of the Muslim world follows the other four schools, which together, are termed Sunni (hence 'Sunni Muslims'). In **Pakistan**, the generally preferred school is Hanafi.

### 7.2.1 Constitution

Many Muslim countries have a written constitution. Both the countries we are using as exemplars of the system, Iran and Pakistan, have such a constitution. The Iranian Constitution upholds the role of Sharia law in Iran, as can be seen from Article 2 of the Constitution.

## 7.3 The role of judges in Sharia law



### Section overview

- In Sharia law, judges may need to **interpret** the law and it cannot be changed. They do this in line with the **Sunnah Ahadith**, meaning sayings of the Prophet, that are varyingly reliable. **Fiqh** is the process of further legal interpretation, using **ijtihad**. Judges may also perform a form of judicial review.

As we have observed above, the **religious nature** of Sharia means that in true Sharia tradition, **judges are clerics**, known as Imam. This is the situation in **Iran**, for example. However, in other Muslim states, there are a **mixture of clerical judges and secular judges**.

Judges are required to apply the law to cases brought before them. However, given the **nature and source** of the law, there are **particular considerations** with regard to **interpretation** of the law.

### 7.3.1 Interpretation of Sharia law

The **Quran cannot be altered**, being the Word of Allah. It may only be **interpreted**. This leads to the problem in Islamic circles of who is **qualified to interpret** the Quran. Muhammad, as Allah's prophet, was qualified to do so.

When clear guidance cannot be obtained from the Quran, the judge may turn to the **Sunnah** to see **how the Quran was interpreted by the Prophet**. The Sunnah is used by Muslim jurists to:

- **Confirm** the law in the Quran,
- **Explain** matters mentioned in the Quran in general terms,
- **Clarify** verses in the Quran that may seem ambiguous, and
- **Introduce** a rule where the Quran is silent.

The **Ahadith** that comprise the Sunnah were recorded some time after the death of the Prophet and are **classified according to reliability**. Some are **virtually guaranteed**, and are known as **muwatir**. Others are **less certain** and known as **mashtur**. Lastly, where there is **little certainty** as to their authenticity, Ahadith are called **ahad**.

### 7.3.2 Schools of Sharia law

There is **controversy** in the Muslim world as to **whether matters of legal and religious significance should be interpreted further**, or whether everything is clear and new cases should not bring the need for further development of the law. Those that believe more development is needed developed a science of understanding and interpreting legal rules, known as **fiqh**, through the techniques of **ijtihad** (see below).

The theory that no more interpretation is needed is known as **Taqlid**, which is the process of strict adherence to established doctrine. Orthodox Muslims would adhere to Taqlid, although some would claim there was a need to deal pragmatically with the results of new, Western influences in their countries.

**Taqlid** was the result of what is known as '**closing the gates of Ijtihad**' which took place during the course of the sixteenth to nineteenth centuries AD.



#### Definition

**Ijtihad** are the processes for ascertaining the law. It is the use of intellectual exertion by a jurist to derive an answer to a legal question.

The basis for Ijtihad is a **Hadith** which records that the Prophet approved an Imam who told him that in making a judgment, he would rely first on the Quran, then on the Sunnah, and then he would exert his own judgment.

There are various rules associated with exercising an ijtihad:

- It **must not be exercised on certain matters** – for example, the existence of Allah.
- The judge must be **suitably qualified**, known as a **muhtahid**.
- There are various **recognised methods**.

In order to **qualify** as a muhtahid a person must be:

- Well versed in the study of the Quran,
- Well versed in the traditions of the Prophet,
- Understand the principle of **ijma'** (see below),
- Understand the conditions for **qiyas** (see below),
- A good and practising Muslim, and
- Just, reliable and trustworthy.

One reason that there is controversy about whether interpretation should still take place is that many people believe that these **qualification criteria** are **too difficult** to meet in modern times, given the time lapse since the death of the Prophet.

Two of the recognised methods for exercising Ijtihad have been mentioned in these **qualification criteria**. The full list of methods is:

- **Ijma'**,
- **Qiyas**,
- **Istihsan**,
- **Maslahah mursalah**,
- **'Urf**, and
- **Istishab**.

The first three are **key methods**. Maslahah mursalah means something very similar to Istihsan (see below). 'Urf is the theory that local custom may be subsumed into the law if it is not contrary to Sharia.

Istishab is a **legal presumption** that the current state of affairs continues until the contrary is proved. Something is permitted until it is shown that it is forbidden.



## Definitions

**Ijma'** is a consensus of opinion. It should be based on consultation between jurists.

**Qiyas** is analogical deduction. In other words, it is a comparison of two things with a view to evaluating one in the light of the other.

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An example of qiyas is to say that taking drugs is forbidden, on the basis that the Quran states that alcohol is forbidden, and the effects of taking drugs are similar to the effects of taking alcohol.



## Definition

**Istihsan** is the concept of equity, or of fairness. However, in Sharia, the exercise of equity is clearly only permissible within the bounds of the Sharia as it is integral to the system.

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### 7.3.3 Judicial review in Sharia law

In some Muslim states, the State will issue statutes, although these should be based on Sharia law principles. In addition, since wholesale adoption of Sharia by Islamic nations is a fairly recent trend, they may have enacted law from before adoption. The Hudood Ordinances in Pakistan from the 1970s set out in statute the Sharia law relating to criminal law.

Pakistan has a **Federal Shariat Court** which has a key role in judicial review. One of its objectives is to determine whether a provision of (statute) law is repugnant to the injunctions of Islam.

Another aspect of the Federal Shariat Court's role is to hear appeals under the Hudood rules.

## 7.4 The rule against usury

A rule in Sharia law that has a significant impact on commerce and trade is the rule against usury, known in Sharia as **riba**.



## Definition

**Riba** is the Islamic concept of unlawful gain, usually translated as interest, which is strictly forbidden by the Quran.

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In theory, riba, 'unlawful gain' translates to be **qualitative inequality** and is a highly technical area. For our purposes, and **in practice**, it is often seen as a **rule against charging or receiving interest**.

The concept of riba also has a significant impact on the way that Muslims bank, which you should be aware of, although we shall not look at the details of Muslim banking in this Study Manual.

## Key chapter points

- The concepts of national and international law
  - National (sovereign state) law and exemplar national legal systems.
  - Legal pluralism in nations.
  - Economic, political and business contexts:
    - Separation of powers
    - Rule of law.
- Legal systems
  - Definition of a legal system (the laws and mechanisms for enforcing the laws).
  - National law is the set of laws belonging to each sovereign state.
  - International law – public and private.
  - Barriers to international trade include tariffs, import quotas, subsidies.
  - Conflict of laws between sovereign states' national laws.
- Criminal law
  - Conduct prohibited by the law.
  - Punishable by the state.
  - Burden of proof is beyond reasonable doubt.
- Civil law
  - State not party to the case.
  - Resolves disputes between parties, eg individuals, companies.
  - Burden of proof is balance of probabilities.
- Common law systems
  - Development in England from 1066.
  - Principles:
    - Builds up over time.
    - Precedent.
    - Judge-made law.
  - Sources:
    - Common law
    - Equity
    - Statute
    - Custom
    - Constitutional.
- Civil law systems
  - Development from Roman Empire and into France and Germany.
  - Codification.
  - Judges only apply the law; they do not create it.
  - Sources:
    - Constitution
    - Statutes
    - Administrative regulations
    - Custom.

- Sharia law systems
  - Sources:
    - Quran (primary)
    - Sunnah (primary)
    - Madhab (secondary).
  - Judges interpret law, review law and interpret law (Fiqh).

## Quick revision questions

1 **Fill in the blanks.**

Law is the ..... body of ..... that govern any society.

2 What is the standard of proof in civil proceedings?

3 What is Istihsan?

4 Statute law is:

- A law made by the legislature
- B law made by judges
- C law found in the Quran
- D law established by a country's constitution

5 **Fill in the blanks.**

In the civil law tradition, ..... is the process of putting all the law on a specific area together in a.....

6 French law is usually drafted as general principles and in simple language to ensure that the law is accessible.

True ☐

False ☐

7 Which of the following is the Sunnah *not* permitted to do?

- A confirm the law in the Quran
- B introduce a rule on a topic set out in the Quran
- C clarify matters in the Quran that may seem ambiguous
- D explain matters mentioned in the Quran in general terms

8 What is riba?

9 What is meant by the term 'conflict of laws'?

## Answers to quick revision questions

- 1 **Law** is the **enforceable body** of **rules** that govern any society.
- 2 The case must be proved on the balance of probability.
- 3 **Istihsan** is the concept of equity or fairness in Islamic law.
- 4 A. Law made by the legislature.
- 5 In the civil law tradition, **codification** is the process of putting **all** the law on a specific area together in a **code**.
- 6 True. Simple language is used so all members of the public can understand it.
- 7 B. The Sunnah must not add law on a matter mentioned in the Quran. This is only permitted where the Quran is silent on an issue.
- 8 Riba is qualitative inequity, or unlawful gain, usually translated as the giving or receiving of interest.
- 9 Conflict of laws is a problem that arises when people from different sovereign states enter into a legal relationship with each other, and it is not clear whose national law will govern that legal relationship.

## Answers to chapter questions

- 1 Your employee may be guilty of a driving offence such as careless driving. The police, to whom the incident should be reported, will investigate, and if the facts indicate a driving offence, will prosecute him. The owner of the damaged vehicle (or his insurers) may sue the driver at fault in civil proceedings to recover damages. There is also the possibility of the vicarious liability of the employer, which is where the employer will be held wholly or partially responsible for the acts or omissions of the employee.
- 2 The law is decided fairly and **predictably**, so that business people and individuals can regulate their conduct by reference to the law. The **risk** of mistakes in individual cases is reduced by the use of precedents. Case law can **adapt** to changing circumstances in society, since it arises directly out of the actions of society. Case law, having been developed in **practical** situations, is suitable for use in other practical situations.
- 3 In civil law systems, codification is understood to be a comprehensive exercise, where ideally all the related law on a subject is incorporated into a code. In common law systems this does not have to be the case, rather codification is the process of putting case law on a statutory basis. The statute is not then necessarily comprehensive of all the law in that area.





# Chapter 2

## Common law and legislation

Learning objectives	Reference
<b>Common law and legislation: precedent and <i>stare decisis</i> and statutory interpretation</b>	<b>LO2</b>
Identify how common law and relevant legislation are applied	LO2.1
Analyse and explain legal cases and principles in setting precedents	LO2.2
Specify how legal cases and principles set precedents	LO2.3
Identify how to deal with the doctrine of <i>stare decisis</i> (legal precedent)	LO2.4
Specify the rules and models for statutory interpretation	LO2.5

### Topic list

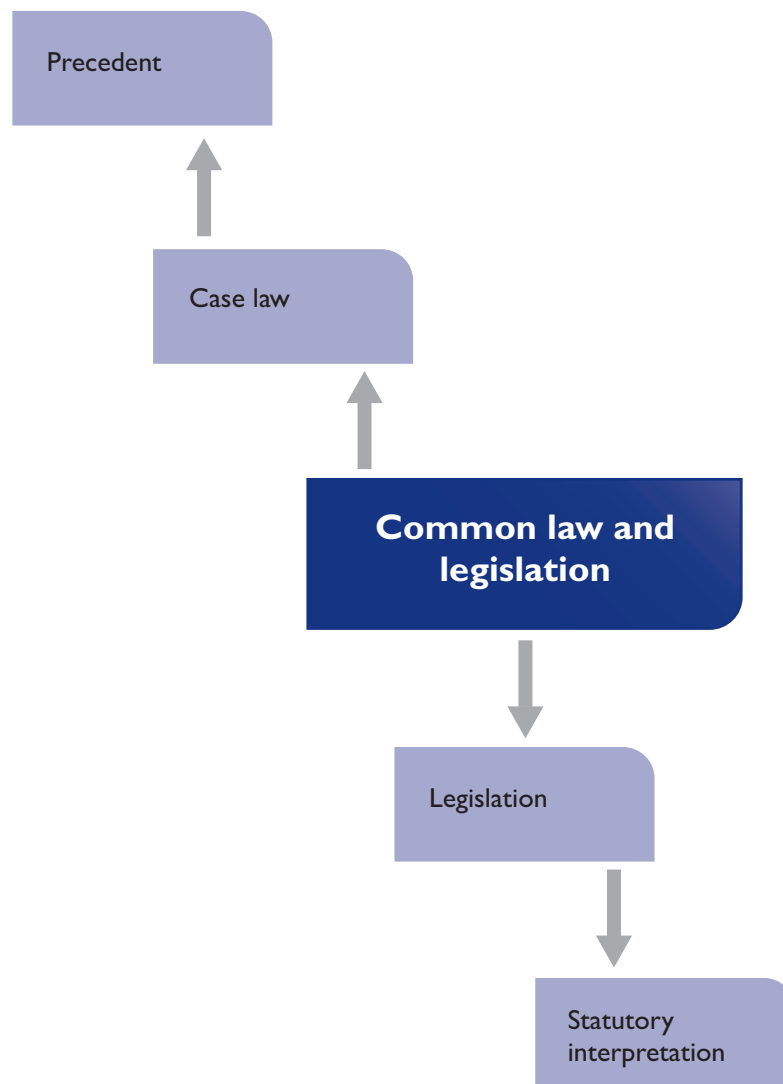
- 1 Case law and precedent
- 2 Legislation
- 3 Statutory interpretation

# Introduction

Continuing with our study of legal systems, we now look at how law is interpreted by the courts.

In a common law system the main law making bodies are the courts (which develop the 'common law') and the legislature which produces statutes and delegated legislation.

The rules on statutory interpretation are used by judges when deciding cases that involve statutes which are open to several different meanings.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Define binding precedent and persuasive precedent. (Sections 1.2 and 1.3)
- 2 What is the doctrine of *stare decisis*? (Section 1.2)
- 3 What are the core components of a law report? (Section 1.4)
- 4 What is the difference between a statement which is *ratio decidendi* and one which is *obiter dicta*? (Section 1.5)
- 5 List common types of legislation. (Section 2.3)
- 6 What is subordinate legislation? (Section 2.6)
- 7 Define the 'purposive model' of statutory interpretation. (Section 3.1.4)
- 8 What are three rules of statutory interpretation? (Section 3.2)

# 1 Case law and precedent



## Section overview

- **Case law** consists of decisions made in the courts, so it is judge-made law based on the principle of consistency. Once a legal principle is decided by an appropriate court it becomes a **precedent**.

## 1.1 Common law and equity

LO  
2.1

As we saw in Chapter 1, **common law** originally developed in England as a system incorporating rigid rules applied by royal courts, often with harsh consequences. **Equity** was developed, two or three hundred years later, as law applied in situations where justice did not appear to be done under common law principles.



## Definitions

**Common law** is the body of legal rules common to the whole jurisdiction which is embodied in judicial decisions.

**Equity** is a term that applies to a specific set of legal principles which supplement, but do not replace, the common law. It is based on fair dealings between the parties. It adds to and improves on the common law by applying the concept of fairness.

The interaction of equity and common law produces three major features of common law systems:

- (a) **Equitable rights.** Equity recognises and protects rights for which the common law provides no safeguards.
- (b) **Better procedure.** Equity may be more effective than common law in resolving a disputed matter.
- (c) **Better remedies.** The standard common law remedy for the successful plaintiff/claimant is the award of damages or financial compensation for loss. Under equity the following orders may be available:
  - (i) **Specific performance:** that the defendant must do what they had agreed to do.
  - (ii) **Injunction:** that the defendant must abstain from wrongdoing.
  - (iii) **Rectification:** alteration of a document to reflect the parties' true intentions.
  - (iv) **Rescission** in relation to contract: restoration of the *status quo*.

Where equitable rules **conflict** with common law rules then **equitable rules prevail**.

LOs  
2.1  
2.3

**Case law** incorporates decisions made by judges under both historic legal systems, and the expression 'common law' is now often used to describe all case law whatever its historic origin. **A court's decision** is expected to be **consistent with previous decisions** and to provide an opinion which can be used to direct future relationships. This is the basis of the system of **precedent**.

The general rules of precedent are as follows:

- (a) Lower courts are bound to follow decisions in superior courts within the same court hierarchy. This is called **binding precedent**.
- (b) Superior courts do not have to follow decisions made in lower courts, though they may use them to help make a decision. This is **persuasive precedent**.
- (c) Decisions made in other **court hierarchies** can also be persuasive, for example an Australian court can consider decisions made in England or the US to help them come to a decision in their case. This is also the case with the various state courts in Australia – for example, the NSW Supreme Court can consider a decision of the Victorian Supreme court to assist in making a decision. The precedent is persuasive only – it is not binding.
- (d) Most courts are not bound by their own decisions but are **reluctant to depart** from them.

The following Australian state's Victorian District Court decision is an example of the doctrine of precedent in action.



### Case study

In 1987, Judge Mullaly of the Victorian District Court (Australia) decided that a particular woman's actions did not constitute offensive behaviour. To decide whether the behaviour was offensive he looked to precedent. He found a Victorian Supreme Court decision in 1951 that said offensive behaviour must be 'calculated to wound the feelings or arouse anger or resentment or disgust or outrage in the mind of a reasonable person'. Judge Mullaly decided that the woman's actions would not have aroused such feelings in a reasonable person so they were not offensive.

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## 1.2 Doctrine of binding precedent and *stare decisis*

LO  
2.4

The system of precedent is based on a fundamental feature of common law which is that **principles of law do not become inoperative through the lapse of time.**



### Definitions

The doctrine of consistency, following precedent, is expressed in the maxim ***stare decisis***: 'to stand by a decision'. In any later case to which a legal principle is relevant the same principle should, subject to certain exceptions, be applied.

A **precedent** is a previous court decision which another court is bound to follow by deciding a subsequent case in the same way.

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The doctrine of **precedent** means that a judge is bound to apply a decision from an earlier case to the facts of the case before the court provided, among other conditions, that:

- There is **no material difference between the cases**, and
- The previous case was one that created a **binding precedent** on the current case.

**Binding precedent** is based on three elements:

- **Reports.** There must be adequate and reliable law reports or published judgments of cases. Cases that are published are those that raise, or expand upon, significant points of law, so only a small proportion of cases are ever reported and they are almost always the decisions of appellate courts such as the High Court of Australia or individual Australian states' highest courts (such as the NSW Supreme Court).
- **Rules.** There must be rules for extracting a legal principle from a previous set of facts and applying it to current facts.
- **Classification.** Precedents must be classified as either **binding** or **persuasive**.

## 1.3 Persuasive precedent

LOs  
2.2  
2.3

Rather than being binding precedents, reported conclusions of any court may be treated as **persuasive precedents**. Persuasive precedents may be, but need not be, followed in a later case.

A court of higher status is not only free to disregard the verdict of a court of lower status, it may also deprive it of authority and expressly **overrule** it. **This does not reverse the previous decision.**

## 1.4 Law reports

Law reports are published to provide consistency in the development of the common law, that is cases which are alike should be decided in the same way. There are several major databases of law reports. The most comprehensive Australian database is the **Australasian Legal Information Institute (AustLII)**, a comprehensive and free online legal database, accessed at [www.austlii.edu.au](http://www.austlii.edu.au). Simply enter this front page and search for any Federal or state piece of legislation or case or browse through the various listed

databases. Another example is the **British and Irish Legal Information Institute** (BAILII) which can be accessed at [www.bailii.org](http://www.bailii.org).

Each case has a title and citation usually (in a civil case) in the form of *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256. (for example). This denotes the **plaintiff/claimant** (Carlill) versus the **defendant** (Carbolic Smoke Ball Co), the **year the decision was made** (1893), the **court hearing the case** (Queen's Bench in the United Kingdom), or the name of the publication listing the decision, and the **page where it appears** in the law reports (256).

More information about **appeals** and **appeal courts** can be found in Chapter 3.

In terms of content, a **full law report** includes details of:

- Name of the plaintiff/claimant or appellant,
- Name of the defendant or respondent,
- Court details,
- Names of the judges,
- Hearing and judgment dates,
- **Catchwords**: this area consists of phrases or keywords that describe the subject matter and legal issues of the case. There is usually a reference to legislation referred to,
- **Headnotes**: a summary of the case and decision along with cases cited in the judgment,
- Reasons for judgment, and
- Orders.

It is only decisions of the **higher courts** in important cases (in **Australia** the High Court, the Federal Court and the Supreme Courts of the states and territories) which are included in the law reports.



### Exam comments

Students are often perplexed as to how much they are expected to memorise of cases referred to in textbooks. By far the most important aspect of a case for exam purposes is what it was about; that is, **the point of law which it illustrates or establishes**. This is the knowledge that you must apply when answering exam questions. Knowing the facts of cases is helpful because exam questions may well include scenarios in which the facts are based on a well-known case.

For case law to provide **consistency** in the law four things must be considered when examining a precedent before it can be applied to a case:

- (a) It must form part of the reason for deciding or **ratio decidendi** of the case (see Section 1.5 below).
- (b) A decision must be based on a **proposition of law** before it can be considered as a precedent. It may **not** be a decision on a **question of fact**.
- (c) The **material facts** of the cases must be comparable.
- (d) The preceding court must have had a **superior (or in some cases, equal) status** to the later court, such that its decisions are binding on the later court.

## 1.5 Ratio decidendi



### Section overview

- Statements made by judges can be classified as either **ratio decidendi** (reason for deciding) or **obiter dicta** (something said 'by the way').

A judgment will start with a description of the facts of the case and probably a review of earlier precedents. The judge will then make **statements of law applicable to the legal problems** raised by the material facts which, **if used as the basis for the decision**, are **known as the ratio decidendi** of the case. This is the **vital element that binds future judges**.



## Definition

'The **ratio decidendi** of a case is any rule of law expressly or impliedly treated by the judge as a necessary step in reaching his conclusion, having regard to the line of reasoning adopted by him, or a necessary part of his direction to the jury.'

(Cross: *Precedent in English Law*.)

Statements made by a judge are either classed as **ratio decidendi** or **obiter dicta** which means something said 'by the way'. There are two **types of obiter dicta**:

- A judge's statements of **legal principle** that do not form the basis of the decision.
- A judge's statements that are not based on the material facts, but on **hypothetical facts**.



## Definition

**Obiter dicta** are words in a judgment which are said 'by the way'. They **do not** form part of the **ratio decidendi** and are not binding on future cases, but they may be persuasive.

It is not always easy to identify the **ratio decidendi**. In decisions of appeal courts, where there are several separate judgments from the judges sitting on the appeal, the members of the court may reach the same conclusion but give different reasons. However, many judges indicate in their speeches which comments are 'ratio' and which are 'obiter'.

## 1.6 Avoiding precedent

LOs  
2.2  
2.3  
2.4

Judges do not always have to apply precedent. The doctrine of precedent allows for flexibility; there are ways a judge can avoid following previously decided cases. The four main methods of **avoiding precedent** are:

- Distinguishing:** Although there may arguably be a finite number of **legal principles** to consider when deciding a case, there is an infinite variety of facts which may be presented. It is necessary to consider how far the facts of the previous and the latest case are similar. If the differences appear significant the judge may **distinguish the earlier case on the facts** and thereby **avoid following it as a precedent**.
- Reversing**, which operates as follows: A lower court makes a decision. The party whom the case was decided against takes the case to a higher court on appeal. The higher court states that the lower court was wrong and reverses the lower court's decision. Therefore, the higher court avoids creating a possible precedent or creates a new precedent.
- Overruling:** This is similar to reversing but it involves two separate cases. For example, Case A is heard in a lower court and that court decides the defendant is guilty. Case B is very similar to Case A but is looked at by a higher court. The higher court decides that the decision made in Case A was wrong. Therefore, it does not follow the precedent set in Case A. It overrules the decision and applies its own decision to Case B. Case A's outcome is not affected.
- Disapproving:** This takes place when a decision from another court system is being considered. It cannot be overruled but it can be ignored, that is, disapproved.

Even if a precedent still appears to be binding, there are **a number of grounds on which a court may decline to follow it**:

- It may declare the *ratio decidendi* **obscure**, particularly when a decision by a court containing three or more judges gives as many sets of *ratio decidendi* as there are judges.
- It may declare that the previous decision was made **per incuriam**: without taking account of some essential point of law, such as an important precedent.
- It may declare the previous decision to be in **conflict with a fundamental principle of law**, for example where a court has failed to apply the rules on consideration in contract.
- It may declare an earlier precedent to be too **wide**. For example, the duty of care to third parties, created by the English legal case *Donoghue v Stevenson* 1932 UKHL100; 1932 AC 562, has since been considerably refined in negligence law, as we shall see in Chapter 7.

## 1.7 Status of the court

**Not every decision made in every court is binding as a precedent.** The **court's status** has a significant effect on whether its decisions are binding, persuasive or disapproved. The court system in every court hierarchy is different and therefore every hierarchy will have a different 'order of play' for how courts bind each other.

Section 1.1 presented the general rules of precedent. To recap, lower courts must follow decisions of superior courts in the same hierarchy (**binding precedent**); superior courts do not have to follow decisions made in lower courts but can use them to help reach a decision (**persuasive precedent**); decisions made in other court hierarchies can also be used in reaching a decision but are not binding (**persuasive precedent**); and courts are not bound by their own decisions.

This recap demonstrates that the status of each court within a court hierarchy is very important in deciding when it must apply **binding precedent** when making a decision. Court systems such as Singapore and the United Kingdom are relatively straightforward as there is only one court hierarchy in operation.

For example, in the United Kingdom the three lowest level courts are the Magistrates Court, the County Court and the Crown Court. None of these courts can create binding precedent as they are the lowest status courts. All three courts must use the decisions made the High Court, the Court of Appeal, the Supreme Court, and finally the European Court of Justice when applying precedent. They are "bound" by the decisions of these courts. Moving upwards in the hierarchy, the High Court is "bound" by the Court of Appeal, the Supreme Court and the European Court of Justice. The Court of Appeal is bound by the Supreme Court and the European Court of Justice, the Supreme Court is only bound by the European Court of Justice is bound by no other court, not even itself.

The situation in **Australia** is more complex because it is a **federation** of states. This means there are two sets of court hierarchy:

- The **federal** system, which has the Federal Magistrates' Court, then the Family Court of Australia and the Federal Court of Australia, then the High Court of Australia at the top of the hierarchy.
- The systems of the **individual states and territories**, which vary in structure but which typically have Local Courts, then District Courts then a Supreme Court, but which are then subject to the High Court of Australia, at the top of the hierarchy.

Australian courts must follow decisions of **superior courts in the same hierarchy**, which may overturn a decision of a lower court. For example, the Supreme Court of New South Wales is bound – like all Australian courts – by a decision of the High Court of Australia, but not by a decision of the Supreme Court of Victoria.

As a detailed example of the complexities that arise in the federal system, here is the situation in the Australian state of New South Wales.

Students are not expected to memorise this diagram- its purpose is to illustrate the complexity of the court hierarchy. However, an understanding of the court systems/ hierarchy is required.



Court	Bound by	Decisions binding on
<b>NSW Local Court</b>	<ul style="list-style-type: none"> <li>• NSW District Court</li> <li>• NSW Supreme Court</li> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• No-one</li> <li>• Not even on itself</li> </ul>
<b>NSW Coroner's Court</b>	<ul style="list-style-type: none"> <li>• NSW District Court</li> <li>• NSW Supreme Court</li> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• No-one</li> <li>• Not even on itself</li> </ul>
<b>NSW Children's Court</b>	<ul style="list-style-type: none"> <li>• NSW District Court</li> <li>• NSW Supreme Court</li> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• No-one</li> <li>• Not even on itself</li> </ul>
<b>NSW District Court</b>	<ul style="list-style-type: none"> <li>• NSW Supreme Court</li> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• NSW Local Court</li> <li>• NSW Coroner's Court</li> <li>• Children's Court</li> </ul>
<b>NSW Supreme Court (single judge)</b>	<ul style="list-style-type: none"> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• No-one (original jurisdiction only; appeals are heard by the Court of Appeal which is part of the Supreme Court)</li> </ul>
<b>Land and Environment Court</b>	<p>This is a distinct court which hears cases pertaining to land and environment matters.</p> <ul style="list-style-type: none"> <li>• NSW Court of Appeal</li> <li>• High Court</li> </ul>	<ul style="list-style-type: none"> <li>• No-one</li> <li>• Not even on itself</li> </ul>
<b>NSW Court of Appeal</b>	<p>Part of the NSW Supreme Court, but normally has three judges sitting.</p> <ul style="list-style-type: none"> <li>• High Court (partial)</li> <li>• High Court (full court)</li> </ul>	<ul style="list-style-type: none"> <li>• NSW Supreme Court (single judge)</li> <li>• Land and Environment Court</li> <li>• NSW District Court</li> <li>• Itself (except in exceptional cases)</li> </ul>
<b>High Court (partial) Federal court system</b>	<p>Part of the High Court, but has one to three judges presiding.</p> <ul style="list-style-type: none"> <li>• High Court (full court)</li> <li>• Itself (except in exceptional cases)</li> </ul>	<ul style="list-style-type: none"> <li>• All Australian state and federal courts (except the full court of the High Court)</li> <li>• Itself (except in exceptional cases)</li> </ul>
<b>High Court (full court) Federal court system</b>	<ul style="list-style-type: none"> <li>• Itself</li> </ul>	<ul style="list-style-type: none"> <li>• All Australian state and federal courts</li> <li>• Itself</li> </ul>



Question 1: Case law

What do you think are the advantages of case law as a source of law?

(The answer is at the end of the chapter)



Exam comments

Where an earlier decision was made by a lower court, the judges can **overrule** that earlier decision if they disagree with the lower court's statement of the law. **The outcome of the earlier judgment remains the same, but will not be followed in future.**

If the decision of a lower court is **appealed** to a higher one, the higher court may **reverse** the verdict if they feel the lower court has wrongly interpreted the law. **When a decision is reversed on appeal, the higher court is usually also overruling the lower court's statement of the law.**



Question 2: Decisions

The following definitions are types of court decision.

Match each of them to the correct term below:

- (a) A court higher up in the hierarchy overturns the verdict of a lower court in the same case.
  - (b) A principle laid down by a lower court is overturned by a higher court in a different, later case.
  - (c) A judge states that the material facts of the case before him are sufficiently different from those of an earlier case as to enable the application of a different rule of law.
- 
- (1) Distinguishing
  - (2) Overruling
  - (3) Reversing

(The answer is at the end of the chapter)

1.8 The advantages and disadvantages of precedent

Many of the strengths of precedent as the cornerstone of common law also indicate some of its weaknesses.

Factor	Advantage	Disadvantage
Certainty	The law is decided fairly and predictably.  Guidance given to judges and risk of mistake reduced.	Judges may sometimes be forced to make illogical distinctions to avoid an unfair result.
Clarity	Following the reasoning of <i>ratio decidendi</i> should lead to statements of general legal principles.	Sometimes, judgments may appear to be inconsistent with each other or the legal principles followed.
Consistency	The law is applied consistently to different cases on the same issue.	Application of the doctrine of precedent means law can be reactive and slow to change.  Judges often distinguish on the facts to avoid applying precedent.
Flexibility	The system is able to change with changing circumstances.	The system can limit judges' discretion.
Detail	Precedent states how the law applies the facts and should be flexible enough to allow for details to be different.	The detail produces a vast body of reports to take into account.  Judges often distinguish on the facts to avoid a precedent.
Practicality	Case law is based on experience of actual cases brought before the courts. This is an advantage over legislation which can be found wanting when tested.	Unfair precedents may be created that allow wrongdoing to be perpetrated.

## 2 Legislation



### Section overview

- The second major source of law is **legislation**, also known as **statute law**. It may take the form of **primary legislation made by the legislature**, or **subordinated legislation** made under delegated authority given by the primary legislation.

LO  
2.1

Statute law is made by **the legislature** or in exercise of law-making powers delegated by the legislature. Common law systems fall into two types with regard to the relative power of the legislature and the judiciary:

- jurisdictions with **legislative supremacy**, and
- jurisdictions with **judicial review**.

### 2.1 Legislative supremacy

**Legislative supremacy**, or **parliamentary sovereignty**, exists when a country's constitution provides that its legislature is supreme to all other government institutions, including the executive and judiciary, so the legislative body may change or repeal any prior legislative acts. It also means that statute law overrides common law i.e. where a statute is about an area covered by common law, the common law no longer applies. This is the situation in **Australia** and **New Zealand**, and also in the **UK** where the courts may not overturn primary legislation and the Parliament may:

- **Repeal** earlier statutes,
- **Overrule** or modify case law developed in the courts, or
- **Make new law** on subjects which have not been regulated by law before.

In practice, the UK Parliament usually follows certain **conventions** which limit its freedom.

- No Parliament can legislate so as to **prevent** a future Parliament changing the law.
- Judges have to **interpret** statute law and they may find a meaning in it which those who promoted the statute did not intend.
- The **validity** of an Act of Parliament cannot be questioned, although judges may declare an Act to be '**incompatible**' with the European Convention on Human Rights.

The Parliaments of Australia, Singapore and Malaysia all have similar conventions in place as much of the design of their parliamentary systems was drawn directly from the UK's "Westminster" model.

### 2.2 Judicial review

As we saw in Chapter 1, where **judicial review** is an aspect of a country's constitution judges can review legislation to establish whether it conflicts with the country's constitution, and as a result may overturn it. In **Australia** the High Court has this power over laws passed by the Parliament of Australia and the parliaments of the States and territories.

### 2.3 Types of legislation

In addition to making new law and altering existing law, the legislature may make the law clearer by passing a **codifying** statute putting case law on a statutory basis. It may also pass **consolidating** statutes that incorporate an original statute and its successive amendments into a single piece of legislation.

Legislation can also be **categorised** in the following ways:

- **Public Acts:** legislation that affects the **general public**.
- **Private Acts:** legislation that affects **specific individuals and groups**.
- **Enabling legislation that empowers a specific individual or body** to produce the detail required by a parent Act in subordinate legislation.

## 2.4 Legislative procedure

Every country has a different procedure for passing legislation. In **Australia**, for instance, whether the Bill in question is introduced for the whole country in the Federal Parliament or for just one state or territory in the relevant state or territory parliament, it is read and debated in both houses of parliament (or the single house of parliament, in the case of a state such as Queensland which has only one) before it is either rejected, changed, or approved. An approved Bill must then receive the assent of either the Governor (if it is state legislation) or the Governor-General (if it is Federal legislation). Often the authority to create legislation is delegated to local councils, statutory authorities and government departments, in which case it is known as **subordinate** or **delegated legislation**.

## 2.5 Advantages and disadvantages of statute law

Statute law has the following advantages and disadvantages:

(a) **Advantages:**

- The legislature is elected in a parliamentary democracy so the law-making process is theoretically **responsive** to public opinion.
- Statute law can in theory deal with **any** problem and laws can be **made or changed** at any time.
- Statutes may be drafted so that they are **carefully constructed** codes of law.
- A **new problem** in society or some **unwelcome development** in case law can be dealt with by passing an Act of Parliament.
- Statute law applies to **all members** of society.
- Parliaments have access to wide **expertise** so are able to conduct lengthy and wide-reaching research to assist in making decisions about laws.

(b) **Disadvantages:**

- Some statutes can be **bulky**.
- **Parliament** often **lacks time** to consider draft legislation in **sufficient detail** or to assess whether **existing legislation requires change**.
- A substantial statute can take up a lot of **Parliamentary time**.
- Statute law is a statement of general rules. However hard they try, **those who draft it cannot anticipate every individual case** which may arise.
- Laws can be **changed** infinitely leading to high costs, unnecessary changes and confusion.
- Parliaments can sometimes **not be impartial** due to influence by pressure groups, political bias and the beliefs of the government of the day.
- Parliaments can **avoid** making law about a sensitive issue or a new problem in society by simply **ignoring the issue** and not introducing legislation into Parliament. In contrast, a judge cannot choose which cases come before the court so will make new case law and precedent over areas legislation may otherwise not address.

## 2.6 Subordinate legislation

To save time in the main legislature, many Acts contain a section by which power is given to a public body such as a local authority to make **subordinate legislation**. In Australia subordinate bodies include **local councils, government departments, state and federal cabinet** (see below), and **statutory authorities** for example, the Reserve Bank of Australia. The majority of subordinate legislation in Australia is in the form of Regulations made by the relevant government's Cabinet (federal or state) pursuant to powers given to the cabinet in the governing legislation.



## Definition

**Subordinate legislation** are rules of law, often of a detailed nature, that are made by subordinate bodies to whom the power to do so has been given by statute.

### 2.6.1 Advantages and disadvantages

Subordinate legislation has the following **advantages**:

- It **saves time** as the legislature does not have to examine matters of detail.
- Much of the content of subordinate legislation is **technical** and is better worked out in consultation with professional, commercial or industrial groups outside the legislature.
- If new or altered regulations are required later, they can be **issued without referring** back to the legislature.
- The system allows the law to be enacted **quickly** and swiftly, responding to the **needs of the community**.

The **disadvantages** of the system are as follows:

- There are concerns over **accountability** for the law. Persons other than the elected legislature effectively become the source of law rather than members of the legislature whose actions are open to questioning and public scrutiny.
- The system is **unrepresentative** in that some power is given to persons who are not democratically elected.
- Because subordinate legislation can be produced in large **volumes**, and often with little or no **publicity**, ordinary members of the legislature, and the public, find it difficult to keep up to date with developments.
- The different sorts of subordinate legislation which may be produced by virtue of one statute can greatly **confuse** users.

## 3 Statutory interpretation



### Section overview

- Legislation must be **interpreted correctly** before judges can **apply it fairly**. The **literal, golden and mischief rules** of interpretation developed over time. Nowadays a **purposive approach** is taken.

LO  
2.5

Judges are faced with the task of **applying** legislation to the particular case heard before them. To apply the legislation they must first **interpret** and **understand** it. Problems occur when the judge has difficulty interpreting the statute.

There are a number of situations which might lead to a need for statutory interpretation:

- **Ambiguity** might be caused by an error in drafting, or words may have a dual meaning.
- **Uncertainty** may arise where the words of a statute are intended to apply to a range of factual situations and the courts must decide whether the case before them falls into any of these situations.
- There may be **unforeseeable developments**.
- The legislation may use a **broad term**. Therefore, the word 'vehicle' may need to be considered in relation to the use of skateboards or bicycles.

There are a number of different sources of assistance for a judge in the task of statutory interpretation:

- Models and rules,
- Presumptions, and
- Extrinsic aids.

### 3.1 Models of statutory interpretation

In interpreting the words of a statute, courts have developed well-established general rules or models.

#### 3.1.1 The literal rule and golden rule



##### Definitions

The **literal rule** means that words in the Act should be given their literal and grammatical meaning rather than what the judge thinks they mean. It is extended by the **golden rule** which states that words should be given their plain, ordinary or literal meaning unless this would give rise to manifest absurdity – meaning a clearly absurd and unintended result of interpretation – or inconsistency with the rest of the statute.

---

Normally a word should be construed in the **same literal sense** wherever it appears in the statute.



##### Case study

In the English case *Whitely v Chapell 1868 LR 4 QB 147* a statute aimed at preventing electoral malpractice made it an offence to impersonate 'any person entitled to vote' at an election. The accused was acquitted because he impersonated a dead person, who was clearly **not** entitled to vote.

---

#### 3.1.2 The mischief rule



##### Definition

Under the **mischief rule** a judge considers what 'mischief' the Act was intended to prevent. Where a statute is designed to remedy a weakness in the law, the correct interpretation is the one which achieves it.

---

#### 3.1.3 The contextual rule



##### Definition

The **contextual rule** means that a word should be construed in its context: it is permissible to look at the statute as a whole to discover the meaning of a word in it.

---

The 'golden' and 'mischief' rules were used until relatively recently but increasingly courts in common law systems, including **Australia, Canada** and the **US** apply the **purposive model** instead.

#### 3.1.4 The purposive model



##### Definitions

Under the **purposive model** to statutory interpretation, the words of a statute are interpreted not only in their **ordinary, literal** and **grammatical** sense, but also with reference to the **context** and **purpose** of the legislation, i.e. what is the legislation trying to achieve?

---

The key to the purposive model is that the judge construes the statute in such a way as to **be consistent with the purpose of the statute** as he or she understands it, even if the wording of the statute could be applied literally without leading to manifest absurdity.

### 3.2 Rules of statutory interpretation

The following general rules of interpretation have also been developed by the courts:

### 3.2.1 The *eiusdem generis* rule

Statutes often list a number of **specific things** and end the list with more general words. In that case the general words are to be limited in their meaning to other things of the same kind as the specific items which precede them. For instance, an Act about farming that lists 'cows, pigs, sheep and other animals' would probably not be construed as covering pythons as these are 'other animals' but not of the same type as, for example, farm animals.

### 3.2.2 *Expressio unius est exclusio alterius*

To express one thing is by implication to **exclude anything else**.

### 3.2.3 *Noscitur a sociis*

It is presumed that words draw meaning from the **other words around them**. If a statute mentioned 'children's books, children's toys and clothes', it would be reasonable to assume that 'clothes' meant children's clothes.

### 3.2.4 *In pari materia*

If the statute forms part of a **series which deals with similar subject matter**, the court may look to the interpretation of previous statutes on the assumption that the legislature intended the same thing.

## 3.3 Presumptions of statutory interpretation

Unless the statute contains express words to the contrary it is often assumed in common law that the following **presumptions** of statutory interpretation apply, which may be rebutted by contrary evidence:

- **A statute does not alter the existing common law.** If a statute is capable of two interpretations, one involving alteration of the common law and the other one not, the latter interpretation is to be preferred.
- **If a statute deprives a person of their property**, say by nationalisation, they are to be compensated for its value.
- **A statute is not intended to deprive a person of their liberty.** If it does so, clear words must be used. This is relevant in legislation covering, for example, mental health and immigration.
- **A statute does not have retrospective effect** to a date earlier than it becoming law.
- **A statute cannot impose criminal liability** without proof of guilty intention. Many modern statutes rebut this presumption by imposing strict liability, say for dangerous driving.
- **A statute does not repeal other statutes.** Any point on which the statute leaves a gap or omission is outside the scope of the statute.

## 3.4 Extrinsic and intrinsic aids to interpretation



### Definitions

**Extrinsic aids to interpretation** are found outside the Act and the models/rules/presumptions listed above. **Intrinsic aids** are found within the Act in some form.

---

### 3.4.1 The Acts Interpretation Act 1901

The **Acts Interpretation Act 1901** in **Australia** sets out the following **aids** to interpretation:

**Intrinsic aids:**

- Anything that does not actually form part of the Act but that is set out in the document containing the text of the Act as printed by the Government Printer.

#### Extrinsic aids:

- Relevant **reports** of a **Royal Commission, Law Reform Commission**, committee of inquiry or other similar body.
- Relevant reports of a **committee of Parliament**.
- Any **treaty** or other **international agreement** that is referred to in the Act.
- Any **explanatory memorandum** or other relevant document relating to the Bill that was laid before, or furnished to the members of, either House of the Parliament by a **Minister** before the time when the Bill was enacted.
- The **speech** made to a House of the Parliament by a **Minister** when the Bill was proceeding through Parliament.
- Any document that is **declared by the Act itself to be relevant**.
- Any relevant material in the **Journals** of the Senate, in the **Votes and Proceedings** of the House of Representatives or in any **official record of debates** in the Parliament or either House of the Parliament.

In deciding whether particular extrinsic aids are to be used attention is also paid to whether it is desirable for **persons to be able to rely on the ordinary meaning conveyed by the text**, and also to the practical need to **avoid prolonging legal or other proceedings** without compensating advantage.

### 3.4.2 Various State Interpretation Acts

Note that the Federal government **Acts Interpretation Act 1901** relates to the interpretation of Federal legislation only. Equally as important is each Australian state and territory 's separate legislation outlining intrinsic and extrinsic aids to the interpretation of its own legislation. The Victorian **Interpretation of Legislation Act 1984 (Vic)** is one example and contains similar provisions to the Federal Act in relation to referencing relevant reports, committees, other legislation, journals and departmental standards when interpreting legislation.



## Key chapter points

- Case law and precedent
  - Interaction of common law and equity.
  - Doctrine of precedent as a fundamental feature of common law:
    - *Stare decisis*
    - Binding precedent
    - Persuasive precedent.
  - Reading and dissecting law reports.
  - Statements made by judges in a decision:
    - *Ratio decidendi*
    - *Obiter dicta*.
  - Avoiding precedent:
    - Distinguishing
    - Reversing
    - Overruling
    - Disapproving.
  - Different courts have different status for appeals and the application of precedent.
  - Advantages and disadvantages of precedent.
- Legislation
  - Legislative supremacy is where the legislature is supreme to all other institutions (including court and executive).
  - Types of legislation:
    - Public Acts
    - Private Acts
    - Enabling legislation.
  - Subordinate legislation which is made by bodies authorised by the legislature.
  - Advantages and disadvantages of legislation.
- Statutory interpretation
  - Literal rule and golden rule.
  - Mischief rule and contextual rule.
  - The purposive model – used in Australia, Canada and US.
  - Rules and presumptions of statutory interpretation.
  - Extrinsic and intrinsic aids to interpretation (Acts).

# Quick revision questions

1 **Fill in the blanks** in the statements below, using the words in the box.

In order that (1) ..... provides (2) ..... in the law, a precedent must be carefully examined before it can be applied to a particular (3) ..... It must be a statement of (4) ..... The (5) ..... must be identified. The (6) ..... must be the same.

The (7) ..... of the court which set the precedent must be such as to (8) ..... the present court.

• bind	• precedent
• case	• status
• <i>ratio decidendi</i>	• law
• material facts	• consistency

2 *Obiter dicta* form part of the *ratio decidendi*.

true ☐

false ☐

3 In 2010, Mr Justice Jeffries, a judge in the Supreme Court of Victoria, is deciding a case which has similar material facts to one decided by the High Court of Australia in 1980. He can decline to be bound by this decision by showing that:

- A the status of the previous court cannot bind him
- B the decision was taken too long ago to be of any relevance
- C the decision does not accord with the rules of a statute passed in 1990
- D the *obiter dicta* are obscure

4 Overruling a decision of a lower court affects the outcome of that earlier decision.

true ☐

false ☐

5 **Fill in the blank** in the statement below.

The model that a statute should be construed to give effect to the intended outcome of the legislation is known as the ..... model.

## Answers to quick revision questions

- 1 (1) precedent (2) consistency (3) case (4) law (5) *ratio decidendi* (6) material facts (7) status (8) bind
- 2 False. *Obiter dicta* do not form part of the *ratio decidendi*.
- 3 C. A Supreme Court judge in Victoria is bound by decisions of the High Court. In this case the 1990 statute has effectively overruled the previous decision.
- 4 False. The decision in that case will stand, but the principle will not be followed again.
- 5 Purposive model.

## Answers to chapter questions

- 1 The law is decided fairly and **predictably**, so that businessmen and individuals can regulate their conduct by reference to the law. The **risk** of mistakes in individual cases is reduced by the use of **precedents**. Case law can **adapt** to changing circumstances in society, since it arises directly out of the actions of society. Case law, having been developed in **practical** situations, is suitable for use in other practical situations.
- 2
  - (a) (3)
  - (b) (2)
  - (c) (1)

Reversing verdicts occur when a case is appealed. Overruling occurs when a previous precedent is overturned. Distinguishing occurs when the judge distinguishes the facts of the cases from previous cases where precedent may have been applied.



# Chapter 3

## The legal framework

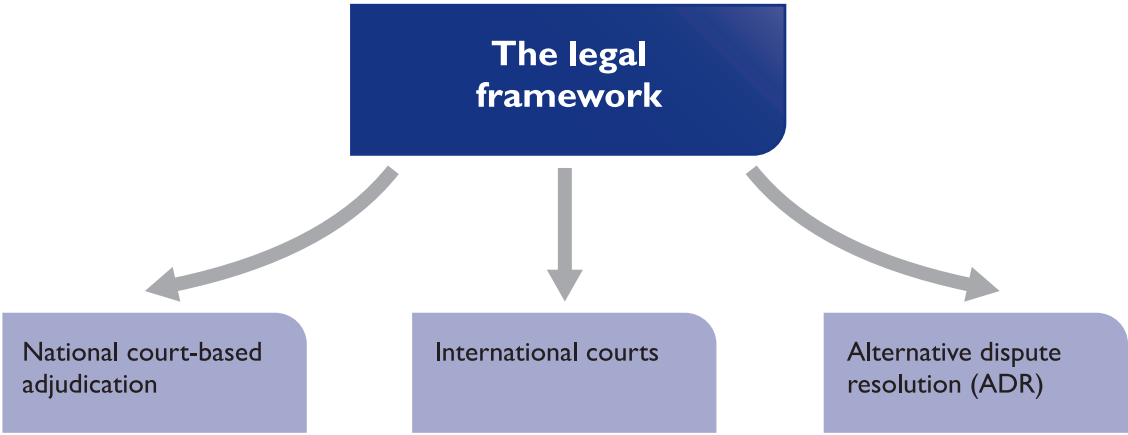
Learning objectives	Reference
<b>Legal framework</b>	<b>LO3</b>
Describe the legal framework of statute law (legislation) and common law	LO3.1
Explain the court system	LO3.2
Explain different methods of alternative dispute resolution	LO3.3

### Topic list

- 1 National court-based adjudication
- 2 Alternative dispute resolution (ADR)
- 3 Role of international courts in trade

# Introduction

We start this chapter with an analysis of court-based adjudication: the criminal and civil court systems, including tribunals. We then examine alternative methods of dispute resolution – conciliation, mediation and arbitration – and the roles of international courts in trade.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 What is the broad structure of the Australian federal and state court system? **(Section 1.1)**
- 2 Briefly describe the court system of the UK **(Section 1.2)**
- 3 Briefly describe the court system of Malaysia **(Section 1.2)**
- 4 List two disadvantages of court-based adjudication. **(Section 1.3)**
- 5 Define alternative dispute resolution. **(Section 2)**
- 6 What is arbitration? **(Section 2.1)**
- 7 What is the role of the International Court of Arbitration? **(Section 2.1.2)**
- 8 Expand the acronym ICJ and list three countries that recognise its jurisdiction. **(Section 3)**

# 1 National court-based adjudication



## Section overview

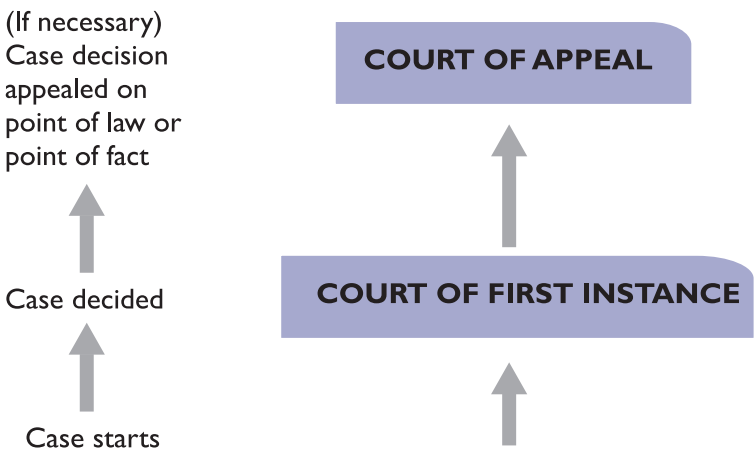
- Court-based adjudication depends on a **system of courts** which settle disputes. A **court of first instance** is a court where a case is heard for the first time. An **appellate court**, or **court of appeal**, is a higher court where the previous decision of a lower court can be re-heard, due to a dispute over a point of law or point of fact in a decided case. **Civil** and **criminal** cases tend to have different court structures and procedures.

LO  
3.1

**Legal disputes**, of whatever nature, have **traditionally** been **settled in courts**. In fact, as we have seen, in the common law system courts have a key role in settling disputes, and in so doing, creating precedent, and therefore creating law.

Most countries have a **system of courts**, with lower level courts for minor matters and higher level courts for more serious matters, and also to hear appeals when court decisions are disputed.

Most legal systems will have a court system that, in its most basic form, resembles the following diagram.



However, in most countries, the court system will be **more complicated** than the one illustrated above. Most countries will have different courts to deal with civil and criminal law, and may also have different courts within those systems to deal with major and minor cases. In addition, in many federal nations, such as **Australia**, there may be one system of courts in a state or territory, and another federal system for the country as a whole. In comparison, **Malaysia** is a federation which operates only one court system that hears cases pertaining to state and federal laws.

Courts may also be characterised by whether they are general or specialist courts, and whether they have a general, or limited, jurisdiction. The number of judges, and the existence of a jury, will differ between those courts as well.

We shall use the **example of the Australian court system** to begin our discussion.

## 1.1 Australian system of courts



## Section overview

- In Australia there are two **different court systems**: the federal system and the system at individual state/territory level, where most criminal cases are dealt with. The highest court in both systems is the Federal **High Court of Australia**.

LO  
3.2

In Australia the first distinction to be made about the court system is between superior and inferior courts:

- **Superior courts** – the Supreme Courts of each state or territory, and the High Court of Australia as a whole – have unlimited jurisdiction by virtue of the constitution of the state/territory/nation to hear disputes in most areas of law. They are the highest courts in their section of the Australian



court hierarchy, with the High Court of Australia having the highest status of all federal and state/territory courts.

- **Inferior courts** have the power to decide on matters which are set out by the relevant state/territory/federal parliament. Appeals about decisions in inferior courts can normally be made to the superior court in that area for example, from a Magistrates' Court to a Supreme Court.

It is also necessary to clearly examine the distinction between federal courts and the state/territory courts.

### 1.1.1 Federal court hierarchy

At the pinnacle of the federal court hierarchy is the **High Court of Australia**, with:

- some **original jurisdiction** over law made by the Federal Parliament of Australia (i.e. some cases which deal only with Federal statutes can be commenced in the High Court itself)
- **appellate jurisdiction over all other courts** (the High Court being the superior court of all federal courts and also the final appeal court from the Supreme Courts of all the states/territories. However, appeals to the High Court are by special leave only, which is rarely granted), and
- the power of **constitutional or judicial review** (i.e. cases dealing with the question of whether a Federal statute is outside the power of the Federal Parliament can be commenced in the High Court).

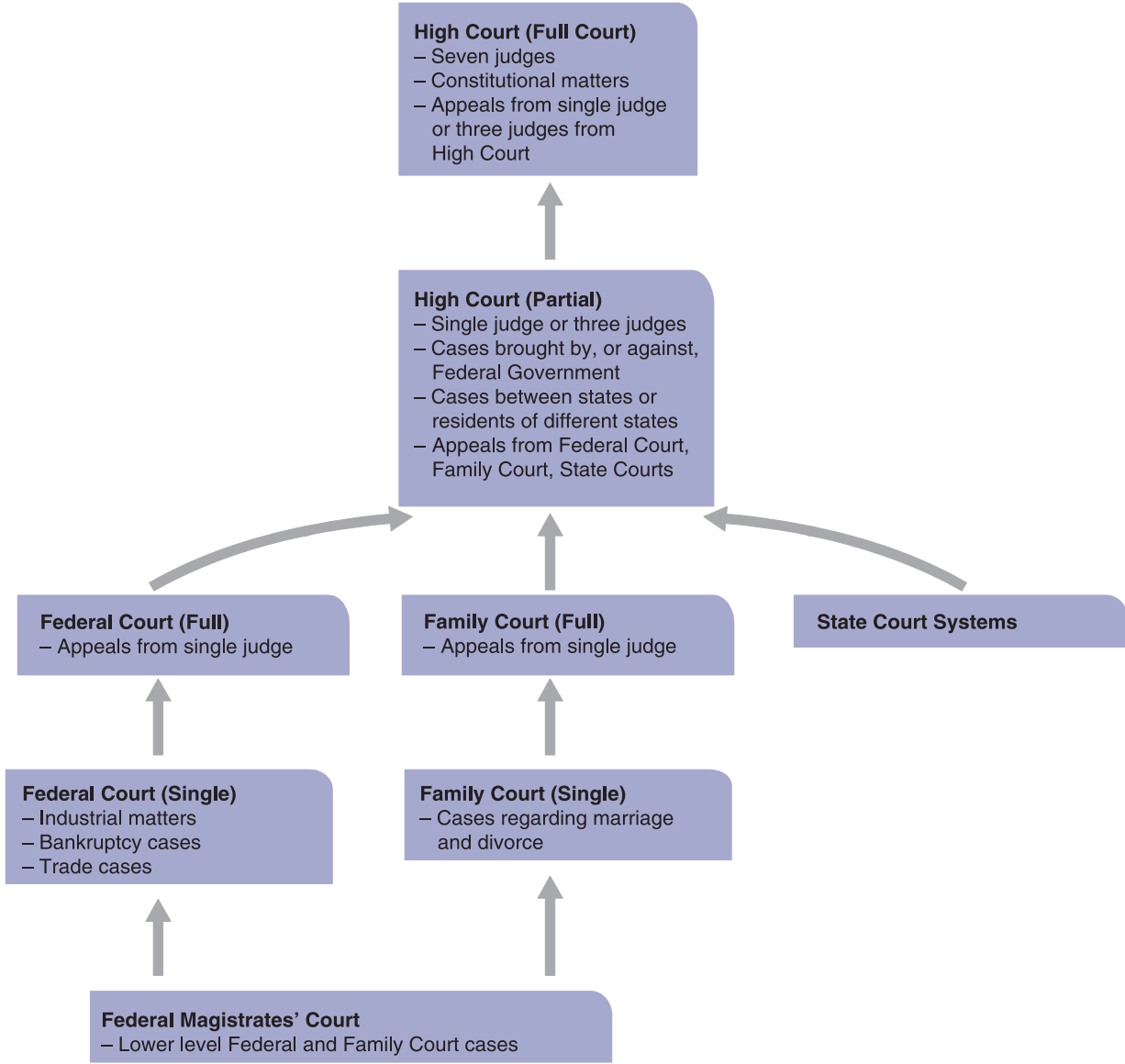
Note that the Full Bench of the High Court of Australia is the highest appeal court. Prior to 1986 appeals could still be taken to England's Privy Council as well as the High Court. This was overruled by the corresponding Australian and UK **Australia Acts 1986**.

Next in the federal hierarchy is the **Federal Court of Australia**. This is a superior court with limited original jurisdiction over civil matters relating to trade practices, industrial relations, bankruptcy, corporations, taxation, customs and immigration. The **Full Court of the Federal Court** is the appeals section and has three to five judges with the power to hear appeals from the Federal Court and a number of other tribunals and other bodies. The Federal Court is bound by decisions of the High Court. Appeals may be made to the High Court if special leave is granted.

The **Family Court** is also a superior court with limited original jurisdiction, namely over family law matters such as parental disputes, matrimonial property, child support and other family-related laws, and it is bound by decisions of the High Court. A single judge of the Family Court may hear appeals in family law matters from the **Federal Magistrates' Court**. Appeals from the Family Court are heard by a **Full Court of the Family Court** which also has three to five judges. Appeals from the Full Court lie with the High Court of Australia, though special leave is required.

The **Federal Magistrates Court of Australia** is an inferior court but it also acts as a 'court of record' in that it can set precedents, in areas in which it shares jurisdiction with the Federal Court or the Family Court. Appeals go to either the Federal Court or the Family Court, depending on the area of law. The Federal Magistrates' Court is bound by decisions of the Full Courts of the Federal and Family Courts.

The diagram below sets out the **federal** court structure in Australia.



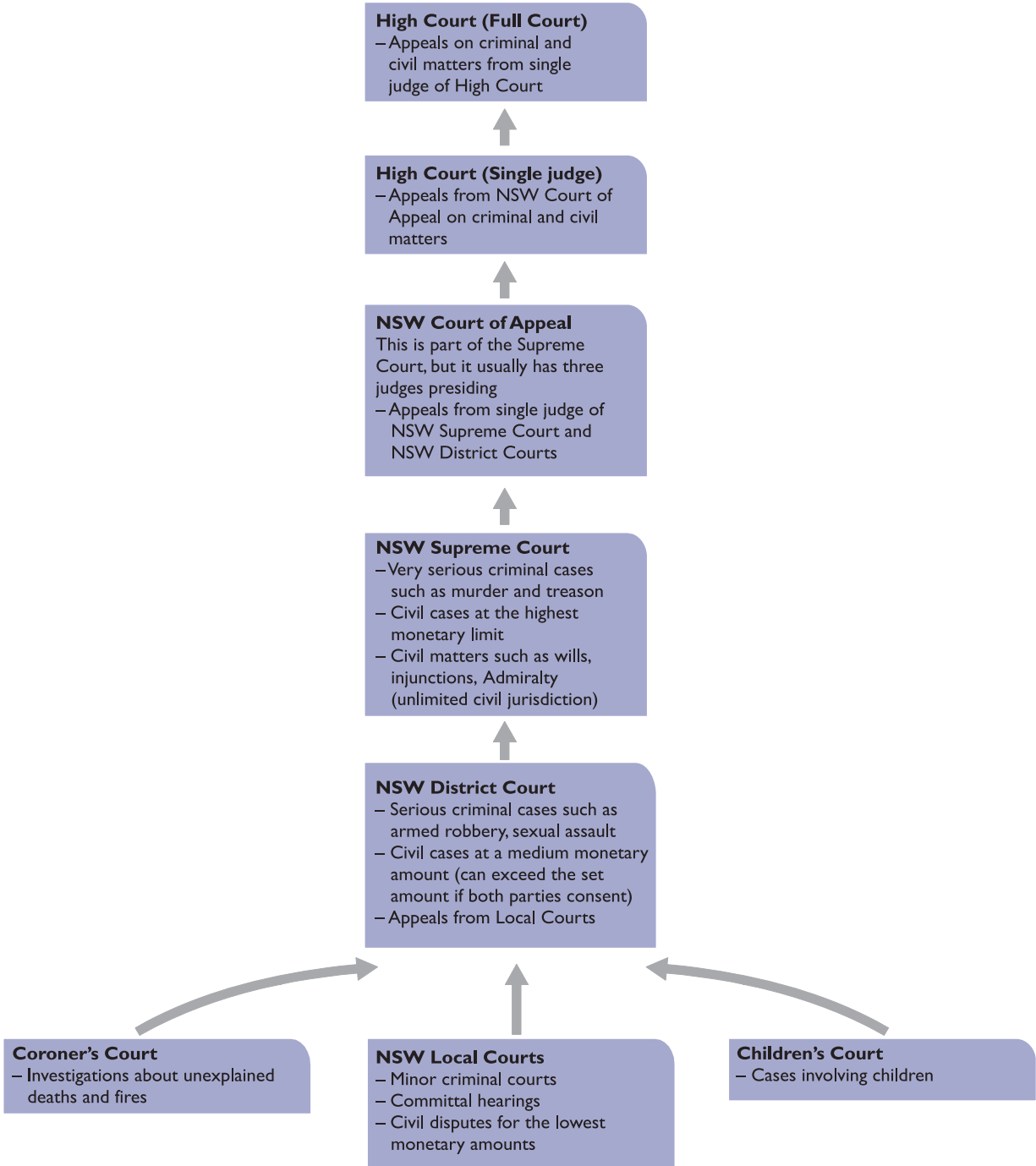
1.1.2 State/territory court hierarchy

Each state and territory in the Commonwealth of Australia has a court hierarchy of its own, the details of which vary from area to area. Most criminal matters, whether arising under federal, state or territory law, are dealt with by state or territory courts. In each case the **Supreme Court** is the highest court within that state or territory and so is the superior court of record. Supreme Courts are bound however by decisions of the High Court of Australia. Supreme Courts have appeal divisions, known as the **Full Court or Court of Appeal of the Supreme Court** in civil matters, or the **Court of Criminal Appeal** in criminal matters.

Most states/territories have two further levels of courts:

- The **District Court** handles most criminal trials for less serious indictable offences, and most civil matters below a set monetary threshold. This amount varies between states/territories.
- The **Magistrates' (or Local) Court** handles summary matters and smaller civil matters. This court may also include subsidiary courts such as the Coroner's Court and the Children's Court.

The diagram below sets out the **state** court structure in New South Wales (NSW), the most populous Australian state.



### Definitions

**Indictable offences** are more serious offences that can only be heard in District Courts or Supreme Courts.

**Summary offences** are minor crimes, only triable summarily in Magistrates' Courts or Local Courts.  
Some offences are '**triable either way**'.

## 1.2 Other court systems

LO  
3.2



### Section overview

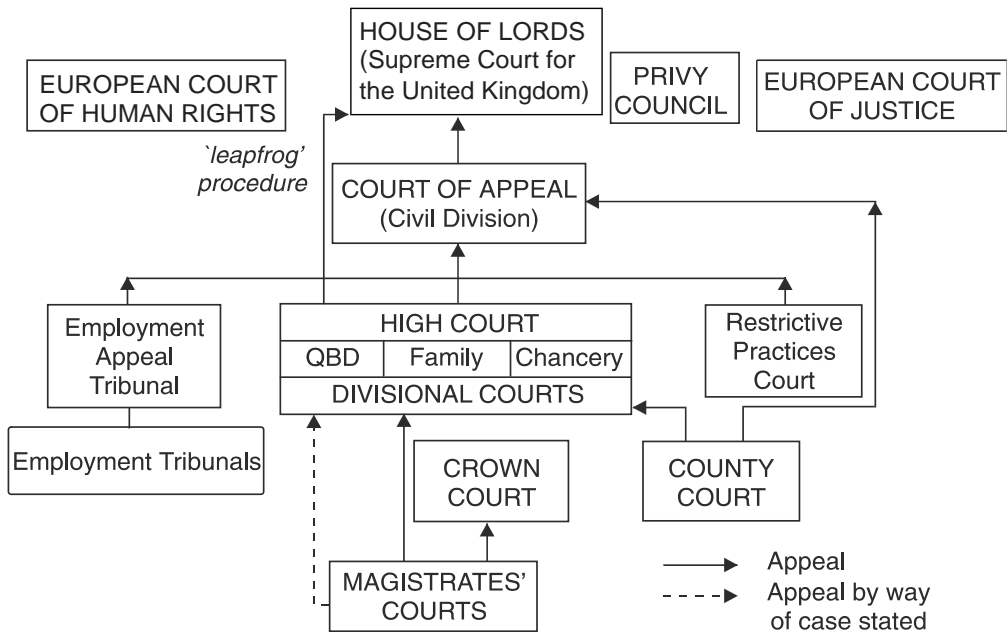
- The court systems of the UK, Singapore and Malaysia are similar to the Australian court system as they are all common law countries.
- In the UK there is a **different court structure** for **civil** and **criminal** law, although some of the higher courts have jurisdiction over both types of law. The **European Court of Justice** is the highest court of appeal.
- In Singapore the **one court system** hears both civil and criminal cases. The **Supreme Court** is the highest court of appeal.
- In Malaysia the **one court system** hears both civil and criminal cases. The **Federal Court** is the highest court of appeal. There is also the system of local village **Penghulu Courts** and the separate Sharia court system (the **Syariah Court**).

### 1.2.1 UK court system

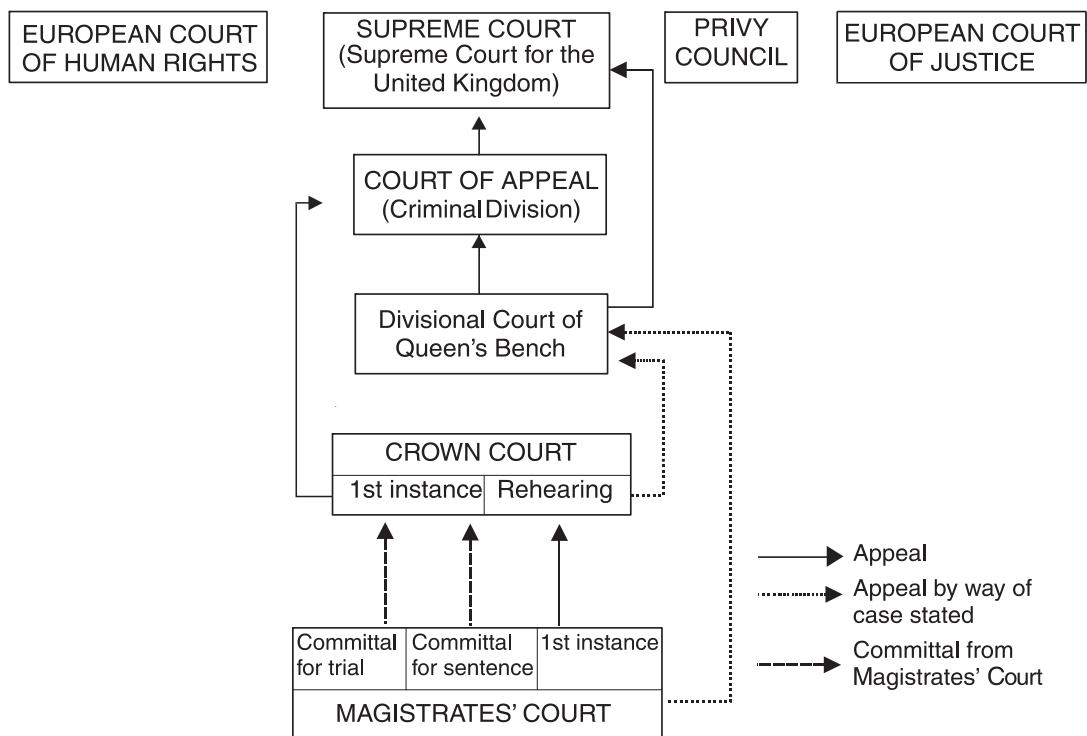
In the UK, there are two different court systems for civil and criminal law, and each court system is **decentralised** through a **system of local courts**, so that matters classified as the least complex and involved or dealing with less serious offences can be dealt with where they have occurred. However, more complex and involved cases dealing with more serious offences are tried in the major courts in the capital city, London.

There is a system of review to higher courts. The English legal system contains a series of **appeal courts**. Cases in either type of law may be appealed up to four times, with the highest court of appeal being the European Court of Justice, due to the UK's membership of the EU.

The diagram below sets out the **civil** court structure for England.



The diagram below sets out the English **criminal** court structure.



### 1.2.2 Singaporean court system

The Singapore Court system consists of two tiers – the subordinate courts (including the District Court and Magistrates Court), and the Supreme Court. The Supreme Court consists of two courts – the High Court and the Court of Appeal. The High Court can hear cases in the first instance (original jurisdiction) as well as appeals from all the subordinate courts. Decisions from the High Court can be appealed to the Court of Appeal which is the highest court in the country. All courts can hear civil and criminal cases.

### 1.2.3 Malaysian court system

Malaysia operates one court system which hears cases relating to both state and federal legislation. Both criminal and civil cases are heard in the same system. The system has two tiers – the subordinate courts (consisting of the Sessions Court and the Magistrates Court) and the superior courts (consisting of the High Court, Court of Appeal and the Federal Court).

Running alongside this court hierarchy is a separate *Syariah Court* system for the application of sharia law. The Syariah Court has jurisdiction over every Muslim in Malaysia, can only hear matters involving Muslims, and has limited jurisdiction (for example, offences for up to three year's imprisonment, a small fine, and/or six strokes of the cane).

The distinct *Penghulu Courts* system are the courts of each Malay village head. Like the Syariah Court, the Penghulu Courts also have limited power and jurisdiction. Each party must be of the Asian race and speak and understand Malay, and the Court can only hear minor civil and criminal cases where the punishment is a small fine. Two states have *Native Courts* instead of *Penghulu Courts* which operate under similar rules.

## 1.3 Advantages and disadvantages of court-based adjudication



### Section overview

- **Court** is generally **expensive** and **slow**, but can offer a wider range of better, more enforceable solutions than alternative dispute resolution.

It is usually more **expensive** to go to court than to submit your case to arbitration, mediation or conciliation, discussed further on. The main reason for this is the cost of legal professionals, and court fees and, in common law systems, the cost of pre-trial disclosure, which can be high.

Another disadvantage is the **time scale** involved. Governments frequently try to make court action more accessible to the public but taking a legal dispute to court can still be a lengthy and very costly business, particularly if the matter is subject to appeal.

A related disadvantage is the **waiting period** before a case comes to trial anyway. This can be substantial due to the large number of cases going through the court system. Combined with often lengthy delays and expense, courts can be a foreign and intimidating environment due to legal procedures and legal language used. This can alienate those unfamiliar with the legal system which may impact upon their ability to settle the dispute.

However, going to court can provide helpful legal **solutions** and settlements, for example, a **court order** to prevent someone from behaving in a certain way, or an order for **compensation**. In some cases, parties may want a **decision** made about which party is legally 'right'.



### Question 1: Summary offences

What is the difference between a summary and an indictable offence?

(The answer is at the end of the chapter)

## 2 Alternative dispute resolution (ADR)

LO  
3.3



### Section overview

- It is increasingly common practice in commercial contracts or agreements to include a clause providing that any dispute between the parties is to be settled by **arbitration**. Arbitration is one example of **alternative dispute resolution** (ADR), which also includes **mediation** and **conciliation**.



### Definition

**Alternative dispute resolution** is any type of procedure or combination of procedures voluntarily used to resolve differences, other than court-based adjudication. ADR procedures may include, but are not limited to, conciliation, facilitation, mediation, early neutral evaluation, adjudication, and arbitration.

### 2.1 Arbitration



#### Definition

**Arbitration** is settlement of a dispute or 'determination' by an independent person, usually chosen by the parties themselves.

Arbitration can produce different solutions from court-based adjudication. For example, it could produce the following results:

- A change in the way a person or organisation behaves.
- A promise that a person or company won't do something.
- An apology.
- An explanation for what happened.
- A mistake corrected.
- Compensation.

An **agreement** between parties to submit any dispute that may arise to **arbitration** is a **contract**, which is subject to the rules of contract law. These rules are discussed in detail in later chapters. Arbitration is founded on the following **principles**:

- The need to obtain a **fair resolution** by means of an independent tribunal without unnecessary delay or expense.
- The fact that **parties are free to agree** how arbitration should work, subject to such safeguards as are necessary to protect the public.
- The fact that **courts should not intervene** except as necessary to protect the public interest.

Although ideally there is no room for courts in a dispute submitted to arbitration, there should still be room for **appeals to courts** if the result is deemed unsatisfactory by either party.

In national law, arbitration is used by bodies such as industrial relations commissions for the settlement of workplace disputes, and companies often choose private arbitration in place of an often lengthy court process. Arbitration is often used in international trade as discussed below.

### 2.1.1 Arbitration in Sharia law

Arbitration in Sharia legal systems is known as **Takhim**. Arbitration is highly recommended in Sharia law.

The law concerning who may be an arbitrator is strict under Sharia law. In particular, the arbitrator must be Muslim, male, just, learned in Sharia and free from any defects that could affect his ability to arbitrate.

### 2.1.2 International commercial arbitration



#### Section overview

- An arbitration is international if the parties have their places of business in **different states** and commercial if it arises from matters of a **commercial nature**, that is, relating to trade.

Parties who engage in trade across national boundaries encounter problems with conflict of laws in a variety of ways. In Chapter 7 of this Study Manual we shall examine:

- Contracts for the **international sale of goods** (including application of UNCISG), and
- Standard terms regarding **international carriage and insurance** (Incoterms).

In this section we shall briefly consider some terms about arbitration that may be incorporated into international commercial contracts. These terms are set out in a **Model Law on International Commercial Arbitration**, created by the UN body, the **United Nations Commission in International Trade Law** (UNCITRAL), and which countries may then voluntarily adopt into their own national laws.

Arbitration is **international** if:

- the parties to the arbitration agreement have their places of business in different states, or if the parties' places of business are in the same state, or
- the place designated for arbitration is in a different state, or the obligations of the commercial relationship are to be performed in a different state.

Arbitration is **commercial** if it covers matters arising from all relationships of a commercial nature, that is, relating to **trade**, whether there is a contract or not. This should be interpreted widely. The Model Law gives the following as examples of commercial transactions:

- |  |  |
|--|--|
| • Supply/exchange of goods and services  | • Engineering                            |
| • Distribution agreement                 | • Licensing                              |
| • Commercial representation              | • Investment                             |
| • Agency                                 | • Financing                              |
| • Factoring                              | • Banking                                |
| • Leasing                                | • Insurance                              |
| • Construction of works                  | • Exploitation agreement or concession   |
| • Consulting                             | • Joint venture                          |
| • Carriage of goods by air/sea/road/rail | • Other industrial/business co-operation |
| • Carriage of passengers by the same     |  |

If a party has **more than one place of business**, the relevant place of business for the purpose of the arbitration agreement is the place with the closest relationship to the arbitration agreement.

The Model Law specifies that **courts shall not intervene** in matters governed by the Model Law, except where stated within the Model Law. Each state that adopts the Model Law should specify a court or other authority within the adopted law which will perform necessary functions if necessary, for example default appointment of arbitrators.

The **International Court of Arbitration (ICA)** is a body that is composed of members from every continent in the world. It has been instrumental in developing the use of international commercial arbitration, which is a useful tool for settling international commercial disputes when parties trade in states where the legal system is very different from their own and legal decisions may not seem fair. In this context the **1958 New York Convention** is important, being a multilateral treaty by which ratifying states agreed to recognise written arbitration agreements and not submit such disputes to national courts. The ICA oversees all aspects of the arbitration process, such as appointment of arbitrators, deciding on challenges to arbitrators, approving arbitral awards and fixing arbitrators' fees.

A separate body, the **International Centre for the Settlement of Investment Disputes**, established by the **1966 Convention on the Settlement of Investment Disputes between States and Nationals of Other States** arbitrates specifically on disputes between member nations and any investors who are nationals of other member countries. Its rules and procedures are similar to that of the ICA.

## 2.2 Mediation and conciliation

**Mediation** is a **facilitative** process that helps parties to reach an agreement and **conciliation** is an **advisory** process which provides advice to the parties as to their best course of action. They both involve the use of an independent third party to assist the parties in coming to their own solution of the problem. These agreements are usually not legally binding on the parties.



### Case study

An example of government-sponsored mediation are the Australian (state of NSW) **Community Justice Centres**, set up to mediate in small disputes between individuals who really want the dispute resolved, such as employer/employee disputes or **simple commercial disputes**. Mediation at such a centre is cheaper and often more satisfying to the parties than court-based adjudication or formal arbitration.

## 2.3 Advantages and disadvantages of alternative dispute resolution

LO  
3.3

A major advantage of ADR is that the parties are involved in choosing the person who is going to settle their dispute. This means that they can gain the services of an **expert** in the particular commercial field that they are in.

It is sometimes argued that ADR is **cheaper** than court action, although this will depend on the practices of the nation that proceedings are being taken in. For example, in **Australia**, the **UK** and **Singapore**, the cost of going to court can be extremely high, mainly due to the high cost of legal representation. It might be cheaper to go to arbitration, where legal representation is not always necessary.

However, in other countries, where the cost of court action is not so high, it might be more expensive to go to arbitration, for example, where the costs of the arbitrator and the venue must be met. In comparison, judges and court costs are shouldered by the State. Although private arbitration may be expensive, it is still often used to avoid the long **delays** in coming to court and the associated rising cost of legal representation.

Another advantage is that ADR is usually **private**, unless the parties want the proceedings to be public. If the dispute is over a commercially-sensitive matter, this may be essential to the parties. Even if the matter is more routine, the parties may not want any publicity about their dispute process. Court proceedings are usually kept on record and are open to the public.

ADR is **informal** and **quicker** than court proceedings.



### 3 Role of international courts in trade



#### Section overview

- **International adjudicators** include **international courts (ICJ)** and international venues for **arbitration (ICA** – see Section 2.1.2 above). They can sort out **conflicts of law** and the **enforcement** of settlements.

When international legal problems need solving, problems can arise due to the issue of **conflicts between the participants' laws** and the problems of **enforcing punishment or settlement** on persons in different countries.

We have discussed some of the solutions to the conflicts of laws problem within this chapter and in Chapters 1 and 2. States may also co-operate with one another for example, by **extraditing** criminals from one country to another.

International adjudication is also important, especially in the promotion and regulation of international trade. The **International Court of Justice (ICJ)** in The Hague, Netherlands is the principal judicial organ of the UN. Because the ICJ cannot hear disputes between individuals, corporations or organizations, it can only settle trade disputes that exist between independent nation-states. This means that most trade disputes are actually heard by the international arbitration bodies (discussed in Section 2.1.2 above) and disputes bodies referred to by international treaties such as the UNSICG (discussed in Chapter 7).

With this proviso, the role of the ICJ is to act as a world court with a dual jurisdiction:

- **Advisory jurisdiction:** to give advisory opinions on legal questions referred to it by authorised UN organs and specialised agencies.
- **Jurisdiction in contentious cases:** to decide legal disputes, which are disagreements on a question of law or fact, a conflict, a clash of legal views or of interests, in accordance with international law, if they are submitted to it by states that are members of the UN. Nearly every country in the world is a member of the UN, which has 192 member states. . However, the ICJ only has compulsory jurisdiction if the states concerned have recognised its jurisdiction, as no state can be a party to proceedings before the ICJ unless it has in some manner or other consented.

A state may manifest its consent or recognition in three ways:

- **Special agreement:** two or more states in a dispute on a specific issue may agree to submit it jointly to the ICJ and conclude an agreement for this purpose.
- **Jurisdictional clause in a Treaty:** over 300 Treaties contain such clauses by which a state party undertakes in advance to accept the jurisdiction of the ICJ should a dispute arise on the interpretation or application of the Treaty with another state party, either immediately or after the failure of other means of settlement such as mediation, conciliation and arbitration.
- **Unilateral declaration:** a state may opt to make a unilateral declaration recognising the ICJ's jurisdiction as binding with respect to any other state which also accepts it as binding. This **optional clause system** has led to the creation of a group of states which have each given the ICJ jurisdiction to settle any dispute that might arise between them in future. In principle, any state in this group is entitled to bring one or more other states in the group before the ICJ. Declarations may contain reservations limiting their duration or excluding certain categories of dispute.
  - **Australia, the UK, Canada, India and Japan** unilaterally recognise the ICJ's compulsory jurisdiction.
  - **Singapore, Malaysia, Brazil, China, and the US** do not recognise the ICJ's compulsory jurisdiction.

The best way to access all UN courts and bodies such as the ICJ and the ICA is to enter the UN parent website at [www.un.org](http://www.un.org) and select International Law. From there you will see the heading International Courts and Tribunals.



## Question 2: Court-based adjudication versus ADR

Company X, a large government service, is having a long running dispute with its delivery staff over the settlement of pay and conditions in the next contract being offered to staff. The union is involved and the delivery staff have threatened to strike if their requests are not met. What is the best dispute resolution alternative in this situation?

**(The answer is at the end of the chapter)**

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## Key chapter points

- National court-based adjudication
  - National legal systems traditionally settled in courts.
  - Summary and indictable offences.
  - Australian court system – civil and criminal; state and federal.
  - English court system – civil and criminal.
  - Singaporean court system – civil and criminal.
  - Malaysian court system – civil and criminal; unified hearing state and federal laws; Penghulu and Syariah courts.
  - Advantages and disadvantages.
- Alternative dispute resolution (ADR)
  - Procedure voluntarily used by the parties to settle disputes rather than using court based adjudication:
  - Three types – arbitration, mediation and conciliation.
  - Arbitration in Sharia law is referred to as Takhim.
  - International commercial arbitration through the UNCITRAL and terms set out in Model Law on International Commercial Arbitration.
- International Court of Arbitration.
  - Advantages and disadvantages.
- Role of international courts in trade
  - International Court of Justice (ICJ) for trade disputes between nation-states.

# Quick revision questions

- 1 The two roles of the International Court of Justice are:
- (1) .....
- (2) .....

- 2 **Fill in the blanks** in the statements below, using the words in the box.
- The distinction between (1) ..... and (2) ..... liability is central to most legal systems.
- (3) ..... allows parties to bring their dispute before a non-legal independent expert so that he may decide the case.

• criminal	• arbitration	• civil
------------	---------------	---------

- 3 The two types of court that can be found in most legal systems are:
- (1) .....
- (2) .....

- 4 **Fill in the blanks** in the sentence below.
- ..... is any type of procedure or combination of procedures ..... used to resolve issues in controversy, other than court-based adjudication.

## Answers to quick revision questions

- 1 The roles of the ICJ:
  - (1) To settle disputes before it in accordance with international law.
  - (2) To provide advice on legal issues put before it by international organisations.
- 2 (1) criminal (2) civil (3) arbitration
- 3 (1) Courts of first instance OR inferior courts  
(2) Appellate courts OR superior courts
- 4 **Alternative dispute resolution** is any type of procedure or combination of procedures **voluntarily** used to resolve issues in controversy, other than court-based adjudication.

## Answers to chapter questions

- 1 Summary offences are usually relatively minor, such as traffic offences or offensive behaviour. They are heard in the Magistrates Court, generally only by a sitting magistrate or judge. An indictable offence is a more serious crime, such as murder or assault, and often heard by a judge and jury.
- 2 A court case will mean the dispute carries on for a long time (several months, if not more), which will impact on the delivery of much-needed services to the community. It will also be extremely expensive for both sides (government and union). In terms of mediation and conciliation, it is likely that these solutions have been tried and that a result was not achieved. It also appears the dispute is now too bitter for mediation. This leaves formal arbitration, which is the best solution in this case. It can either be through a formal industrial relations body or private arbitration.



# Chapter 4

## Formation of contracts

Learning objectives	Reference
<b>Fundamental aspects of contracts and contract law</b>	<b>LO4</b>
Describe the fundamental features and essential requirements (terms) of contracts	LO4.1
Describe the law of contract	LO4.2
Describe the necessary elements in the formulation of a contract	LO4.3

### Topic list

- 1 Definition of contract
- 2 Factors affecting the modern contract
- 3 The essentials of a contract
- 4 Form of a contract
- 5 Offer
- 6 Termination of offer
- 7 Acceptance
- 8 Communication of acceptance
- 9 Consideration
- 10 Adequacy and sufficiency of consideration
- 11 Intention to create legal relations

# Introduction

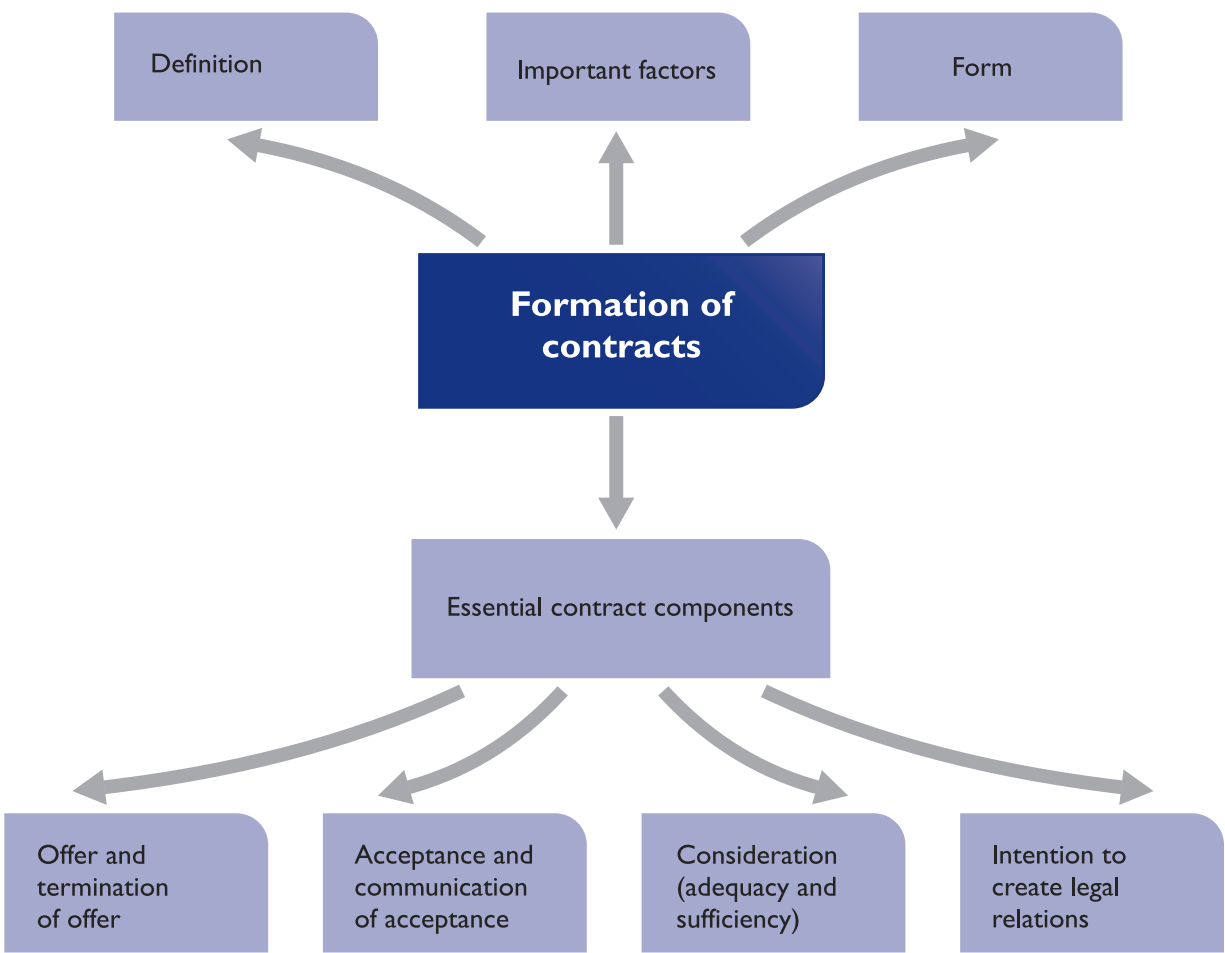
Individuals and businesses form contracts all the time. Despite what many people believe, contracts **do not** all need to be written and signed documents, indeed many valid contracts involve no written or spoken communication at all – for example, where a person buys something from a shop.

This chapter defines a contract, examines the factors influencing the contract, and outlines the form contracts may take. It then introduces the essential elements of a contract which are offer, acceptance, consideration and intention to create legal relations, and the components of a valid contract. It continues by analysing the first requirement for a valid contract – **agreement**, which consists of an **offer** and **acceptance** of the offer.

You must be able to **distinguish offers** from **invitations to treat** and to explain what the consequences of acceptance are. The rules concerning when offers can be **terminated** and how acceptance should be communicated are vital knowledge since exam questions may require you to use them to determine whether or not a valid contract exists.

Consideration is what both parties bring to a contract and the key principle to remember is that it has to be **sufficient** but not necessarily **adequate**.

Agreements between family members are presumed not to have the **intention** of being legally binding, but those between strangers or businesses do have that intention.





## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Define the term 'contract'. **(Section 1)**
- 2 What are the three essential elements of a valid contract? **(Section 3)**
- 3 When does a contract have to be in writing? **(Section 4)**
- 4 What is the legal definition of 'offer' in contract law? **(Section 5)**
- 5 Is an advertisement of goods for sale generally considered a valid contract? **(Section 5.3.2)**
- 6 List two ways a contract can be formally 'accepted'. **(Section 7)**
- 7 What is the 'postal rule'? **(Section 8.4)**
- 8 What is deemed valid consideration? **(Section 9.1)**
- 9 What is sufficient consideration? **(Section 10.2)**
- 10 What is meant by the term 'intention to create legal relations'? **(Section 11)**

# 1 Definition of contract



## Section overview

- A **valid contract** is a **legally binding agreement**, formed by the mutual consent of two parties.

In this chapter we shall cover the basic rules on contract law to be found in common law systems. We shall take the law of **England**, on which is **based the contract law of many common law systems** including that of **Australia, Singapore and Malaysia**, as exemplar. Most of the common law precedents and cases included in this chapter, and in Chapters 5 and 6, are derived from the English common law, however some important Australian cases have been included for illustrative purposes. Full case citations and country of decision (stated as the UK or Aus.) have been listed.



## Definition

A **contract** may be defined as an **agreement which legally binds the parties**. The underlying theory is that a contract is the outcome of 'consenting minds'. However, parties are judged by what they have said, written or done, rather than by what they were actually thinking.

LOs  
4.1  
4.2

# 2 Factors affecting the modern contract



## Section overview

- The law seeks to protect the idea of 'freedom of contract', although **contractual terms** may be regulated by **statute**, particularly where the parties are of unequal bargaining strength.

## 2.1 Inequality of bargaining power

LO  
4.1

Where two parties make an agreement, they invariably have differing levels of **bargaining power**. Many contracts are made between experts and ordinary consumers. The law will intervene **only** where the former takes unfair advantage of their position and not simply because one party was in an inferior bargaining position. **Freedom of contract** is a term sometimes used and can be defined as follows:

'The principle that parties are completely unrestricted in deciding whether or not to enter into an agreement and, if they do so, upon the terms governing that relationship. In practice, this is not always the case because one may be in a much stronger economic position, and legislation has been introduced in order to redress the balance.'

## 2.2 The standard form contract

Mass production and nationalisation have led to the **standard form contract**.



## Definition

The **standard form contract** is a document prepared by many large organisations setting out the terms on which they contract with their customers. The individual must usually take it or leave it. For example, a customer has to accept their supply of electricity on the electricity company's terms – they are not likely to succeed in negotiating special terms, unless they represent a large consumer such as a factory.

## 2.3 Consumer protection

In the second half of the twentieth century, there was a surge of interest in consumer matters. The development of a mass market for complex goods means that the consumer can no longer rely on their own judgment when buying sophisticated goods or services. Consumer interests in Australia are now served by the new national consumer law, the **Australian Consumer Law (ACL)**, which became effective 1 January 2011. This new regime, a schedule to the *Federal Competition and Consumer Act 2010*, has replaced the 13 separate consumer law regimes operating across Australia with one national regime implemented by Federal, state and territory governments and their respective consumer protection agencies.

# 3 The essentials of a contract



## Section overview

- The **three essential elements** of a contract are **offer and acceptance**, **consideration** and **intention to enter into legal relations**.

LOs  
4.1  
4.3

Courts will usually seek out evidence of **three essential elements** in any contract:

- (a) There must be an **agreement** usually made by **offer and acceptance**.
- (b) There must be a bargain by which the obligations assumed by one party are supported by **consideration** (value) given by the other.
- (c) The parties must have an **intention to create legal relations** between themselves.

In **Australia** the contract must be sufficiently **certain and complete** as to allow the parties' rights and obligations to be identified and enforced. An agreement may be **incomplete** because the parties have failed to reach agreement on all of the essential elements, or have decided that an essential matter should be determined by future agreement. It may be **uncertain** because the terms are too vague or ambiguous for a meaning to be attributed by a court. An agreement may in fact be an **illusion** because it is merely an agreement to agree, or because it effectively gives one party an unrestricted discretion as to whether or not to perform the promise they have made.

## 3.1 Validity factors

LO  
4.1

Even if these essential elements can be shown, a contract may not necessarily be valid or may only be partially valid. The validity of a contract may also be affected by any of the following factors:

- (a) **Capacity.** Some persons have restricted capacity to enter into contracts.  
**Minors** cannot enter into contracts for goods other than necessities, nor do they have the capacity to contract for loans.  
Those who lack **mental capacity** or who were **intoxicated** can avoid contracts if they can show they did not understand the nature of their actions and the other party ought to have known about their disability. They still must pay a reasonable price for the goods received.
- (b) **Form.** Some contracts must be made in a particular form.
- (c) **Content.** In general, the parties may enter into a contract on whatever terms they choose. Some terms that the parties do not express may be **implied**, and some terms that the parties do express are **overridden** by statutory rules.
- (d) **Genuine consent.** A mistake or misrepresentation made by one party may affect the validity of a contract. Parties may be induced to enter into a contract by **undue influence** or **duress**.
- (e) **Legality.** The courts will not enforce a contract that is deemed to be illegal or contrary to public policy.

The general case law on contract reflects the tension between, on the one hand, the desire of the courts to hold parties to their bargains in accordance with the principle *pacta sunt servanda* (**agreements must be kept**) and, on the other hand, the **reluctance of the courts to make a bargain for the parties**. The balance in each common law system is different. In **Australia** the courts tend to give priority to the need to uphold agreements, particularly commercial arrangements, while in the UK the courts and the legislature are more willing to intervene in contracts via decisions and statutes.



## Question 1: Essentials of a binding contract

What are the essential elements of a binding contract?

(The answer is at the end of the chapter)

A contract which does not satisfy the relevant tests may be either **void**, **voidable** or **unenforceable**.



### Definitions

A **void contract** is not a contract at all. The parties are not bound by it and if they transfer property under it they can sometimes recover their goods, even from a third party.

A **voidable contract** is a contract which one party may set aside. Property transferred before avoidance is usually irrecoverable from a third party.

An **unenforceable contract** is a valid contract and property transferred under it cannot be recovered even from the other party to the contract. But if either party refuses to perform or to complete their part of the performance of the contract, the other party cannot compel them to do so. A contract is usually unenforceable when the required evidence of its terms, for example, the written evidence of a contract relating to land, is not available.

## 4 Form of a contract



### Section overview

- As a general rule, a **contract may be made in any form**.

**Contracts do not usually have to be in writing** except in the following circumstances:

- Some contracts must be by **deed**.
- Some contracts must be in **writing**.
- Some contracts must be **evidenced in writing**.

### 4.1 Contracts by deed

A contract by deed must be in **writing** and it must be **signed**. Delivery must take place. Delivery is conduct indicating that the person executing the deed intends to be bound by it.

These contracts must be by deed:

- **Leases** for three years or more,
- Any **power of attorney**,
- A **conveyance** or transfer of a legal estate in land (including a mortgage), or
- A promise **not** supported by **consideration** such as a **covenant**, for example, a promise to pay a regular sum to a charity.



### Definition

A **contract by deed** is sometimes referred to as a specialty contract. Any other type of contract may be referred to as a **simple contract**.

### 4.2 Contracts which must be in writing

The following contracts must be in writing and signed by at least one of the parties:

- A **transfer of shares** in a company.
- The sale or disposition of an **interest in land**.
- **Cheques**.

### 4.3 Contracts which must be evidenced in writing

Certain contracts may be made orally, but are not enforceable in a court of law unless there is written evidence of their terms. The most important contract of this type is the **contract of guarantee**.

## 5 Offer



### Section overview

- The first essential element in the formation of a binding contract is **agreement**. This is usually evidenced by **offer and acceptance**. An offer is a definite promise to be bound on specific terms, and must be distinguished from the mere **supply of information** and from an **invitation to treat**.



### Definition

An **offer** is a **definite promise to be bound on specific terms** and may be defined as follows:

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'An express or implied statement of the terms on which the maker is prepared to be contractually bound if it is accepted unconditionally. The offer may be made to one person, to a class of persons or to the world at large, and only the person or one of the persons to whom it is made may accept it.'

A definite offer does not have to be made to a particular person. It may be made to a class of persons or to the world at large. However, it must be distinguished from a statement which supplies information, from a statement of intention, and from an invitation to treat.

*Carlill v Carbolic Smoke Ball Co [1893] 1 QB 256 (UK)*

*The facts:* The manufacturers of a patent medicine published an advertisement by which they undertook to pay '\$100 reward .... to any person who contracts .... influenza .... after having used the smoke ball three times daily for two weeks'. The advertisement added that '\$1 000 had been deposited at a bank 'showing our sincerity in this matter'. The plaintiff read the advertisement, purchased the smoke ball and used it as directed. She contracted influenza and claimed her \$100 reward. In their defence the manufacturers argued against this.

- (a) The offer was so vague that it could not form the basis of a contract, as no time limit was specified.
- (b) It was not an offer which could be accepted since it was offered to the whole world.

*Decision:* The court disagreed.

- (a) The smoke ball must protect the user during the period of use – the offer was not vague.
- (b) Such an offer was possible, as it could be compared to reward cases.

You should note that *Carlill* is an unusual case in that advertisements are not usually regarded as offers, as demonstrated below.

**A statement which is vague** cannot be an offer, but an apparently vague offer can be made certain by reference to previous dealing or customs.

*Gunthing v Lynn [1831] 109 ER 1130 (UK)*

*The facts:* The offeror offered to pay a further sum for a horse if it was 'lucky'.

*Decision:* The offer was too vague and no contract could be formed.

*Hillas & Co Ltd v Arcos Ltd [1932] A11 ER Rep 494 (UK)*

*The facts:* The plaintiffs agreed to purchase from the defendants '22 000 standards of softwood goods of fair specification over the season 1930'. The agreement contained an option to buy a further 100 000 standards

in 1931, without terms as to the kind or size of timber being specified. The 1930 transaction took place, but the sellers refused to supply any wood in 1931, saying that the agreement was too vague.

*Decision:* The missing terms of the agreement could be ascertained by reference to the previous transactions.

The case below is the most cited in Australian contract law and is often classified as important when examining the contractual essentials of offer, acceptance and consideration.

*Australian Woollen Mills Pty Ltd v The Commonwealth [1954] 92 CLR 424 (Aus.)*

*The facts:* The Commonwealth government announced it would pay a subsidy to all manufacturers of wool who purchased and then used the wool for local manufacture. This would apply after 30 June 1946. The plaintiff purchased and used wool for local manufacture between 1946 and 1948. The plaintiff viewed the government's reward scheme as an 'offer' which they 'accepted'. It received some of the subsidies. The government then stopped the scheme. The Plaintiff argued the government was contractually obliged to pay all outstanding subsidies due to its promise; and that it bought the wool in pursuance of this agreement.

*Decision:* There was no contract as the promise made by the government could not be relied on as consideration of doing an act. It was declared that purchasing the wool was a condition allowing access to the subsidy; it was not consideration for a promise by the government to pay the subsidy. In terms of offer and acceptance, the Court established that an offer must induce the party to act in a certain way, and that they must respond to it. It was found that collecting the subsidy was not inducement enough for the purchase of the wool and acceptance of the offer.

## 5.1 Supply of information

Only an offer in the proper sense may be accepted so as to form a binding contract. A statement which sets out possible terms of a contract is not an offer unless this is clearly indicated.

*Harvey v Facey [1893] AC 552 (UK)*

*The facts:* The plaintiff telegraphed to the defendant 'Will you sell us Bumper Hall Pen? Telegraph lowest cash price'. The defendant telegraphed in reply 'Lowest price for Bumper Hall Pen, £900'. The plaintiff telegraphed to accept what he regarded as an offer; the defendant made no further reply.

*Decision:* The defendant's telegram was merely a statement of their minimum price if a sale were to be agreed. It was not an offer which the plaintiff could accept.

If in the course of negotiations for a sale, the vendor states the price at which they will sell, that statement may be an offer which can be accepted.

*Bigg v Boyd Gibbins [1971] 2 All ER 183 (UK)*

*The facts:* In the course of correspondence the defendant rejected an offer of £20 000 by the plaintiff and added 'for a quick sale I would accept £26 000 .... if you are not interested in this price would you please let me know immediately'. The plaintiff accepted this price of £26 000 and the defendant acknowledged their acceptance.

*Decision:* In this context the defendant must be treated as making an offer which the plaintiff had accepted.

## 5.2 A statement of intention

Advertising that an event such as an auction will take place is not an offer to sell. Potential buyers may not sue the auctioneer if the auction does not take place: *Harris v Nickerson [1873] LR 8 QB 286 (UK)*. This is an example of a statement of intention which is not actionable.

## 5.3 An invitation to treat

Where a party is initiating negotiations they are said to have made an invitation to treat. An **invitation to treat** cannot be accepted to form a binding contract. Examples of invitations to treat include:

- **Auction** sales.
- **Advertisements** for example, price lists or newspaper advertisements.
- **Exhibition** of goods for sale.
- An **invitation** for tenders.



### Definition

An **invitation to treat** can be defined as follows:

'An indication that a person is prepared to receive offers with a view to entering into a binding contract, for example, an advertisement of goods for sale or a company prospectus inviting offers for shares. It must be distinguished from an offer which requires only acceptance to conclude the contract.'

Note that on the facts of a particular case, advertisements and other marketing material may be construed as an offer: the Carill case is an example. However, in most exam questions, advertisements are invitations to treat: read the facts of the question carefully.

### 5.3.1 Auction sales

The bid itself is the offer, which the auctioneer is free to accept or reject: *Payne v Cave* [1789] 3 TR 148; 100 502 (UK). An auction is defined as a contract for the sale of property under which offers are made by bidders stating the price at which they are prepared to buy and acceptance takes place by the fall of the auctioneer's hammer.

### 5.3.2 Advertisements

An advertisement of goods for sale is usually an attempt to induce offers.

*Partridge v Crittenden* [1968] 1WLR 1204 (UK)

*The facts:* Mr Partridge placed an advertisement for 'Bramblefinch cocks, bramblefinch hens, 25s each'. The RSPCA brought a prosecution against him for offering for sale a brambling in contravention of the Protection of Birds Act 1954. The justices convicted Partridge and he appealed.

*Decision:* The conviction was quashed. Although there had been a sale in contravention of the Act, the prosecution could not rely on the offence of 'offering for sale', as the advertisement only constituted an invitation to treat.

The circulation of a price list is also an invitation to treat: *Grainger v Gough* [1896] AC 325 (UK), where it was noted:

'The transmission of such a price-list does not amount to an offer.... If it were so, the merchant might find himself involved in any number of contractual obligations to supply wine of a particular description which he would be quite unable to carry out, his stock of wine of that description being necessarily limited'.

### 5.3.3 Exhibition of goods for sale

Displaying goods in a shop window or on the open shelves of a self-service shop or advertising goods for sale, is normally an invitation to treat.

*Fisher v Bell* (1961) 1 QB 394 (UK)

*The facts:* A shopkeeper was prosecuted for offering for sale an offensive weapon by exhibiting a flick knife in his shop window.

*Decision:* The display of an article with a price on it in a shop window is merely an invitation to treat.

*Pharmaceutical Society of Great Britain v Boots Cash Chemists (Southern) [1953] 1 QB 401 (UK)*

*The facts:* Certain drugs could only be sold under the supervision of a registered pharmacist. The plaintiff claimed this rule had been broken by Boots who displayed these drugs in a self-service shop. Boots contended that there was no sale until a customer brought the goods to the cash desk and offered to buy them. A registered pharmacist was stationed at this point.

*Decision:* The court found for Boots and commented that if it were true that a customer accepted an offer to sell by removing goods from the shelf, he could not then change his mind and put them back as this would constitute breach of contract.

### 5.3.4 Invitation for tenders

A **tender** is an estimate submitted in response to a prior request. When a person tenders for a contract they are making an offer to the person who has advertised a contract as being available. An invitation for tenders does not generally amount to an offer to contract with the person quoting the lowest price, except where the person inviting tenders actually makes it clear that they are making an offer.



#### Question 2: Offer

Bianca goes into a shop and sees a price label on a CD for \$5. She takes the CD to the checkout, but the checkout operator tells her that the label is misprinted and should read \$15. Bianca maintains that she only has to pay \$5. How would you describe the price on the price label in terms of contract law?

(The answer is at the end of the chapter)

## 6 Termination of offer

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### Section overview

- An offer may only be accepted while it is still open. In the absence of an acceptance, an offer may be **terminated** in any of the following ways:
  - Rejection.
  - Counter-offer.
  - Lapse of time.
  - Revocation by the offeror.
  - Failure of a condition to which the offer was subject.
  - Death of one of the parties.

### 6.1 Rejection

As noted earlier, outright rejection terminates an offer. A counter-offer, when the person to whom the offer was made proposes new or amended terms, also terminates the original offer.

*Hyde v Wrench [1840] 3 Beav 334; 49 ER 132*

*The facts:* The defendant offered to sell property to the plaintiff for £1 000 on 6 June. Two days later, the plaintiff made a counter-offer of £950 which the defendant rejected on 27 June. The plaintiff then informed the defendant on 29 June that he accepted the original offer of £1 000.

*Decision:* The original offer of £1 000 had been terminated by the counter-offer of £950.

### 6.2 Counter-offer

Acceptance must be **unqualified agreement to the terms of the offer**. A purported acceptance which introduces any new terms is a counter-offer, which has the effect of terminating the original offer.





## Definition

A **counter-offer** is a final rejection of the original offer. If a counter-offer is made, the original offeror may accept it, but if they reject it their original offer is no longer available for acceptance.

A counter-offer may of course be accepted by the original offeror.

*Butler Machine Tool Co v Ex-cell-O Corp (England) [1979] 1 All ER 965 (UK)*

*The facts:* The plaintiff offered to sell tools to the defendant. Their quotation included details of their standard terms. The defendant 'accepted' the offer, enclosing their own standard terms. The plaintiff acknowledged acceptance by returning a tear-off slip from the order form.

*Decision:* The defendant's order was really a counter-offer. The plaintiff had accepted this by returning the tear-off slip.

### 6.2.1 Request for information

It is possible to respond to an offer by making a **request for information**. Such a request may be a request as to whether or not other terms would be acceptable – it is not a counter-offer.

*Stevenson Jaques & Co v McLean [1880] 5 QBD 346 (UK)*

*The facts:* The defendant offered to sell iron at '40s net cash per ton, open till Monday'. The plaintiff enquired whether he would agree to delivery spread over two months. The defendant did not reply and (within the stated time limit), the plaintiff accepted the original offer. Meanwhile the defendant had sold the iron to a third party.

*Decision:* There was a contract since the plaintiff had merely enquired as to a variation of terms.

### 6.3 Lapse of time

An offer may be expressed to last for a **specified time**. If, however, there is no express time limit set, it expires after a **reasonable time**.

*Ramsgate Victoria Hotel Co v Montefiore [1866] LR 1 Ex 109 (UK)*

*The facts:* The defendant applied to the company in June for shares and paid a deposit. At the end of November the company sent him an acceptance by issue of a letter of allotment and requested payment of the balance due. The defendant contended that his offer had expired and could no longer be accepted.

*Decision:* The offer was valid for a reasonable time only and five months was too long.

### 6.4 Revocation of an offer

The offeror may **revoke**, which means to withdraw or remove, their offer at any time before acceptance: *Payne v Cave [1789] 3 TR 148; 100 502 (UK)*. This is the revocation of an offer. If they undertake that their offer shall remain open for acceptance for a specified time they may nonetheless revoke it within that time, unless by a separate contract they have bound themselves to keep it open. This is known as an **option contract**.

*Routledge v Grant [1828] 130 ER 920 (UK)*

*The facts:* The defendant offered to buy the plaintiff's house for a fixed sum, requiring acceptance within six weeks. Within the six weeks specified, he withdrew his offer.

*Decision:* The defendant could revoke his offer at any time before acceptance, even though the time limit had not expired.

Revocation may be an **express statement** or may be an **act** of the offeror. Their revocation does not take effect until the revocation is communicated to the offeree. This raises two important points.

- (a) The first point is that **posting** a letter of revocation is not a sufficient act of revocation.

*Byrne & Co v Van Tienhoven [1880] LR 5 CPD 344 (UK)*

*The facts:* The defendants were in Cardiff; the plaintiffs in New York. The sequence of events was as follows.

1 October	Letter posted in Cardiff, offering to sell 1 000 boxes of tinplates.
8 October	Letter of revocation of offer posted in Cardiff.
11 October	Letter of offer received in New York and telegram of acceptance sent.
15 October	Letter confirming acceptance posted in New York.
20 October	Letter of revocation received in New York. The offeree had meanwhile resold the contract goods.

*Decision:* The letter of revocation could not take effect until received (20 October); it could not revoke the contract made by the telegram acceptance of the offer on 11 October.

- (b) The second point is that **revocation of offer may be communicated by any third party who is a sufficiently reliable informant**.

*Dickinson v Dodds [1876] 2 Ch D 463 (UK)*

*The facts:* The defendant, on 10 June, wrote to the plaintiff to offer property for sale at £800, adding 'this offer to be left open until Friday 12 June, 9.00 am.' On 11 June the defendant sold the property to another buyer, A. B, who had been an intermediary between Dickinson and Dodds, informed Dickinson that the defendant had sold to someone else. On Friday 12 June, before 9.00 am, the plaintiff handed to the defendant a formal letter of acceptance.

*Decision:* The defendant was free to revoke his offer and had done so by sale to a third party; the plaintiff could not accept the offer after he had learnt from a reliable informant of the revocation of the offer to him.

However, this case should be treated with caution and it may be that only an agent can revoke an offer.

## 6.5 Failure of a condition

An offer may be conditional in that it is dependent on some event occurring or there being a change of circumstances. If the condition is not satisfied, the offer is not capable of acceptance.

*Financings Ltd v Stimson [1962] 3 All ER 386 (UK)*

*The facts:* The defendant wished to purchase a car, and on 16 March signed a hire-purchase form. The form, issued by the plaintiffs, stated that the agreement would be binding only upon signature by them. On 20 March the defendant, not satisfied with the car, returned it. On 24 March the car was stolen from the premises of the dealer, and was recovered badly damaged. On 25 March the plaintiffs signed the form. They sued the defendant for breach of contract.

*Decision:* The defendant was not bound to take the car. His signing of the agreement was actually an offer to contract with the plaintiff. There was an implied condition in this offer that the car would be in a reasonable condition.

## 6.6 Termination by death

The **death** of the offeree terminates the offer. The offeror's death terminates the offer, unless the offeree accepts the offer in ignorance of the death, and the offer is not of a personal nature.

*Bradbury v Morgan [1862] 158 ER 877 (UK)*

*The facts:* X offered to guarantee payment by Y in respect of goods to be supplied by the plaintiff. X died and the plaintiff, in ignorance of his death, continued to supply goods to Y. The plaintiff then sued X's executors on the guarantee.

*Decision:* X's offer was a continuing commercial offer which the plaintiff had accepted by supply of goods after X's death. The guarantee stood.

## 7 Acceptance



### Section overview

- **Acceptance** must be an unqualified agreement to all the terms of the offer. **Acceptance** is generally not effective until **communicated** to the offeror, except where the '**postal rule**' applies. In which case acceptance is complete and effective as soon as it is posted.



### Definition

**Acceptance** may be defined as follows:

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'A positive act by a person to whom an offer has been made which, if unconditional, brings a binding contract into effect.'

The contract comes into **effect** once the offeree has **accepted** the terms presented to them. The agreement is now certain; after acceptance, the offeror **cannot withdraw** their offer and both parties will be **bound** by the terms that they have agreed.

Acceptance may be by **express words**, by **action** or **inferred from conduct**.

*Brogden v Metropolitan Railway Co [1877] 2 App Cas 666 (UK)*

*The facts:* For many years the plaintiff supplied coal to the defendant. He suggested that they should enter into a written agreement and the defendant's agent sent a draft to him for consideration. The parties applied to their dealings the terms of the draft agreement, but they never signed a final version. The plaintiff later denied that there was any agreement between him and the defendant.

*Decision:* The conduct of the parties was only explicable on the assumption that they both agreed to the terms of the draft.

### 7.1 Silence

There must be some **act** on the part of the offeree to indicate their acceptance.

*Felthouse v Bindley [1862] 11 CB (NS) 869; 142 ER 1037 (UK)*

*The facts:* The plaintiff wrote to his nephew offering to buy the nephew's horse, adding 'If I hear no more about him, I consider the horse mine'. The nephew intended to accept his uncle's offer but did not reply. He instructed the defendant, an auctioneer, not to sell the horse. Owing to the misunderstanding the horse was sold to someone else. The uncle sued the auctioneer.

*Decision:* The action failed. The plaintiff had no title to the horse.

### 7.2 Acceptance 'subject to contract'

Acceptance '**subject to contract**' means that the offeree is agreeable to the terms of the offer but proposes that the parties should negotiate a formal contract. Neither party is bound until the formal contract is signed. Agreements for the sale of land in England are usually made 'subject to contract'.

Acceptance 'subject to contract' must be distinguished from outright acceptance made on the understanding that the parties wish to replace the preliminary contract with another at a later stage. Even if the immediate contract is described as 'provisional', it takes effect at once.

*Branca v Cobbarro [1947] KB 854; 2 All ER 101 (UK)*

*The facts:* A vendor agreed to sell a mushroom farm under a contract which was declared to be 'a provisional agreement until a fully legalised agreement is signed'.

*Decision:* By the use of the word 'provisional', the parties had intended their agreement to be binding until, by mutual agreement, they made another to replace it.

### 7.3 Acceptance of a tender

As we saw earlier, an invitation for tenders is an invitation to treat. There are two distinct types of tender:

- (a) A tender to perform one task, such as building a new hospital, is an offer which can be accepted.
- (b) A tender to supply or perform a series of things, such as the supply of vegetables daily to a restaurant, is not accepted until an order is placed. It is a standing offer. Each order placed by the offeree is an individual act of acceptance creating a separate contract. Until orders are placed there is no contract and the tenderer can terminate their standing offer.

*Great Northern Railways v Witham [1873] LR 9 CP 16 (UK)*

*The facts:* The defendant tendered successfully for the supply of stores to the plaintiff over a period of one year. In his tender he undertook 'to supply ... such quantities as the company may order from time to time'. After making some deliveries he refused to fulfil an order which the plaintiff had given.

*Decision:* He was in breach of contract in refusing to fulfil the order given but might revoke his tender and need not then fulfil any future orders within the remainder of the 12 month period.

### 7.4 Counter-offers and requests for information

As we saw in Section 6, a counter-offer does not constitute acceptance; it is the making of a new offer which may in turn be accepted or rejected. Nor is a request for further information an acceptance.



#### Question 3: Offer and acceptance

In January Elle offered to buy Jane's boat for \$3 000. Jane immediately wrote a letter to Elle saying 'For a quick sale I would accept \$3 500. If you are not interested please let me know as soon as possible.' Elle did not see the letter until March when she returned from a business trip but then replied. 'I accept your offer. I trust that if I pay \$3 000 now, you can wait until June for the remaining \$500.' On receiving the letter, Jane attached a 'sold' sign to the boat but forgot to reply to Elle. Is there a contract between Elle and Jane? If so, what are its terms?

(The answer is at the end of the chapter)

## 8 Communication of acceptance

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#### Section overview

- The general rule is that acceptance **must be communicated** to the offeror and it is not effective, and there is no contract, until this has been done. However this rule does not apply in all cases.

## 8.1 Waiver of communication

The offeror may **dispense** with the need for communication of acceptance. Such a waiver may be express or may be inferred from the circumstances. In *Carlill v Carbolic Smoke Ball Co* 1893 1 QB 256 (UK), it was held that it was sufficient for the plaintiff to act on the offer without notifying her acceptance of it. This was an example of a **unilateral contract**, where the offer takes the form of a promise to pay money in return for an act.

## 8.2 Prescribed mode of communication

The offeror may call for communication of acceptance by **specified means**. Communication of acceptance by some other means **equally expeditious** generally constitutes a valid acceptance unless specified otherwise: *Tinn v Hoffmann* 1873 29 LT 271 (UK). This would probably apply also to acceptance by fax or e-mail. The offeror must use very precise wording if a specified means of communication is to be treated as mandatory.

*Yates Building Co v R J Pulleyn & Sons (York)* 1975 119 Sol. Jo. 370 (UK)

*The facts:* The offer called for acceptance by registered or recorded delivery letter. The offeree sent an ordinary letter which arrived without delay.

*Decision:* The offeror had suffered no disadvantage and had not stipulated that acceptance must be made in this way only. The acceptance was valid.

## 8.3 No mode of communication prescribed

The offeree can use any method but must ensure that their **acceptance is understood** if they choose an **instantaneous method of communication**.

*Entores v Miles Far Eastern Corporation* [1955] 2 QB 327 (UK)

*The facts:* The plaintiffs sent an offer by telex to the defendants' agent in Amsterdam and the latter sent an acceptance by telex. The plaintiffs alleged breach of contract and wished to serve a writ.

*Decision:* The acceptance took effect and the contract was made when the telex message was printed out on the plaintiffs' terminal in London. A writ could therefore be issued.

## 8.4 The postal rule

The offeror may **expressly** or by **implication** indicate that they expect acceptance by means of a letter sent through the post.



### Definition

The **postal rule** states that, where the use of the post is within the contemplation of both the parties, the acceptance is complete and effective as soon as a letter is posted, even though it may be delayed or even lost altogether in the post.

*Adams v Lindsell* [1818] 106 ER 250; EWHC KB J59 (UK)

*The facts:* The defendants made an offer by letter to the plaintiff on 2 September 1817 requiring an answer 'in course of post'. It reached the plaintiffs on 5 September; they immediately posted a letter of acceptance, which reached the defendants on 9 September. The defendants could have expected a reply by 7 September, and they assumed that the absence of a reply within the expected period indicated non-acceptance and sold the goods to another buyer on 8 September.

*Decision:* The acceptance was made 'in course of post' (no time limit was imposed) and was effective when posted on 5 September.

The **intention** to use the post for communication of acceptance may be deduced from the **circumstances**.

*Household Fire and Carriage Accident Insurance Co v Grant [1879] 4 Ex D 216 (UK)*

*The facts:* The defendant handed a letter of application for shares to the plaintiff company's agent in Swansea for posting to the company in London. The company posted an acceptance which never arrived. The defendant was called upon to pay the amount outstanding on his shares.

*Decision:* The defendant had to pay. The contract had been formed when the acceptance was posted, regardless of the fact that it was lost.

The postal rule **appears** to apply in the following Australian case.

*Bressan v Squires 1974 2 NSWLR 460 (Aus.)*

*The facts:* Squires gave Bressan an option to purchase land. This option could be exercised 'by notice in writing addressed to me [Squires] at any time on or before 20 December, 1972'. Bressan posted a notice on 18 December which exercised the option. This notice was received on 21 December.

*Decision:* On first appearance (*prima facie*) the postal rules applies so the option was deemed as being exercised under this rule. However, in this case, there was further wording in the option that suggested that an actual notice of acceptance was required, so the case ultimately failed.

**Acceptance** of an offer may **only** be made **by a person authorised** to do so. This will usually be the offeree or their authorised agents.

*Powell v Lee [1908] 99 LT 284 (UK)*

*The facts:* The plaintiff was appointed to a post as a headmaster. Without authorisation, he was informed of the appointment by one of the managers. Later, it was decided to give the post to someone else. The plaintiff sued for breach of contract.

*Decision:* Since communication of acceptance was unauthorised, there was no valid agreement and hence no contract.



### Exam comments

Offer and acceptance are key areas of contract law. You must be able to both identify any relevant legal rules and principles, and apply them in the context of the question you are given.



### Question 4: Formation of contract

Frank writes to Xiao-Xiao on 1 July offering to sell him his sailing dinghy for \$1 200. On 8 July, having received no reply, he decides to withdraw this offer and sends a second letter. On 10 July, Xiao-Xiao receives the original offer letter and immediately telephones his acceptance to Frank's wife. He follows this up with a letter posted the same day. Frank's second letter arrives on 14 July and Xiao-Xiao learns that Mel has bought the boat the previous day. What is the legal situation?

## 8.5 Cross-offers

If two offers, identical in terms, cross in the post, there is no contract: *Tinn v Hoffmann 1873 29 LT 271 (UK)*.

For example, if A offers to sell their car to B for \$1 000 and B offers to buy A's car for \$1000, there is no contract, as there is no acceptance.

## 8.6 Unilateral contracts

The question arises as to whether contractual obligations arise if a party, in ignorance of an offer, performs an act which fulfils the terms of the offer. If A offers a **reward** to anyone who finds and returns their lost property and B, in ignorance of the offer, does in fact return it to them, is B entitled to the promised reward? There is agreement by conduct, but B is not accepting A's offer since they are unaware of it.

*R v Clarke [1927] HCA 47 (Aus.)*

*The facts:* A reward was offered for information leading to the arrest and conviction of a murderer. If the information was provided by an accomplice, he would receive a free pardon. C claimed the reward, admitting that he had acted to save his own skin and that all thought of the reward had passed out of his mind.

*Decision:* There could not be acceptance without knowledge of the offer.

However, acceptance may still be **valid** even if the offer was not the sole reason for the action.

*Williams v Carwardine [1833] EWHC KB J44 (UK)*

*The facts:* A reward was offered to bring criminals to book. The plaintiff, an accomplice in the crime, supplied the information, with knowledge of the reward.

*Decision:* As the information was given with knowledge, the acceptance was related to the offer.



### Question 5: Communication of acceptance

John offers to sell his car to Ahmed for \$2 000 on 1 July saying that the offer will stay open for a week. Ahmed tells his brother that he would like to accept the offer. Unknown to Ahmed, his brother informs John of this on 4 July. On 5 July John, with his girlfriend present, sells the car to Gina. John's girlfriend tells Ahmed about this later that day. The next day, Ahmed delivers a letter of acceptance to John. Is John in breach of contract?

(The answer is at the end of the chapter)

As we saw above, *Carlill v Carbolic Smoke Ball Company 1893 1 QB 256 (UK)* is one example of a unilateral contract. Here the defendants advertised that they would pay \$100 to anyone who caught influenza while using their product. This was held to be an offer to the world at large capable of being accepted by anyone fulfilling the necessary conditions. In this instance, it was not possible, but as soon Carlill began to **use** the product, the defendants were bound by their offer.

An ordinary offer can be revoked at any time before complete acceptance and, once revoked, can no longer be accepted (*Routledge v Grant [1828] 130 ER 920 (UK)*). However, in the case of a unilateral contract, the courts have held that an offer cannot be revoked once the offeree has begun to perform whatever act is necessary (*Errington v Errington [1952] 1 KB 290 (UK)*).

## 9 Consideration

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### Section overview

- **Consideration** is an **essential** part of most contracts but is the most difficult to understand. Put simply, it is what each party “brings” to the contract – it is the “price” each party pays or the value given by each party to the contract. Consideration means for the contract to be valid each party must exchange “something for something”



## Definition

**Consideration** has been defined as:

'A valuable consideration in the sense of the law may consist either in some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other.' *From Currie v Misa 1875.*

Put simply, consideration is simply "something for something". Each party must exchange a promise, price or value, which turns an agreement into a valid contract.

Using the language of purchase and sale, it could be said that one party must know that they have bought the other party's **promises** either by performing some act of their own or by offering a promise of their own.

Consideration is an essential requirement of a valid contract in the common law and is what turns a simple agreement into a contract. The requirement for consideration can be avoided if the contract is drafted as a deed.

There is no requirement for consideration in civil law (and other) legal systems.



## Case study

An example of giving consideration by suffering **detriment** is in *Carlill v Carbolic Smoke Ball Co 1 QB 256 (UK)*. Mrs Carlill gave consideration by using the smoke ball as she was instructed. This case is important in Australia in explaining consideration in terms of a bargaining for exchange.

Alternatively, *Australian Woollen Mills Pty Ltd v The Commonwealth [1954] 92 CLR 424 (Aus)* deemed that consideration did not apply as the government's action to pay subsidies could not be deemed a promise to pay the subsidy.

## 9.1 Valid consideration



### Section overview

- Consideration may be **executed** (an act in return for a promise) or **executory** (a promise in return for a promise). It may not be **past**, unless one of three recognised exceptions applies.

There are two broad types of valid consideration – **executed** and **executory**. If consideration is **past** then it is not enforceable.

Executed consideration is **an act in return for a promise**. The consideration for the promise is a performed, or executed, act.



## Case study

A offers a reward for the return of lost property, their promise becomes binding when B performs the act of returning A's property to them. A is not bound to pay anything to anyone until the prescribed act is done. Therefore in *Carlill's* case, the claimant's act, in response to the smoke ball company's promise of reward, was executed consideration.



## Definitions

**Executed consideration** can be defined as follows:

'That which takes place at the present time. Therefore in a contract for the sale of goods, the consideration is executed if the price is paid at the same time that the goods are delivered.'

**Executory consideration is a promise given for a promise**. The consideration in support of each promise is the other promise, not a performed act.





## Case study

If a customer orders goods which a shopkeeper undertakes to obtain from the manufacturer, the shopkeeper promises to supply the goods and the customer promises to accept and pay for them. Neither has yet done anything but each has given a promise to obtain the promise of the other. It would be breach of contract if either withdrew without the consent of the other.



## Definition

**Executory consideration** can be defined as follows:

'That which is to take place at some future time. The consideration for the delivery of goods would be executory if it is a promise to pay at a future date.'

### 9.1.1 Additional rules for valid consideration

As well as being either executed or executory, there are **additional** rules that must be met for consideration to be valid:

- **Performance must be legal**, the courts will not enforce payment for illegal acts.
- **Performance must be possible**, agreeing to perform the impossible is not a basis for a contract.
- **Consideration must pass from the promisee** (privity of contract).
- **Consideration must be sufficient but necessarily adequate** (see Section 10 in this chapter).

The following Australian case provides an interesting insight into consideration for legal/illegal acts.

*Dunton v Dunton [1892] (18 VLR 114 (Aus.))*

*The facts:* Mr Dunton agreed to pay his former wife an allowance on the condition that she behave with 'sobriety, and in a respectable, orderly, and virtuous manner' and promise not to commit an action that made herself or Mr Dunton be subject to 'hate, contempt, or ridicule'.

*Decision:* This was deemed good consideration as the terms of agreement implied a promise by Mrs Dunton. Higginbotham CJ argued that although promising **not** to do something which **cannot be lawfully done** is not good consideration, a promise **not to do something which can be done lawfully** (i.e. behaving 'unrespectably' is a lawful act) is good consideration.

## 9.2 Past consideration



## Definition

**Past consideration** can be defined as follows:

'... something which has already been done at the time the promise is made. An example would be a promise to pay for work already carried out, unless there was an implied promise to pay a reasonable sum before the work began.'

**Anything which has already been done before a promise in return is given is past consideration** which, as a general rule, is not sufficient to make the promise binding. The following is the key case in this area:

*Re McArdle 1951 Ch 669 (UK)*

*The facts:* Under a will the testator's children were entitled to a house after their mother's death. In the mother's lifetime one of the children and his wife lived in the house with the mother. The wife made improvements to the house. The children later agreed in writing to repay the wife 'in consideration of your carrying out certain alterations and improvements'. But at the mother's death they refused to do so.

*Decision:* The work on the house had all been completed before the documents were signed. At the time of the promise the improvements were past consideration and so the promise was not binding.

If there is an **existing contract** and one party makes a further promise, no contract will arise. Even if the promise is directly related to the **previous bargain**, it will be held to have been made upon past consideration.

*Roscorla v Thomas [1842] 3 QB 234; 114 ER 496 (UK)*

*The facts:* The claimant agreed to buy a horse from the defendant at a given price. When negotiations were over and the contract was formed, the defendant told the claimant that the horse was 'sound and free from vice'. The horse turned out to be vicious and the claimant brought an action on the warranty.

*Decision:* The express promise was made after the sale was over and was unsupported by fresh consideration.

When a request is made for a **service** this request may imply a promise to pay for it. If, after the service has been rendered, the person who made the request promises a specific reward, this is treated as fixing the amount to be paid.

*Lampleigh v Braithwaite [1615] Hob 105; 80 ER 255 (UK)*

*The facts:* The defendant had killed a man and had asked the claimant to obtain for him a royal pardon. The claimant did so at his own expense. The defendant then promised to pay him £100. He failed to pay it and was sued.

*Decision:* The defendant's request was regarded as containing an implied promise to pay, and the subsequent promise merely fixed the amount.

Both parties must have assumed during their negotiations that the services were ultimately to be paid for.

*Re Casey's Patents in Stewart v Casey [1892] 1 Ch 104 (UK)*

*The facts:* A and B, joint owners of patent rights, asked their employee, C, as an extra task to find licensees to work the patents. After C had done so, A and B agreed to reward him for his past services with one third of the patent rights. A died and his executors denied that the promise was binding.

*Decision:* The promise to C was binding since it merely fixed the 'reasonable remuneration' which A and B by implication promised to pay before the service was given.



### Question 6: Consideration

Emma, a law student, is in her car, waiting for the traffic lights to change at a busy intersection. Roger steps off the pavement with a bucket and cloth and proceeds to clean the windscreen of her car. Afterwards, Emma tells him that she will pay him \$5. She then drives away. Advise Roger.

(The answer is at the end of the chapter)

## 10 Adequacy and sufficiency of consideration



### Section overview

- The long-established rule is that consideration need **not be adequate** but it **must be sufficient**.

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The court will also seek to ensure that a particular act or promise can actually be deemed to be consideration. Learn these rules:

- Consideration need not be adequate** that is, equal in value to the consideration received in return. There is no remedy at law for someone who simply makes a poor bargain.
- Consideration must be sufficient.** It must be capable in law of being regarded as consideration by the courts.

# 10.1 Adequacy

It is presumed that each party is capable of serving their own interests, and the courts will not seek to weigh up the comparative value of the promises or acts exchanged.

*Thomas v Thomas [1842] 2 QB 851; 114 ER 330 (UK)*

*The facts:* By his will the claimant's husband expressed the wish that his widow should have the use of his house during her life. The defendants, his executors, allowed the widow to occupy the house (a) in accordance with her husband's wishes and (b) in return for her undertaking to pay a rent of £1 per annum. They later said that their promise to let her occupy the house was not supported by consideration.

*Decision:* Compliance with the husband's wishes was not valuable consideration as there no economic value attached to it, but the nominal rent was sufficient consideration.

# 10.2 Sufficiency

Consideration is sufficient if it has some identifiable value. The law only requires an element of bargain, not necessarily that it should be a good bargain.

*Chappell & Co Ltd v Nestle Co Ltd [1960] AC 87 (UK)*

*The facts:* As a sales promotion scheme, the defendant offered to supply a record to anyone who sent in a postal order for 15c and three wrappers from 5c bars of chocolate made by them. The claimants owned the copyright of the tune. They sued for infringement of copyright. In the ensuing dispute over royalties the issue was whether the wrappers, which were thrown away when received, were part of the consideration for the promise to supply the record. The defendants offered to pay a royalty based on the price of 15c per record, but the claimants rejected this, claiming that the wrappers also represented part of the consideration.

*Decision:* The wrappers were part of the consideration as they had commercial value to the defendants.

As stated earlier, forbearance, or the promise of it, may be **sufficient** consideration if it has some value, or amounts to giving up something of value.

*Horton v Horton [1961] 1 QB 215; All ER 649 (UK)*

*The facts:* Under a separation agreement, the defendant agreed to pay his wife (the claimant) £30 per month. Under the deed this amount was a net payment after deduction of income tax; for nine months the husband paid it without any deduction so that the wife had to make the deductions herself. He then signed a document agreeing to pay such amount as 'after the deduction of income tax should amount to the clear sum of £30'. He paid this for three years, then stopped, pleading that the later agreement was not supported by consideration.

*Decision:* The later agreement was supported by consideration: the wife could have sued to have the original agreement rectified, but did not.

## 10.2.1 Performance of existing contractual duties

Performance of an **existing obligation imposed by statute** is no consideration for a promise of reward.

*Collins v Godefroy [1831] 1 B & Ad 950; 109 ER 1040 (UK)*

*The facts:* The claimant had been subpoenaed to give evidence on behalf of the defendant in another case. He alleged that the defendant had promised to pay him six guineas for appearing.

*Decision:* There was no consideration for this promise.

But if some **extra service** is given that is sufficient consideration.

*Glasbrook Bros Ltd v Glamorgan County Council [1925]*

*The facts:* At a time of industrial unrest, colliery owners, rejecting the view of the police that a mobile force was enough, agreed to pay for a special guard on the mine. Later they repudiated liability saying that the police had done no more than perform their public duty of maintaining order, and that no consideration was given.

*Decision:* The police had done more than perform their general duties. The extra services given, beyond what the police in their discretion deemed necessary, were consideration for the promise to pay.

### 10.2.2 Promise of additional reward

If there is already a contract between A and B, and B promises **additional reward** to A if he (A) will perform their existing duties, there is no consideration from A to make that promise binding.

*Stilk v Myrick [1809] 2 Camp 317; 170 ER 1168 (UK)*

*The facts:* Two members of the crew of a ship deserted in a foreign port. The master was unable to recruit substitutes and promised the rest of the crew that they would share the wages of the deserters if they would complete the voyage home short-handed. The shipowners however repudiated the promise.

*Decision:* In performing their existing contractual duties the crew gave no consideration for the promise of extra pay and the promise was not binding.

If a claimant does **more than perform an existing contractual duty** this may amount to consideration.

*Hartley v Ponsonby [1857] 7 E & B 872; 119 ER 1471 (UK)*

*The facts:* 17 men out of a crew of 36 deserted. The remainder were promised an extra £40 each to work the ship to Bombay. The claimant, one of the remaining crew-members, sued to recover this amount.

*Decision:* The large number of desertions made the voyage exceptionally hazardous, and this had the effect of discharging the original contract. The claimant's promise to complete the voyage formed consideration for the promise to pay an additional £40.

*Williams v Roffey Bros & Nicholls (Contractors) Ltd [1991] 1 All ER 512 (UK)*

*The facts:* Roffey Bros was contracted by the Shepherds Bush Housing Association to refurbish 27 flats. Roffey Bros subcontracted the carpenter, Williams, for a total of £20 000 which was to be paid in instalments. Williams completed some of the work and a total of £16 200 was paid. Williams then stopped work as the price was too low to complete the job. Roffey Bros was then going to be liable under a penalty clause for late completion. Williams and Roffey Bros agreed to an extra £575 per flat payable to Williams for on-time completion. Williams completed eight flats and was paid £1,500. He stopped work. New carpenters were engaged. Williams claimed.

*Decision:* Both the original and appeal judgment agreed that Roffey Bros provided good consideration for the new payments even though Williams was conducting a pre-existing duty. Damages were paid to Williams, although not for the full amount.

### 10.2.3 Performance of existing contractual duty to a third party

If A promises B a reward if B will perform their **existing contract** with C, there is consideration for A's promise since they obtain a benefit to which they previously had no right, and B assumes new obligations.

*Shadwell v Shadwell [1860] EWHC CP J88; 9 CB (NS) 159 (UK)*

*The facts:* The claimant, a barrister, was engaged to marry E. His uncle promised the claimant that if he (the nephew) married E (as he did), the uncle would during their joint lives pay to his nephew £150 pa until such time as the nephew was earning £600 pa at the bar (which never transpired). The uncle died after eighteen

years owing six annual payments. The claimant claimed the arrears from his uncle's executors, who denied that there was consideration for the promise.

*Decision:* There was sufficient consideration for the reasons given above.

10.2.4 Waiver of existing rights



Case study

If X owes Y \$100 but Y agrees to accept a lesser sum, say \$80, in full settlement of Y's claim, there is a promise by Y to waive his entitlement to the balance of \$20. The promise, like any other, should be supported by consideration.

The case below is important.

*Foakes v Beer [1884] 9 App Cas 605 (UK)*

*The facts:* The defendant had obtained judgment against the claimant. Judgment debts bear interest from the date of the judgment. By a written agreement the defendant agreed to accept payment by instalments, no mention being made of the interest. Once the claimant had paid the amount of the debt in full, the defendant claimed interest, claiming that the agreement was not supported by consideration.

*Decision:* She was entitled to the debt with interest. No consideration had been given by the claimant for waiver of any part of her rights against him.

There are, however, exceptions to the rule that the debtor (denoted by 'X' in the following paragraphs) must give consideration if the waiver is to be binding.

Exceptions	
<b>Alternative consideration</b>  <i>Anon 1495 (UK)</i> <i>Pinnel's Case 1602 (UK)</i>	If X offers and Y accepts anything to which Y is not already entitled, the extra thing is sufficient consideration for the waiver. <ul style="list-style-type: none"><li>• Goods instead of cash</li><li>• Early payment</li></ul>
<b>Bargain between the creditors</b>  <i>Woods v Roberts 1818 (UK)</i>	If X arranges with creditors that they will each accept part payment in full entitlement, that is bargain between the creditors.  X has given no consideration but they can hold the creditors individually to the agreed terms.
<b>Third party part payment</b>  <i>Welby v Drake 1825 (UK)</i>	If a third party (Z) offers part payment and Y agrees to release X from Y's claim to the balance, Y has received consideration from Z against whom they had no previous claim.

11 Intention to create legal relations



Section overview

- Various cases give us a set of rules to apply when determining whether the **parties** to a contract intended to be **legally bound** by it.

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Where there is no express statement as to whether or not legal relations are intended, the courts apply one of two **rebuttable presumptions** to a case:

- **Social, domestic and family arrangements** are not usually intended to be binding.
- **Commercial agreements** are usually intended by the parties involved to be legally binding.

The word 'presumption' means that it is assumed that something is the case for example, it is presumed that social arrangements are not deemed to be legally binding. 'Rebuttable' means that the presumption can in some cases be refuted, as, for example, in some of the cases described below.



## Definition

**Intention to create legal relations** can be defined as follows:

'An agreement will only become a legally binding contract if the parties intend this to be so. This will be strongly presumed in the case of business agreements but not presumed if the agreement is of a friendly, social or domestic nature.'

## 11.1 Domestic arrangements

### 11.1.1 Husband and wife

The fact that the parties are husband and wife does not mean that they cannot enter into a **binding contract** with one another. Contrast the following two cases.

*Balfour v Balfour* [1919] 2 KB 571 (UK)

*The facts:* The defendant was employed in what is now Sri Lanka. He and his wife returned to the UK on leave but it was agreed that for health reasons she would not return to Sri Lanka with him. He promised to pay her £30 a month as maintenance. Later the marriage ended in divorce and the wife sued for the monthly allowance which the husband no longer paid.

*Decision:* An informal agreement of indefinite duration made between husband and wife whose marriage had not at the time broken up was not intended to be legally binding.

*Merritt v Merritt* [1970] 2 All ER 760 (UK)

*The facts:* The husband had left the matrimonial home, which was owned in the joint names of husband and wife, to live with another woman. The spouses met and held a discussion, in the course of which he agreed to pay her £40 a month out of which she agreed to keep up the mortgage payments. The wife made the husband sign a note of these terms and an undertaking to transfer the house into her name when the mortgage had been paid off. The wife paid off the mortgage but the husband refused to transfer the house to her.

*Decision:* In the circumstances, an intention to create legal relations was to be inferred and the wife could sue for breach of contract.

Where agreements between husband and wife or other relatives relate to **property matters** the courts are very ready to impute an intention to create legal relations.

### 11.1.2 Relatives

Agreements between other family members may also be examined by the courts.

*Jones v Padavatton* [1969] 2 All ER 616 (UK)

*The facts:* The claimant wanted her daughter to move to England to train as a barrister, and offered to pay her a monthly allowance. The daughter did so in 1962. In 1964 the claimant bought a house in London; part of the house was occupied by the daughter and the other part let to tenants whose rent was collected by the daughter for herself. In 1967 the claimant and her daughter quarrelled and the claimant issued a summons claiming possession of the house. The daughter sued for her allowance.

*Decision:* There were two agreements to consider: the daughter's agreement to read for the bar in exchange for a monthly allowance, and the agreement by which the daughter lived in her mother's house and collected the rent from tenants. Neither agreement was intended to create legal relations.

### 11.1.3 Other domestic arrangements

Domestic arrangements extend to those between people who are not related but who have a **close relationship** of some form. The nature of the agreement itself may lead to the conclusion that legal relations were intended.

*Simpkins v Pays [1955] 1 WLR 975 (UK)*

*The facts:* The defendant, her granddaughter and the claimant, a paying boarder, took part together each week in a competition organised by a Sunday newspaper. The arrangements over postage and other expenses were informal and the entries were made in the grandmother's name. One week they won £750; the paying boarder claimed a third share, but the defendant refused to pay on the grounds that there was no intention to create legal relations.

*Decision:* There was a 'mutuality in the arrangements between the parties', amounting to a contract.

## 11.2 Commercial agreements

When business people enter into commercial agreements it is presumed that there is an intention to enter into legal relations unless this is **expressly disclaimed** or the **circumstances indicates otherwise**.

*Rose and Frank Company v JR Crompton & Bros Ltd [1923] 2 KB 261; [1925] AC 445 (UK)*

*The facts:* A commercial agreement by which the defendants appointed the claimant to be its distributor in the USA contained a clause described as 'the Honourable Pledge Clause' which expressly stated that the arrangement was 'not subject to legal jurisdiction' in either country. The defendants terminated the agreement without giving notice as required, and refused to deliver goods ordered by the claimants although they had accepted these orders when placed.

*Decision:* The general agreement was not legally binding as there was no obligation to stand by any clause in it. However, the orders for goods were separate and binding contracts. The claim for damages for breach of the agreement failed, but the claim for damages for non-delivery of goods ordered succeeded.

The words relied on by a party to a commercial agreement in order to show that legal relations are not intended are not always clear. In such cases, the **burden of proof is on the party seeking to escape liability**.

*Edwards v Skyways Ltd [1964] 1 WLR 349 (UK)*

*The facts:* In negotiations over the terms for making the claimant redundant, the defendants gave him the choice either of withdrawing his total contributions from their contributory pension fund or of receiving a paid-up pension. It was agreed that if he chose the first option, the defendants would make an ex gratia payment to him. He chose the first option; his contributions were refunded but the ex gratia payment was not made. He sued for breach of contract.

*Decision:* Although the defendants argued that the use of the phrase ex gratia showed no intention to create legal relations, this was a commercial arrangement and the burden of rebutting the presumption of legal relations had not been discharged by the defendants.

*Air Great Lakes Pty Ltd v KS Easter (Holdings) Pty Ltd [1989] 2 NSWLR 309 (Aus.)* also demonstrates that the burden of proof in commercial contracts lies with the plaintiff, in this instance relating to the validity of the contract document.

*Air Great Lakes Pty Ltd v KS Easter (Holdings) Pty Ltd 1989 Pty Ltd [1989] 2 NSWLR 309 (Aus.)*

*The facts:* Easter entered an agreement with Air Great Lakes to purchase an airline business and an aeroplane. A document was drawn up and signed by both parties. After signature Easter pulled out of the deal (claiming there was no contract) and Air Great Lakes claimed damages for repudiation of the contract.

*Decision:* It was decided by the High Court that intention could be proved, not because of the existence of the signed document, but because of **extrinsic evidence** and assessment of **subjective intention** – namely statements made by both parties about the desire to finalise the agreement.

### 11.3 Transactions binding in honour only

If the parties state that an agreement is '**binding in honour only**', this amounts to an express denial of intention to create legal relations.

*Jones v Vernon's Pools Ltd [1938] 2 All ER 626 (UK)*

*The facts:* The claimant argued that he had sent to the defendant a football pools coupon on which his predictions entitled him to a dividend. The defendants denied having received the coupon. A clause on the coupon stated that the transaction should not 'give rise to any legal relationship ... but ... be binding in honour only'.

*Decision:* This clause was a bar to an action in court.



## Key chapter points

- Definition of contract
  - Legal binding agreement that binds the parties.
- Factors affecting the modern contract
  - Inequality of bargaining power means there must be freedom of contract on both sides.
  - Standard form contracts now often used.
  - Consumer protection measures served by statute and consumer protection agencies.
- The essentials of a contract
  - Three essential elements of a contract:
    - Offer and acceptance.
    - Consideration.
    - Intention to create legal relations.
  - Even if these three components are shown, a contract may still not be valid.
- Form of a contract
  - Contract can take any form.
  - Do not generally have to be in writing.
- Offer
  - Promise to be bound on specific terms.
  - *Carlill v Carbolic Smoke Ball Co [1893] 1 QB 256 (UK)* is an important case establishing offer.
  - A statement that is a supply of information is not an offer.
  - A statement of intention is not a contract.
  - An invitation to treat is not a contract.
- Termination of offer
  - Rejection.
  - Counter-offer.
  - Lapse of time.
  - Revocation by the offeror.
  - Failure of a condition to which the offer was subject.
  - Death of one of the parties.
- Acceptance
  - Unqualified agreement to offer.
  - Acceptance can be subject to contract.
  - A counter-offer does not constitute acceptance.
- Communication of acceptance
  - Generally not effective until communicated to person making the offer.
  - Postal rule may apply.
- Consideration
  - “something for something”.
  - What each party brings to the contract.
  - Valid consideration turns an agreement into a contract.
  - Valid consideration is either executed or executory.
  - Performance must be legal, possible, sufficient and adequate, and privity of contract.
  - Past consideration not sufficient to make a promise binding.

- Adequacy and sufficiency of consideration
  - Consideration need not be adequate.
  - Consideration must be sufficient.
- Intention to create legal relations
  - Contract is only legally binding if parties intend it to be so.
  - Husband and wife can enter into a contract sometimes.
  - Same applies for relatives and other close domestic arrangements.
  - Commercial transactions generally have intention.

# Quick revision questions

- 1 Give the name of a case in which an offer was made to the world at large.
- 2 Give the name of a case where the government’s promise to provide subsidies for wool to manufacturers was not deemed good consideration.
- 3 How is the circulation of a price list categorised in the law of contract?

offer	tender
invitation to treat	auction

- 4 **Fill in the blanks** in the statements below, using the words in the box.

As a general rule, acceptance must be (1) ..... to the (2) ..... and is not effective until this has been done.

An (3) ..... is a definite promise to be bound on specific terms, and must be distinguished from a supply of (4) ..... and from an (5) .....

A counter-offer counts as (6) ..... of the original offer

• information	• offer	• invitation to treat
• rejection	• communicated	• offeror

- 5 Advertising an auction is an offer to sell.

true ☐

false ☐

- 6 As a general rule, silence cannot constitute acceptance.

true ☐

false ☐

- 7 Define the postal rule.

- 8 Give four instances when an offer is terminated.

- 9 **Fill in the blanks** in the statement below

A valid contract is a legally binding agreement. The three essential elements of a contract are (1) ....., (2) ..... and (3) .....

- 10 A voidable contract is not a contract at all.

true ☐

false ☐

- 11 Distinguish between executed and executory consideration.

- 12 Past consideration, as a general rule, is not sufficient to make a promise binding.

true ☐

false ☐

- 13 **Fill in the blanks** in the statement below.

Consideration need not be (1) ..... but it must be (2) .....

## Answers to quick revision questions

- 1 *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256 (UK)
- 2 *Australian Woollen Mills Pty Ltd v The Commonwealth* [1954] 92 CLR 424 (Aus)
- 3 Invitation to treat. *Grainger v Gough* [1896] AC 325 (UK)
- 4 (1) communicated (2) offeror (3) offer (4) information (5) invitation to treat (6) rejection
- 5 False. Advertisements for auctions are not offers to sell.
- 6 True. Generally, silence cannot constitute acceptance.
- 7 The postal rule states that, where the use of the post is within the contemplation of both the parties, the acceptance is complete and effective as soon as a letter is posted, even though it may be delayed or even lost altogether in the post.
- 8 Any four of the following:  
Rejection.  
Counter-offer.  
Lapse of time.  
Revocation by the offeror.  
Failure of a condition to which the offer was subject.  
Death of one of the parties.
- 9 (1) offer and acceptance (agreement) (2) consideration (3) intention to create legal relations.
- 10 False. Voidable contracts may be cancelled by one party if they choose to. They may continue as a valid contract if the affected party chooses to.
- 11 Executed consideration is an act in return for a promise such as paying for goods when the shopkeeper hands them over. Executory consideration is a promise given for a promise, such as promising to pay for goods that the shopkeeper puts on order for you.
- 12 True. Past consideration is not valid consideration for a new contract.
- 13 (1) adequate, (2) sufficient

## Answers to chapter questions

- 1 There must be an intention to create legal relations. There must be an agreement made by offer and acceptance. There must be consideration.
- 2 Display of goods for sale with a price label is an invitation to treat: *Fisher v Bell* 1961 1 QB 394 (UK), that is an invitation to the customer to make an offer which the shop can either accept or reject. But note that it can be a criminal offence to mislabel goods in this way.
- 3 Elle's offer of \$3000 is an **offer**. Many offers are in fact made by prospective purchasers rather than by vendors. Jane's letter forms a **counter-offer**, and this has the effect of terminating Elle's offer: *Hyde v Wrench* [1840] 3 Beav 334; 49 ER 132. Elle may now accept or reject this counter-offer.  
  
There is nothing to indicate that Jane's (counter) offer is not still open in March. An offer may be expressed to last for a **specified time**. It then expires at the end of that time. If, however, there is no express time limit set, it expires after a **reasonable time**.  
  
Elle's reply, using the words 'I accept your offer' **appear conclusive. However they are not**. The enquiry for variation of terms does not constitute acceptance or rejection:  
  
*Stevenson Jaques & Co v McLean* [1880] 5 QBD 346 (UK). The effect of Elle's reply is probably best analysed as being a **new counter-offer** including terms as to deferred payment, which **Jane purports to accept by affixing a 'sold' sign**. The court would need to decide whether, in all the circumstances, acceptance can be deemed to have been communicated.  
  
Following *Butler Machine Tool Co v Ex-Cell-O Corp (England)* [1979] 1 All ER 965 (UK), the **counter-offer introduces new terms**, that is, price. The price is therefore \$3500. As to **date of payment**, it would appear that the attachment of a 'sold' sign to the boat is confirmation that the revised terms proposed by Jane are acceptable.
- 4 The revocation takes effect when received on 14 July: *Byrne v Van Tienhoven* 1850 [1880] LR 5 CPD 344 (UK). The acceptance by Xiao-Xiao takes effect when posted on 10 July: *Adams v Lindsell* [1818] 106 ER 250; *EWHC KB J59* (UK). Therefore a contract is formed on 10 July and Frank's sale of the dinghy to Mel is in breach of his contract with Xiao-Xiao.
- 5 Communication of acceptance may only be made by a person authorised to do so: *Powell v Lee* 1908 [1908] 99 LT 284 (UK), therefore Ahmed's brother's purported acceptance is not valid. Revocation of an offer may be communicated by a reliable informant: *Dickinson v Dodds* 1876 [1876] 2 Ch D 463 (UK), so Ahmed is made aware of the revocation on 5 July. His attempted acceptance on 6 July is therefore not valid.  
  
As there was no consideration to support any separate agreement to keep the offer open for a week, John is free to sell the car to Gina.
- 6 Emma is not bound to pay the \$5, because at the time the promise was made, Roger's actions were past consideration.





# Chapter 5

## Contractual terms

Learning objectives	Reference
<b>Fundamental aspects of contracts and contract law</b>	<b>LO4</b>
Explain the importance of conditions and essential terms of contracts	LO4.4
Identify the nature and status of pre-contract representations	LO4.5
Explain the effect of valid exclusion clauses	LO4.6

### Topic list

- 1 Contract terms
- 2 Express terms and implied terms
- 3 Conditions and warranties
- 4 Exclusion clauses

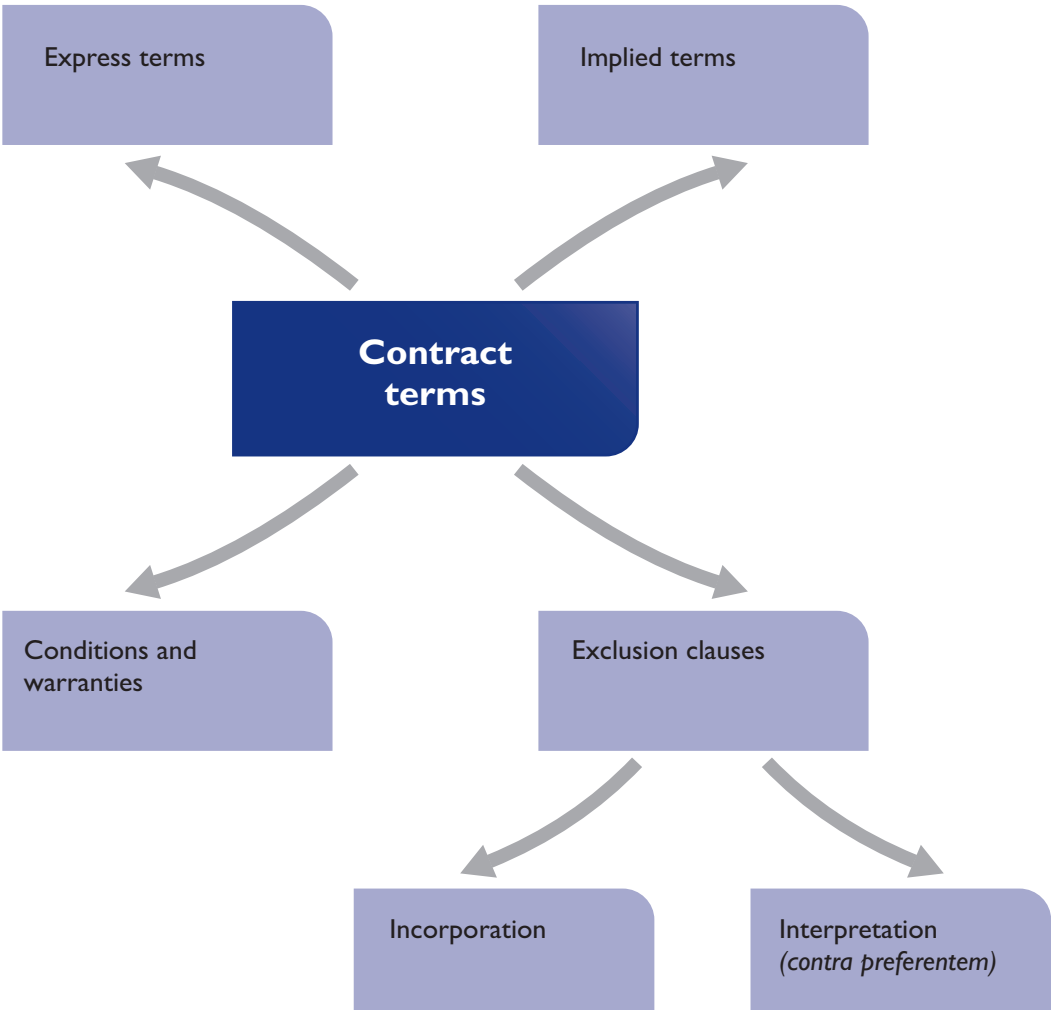
# Introduction

This chapter analyses the contents of a contract, specifically the different types of **contract terms**.

You must be clear as to what **express terms** are and be able to distinguish them from mere **representations**. It is also important that you understand how terms can be **implied** into contracts and whether or not terms are **conditions** or **warranties**.

Once you have grasped these subjects you will be able to determine whether or not an organisation or individual has **breached** the terms of the contract and determine any liability.

We complete the chapter by looking at **exclusion clauses**. You must be familiar with such clauses.





## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Define 'express' term in the context of contract law. (Section 2.1)
- 2 Define 'implied' term in the context of contract law. (Section 2.2)
- 3 Can terms be implied through legislation? (Section 2.2.2)
- 4 What is generally deemed a condition of the contract? (Section 3)
- 5 What is generally deemed a warranty of the contract? (Section 3)
- 6 How do the Australian courts generally view exclusion clauses? (Section 4)
- 7 What is the *contra proferentem* rule? (Section 4.2)

# 1 Contract terms



## Section overview

- Statements made by the parties may be classified as **terms or representations**. Different **remedies** attach to breach of a term and to misrepresentation respectively.

In addition to the final contract, many statements may be made during the process of negotiation that often lead to the formation of a contract. It is important to be able to establish whether what has been written or said actually amounts to a contract term or whether it is simply a representation. **Statements may be classified as terms or as representations.**



## Definition

A **representation** is something which induces the formation of a contract but which does not become a **term** of the contract. The importance of the distinction is that different remedies are available depending on whether a term is broken or a representation turns out to be untrue.

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If something said in negotiations proves to be untrue, the party misled can claim for **breach of contract** if the statement became a **term** of the contract. If the pre-contract statement was merely a **representation** then the party misled can claim misrepresentation, resulting in a lesser remedy than for breach of contract. There are a number of factors that a court may consider when determining whether a statement is or is not a term.

The court will consider **when** the representation was made to assess whether it was designed as a contract term or merely as an incidental statement. The court will also examine the **importance** the recipient of the information attached to it.

*Ellul and Ellul v Oakes [1972] 2 SASR 377 (Aus.)*

*The facts:* The purchaser of a new home claimed damages for the cost of connecting the house to the sewer mains. They argued that the booklet which was provided on the selling of the house stated that the house was connected to the sewer mains; when in fact the house only had a septic tank.

*Decision:* The court said that the representation made in the booklet was in fact a warranty which was intended as a term of the contract.

*Bannerman v White [1861] 10 CB(NS) 844; 142 ER 685 (UK)*

*The facts:* In negotiations for the sale of hops the buyer emphasised that it was **essential** to him that the hops should not have been treated with sulphur adding that, if they had, he would not even bother to ask the price. The seller replied explicitly that no sulphur had been used. It was later discovered that a small proportion of the hops (5 acres out of 300) had been treated with sulphur. The buyer refused to pay the price.

*Decision:* The representation as to the absence of sulphur was intended to be a **term** of the contract.

*Routledge v McKay [1954] 1 WLR 615 (UK)*

*The facts:* The defendant, in discussing the possible sale of his motorcycle to the plaintiff, said on 23 October that the cycle was a 1942 model; he took this information from the registration document. On 30 October the parties made a written contract which did not refer to the year of the model and the purchaser had not indicated that the age of the cycle was of critical importance to him. The actual date was 1930.

*Decision:* The buyer's claim for damages failed. The reference to a 1942 model was a **representation made prior** to the contract.

If the statement is made by a person with **special knowledge** it is more likely to be treated as a contract term.

*Dick Bentley Productions v Harold Smith (Motors) Ltd [1965] 1 WLR 623 (UK)*

*The facts:* The defendants sold the plaintiffs a car which they stated to have done only 20 000 miles since a replacement engine and gear-box had been fitted. In fact the car had covered 100 000 miles since then and was unsatisfactory.

*Decision:* The defendants' statement was a term of the contract and the plaintiffs were entitled to damages.

*Oscar Chess Ltd v Williams [1957] 1 WLR 370 (UK)*

*The facts:* The defendant, when selling his car to the plaintiff car dealers, stated (as the registration book showed) that his car was a 1948 model and the dealers valued it at \$280 in the transaction. In fact it was a 1939 model, worth only \$175, and the registration book had been altered by a previous owner.

*Decision:* The statement was a mere representation. The seller was not an expert and the buyer had better means of discovering the truth.

## 2 Express terms and implied terms



### Section overview

- As a general rule, the parties to a contract may include in the agreement whatever **terms** they choose. This is the principle of **freedom of contract**. Terms clearly included in the contract are **express terms**. The law may complement or replace terms by **implying** terms into a contract.

### 2.1 Express terms



#### Definition

An **express term** is a term expressly agreed by the parties to a contract to be a term of that contract. In examining a contract, the courts will look first at the terms expressly agreed by the parties

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An apparently binding legal agreement must be **complete in its terms** to be a valid contract.

*Scammell & Nephew Ltd v Ouston [1941] AC 251 (UK)*

*The facts:* The defendants wished to buy a motor-van from the plaintiffs on hire-purchase. They placed an order 'on the understanding that the balance of purchase price can be had on hire-purchase terms over a period of two years'. The hire-purchase terms were never specified.

*Decision:* The court was unable to identify a contract which it could uphold because the language used was so vague.

It is always possible for the parties to leave an essential term to be **settled by other means** for example, by an independent third party.



#### Case study

It may be agreed to sell at the open market price on the day of delivery, or to invite an arbitrator to determine a fair price. The price may be determined by the course of dealing between the parties.

Where an agreement appears vague or incomplete, the courts will seek to uphold it by looking at the **intention of the parties**: *Hillas & Co Ltd v Arcos Ltd [1932] All ER Rep 494 (UK)*. If the parties use standard printed conditions, some of which are inappropriate, such phrases may be disregarded.

*Nicolene v Simmonds [1953] 1 QB 543 (UK)*

*The facts:* The plaintiff offered to buy steel bars from the defendant. A contract was made by correspondence, in which the defendant provided that 'the usual conditions of acceptance apply'. The defendant failed to deliver the goods and argued that there had been no explicit agreement.

*Decision:* The words should be disregarded. The contract was complete without these words; there were no usual conditions of acceptance.

## 2.2 Implied terms



### Section overview

- Terms may be implied by the **courts**, by **statute** or by **custom**.

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There are occasions where terms are not **expressly** adopted by the parties. Additional terms of a contract may be **implied** by law: through custom, statute or the courts, to bring efficacy to the contract. Implied terms may override express terms in certain circumstances such as where they are implied by statute.



### Definition

An **implied term** can be defined as follows:

'A term deemed to form part of a contract even though not expressly mentioned. Some such terms may be implied by the courts as necessary to give effect to the presumed intentions of the parties. Other terms may be implied by statute, e.g. the terms contained in **Australian Consumer Law** (discussed in more detail in section 2.2.2 below).

### 2.2.1 Terms implied by custom

The parties may enter into a contract subject to **customs** of their trade. Any express term overrides a term which might be implied by custom.

*Hutton v Warren [1836] 1 M & W 466; 150 ER 517 (UK)*

*The facts:* The defendant landlord gave the plaintiff, a tenant farmer, notice to quit the farm. He insisted that the tenant should continue to farm the land during the period of notice. The tenant asked for 'a fair allowance' for seeds and labour from which he received no benefit because he was to leave the farm.

*Decision:* By custom he was bound to farm the land until the end of the tenancy; but he was also entitled to a fair allowance for seeds and labour incurred.

*Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Aust) Ltd [1986] 160 CLR 226 (Aus.)*

*The facts:* Con-Stan engaged an insurance broker to obtain insurance. They paid the premiums to the broker, who did not pass on their premium payments to the insurer (Norwich). The broker's business then failed and Norwich claimed it was still owed the premiums by Con-Stan. Con-Stan's argument was that it was **custom** in the insurance industry that brokers were responsible for payment of insured premiums on to the insurer. It said that their payments to the broker therefore effectively discharged their obligation to pay the premiums.

*Decision:* The Court found against Con-Stan saying that the rule of custom was not successful. It could not be 100% established that it was custom for the broker to always discharge the insured's responsibility in the industry as a whole and sometimes insurance companies still look to the insured directly, even if a broker were involved.

*Les Affreteurs v Walford [1919] AC 801 (UK)*

*The facts:* A charter of a ship provided expressly for a 3% commission payment to be made 'on signing the charter'. There was a trade custom that it should only be paid at a later stage. The ship was requisitioned by the French government and so no hire was earned.

*Decision:* An express term prevails over a term otherwise implied by custom. The commission was payable on hire.

## 2.2.2 Terms implied by statute

Terms may be implied by statute. In some cases the statute permits the parties to contract out of the **statutory terms**. In other cases the statutory terms are obligatory. Under **Australian Consumer Law**:

- Terms are implied relating to fitness and duty to take reasonable care in some classes of contract, and these cannot be displaced by contrary intention: that is, the term will be implied into a contract of that kind irrespective of the parties' intention.
- A corporation or person can be sued where they have engaged in misleading or deceptive conduct regarding commercial or trade matters.

Businesses can be sued (in business to business or business to consumer contracts) where there has been **unconscionable conduct**, which is unfair, unreasonable, harsh or oppressive conduct in business transactions that goes against good conscience. Section 21 of the Australian Consumer Law lists the items the courts may consider when determining whether unconscionable conduct has occurred – although the court is free to include any factors it thinks are relevant. These include:

- The relative bargaining strengths of the business and the consumer,
- Whether the business required the consumer to comply with conditions that were not reasonably necessary to protect the legitimate interests of the business,
- Whether the consumer understood any documentation that may have been used,
- Whether the business used undue influence, pressure, or unfair tactics, or
- The price and terms on which the consumer could have acquired the same or equivalent goods elsewhere.

## 2.2.3 Terms implied by the courts

Terms may be implied if the court concludes that the parties intended those terms to apply to the contract.

*The 'Moorcock' [1889] 14 PD 64 (UK)*

*The facts:* The owners of a wharf agreed that a ship should be moored alongside to unload its cargo. It was well known that at low water the ship would ground on the mud at the bottom. At ebb tide the ship settled on a ridge concealed beneath the mud and suffered damage.

*Decision:* It was an implied term, though not expressed, that the ground alongside the wharf was safe at low tide since both parties knew that the ship must rest on it.

A term of a contract which is left to be implied and is not expressed is often something that goes without saying; so that, if while the parties were making their bargain an officious bystander were to suggest some express provision for it, they would say 'why should we put that in? That's obvious': This was put forward in *Shirlaw v Southern Foundries [1940] AC 701 (UK)* The terms are required to give **efficacy** to the contract, that is, to make it work in practice.

The court may also imply terms because the court believes such a term to be a 'necessary incident' of this type of contract.

*Liverpool City Council v Irwin [1977] AC 239 (UK)*

*The facts:* The defendants were tenants in a tower block owned by the plaintiffs. There was no formal tenancy agreement. The defendants withheld rent, alleging that the plaintiffs had breached implied terms because *inter alia* the lifts did not work and the stairs were unfit.

*Decision:* Tenants could only occupy the building with access to stairs and/or lifts, so terms needed to be implied on these matters.

Where a term is implied as a 'necessary incident' it has precedent value and such terms will be implied into future contracts of the same type.

## 3 Conditions and warranties



### Section overview

- Statements which are classified as contract terms may be further categorised as **conditions** or **warranties**. A **condition** is a vital term going to the **root** of the **contract**, while a **warranty** is a term **subsidiary** to the main purpose of the **contract**. The remedies available for breach are different in each case.

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The terms of the contract are usually classified by their relative importance as **conditions** or **warranties**:

- A condition is a vital term**, going to the root of the contract, breach of which entitles the injured party to decide to treat the contract as **discharged** and to claim damages.
- A warranty is a term subsidiary to the main purpose of the contract**, breach of which only entitles the injured party to claim damages.



### Definitions

A **condition** can be defined as follows:

'An important term which is vital to a contract in so much that its breach will destroy the basis of the agreement. It may arise from an express agreement between the parties or may be implied by law.'

A **warranty** can be defined as follows:

'A minor term in a contract. If broken, the injured party must continue performance but may claim damages for the loss suffered.'

*Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd [1938] 61 CLR 28 (Aus.)*

*The facts:* The funfair, Luna Park, had a contract to advertise on Sydney trams. The contract said the board advertising Luna Park would be 'on the tracks at least eight hours a day throughout the season'. Evidence found that the boards were in fact on the tracks for an average of eight hours a day, but each board was not actually necessarily on the tracks for eight hours a day.

The argument centred on two points: 1) whether this was a breach, and 2) if yes, if it were a breach of condition which justified termination.

*Decision:* It was decided this was a breach of condition and that termination of the contract was justified.

*Poussard v Spiers [1876] 1 QBD 410 (UK)*

*The facts:* Mme Poussard agreed to sing in an opera throughout a series of performances. Owing to illness she was unable to appear on the opening night and the next few days. The producer engaged a substitute who insisted that she should be engaged for the whole run. When Mme Poussard recovered, the producer declined to accept her services for the remaining performances.

*Decision:* Failure to sing on the opening night was a breach of condition which entitled the producer to treat the contract for the remaining performances as discharged.

*Bettini v Gye [1876] 1 QBD 183 (UK)*

*The facts:* An opera singer was engaged for a series of performances under a contract by which he had to be in London for rehearsals six days before the opening performance. Owing to illness he did not arrive until the third day before the opening. The defendant refused to accept his services, treating the contract as discharged.

*Decision:* The rehearsal clause was subsidiary to the main purpose of the contract.

*Schuler v Wickman Machine Tool Sales 1973 UKHL 2; AC 235 (UK)*

*The facts:* The plaintiffs entered into a contract with the defendants giving them the sole right to sell panel presses in England. A clause of the contract provided that the defendants' representative should visit six named firms each week to solicit orders. The defendants' representative failed on a few occasions to do so and the plaintiffs claimed to be entitled to repudiate the agreement.

*Decision:* Such minor breaches by the defendants did not entitle the plaintiffs to repudiate.

Classification may depend on the following issues:

- (a) **Statute** often identifies implied terms specifically as conditions or warranties. The **Australian Consumer Law**, applicable to all Australian governments (federal, state and territory) implies conditions and warranties relating to merchantable quality of goods, although these statutory terms can often be displaced by the express contrary intention of the parties.
- (b) **Case law** may also define particular types of clauses as conditions, for example a clause as to the date of 'expected readiness' of a ship let to a charterer: *The Mihalis Angelos [1971] 1 QB 164 (UK)*.
- (c) The court may construe what was the **intention of the parties** at the time the contract was made as to whether a broken term was to be a condition or a warranty: *Bunge Corporation v Tradax SA [1981] UKHL 11 (UK)*.

It is important to remember that if the injured party merely wants damages, there is **no** need to consider whether the term broken is a condition or a warranty, since either type of breach entitles the injured party to damages. We shall discuss damages in more detail in Chapter 6.



### Question 1: Conditions and warranties

Norma, a professional singer, enters into a contract to sing throughout a series of concerts. A term in the contract states that she must attend five rehearsals before the opening night. Norma falls ill and misses the last two rehearsals and the opening night. Is she in breach of contract? Give reasons.

(The answer is at the end of the chapter)

## 4 Exclusion clauses



### Section overview

- An **exclusion clause** may attempt to restrict one party's liability for breach of contract or for negligence.

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To be enforceable, a term must be validly incorporated into a contract. Because most disputes about whether a term has been incorporated arise in the context of exclusion clauses, much of the relevant case law surrounds exclusion clauses. In this section, we will examine the ways in which the courts may determine:

- (a) Whether an exclusion clause (as a contract term) has been **validly incorporated** into the contract, and
- (b) If so, how the exclusion clause should be **interpreted**.



## Definition

An **exclusion clause** can be defined as follows:

'A clause in a contract which purports to exclude liability altogether or to restrict it by limiting damages or by imposing other onerous conditions. They are sometimes referred to as **exemption clauses**.'

There has been strong criticism of the use of exclusion clauses in contracts made between manufacturers or sellers of goods or services and private citizens as consumers. The seller puts forward standard conditions of sale which the buyer may not understand, but which he must accept if he wishes to buy. With these so-called **standard form contracts**, the presence of exclusion clauses becomes an important consideration.

For many years **Australian** court systems have demonstrated some hostility by the common law to exclusion clauses by developing various rules of case law designed to restrain their effect. In Australia this is particularly the case in relation to exclusion clauses in contracts with consumers for goods and services but less so in purely commercial contracts, where the courts give primacy to upholding agreements. The UK court system has also demonstrated a similar attitude towards exclusion clauses.

Courts generally seek to protect consumers from the harsher effects of exclusion clauses in two ways:

- (a) Exclusion clauses must be **incorporated** into a contract before they have legal effect.
- (b) Exclusion clauses are **interpreted** strictly and narrowly. This may prevent the application of the clause.

## 4.1 Incorporation of exclusion clauses



### Section overview

- The courts protect customers from the harsher effects of exclusion clauses by ensuring that they are properly **incorporated** into a contract and then by **interpreting** them strictly.

The law seeks to protect customers (usually the weaker party to the contract) from the full force of exclusion clauses. They do this by applying the '**letter of the law**' to ascertain whether such clauses have been incorporated correctly. Where there is uncertainty the clauses may be excluded from the contract.

Such uncertainty can arise in several circumstances:

- The document containing notice of the clause must be an **integral part** of the contract.
- If the document is an integral part of the contract, a term may not usually be disputed if it is included in a document which a party has **signed**.
- The term must be put forward **before** the contract is made.
- If the contract is not signed, an exclusion clause is not a binding term unless the person whose rights it restricts was made **sufficiently aware** of it at the time of agreeing to it.
- **Onerous terms** must be sufficiently highlighted (it is doubtful whether this applies to signed contracts).

*Thompson v London Midland & Scottish Railway Co [1930] 1 KB 40 (UK)*

*The facts:* An elderly lady who could not read asked her niece to buy her a railway excursion ticket on which was printed 'Excursion: for conditions see back'. On the back it was stated that the ticket was issued subject to conditions contained in the company's timetables. These conditions excluded liability for injury.

*Decision:* The conditions had been adequately communicated and therefore had been accepted.

### 4.1.1 Contractual documents

Where the exclusion clause is contained in an unsigned document it must be shown that this document is an integral part of the contract and is one which could be expected to contain terms.



*Chapelton v Barry UDC 1940 1 KB 532 (UK)*

*The facts:* There was a pile of deck chairs and a notice stating 'Hire of chairs 2d per session of three hours'. The plaintiff took two chairs, paid for them and received two tickets which were headed 'receipt' which he put in his pocket. One of the chairs collapsed and he was injured. The defendant council relied on a notice on the back of the tickets by which it disclaimed liability for injury.

*Decision:* The notice advertising chairs for hire gave no warning of limiting conditions and it was not reasonable to communicate them on a receipt. The disclaimer of liability was not binding on the plaintiff.

#### 4.1.2 Signed contracts

If a person **signs** a document containing a term, he is held to have agreed to the term even if he had not read the document. But this is not so if the party who puts forward the document for signature gives a misleading explanation of the term's legal effect.

*L'Estrange v Graucob (F) Ltd [1934] 2 KB 394 (UK)*

*The facts:* The defendant sold to the plaintiff, a shopkeeper, a slot machine under conditions which excluded the plaintiff's normal rights under the Sale of Goods Act 1893 (UK). The plaintiff signed the document described as a 'Sales Agreement' and including clauses in 'legible, but regrettably small print'.

*Decision:* The conditions were binding on the plaintiff since she had signed them. It was not material that the defendant had given her no information of their terms nor called her attention to them.

*Curtis v Chemical Cleaning & Dyeing Co [1952] 1 KB 805*

*The facts:* The plaintiff took her wedding dress to be cleaned. She was asked to sign a receipt on which there were conditions that restricted the cleaner's liability and in particular placed on the plaintiff the risk of damage to beads and sequins on the dress. The document in fact contained a clause 'that the company is not liable for any damage however caused'. The dress was badly stained in the course of cleaning.

*Decision:* The cleaners could not rely on their disclaimer since they had misled the plaintiff. She was entitled to assume that she was running the risk of damage to beads and sequins only.

#### 4.1.3 Unsigned contracts and notices

Each party must be aware of the contract's terms before or **at the time of entering into the agreement** if they are to be binding.

*Olley v Marlborough Court Ltd (1949) 1 KB 532*

*The facts:* A husband and wife arrived at a hotel and paid for a room in advance. On reaching their bedroom they saw a notice on the wall by which the hotel disclaimed liability for loss of valuables unless handed to the management for safe keeping. The wife locked the room and handed the key in at the reception desk. A thief obtained the key and stole the wife's furs from the bedroom.

*Decision:* The hotel could not rely on the notice disclaiming liability since the contract had been made previously and the disclaimer was too late.

Complications can arise when it is difficult to determine at exactly **what point in time** the contract is formed so as to determine whether or not a term is validly included.

*Thornton v Shoe Lane Parking Ltd [1971] 2 QB 116 (UK)*

*The facts:* The plaintiff wished to park his car in the defendant's automatic car park. He had seen a sign saying 'All cars parked at owner's risk' outside the car park and when he received his ticket he saw that it contained words which he did not read. In fact these made the contract subject to conditions displayed obscurely on the premises. These not only disclaimed liability for damage but also excluded liability for injury. When he returned to collect his car there was an accident in which he was badly injured.

*Decision:* The reference on the ticket to conditions was received too late for the conditions to be included as contractual terms. At any rate, it was unreasonable for a term disclaiming liability for personal injury to be presented so obscurely. Note that since the Unfair Contracts Terms Act 1977 (UK) the personal injury clause would be unenforceable anyway.

An exception to the rule that there should be prior notice of the terms is where the parties have had **consistent dealings** with each other in the past, and the documents used then contained similar terms.

*J Spurling Ltd v Bradshaw [1956] 1 WLR 461 (UK)*

*The facts:* Having dealt with a company of warehousemen for many years, the defendant gave it eight barrels of orange juice for storage. A document he received a few days later acknowledged receipt and contained a clause excluding liability for damage caused by negligence. When he collected the barrels they were empty and he refused to pay.

*Decision:* It was a valid clause as it had also been present in the course of previous dealings, even though he had never read it.

If the parties have had previous dealings (but not on a consistent basis), then the person to be bound by the term must be **sufficiently aware** of it at the time of making the latest contract.

*Hollier v Rambler Motors [1972] 2 QB 71 (UK)*

*The facts:* On three or four occasions over a period of five years the plaintiff had had repairs done at a garage. On each occasion he had signed a form by which the garage disclaimed liability for damage caused by fire to customers' cars. The car was damaged by fire caused by negligence of garage employees. The garage contended that the disclaimer had by course of dealing become an established term of any contract made between them and the plaintiff.

*Decision:* The garage was liable. There was no evidence to show that the plaintiff knew of and agreed to the condition as a continuing term of his contracts with the garage.

#### 4.1.4 Onerous terms

Where a term is particularly unusual and onerous it should be highlighted (although it is doubtful whether this applies to signed contracts). Failure to do so may mean that it does not become incorporated into the contract.

*Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd [1988] 2 WLR 615 (UK)*

*The facts:* 47 photographic transparencies were delivered to the defendant together with a delivery note with conditions on the back. Included in small type was a clause stating that for every day late each transparency was held a 'holding fee' of £5 plus VAT (the UK sales tax) would be charged. They were returned 14 days late. The plaintiffs sued for the full amount.

*Decision:* The term was onerous and had not been sufficiently brought to the attention of the defendant. The court reduced the fee to one tenth of the contractual figure to reflect more fairly the loss caused to the plaintiffs by the delay.



#### Question 2: Exclusion clause

Natasha hires a car from a car rental company. On arrival at their office she is given a form, which includes terms and conditions in small print on the back, and asked to sign it. She does so and pays the hire charge. When she gets into the car, she happens to look in the glove compartment and sees a document headed 'Limitation of Liability'. This states that the hire company will not be liable for any injury caused by a defect in the car unless this is as a result of the company's negligence. While Natasha is driving on the motorway, the airbag inflates and causes her to crash. She is badly injured. Assuming that negligence is not claimed, what is the status of the exclusion clause?

**(The answer is at the end of the chapter)**

## 4.2 Interpretation of exclusion clauses

In deciding what an exclusion clause means, the courts **interpret any ambiguity against the person who relies on the exclusion**. This is known as the **contra proferentem rule**. Liability can only be excluded or restricted by clear words.

In the *Hollier* case above, the court decided that as a matter of interpretation the disclaimer of liability could be interpreted to apply:

- only to accidental fire damage, or
- to fire damage caused in any way including negligence.

It should therefore be interpreted against the garage in the **narrower sense** of (a) so that it did not give exemption from fire damage due to negligence. If a person wishes successfully to exclude or limit liability for loss caused by **negligence** the courts require that the word 'negligence', or an accepted synonym for it, should be included in the clause.

*Alderslade v Hendon Laundry [1945] KB 189 (UK)*

*The facts:* The conditions of contracts made by a laundry with its customers excluded liability for loss of or damage to customers' clothing in the possession of the laundry. By its negligence the laundry lost the plaintiff's handkerchief.

*Decision:* The exclusion clause would have no meaning unless it covered loss or damage due to negligence. It did therefore cover loss by negligence.

### 4.2.1 The 'main purpose' rule

When construing an exclusion clause the court will also consider the **main purpose rule**. By this, the court presumes that the clause was not intended to prevent the main purpose of the contract.

### 4.2.2 Fundamental breach

There is no doubt that at common law a **properly drafted** exclusion clause can cover any breach of contract.

*Photo Productions v Securicor Transport [1980] UKHL 2; AC 827 (UK)*

*The facts:* The defendants agreed to guard the plaintiffs' factory under a contract by which the defendant were excluded from liability for damage caused by any of their employees. One of the guards deliberately started a small fire which destroyed the factory and contents. It was contended that Securicor had entirely failed to perform their contract and so they could not rely on any exclusion clause in the contract.

*Decision:* There is no principle that total failure to perform a contract deprives the party at fault of any exclusion from liability provided by the contract. In this case the exclusion clause was drawn widely enough to cover the damage which had happened.

Let's compare the two following Australian cases. In *Sydney Corporation v West* 1965 below the drafted clause was **not** sufficient to cover all instances. Note that this is a consumer case.

*Sydney Corporation v West [1965] 114 CLR 481 (Aus.)* *The facts:* Mr West parked his car in the defendant's car park and upon his return, found that it was gone. The car had been stolen by someone posing as a Mr Robinson who said he had lost his ticket and was able to obtain a duplicate from the car park. He then simply drove the car away. The car park relied on an exclusion clause written on each ticket to escape liability.

*Decision:* The court remained undecided on the question of whether the ticket, and its terms, formed part of the contract. The second question was whether the exclusion clause was worded in a way to cover the incident. It was found that the clause was not worded "significantly comprehensively" to cover the incident.

*Darlington Futures v Delco Australia* 1986 below is a commercial case so the approach is less protective than that of consumer transactions.

*Darlington Futures v Delco Australia [1986] HCA 82 (Aus.)*

*The facts:* There was a contract between a broker investing on the commodities market and an engineering company (the investor). It involved complex trading strategies including 'tax straddles'. As part of the strategy, the broker ended up engaging in speculative transactions not authorised by the investor and large financial loss followed.

*Decision:* The court upheld that the exclusion clause used by the broker had a very wide operation and effectively protected the broker from consequences arising from trading without investor authorisation.



### Exam comments

Reliance on exclusion clauses is an everyday occurrence in business dealings and therefore is of great practical relevance.

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## Key chapter points

- Contract terms
  - Statements are classified as terms or representations.
- Express terms and implied terms
  - Express terms are those clearly included in the contract.
  - Implied terms are those existing in statute, common law, or custom.
- Conditions and warranties
  - Conditions are terms vital to the contract.
  - Warranties are those terms which are subsidiary to the main purpose of the contract.
  - Remedies for breach will vary dependant on whether a condition or a warranty has been breached.
- Exclusion clauses
  - Included in a contract to restrict liability for breach of contract or negligence.
  - Australian courts show some hostility towards exclusion clauses particularly in contracts with consumers for goods and services.
  - The courts ensure exclusion documents are interpreted strictly:
    - Incorporation into the contract.
    - Strict interpretation of the clause – main purpose rule and fundamental breach.

# Quick revision questions

- 1

Why is it important to distinguish between terms and representations?
- 2

A term may be implied into a contract by:

I

Statute

II

Trade practice unless an express term overrides it

III

The court, to provide for events not contemplated by the parties

IV

The court, to give effect to a term which the parties had agreed upon but failed to express because it was obvious

V

The court, to override an express term which is contrary to normal custom

A

II and III only

B

I, II and IV only

C

I, IV and V only

D

I, II, IV and V only
- 3

Fill in the blanks in the statements below, using the words in the box.

A (1) ..... is a vital term, going to the root of the contract, breach of which entitles the injured party to treat the contract as (2) ..... and claim (3) ..... .

A (4) ..... is a term (5) ..... to the main purpose of the contract.

The consequence of a term being classified as innominate is that the court must decide what is the actual effect of its (6) ..... .

• breach

• condition

• subsidiary

• warranty

• damages

• discharged
- 4

Terms implied by custom cannot be overridden

true ☐

false ☐
- 5

Fill in the blanks in the statement below, using the words in the box.

A contract is a consumer contract if the buyer neither makes the contract in course of (1) ..... nor holds himself out as doing so.

The other (2) ..... does make the contract in course of (3) .....

In the case of a contract governed by the law of (4) ....., the goods are of a type ordinarily supplied for (5) ..... .

• business

• sale of goods

• business

• party

• private use or consumption
- 6

What is the 'contra proferentem' rule?

## Answers to quick revision questions

- 1 The importance of the distinction is that different remedies are available depending on whether a term is broken or a representation turns out to be untrue.
- 2 B. Courts will not imply factors outside the contemplation of the parties.
- 3 (1) condition (2) discharged (3) damages (4) warranty (5) subsidiary (6) breach
- 4 False. Such terms can be overridden.
- 5 (1) business, (2) party, (3) business, (4) sale of goods, (5) private use or consumption
- 6 In deciding what an exclusion clause means, the courts interpret any ambiguity against the person at fault who relies on the exclusion.

## Answers to chapter questions

- 1 Norma is in breach of contract as she has failed to fulfil the condition that she would sing on the opening night (*Poussard v Spiers* [1876] 1 QBD 410 (UK)). Had she just failed to attend the two rehearsals, this would have amounted to breach of warranty (*Bettini v Gye* [1876] 1 QBD 183 (UK)).
- 2 There must be prior notice of the presence of an exclusion clause. The answer here will depend on whether this exclusion was included in the original terms and conditions (and therefore merely reinforced by the later document) or not. The hire company's only other possible defence will be to show a consistent course of dealings with Natasha.





# Chapter 6

## Breach of contract and its associated remedies

Learning objectives	Reference
<b>Breaches of contract law</b>	<b>LO5</b>
Recognise the different types of breach of contract and their effects	LO5.1
Specify relevant and available remedies for breach of contract	LO5.2
damages	LO5.2.1
specific performance	LO5.2.2

### Topic list

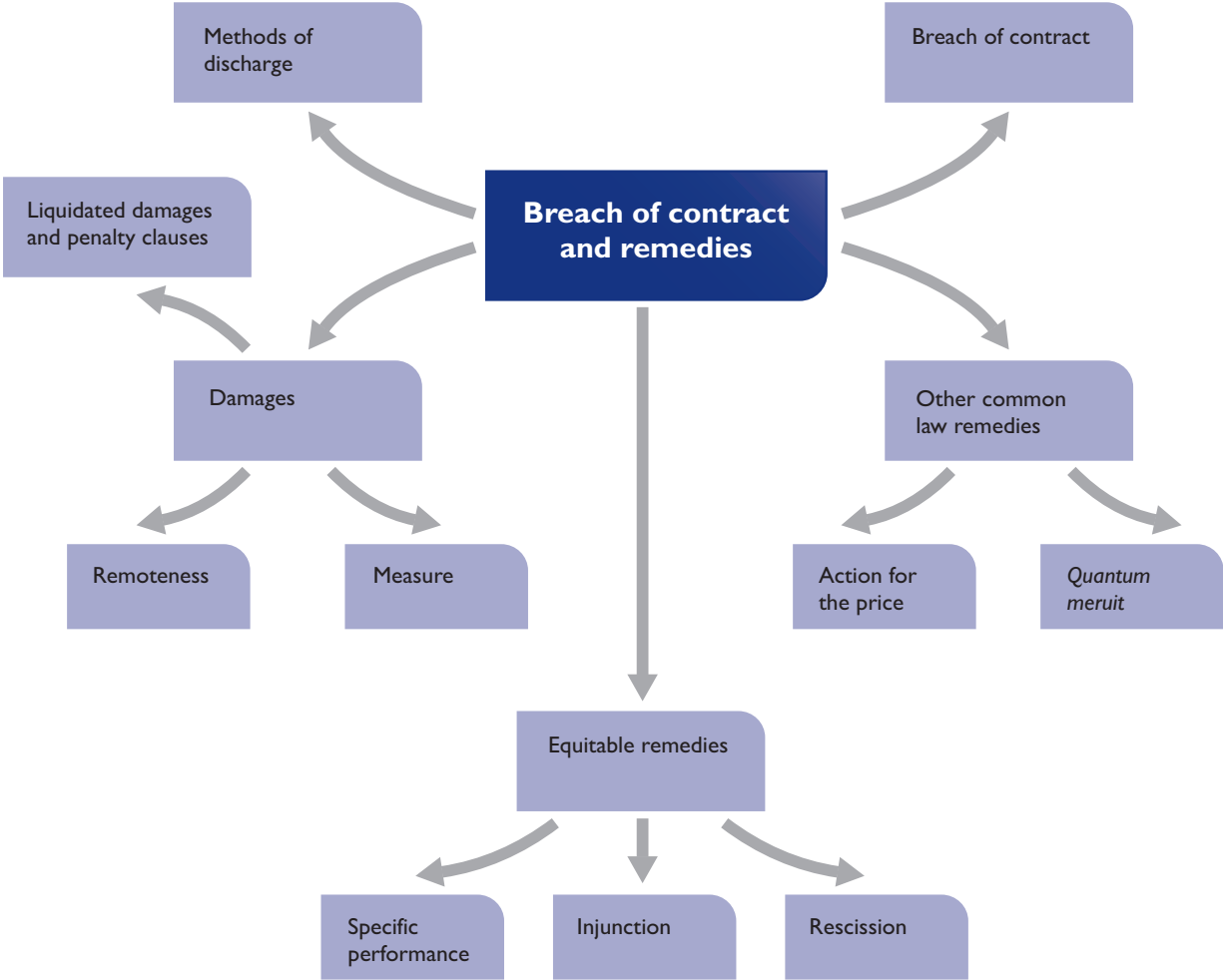
- 1 Discharge of contract
- 2 Breach of contract
- 3 Damages
- 4 Remoteness of damage
- 5 Measure of damages
- 6 Liquidated damages and penalty clauses
- 7 Other common law remedies
- 8 Equitable remedies

# Introduction

Most contracts end with the intended result, however many contracts end with one party breaching the **terms** of the deal. This chapter examines what breach of contract is and what the remedies are for the innocent party.

Damages are **monetary compensation** for a loss and they are always available. However, there are rules concerning what damages can be claimed for and how much should be awarded. **Liquidated damages** and **penalty clauses** are contractual terms that state how damages will be calculated so both parties agree to them in advance. There are rules about when these will and will not be enforced by the court.

There are also **equitable remedies** that can be claimed if damages are not suitable.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 List the four ways a contract can be discharged. (Section 1)
- 2 When is a party deemed to be in breach of contract? (Section 2)
- 3 List the four types of repudiatory breach. (Section 2.1.1)
- 4 What is an anticipatory breach and when is it generally recognised? (Section 2.1.2)
- 5 *Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK) introduces what rule in relation to damages paid for breach of contract? (Section 4)
- 6 Does the law intend that the injured party in a breach of contract case should profit from the breach? (Section 5)
- 7 What are liquidated damages? (Section 6)
- 8 Explain the concept of *quantum meruit*. (Section 7.2)
- 9 What are the three main equitable remedies available through the court system? (Sections 8.1, 8.2, 8.3)

# 1 Discharge of contract



## Section overview

- Contracts can be discharged through **agreement**, **frustration**, **performance** and **breach**.

Contracts can be **discharged** in four ways:

- Agreement.** Where both parties agree to end the agreement and it is supported by consideration.
- Frustration.** Where performance of an obligation is impossible due to specific circumstances occurring after formation of the contract.
- Performance.** The most common method of discharge. The contractual obligations are exactly or substantially met (all contract terms are performed).
- Breach.** Where one party fails to meet its contractual obligations (refer to Section 2 below).



## Exam comments

Your Study Manual and exam syllabus concentrate on **breach of contract** and do not require you to explain the other methods of discharge.

# 2 Breach of contract



## Section overview

- A party is said to be in breach of contract where, without **lawful excuse**, they do not perform their contractual obligations precisely.

LO  
5.1

A person sometimes has a lawful excuse not to perform contractual obligations, if:

- Performance is **impossible**, perhaps because of some unforeseeable event.
- They have tendered performance but this has been **rejected**.
- The **other party** has made it **impossible** for them to perform.
- The contract has been discharged through **frustration**.
- The parties have by **agreement** permitted **non-performance**.

Breach of contract gives rise to a secondary obligation to pay damages to the other party. However, the primary obligation to perform the contract's terms remains, unless the party in default has **repudiated** the contract. This may be before performance is due, or before it has been completed, and repudiation has been accepted by the injured party.



## Definition

**Repudiation** can be defined as a breach of contract which entitles the injured party to end the contract if they so choose.

## 2.1 Repudiatory breach



## Section overview

- Breach of a condition** in a contract or other repudiatory breach allows the injured party to **terminate** the contract unless the injured party elects to treat the contract as continuing and merely claim **damages** for their loss.



## Definition

A **repudiatory breach** occurs where a party indicates, either by words or by conduct, that they do not intend to honour their contractual obligations or commits a breach of condition or commits a breach which has very serious consequences for the injured party. It usually occurs when performance is due.

It does not **automatically** discharge the contract – indeed the injured party has a choice.

- They can elect to treat the contract as repudiated by the other, **recover damages** and treat themselves as being discharged from their primary obligations under the contract.
- They can elect to **affirm** the contract.

### 2.1.1 Types of repudiatory breach

Repudiatory breach arises in the following circumstances.

- Refusal to perform or renunciation.** One party renounces their contractual obligations by showing that they have no intention to perform them: *Hochster v De La Tour 1853* (refer below).
- Failure to perform an entire obligation.** An entire obligation is said to be one where complete and precise performance of it is a precondition of the other party's performance.
- Incapacitation.** Where a party prevents themselves from performing their contractual obligations they are treated as if they refused to perform them. For instance, where A sells a thing to C even though they promised to sell it to B, they are in repudiatory breach of their contract with B.
- Breach of condition** (discussed in Chapter 5). A contract contains conditions and warranties. Breaching a condition will result in repudiation of the contract while breaching a warranty will not: *Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd [1938] 71 CLR 286 (Aus.)*.

### 2.1.2 Anticipatory breach



#### Section overview

- If there is **anticipatory breach** where one party declares in advance that they will not perform their side of the bargain when the time for performance arrives, then the other party may treat the contract as discharged forthwith, or continue with their obligations until actual breach occurs. Their claim for damages will then depend upon what they have actually lost.

Repudiation may be **explicit** or **implicit**. A party may break a condition of the contract merely by declaring in advance that they will not perform it, or by some other action which makes future performance impossible. The other party may treat this as **anticipatory breach** and:

- Treat the contract as discharged forthwith, or
- At their option may allow the contract to continue until there is an actual breach.

*Hochster v De La Tour [1853] 2 E&B 678 (UK)*

*The facts:* The defendant engaged the plaintiff as a courier to accompany him on a European tour commencing on 1 June. On 11 May he wrote to the plaintiff to say that he no longer required his services. On 22 May the plaintiff commenced legal proceedings for anticipatory breach of contract. The defendant objected that there was no actionable breach until 1 June.

*Decision:* The plaintiff was entitled to sue as soon as the anticipatory breach occurred on 11 May.

Where the injured party allows the contract to continue, it may happen that the parties are discharged from their obligations **without** liability by some other cause which occurs later.

If the innocent party elects to treat the contract as still in force, they may continue with their preparations for performance and **recover the agreed price** for their services. Any claim for damages will be assessed on the basis of what the plaintiff has really lost.

*White & Carter (Councils) v McGregor [1962] 2 AC 413 (UK)*

*The facts:* The plaintiffs supplied litter bins to local councils, and were paid not by the councils but by traders who hired advertising space on the bins. The defendant contracted with them for advertising of his business. He then wrote to cancel the contract but the plaintiffs elected to advertise as agreed, even though they had at the time of cancellation taken no steps to perform the contract. They performed the contract and claimed the agreed payment.

*Decision:* The contract continued in force and they were entitled to recover the agreed price for their services. Repudiation does not, of itself, bring the contract to an end. It gives the innocent party the choice of affirmation or rejection.

*The Mihalis Angelos [1971] 1 QB 164 (UK)*

*The facts:* The parties entered into an agreement for the charter of a ship to be 'ready to load at Haiphong' in Vietnam on 1 July 1965. The charterers had the option to cancel if the ship was not ready to load by 20 July. On 17 July the charterers repudiated the contract believing wrongly that they were entitled to do so. The shipowners accepted the repudiation and claimed damages. On 17 July the ship was still in Hong Kong and could not have reached Haiphong by 20 July.

*Decision:* The shipowners were entitled only to nominal damages since they would have been unable to perform the contract and the charterers could have cancelled it without liability on 20 July.

*DTR Nominees Pty Ltd v Mona Homes Pty Ltd [1978] 138 CLR 423 (Aus.)*

*The facts:* There was a contract for the sale of lands. The contract covered the sale of lots 1-9. However, the plan of subdivision which was attached to the contract covered the sale of 35 lots. The vendor promised to lodge the plan for subdivision with the council but only lodged a plan for lots 1-9. With no warning the purchaser repudiated the contract saying that the vendor had lodged a plan with the council which varied from the plan attached to the contract. The vendor said the purchaser was in breach by repudiating. The purchaser then terminated and kept the deposit.

*Decision:* It was established that the vendor was committing an anticipatory breach by insisting on its version of the contract. The High Court then went on to say that the purchasers could not treat the vendor's anticipatory breach as serious enough to repudiate the contract. It then asked whether the vendor was entitled to then terminate because of the purchaser's wrongful repudiation and declared that it was not; because the purchaser's motivation behind the initial termination was honest. The upshot of this confusion was that neither party terminated the contract and a 'mutual abandonment' of the contract was declared.

### 2.1.3 Termination for repudiatory breach

To terminate for repudiatory breach the innocent party must **notify** the other of their decision. This may be by way of refusal to accept defects in performance, refusal to accept further performance, or refusal to perform their own obligations.

- They are not bound by their **future** or **continuing contractual obligations**, and cannot be sued on them.
- They need not **accept** nor pay for further performance.
- They can **refuse to pay** for partial or defective performance already received, unless the contract is severable.
- They can **reclaim money** paid to a defaulter if they can and does reject defective performance.
- They are **not discharged** from the contractual obligations which were due up to the time of termination.

The innocent party can also claim **damages** from the defaulter. An innocent party who began to perform their contractual obligations but who was prevented from completing them by the defaulter can claim **reasonable** remuneration on a *quantum meruit* basis. Refer to section 7.2 for an explanation of *quantum meruit*.

### 2.1.4 Affirmation after repudiatory breach

If a person is aware of the other party's repudiatory breach and of their own right to terminate the contract as a result but still decides to treat the contract as being in existence they are said to have **affirmed the contract**. The contract remains fully in force.



#### Exam comments

Anticipatory breach occurs before the time that performance is due. Repudiatory breach usually occurs at the time of performance.

## 3 Damages



### Section overview

- Damages are awarded to ensure that the party who suffered a loss is restored to the same position had the loss not occurred. It is the main remedy in breach of contract actions. The two tests applied to a claim for damages are **remoteness of damage** and **measure of damages**.



### Definition

**Damages** are a common law remedy intended to restore the party who has suffered loss to the same position they would have been in if the contract had been performed. The two tests applied to a claim for damages relate to **remoteness of damage** and **measure of damages**.

LO  
5.2.1

**Damages** form the **main remedy** in actions for breach of contract, but there are others with injunctions and specific performance are the most important.

In a claim for damages the first issue is **remoteness of damage**. Here the courts consider how far down the sequence of cause and effect the consequences of breach should be traced before they should be ignored. Second, the court must decide how much money to award in respect of the breach and its relevant consequences. This is the **measure of damages**.

## 4 Remoteness of damage



### Section overview

- Remoteness of damage is tested by the two parts of the rule in *Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK)

LO  
5.2.1

Under the rule in *Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK) damages may only be awarded in respect of loss as follows:

- (i) The loss must arise naturally from the breach.
  - (ii) The loss must arise in a manner which the parties may reasonably be supposed to have contemplated, in making the contract, as the probable result of the breach of it.
- (b) A loss outside the **natural course** of events will only be compensated if the exceptional circumstances are within the defendant's knowledge when they made the contract.

*Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK)

*The facts:* The plaintiffs owned a mill at Gloucester whose main crank shaft had broken. They made a contract with the defendant for the transport of the broken shaft to Greenwich to serve as a pattern for making a new shaft. Owing to neglect by the defendant, delivery was delayed and the mill was out of action for a longer period. The defendant did not know that the mill would be idle during this interval. He was merely aware that he had to transport a broken mill shaft. The plaintiffs claimed for loss of profits of the mill during the period of delay.

*Decision:* Although the failure of the carrier to perform the contract promptly was the direct cause of the stoppage of the mill for an unnecessarily long time, the claim must fail since the defendant did not know that the mill would be idle until the new shaft was delivered. Moreover it was not a natural consequence of delay in transport of a broken shaft that the mill would be out of action. The miller might have a spare.

The defendant is liable only if they knew of the **special circumstances** from which the abnormal consequence of breach could arise.

*Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528 (UK)

*The facts:* The defendants contracted to sell a large boiler to the plaintiffs 'for immediate use' in their business of launderers and dyers. Owing to an accident in dismantling the boiler at its previous site delivery was delayed. The defendants were aware of the nature of the plaintiffs' business and had been informed that the plaintiffs were most anxious to put the boiler into use in the shortest possible space of time. The plaintiffs claimed damages for normal loss of profits for the period of delay and for loss of abnormal profits from losing 'highly lucrative' dyeing contracts to be undertaken if the boiler had been delivered on time.

*Decision:* Damages for loss of normal profits were recoverable since in the circumstances failure to deliver major industrial equipment ordered for immediate use would be expected to prevent operation of the plant. The claim for loss of special profits failed because the defendants had no knowledge of the dyeing contracts.

Contrast this ruling with the case below.

*The Heron II* [1969] 1 AC 350 (UK)

*The facts:* K entered into a contract with C for the shipment of a cargo of sugar belonging to C to Basra. He was aware that C were sugar merchants but he did not know that C intended to sell the cargo as soon as it reached Basra. The ship arrived nine days late and in that time the price of sugar on the market in Basra had fallen. C claimed damages for the loss due to the fall in market value.

*Decision:* The claim succeeded. It is common knowledge that market values of commodities fluctuate so that delay might cause loss.

If the type of loss caused is not **too remote** the defendant may be liable for serious consequences.

*H Parsons (Livestock) v Uttley Ingham* [1978] QB 791 (UK)

*The facts:* There was a contract for the supply and installation of a large storage hopper to hold pig foods. Owing to negligence of the defendant supplier the ventilation cowl was left closed. The pig food went mouldy. Young pigs contracted a rare intestinal disease, from which 254 died. The pig farmer claimed damages for the value of the dead pigs and loss of profits from selling the pigs when mature.

*Decision:* Some degree of illness of the pigs was to be expected as a natural consequence. Since illness was to be expected, death from illness was not too remote.



## 5 Measure of damages



### Section overview

- The **measure of damages** is that which will **compensate for the loss incurred**. It is not intended that the injured party should profit from a claim. Damages may be awarded for financial and non-financial loss.

LO  
5.2.1

As a general rule, the amount awarded as damages is what is needed to put the plaintiff in the position they would have achieved if the contract had been performed. This is sometimes referred to as protecting the **expectation interest** of the plaintiff.

A plaintiff may alternatively seek to have their **reliance interest** protected; this refers to the position they would have been in had they not relied on the contract. This compensates for wasted expenditure.

The onus is on the defendant to show that the expenditure would **not** have been recovered if the contract had been performed.

*C & P Haulage v Middleton [1983] 3 All ER 94 (UK)*

*The facts:* The plaintiffs granted to the defendant a 6-month renewable licence to occupy premises as an engineering workshop. He incurred expenditure in doing up the premises, although the contract provided that he could not remove any fixtures he installed. He was ejected in breach of the licence agreement 10 weeks before the end of a 6-month term. He sued for damages.

*Decision:* The defendant could only recover nominal damages. He could not recover the cost of equipping the premises as reliance loss as he would not have been able to do so if the contract had been lawfully terminated.

If a contract is **speculative**, it may be unclear what profit might result.

*Anglia Television Ltd v Reed [1972] 1 QB 60 (UK)*

*The facts:* The plaintiffs engaged an actor to appear in a film they were making for television. He pulled out at the last moment and the project was abandoned. The plaintiffs claimed the preparatory expenditure, such as hiring other actors and researching suitable locations.

*Decision:* Damages were awarded as claimed. It is impossible to tell whether an unmade film will be a success or a failure and, had the plaintiffs claimed for loss of profits, they would not have succeeded.

The general principle is to compensate for **actual financial loss**.

*WL Thompson Ltd v Robinson (Gunmakers) Ltd 1955 Ch 177 (UK)*

*The facts:* The defendants contracted to buy a Vanguard car from the plaintiffs. They refused to take delivery and the plaintiffs sued for loss of profit on the transaction. There was at the time a considerable excess of supply of such cars over demand for them and the plaintiffs were unable to sell the car.

*Decision:* The market price rule (see below), which the defendants argued should be applied, was inappropriate in the current market as demand for such cars was so low as to effectively mean that no market for them existed. The seller had lost a sale and was entitled to the profit.

*Charter v Sullivan [1957] 2 QB 117 (UK)*

*The facts:* The facts were the same as in the previous case, except that the sellers were able to sell every car obtained from the manufacturers.

*Decision:* Only nominal damages were payable.

## 5.1 Market price rule

The measure of damages for breaches of contract for the sale of goods is usually made in relation to the **market price** of the goods. Where a seller fails to sell the goods, the buyer can go into the market and purchase **equivalent goods** instead. The seller would have to compensate the buyer for any additional cost the buyer incurred over the contract cost. The situation is reversed when the buyer fails to purchase the goods. The seller can sell the goods on the **open market** and recover any **loss of income** they incurred by having to sell the goods at a lower price than that they contracted to.

## 5.2 Non-financial loss

In some cases, damages have been recovered for mental distress where that is the main result of the breach. It is uncertain how far the courts will develop this concept. Examine the cases below.

*Dillon v Baltic Shipping Company [1991] (HCA 37 (Aus.))*

*The facts:* Mrs Dillon was on a holiday cruise when the ship sank. This effectively ended the cruise. Mrs Dillon sought return of her fare and various types of damages, including damages for loss of enjoyment.

*Decision:* It was decided that Mrs Dillon was not entitled to claim back part of the fare. She was however entitled to \$5 000 damages for disappointment and distress.

*Jarvis v Swan Tours [1973] 1 QB 233 (UK)*

*The facts:* The plaintiff entered into a contract for holiday accommodation at a winter sports centre. What was provided was much inferior to the description given in the defendant's brochure. Damages on the basis of financial loss only were assessed at \$32.

*Decision:* The damages should be increased to \$125 to compensate for disappointment and distress because the principal purpose of this contract was the giving of pleasure.

## 5.3 Cost of cure

By seeking a sum of money to 'cure' the defect which constituted the breach, a plaintiff may be denied the cost of cure if it is **wholly disproportionate** to the breach.

*Ruxley Electronics and Construction Ltd v Forsyth [1995] UKHL 8 (UK)*

*The facts:* A householder discovered that the swimming pool he had ordered to be built was shallower than specified. He sued the builder for damages, including the cost of demolition of the pool and construction of a new one. Despite its shortcomings, the pool as built was perfectly serviceable and safe to dive into.

*Decision:* The expenditure involved in rectifying the breach was out of all proportion to the benefit of such rectification. The plaintiff was awarded a small sum to cover loss of amenity.

## 5.4 Mitigation of loss

In assessing the amount of damages it is assumed that the plaintiff will take any reasonable steps to reduce or **mitigate** their loss. The burden of proof is on the defendant to show that the plaintiff failed to take a reasonable opportunity of mitigation.

*Payzu Ltd v Saunders [1919] 2 KB 581 (UK)*

*The facts:* The parties had entered into a contract for the supply of goods to be delivered and paid for by instalments. The plaintiffs failed to pay for the first instalment when due, one month after delivery. The defendants declined to make further deliveries unless the plaintiffs paid cash in advance with their orders. The plaintiffs refused to accept delivery on those terms. The price of the goods rose, and they sued for breach of contract.

*Decision:* The seller had no right to repudiate the original contract. But the plaintiffs should have mitigated their loss by accepting the seller's offer of delivery against cash payment. Damages were limited to the amount of their assumed loss if they had paid in advance, which was interest over the period of pre-payment.

The injured party is not required to take **discreditable** or **risky measures** to reduce their loss since these are not 'reasonable'.

*Pilkington v Wood [1953] Ch 770 (UK)*

*The facts:* The plaintiff bought a house, having been advised by his solicitor that title was good. The following year, he decided to sell it. A purchaser was found but it was discovered that the house was not saleable at the agreed price, as the title was not good. The defendant was negligent in his investigation of title and was liable to pay damages of £2 000, being the difference between the market value of the house with good title and its market value with defective title. The defendant argued that the plaintiff should have mitigated his loss by taking action against the previous vendor for conveying a defective title.

*Decision:* This would have involved complicated litigation and it was not clear that he would have succeeded. The plaintiff was under no duty to embark on such a hazardous venture 'to protect his solicitor from the consequences of his own carelessness'.



### Question 1: Measure of damages

Chana agrees to buy a car from Mike's Motors for \$6 000. Mike paid \$5 500 for the car. On the agreed day, Chana arrives at the dealers but refuses to accept or pay for the car. In the meantime, the car's market value has risen to \$7 000. The following week Mike sells the car for \$7 500. Mike claims against Chana for damages. How much is he likely to be awarded?

(The answer is at the end of the chapter)

## 6 Liquidated damages and penalty clauses



### Section overview

- The difference between liquidated damages and penalty clauses is very important. Liquidated damages create a formula to be used in the event of a breach, and are a genuine attempt to pre-estimate the loss. A penalty clause seeks to deter the parties from being in breach of contract and is generally void.

LO  
5.2.1

To avoid later complicated calculations of loss, or disputes over damages payable, the parties may include up-front a formula (**liquidated damages**) for determining the damages payable for breach.



### Definition

**Liquidated damages** are 'a fixed or ascertainable sum agreed by the parties at the time of contracting, payable in the event of a breach, for example, an amount payable per day for failure to complete a building. If they are a genuine attempt to pre-estimate the likely loss the court will enforce payment.'

*Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] AC 79 (UK)*

*The facts:* The contract (for the sale of tyres to a garage) imposed a minimum retail price. The contract provided that £5 per tyre should be paid by the buyer if he resold at less than the prescribed retail price or in four other possible cases of breach of contract. He did sell at a lower price and argued that £5 per tyre was a 'penalty' and not a genuine pre-estimate of loss.

*Decision:* As a general rule when a fixed amount is to be paid as damages for breaches of different kinds, some more serious in their consequences than others, that is not a genuine pre-estimate of loss and so it is void as a 'penalty'. In this case the formula was an honest attempt to agree on liquidated damages and would be upheld.

*Ford Motor Co (England) Ltd v Armstrong [1915] (UK) 31 TLR 267 (UK)*

*The facts:* The defendant had undertaken not to sell the plaintiff's cars below list price, not to sell Ford cars to other dealers and not to exhibit any Ford cars without permission. A £250 penalty was payable for each breach as being the agreed damage which the plaintiff would sustain.

*Decision:* Since the same sum was payable for different kinds of loss it was not a genuine pre-estimate of loss and was in the nature of a penalty. Unlike the *Dunlop* case the figure set was held to be excessive.

A contractual term designed as a **penalty clause** to discourage breach is void and not enforceable. Relief from penalty clauses is an example of the influence of equity in the law of contract, and has most frequently been seen in consumer credit cases.



## Definition

A **penalty clause** can be defined as 'a clause in a contract providing for a specified sum of money to be payable in the event of a subsequent breach. If its purpose is merely to deter a potential difficulty, it will be held void and the court will proceed to assess unliquidated damages.'

*Bridge v Campbell Discount Co [1962] AC 600 (UK)*

*The facts:* A clause in a hire purchase contract required the debtor to pay on termination both arrears of payments due before termination and an amount which, together with payments made and due before termination, amounted to two thirds of the HP price, and additionally to return the goods.

*Decision:* This was a penalty clause and void since, in almost all circumstances, the creditor would receive on termination more than 100% of the value of the goods.

*Esanda Finance Corporation Ltd v Plessnig [1989] 166 CLR 131 (Aus.)*

*The facts:* Mr and Mrs Plessnig took out a hire-purchase agreement to buy a prime mover. The terms stated that if the agreement was terminated due to default in payments by the hirer then a 'recoverable amount' could be paid by the hirer to the finance company. This amount was calculated by a formula which basically said that Esanda were able to keep all payments already made, claim any outstanding payments, claim costs for repossession, deduct value of track and add an amount to reflect the benefit of accelerated payments. Esanda argued this was legitimate liquidated damages and the Plessnig's argued that it was in fact a penalty clause.

*Decision:* It was deemed a justified liquidated damages clause.

We have seen that if a penalty clause is included in the contract it should be highlighted as an **onerous term**. In *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd [1988] 2 WLR (615) (UK)* the defendants did not plead that the clause in question was a penalty clause and hence void, but it is probable that they could have done.

## 7 Other common law remedies

### 7.1 Action for the price



#### Section overview

- A **simple action for the price** to recover the agreed sum should be brought if breach of contract is failure to pay the price. But property must have passed from seller to buyer, and complications arise where there is anticipatory breach.

If the breach of contract arises out of one party's failure to pay the contractually agreed price due under the contract, the creditor should bring a personal action against the debtor to recover that sum, provided the property has passed to the buyer.

Note however that while the injured party may recover an agreed sum due at the time of an anticipatory breach, sums which become due after the anticipatory breach may not be recovered unless they affirm the contract.

### 7.2 Quantum meruit



#### Section overview

- A **quantum meruit** is a claim which is available as an alternative to damages. The injured party in a breach of contract may claim the value of their work. This is to restore the plaintiff to the position they would have been in had the contract never been made. This is a **restitutory award**.

In particular situations, a claim may be made on a *quantum meruit* basis as an **alternative** to an action for damages for breach of contract.



#### Definition

The phrase **quantum meruit** literally means '**how much it is worth**'. It is a measure of the value of contractual work which has been performed. The aim of such an award is to restore the plaintiff to the position they would have been in if the contract had never been made, and is therefore known as a **restitutory award**.

*Quantum meruit* is likely to be sought where one party has already performed part of their obligations and the other party then repudiates the contract.

*De Barnady v Harding 1853 (UK)*

*The facts:* The plaintiff agreed to advertise and sell tickets for the defendant, who was erecting stands for spectators to view the funeral of a public figure. The defendant cancelled the arrangement without justification.

*Decision:* The plaintiff might recover the value of services rendered.

In most cases, a *quantum meruit* claim is needed because the other party has unjustifiably prevented performance: *Planché v Colburn [1831] 172 ER 876 (UK)*.

Because it is **restitutory**, a *quantum meruit* award is usually for a **smaller amount** than an award of damages. However, where only **nominal damages** would be awarded, say because the plaintiff would not have been able to perform the contract anyway, a *quantum meruit* claim would still be available and would yield a **higher amount**.

## 8 Equitable remedies

### 8.1 Specific performance



#### Section overview

- An order for **specific performance** is an equitable remedy. The party in breach is ordered to perform their side of the contract. Such an order is only made where damages are inadequate compensation, such as in a sale of land, and where actual consideration has passed.

LO  
5.2.2

The court may, at its **discretion**, give an equitable remedy by ordering the defendant to perform their part of the contract instead of letting them 'buy himself out of it' by paying damages for breach.



#### Definition

**Specific performance** can be defined as 'an order of the court directing a person to perform an obligation. It is an equitable remedy awarded at the discretion of the court when damages would not be an adequate remedy. Its principal use is in contracts for the sale of land but may also be used to compel a sale of shares or debentures. It will never be used in the case of employment or other contracts involving personal services.'

An order will be made for specific performance of a contract for the **sale of land** since the plaintiff may need the land for a particular purpose and would not be adequately compensated by damages for the loss of their bargain.

The order will **not** be made if it would require performance over a period of time and the court could not ensure that the defendant did comply fully with the order. Therefore specific performance is not ordered for contracts of **employment** or **personal service** nor usually for building contracts.

As stated above the remedy of specific performance is awarded at the court's discretion.

*JC Williamson Ltd v Lukey & Mulholland [1931] 45 CLR 282 (Aus.)*

*The facts:* Lukey & Mulholland (L&M) were given the exclusive rights to sell confectionary in Williamson's theatre. Although legislation required them to record the agreement, this did not occur. L&M acted on the agreement but Williamson subsequently repudiated it. L&M sought equitable remedies in order to enforce the agreement.

*Decision:* Williamson said L&M did not comply with the formalities of the agreement. L&M claimed for 'part performance'. L&M were successful in the first instance. Williamson appealed and the High Court stated that part performance was a legitimate doctrine. It found however that the specific performance was not available as a remedy in this case and the appeal was upheld.

*Waltons Stores Interstate Ltd v Maher [1988] HCA 7 (Aus.)*

*The facts:* Maher owned property and was negotiating with Waltons Stores for a lease of his property. Waltons asked for an existing building to be demolished and a new one built. Maher demolished the building and began erecting a new one, relying on representations made prior to the contract being completed. However, Walton Stores never completed the contract as they did not sign the lease.

*Decision:* Specific performance was not practical in this case, and Waltons was 'estopped' from denying the contract and damages were paid to Maher. Estoppel is a common law principle which applies in this case. Under estoppel, the party (in this case, the Waltons) led another (Maher) to believe that a certain state of affairs existed (that they wanted the existing building demolished and a new one built). This action by the Waltons meant that Maher carried out the work in reliance of that belief. Even though a later action (Waltons not signing the lease) contradicted the initial action the Waltons were estopped (or prevented) from claiming later that this different state of affairs existed.

## 8.2 Injunction



### Definition

An **injunction** is a discretionary court order and an equitable remedy, requiring the defendant to observe a negative restriction of a contract.

An injunction may be made to **enforce** a contract of **personal service** for which an order of specific performance would be refused.

*Warner Bros Pictures Inc v Nelson [1936] 3 All ER 160 (UK)*

*The facts:* The defendant Nelson, the film star Bette Davis, agreed to work for a year for the plaintiffs and not during the year to work for any other producer nor 'to engage in any other occupation' without the consent of the plaintiffs. She came to England during the year to work for a British film producer. The plaintiffs sued for an injunction to restrain her from this work and she resisted arguing that if the restriction were enforced she must either work for them or abandon her livelihood.

*Decision:* The court would not make an injunction if it would have the result suggested by the defendant. But the plaintiffs merely asked for an injunction to restrain her from working for a British film producer. This was one part of the restriction accepted by her and it was fair to hold her to it to that extent.

An injunction is limited to **enforcement of contract terms** which are in substance negative restraints.

*Metropolitan Electric Supply Co v Ginder [1901] 2 Ch 799 (UK)*

*The facts:* The defendant contracted to take all the electricity which he required from the plaintiffs. They sued for an injunction to restrain him from obtaining electricity from another supplier.

*Decision:* The contract term, electricity only from the one supplier, implied a negative restriction of no supplies from any other source, and to that extent it could be enforced by injunction.

An injunction would **not** be made merely to **restrain** the defendant from acts inconsistent with their positive obligations.

*Whitwood Chemical Co v Hardman [1891] 2 Ch 416 (UK)*

*The facts:* The defendant agreed to give the whole of his time to his employers, the plaintiffs. In fact, he occasionally worked for others. The employers sued for an injunction to restrain him.

*Decision:* By his contract he merely stated what he would do. This did not imply an undertaking to abstain from doing other things.

### 8.2.1 Mareva or 'freezing' injunctions

It is possible in the world of international markets that a defendant may try to disobey a court judgement by moving the assets in dispute outside of the jurisdiction of the court. The possibility of this occurring can be stopped through the use of the 'Mareva' or 'freezing' injunction. The Mareva injunction is named from the case of *Mareva Compania Naviera SA v International Bulkcarriers SA [1980] 1 All ER 215 (UK)*. If the plaintiff can convince the court that they have a good case and that there is a real danger of the defendant moving, exporting or dissipating the assets in dispute, then the plaintiff can be awarded an injunction which restricts the defendant's dealing with the assets.

## 8.3 Rescission

Strictly speaking, the equitable right to **rescind** an agreement is not a remedy for breach of contract – it is a right which exists in certain circumstances, such as where a contract is **voidable**.

Rescinding a contract means that it is cancelled or rejected and the parties are restored to their pre-contract condition. Four conditions must be met:

- It must be possible for each party to be returned to the pre-contract condition (*restitutio in integrum*).
- An innocent third party who has acquired rights in the subject matter of the contract will prevent the original transaction being rescinded.
- The right to rescission must be exercised within a reasonable time of it arising.
- Where a person affirms a contract expressly or by conduct it may not then be rescinded by that person.



### **Question 2: *Quantum meruit***

Clare agrees to advertise and sell tickets for an upcoming fashion parade being organised by Matteo. Matteo then cancels the fashion parade at short notice and with no justification. What is Clare's position?

**(The answer is at the end of the chapter)**

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## Key chapter points

- Discharge of contract
  - Agreement.
  - Frustration.
  - Performance.
  - Breach.
- Breach of contract
  - Repudiation – injured party can end the contract as they see fit.
  - Breach of contract gives rise to the obligation to pay damages.
  - Repudiatory breach.
  - Anticipatory breach.
- Damages
  - Main remedy for breach of contract.
  - Court decides how much damages to award – the measure of damages.
- Remoteness of damage
  - *Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK)
    - Loss must arise naturally from breach and in a manner reasonably contemplated.
    - Loss outside natural course of events only compensated in exceptional circumstances.
- Measure of damages
  - Awarded for financial and non-financial loss.
  - Cost of cure – must be proportionate to the breach.
  - Plaintiff take reasonable steps to mitigate the loss.
- Liquidated damages and penalty clauses
  - A formula included in up front to determine damages payable in event of breach.
  - Penalty clause – if the formula is deemed unreasonable or a penalty it will not be considered.
- Other common law remedies
  - Action for the price.
  - *Quantum meruit*.
- Equitable remedies
  - Specific performance.
  - Injunction.
  - Rescission.

# Quick revision questions

1 **Fill in the blanks** in the statements below, using the words in the box.

(1) ..... are a (2) ..... remedy designed to restore the injured party to the position they would have been in had the contract been (3) .....

A loss outside the natural course of events will only be compensated if the (4) ..... circumstances are within the (5) ..... 's knowledge at the time of making the contract.

In assessing the amount of damage it is assumed that the (6) ..... will (7) ..... their loss.

A contractual term designed as a (8) ..... is (9) .....

• mitigate	• performed	• plaintiff
• penalty clause	• exceptional	• damages
• common law	• void	• defendant

2 **Fill in the blanks** in the statements below.

When anticipatory breach occurs, the injured party has two options. These are:

(1) .....

(2) .....

3 What is the two-limbed rule set out in *Hadley v Baxendale* [1854] 9 Exch 341; 156 ER 145 (UK)?

4 The amount awarded as damages is what is needed to put the plaintiff in the position they would have achieved if the contract had been performed. What interest is being protected here?

expectation
reliance

5 A court will never enforce a liquidated damages clause, as any attempt to discourage breach is void.

true ☐

false ☐

6 Are each of the following remedies based on (i) equity or (ii) common law?

- (a) *quantum meruit*
- (b) injunction
- (c) action for the price
- (d) rescission
- (e) specific performance

7 What are the two limitations on the creditor's right to bring an action for the price?

8 What four conditions must be met for rescission to be possible?

## Answers to quick revision questions

- 1
 

(1) damages	(2) common law	(3) performed
(4) exceptional	(5) defendant	(6) plaintiff
(7) mitigate	(8) penalty clause	(9) void
- 2
  - (1) treat the contract as discharged forthwith.
  - (2) allow the contract to continue until there is an actual breach.
- 3
  - I The loss must arise naturally from the breach.
  - II The loss must arise in a manner which the parties may reasonably be supposed to have contemplated when making the contract was made.
- 4 Expectation
- 5 False. Courts will enforce liquidated damages clauses if they are genuine.
- 6
  - (a) common law
  - (b) equity
  - (c) common law
  - (d) equity
  - (e) equity
- 7
  - I An action for the price under a contract for the sale of goods may only be brought if property has passed (or price is payable on a specified date).
  - II Sums which become due after an anticipatory breach may not be recovered unless the creditor has affirmed the contract.
- 8
  - (a) It must be possible for each party to be returned to the pre-contract condition (*restitutio in integrum*).
  - (b) An innocent third party who has acquired rights in the subject matter of the contract will prevent the original transaction being rescinded.
  - (c) The right to rescission must be exercised within a reasonable time of it arising.
  - (d) Where a person affirms a contract expressly or by conduct it may not then be rescinded.

## Answers to chapter questions

- 1 They are likely to be awarded nominal damages only, as they have incurred no loss.
- 2 Under the *quantum meruit* rule Clare will be able to recover the value of services rendered.



# Chapter 7

## International commercial contracts

Learning objectives	Reference
<b>Specialised commercial contracts</b>	<b>LO6</b>
Identify the characteristics of commercial contracts used in international trade	LO6.1
international sales of goods	LO6.1.1
international transportation of goods	LO6.1.2

### Topic list

- 1 UN Convention on Contracts for the International Sale of Goods (UNCISG)
- 2 Formation of a contract for the international sale of goods
- 3 Offer and acceptance
- 4 Modification or termination of the contract
- 5 Obligations of the seller
- 6 Buyer's remedies for seller's breach of contract
- 7 Obligations of the buyer
- 8 Seller's remedies for buyer's breach of contract
- 9 Damages
- 10 Breach of contract
- 11 ICC Incoterms

# Introduction

In this chapter we introduce contracts for the international sale of goods. We mentioned in Chapter 1 that the United Nations has a Convention on sale of goods which applies to parties in member states. Those parties are free to stipulate in their agreement that this Convention does not apply to the agreement, but unless they do so the Convention will apply. We shall examine the provisions of the Convention and some of the cases that have been decided on the basis of it.

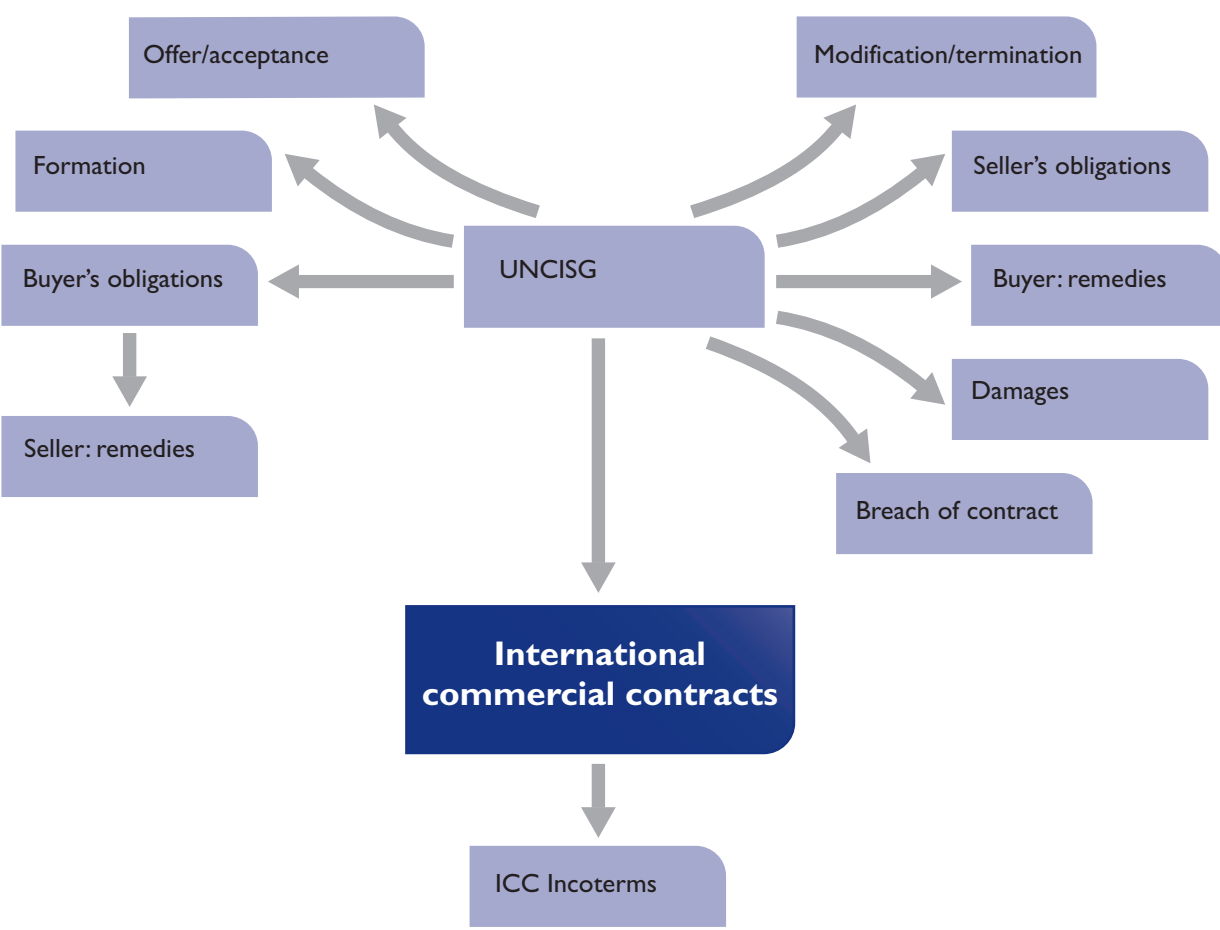
We also discussed some of the problems of contracting with people in other states in Chapter 1. The Convention sets out requirements about **offer** and **acceptance** which we shall examine here. The **obligations** of the parties, the **remedies** available when parties default and the issue of when **risk** (for example, the risk of loss or damage to the goods) passes from the seller to the buyer, are also discussed.

The obligations of the seller fall into two key categories, **delivery** and **quality**. Delivery is a particular issue in international contracts, because contracts will often involve carriage, possibly with more than one carrier. Risk is a key issue when goods are being carried, say at sea, or by more than one party.

If the seller fails to meet his obligations, the buyer may have **remedies**. **Damages** is a remedy common to both the buyer and seller.

The obligations of the buyer and the rights of the seller if the buyer does not meet his obligations are important. The buyer's obligations fall into the categories of **payment**, and **acceptance of delivery**.

Finally, we study some standard terms that parties often incorporate into contracts for the international transportation of goods, known as **Incoterms**.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 What does UNCISG stand for? **(Section 1)**
- 2 What is considered a valid offer for the sale of goods under the Convention? **(Section 3.1)**
- 3 Define a counter-offer under Article 19 of the Convention. **(Section 3.3)**
- 4 What are the two key obligations of the seller under the Convention? **(Section 5)**
- 5 List three specific rights of the buyer under the Convention. **(Section 6.1)**
- 6 What are the two key obligations of the buyer under the Convention? **(Section 7)**
- 7 Explain the payment of damages under the Convention. **(Section 9)**
- 8 What are Incoterms? **(Section 11)**
- 9 Name three current Incoterms. **(Sections 11.1 – 11.13)**

# 1 UN Convention on Contracts for the International Sale of Goods (UNCISG)



## Section overview

- Unless the parties have agreed to exclude it, the **UN Convention on Contracts for the International Sale of Goods (UNCISG)** applies to contracts for the sale of goods between parties whose **places of business** are in different sovereign states, when either the states are **contracting states** or the rules of **private international law** lead to the application of the law of a contracting state.

### LO 6.1.1

We introduced the UN Convention on Contracts for the International Sale of Goods (UNCISG) in Chapter 1. Throughout this chapter we shall be referring to its Articles.

To access the UNCISG directly enter the term into Google and various full text databases will appear. For a direct link go to <http://www.cisg.law.pace.edu/> which is the Pace Law School Institute of Commercial Law. This has a full text version of the Convention and various other articles and learning aids.

Unless excluded by the parties (Article 6), the UNCISG applies to contracts of **sales of goods** between parties whose **places of business are in different sovereign states**:

- When the states are **contracting states**, or
- When the rules of **private international law** lead to the application of the law of a contracting state: Article 1.

Its basic principles are that it is **international, uniform** and **based on good faith**: Article 7.

The nationalities of the parties and their civil or commercial character, or that of the contract, are **not** taken into account when determining whether or not the contract applies.

Parties to a contract covered by the Convention are bound by any **usage** or custom to which they have agreed and by any practices established between themselves: Article 9. These practices may be those commonly accepted in a particular trade.

*Note: It is important for students to remember that the UNCISG only applies to contracts where stated above. Contracts for the international sale of goods which are not covered by the UNCISG are excluded from this chapter. It is also important to remember that international contracts are not governed by UNCISG alone, they are also impacted by relevant tariffs, customs duties, national jurisdictions and jurisdictional prohibitions on the movement and sale of goods, and other international treaties (such as CITES, the Convention on International Trade in Endangered Species of Wild Fauna and Flora which imposes strict rules on the trade of wild animals and plants, and goods derived from them). These factors apply to all international contracts for the sale and movement of goods.*

## 1.1 Example: Application of the Convention



**Australia** and **Singapore** are contracting states to the Convention. The **UK** and **Malaysia** are not contracting states to the Convention.

If the contract was between parties in a contracting state, i.e. one who recognises the Convention, and a non-contracting state i.e. one who does not, and the parties agreed that the **relevant law** for the contract is the national law of the contracting state, the Convention would apply to that contract.

The Convention does not apply to the **liability of the seller for death or personal injury** caused by the goods to any person: Article 5.



## 1.2 Sales of goods



### Section overview

- A **sale of goods** is an agreement by which the seller transfers, or agrees to, the property in goods to a buyer for monetary compensation, called the **price**.



### Definitions

**Sales of goods** can be defined as a contract by which the seller transfers, or agrees to transfer, the property in goods to a buyer in exchange for monetary compensation, called the price.

'**Property**' in this context means legal title.

By Article 2, the Convention does not apply to sales of goods bought for **personal, family or household use**. This is unless the seller neither knew, or ought to have known, that the goods were bought for that use. It also does not apply to:

- Goods bought by auction,
- Goods bought on execution of/by authority of law,
- Stocks, shares, investment securities, negotiable instruments or money,
- Ships, vessels, hovercraft or aircraft, or
- Electricity.

The Convention **does not apply** to the **supply of services**, or contracts where the **main obligation** of one of the parties is the **provision of labour**. It also does not apply to contracts of manufacture where the **buyer provides the substantial part of the materials** for manufacture or production: Article 3.

#### UN Case 105

*The facts:* An Austrian company ordered brushes and brooms from a company in the former Yugoslavia but provided the materials for the production.

*Decision:* The Convention was not applicable because the Yugoslav company was predominantly providing labour under the contract.

The Convention applies only to the formation of **contracts of sale**, and the rights and obligations of the buyer and seller arising from them. It is not usually concerned with the contract's validity or usage, nor with the effect of the contract on the property in goods sold: Article 4.

## 1.3 Place of business

You should note that the Convention refers to **place of business**, not nationality. If either of the parties to the contract has **more than one place of business** and these places of business are in different states, the relevant place of business will be the **one most closely connected to the contract** and its performance: Article 10.

If either of the parties does not have a place of business, the relevant place will be the party's **habitual residence**: Article 10.

## 1.4 Ratification of the Convention



### Section overview

- A state which ratifies the Convention may declare itself **not bound** by certain provisions, in which case it is not a contracting state. However, declaring that contracts must still be in writing because that is the national law does not prevent it being a contracting state.

The UNCISG has to be **ratified**, **accepted** or **approved** by member states. When doing so, member states may declare that they are not bound by parts of the Convention. If they make such a declaration, they are not considered to be contracting states so Article 1(1) does not apply: Article 92.

Two or more contracting states may ratify the Convention but '**opt out**' of the Convention in relation to each other, or in relation to persons whose places of business are in each other's states: Article 94.

Contracting states whose national legislation requires contracts to be in writing may effectively **disapply** the UNCISG in respect of its provisions which allow contracts not to be in writing: Article 96.

If a state has two or more territorial units in which different laws are applicable, for example Western Australia and New South Wales within Australia, it may declare whether this Convention extends to **all its territorial units** or **just some of them**.

Although Australia and all its separate states ratified the Convention through incorporation by legislation in the 1980s, until recently it has been inexplicably ignored in the Australian courts, even when it does appear to apply.

The Australian cases where the treaty has been applied are UN Case 631/ *Downs Investments Pty Ltd v Perwaja Steel Sdn Bhd* [2000] QSC 421 (Aus.) and UN Case 308/ *Roder Zelt- und Hallenkonstruktionen GmbH v Rosedown Park Pty Ltd and Reginald R. Eustace* 57 FCA (Sth Australia) 216 (Aus.). Until these recent cases, the Convention has been rarely referred to or considered in case law or by traders and practitioners – possibly because many of Australia's major trading partners are not party to the Convention (e.g. the UK), or only recently became party to it (e.g. Japan).

## 2 Formation of a contract for international sale of goods



### Section overview

- A contract for the international sale of goods is formed when a valid offer is **validly accepted**.

LO  
6.1.1

A contract for the international sale of goods is concluded when **acceptance of an offer** becomes effective.

The Convention states that a contract for the sale of international goods **does not have to be in or evidenced by writing**. There are no other requirements as to form, and it can be proved by any means, including witnesses: Article 11. This may be disapplied if one of the parties is in a contracting state which requires writing: Articles 12 + 96. 'Writing' includes telegram and telex: Article 13.

## 3 Offer and acceptance



### Section overview

- An **offer** is a **sufficiently definite proposal** for concluding a contract addressed to one or more persons. An offer is sufficiently definite when it indicates the goods in question and makes provision for quantity and price. An offer becomes effective when it reaches the offeree and can be ended by being withdrawn, revoked or rejected.

### 3.1 Offer



#### Definitions

LO  
6.1.1

An **offer** is a proposal for concluding a contract addressed to one or more specific persons that is sufficiently definite and that indicates the intention of the offeror to be bound by acceptance: Article 14.

An **invitation to treat** or to make offers is any other proposal, unless the person making it clearly indicates to the contrary: Article 14.

### 3.1.1 'Sufficiently definite'

An offer is **sufficiently definite** when:

- It indicates the goods in question, and
- It makes provisions for price and quantity of the goods: Article 14.

*UN Case 53*

*The facts:* A US company carried out extensive negotiations with a Hungarian company to manufacture aircraft engines. The US company made two alternative offers and did not quote an exact price.

*Decision:* The court of first instance decided that a valid contract had been concluded. However, on appeal, the US Supreme Court found that the offer and acceptance were both vague. They didn't explicitly, or by implication, fix the price or make provision for that price to be determined. The acceptance was merely an expression of the intention of the Hungarian company to conclude a contract. Therefore no valid contract had been formed.

### 3.1.2 Commencement of offer

The offer becomes **effective when it reaches the offeree**: Article 15. An offer 'reaches' the offeree when:

- it is made orally to him
- it is delivered by other means to him personally, at his place of business or mailing address, and
- if there is no business or mailing address, it is delivered to him personally at his habitual residence: Article 24.

This 'reaching' rule applies to **offer, acceptance** and any other indication of **intention**, such as withdrawal or revocation. A delay or error in the transmission of the communication, or its failure to arrive, does not deprive that party of the right to rely on the communication: Article 27.

### 3.1.3 End of offer

An offer may come to an end in the following ways:

- Withdrawal.
- Revocation.
- Rejection.

Even an irrevocable offer may be **withdrawn** if the withdrawal reaches the offeree before or at the same time as the offer: Article 15. Remember, the rules for the withdrawal reaching the offeree are the same as for the offer reaching the offeree.

An offer may be **revoked** if the revocation reaches the offeree before acceptance is despatched (Article 16).

There are certain instances in which an offer may **not be revoked**: Article 16. These are where:

- the offer was irrevocable, or
- it was reasonable to assume the offer was irrevocable, and the offeree acted on that assumption.



#### Definition

An **irrevocable offer** is one that indicates that it is, whether by means of it stating a fixed time for acceptance or otherwise.

An offer, even one which is irrevocable, is terminated by **rejection** when rejection reaches the offerer: Article 17. Acceptance which contains additions or limitations or other modifications to the offer is a **counter-offer**, which rejects the offer and terminates it: Article 19.



### Question 1: Offer

Penguin Co is in negotiations with Bailey Inc, a company in a different country from Penguin Co. Penguin Co wants Bailey Inc to manufacture 100 000 garden rakes. Penguin Co will supply the wooden handles and Bailey Co will make and fit the rake heads.

Two days ago, Penguin Co faxed Bailey Inc a document setting out the terms on which they wanted to contract. These terms included a reference to the 100 000 rakes and set out a contract price. Does this fax represent a valid offer to contract under the Convention?

(The answer is at the end of the chapter)

## 3.2 Acceptance



### Section overview

- Acceptance is a statement **made by the offeree**, or other conduct of the offeree that indicates assent to an offer. Assent must be a statement or an act. Silence or inactivity cannot be acceptance. Acceptance becomes effective **when it reaches the offeror**.



### Definition

**Acceptance** is a statement made by the offeree, or other conduct of the offeree, that indicates assent to an offer (Article 18).

Acceptance must be a **statement** or **an act**, such as the despatch of goods or payment of an agreed price. Silence or inactivity does **not** constitute acceptance.

#### UN Case 95

*The facts:* A Swiss buyer sent an order to an Austrian seller. The seller had sent the buyer a written confirmation. The buyer failed to react. When the seller sued for the price, it argued that a contract had been concluded.

*Decision:* The court decided that the letter of confirmation constituted acceptance under both Swiss and Austrian law, and the parties should have known that. The exchange of confirmations was also consistent with how the parties had dealt with each other in the past. Acceptance was therefore valid, and a contract had been concluded and the seller was entitled to payment.

### 3.2.1 Commencement of acceptance

Acceptance becomes **effective the moment that the indication of assent reaches the offeror**: Article 18.

The **exceptions** to this rule are that **acceptance is not effective** when:

- Acceptance has not reached the offeror within a fixed timescale (if relevant), or
- Acceptance has not reached the offeror within **reasonable time**, which will be judged in relation to the **method of communication** that was used by the offeror. An **oral offer** must be **accepted immediately** unless the circumstances indicate otherwise: Article 18.

For example, if an offeror made an offer by post, it is reasonable that acceptance could take several days, as it would be reasonable for acceptance to be posted in return.

### 3.2.2 Acceptance by an act

When an offer or the past transactions between the offeror and offeree indicate that the offeree may indicate his assent by performing an act, **acceptance is effective as soon as the act is performed**.

Such acceptance is only effective if the act is performed in the correct time period: Article 18.



## Question 2: Acceptance

Reeve Co has supplied Laurel Inc wooden pallets on demand over the course of the past five years. Laurel Inc faxed Reeve Co a new order yesterday, setting out the quantity required and the price. Reeve Co has not contacted Laurel Inc in response to the fax, but has commenced manufacture on the pallets. Has Reeve Co accepted the offer?

(The answer is at the end of the chapter)

### 3.3 Counter-offer



#### Section overview

- A **counter-offer** is a reply to an offer which purports to be acceptance but which varies the terms of the offer. Minor variations to the offer may not be counter offer, unless the offeror objects to them without undue delay.



#### Definition

A **counter-offer** is a reply to an offer which purports to be acceptance but which contains additions, limitations or other modifications to the terms of the offer: Article 19.

An indication that contains such additions, limitations or modifications that **do not materially alter the terms of the offer is an acceptance of that offer**. The terms that form part of the contract will be the altered terms.

If the **offeror objects** to the new terms, without undue delay, either orally or by notice, the acceptance will not be effective.

Examples of what might constitute material alteration of the terms would be a **significant change to the price** or the **quantity** of goods being provided, the **time** or **place of delivery** or a change to **how disputes are to be settled**.

However, if the offeror had mistakenly used an old price and in the buyer's confirmation they had replaced it with the more up-to-date price, this **small modification** would stand unless the offeror objected.

### 3.4 Communication of acceptance



#### Section overview

- **Acceptance** must reach the offeror within the time specified by the contract or within a reasonable time. There are certain rules governing **communication of acceptance**.

As discussed above, an acceptance is only valid if it reaches the offeror in **reasonable time or within a fixed time fixed by the contract** (Article 18). The period of time commences:

- from the moment the telegram containing the offer is handed in
- from the date shown in the letter containing the offer or on the envelope, or
- when an offer contained in instantaneous communication reaches the offeree: Article 20.

**Official holidays** and **non-business days** are included within the time period. If acceptance cannot be delivered because the last day of the time period is a non-business day or a holiday, an extra business day is given to effect delivery.

However, **late acceptance** can be valid, if the offeror orally accepts it without delay or despatches a notice to that effect (Article 21). Also, if there has been a problem with delivery of acceptance, late acceptance is valid unless the offeror orally informs the offeree that the offer has lapsed, or despatches a notice to that effect.

### 3.5 Withdrawal of acceptance

Acceptance may be **withdrawn** if the withdrawal reaches the offeror before or at the same time as the acceptance would have become effective: Article 22.



#### Question 3: Formation of contract

Sentiero SA has been in negotiations with Betula Co for a new contract, to produce several new ship engines. Various documents have passed between the parties, including quotations for engines to different specifications. The most recent quotation Sentiero sent to Betula sets out a proposal for three engines to different specifications. Each of them had a price attached, on average 20% of each was for labour.

Betula sent an order to Sentiero on the basis of the quotation. The next day they realised a minor amendment they wished to make to the quotation. They faxed Sentiero outlining that they withdraw the offer made in the post and outlined the terms on which they do want to offer the contract, with reference to the quotation, but including an amendment.

Sentiero received the letter in the post and faxed back accepting the contract. The fax was not delivered to the contracts manager, and the contract was performed to the original specification.

Outline what matters will be considered in determining whether Betula will have to accept the goods made to the original specification.

(The answer is at the end of the chapter)

## 4 Modification or termination of the contract



### Section overview

- A contract may be **modified or terminated at any time** provided the parties agree.

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Under Article 29, a contract once formed may be **modified** or **terminated** by the mere agreement of the parties.

The UNCISG governs the formation of the **contracts** and **obligations** of the parties in those contracts to which it applies. It does not set out any internationally agreed terms for the contract and to the relative risks and responsibilities of the parties in getting goods from one part of the world to another.

## 5 Obligations of the seller



### Section overview

- The key obligations of the seller relate to **delivery** and **quality**.

The rules concerning the obligations of the seller are found in Chapter II of Part III of the Convention. There are two key areas for the rules, **delivery**, **quality** and **conformity**. Also in Chapter II are a number of remedies for breach of the rules, and therefore the contract, by the seller.

### 5.1 Delivery



### Section overview

- The seller is required to deliver the goods in **accordance with the contract**, or, if no specifications are made, in accordance with the Convention.

## Article 30

The seller must deliver the goods, hand over any documents relating to them and transfer the property in the goods as required by the contract and this Convention: Article 30.

### 5.1.1 Place of delivery

The terms of the contract between the buyer and seller may **specify a place** where the goods are to be delivered. If so, the goods must be delivered to that place: Article 31.

If the contract does not specify the place, the Convention implies the following terms into the contract:

(a) **Contract involving carriage**

A contract involving carriage is one where the goods have to be transported to the buyer as part of the contract.

The seller discharges his obligation to deliver the goods by handing the goods over to the first carrier for transmission to the buyer. The carrier is the person or entity transporting the goods to the buyer, or to the next carrier, if there are several involved.

(b) **Specific goods/identified goods drawn from specific stock**

If the parties know that the goods are in a particular place at the time the contract is made, then the seller discharges his obligations by placing the goods at the buyer's disposal at that place.



## Definitions

**Specific goods** are those which are identified as the goods to be sold at the time when the contract is made.

**Identified goods from specific stock** are goods which are not specific but that are part of a larger, specific stock of goods.

(c) **Other instances**

If the contract does not fall into the categories of (a) or (b) then the seller discharges his obligation of delivery if he places the goods at the buyer's disposal at the place where the seller had his business at the time the contract was concluded: Article 31.

### 5.1.2 Contracts involving carriage

If the **goods in carriage are not clearly identified** to the contract, the seller must give the buyer **notice of the consignment**, specifying the goods: Article 32. The goods could be identified to the contract by markings on the goods, shipping documents or otherwise.

The means of transport chosen by the seller must be reasonable in the circumstances and according to the usual terms of transportation for such goods.



## Example: Contracts involving carriage

It would not be reasonable, to send perishable goods on a ship when the journey will take four weeks.

When the contract involves carriage, the parties will determine which of them should **insure** the goods while in transit. **If the contract does not require the seller to insure** the goods and the **buyer requests information** from the seller so that he may insure the goods, the **seller must give the buyer the available information**: Article 32.

## 5.2 Time of delivery



### Section overview

- **Delivery** should take place at the **time stated by the contract**.

Delivery should take place **on the date**, or within the period, **specified in the contract**: Article 33.

If the contract specifies a period within which delivery may take place, but makes it clear that the **buyer is entitled to determine** the delivery date, delivery should take place on the date which the buyer determines.

If no date or time period is specified in the contract, delivery should take place within **reasonable time** of the contract being formed: Article 33.

### 5.2.1 Handing over of documents

If the contract also requires **documents** to be handed over to the buyer by the seller (for example, shipping documents), these should be handed over at the time and place specified by the contract: Article 34.

If the seller hands the documents over **before the required time**, and the documents do not correctly conform to the documents required by the contract, he may correct them before the time specified in the contract for original delivery. This is unless this causes the buyer unreasonable expense: Article 34.

## 5.3 Quality and conformity



### Section overview

- Goods must be delivered which are of the **quantity, quality** and **description** as stated in the contract

#### Article 35

The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract: Article 35.

If the contract does not state what the required level of quantity and quality is and the goods are not described in the contract, the following **conformity requirements** must be met.

### 5.3.1 Conformity requirements

#### Conformity requirements: : Article 35(2)

The goods are **fit for the purposes** for which **goods of the same description** would **ordinarily be used**.

The goods are fit for **any particular purpose expressly or impliedly made known to the seller at the time of forming the contract**. This is unless circumstances show that the buyer did not rely, or that it was unreasonable to rely, on the seller's skill and judgment.

The goods **possess the qualities of any sample or model** held out by the seller to the buyer.

The goods are **contained or packaged in the manner usual for such goods**, or where there is no such manner, in a manner adequate to preserve and protect the goods.

The seller is **not** obliged under Article 35(2) to sell goods which conform to all statutory or other public provisions in force in the buyer's state (such as health and safety regulations) unless either:

- (a) The same provisions apply in the seller's state, or
- (b) The buyer told the seller about the provisions and then relied on the seller's expert knowledge, or
- (c) The seller knew of the provisions due to special circumstances.



#### UN Case 84

*The facts:* The seller, a Swiss company, sold New Zealand mussels to the buyer, a German company. The buyer refused to pay because the mussels had been found by the Federal Health Office to be unsafe because they contained a cadmium concentration in excess of the statutory limit.

*Decision:* The supply of mussels with higher cadmium composition did not constitute a fundamental breach of contract justifying avoidance of the contract and a refusal of the buyer to pay the purchase price. The high cadmium composition did not constitute lack of conformity of the mussels with contract specifications under CISG 35(2), and the mussels were still fit for eating. It was also held that, even if the buyer had established faulty packaging of the goods as it had tried to do, the contract could not be avoided. In order to justify avoidance of the contract in these circumstances, faulty packaging must be a fundamental breach of contract, and must be easily detectable. This would enable the buyer to declare avoidance of the contract within a reasonable time after receiving delivery. The buyer was ordered to pay the purchase price plus interest.

The **seller is not liable for a lack of conformity** in the goods **if**, at the time of forming the contract, the **buyer knew**, or could not have been unaware, that the goods did not conform: Article 35(3).

The **seller is liable for any lack of conformity** which exists at the time when risk passes to the buyer, even though the lack of conformity becomes apparent only after that time: Article 36(1). The seller is also liable for any lack of conformity which occurs after risk passed and which is due to a breach of any of his obligations. This includes a breach of any guarantee that for a period of time the goods will remain fit for their ordinary purpose or for some particular purpose, or will retain specified qualities or characteristics: Article 36(2).

When the seller has delivered goods before the date for delivery but there is a shortfall of quantity or some other **non-conformity**, he may deliver any missing part or make up any deficiency up until the agreed date for delivery. This is provided it does not cause the buyer unreasonable expense or inconvenience. In such cases, the buyer may still seek damages: Article 37.

### 5.3.2 Buyer's duty to examine the goods

The buyer must examine the goods to ensure conformity as soon as possible after delivery: Article 38.

- (a) If the contract involves **carriage**, he should examine the goods as soon as possible.
- (b) If the goods are being **despatched immediately by the buyer** and the seller knows that, the goods may be examined on their arrival at the next destination: Article 38.

**The buyer loses the right to rely on a lack of conformity** of the goods **if he does not give notice to the seller** specifying the lack of conformity **within a reasonable time** after he has discovered it or ought to have discovered it: Article 39. If he does not inform the seller within two years of goods being handed over, the right is usually lost: Article 39.

#### UN Case 48

*The facts:* A German buyer of fresh cucumbers wanted to obtain a reduction of the price because the goods did not conform with contract specifications.

*Decision:* The court of first instance dismissed the application because the buyer had inspected the goods at the place of delivery in Turkey and had found them to be in good order. The appellate court found that the UN Convention was applicable as part of German law and it upheld the decision of the first court. The buyers had lost the right to rely on non-conformity because they waited seven days, until the goods arrived in Germany to give notice of the non-conformity.

The seller cannot rely on Articles 38 and 39 to relieve him of responsibility regarding lack of conformity if the lack of conformity relates to facts of which he **knew or could not have been unaware**, and which he did not disclose to the buyer: Article 40.

## 5.4 Third party rights



### Section overview

- The Convention sets out the position regarding third party rights to goods, especially with regard to **intellectual property**.

#### Article 41

The seller must deliver goods which are free from any right or claim of a third party, unless the buyer agreed to take the goods subject to that right or claim. However, if such right or claim is based on industrial property or other intellectual property, the seller's obligation is governed by article 42.

#### Article 42

The seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property:

- (a) Under the law of the state where the goods will be resold or otherwise used, if it was contemplated by the parties at the time of the conclusion of the contract that the goods would be resold or otherwise used in that state, or
- (b) In any other case, under the law of the state where the buyer has his place of business.



### Definition

**Intellectual property** is a term covering a number of distinct rights which provide the owner with a form of limited monopoly or a degree of exclusivity.

Intellectual property includes:

- Trade marks,
- Patents, and
- Copyright.

In other words, if the goods are subject to such a right or claim, the buyer must have **agreed** that he is to receive goods subject to such claims.

Notice that the qualification is that the buyer **must have been aware**, or **could not have been unaware of the right to claim**. An arbitral tribunal might conclude that a party could not have been unaware of a global branding feature, such as the Coke dynamic ribbon. The seller is also relieved from liability where the right or obligation results from the seller's compliance with technical drawings, designs, formulae or other such specifications made by the buyer: Article 42.

The buyer must notify the seller of third party rights and claims within a **reasonable time** of becoming aware of it: Article 43. This does not apply if the seller is already aware of the claim.

## 6 Buyer's remedies for seller's breach of contract



### Section overview

- If the seller **breaches the contract**, the buyer has the right to: require performance; declare the contract avoided; reduce the price in proportion to the non-conformity; seek damages.



## Definitions

**Breach of contract** is where a party fails to perform his obligations under the contract.

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**Fundamental breach of contract** is where a breach results in such detriment to the other party so as to substantially deprive them of what they are entitled to expect under the contract. This is unless the party in breach did not foresee such a result, and a reasonable person in the same kind of circumstances would not have foreseen it: Article 25.

The buyer is given a number of **rights** under the Convention if the seller breaches the contract. These fall into two categories:

- Specific rights given in the Convention.
- Damages – we shall discuss damages in Section 9, as they apply to both the seller and the buyer.

## 6.1 Specific rights of the buyer under the Convention

The buyer is given a number of rights in Articles 46 to 52 of the Convention:

- Article 46: Right to require performance.
- Article 49: Right to declare the contract avoided.
- Article 50: Right to reduce price in relation to non-conformity of goods.

When only part of the goods have been delivered, or only part of them are in conformity, Articles 46–50 apply to the undelivered or non-conforming parts: Article 51.



### Exam comments

Remember that the exercise of any of these rights **does not exclude the buyer's right to claim damages**: Article 45.

## 6.2 Performance

The buyer may require **performance of the contract** by the seller: Article 46.

The buyer may not require the seller to perform if he has already resorted to remedy that is **inconsistent** with performance for example, declaring the contract avoided, referred to below.

The buyer may set an **additional period of time** for the contract to be performed in: Article 47. If he does so, he may not resort to another remedy for breach in that additional time period. Of course, as stated above, he is still entitled to make a claim for damages after the additional time period.

Note that a court does not have to enter a judgment of **specific performance** against any party unless it would do so in local cases under the law of its own contracting state: Article 28.

### 6.2.1 Lack of conformity of the goods

If the goods delivered by the seller do not conform to the contract or Convention requirements, the buyer may require the seller to:

- Deliver **substitute goods** if the breach of that term of the contract was fundamental, or
- Repair the goods** if the lack of conformity is slight, and the request to repair is not unreasonable: Article 46.

Subject to the remedy of avoidance, below, even after the date for performance the **seller may remedy** his own **failure to perform** at his own expense under Article 48 if:

- There is no unreasonable delay, or
- It does not cause the buyer unreasonable inconvenience or uncertainty as to whether expenses advanced to the seller by the buyer will be reimbursed: Article 48.

In order to take such action, the seller should **give notice to the buyer** of his intentions. This notice is **deemed to include a request** that the buyer should contact the seller to let him know whether late performance is **acceptable**. This deemed notice is only effective if the buyer receives it.

If the buyer receives the deemed notice and does not reply, the seller can assume that this means the late performance is acceptable and carry on with his **performance**.

Remember that the buyer retains the right to claim **damages**.

## 6.2.2 Early delivery

If the seller delivers the goods early, the buyer may take delivery or refuse to take delivery at that time: Article 52.

## 6.2.3 Excess delivery

If the seller delivers more than was ordered, the buyer may take delivery of some or all of the excess, or not, as he chooses: Article 52. If he does accept additional goods however, **he must pay for them** at the contract price.

## 6.3 Avoidance

The buyer may declare the contract avoided if a failure by the seller to perform is a **fundamental breach of contract**: Article 51. They may also declare the contract avoided, in case of non-delivery, if the seller does not deliver in the additional time period fixed by the buyer, or declares that he will not be able to deliver in a fixed time period: Article 49. A declaration of avoidance is effective only if made by notice to the other party: Article 24.

### 6.3.1 Example: Fundamental breach of contract



Failure to perform might be a fundamental breach of contract in a contract where time is of the essence. For example, when the goods are needed at a certain stage in the buyer's production, or for a particular point in time.

The buyer **loses the right to declare a contract avoided** if the goods are delivered, unless:

- (a) Delivery is late, and he does so within a reasonable time of discovering the goods have been delivered, or
- (b) The seller commits another breach of contract, and he does so within a reasonable time after he knew or ought to have known of the breach, and after any additional time periods fixed: Article 49.

## 6.4 Reduction of the price

If the goods do not conform to the requirements of the contract (refer to conformity of the goods in Section 1), the **buyer is entitled to reduce the price in proportion to the lack of conformity**. This is unless the seller corrects the lack of conformity in the contract time period or the buyer refuses to accept correction which is in line with Articles 37 and 48: Article 50. In the following case, the seller did not correct within the time period, and was not entitled to do so after that time period.

### UN Case 56

*The facts:* A Swiss retailer refused to pay the seller, an Italian manufacturer of furniture, the purchase price, claiming that the goods did not conform to the contract.

*Decision:* The court held that as the buyer had resold some of the goods without notifying the seller in time about that resale, the buyer had lost its right to rely on the non-conformity of those goods. However, with regard to the rest of the goods, the buyer was granted a reduction in the price as he had notified the seller of the defects promptly and the seller had refused to remedy them. The seller offered to pay the repair costs instead, but the court held that the intention of the convention was not to cover repair costs. It was to reduce the purchase price in relation to what value the delivered goods had in comparison to the value that conforming goods would have had.

The buyer may also reduce the price if the buyer has a reasonable excuse for failing to give notice of third party rights under Article 43: Article 44.

## 7 Obligations of the buyer



### Section overview

- The buyer has obligations in respect of taking delivery of the goods and making payment.

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The rules concerning the obligations of the buyer are found in Chapter III of Part III of the Convention. There are two key areas for the rules – **payment** and **taking receipt of delivery**. Also in Chapter III are a number of remedies for breach of the rules, and therefore the contract, by the seller.

### 7.1 Payment

#### Article 53

The buyer must pay the price for the goods and take delivery of them as required by the contract and this Convention: Article 53.

This general requirement includes a duty to take steps to **comply with any formalities** to enable payments to be made: Article 54.

The following provisions also apply:

- (a) **Price not concluded:** Where the contract has been formed without reference to the price, the buyer and seller are deemed to have, by implication, made reference to the price generally charged at the time the contract was formed: Article 55.
- (b) **Price determined according to weight:** Where the price is to be fixed according to weight, if there is doubt, the price is to be determined by net weight: Article 56.

#### 7.1.1 Where price is to be paid

The contract may specify where the price is to be paid. If it does not, the buyer must:

- Pay it at the seller's place of business, or
- If payment is to be made when goods or documents are handed over, at the place **where the goods or documents are handed over**: Article 57.

If the seller changes his place of business after the contract has been formed, and it costs the buyer more to make payment as a result, the seller should bear that increase in price: Article 57.

#### 7.1.2 When the price is to be paid

The contract may specify when the price is to be paid. If it does not, the buyer must pay the price when the seller places the goods and/or documents at the buyer's disposal, except:

- The buyer is **not obliged** to pay until he has **examined** the goods. This is unless the procedures for delivery or payment agreed upon by the parties are inconsistent with the buyer having that opportunity.
- The seller may make payment a **condition** of handing over the goods.
- If the contract includes **carriage**, the seller may **despatch** the goods on the condition that they will not be released unless **payment is made**: Article 58.

If a fixed date for payment has been set, the buyer must pay the price without the seller needing to request that he does so: Article 59.

## 7.2 Taking delivery

The **buyer's obligation** to take delivery consists of the buyer:

- Doing all acts which could reasonably be expected of him in order to enable the seller to make delivery, or
- Taking over the goods: Article 60.

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# 8 Seller's remedies for buyer's breach of contract



## Section overview

- If the buyer breaches the contract the seller has the right to: require **payment** and **acceptance** of the goods; **declare** the **contract avoided**; **seek damages**.

The seller is given a number of **rights** under the Convention by Article 61 if the buyer breaches the contract. These fall into two categories:

- Specific rights given in the Convention in Articles 62 to 65.
- Damages. Damages are explored in Section 9 below, as they apply to both the seller and the buyer.

If a seller seeks a remedy for breach of contract the court may not grant the buyer any period of grace: Article 61.

## 8.1 Specific rights under the Convention

The seller is given a number of rights in Articles 61–65 of the Convention.

- (a) Article 62: Right to require payment and acceptance of goods.
- (b) Article 64: Right to declare the contract avoided.



## Exam comments

Remember that the exercise of any of these rights does not exclude the seller's right to claim damages: Article 61.

## 8.2 Right to require payment and acceptance of the goods

The **seller has the right to require the buyer to make payment, take delivery or perform his other obligations**, unless he has resorted to a remedy which is incompatible with this: Article 62.

The seller may fix an **additional time period** within which the buyer should perform his obligations: Article 63. This should be of **reasonable** length. The seller may not resort to any remedy for breach of contract during this time period. The seller is not deprived however of the right to claim damages for delay in performance.

## 8.3 Avoidance

The seller may declare the contract avoided:

- If the buyer's failure to perform is a fundamental breach, or
- If the **buyer does not accept the goods** and/or **pay for them** in the additional time period allowed by the seller, or
- The buyer **declares that he will not accept the goods and pay for them** in that time: Article 64.

Where the buyer has paid for the goods, the seller loses the right to declare it avoided, unless he does so in the following circumstances:

- In respect of **late performance** by the buyer, before the seller becomes aware that performance has been rendered.
- In respect of **any other breach** by the buyer, within a reasonable time of knowing of the breach, or in the expectation of additional time allowed: Article 65.

## 8.4 Buyer's failure to specify

The contract may state that the buyer is to specify the **form, measurement** or other **features** of the goods. If he fails to do so, the seller may make the specification, taking into account the buyer's known requirements: Article 65. He must inform the buyer of this and fix a reasonable time by which the buyer can make amendments. Further failure by the buyer to act means that the seller's specification is binding.

# LO 6.1.1 9 Damages



## Section overview

- An injured party is **always entitled to claim damages** under the Convention, regardless of any other remedy sought or obtained, though he is required to **mitigate**, or seek to limit, the extent of his loss made. Damages is a monetary remedy equal to the **loss suffered by the injured party** as a result of the breach.



## Exam comments

Damages is a key remedy and you must be able to explain it in an exam. Remember that the **injured party** is **always entitled to claim damages, regardless** of any **other claims** he makes under the Convention.



## Definition

**Damages** is a monetary sum equal to the loss, including loss of profit, suffered by the injured party as a consequence of the breach: Article 74.

The **amount** of damages may not be greater than the loss which the party in breach foresaw, or should have foreseen, at the time of the contract being formed, in the light of known facts then.

If the buyer has avoided the contract for the seller's breach and has bought **replacement goods** he may claim the value of these as damages: Article 75.

If the seller has avoided the contract for the buyer's breach, and has sold the goods to another party, the **proceeds of this sale** should be deducted from any damages awarded: Article 75.

If the contract is avoided and there is a current price for the goods, the party claiming damages may, if he has not made a purchase or resale, recover the difference between the price fixed by the contract and the current price at the time of avoidance, as well as any further damages recoverable.

However, if the party claiming the damages has avoided the contract after taking over the goods, the current price at the time of such taking over shall be applied instead of the current price at the time of avoidance: Article 76.

The 'current price' is the price prevailing at the place where delivery of the goods should have been made or, if there is no current price at that place, the price at such other place as serves as a reasonable substitute, making due allowance for differences in the cost of transporting the goods.

## 9.1 Mitigation of the loss

Article 77 requires an injured party to take **reasonable measures** to mitigate the loss, including loss of profit, resulting from the breach.

Examples of mitigation include:

- Selling goods rejected by the buyer to a **third party**, or
- Buying **replacement goods** from a third party when the seller has failed to deliver.

If a party fails to mitigate his loss, damages may be **reduced** by the amount in which the loss should have been mitigated: Article 77.

# 10 Breach of contract



## Section overview

- A party may **suspend performance** if he has reason to believe that the other party will not perform a substantial part of the contract. A party suspending performance should give notice to the other party, and if the other party assures performance, the suspension should not be carried out. In cases of **fundamental breach**, the contract may be **avoided**.



## Attention

Remember, **breach of contract** is defined as the failure of one party to perform their obligations under the contract.

## 10.1 Anticipatory breach: suspension of performance

The Convention gives parties the right to **suspend performance** in certain situations. The general rule is as follows: a party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a substantial part of his obligations due to:

- A serious deficiency in his ability to perform, or his creditworthiness.
- His conduct in preparing to perform/performing the contract: Article 71.

What this means is that a party may suspend performance if the other party is in **anticipatory breach**. In other words, it is clear that the party will breach the contract, even if the time for performance has not arrived.

In order to suspend performance in this way, the person suspending performance must give the other party **notice** of his actions. If the other party gives adequate **assurance** that they are going to perform the contract, then the suspending party must **not suspend performance**, but must **carry on** with it: Article 71.

If the seller has already despatched the goods before grounds for believing the buyer will be in anticipatory breach become evident, he may **prevent the goods being handed over** to the buyer. This may be even though the buyer holds documents of title: Article 71.

## 10.2 Fundamental breach: avoidance of the contract

If it becomes clear that the other party is going to commit a fundamental breach of contract, the other party may **declare the contract avoided**: Article 72. If time allows, he must give reasonable notice of avoiding the contract in order to give the other party time to provide adequate assurance of performance. This is unless the other party has declared that he will not perform his obligations: Article 72.



# 11 ICC Incoterms



## Section overview

- Incoterms** (international contract terms) are standard trade definitions used in international sales contracts. Seller and buyer may include an Incoterm in their contract, defining the **risks and responsibilities** borne by the parties in getting goods from one part of the world to another. They cover issues to do with **carriage, insurance, risk, customs documentation and duties/taxes**.

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The ICC is the International Chamber of Commerce. It develops and publishes '**Incoterms**', that is, '**international contract terms**', which are **standard trade definitions commonly used** in international sales contracts.

The first version of Incoterms were introduced in 1936 and they have been updated by the ICC seven times to keep them up to date with developments in international trade. The version currently in operation is the 8<sup>th</sup> edition, Incoterms 2010.

There are **eleven** Incoterms 2010 which are divided into two categories (the terms are explained below):

Rules for any mode of transport	
'E' terms	EXW
'F' terms	FCA
'C' terms	CIP, CPT
'D' terms	DAP, DAT, DDP
Rules for sea and inland waterway transport only	
'F' terms	FAS, FOB
'C' terms	CFR, CIF

The main **issues in international trade** that are addressed by deciding to use particular Incoterms are:

- Who pays for carriage from the seller to the buyer i.e. how far are **carriage costs** included in the contract price?
- Who bears the **risk** that damage will occur to the goods at any point in time?
- Who bears the cost of insuring against this risk i.e. how far are **insurance costs** included in the contract price?
- When does **property** in the goods pass?
- When does **risk** pass?
- Who pays customs duties i.e. how far are **customs costs** included in the contract price?
- Who raises customs documentation?

The Incoterms range from the **most basic deal (EXW)**, where the seller simply makes goods available at its premises in the country of export to the **most all-encompassing deal (DDP)**, where the seller delivers to a place in the country of import named by the buyer, having sorted out all the insurance and customs issues, and having paid all the tax, insurance and carriage costs. The **level of service** should be reflected in the **contract price** agreed between buyer and seller, but that is for the parties to agree. **Incoterms determine responsibilities, not the amount of the contract price.**

The terms are examined below. Although the **obligations** associated with contracts using Incoterms are not legal requirements, they will affect the rights and duties of parties if incorporated into the contract.

## 11.1 Ex works (EXW)

Under such a contract, the seller has **minimum obligations** with respect to delivery. He simply has to make the goods available to the buyer at his own place of business (works).

## 11.2 Free carrier (named place) FCA

Under this term, the seller fulfils his obligations when the goods have been **cleared for export** and handed over to the carrier named by the buyer at a named point.

## 11.3 Free alongside ship (FAS)

This term can only be used when goods are being transported by ship. It means that the seller discharges his obligations to deliver the goods when the goods have been placed **alongside the ship** at a named port of shipment in the country of export. The buyer bears all risk from that moment. This term should not be used if the buyer is not capable of carrying out export formalities.

## 11.4 Free on board (FOB)

The term FOB is usually followed by the name of the port of departure of the goods from the country of export. A FOB contract is one where the **buyer** makes arrangements for shipping and the **seller** discharges his duty by putting the goods on board the ship. This is the default position.

In such a contract, the seller does **not** have obligations in respect of carriage or insurance of the goods after he has placed them on the vessel. However, he is required to provide any export licence or other authorisation required at his own expense and bear the risk and expense of the goods until they are on the vessel.

Thereafter, the buyer must bear responsibility for risk of the goods from when they are on the vessel and obtain any **import licences** required.

## 11.5 Cost and freight (CFR)

This term can only be used when goods are being transported by ship. This is because the seller **pays for all costs and freight** (carriage) to take the goods to a named port of destination in the country of import, but once the goods have 'passed the ship's rail' in the exporting country port, the goods become the risk of the buyer. The seller is therefore required to clear the goods for export, and the buyer arranges and pays for marine insurance.

## 11.6 Cost, insurance and freight (CIF)

Under a CIF contract, the seller is required to **bear the cost of insurance and freight** (carriage) for the goods.

The seller must contract for carriage on the usual terms for the goods to the named port of destination by the usual route and in the way normally used for such goods.

In terms of insurance, he must obtain insurance for the goods that enables the buyer to claim directly from the insurers in the event of loss. This should be with an insurance company of good repute. The minimum insurance cover should be that which is stated in the contract plus 10%.

## 11.7 Carriage paid to (CPT)

This is where the seller pays for carriage to a **named location**. The risk for the goods passes from seller to buyer when the goods reach their destination.

## 11.8 Carriage and insurance paid to (CIP)

This is where **carriage and insurance** are paid by the seller up to a named destination and thereafter, the buyer assumes costs, such as import duties and other taxes.

## 11.9 Delivered at Terminal (DAT)

The seller is considered to have delivered when the goods, having been unloaded from the arriving means of transport, are placed at the buyer's disposal at a named terminal at the named port or destination place. This can be used irrespective of mode of transport or where more than one mode of transport is used.

## 11.10 Delivered at Place (DAP)

The seller is considered to have delivered when the goods, having been unloaded from any defined arriving "vehicle", are placed at a named terminal. This could be any named mode of transport and importantly, any named place.

## 11.11 Delivered duty paid (DDP)

This is in effect the opposite to the EXW term, which represents the minimum obligation for the seller. DDP means that the seller is obliged to **deliver goods** to a **named place** in the **country the goods are being imported to**, **with all duties relating to that importation paid**.

## Key chapter points

- UN Convention on Contracts for the International Sale of Goods (UNCISG)
  - Applies to contracts for sales of goods between parties where their businesses are located in different sovereign states which are contracting states to the Convention, unless the parties exclude it.
  - Both states are contracting states.
  - Basic principles are that it is international, uniform, and based on good faith.
  - Convention must be ratified, accepted or approved by member states.
  - Australia and Singapore are parties to the Convention, UK and Malaysia are not.
  - Only two instances in Australian case law where the applicability of the Convention was clear.
- Formation of a contract for the international sale of goods
  - Formed when validly accepted.
  - Concluded when acceptance of offer is effective.
- Offer and acceptance
  - Offer must be sufficiently definite.
  - Offer ends by either withdrawal, revocation or rejection.
  - Acceptance by assent or by act.
  - Counter-offer.
  - Communication of acceptance.
  - Withdrawal of acceptance.
- Modification or termination of the contract
  - Modified or terminated at any point if both parties agree.
- Obligations of the seller
  - Two key obligations are delivery and quality.
  - Place and time of delivery.
  - Quality and conformity of goods.
  - Buyers have a duty to examine the goods.
  - Third party rights with regards to intellectual property.
- Buyer's remedies for seller's breach of contract
  - Right to require performance of contract.
  - Right to declare contract avoided.
  - Right to reduce price in relation to non-conformity of goods.
- Obligations of the buyer
  - To make payment.
  - To take delivery of goods.
- Seller's remedies for buyer's breach of contract
  - Right to require payment and acceptance of goods.
  - Right to declare contract avoided.
- Damages
  - Injured party is always entitled to claim damages under the Convention.
  - Injured party must take reasonable measures to mitigate the loss.

- Breach of contract
  - Anticipatory breach.
  - Fundamental breach.
- ICC Incoterms
  - International contract terms which are standard trade definitions used in international contracts.
  - Current version is Incoterms 2010

# Quick revision questions

- 1 When does the UN Convention on Contracts for the International Sale of Goods apply to sales of goods?
- 2 **Fill in the blanks.**  
..... can be defined as a contract by which the seller transfers, or agrees to transfer, the ..... in goods to a buyer in exchange for ..... compensation, called the .....
- 3 An offer is sufficiently definite when:  
(1) ..... and  
(2) .....
- 4 Name four ways an offer may end.  
(1) .....  
(2) .....  
(3) .....  
(4) .....
- 5 Silence may be acceptance.  
true ☐  
false ☐
- 6 **Fill in the blanks.**  
A ..... is a reply to an offer which purports to be acceptance but which contains ....., ..... or other ..... to the terms of the offer.
- 7 Acceptance is effective when the indication of assent reaches the offeror, except when:  
(1) .....  
(2) .....
- 8 Acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance.  
true ☐  
false ☐
- 9 **Fill in the blanks.**  
..... are those goods which are identified as the goods to be sold at the time when the contract is made.
- 10 What are the four minimum conformity requirements set out in the Convention?  
(1) .....  
(2) .....  
(3) .....  
(4) .....

- 11 If the seller delivers goods which do not conform to the contract specifications, the buyer always has the right to demand substitute goods.
- true ☐
- false ☐
- 12 When the contract does not refer to price, the buyer and seller are deemed to have made reference to the price generally charged at the time the contract was formed.
- true ☐
- false ☐
- 13 What does the buyer's obligation to take delivery consist of?
- (1) .....
- (2) .....
- 14 **Fill in the blanks.**
- A party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a ..... part of his obligations because of:
- A ..... in his ability to perform or creditworthiness.
- His ..... in preparing to perform the contract.

## Answers to quick revision questions

- 1 It applies to contracts of sale of goods between parties whose places of business are in different states, when the states are contracting states or when the rules of private international law lead to the application of the law of a contracting state.
- 2 **Sales of goods** can be defined as a contract by which the seller transfers, or agrees to transfer, the **property** in goods to a buyer in exchange for **monetary** compensation, called the **price**.
- 3
  - (1) It indicates the goods in question, and
  - (2) It makes provisions for price and quantity of the goods.
- 4
  - (1) Withdrawal
  - (2) Revocation
  - (3) Rejection
  - (4) Acceptance
- 5 False. Silence and inactivity cannot be acceptance.
- 6 A **counter offer** is a reply to an offer which purports to be acceptance but which contains **additional limitations** or other **modifications** to the terms of the offer.
- 7
  - (1) Acceptance has not reached the offeror within a fixed timescale (if relevant).
  - (2) Acceptance has not reached the offeror within reasonable time.
- 8 True. This is also true of an offer.
- 9 **Specific goods** are those goods which are identified as the goods to be sold at the time when the contract is made.
- 10
  - (1) Fit for the purpose for which goods of that description would ordinarily be used.
  - (2) Fit for any purpose express or implied to the seller at the time of the contract.
  - (3) Possess qualities of any sample or model used to obtain the sale.
  - (4) Contained/packaged in a manner usual for such goods.
- 11 False. If the lack of conformity is minor, the seller may repair the goods.
- 12 True. The price generally charged at the time the contract was formed will apply if a contract does not refer to a price.
- 13
  - (1) Doing all acts that could reasonably be expected of him to take delivery.
  - (2) Taking over the goods.
- 14 A party may suspend performance if, after the contract starts, it becomes apparent that the other party will not perform a **substantial** part of his obligations because of:
  - A **serious deficiency** in his ability to perform or creditworthiness, or
  - His **conduct** in preparing to perform the contract.



## Answers to chapter questions

- 1 Two things need to be considered in order to determine whether this is a valid offer for a contract for international sale of goods under the Convention:

- Does the proposed contract fall within the scope of the Convention?
- Is the offer sufficiently definite to be valid?

### *Scope*

The proposed contract is for Bailey Inc to manufacture rake heads and fit them to poles supplied by the purchaser. The Convention does not apply to the supply of services, contracts where the major obligation of one of the parties is to provide labour, or where the buyer provides a substantial part of the materials necessary for the manufacture.

In this case, Penguin is providing the wooden handles and Bailey is making and attaching the rake heads. In manufacturing rakes, it seems sensible to conclude that the manufacture of the rake head is the greater part of the process. It will require a number of materials (plastics or metals and screws). Given that Bailey has to provide this part of the manufacture and materials, it would seem that Penguin is not providing the substantial part of the materials for the contract. Nor is Bailey providing solely labour. Bailey is under an obligation to provide materials of sufficient quality to manufacture the rake heads. The contract therefore appears to fall within the scope of the Convention.

### *Sufficiently definite?*

The fax contains details of the quantity of the required product and the price of the contract. It is therefore sufficiently definite to constitute an offer under the Convention.

### *Conclusion*

The fax from Penguin to Bailey is sufficiently detailed to constitute an offer under the Convention, and the details of the contract do fall within its scope.

- 2 Acceptance must be a **statement** or an **act**. Reeve Co has not made a statement to the buyer, but has commenced manufacture of the pallets, which is an act.

Whether this act will be **sufficient to constitute acceptance** in this case **will depend** on what the fax said, or, given that the parties have been contracting for a substantial period of time, the **past transactions** between the parties.

The fax containing the offer from Laurel Inc may have indicated that acceptance by an act is acceptable. Alternatively, if the **past practice** of Reeve has been to carry out the order without acknowledging the acceptance any other way, then this will be considered acceptable acceptance, assuming that they deliver the order within a **reasonable time**.

- 3 The court would consider whether a contract has been validly formed in this instance.

### *Matters to consider:*

- *Whether a valid offer was made to Sentiero*

This will involve considering whether the original offer was withdrawn effectively by the fax. This will involve determining whether the withdrawal 'reached' Sentiero before the offer was received. It will also depend on whether the new offer's references to the quotation constituted a sufficiently definite offer.

- *Whether a valid acceptance was made to Betula*

This will depend on whether the original offer was open to be accepted, as Sentiero could not have accepted the second offer which they were not aware of.

If the original offer had been validly withdrawn, it could not have been accepted by Sentiero, in which case, no contract has been formed and Betula will not have to accept the goods. However, if it was not withdrawn, Sentiero has indicated assent to the original offer by a reasonable method of communication and this would constitute valid acceptance if the offer was open to be accepted.





# Chapter 8

## Torts

Learning objectives	Reference
<b>Torts</b>	<b>LO7</b>
Explain that the law of torts concerns a civil wrong which may mean a civil action for compensation arises	LO7.1
Explain the tort of negligence	LO7.2
Explain that tort law provides legal remedies for damages caused by negligence	LO7.3
Explain that negligence means failure to exercise reasonable care	LO7.4
Explain consumer protection law and negligence	LO7.5

### Topic list

- 1 Tort and other wrongs
- 2 The tort of negligence
- 3 Duty of care
- 4 Breach of duty of care
- 5 Causation and remoteness of damage
- 6 Defences to negligence
- 7 Limitations to actions for negligence
- 8 Consumer protection

# Introduction

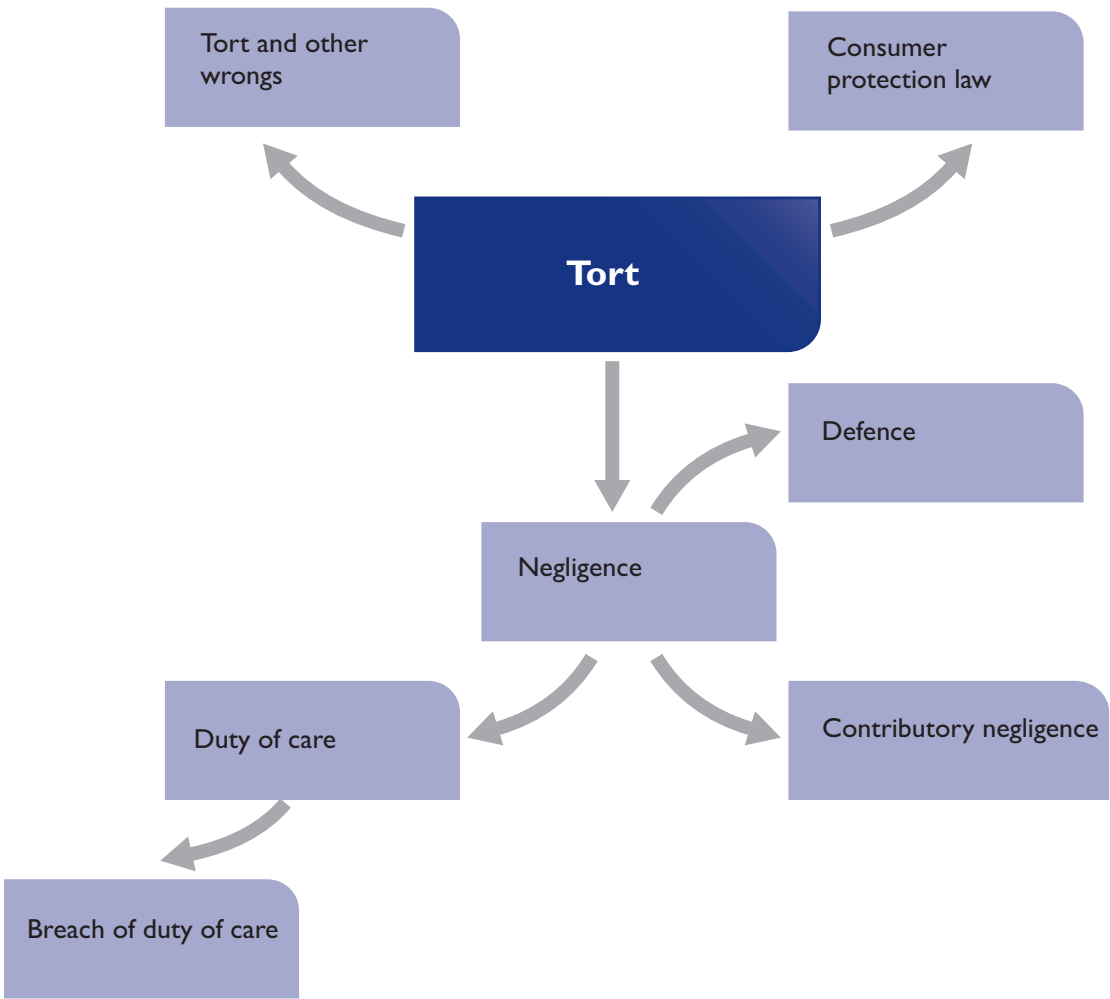
In this chapter we introduce the law of torts.

Torts are **wrongful acts** against an **individual**, a **company** or their **property** that gives rise to a **civil liability** against the person who committed them. Torts are one of the two major branches of private obligations; the other being contract law. Torts are found in both **common law** and **civil law** jurisdictions.

There are a number of torts, however **negligence** is the one that will concern you most in your studies. This leads into the topic of **consumer protection**.

Your learning outcomes require you to specify the **nature** of torts and to recognise the **factors** that must be present for claims to succeed. By focusing on the rules and their related **cases** you will be able to apply them to any case given to you in an exam question scenario.

The law on **consumer protection** and **product liability** is one where legislation intervenes in many jurisdictions, however where there are gaps then the principles of tort law, especially of **negligence**, are applied.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 What is a tort? (Section 1.1)
- 2 List three different 'types' of tort. (Section 1.2)
- 3 Define the tort of negligence. (Section 2.1)
- 4 A plaintiff must prove three factors to effectively succeed in a tort of negligence. What are these three factors? (Section 2)
- 5 How did one small snail have one large impact in the world of tort law? (Section 3.1)
- 6 What must be demonstrated to successfully argue the rule of *res ipsa loquitur*? (Section 4.2)
- 7 What is contributory negligence and how does it impact on the amount of damages paid to the plaintiff? (Section 6.1)
- 8 How does statute law provide protection to consumers against defective products in Australia? (Sections 8.1)

# 1 Tort and other wrongs



## Section overview

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

## 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.



## Definition

A **tort** is a civil wrong and the person wronged will make a **civil claim** for compensation or an injunction. The plaintiff's claim generally is that he has suffered a loss such as personal injury at the hands of the defendant, and the defendant should pay damages.

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

LO  
7.1

## 1.2 Types of tort

The nature of tort can best be understood by examining examples of torts.

### 1.2.1 Trespass to land

Trespass to land involves **one** or a **combination** of the following acts without lawful justification:

- **Entering** land that is owned by the plaintiff.
- **Remaining** on the land.
- **Placing** objects or projections onto the land.

Liability for trespass is **strict**, which means that even if the action is accidental or no damage results from it, the trespasser is still liable. There is a fundamental right to the privacy of the home under the common law.

### 1.2.2 Nuisance

Landowners have the right to use their land as they see fit and not to have their land interfered with. Nuisance occurs where the use of land by one occupier causes **damage** to a neighbouring occupier or their land.

There are two types of nuisance, **private** and **public**:

#### (a) Private nuisance

This is the 'unlawful interference with a person's use, or enjoyment of land, or some right or in connection with it'.

Cases of private nuisance often involve neighbours and are caused by noise, smell, vibrations, animals, trees and incursions by other such items. Judging liability is a **balancing act**: occupiers are entitled to 'reasonable comfort' but no more.

(b) **Public nuisance**

Public nuisances are not related to private nuisance as they are created by statute and are **criminal offences**. Examples include obstructing the highway, takeaway restaurants creating litter, and 'raves' that attract hundreds of people late at night creating noise and disturbance to a wide area.

These nuisances are 'acts or omissions that materially affect the reasonable comfort and convenience of the life of a class of Her Majesty's subjects': *Att.-Gen v P.Y.A. Quarries Ltd* [1957] 2 QB 169 (UK). The plaintiff is **not** required to have an **interest in land** before being entitled to sue, unlike private nuisances.

### 1.2.3 Trespass to the person

The acts of **battery**, **assault** and **false imprisonment** are commonly considered within the scope of trespass to the person. You should note that the acts may also result in a criminal action against the defendant.

(a) **Battery**

Battery involves the **intentional** bringing of a material object into contact with another person. It is not just restricted to violent acts, but can also include non-violent acts such as the application of 'tone rinse' to a scalp – *Nash v Sheen* [1953] CLY 3726 (UK). For liability to be created it is just the **act** that must be intentional – not the injury.

(b) **Assault**

Assault is the intentional act of putting another in **reasonable fear or apprehension of immediate battery**. Words may not be enough to create a liability unless they are accompanied by menacing or threatening actions. For example, telling someone you will shoot them may not be classed as assault unless you are pointing a gun at them as well. The plaintiff does not have to prove the defendant intended to cause battery, it is sufficient to prove that they were **in reasonable fear** of it. Therefore, pointing an unloaded gun constitutes assault even if there is no intention to cause injury.

(c) **False imprisonment**

False imprisonment involves **unlawfully arresting, imprisoning or preventing a person from leaving** from where they are. The plaintiff does not have to prove damage was caused as it was their liberty that was taken from them.

If a person interferes with another person's autonomy, say by beating or restraining them, this constitutes the tort of **trespass to the person** in **Australia**. There does not have to be **intent**. This differs from the law in other jurisdictions, for example the **UK**, where there must be **intent to trespass**. Therefore, in Australia, an act which is direct but unintentional can lead to an action for negligent trespass, but the plaintiff must prove how there was a 'direct' and 'substantial' interference with their personal autonomy when the incident occurs in a public place.



#### Question 1: Assault and battery

Describe the difference between assault and battery.

(The answer is at the end of the chapter)

### 1.2.4 Defamation

The **expression** or **publication** of **false** or **defamatory statements** that is not lawfully justified are known collectively as defamation. In other words, defamation involves the **ridicule** of an individual or holding them in **contempt**. The words **libel** and **slander** are often used to describe this tort. In legal terms, libel refers to **visible** acts such as writing, pictures and even effigies. Slandorous acts are those that are **spoken** or **gestured**. You should note that **libel** is a **criminal act** which will be actionable in all cases while **slander** is a **civil injury** and in almost all cases damage must be proved. In Australia, a company or corporation cannot sue for defamation.

### 1.2.5 Deceit, injurious falsehood and 'passing-off'

**Deceit** is a wrong whereby the plaintiff is **misled** into taking actions that are to his detriment. A typical example of deceit is the con-artist who encourages an individual to pay him money for goods that he has no intention of supplying.

**Injurious falsehood** involves the defendant making **false statements** about the plaintiff that cause the plaintiff damage through the actions of others. A key example in the business context is the tort of **passing-off**.

**Passing-off** is the use of a name, mark or description by A that **misleads a consumer** to believe that A's 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.

### 1.2.6 Negligence

The number of actions under negligence far exceeds the number under the other torts. In simple terms the **carelessness** of an individual or company causes damage (physical, emotional or economic) to the plaintiff. Negligent acts tend to be **inadvertent** or **reckless**, but not normally intentional.

We shall be studying negligence in more detail in Section 2.



#### Question 2: Torts

John has run his fish and chip shop called 'Fry and Fish' for the last 10 years. He finds out that a new fish and chip shop called 'Fish and Fries' run by Kevin has recently opened round the corner from him. Angry that he may lose custom he arranges for leaflets to be printed that state '... Kevin, from Fish and Fries, folded his last business after a food poisoning scandal so before you try, check those fries....' John distributes the leaflets to homes in the vicinity of the shops even though he knows the statement to be untrue.

Which torts may have been committed?

(The answer is at the end of the chapter)

LO  
7.2

## 2 The tort of negligence



### Section overview

- **Negligence** is the most important modern tort. To succeed in an action for negligence the plaintiff 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 plaintiff suffered **injury, damage or loss**.

### 2.1 Definition

LO  
7.3

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**.



#### Exam comments

You must be aware of the academic requirements for negligence to be proved. The criteria for a successful negligence action are fundamental and should be learned by all students.



## 3 Duty of care



### Section overview

- In the landmark case of *Donoghue v Stevenson* [1932] AC 562 (UK) the UK House of Lords ruled that a person might **owe a duty of care to another with whom he had no contractual relationship** at all. The doctrine has been refined in subsequent rulings, but the principle is unchanged.
- *Donoghue v Stevenson* [1932] AC 562 (UK) is significant as it brings together a number of legal rules into one coherent principle of duty of care.
- The leading case with regard to professional negligence is the UK House of Lords decision in *Hedley Byrne & Co Ltd v Heller and Partners Ltd* [1964] AC 465 (UK)

### 3.1 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 UK's highest court was attempting to establish a general duty that could be applied to all subsequent cases and situations.

LO  
7.4

*Donoghue v Stevenson* [1932] AC 562 (UK)

*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 and suffered nervous shock. The manufacturer argued that, as there was no contract (privity) between himself and B, he owed her no duty of care and so was not liable.

*Decision:* The UK's highest court laid down, in a three to two majority, 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'.

### 3.2 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, there is a three stage test for establishing it:

- 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?

### 3.3 The *Hedley Byrne* case

The doctrine of the duty of care applies especially in the context of professional relationships, for example those between accountant and client, or solicitor and client. This is the context in which you are most likely to see it in practice. The leading case on what is termed negligent misstatement is the UK House of Lords case *Hedley Byrne & Co Ltd v Heller and Partners Ltd* [1964] AC 465 (UK) in which it was confirmed that accountants owed a duty of care to those who relied on the work done by the accountants, despite the fact that there was no contractual or fiduciary relationship between the parties.

*Hedley Byrne & Co Ltd v Heller and Partners Ltd [1964] AC 465 (UK)*

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.

In reaching the decision in *Hedley Byrne*, Lord Morris said the following:

*'If someone possessed of a special skill undertakes....to apply that skill for the assistance of another person who **relies** on that skill, a duty of care will arise....If, in a sphere in which a person is so placed that others could reasonably rely on his skill....a person takes it on himself to give information or advice to....another person who, as he **knows or should know**, will place reliance on it, then a duty of care will arise.'*

LO  
7.4

## 4 Breach of duty of care



### Section overview

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

### 4.1 The basic rule

Breach of the 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. This is an objective rather than subjective test. 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. Therefore, when the risk is higher the defendant must do more to meet his duty.

(b) **Seriousness of the risk and duty of disclosure**

The young, old or disabled may be prone to more serious injury than a fit, able-bodied person. The '**thin-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.

*Paris v Stepney Borough Council [1951] AC 367 (UK)*

*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.

The 1992 Australian case, *Rogers v Whitaker* is an important case in establishing the duty of disclosure requirements of 'material risks' for medical staff.

*Rogers v Whitaker [1992] HCA 58 (Aus.)*

*The facts:* Whitaker had been totally blind in her right eye for nearly 40 years due to a childhood injury. She saw an ophthalmologist (Rogers) who told her an operation on the right eye would improve its appearance and perhaps restore sight to it. After the operation Whitaker developed a condition in her left (good) eye called 'sympathetic ophthalmia', a rare condition which Rogers did not tell her about. She lost all sight in her left eye and, as sight was not restored in her right eye, was left practically blind.

*Decision:* It was found that the ophthalmologist breached his duty of care to the patient by not disclosing all 'material risks' to her. It was found that a reasonable patient in her condition (only one good eye) would want to be told of the risks of this rare occurrence as they would attach significance to the risk. The case is significant also in establishing that the court will decide what is reasonable in such cases, not the consensus of a body of medical practitioners.

This principle was further developed in *Perre v Apand [1999]* which shows the existence of a duty of care for pure economic loss.

*Perre v Apand [1999] 198 CLR 180 (Aus.)*

*The facts:* The defendant, Apand, manufactured potato chips. It had supply arrangements with various potato growers, in this case the Sparnons. The agreement included Apand supplying the Sparnons with seed potato for planting on the property. A number of these seed potatoes were infected with bacterial wilt.

The plaintiff, Perre, grew potatoes three kilometres from the Sparnons' property. While the Perres' property did not have a bacterial wilt infection, they were no longer able to export their potatoes to the Western Australian market as under the *Plant Diseases Act 1914* (WA) the importation of potatoes grown on land within 20 kilometres from a known outbreak of bacterial wilt was prevented. Therefore, the Perres suffered pure economic loss as they lost access to the market.

*Decision:* All seven high court judges found that Apand owed a duty of care to the Perres.

(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] AC 642 (UK)*

*The facts:* The defendants owned a factory that became 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 plaintiff 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. An example is that of company directors' duty of care.

## 4.2 *Res ipsa loquitur*

In some circumstances the plaintiff 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.



### Definition

***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 he was *not* negligent.

The plaintiff 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 as would not occur if those in control used **proper care**.



### Case study

In *Mahon v Osborne [1939] 2 KB 14 (UK)* a surgeon was required to prove that leaving a swab inside a patient after an operation was **not** negligent.

## 5 Causation and remoteness of damage



### Section overview

- Finally the plaintiff must demonstrate that he suffered **harm** (injury or loss) and that this was as a **result** of the breach.

### 5.1 Harm: 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 he has 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 - loss not related to personal injury or property damage - is rarely recoverable).

### 5.2 The 'but for' test

To satisfy the requirement that harm must be caused by another's actions, the **'but for' test** is applied. The plaintiff must prove that 'but for' the other's actions they would not have suffered damage. Therefore, plaintiffs 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] 1 QB 248 (UK)*

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

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

*Alexander v Cambridge Credit Corporation Ltd [1987] 9 NSWLR 310 (Aus.)*

*The facts:* Cambridge Credit Corporation was a property company issuing debentures. In 1971 its accounts incorrectly overstated the value of the shareholders' funds. The auditors stated the accounts were a true and fair account, and also incorrectly stated that the issue of more debentures would not breach the ratio stated in the trust deed. Cambridge continued its business. In 1974 a property market crash led to the collapse of Cambridge. It sued its auditors (Alexander) for their earlier statements in 1971.

*Decision:* The collapse of the property market was mostly due to government intervention and so broke the chain of causation so that the auditors were not liable. The test of remoteness also applied; it was found that the loss was too remote from the negligence of the auditors.

### 5.2.1 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] AC 1074 (UK)*

*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 were 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.

## 5.3 Intervening acts

Courts will only impute liability where there is a chain of events that are a **probable** result of the defendant's actions. Defendants will not be liable for damage when the chain of events is broken, i.e. when there is an intervening act. There are **three types** of intervening act that will break the chain of causation.

### 5.3.1 Intervening act of the plaintiff

The actions of the plaintiff themselves may **break** the chain of causation. The rule is that where the plaintiff's act is **reasonable** and in the **ordinary course of things**, in itself it will not break the chain.

*McKew v Holland, Hannen and Cubits (Scotland) Ltd [1969] 3 All ER 1621 (UK)*

*The facts:* The plaintiff had a leg injury which was prone to causing his leg to give way from time to time. While 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 plaintiff failed to seek assistance was unreasonable and was sufficient to break the chain of causation.

### 5.3.2 Intervening 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.

*Lamb v Camden LBC [1981] 2 All ER 408 (UK)*

*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.

### 5.3.3 Natural events

The chain of causation is **not automatically** broken by an intervening natural event. In situations where the defendant's breach puts the plaintiff 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] 1 All ER 20 (UK)*

*The facts:* A ship owned by the plaintiffs 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 plaintiffs claimed loss of charter revenue for the period the ship was out of action for repairs caused by the original incident.

*Decision:* The defendants were liable for loss of profit suffered as result of the defendants' wrongful act only. While 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 plaintiffs 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.

## 5.4 Remoteness of damage

Even where causation is proved, a negligence claim can still fail if the damage caused is 'too remote'. This test of **reasonable foresight** developed out of *The Wagon Mound [1961]* case (refer below), and it means that 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 (No. 1) [1961] AC 368 (UK)*

*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 owners of the wharf sued the charterers of the *Wagon Mound*.

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

# 6 Defences to negligence



## Section overview

- The remedial objective of tort law is to **restore the injured party to their original position** as the best monetary compensation can allow.
- The amount of damages awarded to the plaintiff can be reduced if it is shown that he **contributed** to his injury. The defendant can be **exonerated** from paying damages if it can be proved that the plaintiff **expressly** or **impliedly** consented to the risk.

## 6.1 Contributory negligence

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

*Sayers v Harlow UDC [1958] 1 WLR 623 (UK)*

*The facts:* The plaintiff was injured while trying to climb out of a public toilet cubicle with a defective lock.

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

If the defendant proves that the plaintiff 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 **plaintiff'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%.

*March v E & MH Stramare Pty Ltd [1991] 171 CLR 506 (Aus.)*

*The facts:* The defendant parked a truck in the middle of a six lane highway early in the morning. The plaintiff, who was speeding and affected by alcohol, collided with the truck and was injured.

*Decision:* In the initial case both defendant and plaintiff were found negligent but the plaintiff was found wholly liable for the injury caused. The High Court held that the defendant was also liable as parking the car over the highway created a situation of danger and causation was not broken. However, the plaintiff did contribute to the situation so damages were therefore apportioned.

## 6.2 Acceptance of the risk of injury

Where actions carry the risk of a tort being committed a defendant will have a defence if it can be proved that the plaintiff consented to the risk. This doctrine is known as *volenti non fit injuria*: 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 for dangerous sports, or it may be **implied** by the **conduct** of the plaintiff.

*ICI v Shatwell [1965] AC 656 (UK)*

*The facts:* The plaintiff and his brother disregarded safety precautions while using detonators, resulting in injury to the plaintiff.

*Decision:* The court upheld the defence of *volenti non fit injuria*. The plaintiff 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 plaintiff was **fully informed** of the **risks** and that they consented to them.

This point was made in *Dann v Hamilton [1939] 1 KB 209 (UK)* 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. The defence of *volenti* is unlikely to succeed in cases where consent is **implied**.

# 7 Limitations to actions for negligence



### Section overview

- **Personal injury** claims arising from the tort of negligence represent a very significant field of activity in courts around the world.

The increase in the willingness of individuals to take legal action for personal injury – or '**litigiousness**' – has often been blamed for both rises in **public liability insurance premiums** and the increasing



reluctance of bodies such as schools and local authorities to undertake activities which may be regarded as potentially risky.

Therefore, in some jurisdictions there have been attempts to limit the extent to which actions for negligence can be brought.

In **Australia** various **Civil Liability Laws** passed at state/territory level have sought to limit:

- The circumstances in which damages can be recovered for negligence,
- The types and *quantum* of damage that can be recovered, and
- Further increases in public liability insurance premiums.

In most jurisdictions there are also **time limits** on initiating a claim for personal injury through negligence, usually of between three and six years.

LO  
7.5

## 8 Consumer protection



### Section overview

- While tort under the common law provides some protection to consumers from the consequences of negligence on the part of businesses with which they have dealings, many jurisdictions have found that legislation is necessary to ensure fairness.

LO  
6.1.1

### 8.1 Product liability (Australia)

In **Australia** the Federal government's **Competition and Consumer Law Act 2010** introduced the **Australian Consumer Law** as of 1 January 2011. The Australian Consumer Law is one set of uniform consumer protection provisions for all state, territory and federal governments. It contains a range of both civil and criminal consumer protection provisions. The Australian Consumer Law provides for 'strict liability' for death, personal injury and damage to consumer property caused by defective products. This means that **the consumer does not have to prove negligence**, and there does not have to be any contractual relationship between him and the defendant. This **strict liability cannot be avoided by any exclusion clause**.

An action for product liability can be brought by an individual who must show that, on the **balance of probabilities**:

- The product supplied by the manufacturer or importer was defective, and
- The defect was the cause of a loss or injury. In addition, individuals who have suffered loss or damage as a result of a failure by a business to comply with **safety standards**, banning orders or compulsory recall orders issued under the Australian Consumer Law can sue for damages, injunctions or other court order.

### 8.2 Product liability (Singapore and Malaysia)

Product liability and consumer protection law in Malaysia is based upon UK product liability law (the UK **Consumer Protection Act 1987**) which is also the basis of the Australian Consumer Law. The chief piece of legislation governing product liability and consumer protection in Malaysia is the **Consumer Protection Act 1999**. This act provides strict liability under the same conditions as the Australian Consumer Law – namely that the consumer does not have to prove negligence, no contractual relationship need be in existence, and the strict liability cannot be avoided by an exclusion clause.

There is **no legislation in place concerning product liability in Singapore**. This area is still governed through contract and tort law and the application of historical United Kingdom legislation. Singapore has extensive legislative protection in other areas of consumer protection, and the lack of product liability legislation appears to be because of the application of UK legislation and common law in this area.



## Key chapter points

- Tort and other wrongs
  - Definition of tort as a civil wrong.
  - Types of tort
    - Trespass to land
    - Nuisance
    - Trespass to the person
    - Defamation
    - Deceit, injurious falsehood and passing-off
    - Negligence.
- The tort of negligence
  - Definition of tort of negligence – failing to exercise the duty of care.
- Duty of care
  - *Donoghue v Stevenson* 1932 establishes doctrine of duty of care.
  - Three stage test for establishing duty of care.
  - *Hedley Byrne v Heller* established the principle of the duty of care in a professional relationship.
- Breach of duty of care
  - The person would do what a reasonable man would do.
  - *Res ipsa loquitur* (the facts speak for themselves).
- Causality and remoteness of damage
  - Plaintiff shows he has suffered harm as a result of breach.
  - 'But for' the other's actions the damage would not have occurred.
  - Intervening acts where the chain of events is broken.
  - Remoteness of damage – the claim will fail if the damage is too remote.
- Defences to negligence
  - Contributory
  - *Volenti non fit injuria* – acceptance of risk of injury.
- Limitations to actions for negligence
  - Australian civil liability laws to limit damages and amounts paid.
- Consumer protection
  - Australian Consumer Law (Australia).
  - Consumer Protection Act 1999 (Malaysia)
  - No statutory approach (Singapore)

## Quick revision questions

- 1 In tort no previous transaction or contractual relationship need exist.  
true ☐  
false ☐
- 2 The 'neighbour' principle was established by the landmark case \_\_\_\_\_.
- 3 When the court applies the maxim *res ipsa loquitur*, it is held that the facts speak for themselves and the defendant does not have to prove anything, since the burden of proof is on the plaintiff.  
true ☐  
false ☐
- 4 **Fill in the blanks** in the statements below.  
Which three things must a plaintiff prove to succeed in an action for negligence?
  - The defendant owed the plaintiff a (1).....
  - There was a (2)..... of the (3)..... by the defendant
  - In (4)..... the plaintiff suffered (5)....., (6)..... or (7).....
- 5 Which of the following would prevent a claim for negligence from being successful?
  - (a) the plaintiff acted unreasonably
  - (b) the defendant caused the harm to the plaintiff
  - (c) a third party is the actual cause of harm
  - (d) the parties were proximate and the harm suffered was reasonably foreseeable
  - (e) an intervening act broke the 'chain of causation'
  - (f) the duty of care was restricted by public policy
- 6 Briefly describe the defence of *volenti non fit injuria*.
- 7 Under which circumstance will a court reduce the award of damages to a plaintiff?
  - A the plaintiff intervened in the chain of causation
  - B a natural event occurred which caused additional damage
  - C the plaintiff contributed to the loss he suffered
  - D the defendant acknowledged he was to blame

## Answers to quick revision questions

- 1 True. No transaction or relationship is needed.
- 2 *Donogue v Stevenson 1932*
- 3 False. The burden of proof under *res ipsa loquitur* is reversed, the defendant must prove that he was not negligent.
- 4
  - (1) duty of care
  - (2) breach
  - (3) duty
  - (4) consequence
  - (5) injury
  - (6) loss
  - (7) damage
- 5 (a), (c), (e), (f) would all prevent a claim for negligence from being successful.
- 6 *Volenti non fit injuria* is a valid defence to a negligence claim where the plaintiff expressly or impliedly consented to the risk.
- 7 C. The correct answer describes contributory negligence. Options A and B are intervening acts that break the chain of causation.

## Answers to chapter questions

- 1 Battery is the intentional action of bringing a material object into contact with another person. Assault involves putting a person in reasonable fear of battery through their words and actions.
- 2 The first tort that must be considered is passing-off. Kevin's shop has a similar name to John's but it is unlikely that it would mislead customers to think that his shop is John's. Therefore no tort has been committed.

John's printed statement is unlawful, and is clearly defamatory. The fact that it is written makes it libellous rather than slanderous.



## Chapter 9

# Incorporation and agency theory

Learning objectives	Reference
<b>Incorporation and its effects</b>	<b>LO9</b>
Recognise the nature and effect of a company having a separate legal personality	LO.9.1
Explain the effects of incorporation	LO9.2.
limited liability	LO9.2.1
perpetual succession	LO9.2.2
Distinguish the differences between public and proprietary companies	LO9.3
<b>Agency theory</b>	<b>LO8</b>
Explain that agency is the relationship between principal and agent	LO8.1
Explain how agency theory underlies the principle of corporate governance	LO8.2
Explain that partnership is an agency relationship	LO8.3
Explain the application of agency theory to companies	LO8.4

### Topic list

- 1 A company's legal identity
- 2 Limited liability of members
- 3 Types of company
- 4 Effect of legal personality
- 5 Ignoring legal personality
- 6 Role of agency and agency relationships
- 7 Formation of agency
- 8 Authority of the agent
- 9 Relations between the agent and third parties

# Introduction

The most popular vehicle for business in the world is the **corporate form**, the joint stock company. Companies are found in most countries of the world.

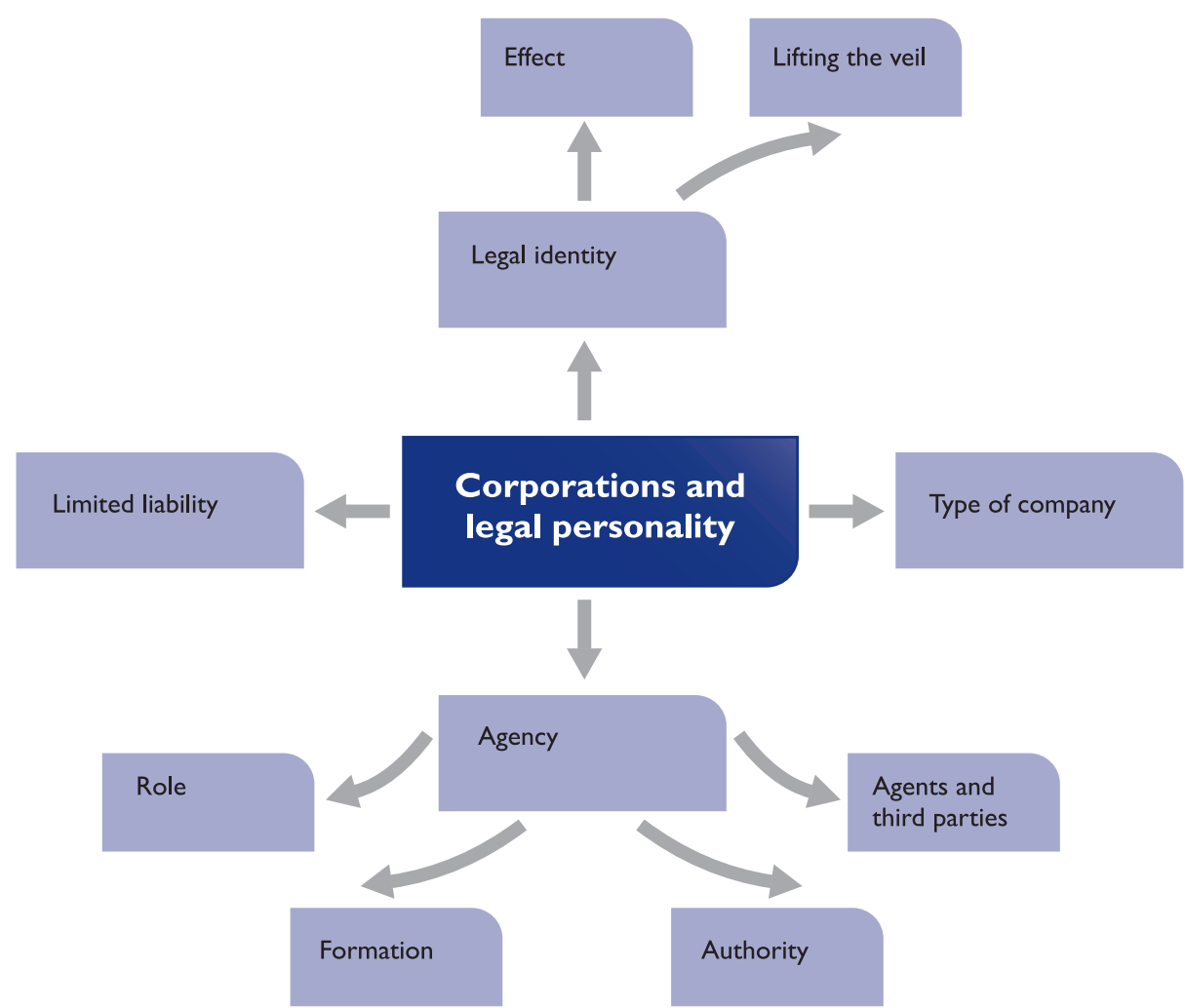
We shall be primarily using the **Australian model** of companies to examine the corporate form and use secondary examples from the **UK, Singapore and Malaysia**. Note that Australian, Singaporean and Malaysian company law is based on English company legislation and the common law.

The key difference between partnerships and companies is the concept of **separate legal personality**. This chapter outlines this doctrine, and also discusses its implications (primarily **limited liability** for members) and the exceptions to it (lifting the **veil of incorporation**).

In this chapter we examine how an **agency relationship** arises and how the **agent's authority** is acquired and defined. Agency is the foundation of most business relationships where more than one person engages in commerce together. Examples include **partnerships** and **companies**.

'**Agents**' are employed by '**principals**' to perform tasks which the principals cannot do or do not wish to perform themselves. This is often because the principal does not have the time or expertise to carry out the task. If business people did not employ the services of agents they would be weighed down by contractual details, and would probably get little else done!

When parties enter into an **agency arrangement**, the principal gives a measure of authority to the agent to carry out tasks on his behalf. The agent **contracts and deals with third parties** on their behalf.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Explain the concept of a 'separate legal personality' for companies. **(Section 1.2)**
- 2 Can you define the terms 'limited liability', 'unlimited liability', 'public company' and 'proprietary company'? **(Sections 3.1, 3.2, 3.4)**
- 3 List three differences between public and proprietary (private) companies. **(Section 3.7)**
- 4 How does someone lift the 'veil of incorporation'? **(Section 5)**
- 5 What is a quasi-partnership? **(Section 5.2.3)**
- 6 What is an agency relationship? **(Section 6)**
- 7 Does a partnership constitute an agency relationship? **(Section 6.1)**
- 8 What are two ways in which ostensible authority arises? **(Section 8)**
- 9 Explain how agency theory applies to company structures. **(Sections 7, 8, 9)**

# 1 A company's legal identity



## Section overview

- A company has a **legal personality** separate from its owners, also 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. By far the majority of companies are companies limited by shares. The members of a company limited by shares are called its shareholders.

By its nature, a company is more **formal** than a partnership or a sole tradership. There is substantially **more legislation** on the formation and procedures of companies than any other business association, hence the weighting towards company law of the rest of this Study Manual

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**. This will be explained more later in this chapter. For many people, this benefit outweighs the disadvantage of the formality surrounding companies, and encourages them not to trade as sole traders or partnerships.

## LO 9.1 1.1 Definition of a company



### Definition

For the purposes of this Study Manual, a **company** is an entity so registered under the law. This is governed by Corporations Act 2001 in Australia, the Companies Act 2006 in the UK, the Companies Act 1967 in Singapore and the Companies Act 1965 in Malaysia. Australian corporations law is heavily based on the concepts developed in the English company law system, and both the Singapore or Malaysian Companies Acts are closely based on the UK Companies Act.

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

## 1.2 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 a sole tradership.
- The law also recognises **artificial persons** in the form of companies.



### Definitions

**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.

The principle of **perpetual succession** is that the company continues to exist despite the death, insolvency, or insanity of any member or director, any change in membership or any transfer of shares. The company will continue as a separate entity from its members until it is wound up/liquidated.

A corporation is a **legal entity** separate from the natural persons connected with it, for example as members or directors. We shall come back to this later.



## 2 Limited liability of members



### Section overview

- 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.



LO  
9.2.1

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



### Definition

**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 who 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 that **creditors** of a limited company **cannot demand payment of the company's debts** from members of the company. This can be explained by the legal personality of the company and its capacity to contract in its own right.

### 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 **insolvency** of the company and its **dissolution, liquidation or winding up**, which will enable the creditors to be paid from the proceeds of any assets remaining in the company. It is at this stage that limited liability becomes most relevant, as discussed in Chapter 11.

### 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
<b>Company limited by shares</b>	Any <b>amount</b> unpaid by the member to the company from when shares were issued to the member.  If the member's shares are fully paid, they <b>do not have to contribute anything in the event of a winding up</b> .
<b>Company limited by guarantee</b>	The <b>amount they guarantee</b> 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**.



Question 1: Limited liability

Explain limited liability and how it links into the concept of separate legal personality.

(The answer is at the end of the chapter)

3 Types of company



Section overview

- Corporations consist of chartered corporations, statutory corporations and registered companies. There are two broad company types – limited and unlimited. Companies are further classified into proprietary (private) or public. . There are differences between proprietary (private) and public companies with regards to capital, dealings in shares, accounts, commencement of business, general meetings, names, identification, and disclosure requirements.

Corporations are classified in one of the following categories:

Category	Description
Chartered corporations	These are usually <b>charities</b> or <b>professional bodies</b> .
Statutory corporations	Statutory corporations are formed by special legislation. This method is little used now, as it is slow and expensive. It was used in the nineteenth century in the UK and Australia to form railway and canal companies.
Registered companies	Registration under the relevant legislation is the normal method of incorporating a commercial concern. In Australia this is the Corporations Act 2001, while in the UK, Singapore and Malaysia companies are registered under the relevant Companies Acts. Any body of this type is properly called a company.

3.1 Limited companies



Section overview

- A company member's liability may be limited by **shares** or by **guarantee**, or it may be **unlimited**.

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. Let's revisit this below.

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. A creditor has no direct claim against a member under his guarantee, nor can the company require a member to pay up under his guarantee until the company goes into liquidation.

Companies limited by guarantee are appropriate to **non-commercial activities**. For example, a charity or a trade association which is non-profit making but wishes to have the members' guarantee as a form of reserve capital if it becomes insolvent. Examples include CPA Australia, Cricket Australia and World Vision Malaysia. They do **not** have **share capital**.

## 3.2 Unlimited liability companies



### Definition

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

An unlimited company usually **does not need to file a copy of its annual accounts** and reports i.e. make them a matter of public record.

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.

In **Australia**, an unlimited company may be either a public company or a proprietary company. In the **UK**, for example, an unlimited company **can only be a private company** as, by definition, a **public company is always limited**. All jurisdictions have different requirements for unlimited companies but the **common factor is the definition – the members do not have limited liability and may be required to personally repay company debts**.

Some of these requirements and terms will seem unfamiliar to you and will be examined in further detail in the following chapters.

## 3.3 No liability companies



### Definition

A **no liability company** is a public company where members are not required to pay calls. It is restricted to Australian mining companies only. It is not used in any other jurisdictions except for Australia.

A no liability company must be a public company and is a little-used structure. A company can only be registered as no liability if it has share capital, the constitution states its sole purpose is mining, and the constitution states there is no right to recover calls from members who are unable to pay them. A no liability company must include at the end of its name No Liability or NL.

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## 3.4 Public and proprietary (private) companies



### Section overview

- A company may be **proprietary (private)** or **public**. Only the latter may offer its shares to the public.



### Definitions

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 in the UK or the Corporations Act 2001 in Australia. In **Australia** these are known as **proprietary companies** which have Proprietary Limited or Pty Ltd at the end of their names. The major practical distinction between a proprietary (private) and public company is that the former may not offer its securities to the public.

In Australia public and proprietary companies are registered under the Corporations Act 2001 by the Australian Securities and Investment Commission (ASIC) and the **type and class of company** must be specified in the application for company registration. In the UK a **public company** is a company registered as such under the Companies Act with the Registrar of Companies. **Any company not registered as a public company 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 proprietary (private) company.

## 3.5 Conditions for being a public company



### Section overview

- Conditions for a public company are similar across Australian, Singaporean, Malaysian and UK company law.
- There is no minimum capital requirement for public companies under Australian Corporations law.
- All public and proprietary (private) companies must have a minimum of one member. Under Australian law, public companies must have three directors and one secretary.

### 3.5.1 Minimum capital requirements

Australian corporations law sets no minimum capital requirements for public companies. Certain types of registered public companies, such as insurance companies and banks, have separate minimum capital requirements in place. In Australia a public company **can** be either limited by shares which is the most common form, limited by guarantee (mostly charities and clubs), unlimited with share capital or no liability.

Minimum capital requirements do apply in other jurisdictions, for example in the UK public companies must meet a minimum capital requirement of £50 000 and hold an appropriate Registrar's trading certificate. Unlike Australia, in the UK a company limited by guarantee which has no share capital, and an unlimited company, **cannot** be public companies.

### 3.5.2 Minimum membership and directors

All public company must have a minimum of **one member**. This is the same as a proprietary (private) company. There is no limit on the number of members in a public company. However, unlike a proprietary (private) company a public company must **three directors** under Australian law, two of which must readily reside in Australia **and one secretary** who must ordinarily reside in Australia. A company director can act as secretary. A proprietary (private) company must have just one director. Directors do not usually have liability for the company's debts – we shall learn more about the position of directors and their management of companies in Chapter 10.

## 3.6 Proprietary (private) companies



### Section overview

- There are two types of proprietary companies in Australia – a small proprietary and a large proprietary company.
- In the UK, Singapore and Malaysia, proprietary companies are referred to as private companies.
- Small proprietary and private companies are generally small enterprises where members are also directors

In Australia, a proprietary company must be either **limited by shares** or **unlimited with share capital**. It must also have no more than **50 non-employee members**. There are two types of proprietary company:

- **Small proprietary company.** To classify as such, it must comply with two of the following – annual revenues of less than \$25 million AUD, value of gross assets less than 12.5 million AUD, and fewer than 50 employees.
- **Large proprietary company.** To classify as such, it must comply with two of the following – annual revenues of \$25 million AUD or more, gross assets of \$12.5 million AUD or more, and 50 or more employees.

In **Singapore, Malaysia** and the **UK** proprietary companies are known as '**private**' companies. Because of this variance in terminology, this company type will be referred to as **proprietary (private) companies** throughout the rest of the Study Manual.

There are differences in definitions between jurisdictions. For example, in the UK private company is the residual category and so **does not need to satisfy any special conditions**. In Singapore, there are two types which is similar to the Australian model – **exempt private companies** for companies with between 1 and 20 employees, and **private companies** for those with between 1 and 50 employees.

Small proprietary and private companies are generally small enterprises in which some if not all **members 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 and large proprietary companies (Australia) and are reduced for private and small proprietary companies (Australia).

## 3.7 Differences between proprietary (private) and public companies



### Section overview

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

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The more important differences between public and proprietary (private) companies imposed by law relate to the following factors:

### 3.7.1 Capital

The main differences are:

- In Australia there is **no minimum capital requirement**. In the UK, there is a minimum amount of **£50 000** for a **public** company, but **no minimum** for a **private** company.
- A public company may **raise capital** by **offering** its **shares** or debentures to the public; a **proprietary (private)** company is **prohibited** from doing so. In addition, for a company to list on the **Australian Securities Exchange (ASX)** it must have over \$2 million net tangible assets, **or** \$10 million market capitalisation, **or** net aggregated profit after tax of \$1 million over the previous three years. In the 12 months prior to listing the entity must have an operating profit greater than \$400,000.
- Both **public** and **proprietary (private)** companies must generally **offer** to **existing members first** any ordinary shares to be allotted for cash. However, a **proprietary (private)** company may **permanently disapply** this rule.

### 3.7.2 Dealings in shares

Only a **public company** can obtain a listing for its shares on a **Stock Exchange** (such as the **ASX**) 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.

### 3.7.3 Accounts

- In Australia, a **small proprietary company** is **exempt** from preparing formal annual financial reports. They must keep financial records and any financial reports prepared for their own requirements. A failure to keep financial records gives rise to a presumption of insolvency. All **large proprietary companies** and **public companies**, including those limited by guarantee, must prepare annual financial reports, have them audited, and lodge them with ASIC within 3 months after the end of its financial year (within four months for non-disclosing entities).
- A **listed public company** must publish its full accounts and reports on its **website**.
- Public companies must lay their **accounts** and reports before a general meeting annually. Proprietary (private) companies have no such requirement.

### 3.7.4 Commencement of business

In Australia, both public and proprietary companies may commence business **on the day they are registered**.

### 3.7.5 General meetings

**Proprietary (private) companies** are not required to hold annual general meetings (AGMs). **Australian public companies** must hold one within five months of their financial year end.

### 3.7.6 Names and identification

The rules on identification as public or private are as follows:

- Public company in Australia must use '**limited**' or '**Ltd**' while an Australian proprietary company is listed as '**proprietary limited**' or '**Pty Ltd**'. A no liability company must use NL. Somewhat confusingly naming and identification is different across all national jurisdictions, **for example in the UK**, 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 **proprietary (private) company** should be identified as such in its constitution.

### 3.7.7 Disclosure requirements

There are **special disclosure and publicity requirements** for public companies.

Despite the added disclosure requirements, 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 a **Stock Exchange** (such as the ASX) and so mobilise capital from the investing public generally.

## LO 9.1 4 Effect of legal personality



### Section overview

- *Salomon v Salomon & Co Ltd* [1897] AC 22 was the first case (from England) which clearly demonstrated the **separate legal personality** of companies, and is of great significance to any study of English and Australian company law. The fact that members of the company are 'hidden' by the company structure is known as the **veil of incorporation**.

*Salomon v Salomon & Co Ltd* [1897] AC 22 (UK)

**The facts:** The plaintiff, 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 plaintiff by way of the issue of 20 000 £1 shares, £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 plaintiff's as 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 plaintiff 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 is because the company was a legal entity separate and distinct from S.

## 4.1 Veil of incorporation

Because a company has a separate legal personality from the people who own or run it (the members/directors), people can examine 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.

# 5 Ignoring legal personality



## Section overview

The veil of incorporation can 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.

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Separate personality can be ignored to:

- **Identify** the **company** with its **members** and/or directors, or
- 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 given below.

## 5.1 Lifting the veil by statute to enforce the law

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

### 5.1.1 Liability for trading without trading certificate

An Australian public company must obtain a certificate of registration from ASIC before it starts trading. 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 trading certificate requirement. They are also liable for a fine.

### 5.1.2 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** or **trading while insolvent** shall be **personally responsible** under **civil law** for debts and other liabilities of the company.

**Fraudulent trading** is also a **criminal offence**; any person guilty of the offence, even if the company has not been or is not being wound up, is liable for a fine or imprisonment.

If a company in insolvency proceedings is found to have traded when there is no reasonable prospect of avoiding insolvent liquidation, its directors may be liable under civil law for **wrongful trading**. Again, a court may order such directors to make a contribution to the company's assets.

Under Section 588G of the Australian Corporations Act (2001) a company director commits a criminal offence if they allow a company to trade while insolvent, and s.588M states that the director can be held personally liable to pay the debt incurred during the period of insolvent trading.

### 5.1.3 Disqualified directors

Directors who participate in the management of a company in contravention of an order disqualifying them from doing so under the Corporations Act 2001 (Australia) will be **jointly** or **severally liable** along with the company for the company's debts.



### 5.1.4 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 Corporations Act 2001 (Australia) makes it a **criminal offence** and the **directors personally liable** where they are directors 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. There are similar provisions in the UK, Singaporean and Malaysian law.

## 5.2 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. A company, as with a natural person, is recognised as being domiciled in a particular jurisdiction for taxation purposes. For a company this is determined by the location of central management and control. 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 Horne [1933] Ch 935 (UK)*

*The facts:* The defendant had been employed by the plaintiff 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 and his wife and an employee were the sole directors and shareholders/members. 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 'mere cloak or sham'.

### 5.2.1 Evasion of liabilities

The veil 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.

### 5.2.2 Evasion of taxation

The court may lift the veil of incorporation where it is being used to **conceal** the nationality of the company, usually so as to evade taxation.

*Unit Construction Co Ltd v Bullock [1960] AC 351 (UK)*

*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 UK 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.

### 5.2.3 Quasi-partnership

An application to wind up a company on just and equitable grounds the Corporations Act 2001 (Australia) 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 seek 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] AC 360 (UK)*, examined in more detail in a later chapter.



### 5.3 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 are three reasons for identifying the companies as one, and lifting the veil of incorporation:

- 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.

## 6 Role of agency and agency relationships

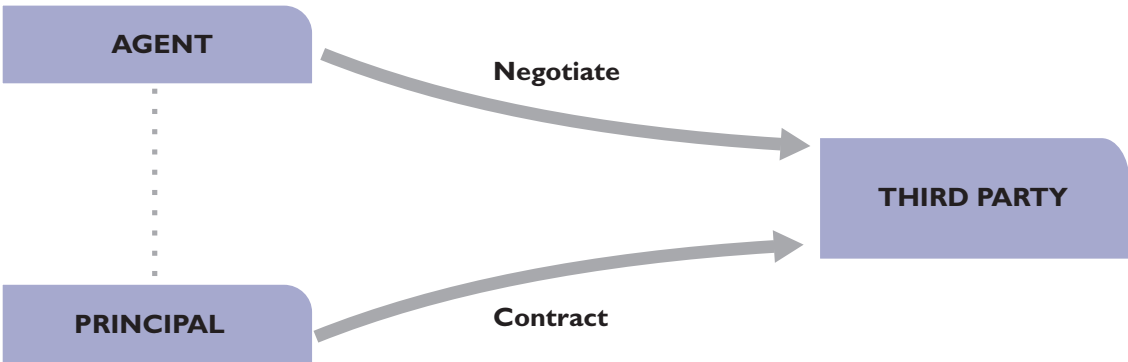


### Section overview

- **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 his principal and a third party**. Company directors act as agents of the company. Agency law is a significant element in understanding how the company as an artificial legal person is able to enter into contracts. The law of agency also impacts on company promoters.

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



### Case study

For example, 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.

### 6.1 Types of agent

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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 relationship for the *Business Law* learning objectives is that of **company directors**, who act as agents of the company. As agents of the company, company directors are therefore acting to promote the interests of the members of the company and not their own self-interest. Therein lays one of the core principles of corporate governance – that the existence of agency theory and agency relationships underpins all corporate behaviour.

**Promoters** may also act as agents of the company. An agency relationship exists in a **partnership** where one partner acts as the agent for the other. As long as each partner acts within their express and implied authority then they are acting for the whole partnership when carrying out an ordinary partnership business. We will study the topic of promoters in greater detail in Chapter 10.

## 7 Formation of agency



### Section overview

- 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.

### 7.1 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**, which we shall outline in Section 8.

### 7.2 Implied agreement

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

#### 7.2.1 Example: Agency implied by employment relationship



An employee's duties involve him entering into contracts on his employer's behalf. Although an employer and employee are not automatically agents an implied agency relationship exists between the employee (agent) and the employer (principal).

The authority of an implied agent may be different to the authority of an expressly appointed agent, as we shall discuss in Section 8.2.

### 7.3 Ratification of an agent's act: retrospective agreement



### Section overview

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

An agency relationship may be created retrospectively, after the 'agent' has formed a contract on behalf of the 'principal'. Therefore, it is created by the 'principal' **ratifying** the act of the 'agent'. If the principal agrees to the acts of the agent after the event, he 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**.
- He ratifies the contract in its **entirety**.
- He **communicates** his 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.

### 7.4 Formation of agency agreement without consent

An agency may be created, or an agent's authority may be extended, without express consent. This happens when the principal **'holds out'** a person to be his agent.

### 7.4.1 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. Authority shall be discussed in Section 8.

### 7.4.2 Agent by holding out

An agency relationship may be formed by implication when the **principal holds out to third parties** that a person is his agent, even if the principal and the 'agent' do not agree to form such a relationship. In such a case, the principal is prevented from denying the agent's apparent/ostensible authority (Section 8). An agency relationship is not so formed if it is the 'agent' who creates the impression that he is in an agency relationship with a 'principal'.



### Question 2: Types of agency relationships

Explain the following types of agency relationships:

- Partnership.
- Company directors.
- Promoters.

(The answer is at the end of the chapter)

## 8 Authority of the agent



### Section overview

- If an agent acts within the limits of his authority, any contract he makes 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 authority are both forms of **actual authority**.

A principal does not give the agent unlimited authority to act on his 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 his authority** from his principal. In analysing the limits of an agent's authority, three distinct sources of authority can be identified:

- Express authority.
- Implied authority.
- Ostensible authority.

### 8.1 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 his 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 his express (actual) authority, he may be **liable** to the principal and the third party for **breach of warranty of authority**.

#### 8.1.1 Example: Express authority



A board of directors may give an individual director 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.

## 8.2 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 he had implied authority for acting in the way he 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] 1 QB 346 (UK)*

*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 who 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 1 QB 549 (UK)*

*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.

## 8.3 Actual authority

Express and implied authority are sometimes referred to together as **actual authority**. This distinguishes them from **ostensible** or **apparent authority**, which is discussed next in this section.



### Definition

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

## 8.4 Apparent or ostensible authority



### Section overview

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

The **ostensible**, or **apparent**, authority of an agent is the authority that the principal tells other people that he has given to the agent. This may differ from the express or implied authority of the agent. As a result, the agent can be held in practice to have a more extensive authority than what actually exists.

Difficulties with apparent/ostensible authority usually arise either:

- (a) Where the **principal** has **represented** the agent as having authority even though he has not actually been appointed.
- (b) Where the **principal** has **revoked** the agent's authority but the third party has not received notice.

### 8.4.1 The extent of ostensible authority

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

### 8.4.2 Example: Directors



*Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964] 2 QB 480 (UK)*

*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 authorised agent and the claimants had relied on it. The company was bound by the contract made by K under the principle of 'holding out'. The company was 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.



#### Exam comments

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.

### 8.4.3 Representations creating ostensible authority

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

It must be a **representation of fact, not law** and the representation 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.

### 8.4.4 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.

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.

### 8.4.5 Alteration of position following a representation

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

## 8.5 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.

## 8.6 Termination of agency

Agency is terminated by **agreement** or by **operation of law** through 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 agent becomes bankrupt and this affects his 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.

# 9 Relations between the agent and third parties



### Section overview

- 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 his own behalf; where agent and principal have joint liability.
- A third party to a contract entered into with an agent acting outside his ostensible authority can sue for breach of **warranty of authority**.

## 9.1 Liability of the agent for contracts formed

An agent contracting for his principal within his 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.

- (a) When he **intended to undertake personal liability** – for example, where he signs a contract as party to it without signifying that he is an agent.
- (b) Where it is **usual business practice or trade custom** for an agent to be liable and entitled.
- (c) Where the agent **is acting on his own behalf** even though he purports to act for a principal.

Where an agent enters into a **collateral contract** with the third party with whom he has 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 he acted for a principal.

## 9.2 Breach of warranty of authority

An agent who **exceeds his ostensible authority** will generally have **no liability to his 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.

## Key chapter points

- A company's legal identity
  - Company has a legal personality separate from its members and directors.
- Limited liability of members
  - The company's members have limited liability for debts – this is central to company law.
    - Protects members against creditors
    - Protects members from business failure
    - Members may be asked to contribute amounts in the event of a winding up.
  - The company has liability under torts and crime (not the members).
- Types of company
  - Limited liability – by shares or by guarantee.
  - Unlimited liability.
  - No liability (Australia only – does not exist in other jurisdictions).
  - Public
    - Conditions for public companies.
  - Proprietary (Australia), Private (UK, Singapore, Malaysia).
    - Conditions for proprietary (private) companies.
- Effect of legal personality
  - Veil of incorporation.
- Ignoring legal personality
  - Lifting the veil of incorporation to make members liable in certain situations.
  - Lifting the veil by statute.
  - Lifting the veil in order to prevent evasion of existing legal obligations.
  - Lifting the view in group situations (agent, group is one entity, corporate structure is facade).
- Role of agency and agency relationships
  - Definition of agency in common law.
  - Directors are agents of the company.
  - Partners are agents for each other.
  - Promoters are agents of the company.
- Formation of agency
  - Express or implied agreement.
  - Retrospective agreement after agent has acted.
  - Agency agreements can be formed without consent.
- Authority of the agent
  - Express authority.
  - Implied authority.
  - Actual authority.
  - Apparent/ostensible authority – can be greater than express or implied.
  - Revocation and termination of authority.
- Relations between the agent and third parties
  - Agent normally has no liability or right to enforce contract entered into.
  - Liability will apply in certain situations.

## Quick revision questions

- 1 Which of the following types of company can be incorporated under the Australian Corporations Act 2001?
  - A a proprietary limited company
  - B a public limited company
  - C a company limited by guarantee with a share capital
  - D a company limited by guarantee with no share capital
  - E a proprietary unlimited company
  - F a public unlimited company
- 2 Under the Australian Corporations Act 2001 which of the following forms of company can be registered as a public company?
  - A a no liability company
  - B a company limited by shares
  - C a large proprietary company
  - D a company unlimited with share capital
  - E a company limited by guarantee
  - F a small proprietary company
- 3 Which two of the following statements are true? A proprietary (private) company:
  - A is defined as any company that is not a public company
  - B sells its shares on a Stock Exchange
  - C must have at least one director with unlimited liability
  - D is a significant form of business organisation in areas of the economy that do not require large amounts of capital
- 4 Under which circumstance would a member of a limited company have to contribute funds on winding up?
  - A where there is not enough cash to pay the creditors
  - B where they have an outstanding amount from when they originally purchased their shares
  - C to allow the company to repurchase debentures it issued
  - D where the directors have been disqualified
- 5 Which two of the following are correct? A public company:
  - A is defined as any company which is not a proprietary (private) company
  - B has a legal personality that is separate from its members or owners
  - C must have at least one director with unlimited liability
  - D can own property and make contracts in its own name



6 Put the examples given below in the correct category box.

WHEN THE VEIL OF INCORPORATION IS LIFTED		
To enforce law	To enforce obligations	To expose groups

- Wrong use of company name
- Legal obligations
- Quasi-partnership
- Disqualified directors
- Fraudulent and wrongful trading
- Single economic entity
- Corporate structure a sham
- Public interest

7 Fill in the gaps using the words in the boxes below.

**Agency** is the..... which exists between two ..... persons.  
They are .....and the agent, in which the function of the agent is to form a  
..... between his ..... and a .....

(1) relationship	(3) contract	(5) legal
(2) third party	(4) principal	(6) principal

8 A principal may, in certain circumstances, ratify the acts of the agent which has retrospective effect.

True ☐  
False ☐

9 What is the best definition of ostensible authority?

- A the authority which the principal represents to other persons that he has given to the agent  
B the authority implied to other persons by the agent's actions

# Answers to quick revision questions

- 1 A, B, D and E are correct. It is not possible to incorporate a company limited by guarantee with a share capital, so C is incorrect. A public limited company is by definition limited, so F is wrong.
- 2 A, B, D and E are correct. Both small and large proprietary companies are still private (proprietary) companies so cannot also be a public company (meaning C and F are incorrect).
- 3 A and D are correct. A private company cannot sell its shares to the public on any stock market, so B is incorrect. Directors need not have unlimited liability, so C is incorrect.
- 4 B Members only have a liability for any outstanding amounts of share capital partly paid for.
- 5 B and D are correct. A public company has to be defined as such in its constitution so A is incorrect. No directors *need* have unlimited liability, so C is incorrect.

6

WHEN THE VEIL OF INCORPORATION IS LIFTED		
To enforce law	To enforce obligations	To expose groups
Wrong use of company name	Legal obligations	Single economic entity
Disqualified directors	Quasi-partnership	Corporate structure a sham
Fraudulent and wrongful trading	Public interest	

- 7 1, 5, 4 (6), 3, 6 (4), 2
- 8 True. Principals may ratify retrospectively.
- 9 A The key word is 'represents'.

## Answers to chapter questions

- 1 Limited liability is linked to the concept of companies having a separate legal personality from the individual members within them. The concept of companies having a separate legal personality is core to all company law. Accordingly, companies holding a separate legal personality mean that members of certain types of companies therefore have limited liability in the event of business failure.
- 2 An agency relationship exists in a **partnership** as one partner acts as the agent for the other when carrying on ordinary business.

**Company directors** are agents of the companies they are directors of and act for members' interests when carrying on ordinary business.

**Promoters** are agents of the company they are promoting/establishing.





# Chapter 10

## Company formation and constitution

Learning objectives list	Reference
<b>Torts</b>	<b>LO7</b>
Explain the implications under common law in relation to pre-registration contracts	LO7.6
<b>Incorporation and its effects</b>	<b>LO9</b>
Identify the processes necessary in forming a company	LO9.4
Specify the elements of the constitution of a company	LO9.5
Describe the role of promoters in forming a company	LO9.6
Recognise the difficulties and implications of pre-registration contracts	LO9.7

### Topic list

- 1 Promoters
- 2 Pre-registration expenses and contracts
- 3 Company formation procedures
- 4 A company's constitution
- 5 Company objects and capacity
- 6 The constitution as a contract

# Introduction

In Chapter 9 of this Study Manual you were introduced to the idea of the separate legal personality of a company, and also to the principles of agency. The first two sections of this chapter outlines how agency affects the role of **promoters** and the status of contracts entered into before the company is formed, that is **pre-registration contracts**.

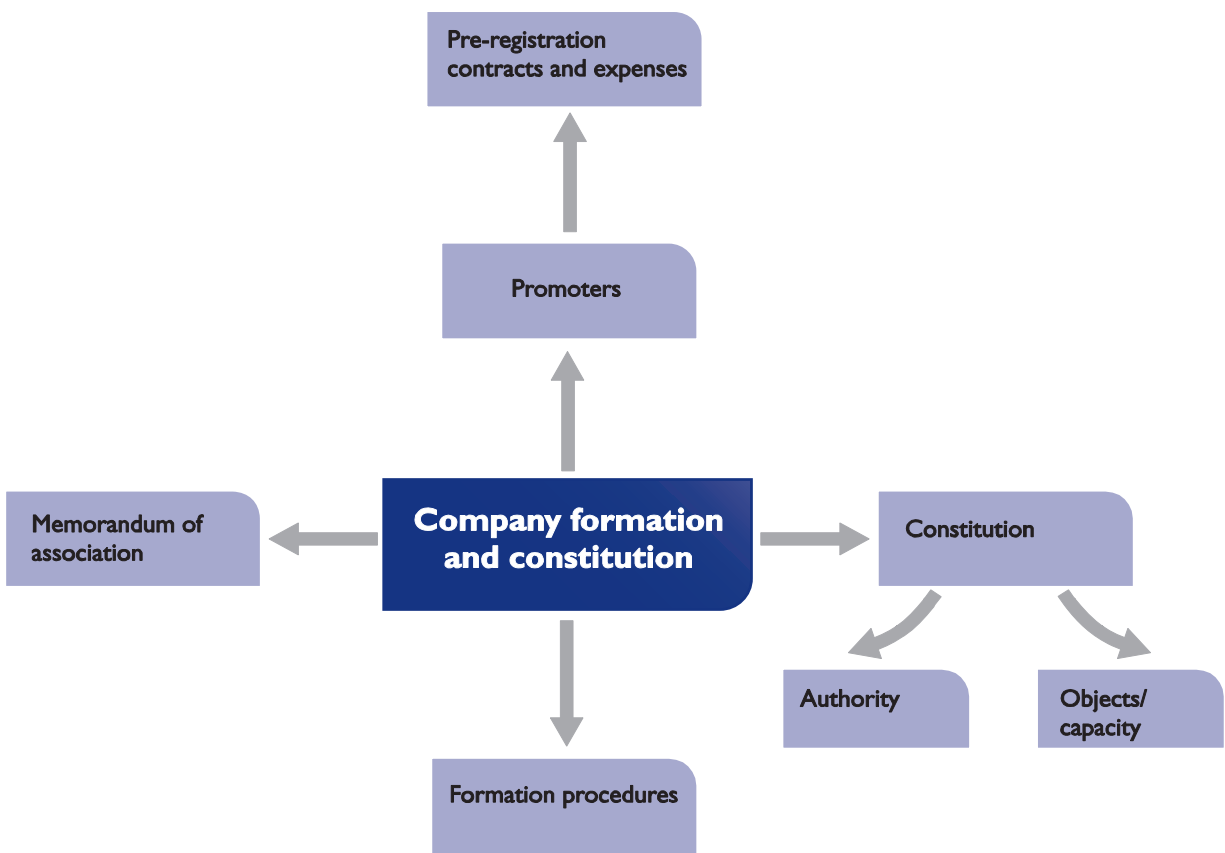
Sections 3 to 5 of this chapter concentrate on the **procedural aspects of company formation**. Important topics in these sections include the **formalities** that a company must observe in order to be formed, and the liability of **promoters for pre-registration contracts**.

We shall again be using the **Australian** model of companies and will **introduce examples from the UK, Singapore or Malaysia where relevant**. Note that Australian, Singaporean and Malaysian company law is based on English company law and common law.

The articles, together with any resolutions and agreements which may affect them, form the company's **constitution**.

The constitution sets out what the company does; if there are no restrictions specified then the company may do anything provided it is legal. Clearly this includes the capacity to contract, an important aspect of legal personality. Also significant is the concept of *ultra vires*, a term used to describe transactions that are outside the scope of the company's capacity.

Sections 6 and 7 of this chapter consider the concept of the **public accountability of limited companies**.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 What is a promoter and what is their role in company formation? **(Section 1)**
- 2 List two fiduciary duties held by promoters. **(Section 1.1)**
- 3 Define a pre-registration contract. **(Section 2.2)**
- 4 How are pre-registration contracts treated in the common law? **(Section 2.2)**
- 5 What are the steps for registering a proprietary company in Australia? **(Sections 3.1, 3.2)**
- 6 When can companies commence operating in Australia? **(Section 3.5)**
- 7 When must a company have a constitution in place? **(Section 4)**
- 8 What is the difference between replaceable rules and model articles?? **(Sections 4.2.1, 4.2.2)**
- 9 The constitution forms a contract. What is this contract, and who is the contract between? **(Section 6)**

# 1 Promoters



## Section overview

- 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 company.

LO  
9.6

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



## Definition

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: *Twycross v Grant* [1877] 46 LJCP 636 (UK).

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 the 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 is an **agent** of the company. This means they have 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** of 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 their fiduciary duty.

A promoter of a public company makes their disclosure of a legitimate profit through listing particulars or issuing 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**.

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.

## 2 Pre-registration expenses and contracts



### Section overview

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

### 2.1 Pre-registration 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-registration 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-registration contracts



### Section overview

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



### Definition

A **pre-registration contract** –referred to as a **pre-incorporation contract** in the English, Singapore and Malaysia Companies Acts – is a contract purported to be made by a company or its agent at a time before the company has been formed.

LO  
7.6

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** because it did not exist when the pre-registration contract was made; therefore one of the conditions for ratification fails.

A company may enter into a **new contract** on **similar terms** after it has been incorporated. This is known as **novation**. For example, in the UK, there must be **sufficient evidence** that the company has made a new contract. Mere recognition of the pre-registration 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-registration contracts

The company's promoter as its **agent** is **liable** on a contract to which they are deemed to be a party. The agent may also be entitled to enforce the contract against the other party and so they could transfer the right to **enforce** the contract to the company.

LO  
9.7

The Corporations Act 2001 determines liability in Australian law. Section 131 (2) states:

'The person is liable to pay damages to each other party to the pre-registration contract if the company is not registered, or the company is registered but does not ratify the contract or enter into a substitute for it (a) within the time agreed to by the parties to the contract; (b) if there is no agreed time-within a reasonable time after the contract is entered into.

The amount that the person is liable to pay to a party is the amount the company would be liable to pay to the party if the company had ratified the contract and then did not perform it at all.'

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

LO  
9.7

There are various other ways for promoters to avoid liability for a pre-registration contract:

- (a) The contract remains as a **draft** and 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-registration contracts is to buy a company '**off-the-shelf**' (Section 3.3 of this chapter). Even if a person contracts on behalf of the new company before it is bought the company will be able to ratify the contract if the company existed 'on-the-shelf' at the time the contract was made.



### Question 1: Liability for pre-registration contracts

What is the liability of promoters relating to pre-registration contracts under Australian law?  
(The answer is at the end of the chapter)

## 3 Company formation procedures



### Section overview

- Companies are registered under the Corporations Act 2001 in Australia, the Companies Act 2006 in the UK, the Companies Act 1967 in Singapore and the Companies Act 1965 in Malaysia.
- In Australia a company is formed when it is registered under the Corporations Act 2001 by issue of a **certificate of registration** by ASIC after the submission of a number of documents and a fee.

LO  
9.4

This remainder of the section **examines the formation of a company in Australia** under the **Corporations Act 2001**. Despite different terms, forms and fees, the core components of company registration in the UK, Singapore and Malaysia are the same as the Australian example.

### 3.1 Documents to be delivered to ASIC

The application to register a public or private company is managed by the Australian Securities and Investments Commission (ASIC). All documents and fees must be supplied electronically or via hard copy to ASIC.

#### 3.1.1 Application for registration

The **application for registration** must be made and submitted to ASIC with the specific documents described in the table below. The application form (Form 201) itself must contain:

- The company's **proposed name**.
- That the **liability of members** is to be **limited by shares** or **guarantee**.
- Whether the company is to be **propriety** (small or large) or **public**.
- A statement of the **intended address** of the **registered office** and of the principal business premises.
- Director and member details.
- Share structure details.
- Member's share details.

The actual documents required to register a company in Australia are contained in the table below:

Documents to be delivered	Description
<b>Form 201</b>	<p>This is the formal application form for 'Application for registration as an Australian company'. It contains information relating to:</p> <ul style="list-style-type: none"><li>• Company registered office details,</li><li>• Type and class of company,</li><li>• Proposed director(s) and company secretary (if applicable),</li><li>• All proposed members,</li><li>• Share structure, and</li><li>• Declaration.</li></ul>
<b>Constitution</b>  Only if the company is not using replaceable rules – refer to Section 4.2.2 for more information	<p>A written constitution must be lodged with the application in the following circumstances:</p> <ul style="list-style-type: none"><li>• No liability company applications,</li><li>• If a public company has chosen to use a written constitution instead of, or as well as, the replaceable rules,</li><li>• A 'special purpose' company, or</li><li>• Other specific company types under legislation.</li></ul> <p>If a proprietary company chooses to adopt a constitution instead of using replaceable rules they do not have to lodge it with the application, but it must be retained on file.</p>
<b>Registration fee</b>	A set fee for a public or proprietary company with share capital is also payable on registration

### 3.2 Certificate of registration

ASIC considers whether the documents are formally in order. If satisfied, the company is given an '**Australian company number**' or '**ACN**'. A **certificate of registration** is then issued, the company is included in the register, and its inclusion is published in the *Commonwealth Gazette*. The certificate of registration:

- Identifies the company by its **name** and **ACN**.
- States the type and class of company – whether it is **limited** (if appropriate) and whether it is a **proprietary** (small or large) **public** company.
- States whether the **registered office** is in New South Wales, Victoria, Tasmania, South Australia, Western Australia, Queensland, Northern Territory or the Australian Capital Territory.
- States the date of registration.
- Is **signed** by **ASIC**.



#### Definition

The **certificate of registration** is a certificate issued by ASIC which demonstrates that from the date of registration the company comes into existence as a body corporate at the beginning of the day on which it is registered. The company's name is the name specified in the certificate of registration.

*Note:* The company remains in existence until it is deregistered (Corporations Act 2001 S119).

The certificate of registration is **conclusive evidence** that:

- All the **requirements** of the **Corporations Act 2001** have been **followed**,
- The company is a company authorised to be registered and has been **duly registered**, and
- The company is a **public company** if the certificate states that it is.

Upon registration persons named as **directors** and **secretary** in the Form 201 automatically become such officers.

### 3.3 Companies 'off-the-shelf'



#### Section overview

- 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 ASIC 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 registration form (Form 201), constitution (if applicable) and fee will not have to be lodged.  
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-registration contracts**. The company can trade without needing to worry about waiting for ASIC's certificate of registration.

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 could use a **template constitution**. 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**.

### 3.4 Re-registration procedures



#### Section overview

- 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. A proprietary company limited by shares is able to re-register as an unlimited public company or a public company limited by shares.

For a proprietary company limited by shares to re-register as a public company either unlimited or limited by shares it must:

- Have the agreement of the requisite **majority of its shareholders (75%)** through a special resolution, and
- Complete the relevant application and pay the nominal fee.

There are no minimum capital requirements.

The company is not re-registered as a public company **until one month after** notification of the intention to change is published in the *Commonwealth Gazette*.

## 3.5 Commencement of business rules



### Section overview

- All Australian companies – public or proprietary – commence business on registration.



### Definition

Section 119 of the Corporations Act 2001 states that a company becomes a body corporate and can commence operations on the day of its registration. This applies to public and proprietary companies.

## 4 A company's constitution



### Section overview

- A **company's constitution** comprises the **articles of association** and any **resolutions and agreements** it makes which affect the constitution. It is a matter of **public record** so the original constitution and any alterations are sent to ASIC in Australia or the relevant authority in other jurisdictions.

LO  
9.5

The constitution of a company consists of:

- **Resolutions and agreements** that it makes that affect the constitution, and
- The **articles of association**.

Most Australian companies (both public and proprietary) are **not required to have a constitution in place**. They can operate using:

- A constitution, or
- The **replaceable rules**, which are selected provisions of the Corporations Act 2001 that apply to the running of a company and discussed further below, or
- A combination of both.

No liability companies must still have a constitution and must supply this to ASIC upon registration. If a public company chooses to adopt a constitution it must supply this to ASIC upon registration. If a proprietary company chooses to adopt a constitution it does not have to supply this on registering, but must retain a copy.

**The replaceable rules do not apply to** sole director/shareholder proprietary companies as they are not required to have any form of constitution in place.

### 4.1 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 covered in Chapter 12 of this Study Manual, so you may find it beneficial to study the relevant section of that chapter now so that you understand the various types of resolution that a company may pass.

**Resolutions** directly affect the constitution of a company as they are used to **introduce** new provisions, or to **amend** or **remove** existing ones. **Agreements** made, for example, between the company and members of specific classes of share, are also deemed to be amendments of the constitution. Both resolutions and agreements must be notified to ASIC (or the relevant body in other jurisdictions) so that the company's constitution continues to be a matter of public record.

4.2 Articles of association



Definition

The **articles of association** consist of the internal rules that relate to the management and administration of the company.

The articles contain the detailed **rules** and **regulations** setting out how the company is to be **managed** and **administered**. 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

4.2.1 Replaceable rules

The **replaceable rules** are selected sections of the Australian Corporations Act 2001 which can be used by most public and proprietary companies instead of a written constitution, or in combination with a written constitution. This effectively means the company is always acting under the most updated requirements as the rules are automatically updated by amendments to the underlying Act.

A constitution is generally adopted where the company wishes to modify or add to the underlying replaceable rules. A company is able to refer to a replaceable rule which may otherwise not apply to it by incorporating it into its constitution.

The provisions of the Act which apply as replaceable rules and their section number are listed in the table below:

		Section
Officers and employees		
1	Voting and completion of transactions-directors of proprietary companies	194
2	Powers of directors	198A
3	Negotiable instruments	198B
4	Managing director	198C
5	Company may appoint a director	201G
6	Directors may appoint other directors	201H
7	Appointment of managing directors	201J
8	Alternate directors	201K
9	Remuneration of directors	202A
10	Director may resign by giving written notice to company	203A
11	Removal by members–proprietary company	203C
12	Termination of appointment of managing director	203F
13	Terms and conditions of office for secretaries	204F

	Section
<b>Inspection of books</b>	
14 Company or directors may allow member to inspect books	247D
<b>Directors' meetings</b>	
15 Circulating resolutions of companies with more than one director	248A
16 Calling directors' meetings	248C
17 Chairing directors' meetings	248E
18 Quorum at directors' meetings	248F
19 Passing of directors' resolutions	248G
<b>Meetings of members</b>	
20 Calling of meetings of members by a director	249C
21 Notice to joint members	249J(2)
22 When notice by post or fax is given	249J(4)
23 Notice of adjourned meetings	249M
24 Quorum	249T
25 Chairing meetings of members	249U
26 Business at adjourned meetings	249W(2)
27 Who can appoint a proxy [replaceable rule for proprietary companies only]	249X
28 Proxy vote valid even if member dies, revokes appointment	250C(2)
29 How many votes a member has	250E
30 Jointly held shares	250F
31 Objections to right to vote	250G
32 How voting is carried out	250J
33 When and how polls must be taken	250M
<b>Shares</b>	
34 Pre-emption for existing shareholders on issue of shares in proprietary company	254D
35 Other provisions about paying dividends	254U
36 Dividend rights for shares in proprietary companies	254W(2)
<b>Transfer of shares</b>	
37 Transmission of shares on death	1072A
38 Transmission of shares on bankruptcy	1072B
39 Transmission of shares on mental incapacity	1072D
40 Registration of transfers	1072F
41 Additional general discretion for directors of proprietary companies to refuse to register transfers	1072G

### 4.2.2 Model articles

The UK, Singapore and Malaysia all use model or standardised articles of association instead of replaceable rules, but they are based on the same concept. Rather than each company having to draft their own articles, and to allow companies to be set up **quickly** and **easily**, **model articles** can be used. 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 by registering them on incorporation.

If **no articles** are registered then the company will be **automatically incorporated** with the **default model articles** that 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

### 4.2.3 Alteration of the articles



#### Section overview

- 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**.

All companies have a statutory power to alter their articles by special resolution. Additionally, in Australia, a proprietary company may pass a written resolution with 100% agreement. The alteration will be valid and binding on **all** members of the company. In Australia, a copy of the special resolution amending the articles of a public company must be lodged with ASIC.

### 4.2.4 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 to a member **additional votes** so that he can block a resolution to alter articles on particular points, including the removal of his weighted voting rights from the articles: *Bushell v Faith* [1970] AC 1099 (UK). 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 (refer to Chapter 12).
- (c) Some **provisions** may be '**entrenched**' in the 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.

### 4.2.5 Restrictions on alteration

Even when it is possible to pass a special resolution, alteration of the articles is **restricted** by the following principles:

- (a) The alteration is **void** if it **conflicts with the Corporations Act 2001 (or the Companies Acts of UK, Singapore or Malaysia)** or with the general law in each jurisdiction.
- (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 in order to obtain the consent of the class. A proscribed 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: refer to *Southern Foundries (1926) Ltd v Shirlaw* [1940] AC 706 (UK) in Chapter 11. 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 (explained below).

The case law on the **bona fide test** is an effort to hold the balance between two principles:

- (a) The **majority** is **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 in the case of *Greenhalgh v Arderne Cinemas Ltd* [1950] 2 All ER 1120 (UK). Two main propositions were laid down:

- (a) '**Bona fide for the benefit of the company as a whole**' is a **single test** and also a **subjective test** i.e. 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.

#### 4.2.6 Expulsion of minorities

Expulsion cases are concerned with:

- Alteration of the articles for the purpose of **removing a director from office**, and/or
- Alteration of the articles to permit a majority of members to **enforce a transfer** to themselves of the shareholding of a minority.

Under Australian corporations legislation, the corporate constitution is specifically recognised as having the effect of a contract between the company and each member; between the company and each director and company secretary; and between a member and each other member.

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.

*Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927] 2 KB 9 (UK)

*The facts:* Expulsion of director appointed by the articles who had failed to account for funds was held to be valid.

*Sidebottom v Kershaw, Leese & Co Ltd* [1920] 1 Ch 154 (UK)

*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] 1 Ch 290 (UK)*

*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 2 Ch 124 (UK)*

*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.

#### 4.2.7 Filing of alteration

Whenever any alteration is made to the articles a copy of the altered articles must be delivered to the relevant authority within a stated period (for ASIC, this is 14 days), together with a signed copy of the special resolution making the alteration.

#### 4.2.8 Interaction of statute and articles

There are two aspects to consider:

- (a) The Corporations Act 2001 (Australia) 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. This is also the case under the UK, Singaporean and Malaysian Companies Acts.
- (b) The Corporations Act 2001 (and relevant Companies Acts) will **override** the articles:
  - (i) If the Act **prohibits something**.
  - (ii) If something is permitted by the Act **only** by a **special procedure** such as passing a special resolution in a general meeting.



#### Question 2: Model articles and replaceable rules

What are the main differences between the application Australia's replaceable rules and the UK/Singaporean/Malaysian model articles?

(The answer is at the end of the chapter)

## 5 Company objects and capacity



### Section overview

- A company's objects are its aims and purposes. A company has the legal capacity and powers of an individual and may carry out any lawful activity.

### 5.1 The objects

The objects are the '**aims**' and '**purposes**' of a company. A company's objects are usually **completely unrestricted**, that is it can carry out **any lawful activity**; in **Australia** a *company* has the legal capacity and powers of an individual.

#### 5.1.1 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.

### 5.2 Transactions with directors

When a 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.

## 6 The constitution as a contract



### Section overview

- The constitution **constitutes a contract** between:
  - Company and members.
  - Members and the company.
  - Members and members.
- In Australia, the constitution also constitutes a contract between the company and each director and secretary of the company
- The constitution **does not constitute** a contract between the **company** and **third parties**, or members in a **capacity** other than as **members** (the *Eley* case).

### 6.1 Effect

A company's constitution binds:

- Members to company,
- Company to members (but refer below), and
- Members to members.

In **Australia**, the constitution also constitutes a contract between the company and each director and secretary of the company.

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] 1 Ch 881 (UK)*

*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 1 ExD 88 (UK)*

*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 company constitution **does not constitute a contract between director and members**. This can be rationalised with reference to corporate legal personality and the division of corporate powers.

## 6.2 Constitution as a contract between members

The **constitution** has the effect of a contract made 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] 2 All ER 194 (UK)*

*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.

Constitutions 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 his shares must, if the articles so require, give **notice of his intention to the company**.
- (b) The company must give notice to other members that they have an **option to take up his shares**.

## 6.3 Constitution as a supplement to contracts



### Section overview

- 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. One example is when services, say as a director, are provided under contract without agreement as to remuneration: *Re New British Iron Co, ex parte Beckwith [1898] 1 Ch 234 (UK)*.

If a contract incorporates terms of the articles it is subject to the company's **right to alter** its articles: *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd [1927] 2 KB 9 (UK)*. 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.



## Exam comments

Remember the constitution only creates contractual rights/obligations in relation to rights **as a member**.

## 6.4 Shareholder agreements



### Section overview

- **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 (the members of the company) agree how they will vote on various issues.

They offer more protection to the interests of shareholders than do the articles of association. Because a shareholder who is a party to such an agreement can take proceedings in court to enforce it, a shareholders' agreement effectively gives shareholders a power of veto over any proposal which is contrary to the terms of the agreement. This enables a minority shareholder to protect his interests against unfavourable decisions of the majority.

## Chapter summary

- Promoters
  - Promoters form companies and are an agent.
  - Duties of promoters:
    - Reasonable skill and care
    - Fiduciary duties
- Pre-registration expenses and contracts
  - Agent has no automatic right to be reimbursed for pre-registration expenses.
  - Pre-registration contract is the contract made by the agent at formation.
  - Agent is liable for these contracts where they are deemed to be party to it.
  - Liability can be avoided.
- Formation procedures
  - Australian formation procedures used as exemplar.
  - Certification of registration issued.
  - Using off-the-shelf companies to register.
  - When business trading commences after registration.
- A company's constitution
  - Articles of association.
  - Resolutions (ordinary and special) and agreements.
  - Replaceable rules can be used instead of a constitution (Australia).
  - Model articles or similar used instead of a constitution (UK, Singapore, Malaysia)
  - Methods for altering the articles – generally special resolution.
  - Administrative requirements when altering the articles.
- Company objects and capacity
  - Objects are aims and purposes of the company and can be altered by special resolution.
- The constitution as a contract
  - Contract between company and members; members and company; members and members.
  - A contract between the company and each director and secretary of the company (Australia)
  - Shareholder agreements can supplement a constitution.

## Quick revision questions

- 1 A company can confirm a pre-registration contract by performing it or obtaining benefits from it.  
true ☐  
false ☐
- 2 Which of the following persons are bound to one another by the constitution?  
A members to company  
B company to members  
C members to members  
D company to unrelated third parties
- 3 Which of the following documents must be submitted when registering a proprietary company limited by shares in Australia?  
A constitution  
B form 201  
C articles of association  
D statement of compliance
- 4 An Australian public company with no liability does not have to provide a copy of its constitution on registration.  
true ☐  
false ☐

## Answers to quick revision questions

- 1 False. The company must make a new contract on similar terms.
- 2 A, B and C are correct: S33. D is incorrect, illustrated by the *Eley* decision.
- 3 Only C is correct. A is incorrect as the constitution does not need to be supplied to ASIC for a proprietary company. B is incorrect as the replaceable rules are found within the Corporations Act 2001 and are not a separate document to be supplied. D and E are all requirements under UK law only.
- 4 False. A no liability company must provide its constitution to ASIC to confirm it can be correctly classed as 'no liability'.



## Answers to chapter questions

- 1 Promoters (as agents of the company) will be liable for pre-registration contracts if the company is subsequently not registered (subject to any agreements to the contrary).
- 2 Replaceable rules are used **instead** of a constitution; model articles are used **within** a constitution.





## Chapter 11

# Company directors and other company officers

Learning objectives	Reference
<b>Management of companies</b>	<b>LO10</b>
Identify the key legal issues that arise in the management and governance of companies	LO10.1
Identify the impact of key business decisions on member interests	LO10.1.1
Identify the impact of key business decisions on the public	LO10.1.2
Specify the nature and role of company directors and other officers as agents of the company	LO10.2
Specify the nature, role and powers of the board of directors	LO10.3
Specify the relationship between the board and the company in a general meeting	LO10.3.1
Identify the rules on directors' remuneration and financial benefits to directors and other related parties	LO10.4
Identify the rules on appointment and removal of directors from office	LO10.5
Specify the extent of directors' duties and powers	LO10.6
Recognise the issues that arise when there are related party transactions	LO10.7
Identify the role and powers of the company secretary	LO10.9
Identify the role and powers of the registered company auditor	LO10.10
<b>Membership and dividends</b>	<b>LO11</b>
Distinguish the rights and remedies of members of companies including:	LO11.4
Appointing a registered company auditor	LO11.4.1

### Topic list

- 1 The role of directors
- 2 Appointment of directors
- 3 Remuneration of directors
- 4 Vacation of office
- 5 Disqualification of directors
- 6 Powers of directors
- 7 Powers of the managing director
- 8 Powers of an individual director
- 9 Duties of directors
- 10 The company secretary
- 11 The registered company auditor

# Introduction

In this chapter we turn our attention to the **appointment** and **removal**, **remuneration**, and the **powers and duties** of **company directors**.

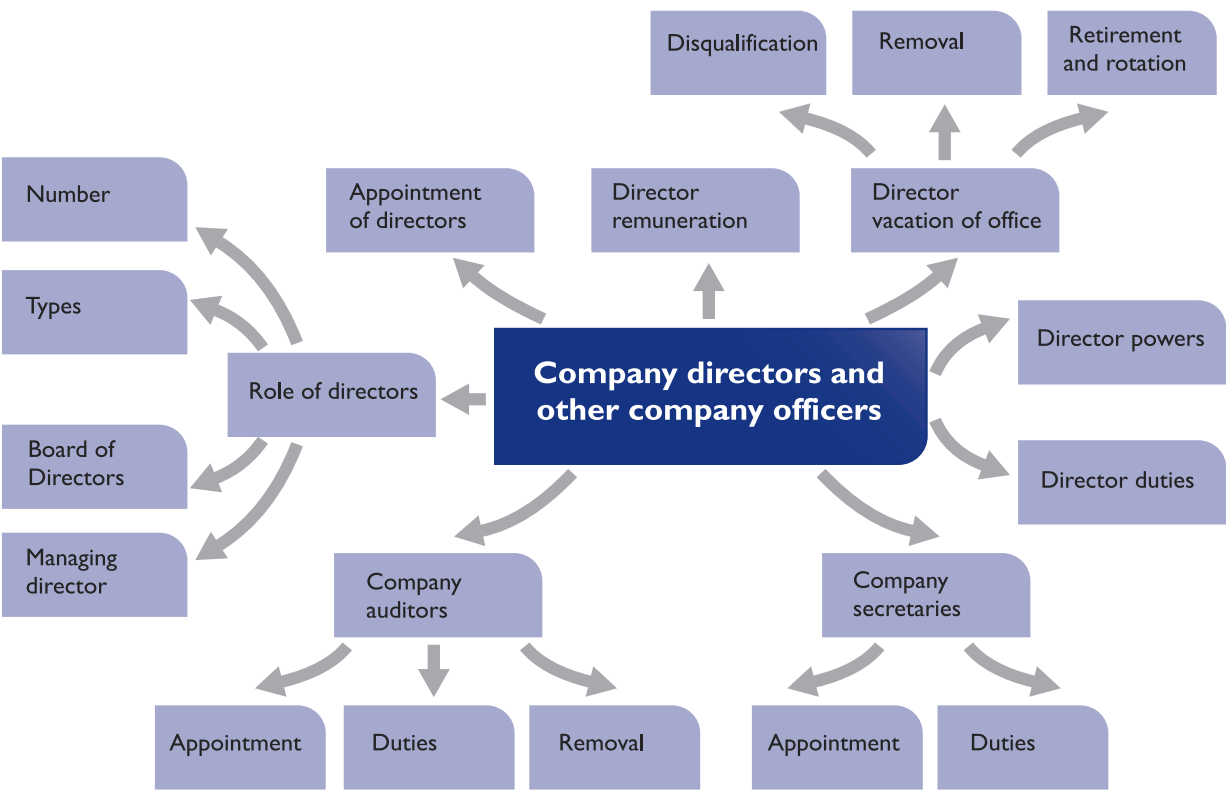
The important principle to grasp is that the **extent of directors' powers is defined by the articles** of the constitution.

If **shareholders** do not approve of the directors' acts they must either **remove them** or **alter the constitution** to regulate their future conduct. However, they **cannot** simply **take over** the functions of the directors.

In essence, the directors act as **agents of the company**. This ties in with the concept of **agency** as seen in Chapter 9. The different types of authority a director can have (implied and actual) are important in this area.

We also consider the **duties** of directors under statute and **remedies for the breach of such duties**. **Statute** also imposes some duties on directors, specifically concerning openness when transacting with the company. Finally, we examine the duties and powers of the **company secretary** and **auditor**.

We shall be primarily using the **Australian model** of companies to examine the corporate form and use secondary examples from the **UK, Singapore** and **Malaysia**. Note that Australian, Singaporean and Malaysian company law is based on English company legislation and the common law.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Define company director, company secretary and company auditor. (Sections 1, 10, 11)
- 2 What is the board of directors and what powers does it hold? (Section 1.7)
- 3 Explain the difference between appointing a first director and a subsequent director. (Sections 2.1, 2.2)
- 4 What is a remuneration report? What power do members have over directors' remuneration? (Section 3.3)
- 5 How can directors be removed from office? (Section 4.2)
- 6 What behaviour will result in a director's disqualification under statute? (Section 5.1)
- 7 How do members control director behaviour? (Section 6.1.3)
- 8 What is a fiduciary duty? (Section 9)
- 9 List three duties of a company secretary. (Section 10.2)
- 10 List three duties of a company auditor. (Section 11.5)

# 1 The role of directors



## Section overview

- Any person who occupies the position of director is treated as such, the test being one of **function**.

### LOs

10.1

10.1.1

10.1.2

10.2

## Definition

Any person who occupies the position of director is treated as such. The test is one of **function**. The directors' function is to take part in **making decisions by attending meetings** of the **board of directors**. Anyone who does that is a director, whatever they may be called

People who are given the title of director, such as 'sales director' or 'director of research', to give them status in the company structure are **not** directors in company law. This is unless, by virtue of their appointment, they are a **member** of the **board of directors**, or they carry out functions that would be properly discharged only by a director. Anyone who is held out by a company as a director, and who acts as a director although not validly appointed as one, is known as a **de facto** director.

## 1.1 Shadow directors

A person might seek to **avoid the legal responsibilities of being a director** by avoiding appointment as such but using their power, say as a major shareholder, to manipulate the acknowledged board of directors.

Company law seeks to prevent this abuse by extending several statutory rules to **shadow and de facto directors**. Shadow directors are directors for legal purposes if the board of directors are accustomed to act in **accordance with their directions and instructions**.

This rule **does not apply to professional advisers** merely acting in that capacity.

## 1.2 Alternate directors

A director may, if the constitution permits, appoint an **alternate director** to attend and vote for them at board meetings which they are unable to attend. Such an alternate may be another director, in which case they have the vote of the absentee as well as their own. More usually they are outsiders. The company's constitution could make specific provisions for this situation.

## 1.3 Executive directors



## Definition

An **executive director** is a director who performs a specific role in a company under a **service contract** which requires a regular, possibly daily, involvement in management. They are both a director and an employee of the company.

An executive director is also a full time **employee** of their company, such as the managing director or chief executive officer (CEO). Since the company is also their **employer** there is a potential conflict of interest which, in principle, a director is required to avoid.

To allow an individual to be **both a director and employee** the articles usually make express provision for it, but prohibit the director from voting at a board meeting on the terms of their own employment.

Directors who have additional management duties as employees may be distinguished by **special titles**, such as 'Finance Director' or 'CEO'. However, except in the case of a managing director (discussed in Section 1.6 below), **any such title does not affect their personal legal position**. They have two distinct positions as:

- A member of the board of directors, and
- A manager with management responsibilities as an **employee**.

## 1.4 Independent non-executive directors



### Definition

A **non-executive director** does not have a function to perform full-time in a company's management and is not an employee of the company. An **independent non-executive director** is not a substantial shareholder, an employee of the company or otherwise connected with the company.

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In **listed companies**, corporate governance codes usually state that boards of directors are more likely to be fully effective if they comprise both **executive directors** and strong, **independent non-executive directors**. An independent non-executive director is not involved in company management, is not an employee of the company, is not a substantial shareholder, and is not connected with the company in any capacity.

The main tasks of the independent non-executive directors are as follows:

- **Contribute an independent view** to the board's deliberations.
- **Help the board provide** the company with **effective leadership**.
- **Ensure the continuing effectiveness** of the **executive directors** and management.
- **Ensure high standards of financial probity** on the part of the company.

Non-executive and shadow directors are subject to the same duties as executive directors. Duties are discussed in Section 9.

## 1.5 The managing director



### Definition

A **managing director** is an executive director of the company appointed to carry out overall day-to-day management functions.

---

If the constitution provides for it the board may appoint one or more of the executive directors to be **managing directors**. A managing director (MD) does have a **special position** and has **wider apparent powers** than any director who is not appointed an MD.

## 1.6 Number of directors

Australian proprietary companies must have a minimum of **one** director (this is the same for **private companies** in Singapore and the UK).

Australian public companies must have a minimum of **three directors**, two of whom must be **ordinarily resident** in Australia. There is no statutory maximum number of directors stated but the company constitution usually imposes a limit. Only natural persons can act as company directors, though Australian case law has shown that a company can be recognised as a shadow director of another company.

The rules concerning the number and type of directors in public companies vary across the UK, Malaysian and Singaporean jurisdictions; for example, in the UK public companies must have a minimum of two directors. One director must be a natural person, not a body corporate and a company may be a director, in which case the director company sends an individual to attend board meetings as its representative.

## 1.7 The board of directors

LO  
10.3

Companies are run by the directors collectively, in a **board of directors**.



### Definition

The **board of directors** is the elected representative of the shareholders acting collectively in the management of a company's affairs.

---

One of the basic principles of company law is that the **powers** which are delegated to the directors under the constitution are given to them as a **collective body**.

LO  
10.3.1

The **board meeting** is the **proper place for the exercise of the powers**, unless they have been validly passed on, or 'sub-delegated', to committees or individual directors.

## 2 Appointment of directors



### Section overview

- The method of appointing directors, along with their rotation and co-option is **controlled** by the **constitution**.

LO  
10.5

A director may be **appointed expressly**, in which case they are known as a *de jure* director.

Where a person acts as a director without actually being appointed as such in the role of a *de facto* or **shadow director**, then they incur the obligations and have some of the powers of a proper director. In addition, a shadow director is subject to many of the duties imposed on directors.

### 2.1 Appointment of first directors

The application for registration to form a company includes particulars of the first directors, with their consents. On the formation of the company, those persons become the first directors.

### 2.2 Appointment of subsequent directors

Once a company has been formed further directors can be appointed, either to **replace existing directors** or as **additional** directors.

Appointment of further directors is carried in accordance with the **company articles**. Most company articles allow for the appointment of directors:

- By **ordinary resolution** of the shareholders, and
- By a **decision** of the directors.

However, the company does not have to follow these provisions and may impose **different methods** on the company.

When the appointment of directors is proposed at a general meeting of a public company a **separate** resolution should be proposed for the election of **each director**. However, the rule may be waived if a resolution to that effect is first carried without any vote being given against it.

### 2.3 Publicity

In addition to giving notice of the first directors, every Australian company must within **28 days** give **notice** to **ASIC** of any **change among its directors**. The timeframe differs between jurisdictions, for example in the UK it is 14 days. .

### 2.4 Age limit

In Australia, the **minimum age** limit for a director is **18**, while directors of public companies must retire at the age of 72, unless members approve their continuation at each successive annual general meeting. The age limits differ between jurisdictions, for example in **Malaysia** and **Singapore** the lower limit is **18**, while in the **UK** the lower limit is **16**.



## 3 Remuneration of directors



### Section overview

- Directors are entitled to **fees** and **expenses** as directors as per the articles, **emoluments** and compensation for loss of office, as per their service contracts which can generally be inspected by members. Some details are published in the **directors' remuneration and top executive report** along with accounts. It should be noted that setting the remuneration of executives falls with directors' power of management.

LO  
10.4

Directors are entitled to remuneration as laid out in the company's articles. In Australia, if the articles do not make provision for remuneration or if there is no constitution in place, i.e. replaceable rules are used, then remuneration is to be decided by an ordinary resolution. The Corporations Act 2001 allows for challenges by members to 'excessive' remuneration for directors.

Specific details of directors' remuneration are usually contained within their service or employment contract. This is a contract where the director agrees to personally perform services for the company.

### 3.1 Directors' expenses

Most articles (and the Australian replaceable rules) state that directors are entitled to **reimbursement of reasonable expenses** incurred while carrying out their duties or functions as directors. In addition, most directors have **written service or employment contracts** setting out their entitlement to emoluments and expenses.

### 3.2 Compensation for loss of office

Any director may receive **non-contractual** compensation for loss of office paid to them voluntarily. Any such compensation is lawful **only if approved by members of the company in general meeting** after proper disclosure has been made to all members, whether voting or not.

This only applies to non-contractual payments; approval is not required where the company is contractually bound to make the payment.

**Compensation paid to directors for loss of office** is distinguished from any payments made to **directors as employees** for example, to settle claims arising from the premature termination of the service contracts. These are contractual payments which do not require approval by the members, though increasingly are subject to statutory limits in Australia.

### 3.3 Directors' remuneration report

Listed public companies are required to include a **directors' remuneration report** as part of their annual report, part of which is subject to audit. The report must cover the:

- Details of each individual director's remuneration package,
- Company's remuneration policy, and
- Role of the board and remuneration committee in deciding the remuneration of directors.

It is the **duty of the directors**, including those who were a director in the preceding five years, to **provide any information** about themselves that is necessary to produce this report.

Listed companies are required to allow a **vote by members on the directors' remuneration report**. The vote is **purely advisory** and does not mean the remuneration should change if the resolution is not passed. A negative vote would be a strong signal to the directors that the members are unhappy with remuneration levels, or 'related party' remuneration payments in Australia.

**Items in remuneration report that are not subject to audit:**

- Consideration by the directors' remuneration committee of matters relating to directors' remuneration.

- Statement of company's policy on directors' remuneration.
- Performance graph of share performance.
- Directors' service contracts including dates, unexpired length, compensation payable for early termination.

**Items in remuneration report that are subject to audit:**

- Salary/fees payable to each director.
- Bonuses paid/to be paid.
- Expenses.
- Compensation for loss of office paid.
- Any benefits received.
- Share options and long term incentive schemes – performance criteria and conditions.
- Pensions and superannuation payments.
- Excess retirement benefits.
- Compensation to past directors.
- Sums paid to third parties in respect of a director's services.

### 3.4 Inspection of directors' service contracts

LO  
11.4

A company must make available for inspection by members a copy or particulars of **contracts of service** between the company or a subsidiary with a director of the company. Such contracts must cover all services that a director may provide including services outside the role of a director, and those made by a third party in respect of services that a director is contracted to perform. In Australia, directors are not required to make their service contracts available for inspection, although members are enabled by statute to obtain information about directors' remuneration.

Prescribed particulars of **directors' emoluments** must be given in the accounts and also particulars of any **compensation for loss of office** and directors' **pensions**.

## 4 Vacation of office



### Section overview

- A director may vacate office as director due to: **resignation; not going for re-election; death; dissolution** of the company; **removal; disqualification**.

LO  
10.5

A director may leave office in the following ways:

- Resignation.
- Not offering themselves for re-election when their term of office ends (part of the retirement and re-election of officers procedure discussed in Section 4.1).
- Death.
- Dissolution of the company.
- Being removed from office through company resolution, as discussed in more detail in Section 4.2
- Being disqualified. Disqualification is discussed in more detail in Section 5.

## 4.1 Retirement and re-election of directors

The Australian Corporations Act 2001 does not provide any restrictions for the term of appointment of directors, apart from an age limit of 72 for directors of public companies. If the company is listed on the Australian Securities Exchange (ASX) then a director must not hold office for longer than three years without re-election.

Many Australian companies including those listed on the ASX will adopt **rotation** and **retirement articles** in their constitution which may be similar to those described below:

- (a) Every year **half** (or the number nearest to half) all directors (except the managing director) must **retire**; at the first AGM of the company they all retire.
- (b) **Retiring directors** are **eligible** for **re-election** (unless they choose not to stand for re-election which means they cease being a director)
- (c) Those retiring shall be those **in office longest** since their last election.
- (d) When calculating which directors are required to retire by rotation, directors who were **appointed to the board** during the year (and therefore are obliged to stand for re-election) and those **retiring** and **not seeking re-election** are **not included** in the calculation.



### Question 1: Rotation of directors

The board of Teddy Corporation Limited has the following directors at the start of its AGM on 31 December 20X7.

	Age	When last re-elected
Mrs Clare	42	31 December 20X4
Mr Paul	64	31 December 20X5
Mr Bob	27	31 December 20X5
Mr Nick	30	31 December 20X5
Miss Alison	60	31 December 20X6
Mr Maurice	38	31 December 20X6
Mrs Pippa	34	31 December 20X6
Mr Gordon	43	2 May 20X7
Mrs Helen	41	2 May 20X7

At a board meeting on 2 May 20X7 Mr Gordon and Mrs Helen were appointed to fill casual vacancies and Mrs Clare was appointed managing director.

Which directors would be due for re-election at the AGM on 31 December 20X7?

(The answer is at the end of the chapter)

## 4.2 Removal of directors

LO  
11.4

In addition to provisions in the articles for removal of directors, a director may be removed from office by **ordinary resolution** at a meeting of which **special notice** to the company has been given by the person proposing the removal of the director. Note that directors cannot remove other directors from office; it is the power of a majority of members. For Australian public companies **special notice** of 2 months must be provided. For Australian proprietary companies a special notice is not required; only a board resolution or a member ordinary resolution is sufficient.

On receipt of the special notice the company must send a copy to the director who may require that a **memorandum of reasonable length** shall be issued to members. They also have the **right to address the meeting** at which the resolution is considered. The **constitution** and any **service contract** of the director **cannot override the statutory power**. However, the articles can **permit dismissal without the statutory formalities** being observed for example, dismissal by a resolution of the board of directors.

The power to remove a director through resolution is **limited** in its effect in four ways:

Restrictions on power to remove directors	
Shareholding qualification to call a meeting	<p>In order to propose a resolution to remove a director, the shareholder(s) involved must call a general meeting. To do this they must hold:</p> <ul style="list-style-type: none"><li>• Either 5% (Australia) or 10% (UK) of the paid up share capital.</li><li>• Or, 10% of the voting rights where the company does not have shares (UK only).</li></ul>
Shareholding to request a resolution	<p>Australia – Where a meeting is already convened, 100 members who are entitled to vote, or members with collectively at least 5% of the votes, may request a resolution to remove a director.</p> <p>UK – Where a meeting is already convened, 100 members holding an average £100 of share capital each may request a resolution to remove a director.</p>
Weighted voting rights	<p>A director who is also a member may have weighted voting rights given to them under the constitution for such an eventuality, so that they can automatically defeat any motion to remove them as a director: <i>Bushell v Faith</i> [1970] AC 1099 (UK).</p>
Class right agreement	<p>It is possible to draft a shareholder agreement stating that a member holding each class of share must be present at a general meeting to constitute quorum. If so, a member holding shares of a certain class could prevent a director being removed by not attending the meeting.</p>

The dismissal of a director may also entail payment of a **substantial sum** to settle their claim for **breach of contract** if they have a service contract. No resolution may deprive a removed director of any compensation or damages related to their termination to which they are entitled.

*Southern Foundries (1926) Ltd v Shirlaw* [1940] AC 701 (UK)

*The facts:* In 1933 S entered into a written agreement to serve the company as managing director for ten years. In 1936 SF Co gained control of the company and used its votes to alter its articles to confer on SF Co power to remove any director from office. In 1937 SF Co exercised the power by removing S from his directorship and thereby terminated his appointment as managing director (which he could only hold so long as he was a director).

*Decision:* The alteration of the articles was not a breach of the service agreement but the exercise of the power was a breach of the service agreement for which the company was liable.

## 5 Disqualification of directors



### Section overview

- Directors may be required to vacate office because they have been disqualified on grounds dictated by the **constitution**. Directors may also be disqualified from a wider range of company involvements under **Australian statute** through the Corporations Act 2001.

LO  
10.4

A person cannot be appointed a director or continue in office if they are or become **disqualified** under the company constitution or relevant jurisdiction statutory rules as explained below. **The articles of the constitution** often embody the statutory grounds of disqualification and add some optional extra grounds.

The Australian Corporations Act 2001 provides that a director must vacate office if:

- (a) They are disqualified by statute or any rule of law (including that of applicable laws in foreign jurisdictions).
- (b) They become **bankrupt** or enter into an arrangement with creditors. Unless the court approves it, an **undischarged bankrupt** cannot act as a director nor be concerned directly or indirectly in the management of a company. If they do continue to act, they become personally liable for the company's relevant debts.

- (c) They become of **unsound mind**.
- (d) They **resign** by notice in writing.
- (e) They are absent from board meetings without obtaining the leave of the board (see Section 5.1 below).

## 5.1 Disqualification under statute

The **Corporations Act 2001** provide that a **court may** formally **disqualify a person from being a director**, or in any way directly or indirectly being concerned or taking part in the promotion, formation or management of a company. The Corporations Act 2001 delegates the responsibility for disqualification of directors to ASIC under prescribed circumstances. Therefore, the terms of the disqualification order are very wide and do not just apply to directors. Other company officers can be disqualified under statute, even those acting as a consultant to a company.

The company articles may provide that **a director shall automatically vacate office** if they are **absent** from **board meetings** without obtaining the leave of the board for a **specified period** – three months is usual. The effect of this disqualification depends on the words used:

- If the articles refer merely to 'absence' this includes involuntary absence due to illness.
- The words 'if he shall absent himself' restrict the disqualification to periods of voluntary absence.

The period of **three months** is reckoned to begin from the **last meeting** which the absent director did attend. The normal procedure is that a director who foresees a period of absence applies for leave of absence at the last board meeting which they attend; the leave granted is duly minuted. They are not then absent 'without leave' during the period.

If they fail to obtain leave but later offer a reasonable explanation the other directors may let the matter drop by simply not resolving that they shall vacate office. The general intention of the rule is to **impose a sanction against slackness**; a director has a duty to attend board meetings when they are able to do so.

Similar statutory provisions apply in other jurisdictions, for example the UK statute relating to the disqualification of company directors is the **Company Directors Disqualification Act 1986 (CDDA)**.



### Question 2: Disqualification of directors

Which of the following are grounds provided for a director being compelled to leave office?

- A becoming bankrupt
- B entering into an arrangement with personal creditors
- C becoming of unsound mind
- D resigning by notice in writing

(The answer is at the end of the chapter)



### Question 3: Vacation of office

The articles of Robert Co provide that if a director should 'absent himself' for a period exceeding three months from board meetings, the director shall automatically vacate office. Miles, a director, obtains a twelve month leave of absence to go abroad. While abroad, he contracts a rare illness; on his return he is rushed to hospital and remains there for nine months. On the day of his release, there is a board meeting which he does not attend, and he resolves not to attend board meetings again. After a further two months he has a relapse and dies a fortnight later. At what point does he cease to be a director?

- A after three months of his holiday
- B after three months of hospitalisation
- C at the point where he decides not to attend board meetings again
- D when he dies

(The answer is at the end of the chapter)

## 5.2 Grounds for disqualification of directors



### Definition

Directors may be **disqualified** from acting as directors or being involved in the management of companies in a number of circumstances. They must be disqualified if the company is insolvent, and if the director is found to be unfit to be concerned with management of a company.

Under the Corporations Act 2001 the director **may** be disqualified on any of the following grounds. Similar provisions apply in other jurisdictions.

- (a) Where a person is **convicted of an indictable offence** in connection with the **promotion, formation, management or liquidation** of a company or with the **receivership or management** of a company's property.
- (b) Where it appears that a person has been **persistently in default** in relation to **provisions of company legislation**, such as returns, accounts or other documents to be filed with, delivered or sent or notice of any matter to be given to ASIC.
- (c) **Where it appears that a person has been guilty of fraudulent trading.** This is carrying on business with intent to defraud creditors or for any fraudulent purpose whether or not the company has been, or is in the course of being, wound up (Chapter 13). The person does not actually have to have been convicted of fraudulent trading. The legislation also applies to anyone who has otherwise been guilty of any fraud in relation to the company or of any breach of their duty as an officer.
- (d) Where the **government**, acting on a report made by inspectors or from information or documents obtained under legislation, applies for an **order** believing it to be expedient in the **public interest**.
- (e) Where a director was involved in certain **competition violations**.
- (f) Where a director of an insolvent company has participated in **wrongful trading** (Chapter 13).

The director **must** be disqualified where the following apply:

- (a) A person has been a director of a company which has at any time become **insolvent**, whether while they were a director or subsequently. The test is whether the director has been an officer of two failed companies in seven years.
- (b) Their conduct as a director of that company makes them **unfit** to be **concerned** in the **management** of a company. The courts may also take into account their conduct as a director of other companies, whether or not these other companies are insolvent. Directors can be disqualified under this section even if they take no active part in the running of the business.

Offences for which directors have been disqualified include the following:

- (a) **Insider dealing/trading.**
- (b) **Failure to keep proper accounting records.**
- (c) **Failure to read the company's accounts.**
- (d) **Loans** to another company for the purposes of purchasing its own shares with **no grounds for believing the money would be repaid.**
- (e) **Loans** to associated companies on **uncommercial terms** to the detriment of creditors.

Examples of circumstances which have led to a reduction in the period of disqualification include:

- **Lack of dishonesty** displayed in the situation.
- **Loss of director's own money** in the company.
- **Absence of personal gain** for example, excessive remuneration.
- **Efforts to mitigate** the situation.
- **Unlikelihood of re-offending.**
- **Proceedings hanging over director** for a long time.

## 5.3 Procedures for disqualification

Administrators, receivers and liquidators all have a statutory duty to report directors where they believe the conditions for disqualification are satisfied. The government – through the ASIC in Australia – then decides whether to apply to the court for an order, but if they do decide to apply they must do so within a stated timeframe. The ASIC will generally apply when the director has been an officer of two failed companies in the last seven years.

# 6 Powers of directors



## Section overview

- The **powers** of the directors are **defined** by the **company articles**.

LO  
10.6

The powers of the directors are **defined by the articles**. The directors are usually authorised 'to manage the company's business' and 'to exercise all the powers of the company for any purpose connected with the company's business'.

Therefore, they may take **any decision which is within the capacity** of the company **unless** either **the Act**, the **replaceable rules** (Australia) or **the articles** themselves **require** that the **decision shall be taken by the members in a general meeting**.

## 6.1 Restrictions on directors' powers



## Section overview

- Directors' powers may be restricted by statute or by the constitution. The directors have a duty to exercise their powers in what they honestly believe to be the **best interests** of the company and for the **purposes** for which the powers are given.

### 6.1.1 Statutory restrictions

Many transactions, such as an alteration of the articles or a reduction of capital, must by law be effected by passing a **special resolution**. If the directors propose such changes they must secure the passing of the appropriate resolution by shareholders in a general meeting.

### 6.1.2 Restrictions imposed by articles

As an example, the articles often set a maximum amount which the directors may **borrow**. If the directors wish to exceed that limit, they should **seek authority** from a **general meeting**.

When the directors clearly have the necessary power, their decision may be challenged if they exercise the power in the wrong way. They must exercise their powers:

- In what they **honestly believe to be the best interests of the company**, and
- For a **proper purpose**, being the purpose for which the power is given.

### 6.1.3 Members' control of directors

LO  
11.4

There is a **division of power** between the board of directors who manage the business and the members who as owners take the major policy decisions at general meetings. How, then, do the owners seek to 'control' the people in charge of their property?

- The members **appoint** the directors and may **remove** them from office.
- The members can, by **altering the articles** through a special resolution, re-allocate powers between the board and the general meeting.
- Articles may allow the members to pass a **special resolution ordering the directors to act**, or **refrain from acting**, in a **particular way**. Such special resolutions cannot invalidate anything the directors have already done. This again is supported in the contractual nature of the company constitution.



**Directors are agents of the company as a whole, not of the members.** They cannot be instructed by the members as to how they should exercise their powers. **The directors' powers are derived from the company as a whole** and are to be exercised by the directors as the directors think best in the interests of the company.

#### 6.1.4 Control by the law

Certain powers must be exercised '**for the proper purpose**' and all powers must be exercised *bona fide* **for the benefit of the company**. Failure by the directors to comply with these rules will result in the **court setting aside their powers** unless the shareholders **ratify** the directors' actions by **ordinary resolution** which is a 50% majority.

## 7 Powers of the managing director



### Section overview

- One or more directors may be appointed by the board as **managing director**. The managing director has **apparent** authority to make business contracts on behalf of the company. The managing director's **actual** authority is whatever the board gives them.

LO  
10.6

If the company articles provide for it the **board** may appoint one or more directors to be **managing directors**.

In their dealings with outsiders the managing director has **apparent authority** as agent of the company to **make business contracts**. No other director, even if they work full time, has that **apparent** authority as a director, though if they are employed as a manager they may have apparent authority at a slightly lower level.

The managing director's **actual authority** is whatever the board gives them.

Although a managing director has this special status, their appointment may be **terminated** as per the standard employee termination procedures; they then revert to the position of an ordinary director. Alternatively, the company in a general meeting may **remove them from their office of director** and they immediately cease to be managing the company since being a director is a necessary qualification for holding the position.

### 7.1 Agency and the managing director

LO  
10.2

The directors are **agents of the company, not agents of the members**. Where they have **actual or usual** authority they can **bind the company**. In addition, a director may have **apparent authority** by virtue of **holding out**.

**Holding out** is a basic rule of the law of agency and we saw it in Chapter 9. If the principal (the company) holds out a person as its authorised agent they are prevented from denying that they are its **authorised agent**. The company is then bound by a contract entered into by the authorised agent (the director) on the company's behalf.



### Definition

**Apparent authority** is the authority which an agent appears to have to a third party. A contract made within the scope of such authority will bind the principal even if the agent was not following instructions.

Therefore, if the board of directors **permits a director** to behave as if they were a **managing director** duly appointed when in fact they are not, the company may be bound by their actions.

A managing director has, by virtue of their position, **apparent authority** to make commercial contracts for the company. Moreover if the board allows a director to enter into contracts, being aware of their dealings and taking no steps to disown them, the company will usually be bound.



*Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd [1964] 2 QB 480 (UK)*

**The facts:** A company carried on a business as property developers. The articles contained a power to appoint a managing director but this was never done. One of the directors of the company, to the knowledge but without the express authority of the remainder of the board, acted as if he were managing director. He found a purchaser for an estate and also engaged a firm of architects to make a planning application. The company later refused to pay the architect's fees on the grounds that the director had no actual or apparent authority.

**Decision:** The company was liable since by its acquiescence it had represented that the director was a managing director with the authority to enter into contracts that were normal commercial arrangements and which the board itself would have been able to enter.



### Exam comments

Situations where the facts are similar to the *Freeman & Lockyer* case often occur in law exams so be prepared to spot them.

In the *Freeman & Lockyer* case, four conditions were laid down which must be satisfied in claiming under the principle of **holding out**. The claimant must show that:

- (a) A **representation** was made to them that the **agent had the authority** to enter on behalf of the company into the contract of the kind sought to be enforced.
- (b) Such **representation was made by a person** who had **'actual' authority to manage the business** of the company.

The board of directors would certainly have actual authority to manage the company.

Some commentators have also argued that the managing director has actual or apparent authority to make representations about the extent of the actual authority of other company agents. However, a third party cannot rely on the representations a managing director makes about their own actual authority.

- (c) They were **induced** by the **representation** to enter into the contract; they had in fact relied on it.
- (d) There must be **nothing** in the **articles** which would prevent the company from giving valid authority to its agent to enter into the contract.

## 8 Powers of an individual director

The position of any other individual executive director (not an managing director) **who is also an employee** is that:

- (a) They do not have the apparent authority to make general contracts which attaches to the position of managing director, but they have whatever apparent authority attaches to their management position.
- (b) Removal from the office of director may be a breach of their service contract if that agreement stipulates that they are to have the status of director as part of the conditions of employment.

## 9 Duties of directors



### Section overview

- The **common law duties of directors** have developed over time and are applied across all common law countries including Australia, the UK, Singapore and Malaysia.
- **Common law duties have been enshrined in statute law** in Australia, the UK, Singapore and Malaysia. There are **six principal duties under Australian statute**. These duties are similar to those found in the UK, Singaporean and Malaysian systems and the Australian duties will be used as exemplar.

The Corporations Act 2001 lists the **six principal duties** that directors owe to their company in **Australia**. Many of these duties developed over time through the operation of **common law** and **equity**, or are **fiduciary duties** which have been codified to make the law clearer and more accessible. The Corporations Act 2001 codifies these common law and fiduciary duties, many of which still co-exist with the statutory rules.



### Exam comments

When deciding whether a duty has been broken, the courts will consider statute primarily. All case law explained in this section is included here to help you understand the types of situation that arise and how the law may be interpreted and applied by the courts.



### Definition

**Fiduciary duty** is a duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflict of interest.

Broadly speaking, directors must be **honest** and **not allow their personal interests to conflict with their duties as directors**. The directors are said to hold a **fiduciary position** since they make contracts as **agents** of the company and have control of its property.

The duties included in Corporations Act 2001 form a **code of conduct** for directors. They do not tell them what to do but rather create a framework that sets out how they are expected to **behave** generally. This code is important as it addresses situations where:

- A director may put their **own interests** ahead of the company's, and
- A director may be **negligent** and liable to an action under tort.

## 9.1 Who are the duties owed to?

**Directors owe their duties to the company, not the members.** This means that **only the company itself can take action against a director** who breaches them. However, it is possible for a member to bring a **derivative claim** against the director on behalf of the company.

The effect of the **duties are cumulative**, in other words, a director owes **every duty** to the company that could apply in any given situation. Where a director accepts a **bribe** for instance:

- They will be **breaking the duty not to accept a benefit from a third party** and
- They will also **not be promoting the company for the benefit of the members**.

When deciding whether or not a director has breached a duty, the court should consider their actions in the context of **each individual duty** in turn.

## 9.2 Who are the duties owed by?

Every person who is **classed as a director** owes the duties that are outlined below.

Certain aspects of the duties regarding conflicts of interest and accepting benefits from third parties also apply to **past directors**. This is to prevent directors from exploiting a situation for their own benefit by simply resigning. The courts are directed to apply duties to **shadow directors** where they would have been applied to them previously under common law and equity.

Directors must at all times continue to **act in accordance with all other laws**; no authorisation is given by the duties for a director to breach any other law or regulation.

## 9.3 The duties and the articles

The articles may provide more onerous regulations than statute, but **they may not reduce** the level of duty expected **unless** it is in the following circumstances:

- If a director has **acted in accordance with the articles** they cannot be in breach of the duty to exercise independent judgment.
- Some **conflicts of interest by independent directors** are permissible by the articles.
- Directors will not be in breach of duty concerning **conflicts of interest** if they **follow any provisions in the articles for dealing with them**, as long as the provisions are lawful.
- The company may **authorise anything** that would otherwise be a breach of duty.

## 9.4 The duties of directors



### Section overview

- The **Australian statutory duties** owed by directors are:
  - Utilise powers with care and diligence
  - Manage company in the best interests of the company.
  - Act in good faith.
  - Not to improperly use the position of director.
  - Not to improperly use information obtained through the position of director.
  - Avoid conflicts of interest.

General directors' duties in Australia were established in the common law and are codified through the Corporations Act 2001. The **general duties** under the **Corporations Act 2001** are:

- The duty to exercise director powers and duties with the care and diligence that a **reasonable person** would hold in the same circumstances. To meet the standard of reasonableness, all of the following would need to be satisfied:
  - Business judgment made in good faith. It should be noted that 'business judgment' protection does not extend to duties of fiduciary character.
  - It is an informed decision.
  - The director does not have a material interest in the subject matter of the judgment.
  - The judgment is made in the best interests of the company.
- The duty to manage and conduct the business of the company in the **best interests of the company** and for a proper purpose.
- The duty to act in **good faith** for the benefits of the company and for a proper purpose.
- The duty not to **improperly use the position of director** to gain an advantage for themselves or for someone else, or to cause detriment to the company.
- The duty not to **improperly use information obtained through the position of director** to gain an advantage for themselves or someone else, or to cause detriment to the company.
- The duty to avoid situations where they may be a real or perceived **conflict of interest**.

## 9.5 Consequences of breach of duty

In **Australia**, some breaches of director's duties are criminal offences. Section 184 of the Corporations Act 2001 states that a director commits a criminal offence if they are reckless or intentionally dishonest and fail to exercise their powers as directors and duties as directors in:

- good faith in the best interests of the corporation, and
- for a proper purpose.

A director also commits a criminal offence if they use their position or information gained in their position to directly or indirectly gain advantage for themselves, or someone else, to the detriment of the corporation.

The criminal liability of a director in such situations is **in addition to** their civil liability. **Consequences for breach** under **civil law** include the following:

- **Damages** payable to the company where it has suffered loss.
- **Restoration** of company property.
- **Repayment of any profits** made by the director.
- **Rescission of contract** where the director did not disclose an interest.

Corporations Act S185 preserves the civil rights of wronged parties against directors.

## 9.6 Declaration of an interest in an existing transaction or arrangement

LO  
10.7

Directors have a statutory obligation to declare any direct or indirect interest in an **existing transaction** entered into by the company. This duty exists in the Corporations Act 2001 through the duty to avoid conflicts of interest and the duties not to improperly use the position/or information derived from the position, of director. A declaration of a direct or indirect interest in an **existing transaction** is **not** required if:

- It has **already been disclosed** as a **proposed** transaction.
- The director is **not aware** of either:
  - **The interest** they have in the transaction, or
  - **The transaction** itself.
- The director's interest in the transaction **cannot reasonably** be regarded as likely to give rise to a conflict of interest.
- The **other directors are aware**, or reasonably should be aware, of the situation.
- It concerns the **director's service contract** and it has been considered by a board meeting or special board committee.

Where a declaration is required it should be made as soon as **reasonably practicable** either:

- By written notice,
- By general notice, or
- Verbally at a board meeting.

If the declaration becomes **void** or **inaccurate**, a **further declaration** should be made.

## 9.7 Examples of remedies against directors

Remedies against directors for breach of duties include accounting to the company for a **personal gain**, **indemnifying the company**, and **rescission of contracts** made with the company.

The type of remedy varies with the breach of duty:

- (a) The director may have to **account for a personal gain**.
- (b) They may have to **indemnify the company** against loss caused by their negligence such as an unlawful transaction which they approved.
- (c) If they contract with the company in a conflict of interest the **contract may be rescinded by the company**. However, under common law rules the company cannot both affirm the contract and recover the director's profit: *Burland v Earle* [1902] AC 83 (UK)
- (d) The court may declare that a transaction is unlawful.

A company may, either by its **articles** or by **passing a resolution** in general meeting, **authorise or ratify** the conduct of directors in breach of duty. There are some limits on the power of members in general meeting to **sanction a breach of duty** by directors or to release them from their strict obligations:

- (a) If the directors **defraud** the company and vote in general meeting to approve their own fraud, their votes are invalid.
- (b) If the directors **allot shares** to alter the balance of votes in a general meeting the votes attached to those shares may not be cast to support a resolution approving the issue.

## 9.8 Directors' liability for acts of other directors

A director is **not liable** for the actions of fellow directors. If directors become aware of serious breaches of duty by other directors, they may have a duty to inform members of them or to take control of assets of the company without having proper delegated authority to do so. In such cases the director is **liable for their own negligence** in what they allow to happen and not directly for the misconduct of the other directors.

## 9.9 Directors' personal liability

As a general rule a director has no personal liability for the debts of the company – except:

- Personal liability **may arise** by **lifting the veil of incorporation**,
- A **limited company** may by its articles or by **special resolution** provide that its directors shall have unlimited liability for its debts, or
- A director may be **liable** to the **company's creditors** in certain circumstances.
- A director may be **personally liable** for debts incurred during any period of **insolvent trading**.

## 9.10 Fraudulent and wrongful trading

In cases of **fraudulent or wrongful trading** liquidators can apply to the court for an order that those responsible, usually the directors, are liable to repay all or some specified part of the **company's debts**. Directors may also be subject to criminal charges if the crime of fraud is proved. The liquidator should also report the facts to the relevant authorities so that they may **institute criminal proceedings**.

Under Section 588G of the Corporations Act 2001 a company director commits a criminal offence if they allow a company to trade while insolvent, and s.588M states that the director can be held personally liable to pay the debt incurred during the period of insolvent trading.

# 10 The company secretary



### Section overview

- All public companies must have a **company secretary** who may also be a director of the company. Proprietary (private) companies do not have to appoint a secretary but may do so if they wish.

LO  
10.9

Every public company must have a **company secretary**, who is one of the officers of a company and may also be a director. Private (proprietary) companies are not required to have a secretary, but may do so if they desire. The duties of a company secretary including maintaining statutory registers, filing returns with the authorities, ensuring all accounting requirements meet statute, and organising and minuting board meetings. In the absence of a company secretary, the duties normally performed by the company secretary may be done by one of the directors, or an approved person.

## 10.1 Appointment of a company secretary

There are no **statutory requirements** surrounding the qualifications and appointment of secretaries of public companies in Australia beyond the fact they must be over 18, ordinarily resident in Australia, and **not** be an undischarged bankrupt, subject to a personal insolvency agreement, nor convicted of company law offences such as fraud or insolvent trading within five years of the appointment. However, company constitutions normally contain provisions for suitable qualifications and common law recognises that secretaries need to be suitably qualified.

A **sole director** of a proprietary (private) company cannot also be the company secretary, but a company can have **two** or more joint secretaries. A **corporation** can fulfil the role of company secretary in the UK, however this is not allowable in Australia. In Australia, ASIC must be notified of all departures and appointments of company secretaries within 28 days.

## 10.2 Duties of a company secretary

The specific **duties** of each company secretary are **determined by the directors** of the company. As a company officer, the company secretary is responsible for ensuring that the company complies with its statutory obligations. In particular, this means:

- **Establishing and maintaining** the company's **statutory registers**.
- **Filing accurate returns** with the relevant body (such as Australia's ASIC) on time.
- **Organising and minuting** company and **board meetings**.
- **Ensuring** that **accounting records** meet **statutory requirements**.
- **Ensuring** that **annual accounts** are **prepared** and **filed** in accordance with **statutory requirements**.
- **Monitoring statutory requirements** of the company.
- **Signing company documents** as required by law.

## 10.3 Powers and authority of a company secretary

The powers of the company secretary have historically been very limited. However, common law increasingly recognises that they may be able to act as **agents** to exercise apparent or **ostensible authority**. Therefore, they may enter the company into contracts connected with the administrative side of the company's business.

# 11 The registered company auditor



### Section overview

- Every company, apart from certain small companies, must appoint appropriately qualified **auditors**. An audit is a check on the stewardship of the directors.

LO  
10.10

Every company, except a dormant private company and certain small companies (including Australian small proprietary companies), must appoint a registered company auditor for each financial year. However, in Australia relief from the requirement to appoint an auditor may apply to a small proprietary company, under one of the 'class orders' issued by ASIC.

## 11.1 Appointment

LO  
11.4.1

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 (proprietary and private companies) or the next accounts meeting (public companies) unless re-appointed.

Appointment of auditors

- |                  |   |
|------------------|---|
| <b>Members</b>   | <ul style="list-style-type: none"><li>• Usually appoint auditor in general meeting by ordinary resolution.</li><li>• 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.</li><li>• May appoint in general meeting to fill a casual vacancy.</li></ul> |
| <b>Directors</b> | <ul style="list-style-type: none"><li>• Appoint the first ever auditors. They hold office until the end of the first meeting at which the accounts are considered.</li><li>• May appoint to fill a casual vacancy.</li></ul>  |
| <b>Regulator</b> | <ul style="list-style-type: none"><li>• May appoint auditors if members fail to.</li><li>• Company must notify regulator within 28 days of the general meeting where the accounts were laid.</li></ul>  |

11.1.1 Eligibility as auditor

Auditors must 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 relevant jurisdiction.
- Hold an **approved overseas qualification**.

An audit firm may be either a body corporate, a partnership or a sole practitioner. In Australia, an auditor must be a registered company auditor with ASIC. In the UK, membership of a **Recognised Supervisory Body** is the main prerequisite for eligibility as an auditor.

11.1.2 Ineligibility as auditor

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 (Australia – or have been in the last 12 months).
- A **partner** or **employee** of such a person (Australia – or have been in the last 12 months).
- A **partnership** in which such a person is a partner (Australia – or have been in the last 12 months).
- **Ineligible** by virtue of the above for appointment as auditor of any parent or subsidiary undertaking or a subsidiary undertaking of any parent undertaking of the company, and there exists between them or any associate (of theirs) and the company (or company as referred to above) a **connection** of any description as may be specified in regulations.
- Assessed as owing the company, or any related parties, more than \$5 000 (Australia only).

11.1.3 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. This is restricted by Australian law, where the auditor cannot be a debtor of the company for over \$5 000.
- 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**.

## 11.2 Reappointing an auditor of a private company

The above rules on appointment make reference to a **meeting** where the accounts are laid. This is not always relevant for private and large proprietary companies as under the two Acts 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.

## 11.3 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**.

## 11.4 Exemption from audit

Companies can be exempted from audit under certain circumstances, which differ depending on the jurisdiction. In Australia, small proprietary companies are exempt from audit.

To classify as small proprietary, the company must comply with two of the following: annual revenues of less than **\$25 million**, value of gross assets less than **\$12.5 million**, and/or **fewer than 50 employees**.

The only time a small proprietary company is required to undergo audit is if it is foreign-controlled (unless relief from the audit requirements is obtained from ASIC) or if ASIC directs it to do so.

In the UK, Singapore and Malaysia companies are exempt from audit if they are under a certain turnover/annual revenues and are a private company. All public companies, insurance and banking companies must undergo an annual audit. Dormant companies are also exempt from audit.

## 11.5 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 relevant statutes and regulations.

They must also comply with the following:

- **State** whether or not the **directors' report** is **consistent** with the **accounts**.
- For **listed 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 relevant legislation.
- 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 the following has occurred:

- (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**.

## 11.6 Rights of auditors



### Section overview

- Auditors have **statutory rights** 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.

Principles rights of auditors	
<b>Access to records</b>	A right of access at all times to the books, accounts and vouchers of the company.
<b>Information and explanations</b>	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.
<b>Attendance at/notices of general meetings</b>	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.
<b>Right to speak at general meetings</b>	A right to be heard at general meetings which they attend on any part of the business that concerns them as auditors.
<b>Rights in relation to written resolutions</b>	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.

It is 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.

## 11.7 Auditors' liability

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**.

## 11.8 Termination of auditors' appointment



### Section overview

- 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:

- Auditors may **resign** their appointment by giving notice in writing to the company delivered to the registered office.
- Auditors may **decline reappointment**.
- 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 (proprietary) companies cannot remove an auditor by written resolution**; a meeting must be held.
- 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.

In Australia the appointment of new auditors must be by the passing of a ordinary resolution at a general meeting. In the UK, 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 outlining any reasons against termination if they notify the company within 14 days of receiving the copy of the written resolution.

### 11.8.1 Resignation of auditors



### Section overview

- 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. Under Australian law ASIC must **consent to the resignation of an auditor of a public company**.

The general procedure for the resignation of auditors is as follows:

- Auditors must deposit a statement at the registered office with their resignation outlining the circumstances of their resignation. This statement – referred to as the **notice of resignation** in Australia - must also be submitted to the relevant audit authority.
- Auditors are able to requisition a general meeting or speak at a general meeting to explain the circumstances of their resignation.
- The company must supply notice of the auditor registration to the relevant authority (ASIC in Australia) and circulate the notice of resignation to all those entitled to receive a copy of the annual accounts.

- (d) In Australia, an auditor cannot automatically resign from a public company; ASIC must approve the resignation. An auditor must:
- Make a written application to ASIC to resign as an auditor (detailing the reasons for the resignation).
  - Inform the company that such an application has been made.
  - Wait for ASIC to consent to the resignation.

ASIC does not always consent to the resignation of an auditor. The reason for these provisions is to prevent auditors who are unhappy with the company's affairs keeping their suspicions secret.

If the auditors decline to seek reappointment at an annual general meeting, they must still follow the general procedure for the resignation of auditors described above.

Of course, the procedures for removal of the company auditor at a general meeting (explained below) are often used by Australian public companies instead of auditor resignation – often with the agreement of the auditor – as this requires approval from ASIC.

### 11.8.2 Removal of the auditor from office

An auditor can also be removed from office at a general meeting. The procedures for removal of the company auditor at a general meeting (explained below) are often used by Australian public companies instead of auditor resignation – often with the agreement of the auditor – as this resignation requires approval from ASIC. Removal does not.

Across all jurisdictions, 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,

then the auditors have the right to make representations concerning their removal to the company. The auditor is able to attend the meeting at which their office would have expired, and attend any meeting at which the appointment of their successors is discussed.

The company must advise the auditor and the relevant authority of the notice to the auditor as soon as possible after convening the general meeting, notify members in the notice of the meeting of the representations and send a copy of any relevant representations or resulting notice or resignation.



#### Exam comments

Remember that:

- (a) Under Australian law, ASIC must approve the resignation of auditors from a public company.
- (b) The auditors have **additional rights** depending on how they leave office.

In the exam you **must** read any question on this area carefully to ensure you answer it correctly.

## Key chapter points

- The role of directors
  - Number of directors.
  - Types of director
    - Shadow and *de facto*
    - Alternate
    - Executive
    - Independent non-executive.
  - Role and responsibilities of the managing director (MD).
  - Board of directors.
- Appointment of directors
  - Appointment of first and subsequent directors.
  - Age limit – minimum generally 18
- Remuneration of directors
  - Entitled to reimbursement of reasonable expenses.
  - Most directors have written service contracts.
  - May receive non-contractual compensation for loss of office.
  - Content of the directors' remuneration report.
- Vacation of office
  - Retirement and re-election.
  - Removal.
- Disqualification of directors
  - Under statute Corporations Act 2001 in Australia.
  - Grounds for disqualification include:
    - Company insolvency
    - Fraudulent trading
    - Convicted of related indictable offence
    - Wrongful trading.
- Powers of directors
  - Defined by the articles.
  - Statutory restrictions on directors' powers.
  - Restrictions on power through articles.
  - Restrictions on power through member control.
- Powers of the managing director
  - Agency relationship.
  - Apparent authority to make business contracts – actual authority is what the board provides.
- Powers of an individual director
  - Do not have apparent authority to make contracts.
- Duties of directors
  - Six general duties under Australian statute
    - Standard of reasonableness.
    - Manage company in the best interests of the company.

- Act in good faith.
- Not to improperly use the position of director.
- Not to improperly use information obtained through the position of director.
- Avoid conflicts of interest.
- Fiduciary duty.
- Duties are owed to the company as a separate legal entity.
- The company secretary
  - Appointment.
  - Duties.
  - Powers and authority.
- The company auditor
  - Appointment.
  - Remuneration.
  - Duties.
  - Rights.
  - Removal.

## Quick revision questions

- 1 There are generally adopted rules on retirement and re-election of directors. These include which of the following?
  - A every year one third of the directors (or the nearest number thereto) shall retire
  - B the managing director and any other director holding executive office are not subject to retirement by rotation and are excluded from the reckoning of the one third figure
  - C those retiring will be those in service longest since their last election
  - D directors appointed to the board during the year are not included in the calculation
- 2 **Fill in the blanks** in the statements below.

Directors are authorised to manage the b..... of the company, and e..... the p.....of the company.
- 3 Under which of the following grounds may a director be disqualified if they are guilty, and under which must a director be disqualified?
  - A conviction of an indictable offence in connection with a company
  - B persistent default with the provisions of company legislation
  - C wrongful trading
  - D director of an insolvent company whose conduct makes them unfit to be concerned in the management of the company
- 4 What is the extent of a managing director's actual authority?
- 5 What are the two principal ways by which members can control the activities of directors?
- 6 Generally, a public company must have two directors, a proprietary (private) company only needs one.

true ☐

false ☐
- 7 The directors of a company are in breach of the rule requiring them to act for a proper purpose. A general meeting can:
  - A do nothing that will authorise the transaction
  - B authorise the transaction by ordinary resolution
  - C authorise the transaction by special resolution only
  - D relieve the directors of any liability under the transaction by special resolution only
- 8 A proprietary (private) company with a sole director is not legally required to have a company secretary, but if it does, the sole director cannot also be the company secretary.

true ☐

false ☐
- 9 Name two reasons a person would be ineligible to be an auditor.

(1) .....

(2) .....

## Answers to quick revision questions

- 1 C and D are correct. One half of the directors shall retire each year. Executive directors excluding the managing director are subject to retirement by rotation.
- 2 Directors are authorised to manage the **business** of the company, and **exercise all the powers** of the company.
- 3 A to C are grounds under which a director **may** be disqualified; D is grounds under which a director **must** be disqualified.
- 4 The actual authority is whatever the board gives them.
- 5 Appointing and removing directors in general meeting  
Reallocating powers by altering the articles
- 6 True. Proprietary (private) companies only need one director.
- 7 B. The transaction can be authorised through an ordinary resolution at a general meeting.
- 8 True. Sole directors cannot be company secretaries. Proprietary (private) companies are not legally required to have a company secretary.
- 9 Any of:
  - (1) Is an officer/employee of the company being audited.
  - (2) A partner or employee of a person in (1).
  - (3) A partnership in which (1) is a partner.
  - (4) Ineligible by (1), (2) and (3) to be auditor of any of the entity's subsidiaries.

## Answers to chapter questions

- 1 Mr Gordon and Mrs Helen must stand for re-election since they have been appointed during the year.  
Calculation of who is to retire by rotation excludes Mr Gordon, Mrs Helen and Mrs Clare (as Managing Director), therefore leaving six directors. Three of those must therefore retire, and as Mr Paul, Mr Bob and Mr Nick have been in office the longest, it must be them.
- 2 All of them.
- 3 D The board can grant leave of absence, and 'absenting himself' does not include forced hospitalisation. The period of three months **begins** on their release from hospital, and has not been completed when they die.





# Chapter 12

## Membership and dividends

Learning objectives	Reference
<b>Management of companies</b>	<b>LO10</b>
Specify the rules on transfers of shares and refusal to register a transfer of shares	LO10.8
<b>Membership and dividends</b>	<b>LO11</b>
Identify the significance of the register of members	LO11.1
Identify the significance of the requirement for disclosure of interests in shares	LO11.2
Recognise the role of general meetings of members including voting and resolutions	LO11.3
Distinguish the rights and remedies of members of companies, including:	LO11.4
Inspection of the books of the company	LO11.4.2
Protection of the minority and the treatment for unfair or oppressive company practices	LO11.4.3
Specify the procedure for payment of dividends	LO11.5
Specify the rights of shareholders regarding dividends	LO11.6
Specify the company formalities in determining when dividends are payable to shareholders	LO11.7
Identify the rules governing the maximum amount for dividend distribution	LO11.8

Topic list

- 1 The nature of shares
- 2 The role of members
- 3 Rights and remedies of members
- 4 Meetings of members
- 5 Resolutions of members
- 6 Distributing dividends

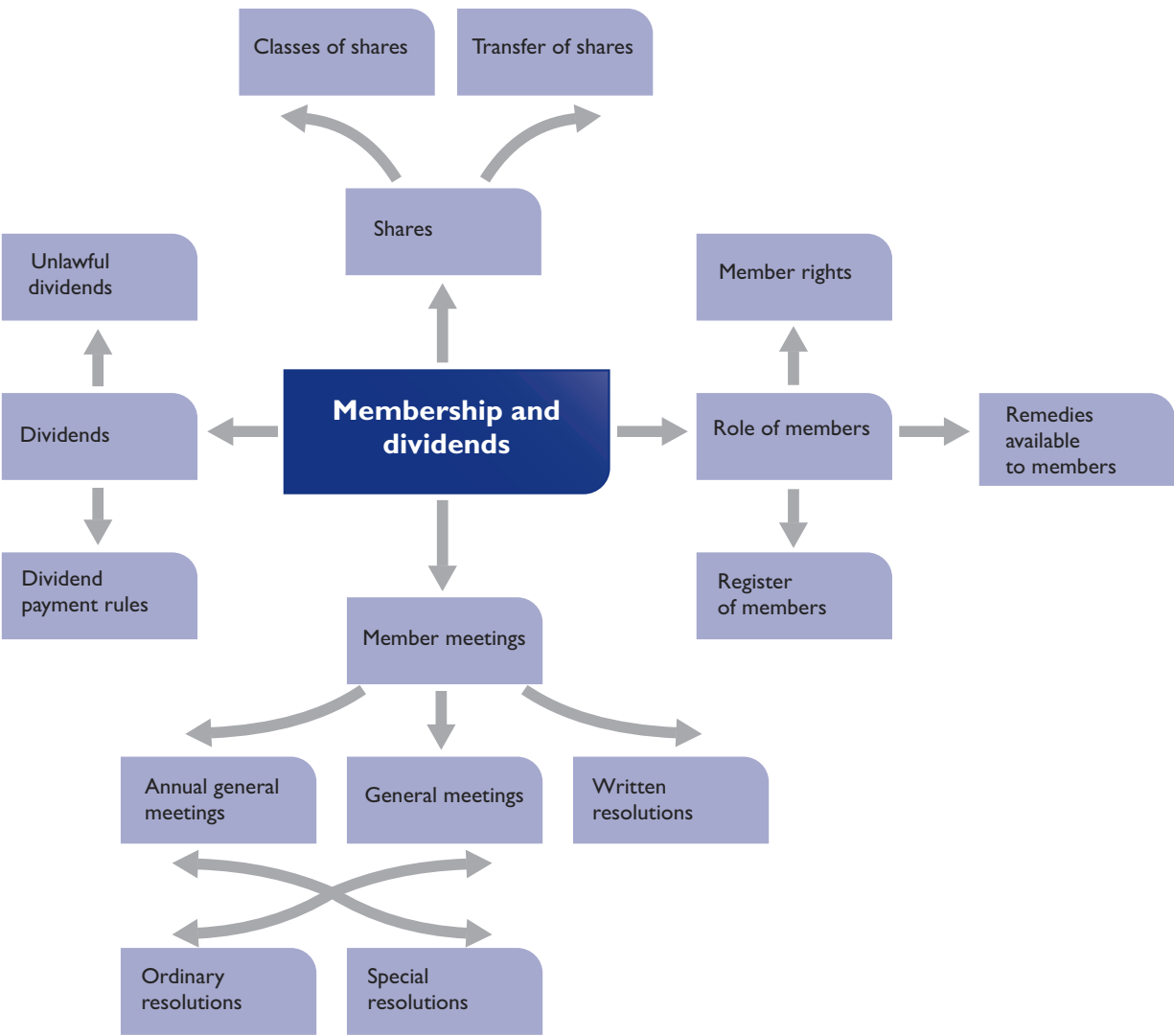
# Introduction

Companies are usually set up with a view to making a profit and, like any business, a company needs to fund its activities to make profits: it needs money to make money. One of the advantages of the corporate form is that companies find it easier to raise long-term, permanent finance or **capital** in the form of **share capital**.

In this chapter we study both the **nature of shares** and **the nature of membership of a company**, in particular the **rights and remedies** it offers. The rules surrounding **meetings and resolutions** of members are also covered.

A member of a company who holds one or more shares in a company is a **shareholder**. They receive a return on their capital investment in the form of **dividends**.

We shall again be using the **Australian model** of companies to examine the corporate form and use secondary examples from the **UK, Singapore and Malaysia**. Note that Australian, Singaporean and Malaysian company law is based on English company legislation and the common law.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 Define a share. (Section 1)
- 2 What are the rules on a transfer of shares? (Section 1.2)
- 3 What are the procedures for keeping a register of members in Australia? (Section 2.4)
- 4 Explain the concept of unfair prejudice and how this protects minority shareholders. (Section 3.3)
- 5 What is a derivative claim? (Section 3.4)
- 6 Describe the normal running of an annual general meeting (AGM). (Section 4.1)
- 7 What is the general procedure for the payment of dividends to members? (Section 6.3)
- 8 When will a director be held liable for the payment of an unlawful dividend? What rights do members have in regard to unlawful dividends? (Section 6.4)

# 1 The nature of shares



## Section overview

- A member of a company who holds one or more shares is a **shareholder**.
- Shares are the interest of a shareholder in the company measured by a sum of money. Each share has a fixed nominal value (except in Australia) and must be paid for. It is a contract, a form of personal property, and gives an entitlement to dividends, return of capital and the right to vote.
- A company can attach special rights to different shares regarding voting, access to capital, director removal and dividend payments. The two most common classes of shares are ordinary and preferential.
- Shares can be transferred by sale, death, bankruptcy or mental incapacity. A share transfer is not finalised until the relevant authority is notified and the register of members is updated.



## Definition

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 between themselves.

The key points about shares are as follows:

- (a) The share must be paid for. In Australia, a share has no par or nominal value, and the amount which must be paid for the share is determined by the terms of its issue. This varies in other jurisdictions. For example in the UK, the **nominal value** of the share fixes this liability; it is the base price of the share e.g. a £1 ordinary share. Every share must have a fixed nominal value.
- (b) A share gives a proportionate entitlement to **dividends, votes** and any **return of capital**.
- (c) A share is a form of **contract** ('mutual covenants') between shareholders which underlies such principles as majority control and minority protection.
- (d) A share is a form of **personal property**, carrying rights and obligations. It is transferable in accordance with the company's articles.



## Definition

Traditionally (and still applicable in the UK) a share's **nominal value** is its face value, so a £1 ordinary share has a nominal value of £1. No share can be allotted at a value below its nominal value. Shares in a public company must have a quarter of their nominal value plus the whole of any premium paid up on allotment.

The **concept of nominal value no longer applies in Australia**. A share has no nominal value, and the amount which must be paid for in the share is determined by the terms of its issue.

A member of a company who holds one or more shares is a **shareholder**. Some companies, such as most companies limited by guarantee, do not have a share capital, so they have **members who are not shareholders**.

Information about any **special rights attached to shares** is obtainable from one of the following documents which are on file with the relevant authority. In the case of Australia this is ASIC.

- The **articles** which are the normal context in which share rights are defined.
- A **resolution** incidental to the creation of a new class of shares. In Australia, it must only be delivered to ASIC if the constitution itself is required to be delivered to ASIC (generally a requirement for public companies).
- A **return of allotment** given to the relevant authority (e.g. ASIC) within one month of allotment.

## 1.1 Classes of share

A company may, at its option, attach **special rights to different shares** regarding, for instance:

- Dividends.
- Return of capital.
- Voting.
- The right to appoint or remove a director.

Any shares having different rights from others is grouped with the other shares carrying uniform rights to form a **class**. The most common classes 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.

- **Ordinary shares** typically carry the right to vote, to be paid dividends, and to receive surplus assets on a winding up.
- **Preference shares** tend to have preferential rights to dividends (ahead of the ordinary shares), but they usually only entitle the holder to a repayment of capital on a winding up, so they are not entitled to share in a surplus on a winding up as well. They typically have no, or limited, voting rights.

## 1.2 Transfer of shares

LO  
10.8

Shares can be transferred upon the:

- Sale of some or all of the shares,
- Death of the member,
- Permanent mental incapacity of the member, or
- Bankruptcy of the member.

In all cases, share transfers must be processed using the relevant transfer forms and the relevant authority informed of the transfer. The register of members must be updated accordingly. The share transfer is not effective until the transfer is registered and the name of the person to whom they are being transferred is entered into the register of members.

In Australia, the directors of a proprietary company can refuse to register a transfer of shares for any reason.

# 2 The role of members



### Section overview

- Every company must maintain a register of members, and in some situations there are limits as to the number of members permitted.



### Definition

A **member** of a company is a person who agrees to become a member of the company and whose name is entered in its register of members. It is possible to be a member without being a shareholder (for example, in most companies limited by guarantee), but generally in public and private unlimited companies members are also shareholders.

Entry in the register is **essential**. Mere delivery to the company of a transfer of shares does not make the transferee a member – until the transfer is entered in the register.

The relationship of the members among themselves is determined by the **articles**, as we have seen. Their participation in company affairs is exercised through **general meetings** and each member generally has one **vote** for every share held.

Decisions at meetings are usually **ordinary resolutions**, which require majority of at least 50% of the votes. For **special resolutions** a 75% majority of votes is required.

## 2.1 Ceasing to be a member



### Section overview

- 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:

- He **transfers** all his shares to another person and the transfer is registered.
- The member **dies**.
- The **shares** of a bankrupt member are **registered** in the name of his trustee.
- A **member who is a minor repudiates his shares**.
- The **trustee** of a **bankrupt member disclaims** his 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**.

## 2.2 The number of members



### Section overview

- **Public and proprietary (private) companies** must have a minimum of **one** member. There is **no maximum** number for public companies.

**Public and proprietary (private) companies** must have a minimum of **one member**. In Australia, there is no maximum imposed on public companies; however, proprietary companies must have no more than 50 members that aren't employees of the company. In the UK, there is **no maximum** number. Where a company has a sole member, then there are rules surrounding the number of members required for a quorum at meetings – Australian statute generally permits a **quorum of two**. Meetings are outlined in more detail in Section 4.

## 2.3 Register of members

LO  
11.1

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.

The company may choose where it keeps the register of members available for inspection. Options are:

- The registered office.
- Another office of the company.
- The office of a professional share registrar.
- Any other office approved by ASIC (Australia only).

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.

## 2.4 Disclosure of interests in shares

LO  
11.2

In order to keep an eye on possible takeovers and such like, a public company may give notice to persons whom the company believes to have **substantial direct and indirect interests in its shares** to give further particulars of their interests, so the company can:

- Record substantial interests in shares in a **register of disclosed interests in shares**, and
- Monitor the **activities and intentions** of those persons with regard to the company.

# 3 Rights and remedies of members



## Section overview

- Although law generally enshrines the principle of protection of the minority, the law does seek to ensure that the remedies available are feasible.

## 3.1 Rights of members

Members have a wide variety of rights with regard to the company, as set out in statute and in the articles. These rights include meetings and resolutions.

LO  
11.4.2

We saw in Chapter 11 that they have the right to **appoint auditors** and also have extensive rights regarding the **appointment and removal of directors**. They have rights regarding **inspection of the company's registers** and **receipt of the annual financial statements** but note that **members have no clear statutory rights to inspect the company's books**, although they may be granted the right by the articles.

## 3.2 Remedies of members: minority protection

If directors or majority members make use of the majority's effective voice to take a course of action which is detrimental to the minority, then **the minority must have some protection against them**. The protection of a minority in Australia is provided by the:

- Corporations Act 2001:
  - Petition the court for relief for **unfair prejudice**.
  - Bring a derivative claim against directors.
- Common law, by making exceptions to the 'majority control' rule. This is rare in modern times.

## 3.3 Unfair prejudice

Any member may apply to the court for relief on the grounds that the company's **affairs are being or have been conducted in a manner which is unfairly prejudicial** to the interests of the members generally or of some part of the members, including at least himself. Application may also be made in respect of an actual or proposed single prejudicial act or omission.

The statutory expression used to define **unfairly prejudicial conduct** in Australia is 'oppressive to, unfairly prejudicial to, or unfairly discriminatory against'.

Applications against unfairly prejudicial conduct often arise from:

- **Exclusion of a director** from participation in the management of a quasi-partnership company. A quasi-partnership is a small, generally private and often family-owned company where essentially the relationship between the directors and members is equivalent to partners in a partnership.
- **Discrimination against a minority.**

The following have been found to be conduct which is **unfairly prejudicial** in past cases; remember that each case is decided on its own particular facts:

- **Exclusion and removal of a director** from the board.
- **Improper allotment of shares.**
- **Failure to call a meeting.**

- Making an **inaccurate statement to shareholders**.
- A managing director **using assets for personal benefit** and the personal benefit of family and friends.
- **Diversion of the company's business** to a director-controlled company.
- Payment of **excessive directors' bonuses and pension contributions**.

### 3.4 Derivative claim

Under a **derivative claim**, the plaintiff brings an action on behalf of the company to enforce the company's rights or to recover its property. Any benefits received from the claim accrue to the company and not to the member.

Directors owe their general duties to the company as a whole rather than to an individual member, so the company is the only **proper plaintiff** which can enforce them. This is the principle of **majority control**. The proper plaintiff rule establishes that a wrong done to a company may be vindicated by the company alone, and the company has the right to bring proceedings.

However, there is also a statutory basis for deciding whether or not a member has a right to bring a **derivative claim** for misfeasance, negligence, default, breach of trust or breach of duty against a director or other person, even if the director has not benefited personally. Derivative claims are particularly likely where shareholders are attempting to restrain directors' actions taken in breach of their powers.

A member can usually combine a derivative claim with a **representative action** on behalf of the other members who are not defendants and a **personal claim for damages**.

There are some **limitations to the principle of majority control**, in which case a minority can bring legal proceedings:

- No majority vote can be effective to sanction an act of the company which is **illegal**.
- If those who control the company use their control to **defraud** it, or to **act oppressively** to a minority, the minority may bring legal proceedings against the fraudulent or oppressive majority.
- If the company under majority control deprives members of their **individual rights of membership**, they may sue the company to enforce their rights.



#### Question 1: Rights of members

Do members have the right to remove directors from office?

(The answer is at the end of the chapter)

## 4 Meetings of members



### Section overview

- The most common form of company meeting for a public company is the annual general meeting (AGM). Proprietary and private companies do not have to hold these.

### 4.1 Annual general meetings (AGMs)

LO  
11.3

A public company must have an **annual general meeting (AGM)** every year but proprietary (private) companies need not have an AGM, as they may conduct their business using written resolutions almost exclusively – but not when removing a director or an auditor. Any company may have a **general meeting**, called as and when it is needed.

The **business of an AGM** usually includes:

- Receiving the accounts.
- Receiving the directors' report, and the auditor's report and, if the company is listed, the directors' remuneration report.
- Approving dividends.



- Electing directors.
- Appointing auditors and setting auditor remuneration.

**Public companies** must hold an **AGM** within five months (Australia) of the submission of financial statements or within six months (UK) from their accounting reference date. The procedure for calling an AGM is as follows:

- Notice must be in writing and in accordance with the articles.
- Notice may be in hard or electronic form and may also be by means of a website.
- At least 21 days' notice should be given, though a longer period may be specified in the articles.
- Shorter notice is only valid if all members agree.
- The notice must specify the time, date and place of the meeting and that the meeting is an AGM.
- Where notice is given on a website it must be available from the date of notification until the conclusion of the meeting.

## 4.2 Other general meetings

Directors of any company usually have power under the articles to convene a **general meeting** whenever they see fit, and the directors of both public and proprietary (private) companies may be required to convene a general meeting by **requisition of the members**. The request must be made in hard copy or electronic form, and it must state the general nature of the business to be dealt with. It may include the text of **resolutions** proposed. A notice convening the meeting must be sent out within 21 days of the requisition, and the meeting must be held within two months (Australia) or 28 days (UK) of the notice calling a meeting being sent out. In all cases, at least 28 days' (for Australian listed companies) and 21 days' (UK companies) notice of the meeting must be given to members.

In addition to directors and members, the following persons have the **right to call a general meeting** in certain circumstances:

- The **court**, on the application of a director or a member entitled to vote, may order that a meeting shall be held and may give instructions for that purpose, including fixing a quorum of one. This is a method of last resort to resolve a deadlock such as the refusal of one member out of two to attend and therefore provide a quorum at a general meeting.
- An **auditor** who gives a 'notice of resignation' explaining its resignation or other loss of office may requisition a meeting to receive and consider it.

A general meeting that is not an AGM cannot make valid and binding decisions until it has been properly **convened** according to the company's articles, though there are also statutory rules. Using Australia as exemplar, the following statutory rules apply:

- One or more directors can call the meeting at their own instigation or on requisition by the members.
- Notice of a general meeting must be issued to every member and every director in advance of the meeting so as to give them 21 days' notice of the meeting, though the members may agree to shorter notice. Notice for all general meetings is 21 days irrespective of the resolution being voted on. The exception is listed companies, which have a minimum notice period of 28 days.
- The notice must state the **time, date and place of the meeting** and must state the **general nature** of the business to be dealt with at the meeting, subject to any provision of the articles.

## 4.3 Proceedings at meetings

A **meeting** can only reach binding decisions if the following conditions are met:

- A **quorum** is present. This is usually two persons.
- There is a **chairman** elected.
- The business is properly transacted and **resolutions are put to the vote**. Each item of business comprised in the notice should be taken separately, discussed and put to the vote.

Members of a company which has a share capital, provided they are entitled to attend and vote at a general meeting of the company, have a statutory right to appoint an agent, called a **proxy**, to attend and vote for them.

The rights of members to **vote** and the number of votes to which they are entitled in respect of their shares are fixed by the articles. One vote per share is normal but some shares, for instance preference shares, may carry no voting rights in normal circumstances. To shorten the proceedings at meetings the procedure is as follows:

- On putting a resolution to the vote the chairman calls for a **show of hands**. One vote may be given by each member present in person, including proxies.
- Unless a poll is then demanded, the **chairman's declaration of the result is conclusive**. It is still possible to challenge the chairman's declaration on the grounds that it was fraudulent or manifestly wrong.
- If a real test of voting strength is required a **poll** may be demanded. The result of the previous show of hands is then disregarded. On a poll every member and also proxies representing absent members may cast the full number of votes to which they are entitled. A poll need not be held at the time but may be postponed so that arrangements to hold it can be made.

In voting, either by show of hands or on a poll, the **number of votes cast determines the result**. Votes which are not cast, whether the member who does not use them is present or absent, are simply disregarded. Hence the majority vote may be much less than half (or three-quarters) of the total votes which could be cast.

## 5 Resolutions of members



### Section overview

- Members reach a decision by passing a **resolution**; business is transacted by **ordinary resolution**, unless the law or the articles require a **special resolution**. There are two kinds of resolution for all companies, and an additional one for proprietary (private) companies.

Types of resolution	
<b>Ordinary resolution</b>	<ul style="list-style-type: none"><li>• For most business.</li><li>• Requires simple (50%+) majority of the votes cast.</li><li>• 21 days' notice and 28 days for listed companies (Australia).</li></ul>
<b>Special resolution</b>	<ul style="list-style-type: none"><li>• For major changes (see below).</li><li>• Requires 75% majority of the votes cast.</li><li>• 21 days' notice and 28 days' for listed companies (Australia).</li></ul>
<b>Written resolution</b> (example used of Australian proprietary companies)	<ul style="list-style-type: none"><li>• Can be used for all ordinary and special resolutions except for removing auditors before their term of office expires.</li><li>• A proprietary company can pass a resolution (except for the appointment of an auditor) by obtaining signed agreement from all members ( This is the <b>principle of unanimity</b>.•The sole member of a small proprietary company can pass a resolution by recording and signing their decision (Australia only).</li></ul>

### 5.1 Special resolutions

Apart from the required size of the majority and period of notice, the main difference between the types of resolution are that the **text of special resolutions** must be set out in full in the notice convening the meeting, and it must be described as a special resolution. This is not necessary for most ordinary resolutions, though the text of a resolution to remove a director would be set out.

A **special resolution** is required for major changes in the company such as the following:

- A change of name.
- Alteration of the articles.
- Reduction of share capital.

## 5.2 Written resolutions

As we saw earlier, a proprietary (private) company is not required to hold an AGM. There are mechanisms in all jurisdictions (Australia, UK, Malaysia and Singapore) for directors and members of these companies to conduct business quickly and simply.

Let's use Australia as exemplar. Under the Corporations Act 2001 proprietary company can pass any decision needed, except for the removal of auditors before their term of office expires, by means of a **written resolution**, using the post, website or email. A proprietary company may pass a resolution without a general meeting, except when it is to appoint an auditor, if **all members** entitled to vote on the resolution sign a document saying they are in **favour of the resolution**. This reflects the **principal of unanimity**. The resolution is passed when the last member signs. Written information about the resolution being proposed must be supplied, and a copy of the signed document passing the resolution must be lodged with ASIC.

A sole member/director of a small proprietary company can pass resolutions by recording and signing their decision.



### Question 2: Ordinary and special resolutions

What are the main differences between ordinary and special resolutions?

(The answer is at the end of the chapter)

LOs  
11.6  
11.7  
11.8

## 6 Distributing dividends



### Section overview

- Australia has now moved to the **liquidity-test basis** for dividend distributions as opposed to the **distributable profits only model** used in the UK, Singapore and Malaysia
- Dividends may be declared by **directors** or by the **company in a general meeting**. Rules pertaining to the procedure of the payment of dividends (as discussed in Section 6.3) are common across jurisdictions



### Definition

A **dividend** is an amount payable from the company to shareholders from distributable profits or other allowable monies as declared under legislation.

## 6.1 Australian dividend payment rules

Australia has now moved to the liquidity-test basis for dividend distributions as opposed to the distributable profits only model used in the UK, Singapore and Malaysia (see Section 6.2 below). Under recent changes to Australian Corporations Act 2001 (s 254T) dividends cannot be paid by a company unless (Section 254T):

- the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and
- the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and
- the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

For example, payment of a dividend would ‘materially prejudice’ the company’s ability to pay its creditors if the company would become insolvent if the payment was made. Company directors have a duty to prevent insolvent trading upon the payment of dividends.

The assets and liabilities of the company are calculated for the purpose of the payment of dividends in accordance with the relevant accounting standards in force at that time.

## 6.2 UK, Singapore and Malaysian dividend payment rules

In the UK, Singapore and Malaysia dividends can **only be paid out of profits available for distribution**.



### Definition

**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.

Let’s look at the UK model as an example:

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 depreciation 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 as a realised profit. Effectively there is a cancelling out, and at the end **only depreciation that relates to historical cost will affect dividends**.

## 6.3 Procedure for declaring dividends

The power to declare a dividend is given by the constitution which often includes 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 or other allowable monies as reserves.

The **directors can also determine that a dividend is payable** and fix the amount, the time of payment and the method of payment.

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 50c paid.

A dividend may be paid **otherwise than in cash** (for example in Australia they may be paid by cash, the issue of shares, the grant of options and the transfer of assets)

**Interest is not payable** on a dividend

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 only** 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**, meaning otherwise than in cash, is not implied but may be expressly created. **Scrip dividends** are dividends paid by the issue of additional shares.

## 6.4 Infringement of dividend rules



### Section overview

- Directors are responsible for any unlawful dividend paid and, together with members, may be liable to make good to the company the amount of the unlawful dividend. Members have rights and duties in relation to the payment and to the stopping of a payment of an unlawful dividend.

In certain situations the **directors** and **members** may be liable to make good to the company the amount of an **unlawful dividend**. 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 recommend or 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 or which meets the assets and liability liquidity test 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.

*Re London & General Bank (No 2) 1895*

*The facts:* The auditor had drawn the attention of the directors to the fact that certain loans to associated companies were likely to prove irrecoverable. The directors refused to make any provision for these potential losses. They persuaded the auditor to confine his comments in his audit report to the uninformative statement that the value of assets shown in the balance sheet 'is dependent on realisation'. A dividend was paid in reliance on the apparent profits shown in the accounts. The company went into liquidation and the liquidator claimed from the auditor compensation for loss of capital due to his failure to report clearly to members what he well knew affecting the reliability of the accounts.

*Decision:* The auditor has a duty to report what he knows of the true financial position: otherwise his audit is 'an idle farce'. He had failed in this duty and was liable.

## Key chapter points

- The nature of shares
  - A share is an interest of a shareholder measured by a sum of money
  - Classes of share.
  - Transfer of shares.
- The role of members
  - Relationship between members determined by articles.
  - Participation in company through general meetings.
  - Procedures for becoming a member.
  - Cessation of membership.
  - Number of members allowed at any one time
    - Proprietary (private) companies must have one member
    - No maximum number for public companies
  - Register of members must be kept and updated.
  - Public companies can ask members to disclosure interests in shares.
- Rights and remedies of members
  - Rights concerning appointment of auditors, directors, inspection of registers and financial statements.
  - Minority protection as a remedy.
  - Can make an application of unfair prejudice.
  - Derivative claim.
- Meetings of members
  - Annual general meeting (AGM).
  - Other general meetings.
  - Meeting procedures
    - Quorum of two must be present
    - Chairman elected
    - Resolutions put to vote.
- Resolutions of members
  - Ordinary resolution must have 50% of votes in favour.
  - Special resolution must have 75% of votes in favour.
  - Written resolution for private and proprietary companies.
  - Sole member proprietary companies can record and sign decision (Australia only).
- Distributing dividends
  - In Australia, dividends can now be paid out of monies other than profits of the company provided certain conditions are met.
  - In the UK, Singapore and Malaysia, dividends must be paid from distributable profit.
  - Procedure for paying dividends and general rules
  - Infringement of dividend rules

## Quick revision questions

- 1 **Fill the blanks** in the statement below.

There are two types of shares. .... shares carry the right to vote, to be paid dividends, and to receive surplus assets on a winding up. .... shares usually only entitle the shareholder to a repayment of capital on winding up, and have no (or limited) voting rights.

- 2 The register of members must contain which of the following:

- A member name and address
- B member date of birth
- C member shareholder class
- D distinguishing share numbers (if applicable)
- E date member became a member
- F date member ceased to be a member
- G member next of kin

- 3 Australian public and proprietary companies must hold an AGM every year within five months of the submission of financial statements

true ☐

false ☐

- 4 Fill in the blanks in the statements below.

In Australia, dividends cannot be paid by a company unless the company's ..... exceed its ..... immediately before the ..... is declared and the excess is sufficient for the payment of the dividend. This is one component of the ..... test.

- 5 **Fill in the blanks** in the statements below.

Distributable profits may be defined as ..... profits less ..... losses.

- 6 If a company makes an unlawful dividend, who may be involved in making good the distribution?

- A the company
- B the directors
- C the shareholders



## Answers to quick revision questions

- 1 **Ordinary** shares carry the right to vote, to be paid dividends, and to receive surplus assets on a winding up. **Preferential** shares usually only entitle the shareholder to a repayment of capital on winding up, and have no (or limited) voting rights.
2. A, C, D, E and F are all requirements for member registers in the UK and Australia. Date of birth details and next of kin are not required under law.
- 3 This is incorrect as only public companies are required to hold an AGM.
- 4 In Australia, dividends cannot be paid by a company unless the company's **assets** exceed its **liabilities** immediately before the **dividend** is declared and the excess is sufficient for the payment of the dividend. This is one component of the **liquidity** test.
- 5 Distributable profits may be defined as **accumulated realised** profits less **accumulated realised** losses.
- 6 All three may be liable.

## Answers to chapter questions

- 1 The appointment and removal of directors was discussed in Chapter 11. In essence, a director may be removed from office by **ordinary resolution** at a meeting of which **special notice** to the company has been given by the person proposing it. **Note that directors cannot remove other directors from office; it is the power of a majority of members.** For Australian proprietary companies a special notice is not required; only a board resolution or a member ordinary resolution is sufficient.
- 2 There are two main differences between ordinary and special resolutions. First, the **type of resolution** being considered, and second, the **percentage of member votes** needed to successfully pass the resolution.

Special resolutions must be used for certain matters, chiefly a change in company name, alteration of the articles and reduction of share capital. A special resolution must be passed by at least 75% of members entitled to vote (or by proxy). An ordinary resolution deals with most company business, including the appointment and removal of directors and auditors. An ordinary resolution is successful if it is passed by the majority (50%).

Additionally, the full text of a special resolution must be set out in full in the notice convening the meeting and must be termed a special resolution; this is not required for ordinary resolutions.



# Chapter 13

## Corporate insolvency

Learning objectives	Reference
<b>Corporate insolvency</b>	<b>LO12</b>
Specify the grounds relating to the dissolution and winding up of companies and partnerships	LO12.1
Specify the procedures for dissolution and winding up of companies and partnerships	LO12.2
Specify the procedures for addressing corporate insolvency including stakeholders and the rights of claimants	LO12.3
Identify the powers and duties of receivers and liquidators	LO12.4
Recognise administration as an appropriate alternative to winding up when a company is in financial difficulties	LO12.5

### Topic list

- 1 What is winding up?
- 2 Voluntary winding up
- 3 Compulsory winding up
- 4 Differences between compulsory and voluntary winding up
- 5 Winding up of partnerships
- 6 Claimants' rights in corporate insolvency
- 7 Receivership
- 8 Saving a company: voluntary administration

# Introduction

A **company in difficulty** or in **crisis** (an **insolvent** company) basically has a choice of two alternatives:

- (1) To continue the business, using statutory methods to help remedy the situation.
- (2) To stop.

A company which is heading towards insolvency can often be **saved**, using a variety of **legal protections** from creditors, until the problem is sorted out. The **directors** of a company can get into a lot of trouble if they carry on trading through a company in serious financial difficulties and their actions result in **creditors** being **defrauded**.

However, alternative 1 does not have to mean carrying on as if everything is normal. It can mean **seeking help** from the **court** or a **qualified insolvency practitioner** to put a plan together to **save the company** and get it out of its bad financial position.

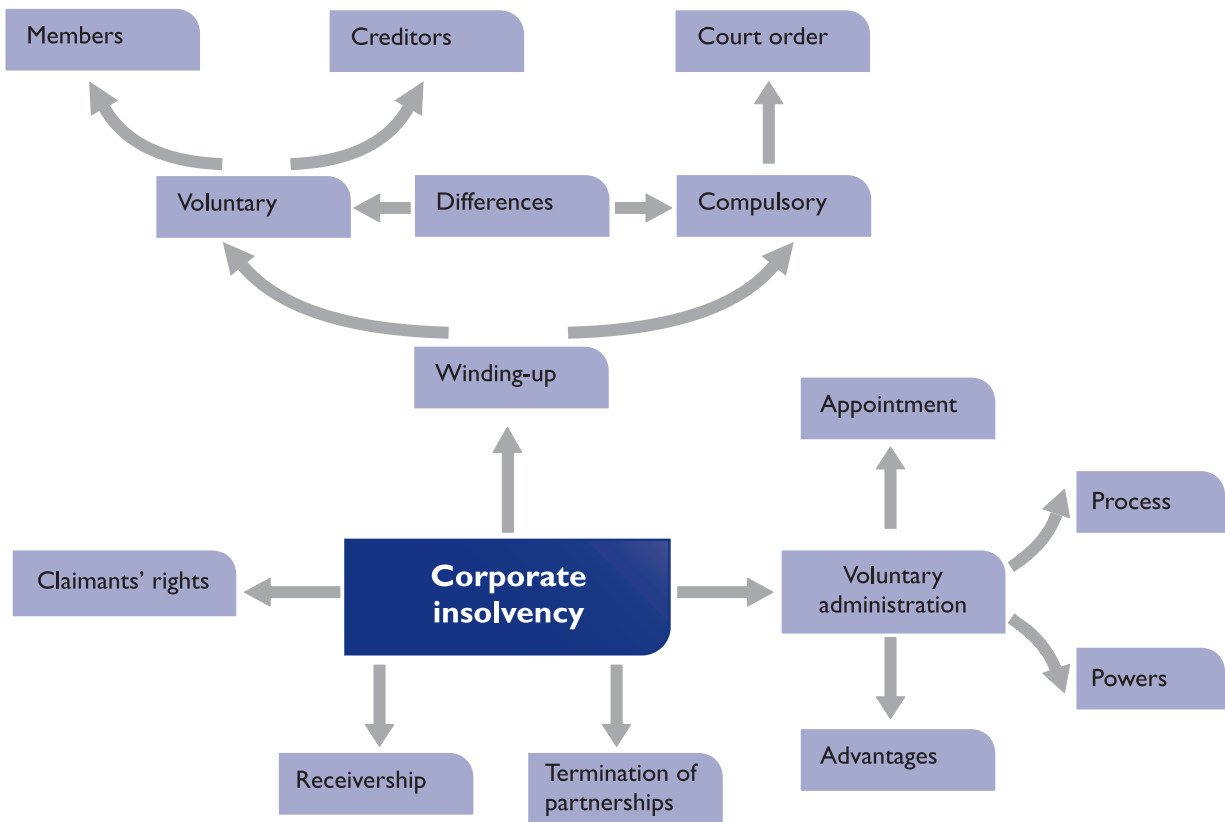
Unfortunately, many companies cannot be saved, and the members and directors are forced to take alternative 2, **to stop** operating the business through the company. Winding up (also referred to as liquidation) is **when a company is formally dissolved** and ceases to exist.

Various methods of winding up are covered in the first two sections of this chapter. Note, though, that a company **does not have to be in financial difficulty to be wound up**.

Alternative procedures may be applicable to the company, namely **receivership**, if any of its assets have been used as security for loans using charges, and **administration**.

This chapter also examines the grounds and procedures for the **dissolution of a partnership**, which is more straightforward than that of company dissolution.

We shall be using the **Australian model** of companies to examine corporate insolvency and all terminology used is drawn from the Australian model. Note that all Australian, Singaporean and Malaysian company law is based on English company legislation and the common law.



## Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

- 1 List the three methods of winding up a company. (Section 1.1)
- 2 Explain the procedure for a members' voluntary winding up. (Section 2.1)
- 3 Explain the procedure for a creditors' voluntary winding up. (Section 2.2)
- 4 Explain the procedure for a compulsory winding up. (Section 3.3)
- 5 Explain the procedure for winding up a partnership (Section 5)
- 6 What are the claimants' rights in a corporate insolvency? (Section 6)
- 7 Define secured creditor, unsecured creditor and receiver. (Section 7)
- 8 Define voluntary administration. (Section 8.1)
- 9 Explain the role and duties of the administrator. (Sections 8.4, 8.5)
- 10 List three advantages of voluntary company administration. (Section 8.10)

# 1 What is winding up?



## Section overview

- **Winding up** is the **dissolution** of a company.



## Definition

**Winding up** means that the company must be dissolved and its affairs 'wound up', or brought to an end.

The assets are realised, debts are paid out of the proceeds, and any surplus amounts are returned to members. Winding up leads on to **dissolution** of the company. It is often referred to as **liquidation**.

## 1.1 Who decides to wind up?



## Section overview

- There are three different methods of **winding up**; **compulsory**, **members' voluntary** and **creditors' voluntary**. Compulsory winding up and creditors' voluntary winding up are proceedings for insolvent companies, and members' voluntary winding up is for solvent companies.

The parties most likely to be involved in the decision to wind up are:

- The directors.
- The creditors.
- The members.

The **directors** are best placed to know the financial position and difficulty that the company is in. The **creditors** may become aware that the company is in financial difficulty when their invoices do not get paid on a timely basis, or at all. The **members** are likely to be the last people to know that the company is in financial difficulty, as they rely on the directors to tell them. As explored in the next two sections, there are three methods of winding up. They depend on **who has instigated the proceedings**. Directors cannot formally instigate proceedings for winding up; they can only make recommendations to the members.

However, if the **members refuse** to place the company into winding up and the directors feel that to continue to trade will prejudice creditors, they could resign their posts.

In any case, if the company was in such serious financial difficulty for this to be an issue, it is likely that a **creditor** would have commenced proceedings against it.

### 1.1.1 Creditors

If a creditor has grounds, as discussed in Section 2, he may **apply to the court** for the **compulsory winding up** of the company.

Creditors may also be closely involved in a **voluntary winding up**, if the company is **insolvent** when the **members** decide to wind the company up.

### 1.1.2 Members

The members may decide to wind the company up, probably on the advice of the directors. If they do so, the company is **voluntarily wound up**. This can lead to two different types of members' winding up:

- Members' voluntary winding up if the company is solvent, and
- Creditors' voluntary winding up if the company is insolvent.

## 1.2 Role of the liquidator



### Section overview

- Once the decision to wind up a company has been made, the company goes into the control of a suitably qualified and authorised insolvency practitioner, referred to as a liquidator

A **liquidator** must be an authorised, qualified insolvency practitioner.

Once the decision to wind up has been taken, the company goes into the **control of a liquidator**, who must be a **qualified** and **authorised** insolvency practitioner.

We shall examine the procedures that the liquidator carries out in the next two sections. However, the liquidator also has a **statutory duty to report** to the authorities where he feels that any **director** of the insolvent company is **unfit** to be involved in the management of a company.

## 1.3 Common features of winding ups



### Section overview

- The following must occur at the commencement of any winding up; no further share dealings or change in members; all company documents must say the company is winding up; the directors' power to manage ceases.

Once **insolvency procedures** have commenced, share trading must cease, the company documents must state that the company is in winding up and the directors' power to manage the company ceases.

Regardless of what method of winding up is used, similar **legal problems** may arise in each of them. In addition, the following factors are true at the start of any winding up:

- **No share dealings or changes in members** are allowed.
- All company documents for example invoices, letters, emails, and the website must **state the company is in winding up**.
- The **directors' power to manage ceases**.

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## 2 Voluntary winding up



### Section overview

- There are two types of voluntary winding up; members' voluntary winding up and creditors' voluntary winding up. In both types of winding up the court has power to appoint a liquidator if required or to remove one and appoint another.

A **winding up** is **voluntary** where the decision to wind up is taken by the company's members, although if the company is insolvent, the creditors will be heavily involved in the proceedings.

As we discussed in Section 1, there are two types of voluntary winding up:

- A **members' voluntary winding up**, where the company is **solvent** and the members merely decide to 'kill it off'.
- A **creditors' voluntary winding up**, where the company is **insolvent** and the members resolve to wind up in consultation with creditors.

The main differences between a members' and a creditors' voluntary winding up are set out below:

Function	Winding up	
	Members' voluntary	Creditors' voluntary
(1) Appointment of liquidator	By members	Normally by creditors though responsible to both members and creditors
(2) Approval for liquidator's actions	General meeting of members	Winding up committee
(3) Committee of inspection	None	Up to 5 representatives of creditors and 5 representatives of members

The effect of the voluntary winding up being a creditors' one is that the **creditors** have a **decisive influence** on the conduct of the winding up.

**Meetings** in a creditors' voluntary winding up are held in the same sequence as in a members' voluntary winding up, but meetings of creditors are called at the same intervals as the meetings of members and for similar purposes.

In both kinds of voluntary winding up, the **court has the power to appoint a liquidator**, if for some reason there is none acting, or to remove one liquidator and appoint another.

## 2.1 Members' voluntary winding up



### Section overview

- In order to be a members' winding up, the directors must make a **declaration of solvency**. It is a criminal offence to make a declaration of solvency without reasonable grounds.

#### Type of resolution to be passed

<b>Ordinary</b>	This is <b>rare, but</b> if the <b>articles</b> specify winding up at a certain point, only an ordinary resolution is required.
<b>Special</b>	A company may resolve to be <b>wound up</b> by special resolution. This is more common than through an ordinary resolution.

The winding up **commences** on the passing of the resolution. A signed copy of the resolution must be delivered to ASIC within 7 days. A **liquidator** is usually appointed by the same resolution or by a second resolution passed at the same time.

### 2.1.1 Declaration of solvency

A voluntary winding up is a members' voluntary winding up **only** if the directors make and deliver to the relevant authority (eg. ASIC) a **declaration of solvency**.

This is a **statutory declaration** that the directors have made full enquiry into the affairs of the company and are of the opinion that it will be able to pay its debts in full within a specified period not exceeding 12 months.

- (a) The declaration is made by all the directors or, if there are more than two or three directors, by a **majority** of them.
- (b) The declaration includes a statement of the company's assets and liabilities as at the latest practicable date before the declaration is made.
- (c) The declaration must be:
  - (i) Made not more than five weeks before the resolution to wind up is passed, and
  - (ii) Delivered to ASIC within 7 days.



If the liquidator later concludes that the company will be unable to pay its debts they must call a meeting of creditors and lay before them a **statement of assets and liabilities**.



### Exam comments

It is a **criminal offence** punishable by fine or imprisonment for a director to make a declaration of solvency without having **reasonable grounds** for it. If the company proves to be insolvent the directors will have to justify their previous declaration or be punished.

In a members' voluntary winding up the **creditors play no part** since the assumption is that their debts will be paid in full. The liquidator calls special and annual general meetings of contributories (members) to whom they report:

- (a) Within six months after each anniversary of the commencement of the winding up the liquidator must call a meeting and lay before it an account of his transactions during the year.
- (b) When the winding up is complete the liquidator calls a meeting to lay before it his final accounts.

After holding the final meeting the liquidator sends a **copy of his accounts** to ASIC within seven days after the final meeting. ASIC will then dissolve the company three months later by removing its name from the register.

## 2.2 Creditors' voluntary winding up



### Section overview

- When there is no declaration of solvency there is a **creditors' voluntary winding up**.

If no declaration of solvency is made and delivered to ASIC the winding up proceeds as a creditors' voluntary winding up **even if** in the end the company pays its debts in full.

To commence a creditors' voluntary winding up the directors convene a general meeting of members to pass a **special resolution** (proprietary companies must have 100% written agreement from members). They must also convene a meeting of creditors, giving at least seven days notice of this meeting. The notice must be published in each Australian state or territory's daily newspaper where the company operated in the last two years. The notice must either:

- Give the name and address of a **qualified insolvency practitioner** to whom the creditors can apply before the meeting for information about the company, **or**
- State a place in the locality of the company's principal place of business where, on the two business days before the meeting, a **list of creditors** can be inspected.

The **meeting of members** is held first and its business is as follows:

- To resolve to wind up,
- To appoint a liquidator, and
- To nominate up to five representatives to be members of the **committee of inspection**.

The **creditors' meeting** should preferably be convened on the same day but at a later time than the members' meeting, or on the next day, but in any event within 11 days of it.

One of the **directors** presides at the creditors' meeting and lays before it a full statement of the company's affairs and a list of creditors with the amounts owing to them. The meeting may nominate a liquidator and up to five representatives to be members of the committee of inspection.

If the creditors nominate a different person to be liquidator, **their choice prevails** over the nomination by the members.

Of course, the creditors may decide **not to appoint a liquidator** at all. They cannot be compelled to appoint a liquidator, and if they do fail to appoint one it will be the members' nominee who will take office.

However even if creditors do appoint a liquidator there is a period of 11 days before the creditors' meeting takes place at which they will actually make the **appointment**. In the interim it will be the members' nominee who takes office as liquidator.

In either case the presence of the members' nominee as liquidator has been exploited in the past for the purpose known as '**centrebinding**'.

*Re Centrebind Co [1966] 3 All ER 899 (UK)*

*The facts:* The directors convened a general meeting, without making a statutory declaration of solvency, but failed to call a creditors' meeting for the same or the next day. The penalty for this was merely a small default fine. The liquidator chosen by the members had disposed of the assets before the creditors could appoint a liquidator. The creditors' liquidator challenged the sale of the assets at a low price as invalid.

*Decision:* The first liquidator had been in office when he made the sale and so it was a valid exercise of the normal power of sale.

In a 'centrebinding' transaction the assets are sold by an **obliging liquidator** to a new company formed by the members of the insolvent company. The purpose is to defeat the claims of the creditors at minimum cost and enable the same people to continue in business until the next insolvency supervenes.

The Australian government has sought to limit the abuses during the period between the members' and creditors' meetings by limiting the powers of the members' nominee and by ensuring that the members' and creditors' meetings are held as closely together as possible. The **powers of the members' nominee as liquidator are now restricted** to:

- Taking control of the company's property,
- Disposing of perishable or other goods which might diminish in value if not disposed of immediately, and
- Doing all other things necessary for the protection of the company's assets.

If the members' liquidator wishes to perform any act other than those listed above, he will have to **apply to the court for leave**.



### Question 1: Voluntary liquidation

What are the key differences between a creditors' voluntary winding up and a members' voluntary winding up?

(The answer is at the end of the chapter)

## 3 Compulsory winding up



### Section overview

- A creditor may apply to the court to wind up the company, primarily if the company is **unable to pay its debts**. There are statutory tests to prove that a company is unable to pay its debts.

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A **creditor** may apply to the court for a compulsory winding up. There are five grounds for a compulsory winding up, and we shall consider the two most important here:

- Company unable to pay its debts
- It is 'just and equitable' to wind up the company.

The government can also apply for the compulsory winding up of a company if an investigation by ASIC reveals it is in the public interest and that it is 'fair and equitable' for the company to be wound up.

### 3.1 Company unable to pay its debts

A creditor who petitions on the grounds of the company's insolvency must show that the company is unable to pay its debts. There are three permitted ways to do that:

- (a) A creditor owed more than a statutory amount serves the company at its registered office a **written demand** for payment and the **company neglects to pay the debt** or to offer reasonable security for it within 21 days.  
  
If the company denies it owes the amount demanded on apparently reasonable grounds, the court will dismiss the petition and leave the creditor to take legal proceedings for debt.
- (b) A creditor obtains **judgment** against the company for debt, and attempts to enforce the judgment. However, they are **unable to obtain payment**, because no assets of the company have been found and seized.
- (c) A creditor satisfies the court that, taking into account the contingent and prospective liabilities of the company, it is **unable to pay its debts**. The creditor may be able to show this in one of two ways:
  - (i) By proof that the company is not able to pay its debts as they fall due – the **commercial insolvency test**.
  - (ii) By proof that the company's assets are less than its liabilities – the **balance sheet test**.

This is a residual category. Any suitable evidence of actual or prospective insolvency may be produced.



#### Exam comments

In Section 5 below, we outline that a secured creditor might appoint a receiver to control the secured asset for the purpose of realising the creditor's loan. If the receiver cannot find an asset to realise, the creditor might file a petition for compulsory winding up under (b).

### 3.2 The just and equitable ground



#### Section overview

- A **dissatisfied member** may get the court to wind the company up on the **just and equitable ground**.

A member who is dissatisfied with the directors or controlling shareholders over the management of the company may petition the court for the company to be wound up on the **just and equitable ground**.

For such a petition to be successful, the member must show that **no** other remedy is available. It is not enough for a member to be **dissatisfied** to make it just and equitable that the company should be wound up, since winding up what may be an otherwise healthy company is a **drastic step**.

#### 3.2.1 Case studies: When companies have been wound up



- (a) The 'substratum' of the company has gone – the **only or main object(s) of the company (referred to as its underlying basis or its substratum) cannot be or can no longer be achieved**.

*Re German Date Coffee Co [1882] 20 Ch D 169 (UK)*

*The facts:* The objects clause specified very pointedly that the sole object was to manufacture coffee from dates under a German patent. The German government refused to grant a patent. The company manufactured coffee under a Swedish patent for sale in Germany. A member petitioned for compulsory winding up.

*Decision:* The company existed only to 'work a particular patent' and as it could not do so it should be wound up.

- (b) **The company was formed for an illegal or fraudulent purpose or there is a complete deadlock in the management of its affairs.**

*Re Yenidje Tobacco Co*[1916] 2 Ch 426 (UK)

*The facts:* Two sole traders merged their businesses in a company of which they were the only directors and members. They quarrelled bitterly and one sued the other for fraud. Meanwhile they refused to speak to each other and conducted board meetings by passing notes through the hands of the secretary. The defendant in the fraud action petitioned for compulsory winding up.

*Decision:* 'In substance these two people are really partners' and by analogy with the law of partnership, which permits dissolution if the partners are really unable to work together, it was just and equitable to order winding up.

- (c) **The understandings between members or directors which were the basis of the association have been unfairly breached by lawful action.**

*Ebrahimi v Westbourne Galleries Co* 1973 AC 360 (UK)

*The facts:* E and N carried on business together for 25 years, originally as partners and for the last 10 years through a company in which each originally had 500 shares. E and N were the first directors and shared the profits as directors' remuneration; no dividends were paid. When N's son joined the business he became a third director and E and N each transferred 100 shares to N's son. Eventually there were disputes. N and his son used their voting control in general meeting (600 votes against 400) to remove E from his directorship under the power of removal given by what is now s168 of the UK Companies Act 2006 (removal by ordinary resolution).

*Decision:* The company should be wound up. N and his son were within their legal rights in removing E from his directorship, but the past relationship made it 'unjust or inequitable' to insist on legal rights and the court could intervene on equitable principles to order winding up.

### 3.3 Proceedings for compulsory winding up

When a petition is presented to the **court** a copy is delivered to the **company** in case it objects. It is advertised so that other creditors may intervene if they wish.

The petition **may** be presented by a member. The court will not order compulsory winding up on a member's petition if he has nothing to gain from it. If the company is insolvent he would receive nothing since the creditors will take all the assets.

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Once the court has been petitioned, a **provisional liquidator** may be appointed by the **court**. The **official liquidator** is usually appointed, and his powers are conferred by the court. These usually extend to taking control of the company's property and applying for a special manager to be appointed.



#### Definition

The **official liquidator** is an officer of the court. They are appointed as liquidator of any company ordered to be wound up by the court, although an insolvency practitioner may replace them.

### 3.4 Effects of an order for compulsory winding up

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The effects of an **order** for compulsory winding up are:

- The **official liquidator** who is an official of the court whose duties relate mainly to bankruptcy of individuals **becomes liquidator**.
- The winding up is **deemed to have commenced at the time**, possibly several months earlier, **when the petition was first presented**.
- Any **disposition** of the **company's property** and any transfer of its shares subsequent to the commencement of winding up is **void** unless the court orders otherwise.
- Any **legal proceedings** in progress against the company are halted (and none may thereafter begin) unless the court gives leave. Any seizure of the company's assets after commencement of winding up is void.

- (e) The **employees** of the company are **automatically dismissed**. The liquidator assumes the powers of management previously held by the directors.
- (f) Any **floating charge crystallises** (see Section 6 below).

The assets of the company may remain the company's legal property but **under the liquidator's control** unless the court by order **vests** the assets in the liquidator. The business of the company may continue but it is the liquidator's duty to continue it with a view only to realisation, for instance by sale as a going concern.

Within 21 days of the making of the order for winding up a **statement of affairs** must be delivered to the liquidator verified by one or more directors and by the secretary and possibly by other persons. The statement shows the assets and liabilities of the company and includes a list of creditors with particulars of any security.

The liquidator may require that any **officers or employees** concerned in the recent management of the company shall join in submitting the statement of affairs.

### 3.4.1 Investigations by the official liquidator

The official liquidator **must investigate**

- The **causes of the failure** of the company, and
- Generally the **promotion, formation, business dealings** and **affairs** of the company.

The official liquidator **may report** to the court on the results.

- (a) The official liquidator may require the **public examination** in open court of those believed to be implicated. This is a much-feared sanction.
- (b) The official liquidator may apply to the court for public examination where half the **creditors** or three-quarters of the **members**, in value in either case, so request. Failure to attend, or reasonable suspicion that the examinees will abscond, may lead to arrest and detention in custody for contempt of court.

### 3.4.2 Meetings of contributories and creditors



#### Definition

**Contributories** are **members** of a company who, upon winding up, may have to make payments to the company in respect of any unpaid share capital or guarantees.

The official liquidator has 12 weeks to decide whether or not to convene **separate meetings** of creditors and contributories. The meetings provide the creditors and contributories with the opportunity to appoint their own nominee as permanent liquidator to replace the official liquidator, and a **committee of inspection** to work with the liquidator.

If the official liquidator believes there is little interest and that the creditors will be unlikely to appoint a liquidator he can **dispense with a meeting**, informing the court, the creditors and the contributories of the decision. He can always be required to call a meeting if at least 25% in value of the creditors require him to do so.

If no meeting is held, or one is held but no liquidator is appointed, the official liquidator continues to act as liquidator. If the creditors do hold a meeting and **appoint their own nominee** this person automatically becomes liquidator subject to a right of objection to the court. Any person appointed to act as liquidator must be a qualified insolvency practitioner.

At any time after a winding up order is made, **the official liquidator** may request an appointment if the creditors and members fail to appoint a liquidator. The **official liquidator can also be appointed by the Court** to be liquidator of the company.

If separate meetings of creditors and contributories are held and different persons are nominated as liquidators, it is the **creditors' nominee** who **takes precedence**.

Notice of the winding up order must be provided to ASIC and the appointed liquidator.

If, while the winding up is in progress, the liquidator decides to call meetings of contributories or creditors they may arrange to do so under powers vested in the court.

### 3.5 Completion of compulsory winding up

When the liquidator completes his task they report to the Government, which **examines their accounts**. They may apply to the court for an order for dissolution of the company.

An official receiver may also apply to ASIC for an **early dissolution** of the company if its realisable assets will not cover their expenses and further investigation is not required.



#### Question 2: Compulsory liquidation order

What are the six effects of a compulsory winding up order?

(The answer is at the end of the chapter)

## 4 Differences between compulsory and voluntary winding up



### Section overview

- The differences between compulsory and voluntary winding up are associated with **timing**, the **role of the official liquidator**, **stay of legal proceedings** and the **dismissal of employees**.

The main differences in **legal consequences** between a compulsory and a voluntary winding up are as follows:

Differences	
Control	Under a members' voluntary winding up the members control the winding up process. Under a creditors' voluntary winding up the creditors control the process. The court controls the process under a compulsory winding up.
Timing	A voluntary winding up commences on the day when the <b>resolution to wind up is passed</b> . It is not retrospective. A compulsory winding up, once agreed to by the court, commences on the day the <b>petition was presented</b> .
Liquidator	The <b>official liquidator</b> plays <b>no role</b> in a <b>voluntary winding up</b> . The members or creditors select and appoint the liquidator and he is not an officer of the court.
Management and staff	In any <b>winding up the liquidator replaces the directors</b> in the management of the company unless he decides to retain them. However, the employees are <b>not automatically dismissed by commencement of voluntary winding up</b> . Insolvent winding up may amount to repudiation of their employment contracts. Provisions of the relevant statutory employment protection codes apply.

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## 5 Winding up of partnerships



### Section overview

- The grounds and procedures for the dissolution of partnerships are much less complex than that of companies mainly due because each member of the partnership is liable **without limit** for the debts of the partnership and the **partnership terminates** when one partner chooses to leave it.

## 5.1 Definition of partnership



### Definition

**Partnership** is the relation which subsists between persons carrying on a business in common with a view of profit. (NSW Partnership Act 1892 s (1)1 (NSW) (Australia))

Carrying on a business must have a **beginning and an end**. A partnership begins when the partners agree to conduct their **business activity** together. This can be before the business actually begins to trade, such as when premises are leased and a bank account opened. There must be at least **two** partners. If, therefore, two people are in partnership, one dies and the survivor carries on the business, that person is a sole trader. There is no longer a partnership.

In most cases there is no doubt about the existence of a partnership. The partners declare their intention by such steps as signing a **written partnership agreement** and adopting a **firm name**. These outward and visible signs of the existence of a partnership are not essential however – a partnership can exist without them. No formal agreement is required to set up a partnership, and the fact that two people carry on business together may be enough to show that a partnership does exist – there may be a partnership in law even if the parties do not legally recognise themselves as partners.

The law governing partnerships is state-based law in Australia, meaning that each state and territory has its own Partnership Act. The rules surrounding the establishment and dissolution of partnerships is very similar between each separate state and territory legislation, and for the purposes of this Study Manual the rules are presented as a general summary across all states. The body of Australian partnership law is based on the UK's Partnership Act 1890.

## 5.2 Termination

Termination is when the partnership comes to an end. In this context, 'partnership' means the existing partners.

Partnerships may be **terminated** by retirement, passing of time, termination of the underlying venture, death or bankruptcy of a partner, illegality, the giving of notice, agreement or by order of the court.



### Case study

Alison, Ben, Caroline and David are in partnership as accountants. Caroline decides to change career and become an interior designer. In her place, Alison, Ben and David invite Emily to join the partnership.

As far as third parties are concerned, a partnership offering accountancy services still exists. In fact, however, the old partnership (ABCD) has been dissolved, and a new partnership (ABDE) has replaced it.

### 5.2.1 Events causing termination

Partnership is terminated in the following instances:

- **Passing of time**, if the partnership was entered into for a fixed term.
- **Retirement**, of one of the partners
- **Termination of the venture**, if entered into for a single venture.
- The **death or bankruptcy** of a partner. A partnership agreement may vary this.
- **Subsequent illegality**.
- **Notice** given by a partner if it is a partnership of indefinite duration.
- **Order of the court** granted to a partner.
- **Agreement** between the partners.

In the event of the **termination** of a partnership, the partnership's **assets are realised** and the proceeds applied in this order:

- Paying off external debts.
- Repaying to the **partners** any **loans** or **advances**.
- Repaying the partners' **capital contribution**.
- Anything left over is then **repaid** to the **partners** in the **profit sharing ratio**.



The partnership agreement can exclude some of these provisions and can **avoid dissolution** in the following circumstances:

- Death of a partner.
- Bankruptcy of a partner.

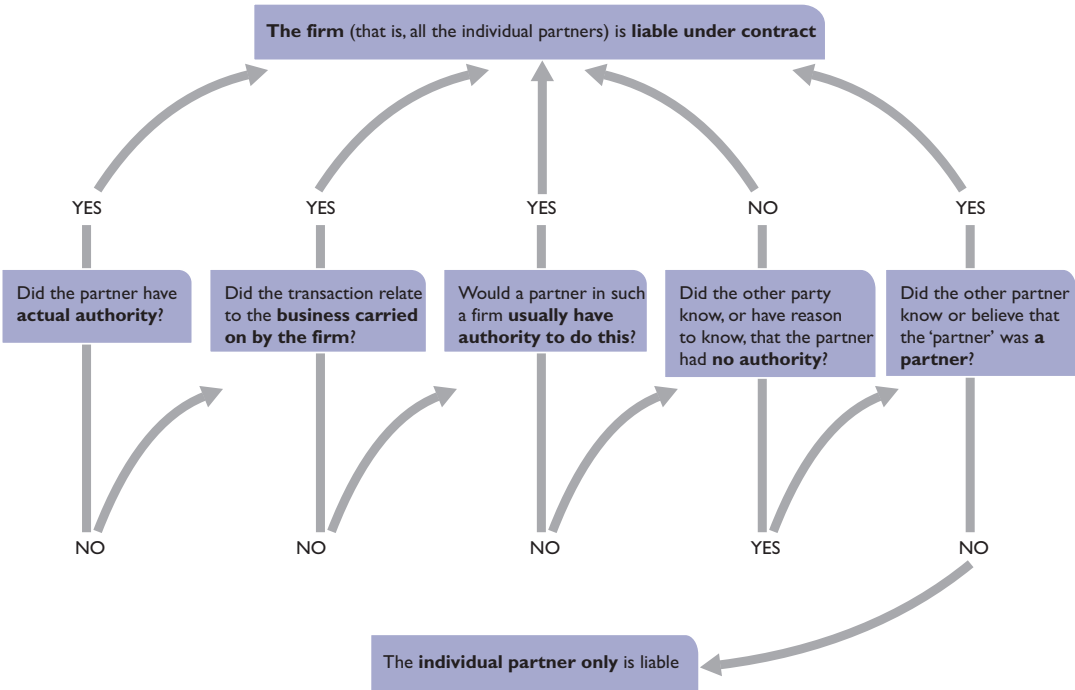
It is wise to make such provisions to give **stability** to the partnership.

5.3 Liability of the partners upon termination

Every partner is liable **without limit** for the debts of the partnership throughout and at the end of the partnership. It is possible to register a partnership with limited liability (an LLP). LLPs are discussed in Section 5.5.

Partners are **jointly liable** for all partnership debts that result from contracts that the partners have made which bind the firm.

Partners are **jointly liable** for all partnership debts that result from contracts made by other partners which bind the firm. The link between authority and liability can be seen in the following diagram.



There are particular rules on liability for new and retiring partners.

Partner	Partner liability
New partners	A new partner admitted to an existing firm is liable for <b>debts incurred</b> only <b>after</b> he becomes a partner. He is not liable for debts incurred before he was a partner unless he agrees to become liable.
Retiring partners	<p>A partner who retires is still <b>liable</b> for any <b>outstanding debts</b> incurred while he was a partner, unless the creditor has agreed to release him from liability. He is also <b>liable</b> for debts of the firm <b>incurred after his retirement</b> if the creditor knew him to be a partner before retirement, and has not had <b>notice</b> of their retirement.</p> <p>Therefore, it is <b>vital</b> on retirement that a partner <b>gives notice</b> to all the creditors of the firm. The retiring partner may have an indemnity from the remaining partners with respect to this issue.</p>



## 5.4 Procedures for termination

There is no formal statutory supervision or regulation of partnerships on formation, running or upon dissolution. Their accounts need not be in prescribed form nor is an audit necessary. The public has no means or legal right of inspection of the firm's accounts or other information such as companies must provide. Partnerships can grant a mortgage or fixed charge over property, but cannot grant floating charges.

## 5.5 Termination of a limited liability partnership

The other form of partnership commonly used for professional partnerships is the limited liability partnership (LLP). This type of business association is also available in most of the Australian states and territories under varying legislation, namely NSW, Victoria, South Australia, Queensland, Northern Territory and the ACT.

LLPs are similar to limited companies in that they have separate legal identity and unlimited liability for debts, but the liability of the individual partners is limited to the amount of their capital contribution.

LLPs have similar requirements for governance, accountability and dissolution as limited companies.

An LLP does not dissolve on a member leaving it in the same way that a traditional partnership does. Where a member has died, or a corporate member has been wound up, that member ceases to be a member, but the LLP continues in existence.

An LLP must therefore be wound up when the time has come for it to be dissolved. This is achieved under provisions similar to company winding up provisions previously discussed.

# 6 Claimants' rights in corporate insolvency



### Section overview

- In most jurisdictions there is a set order of repayment for the creditors of a company. Preferential debts rank before floating and then fixed charges. The unsecured creditors and the company members rank last and are least likely to be repaid.

LO  
12.3

A liquidator in a compulsory winding up **must**, and in a voluntary winding up is **likely to**, adhere to the following prescribed order for distributing the company's assets:

- 1 **Costs.** This includes the costs of getting in the assets, liquidator's remuneration and all costs incidental to the liquidation procedure.
- 2 **Australian preferential debts** are grouped into classes and paid in the following order:
  - **Employees' wages** and superannuation.
  - **Accrued sick leave, holiday pay and long service leave** where applicable
  - Retrenchment funds.Each class is paid in full before the next class is paid.
- 3 **Secured creditors** with debts secured by **floating charges**. Assets subject to a **fixed charge** will already have been dealt with by a **receiver** (see Section 7 below), who must pass any surplus to the liquidator.
- 4 **Unsecured ordinary creditors.**
- 5 **Deferred debts**, for example, dividends declared but not paid and interest accrued on debts since liquidation
- 6 **Members.** Any surplus, meaning that the company is in fact solvent, is distributed to members according to their rights under the articles or the terms of issue of their shares.

## 7 Receivership



### Section overview

- A **secured creditor** may enforce his security over a company's assets by taking possession of the assets, selling the asset, applying to the court for a transfer or **appointing a receiver**, meaning the company is now in receivership.

A **secured creditor** is a creditor who has registered a charge over the company's assets, which gives the creditor the right to settlement of his debt out of the funds raised by that asset on its sale. An **unsecured creditor** is one who does not hold a security over the company's assets.

A **secured creditor** may enforce the security in the following ways:

- Take **possession of the asset** subject to the charge if they have a **fixed charge** over that specific asset. If they have a floating charge over the company's assets in general they may only take possession if the contract allows.
- **Sell it**, provided the charge contract is executed as a deed.
- Apply to the court for its **transfer** to the creditor's ownership by foreclosure order.
- Appoint a **receiver** of it if there is a **fixed charge**, provided an **administration order** is not in effect, or in the case of **floating charge**, appoint an **administrator** without needing to apply to the court. The company is now in receivership. The receiver has similar duties and powers to an administrator (defined below), but importantly the **receiver is only in control of charged assets** not the company as a whole unlike in administration. A company in receivership can also be in liquidation or under administration.

LO  
12.5

## 8 Saving a company: voluntary administration

### 8.1 What is voluntary administration?



### Section overview

- An **administrator** is appointed primarily to try to rescue the company as a going concern. A company may go into voluntary administration to carry out an established plan to save the company and to avoid it having to enter liquidation.



### Definition

**Administration** puts an **insolvency practitioner** in **control** of the company with a defined program for **rescuing the company** from insolvency as a going concern.

The purpose of a voluntary administration is to **insulate** the company **from its creditors while it seeks** to:

- Save itself as a going concern, or failing that
- Achieve a better result for creditors than an immediate winding up would secure, or failing that
- To realise property so as to make a distribution to creditors.

Administration orders and winding ups are **mutually exclusive**. Once an administration order has been passed by the court, it is **no longer possible to petition the court** for a **winding up** order against the company. Similarly, however, once an order for winding up has been made, an administration order cannot be granted (except when appointed by a floating chargeholder, see Section 8.2.1).

Voluntary administration can be initiated with or without a court order.

## 8.2 Appointment without a court order



### Section overview

- Some parties – **secured creditors** and **directors** and the **members** by resolution – can appoint an administrator without a court order.

It is possible to appoint an administrator **without reference to the court**. There are four sets of people who might be able to do this:

- Directors.
- Company.
- Floating chargeholders.
- Liquidators and provisional liquidators (in limited circumstances in Australia).

### 8.2.1 Floating chargeholders

Floating chargeholders have the right to appoint an administrator without reference to the court even if there is no actual or impending insolvency. They may also **appoint an administrator even if the company is in a compulsory winding up**. This enables steps to be taken to save the company before its financial situation becomes irreversible.

In order to qualify for this right, the **floating charge must entitle the holder to appoint an administrator**. This would be in the terms of the charge. It must also be over all, or substantially all, the company's property.



### Exam comments

In practice, such a floating chargeholder with a charge over all or substantially all the company's property is likely to be a **bank**.

However, **floating chargeholders may only appoint an administrator if:**

- They have given **two days'** written notice to the holder of any prior floating charge where that person has the right to appoint an administrator.
- Their floating charge is **enforceable**.

After any relevant two-day notice period (see above), the floating chargeholder will file the following **documents** at court:

- A **notice of appointment** in the prescribed form identifying the administrator.
- A **statement by the administrator** that he **consents to the appointment**.
- A **statement by the administrator** that, in his **opinion**, the **purpose of the administration** is likely to be **achieved**.
- A **statutory declaration** that he **qualifies** to make the appointment.

Once these documents have been filed, the **appointment is valid**. The appointer must notify the administrator and other people prescribed by regulations of the appointment as soon as is reasonably practicable.

### 8.2.2 Company and directors

The process by which a company commences appointing an administrator will depend upon its **articles of association** but generally a resolution of the board and through writing. A company or its directors may appoint an administrator if:

- The company has not done so in the last 12 months or been subject to a **moratorium** as a result of a voluntary arrangement with its creditors in the last 12 months.
- The company is, or is likely to be, **unable to pay its debts**.

- **No petition for winding up** nor any **administration order** in respect of the company has been presented to the court and is outstanding.
- The company is **not in winding up**.
- **No administrator** is already in office.
- **No administrative receiver** is already in office.

The company or its directors must give notice to any floating chargeholders entitled to appoint an administrator. This means that the **floating chargeholders may** appoint their own administrator within this time period, and so **block the company's choice of administrator**.

## 8.3 Appointment with a court order



### Section overview

- Various parties can apply for **administration** through the court.

There are four sets of parties that may apply to the court for an administration order:

- The **company** (that is, a majority of the members by (ordinary) resolution).
- The **directors** of the company.
- One or more **creditors** of the company.
- The **court** following non-payment of a fine imposed on the company.



### Exam comments

**Individual** members **cannot** apply to the court for an administration order.

The court will grant the administration order if it is satisfied that:

- The company is, or is likely to be, **unable to pay its debts**, and
- The administration order is reasonably likely to **achieve the purpose of administration**.

The application will name the person whom the applicants want to be the **administrator**. Unless certain interested parties object, this person is appointed as administrator.

## 8.4 The effects of appointing an administrator



### Section overview

- The **effects** of voluntary administration depend to some degree on whether it is effected by the **court** or by a **floating chargeholder**.

#### Effects of an administrator appointment

A **moratorium** over the company's debts commences, that is, no creditors can enforce their debts during the administration period without the court's permission. This is the advantageous aspect of being under voluntary administration.

The court must give its permission for:

- **Security** over company property to be **enforced**.
- Goods held under hire purchase to be **repossessed**.
- A landlord to conduct **forfeiture** by peaceable entry.
- Commencement/continuation of any **legal process** against the company.

## Effects of an administrator appointment

The **powers of management** are subjugated to the authority of the administrator and managers can only act with his consent.

All outstanding **petitions for winding-up** of the company are **dismissed**.

Any **administrative receiver** in place **must vacate** office. No appointments to this position can be made.

## 8.5 Duties of the administrator



### Section overview

- The administrator has **fiduciary duties** to the company as its agent, plus some legal duties.

The administrator is an **agent of the company** and the **creditors as a whole**. He therefore owes fiduciary duties to them and has the following legal duties:

### Legal duties of the administrator

As soon as **reasonably practicable** after appointment he must:

- **Send notice** of appointment to the company on the first business day after appointment.
- Convene the first creditors' meeting, to be held within eight days of appointment..
- **Publish notification** of first creditors' meeting within three days of appointment with five days' notice in applicable state and territory newspapers.
- Obtain a list of **company creditors** and sent notice of appointment and of the creditors' meeting to each on the first business day after appointment.
- Require certain relevant people to provide a **statement of affairs** of the company.
- Ensure that every **business document** of the company **bears the identity** of the administrator and a statement that the affairs, business and property of the company are being managed by him.
- Consider the **statements of affairs** submitted to him and set out his **proposals** for achieving the aim of administration. The proposals must be sent to the company's **creditors**, and be made available to **every member of the company** as soon as is reasonably practicable before the second creditors' meeting.
- While preparing his proposals, the administrator must **manage the affairs** of the company.

The **statement of affairs** must be provided by the people from whom it is requested within a stated timeframe. It is in a prescribed form, and contains:

- Details of the **company's property**,
- The company's **debts and liabilities**,
- The **names and addresses** of the **company's creditors**, and
- Details of any **security** held by any **creditor**.

Failing to provide a statement of affairs, or providing a statement in which the writer has no reasonable belief of truth, is a **criminal offence** punishable by fine.

## 8.6 Administrator's proposals



### Section overview

- The administrator must either **propose a rescue plan**, or state that the **company cannot be rescued**.

Having considered all information the administrator must, at least five days before the creditor's meeting, either:

- Set out his **proposals for achieving the aim of the administration**, or
- Set out why it is not **reasonable and practicable** that the company be rescued. In this case, he will also set out why the creditors as a whole would benefit from winding up.

The proposal must be sent to all members and creditors of whom he is aware. It must not:

- Affect the right of a **secured creditor** to enforce his security,
- Result in a non-preferential debt being paid in priority to a preferential debt, or
- Result in one preferential creditor being paid a smaller proportion of his debt than another.

### 8.6.1 Creditors' meeting

The administrator must call a **meeting of creditors** within **25 to 30 days** of his appointment to approve the proposals. The creditors may either accept or reject them. Once the proposals have been agreed, the administrator cannot make any substantial amendment without first gaining the creditors' consent.

## 8.7 Administrator's powers



### Section overview

- The administrator takes on the **powers** of the directors.

The powers of the administrator are summed up as follows:

'The administrator of a company may do **anything necessarily expedient** for the management of the affairs, business and property of the company.'

The administrator **takes on the powers previously enjoyed by the directors** and the following specific powers to:

- Remove or appoint a **director**.
- Call a **meeting of members or creditors**.
- **Apply to court for directions** regarding the carrying out of his functions.
- Make payments to **secured or preferential creditors**.
- With the permission of the court, **make payments to unsecured creditors**.

The administrator usually requires the permission of the court to make payments to unsecured creditors. However, this is not the case if the administrator feels that paying the unsecured creditor will assist the **achievement of the administration**, for example, if the company has been denied further supplies by a major supplier unless payment is tendered.

Any creditor or member of the company may **apply to the court** if he feels that the administrator has acted or will act in a way that has harmed or will harm his interest. The court may take various actions against the administrator.

## 8.8 End of voluntary administration



### Section overview

- The term of a voluntary administration is generally **30 days**, though the court can order an extension of this period.

The administration period **ends** when:

- The proposals at the creditors' meeting have been successfully adopted which is generally between 25 – 30 days from appointment of the administrator.
- 30 days after the appointment of administrator though the administrator to the court can apply for an extension and/or an additional creditors' meeting. The creditor's meeting can be adjourned for up to 60 days.
- The administrator applies to the court to end the appointment.
- A creditor applies to the court to end the appointment.
- An improper motive of the applicant for applying for the administration is discovered.

An administrator must vacate office **after the creditor's meeting** unless a result was not reached and a court extension granted. Alternatively, the administrator may **apply to the court** when he thinks the:

- Purpose of administration cannot be achieved
- Company should not have entered into administration
- Administration has been successful (if appointed by the court), or
- He must also apply to the court if required to by the **creditors' meeting**.

Where the administrator was appointed by a chargeholder or the company/its directors, and the purposes of administration have been achieved, he must file a **notice** with the court and ASIC.

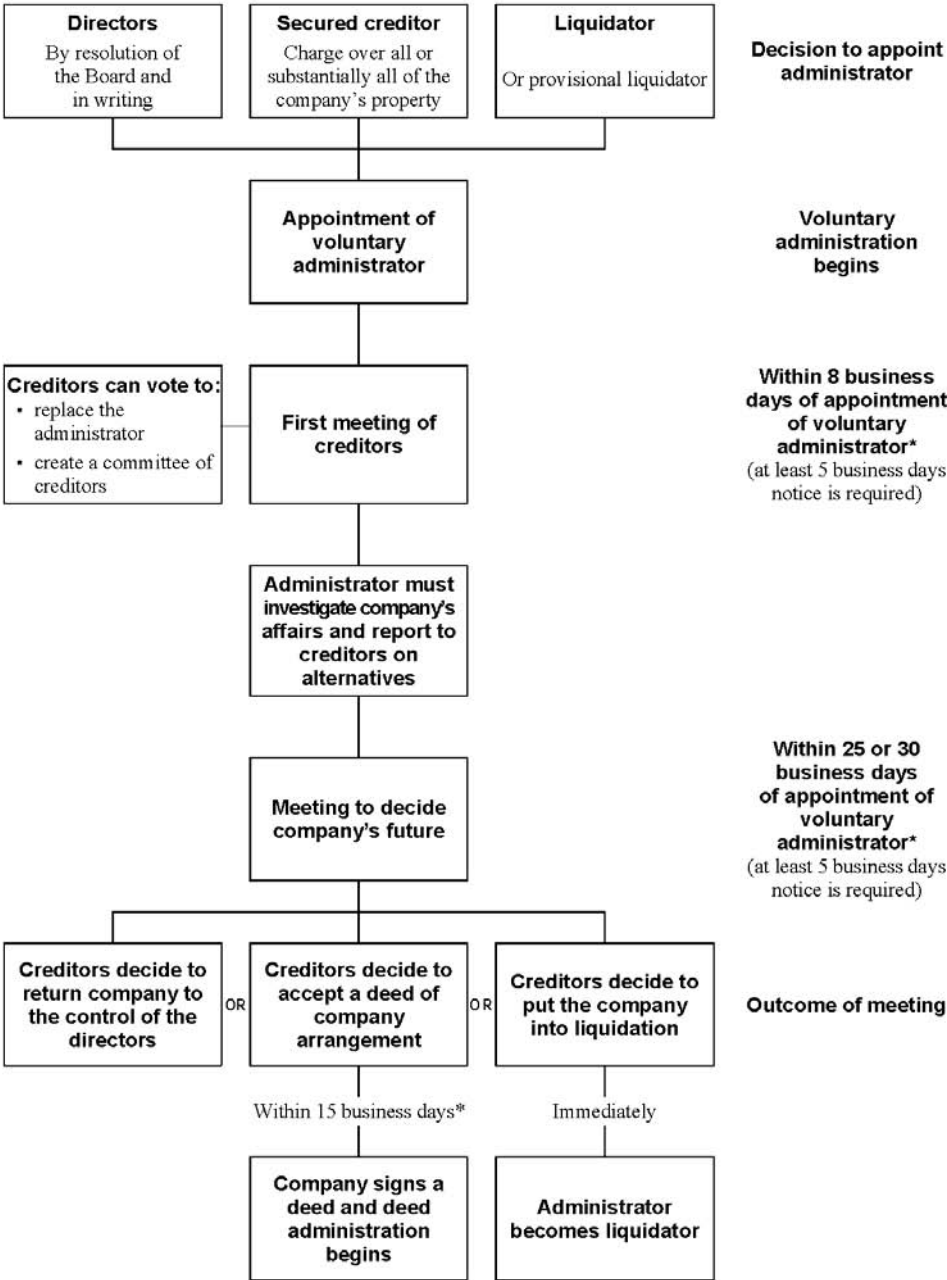
The time period for an administration varies between jurisdictions. For example, in the UK, the administrator automatically vacates office after **12 months of his appointment**. This time period can be extended by court order or by consent from the appropriate creditors.

## 8.9 Sample voluntary administration process

The flowchart included below shows the process of company voluntary administration described in the sections above. This flowchart outlines the Australian process of administration and is taken from ASIC public guidance to creditors

VOLUNTARY ADMINISTRATION: A GUIDE FOR CREDITORS

Figure 1: The voluntary administration process



\* Unless the court allows an extension of time.



## 8.10 Advantages of voluntary administration



### Section overview

- Voluntary administration has been found to have many advantages for the **company**, **members** and **creditors**.

#### Advantages of voluntary administration

<b>To the company</b>	<p>The company does not necessarily cease to exist at the end of the process, whereas winding up will always result in the company being wound up and ceasing to exist.</p> <p>It provides temporary relief from creditors to allow breathing space to formulate rescue plans.</p> <p>It prevents any creditor applying for compulsory winding up.</p> <p>It provides for past transactions to be challenged.</p>
<b>To the members</b>	<p>They will continue to have shares in the company which has not been wound up. If the voluntary administration is successful, regenerating the business should enhance share value and will restore any income from the business.</p>
<b>To the creditors</b>	<p>Creditors should obtain a return in relation to their past debts from an administration.</p> <p>Unsecured creditors will benefit from asset realisations.</p> <p>Any creditor may apply to the court for an administration order, while only certain creditors may apply for other forms of relief from debt. For example, the use of receivers or an application for winding up.</p> <p>Floating chargeholders may appoint an administrator without reference to the court.</p> <p>It may also be in the interests of the creditors to have a continued business relationship with the company once the business has been turned around.</p>

## Key chapter points

- What is winding up?
  - Dissolution of a company.
  - Parties involved in winding up are directors, creditors, members.
  - Liquidator must be a authorised, qualified, insolvency practitioner.
  - Common features of a winding up.
- Voluntary winding up
  - Taken voluntarily by the members when the company is solvent:
    - Must make a declaration of solvency
    - Wind up on reasonable grounds
  - Creditors' voluntary winding up when the company is insolvent:
    - Passed by special resolution
    - Role and appointment of the liquidator by resolution or by creditors
- Compulsory winding up
  - Creditor may apply to the court to have the company wound up.
  - Winding up when company cannot pay its debts.
  - Winding up on the just and equitable ground.
  - Proceedings for carrying out a compulsory winding up.
  - The effects of a compulsory winding up.
  - Completion of the winding up resulting in dissolution of the company.
- Differences between compulsory and voluntary winding up
  - Control.
  - Timing.
  - Appointment and role of liquidator.
  - Treatment of management and staff.
- Winding up partnerships
  - Termination of partnerships.
  - Liability of partners upon termination.
  - Procedures for termination.
  - Limited liability partnership
- Claimants' rights in corporate insolvency
  - Order of payment:
    - Costs
    - Preferential debts equal with costs
    - Floating charges
    - Unsecured ordinary creditors
    - Deferred debts
    - Members.
- Receivership
  - Secured creditors can enforce their security:
    - Taking possession of the asset
    - Selling the asset
    - Applying to court for a transfer
    - Appointing a receiver.

- Saving a company: voluntary administration
  - Administration saves a company from winding up.
  - Administrator is appointed to rescue the company as a going concern.
  - Appointment can be with or without a court order.
  - Treatment of floating chargeholders.
  - Effects and duties.
  - Procedures for administration.
  - Completion of administration.
  - Advantages.

# Quick revision questions

1 **Complete the following definition.**

Winding up means that a company must be ..... and its affairs wound up.

2 Name three common features of winding ups.

- (1) .....
- (2) .....
- (3) .....

3 What are the two most important reasons for compulsory winding up?

- (1) .....
- (2) .....

4 A members' voluntary winding up is where the members decide to dissolve a healthy company.

true ☐

false ☐

5 Rearrange the list in order of proceedings in a creditors' voluntary winding up.

- (a) creditors' meeting
- (b) liquidator appointed
- (c) directors' notice of meeting outlines situation
- (d) members' meeting
- (e) winding up committee nominated

6 List three grounds for the termination of a partnership.

- (1) .....
- (2) .....
- (3) .....

7 **Complete the following definition,** using the words given below.

An ..... is an arrangement which puts an .....  
..... in control of the business to attempt to save it.

- |              |                |                  |
|--------------|----------------|------------------|
| • insolvency | • practitioner | • administration |
|--------------|----------------|------------------|

8 Name two advantages of voluntary administration.

- (1) .....
- (2) .....

## Answers to quick revision questions

- 1 Dissolved
- 2
  - (1) No further changes in membership permitted.
  - (2) All documents must state prominently that company is in winding up.
  - (3) Directors' power to manage ceases.
- 3
  - (1) Company is unable to pay its debts.
  - (2) It is just and equitable to wind up the company.
- 4 True. Members can decide to wind up a healthy company.
- 5 The correct order of proceedings in a voluntary winding up is: (c) directors' notice of meeting outlines situation; (d) members' meeting; (a) creditors' meeting. Both (b) liquidator appointed, and (e) the winding up committee is nominated, occur at the creditor's meeting
- 6 Three of the following:
  - (1) **Passing of time**, if the partnership was entered into for a fixed term.
  - (2) **Termination of the venture**, if entered into for a single venture.
  - (3) The **death or bankruptcy** of a partner (partnership agreement may vary this).
  - (4) **Subsequent illegality**.
  - (5) **Notice** given by a partner if it is a partnership of indefinite duration.
  - (6) **Order of the court** granted to a partner.
  - (7) **Agreement** between the partners.
- 7 Administration, Insolvency, Practitioner.
- 8
  - (1) It does not necessarily result in the dissolution of the company.
  - (2) It prevents creditors applying for compulsory winding up.

Subsidiary advantages are:

  - (3) All creditors can apply for an administration order.
  - (4) The administrator may challenge past transactions of the company.

# Answers to chapter questions

1

Creditors' voluntary winding up	Members' voluntary winding up
Company is insolvent	Company is solvent
Creditors (usually) appoint liquidator	Members appoint liquidator
Winding up committee/committe of inspection approve liquidator's action	Members approve liquidator's actions in general meeting

2

- Official liquidator is appointed as liquidator.
- Winding up deemed to have commenced at time when petition first presented.
- Disposition of company property since commencement of winding up deemed void.
- Legal proceedings against the company are halted.
- Employees are dismissed.
- Any floating charge crystallises.



## Revision questions





# Chapter 1

- 1 The legal system in Australia is:
  - A a civil law system
  - B a common law system
  - C a criminal law system
  - D a Sharia law system
- 2 The combination of written constitutions and national rules of law together are known as a country's:
  - A national law
  - B positive law
  - C international law
  - D negative law
- 3 The set of laws which regulates how entities relate to each other and to the state is known as:
  - A national law
  - B public international law
  - C positive law
  - D private international law
- 4 Which two of the following would be seen in a civil system of law as opposed to a criminal system of law?
  - A proof to be on the balance of probabilities
  - B proof to be beyond reasonable doubt
  - C a claimant (plaintiff) and a defendant
  - D an accused and a prosecution
  - E punishment
- 5 In a civil law system such as France, the key source of law is:
  - A custom
  - B statute
  - C administrative regulations
  - D the Constitution
- 6 Which of the following is a secondary source of Sharia law?
  - A the Quran
  - B the Madhab
  - C the Sunnah
  - D the Imam
- 7 In a democratic political system the role of the law is:
  - A to ensure that the state controls economic resources
  - B to ensure that individual behaviour is controlled by the State
  - C to ensure that individuals and groups relate to each other in predictable ways
  - D to ensure that problems between individuals and groups are sorted out as they arise

- 8 Heavy state regulation of individual behaviour is more likely to be found in:
- A a *laissez faire* political system
  - B a democratic political system
  - C a dictatorial political system
  - D a market political system
- 9 The degree of separation of powers in a political system describes the separation between:
- A the head of state and the head of the judiciary
  - B the judiciary, the executive and the legislature
  - C the head of the executive and the head of the legislature
  - D the police and the judiciary

## Chapter 2

- 1 In order to apply a precedent to a case, the judge must be satisfied that:
  - A the previous decision was made on a question of fact
  - B the precedent formed part of the obiter dicta of the earlier case
  - C the material facts of the earlier and current cases are the same
  - D the earlier court had an inferior status
- 2 Which of the following is a presumption of statutory interpretation?
  - A if a person is deprived of his property by a statute, he is to be compensated
  - B words in a statute should be given the plain, ordinary meaning
  - C if a statute states that it relates to cars it does not automatically extend to motorbikes
  - D words in a statute should be construed in their context
- 3 Which of the following is the application of a rule of statutory interpretation as opposed to a presumption?
  - A if a statute deprives a person of his property, he is to receive compensation
  - B if a statute states that it relates to offices it does not automatically extend to hotels
  - C if a statute intends to deprive a person of his liberty, this must be clearly and expressly stated
  - D if a statute imposes criminal liability, a guilty intention must be proved
- 4 What does the 'purposive model' of interpretation used by the judiciary to interpret statutes state?
  - A statute should be interpreted with reference to the context and purpose of the legislation
  - B if a statute is passed to remedy an error, the court must apply the correct interpretation
  - C words must be interpreted to avoid absurd results
  - D words should be given their everyday meaning
- 5 The doctrine of consistency in case law is expressed in the maxim:
  - A *ratio decidendi*
  - B *obiter dicta*
  - C *stare decisis*
  - D *in pari materia*
- 6 What is the effect of a judge overruling a decision in an earlier case?
  - A the outcome of the earlier judgment remains the same, and it will be followed in future
  - B the outcome of the earlier judgment changes, and it will be followed in future
  - C the outcome of the earlier judgment changes, but it will not be followed in future
  - D the outcome of the earlier judgment remains the same, but it will not be followed in future
- 7 If a later judge finds that an apparent precedent has been made *per incuriam*, this means that:
  - A the earlier court was not of sufficient status to bind the later one
  - B the later court is distinguishing the facts
  - C the earlier court's decision was obscure
  - D the earlier court had made its decision without taking into account some essential point of law

- 8 In relation to legislation, the practice of judicial review by the highest court in the land means that:
- A legislation is reviewed by the court and overturned if it conflicts with the country's constitution
  - B earlier court cases may be reversed on appeal
  - C earlier court cases may be overturned on appeal
  - D legislation is reviewed by the court, which can make recommendations for further legislature review
- 9 Rules of law that are often of a detailed nature and that are made by bodies to whom the power to do so has been given by statute are called:
- A private Acts
  - B public Acts
  - C subordinate legislation
  - D primary legislation
- 10 Which of the following is termed an intrinsic aid to statutory interpretation?
- A relevant reports of a Royal Commission, Law Reform Commission, committee of inquiry or other similar body
  - B anything that does not actually form part of the Act but that is set out in the document containing the text of the Act as printed by the Government Printer
  - C relevant reports of a committee of Parliament
  - D any treaty or other international agreement that is referred to in the Act

## Chapter 3

- 1 Summary offences are most likely to be heard in:
  - A the highest court in the jurisdiction trying civil cases
  - B the lowest court in the jurisdiction trying civil cases
  - C the highest court in the jurisdiction trying criminal cases
  - D the lowest court in the jurisdiction trying criminal cases
- 2 The superior court in Australia is:
  - A the Federal Court
  - B the Supreme Court
  - C the High Court
  - D the District Court
- 3 Which of the following is a key advantage of court-based adjudication over alternative dispute resolution?
  - A timescale
  - B more enforceable solutions and remedies
  - C lower cost
  - D shorter waiting period
- 4 Which method of alternative dispute resolution involves determination by an independent person selected by the parties themselves?
  - A arbitration
  - B conciliation
  - C facilitation
  - D mediation
- 5 Which of the following statements about arbitration is correct?
  - A courts often intervene in disputes that are subject to arbitration on application by one of the parties
  - B courts can never intervene in disputes that are subject to arbitration
  - C courts may sometimes intervene in a dispute that is subject to arbitration if it is in the public interest to do so
  - D there is never scope for appeal against an arbitration decision to a court
- 6 For a dispute in a relationship between two parties to be subject to the UNCITRAL Model Law on Arbitration, which of the following statements *must* be true?
  - A the parties have a contractual relationship relating to trade
  - B the parties have a family relationship
  - C the parties have a contractual relationship
  - D the parties have a relationship based on trade
- 7 Which of the following sovereign states unilaterally recognises the International Court of Justice's compulsory jurisdiction to settle any dispute arising between fellow sovereign states with recognition?
  - A Brazil
  - B Japan
  - C China
  - D Singapore
- 8 What is the highest court of appeal for Singapore?
  - A the High Court
  - B the Session's Court
  - C the Supreme Court
  - D the Federal Court

## Chapter 4

- 1 Which of the following is an offer capable of acceptance?
  - A a declaration of intent
  - B a statement of intention to be bound
  - C an invitation to treat
  - D a supply of information
- 2 Which of the following statements concerning consideration is true?
  - A consideration must move from the promisor
  - B consideration must be adequate
  - C consideration must be sufficient
  - D consideration may be past
- 3 Which of the following types of contract is void if it is not in a signed, written contract?
  - A an assignment of a debt
  - B a sub contract of an obligation
  - C a contract of guarantee
  - D a sale of goods
- 4 A contract which one party may choose to 'set aside' is referred to as which of the following?
  - A void contract
  - B voidable contract
  - C enforceable contract
  - D unenforceable contract
- 5 Which of the following is *not* an essential feature of a contract under common law?
  - A intention to create legal relations
  - B written form
  - C offer and acceptance
  - D consideration
- 6 Which of the following is *not* a way by which an offer may be terminated?
  - A rejection by the offeror
  - B counter-offer by the offeree
  - C lapse of time
  - D failure of condition precedent
- 7 Consider the following chain of events. Is there a contract?

1 April	Amy sends a letter to Beth offering to sell her a bicycle for \$100.
3 April	Amy changes her mind and writes to Beth informing her that the offer is no longer open.
4 April	Beth receives Amy's offer letter and writes back to accept.
5 April	Beth receives Amy's second letter.
7 April	Amy receives Beth's letter of acceptance which she returns, unread.

  - A no. Amy has revoked the offer by the time that Beth accepts it by writing to Beth. Beth cannot accept a revoked offer
  - B yes. Beth can accept the offer until she receives notice of the revocation
  - C no. Amy has not read the acceptance, therefore she has not agreed to it
  - D no. Beth has given no consideration

- 8 Which of the following examples of performance amounts to good consideration?
- I The performance of an existing duty under general law
  - II The performance of an existing contract in return for a promise by a third party
  - III The performance of an act, followed by a promise to pay for that act
- A I only
  - B II only
  - C III only
  - D I and II only
- 9 An act which has already been performed before an act or promise is given in return is not usually sufficient as consideration. But it will be where:
- A a person performs a service at another's request and is later promised payment
  - B a person spends money on their own initiative and another party later agrees in writing to repay it
  - C a debt has become statute-barred but the debtor verbally acknowledges its existence
  - D a promissory note is given in settlement of an existing debt
- 10 Tim offered to sell a camera to Neil for \$200 on 2 September saying that the offer would stay open for a week. Neil told his brother that he would like to accept Tim's offer and, unknown to Neil, his brother told Tim of this on 3 September. On 4 September Tim, with his lodger present, sold the stereo to Ingrid. The lodger informed Neil of this fact on the same day. On 5 September Neil delivered a letter of acceptance to Tim. Is Tim in breach of contract?
- A no. Neil delayed beyond a reasonable time and so the offer had lapsed by the time Tim sold to Ingrid
  - B no. Neil was told by a reliable informant of Tim's effective revocation before Neil accepted the offer
  - C yes. Tim agreed to keep the offer open and failed to do so
  - D yes. Tim was reliably informed of Neil's acceptance on 3 September so his sale to Ingrid on 4 September is breach of contract

## Chapter 5

- 1 Which of the following statements concerning contractual terms are *untrue*?
  - I Terms are usually classified as either conditions or warranties, but some terms may be unclassifiable in this way
  - II If a condition in a contract is not fulfilled the whole contract is said to be discharged by breach
  - III If a warranty in a contract is not fulfilled the whole contract is said to be discharged by breach, but either party may elect to continue with his performance
  - IV Terms which are implied into a contract by law are never contractual conditions
  - A I and II only
  - B III and IV only
  - C I, II and III only
  - D I, II, III and IV
- 2 Grace and Geoffrey are both opera singers. They have each contracted with Opera Organisers Co to attend rehearsals for a week and then appear in the two month long run of a new production. Due to illness, Grace did not attend the rehearsals or the opening night but recovered sufficiently to appear by the fourth night. Due to illness, Geoffrey was unable to attend for the first four days of rehearsals. Opera Organisers Co have booked substitutes for both Grace and Geoffrey for the entire run.

What is the legal position?

  - A both Grace and Geoffrey are in breach of a condition of their contract and both of their contracts with Opera Organisers are completely discharged
  - B Grace is in breach of condition of her contract, but Geoffrey is in breach of warranty only and his contract is not discharged
  - C Grace is in breach of warranty and her contract is not discharged, while Geoffrey is in breach of condition, so his contract is discharged
  - D neither Grace nor Geoffrey are in breach of condition. They are both in breach of warranty, so neither contract is discharged
- 3 Dee Co has broken one of the terms of its contract with E Co. If that term is a warranty, which of the following is correct?
  - A E Co may repudiate the contract with Dee Co
  - B E Co can avoid the contract and recover damages
  - C E Co is entitled to sue for damages only
  - D E Co is entitled to sue for damages or to repudiate the contract
- 4 Michael cannot read. He buys a railway ticket on which is printed 'conditions – see back'. The back of the ticket stated that the ticket was subject to conditions printed in the timetables. These included an exclusion of liability for injury. During Michael's journey, a suitcase fell off the racks and injured him.

What is the legal position?

  - A the ticket office contained no notice of the conditions of carriage and the railway could not rely on the notice given on the back of the ticket
  - B the conditions are contained in the timetable. As such, they are adequately communicated and the railway can avoid liability
  - C the railway cannot rely on Michael being able to read. The conditions should have been communicated to him verbally and the railway cannot avoid liability
  - D the railway cannot rely on the notice disclaiming liability as the contract had been made previously and the disclaimer was made too late



- 5 What is an exclusion clause?
- A it is a contractual warranty that the terms of the contract will be performed
  - B it is a clause excluding the rights of persons other than the contracting parties to sue for breach of contract
  - C it is a clause which limits the contractual capacity of one of the parties
  - D it is a contractual clause which limits or excludes entirely a person's obligation to perform a contract or his liability for breach of contract
- 6 During negotiations before entering into a contract for the sale of a car Howard says to Hilda 'the car will be ready for collection on the day you require it'. This statement is described as:
- A a representation
  - B a term
  - C a warranty
  - D an advertiser's puff
- 7 What is the effect of the '*contra proferentem*' rule?
- A a person who signs a written contract is deemed to have notice of and accepted the terms contained in it in the absence of misinformation as to their meaning
  - B a person who seeks to enforce an exclusion clause in a consumer contract must show that it is reasonable
  - C the working of an exclusion clause will generally, in the absence of absolute clarity, be construed against the party seeking to rely on it
  - D the court acts on the presumption that an exclusion clause was not intended to work against the main purpose of the contract
- 8 A term may be implied into a contract:
- I by statute
  - II by trade practice unless an express term overrides it
  - III by the court to provide for events not contemplated by the parties
  - IV by the court to give effect to a term which the parties had agreed upon but failed to express because it was obvious
  - V by the court to override an express term which is contrary to normal custom
- A II and III only
  - B I, II and IV only
  - C I, IV and V only
  - D I, III, IV and V only
- 9 Katie took her wedding dress to the dry cleaners to be cleaned. It was a silk dress, made with intricate beading and sequins. She was given a receipt which contained conditions, which she was told restricted the cleaner's liability, particularly with regard to the risk of damage to the beads and sequins on her dress. The conditions actually stated that the cleaners had absolutely no liability for damage to the dress. Katie signed the agreement assuming that all dry cleaners would want to protect themselves against damaging beads and sequins.
- The dress was badly stained in the cleaning process.
- What is Katie's legal position?
- A she signed the document restricting the cleaner's liability so she is bound by its terms
  - B the conditions have been adequately communicated and so are binding regardless of her signature
  - C she was misled by the cleaners as to the extent of the exclusion clause and so she is not bound by the terms
  - D she is not bound by the terms because they were not made available to her at the time of the contract

- 10 A famous waxworks museum takes out a contract with the bus company for large external posters to be placed on the buses and driven around for at least eight hours every single day for the three month summer period. Evidence found that the buses displaying the posters were in fact on the road for an average of eight hours a day, but each poster was not actually necessarily on the road for eight hours a day. The waxworks museum said this was a breach of contract that resulted in the termination of the agreement.

What is the bus company's legal position?

- A a warranty of the contract has been breached. The museum can seek damages but they cannot terminate
- B they have breached a condition of the contract and it can now be terminated by the museum
- C a condition of the contract has been breached and the museum is liable for damages. They cannot terminate the contract
- D it is sufficient that the posters were on the road for an average of eight hours a day and the contract is valid

## Chapter 6

- 1 One of the following statements regarding anticipatory breach is untrue. Which one?
  - A repudiatory breach automatically discharges the contract
  - B genuine mistakes will not necessarily repudiate a contract
  - C action for breach can be delayed until actual breach occurs
  - D subsequent events can affect the party's right to action
- 2 The general rule for a contract to be discharged by performance is that performance must be exact and precise. Which of the following is not an exception to that rule?
  - A where time is not of the essence
  - B where the promisee prevents performance
  - C where the contract is substantially performed
  - D where the contract is partially performed
- 3 Where there has been anticipatory breach of contract the injured party is entitled to sue:
  - A after a reasonable time
  - B only from the moment the other party actually breaches a contractual condition
  - C from the moment the other party indicates that they do not intend to be bound
  - D from the moment the injured party has fulfilled their obligations but the other party indicates that they do not intend to be bound
- 4 Where a contract has been breached which of the following remedies must always be considered by the court?
  - A damages
  - B specific performance
  - C mitigation of loss
  - D retention of title
- 5 In an action for breach of contract, the court will not award:
  - A unliquidated damages
  - B nominal damages
  - C liquidated damages
  - D exemplary damages
- 6 Which of the following statements is true?
  - A damages are an equitable remedy and are primarily intended to restore the party who has suffered loss to the same position they would have been in if the contract had been performed
  - B damages are a common law remedy and are primarily intended to restore the party who has suffered loss to the same position as they would have been in if the contract had been performed
  - C damages are an equitable remedy whereby the court orders a person to perform a contract so that the other party to the contract does not suffer loss
  - D damages are a common law remedy whereby the court orders a person to perform a contract so that the other party to the contract does not suffer loss

- 7 Daniel owns a mill. The main crank shaft of the mill has broken and it has to be sent to Melbourne to be used by specialist manufacturers as a pattern for a new one. Daniel contracts with Lionel to transport the broken shaft to Melbourne.
- Lionel neglects to take the shaft to Melbourne on his next delivery, and the shaft does not get repaired and returned to Daniel for two weeks, when it was supposed to have taken one week. During that time, the mill has been out of operation as it cannot run without its main crank shaft. Daniel claims loss of profits against Lionel.
- Which of the following is true?
- A the claim must fail. Daniel's loss could not reasonably be foreseen by Lionel
  - B the claim will succeed for the second week. Lionel was contracted to deliver within a certain time and might reasonably have known that delay would inconvenience Daniel
  - C the claim must fail. Damages are not awarded for loss of profits, but only for expenses arising from the breach. Daniel has incurred no extra expenses
  - D the claim will succeed in part. Only nominal damages will be awarded as the claim is speculative and it is impossible to ascertain the loss
- 8 Cee Co ordered goods from Dee Co to be delivered to F Co. If the goods are not delivered:
- A F Co can sue Dee Co for breach of contract
  - B Cee Co can sue Dee Co for breach of contract and recover compensation for its own loss
  - C Cee Co may sue Dee Co for breach of contract and recover compensation for its own loss and the loss to F Co
  - D Cee Co can sue Dee Co for breach of contract only if it was acting as the agent of F Co
- 9 Which of the following is not an equitable right in contractual breakdown?
- A rescission
  - B specific performance
  - C *quantum meruit*
  - D injunction
- 10 Which of the following statements is true?
- I The purpose of an injunction is to enforce a negative restraint in a contract
  - II The purpose of an injunction is to restrain acts which appear inconsistent with the contract's obligations
- A I only
  - B II only
  - C both I and II
  - D neither I nor II

## Chapter 7

- 1 To which two of the following contracts does the UNCISG apply, assuming the parties have not agreed to exclude it?
  - A a supply of services between two parties in contracting states
  - B a supply of services between a party in a contracting state and a party in a non-contracting state, where they agree that the law of the former state applies
  - C a sale of goods between two parties in contracting states
  - D a sale of goods between a party in a contracting state and a party in a non-contracting state, where they agree that the law of the latter state applies
  - E a sale of goods between a party in a contracting state and a party in a non-contracting state, where they agree that the law of the former state applies
- 2 To which of the following sales does the UNCISG apply?
  - A sale of electricity
  - B sale of a ship
  - C sale at auction
  - D sale of household vacuum cleaners
- 3 The following definition of a sale of goods from the UNCISG is incomplete:

Sale of goods is a contract by which the \_\_\_\_\_ transfers, or agrees to transfer, the \_\_\_\_\_ in goods to a \_\_\_\_\_ in exchange for monetary compensation, called the \_\_\_\_\_.

Which of the following sets of words, in the order given, completes the definition?

  - A seller, property, buyer, price
  - B buyer, property, seller, price
  - C seller, price, buyer, property
  - D buyer, price, seller, property
- 4 Complete the following statement:

A contract for the international sale of goods is concluded when:

  - A acceptance of an offer becomes effective
  - B an offer becomes effective
  - C an offer is accepted in writing
  - D acceptance of an offer becomes effective by being evidenced in writing
- 5 Which *three* of the following factors are required for a proposal to qualify as an offer under UNCISG?
  - A it is made with the intention of creating legal relations
  - B it is made to a specific person
  - C it is sufficiently reasonable
  - D it is sufficiently definite
  - E it indicates the offeror's intention to be bound by acceptance
- 6 Harold is keen to reach Tori with his offer to buy goods from her in a contract covered by UNCISG. He therefore makes the offer orally to Tori, he delivers the offer to her personally, first at her mailing address, then at her place of business, then at her habitual residence.

When does Harold's offer become effective?

  - A when he makes the offer orally to her
  - B when he delivers the offer to her at her mailing address
  - C when he delivers the offer to her at her place of business
  - D when he delivers the offer to her at her habitual residence

- 7     Tori is keen to reach Harold with her acceptance of his offer to buy goods from her in a contract covered by UNCISG. She therefore accepts orally to Harold, then delivers the acceptance to him personally, first at his mailing address, then at his place of business, then at his habitual residence.
- When does Tori's acceptance become effective?
- A     when she accepts orally to him
  - B     when she delivers the acceptance to him at his mailing address
  - C     when she delivers the acceptance to him at his place of business
  - D     when she delivers the acceptance to him at his habitual residence
- 8     In response to an offer a statement of assent from an offeree which contains modifications to the terms of the offer is:
- A     a revocation of the offer
  - B     a withdrawal of the offer
  - C     an acceptance of the offer
  - D     a counter-offer
- 9     Under UNCISG a contract once formed can be modified:
- A     by the buyer
  - B     by the seller
  - C     by the courts
  - D     by agreement between the parties
- 10    Which *three* of the following issues may be dealt with by using INCOTERMS in contracts for the international sale of goods?
- A     insurance
  - B     carriage costs
  - C     customs costs
  - D     quality
  - E     time of delivery

## Chapter 8

- 1 Which of the following is one of the specific tests applied when establishing whether the defendant is liable for negligent misstatement?
  - A was the damage reasonably foreseeable by the defendant as damage to the plaintiff?
  - B was there sufficient proximity between the parties?
  - C is it fair, just and reasonable that the law should impose a duty on the defendant on the facts of the case?
  - D did the defendant act in some professional or expert capacity which makes it likely that others will rely on what he says?
- 2 In seeking to establish negligence against an adviser, which of the following does the plaintiff *not* have to prove?
  - A that a valid contract existed between the parties
  - B that the adviser owed a duty of care
  - C that the duty of care was breached by the adviser
  - D that the client suffered loss as a result
- 3 In negligence for misstatements which result in economic loss to the plaintiff, what forms the basis of the existence of a legal duty of care?
  - A foreseeability only
  - B proximity only
  - C foreseeability and proximity
  - D foreseeability and damage
- 4 Which *three* of the following statements correctly complete this sentence?

In order to show that there exists a duty of care not to cause financial loss by negligent misstatement, the plaintiff must show that:

  - A the person making the statement did so in an expert capacity of which the plaintiff was aware
  - B the context in which the statement was made was such as to make it likely that the plaintiff would rely on it
  - C in making the statement the defendant foresaw that it would be relied upon by the plaintiff
  - D the plaintiff considered the statement
  - E the plaintiff was not insured for financial loss
- 5 Which of the following statements is correct?
  - I Auditors who provide negligent advice may be held liable for breach of contract by the company which appointed them
  - II Auditors who provide negligent advice to the company which appointed them may be held liable for breach of contract by the company and its shareholders
  - III Auditors who provide advice to a particular person and who know what the advice will be used for may be held liable to that person in the tort of negligence if the advice proves to be incorrect and was carelessly prepared
  - A I only
  - B I and II only
  - C I and III only
  - D II and III only

- 6 James negligently drove his car down a busy high street and hit Sally, who was badly injured. Sally suffers from a rare disease which means that her body takes twice as long to repair itself as a normal person's and because of this she could not work for eight months. As a highly paid city banker she claimed compensation for loss of earnings of \$120 000 which is the equivalent of eight month's salary.
- A normal person would have returned to work after four months. James thinks Sally's claim is excessive, what is the legal position?
- A James is only liable for 'normal damages', in this case loss of earnings for four months calculated on the basis of an average person's earnings
  - B James is only liable for 'foreseeable damages', in this case loss of earnings for four months calculated on the basis of Sally's actual earnings
  - C James is liable for the total of Sally's claim of \$120 000 as you must 'take your victim as you find them'
  - D James is not liable for loss of earnings as this is an example of 'financial loss' which is not claimable under the tort of negligence
- 7 Which of the following statements concerning the tort of negligence is *not* correct?
- A the standard of care expected is that of a reasonable person
  - B the same level of care is expected of adults and children
  - C the plaintiff must demonstrate 'sufficient proximity' existed between themselves and the defendant
  - D where the risk of injury or loss is great, the standard of care increases in proportion
- 8 Are the following statements true or false?
- The measure of damages in contract is such amount as would restore the party to the position he was in before the breach of contract.
- A true
  - B false
- The measure of damages in tort is such amount as would put the party in the position he would have been in, if the tort had not been committed.
- C true
  - D false
- 9 Which of the following statements is *not* true?
- A if the defendant succeeds in arguing *res ipsa loquitur*, the burden of proof is then on the plaintiff to show negligence
  - B in arguing *res ipsa loquitur*, it must be shown that the thing that caused the damage was under the management and control of the defendant
  - C *res ipsa loquitur* is relevant where the reason for the damage is not known
  - D whether a breach of the duty of care has occurred is a matter of fact
- 10 Anton is learning to drive with his father, when he mistakenly goes into reverse gear instead of first gear, and hits a pedestrian on the road behind him. Although he is moving very slowly, the elderly and frail pedestrian suffers bruising, but also a heart attack induced by the shock. She dies within minutes.
- Which of the following best describes the legal position?
- A the standard of care owed by Anton is that of a reasonable learner driver and the fact that she is especially vulnerable is irrelevant
  - B the standard of care owed is that of a reasonable driver and it is irrelevant that she was especially vulnerable
  - C the standard of care owed is that of a reasonable learner driver but the fact that she was especially vulnerable means that a higher standard will be applied
  - D the standard of care owed is that of a reasonable driver but the fact that she was especially vulnerable means that a higher standard will be applied.



## Chapter 9

- 1 Which of the following is not a feature of limited liability?
  - A the company is liable without limit for its own debts
  - B the company's ability to issue debenture stock is limited to the total amount of its share capital
  - C the members may be required to contribute the amount outstanding on their shares if the company becomes insolvent
  - D the members may be required to contribute an amount of money if the company becomes insolvent
- 2 What is the minimum paid up share capital of an Australian proprietary (private) limited company?
  - A there is no limit set
  - B \$25 000
  - C \$100 000
  - D \$50 000
- 3 Which one of the following would not make the agent solely liable for a contract?
  - A it is trade custom for the agent to be solely liable
  - B the agent intended to undertake personal liability
  - C the agent is acting on their own behalf even though they purport to be acting for a principal
  - D the agent did not disclose they were acting for the principal
- 4 In which of the following situations would a contract made by an agent not be binding on the principal?
  - I The principal has given the agent express authority to form the particular contract
  - II The actions of the agent are consistent with what is customary in the circumstances
  - III The principal 'holds out' to a third party that the agent has unlimited authority to contract even though this is not contained in the agency agreement and exceeds what is unusual or customary in the circumstances
  - IV The principal has revoked the authority of the agent to make contracts but has failed to communicate this to third parties that they had previously dealt with
  - A IV only
  - B II and III only
  - C III and IV only
  - D none of the above
- 5 Which of the following most accurately describes the role of an agent?
  - A agents have a contractual relationship between themselves and the principal in which their function is to seek a third party for the principal to contract with
  - B agents have a relationship between themselves and a third party in which the function of the agent is to form a contract between the third party and a principal
  - C agents have a relationship between themselves and a principal in which their function is to form a contract with a third party on behalf of the principal
  - D agents have a relationship between themselves and a principal in which the function of the agent is to form a contract between the principal and a third party

- 6 Which three of the following statements are *correct*?
- A proprietary (private) company limited by shares:
- A cannot offer its shares to the public
  - B cannot allow its shareholders to offer their shares direct to the public
  - C must have a minimum of two members, otherwise the sole member may become personally liable for the debts of the company
  - D cannot be registered with a name which is the same as that of an existing registered company
  - E must have at least two directors
- 7 Tom has transferred his business to Tom Pty Ltd, a proprietary company limited by shares. Broadly, and applying the principle of separate legal identity, which of the following statements is *correct*?
- A Tom Pty Ltd is fully liable for all debts and liabilities of the business incurred after the date of transfer
  - B Tom as an individual is fully liable for all debts and liabilities of the business incurred after the date of transfer
  - C Tom as an individual and Tom Pty Ltd are jointly liable for all debts and liabilities of the business incurred after the date of transfer
  - D Tom Pty Ltd and its members as individuals are fully liable for all debts and liabilities incurred after the date of transfer
- 8 The case of *Salomon v Salomon 1897 AC 22 (UK)* confirmed which important principle of company law?
- A a company and its members are separate legal persons
  - B a director cannot take a decision to employ himself and later make a claim against the company as an employee
  - C when a company is wound up, directors who knowingly carried on the business with intent to defraud creditors may be made personally liable for the company's liabilities
  - D the sale of a business to a company owned by the vendor of the business will be a legal nullity if the sale made no change in the business's commercial position
- 9 Which of the following is *not* a situation in which the court will 'lift the veil of incorporation'?
- A where the members or managers are using the veil to evade their legal obligations
  - B where the directors are in breach of the regulations governing the giving of financial assistance for the purchase of the company's own shares
  - C where the true nationality of the company is being concealed
  - D where it is suspected that the company is controlled by enemy aliens during wartime
- 10 Q Co is a company limited by shares. On winding up, the members of Q Co are liable for:
- A the amount they paid for their shares
  - B the amount they have not yet paid for their shares
  - C the amount of dividend they have received from the company over time
  - D the amount of the company's debts

## Chapter 10

- 1 Which of the following persons are not contractually bound to one another by the constitution?
  - A members to company
  - B company to unrelated third parties
  - C members to members
  - D company to members
- 2 Can companies be formed with a single member?
  - A no
  - B yes, if either a public or proprietary (private) company
  - C yes, if it's a proprietary (private) company only
  - D yes, if it's a public company only
- 3 If a contract is entered into by promoters before the incorporation of a company, which of the following is incorrect?
  - A the company may ratify the contract as soon as it receives its certificate of registration.
  - B subject to agreement to the contrary, the promoters may be held personally liable on the contract.
  - C the company cannot enforce the contract prior to its incorporation.
  - D the company cannot be held liable even if it has adopted the contract after receiving its certificate of registration.
- 4 Which document must be submitted to register a proprietary company in Australia?
  - A a memorandum of association
  - B articles of association
  - C a statement of the first directors and secretary
  - D Form 201
  - E a register of members
- 5 How can a promoter ensure that the expenses he or she incurs in setting up a company will be recoverable?
  - A by making it clear in all transactions that he or she is acting as agent for the company
  - B by entering into a contract with the company after its incorporation for reimbursement of expenses by the company
  - C he or she has no automatic right but by drafting the articles of the company, he or she can provide for the reimbursement of expenses
  - D by the promoter declaring in all transactions that he or she is a trustee for the company
- 6 In Paul Co's articles there is a clause stating that Fred should act as solicitor to the company for life. A number of members are unhappy with Fred's performance and have sufficient votes to change the articles to remove him from office. Are they able to do this?
  - A yes, and Fred has no recourse against the company
  - B yes, but Fred can sue the company for breach of contract
  - C no, because the articles cannot be changed for this reason
  - D no, because the articles cannot be changed to override the contract with Fred

- 7 Paul, a promoter, is in the process of incorporating Vendor Co, and has ordered goods to be used by the company. He has signed the order form 'Paul, for and on behalf of Vendor Co'. Who is liable if the goods are not paid for?
- A Vendor Co
  - B Paul
  - C Paul and Vendor Co jointly
  - D Neither Paul nor Vendor Co as there is no contract
- 8 Y Co's promoter has made a wrongful profit on a contract related to setting up the company. What is Y Co's remedy?
- A both rescission of the contract and recovery of the profit
  - B rescission of the contract only
  - C recovery of the profit only
  - D damages in tort

## Chapter 11

- 1 There are generally adopted rules on the retirement and re-election of directors. These include which of the following?
  - I Every year half (or the nearest number thereto) shall retire
  - II Directors appointed during the year or those retiring and not seeking re-election are not subject to retirement by rotation and are excluded from the reckoning of the one half figure
  - III Those retiring shall be those in office longest since their last election
  - IV Retiring directors are eligible for re-election
  - V A co-opted director must stand for re-election at each AGM after this appointment
  - A I, II and V only
  - B I, III and IV only
  - C II, III and IV only
  - D I, II, III and IV only
- 2 Which of the following is not a role of a company director?
  - A to make major policy decisions of the company such as changing the company's name, restricting the objects of the company and to ratifying amendments to the rights which attach to classes of share
  - B to carry out the day-to-day management of the company
  - C to exercise properly the powers of the company
  - D to attend and take part in board meetings of the company
- 3 A managing director of a company has apparent authority to bind the company by their acts. Which of the following represents the full limit of this authority?
  - A such commercial activities as are delegated to them by the board of directors
  - B all activities of the company whether commercial or not
  - C such commercial activities as are directed by the company in a general meeting
  - D all business matters relating to the running of the business
- 4 Which of the following is *incorrect*?
  - A directors are agents of a company
  - B if the board of directors exceeds its powers, the company cannot be held liable on a contract with a third party
  - C individual directors cannot contract on behalf of the company unless authorised by the company
  - D the board of directors may delegate authority to a managing director who may contract on behalf of the company
- 5 In relation to the company secretary, which of the following is *correct*?
  - A a company secretary of a proprietary (private) or public company is not required to be appropriately qualified
  - B a public company need not appoint a person to be company secretary
  - C a company secretary cannot bind the company in contract
  - D a company secretary cannot bind the company in contract if acting outside their actual or apparent authority

- 6 Sophia is a director of a company which has just failed to win a valuable contract. She persuades the company to release her from her service agreement on the grounds of ill-health. Now that she is no longer a director, she feels free to attempt to obtain the contract for herself, which she successfully does. Is she accountable for this profit when the company sues her?
- A no, since the company chose to release her from her service agreement and therefore from her obligations to it
  - B no, since she is no longer a director and therefore no longer owes any duty
  - C no, since the company could not have obtained the contract anyway and therefore lost nothing
  - D yes, she is accountable in this situation
- 7 A sale to a company of property owned by one of its directors is disclosable in its accounts. What are the consequences of non-disclosure assuming the transaction has been properly disclosed elsewhere?
- A the sale of the property is voidable by the company
  - B the director will hold any proceeds on constructive trust for the company
  - C the auditors must refuse to approve the accounts and resign
  - D the auditors must include details of the transaction in their report to members

## Chapter 12

- 1 Which one of the following percentage of votes is required to successfully pass a special resolution?
  - A 10% of all members entitled to vote (or their proxy)
  - B 25% of all members entitled to vote (or their proxy)
  - C 50% of all members entitled to vote (or their proxy)
  - D 75% of all members entitled to vote (or their proxy)
- 2 Which three of the following methods can be employed by the members to control the board of directors?
  - A give specific instructions to the directors in general meeting
  - B appoint directors
  - C alter the constitution to re-allocate powers to general meetings
  - D remove directors from office
  - E exercise the directors' powers in general meeting
- 3 The right of a member to appoint a proxy is:
  - A conferred by the articles
  - B at the board's discretion
  - C statutory
  - D at the chairman's discretion
- 4 What is the minimum period of notice for an AGM in Australia?
  - A 14 days
  - B 28 days
  - C 21 days
  - D 1 calendar month
- 5 A company in a general meeting makes an illegal decision. Application to the court for a declaration that the decision is void may be made by:
  - A any member
  - B members holding a minimum of 5% of the voting rights
  - C members holding a minimum of 10% of the voting rights
  - D members holding a minimum of 5% of the voting rights on shares of which an average of \$2000 has been paid up
- 6 If a public company pays a dividend other than out of distributable profits, who may be involved in making good the unlawful distribution?
  - A the company only
  - B the company and directors only
  - C the directors, company and members
  - D the directors and members only
- 7 Which of the following *cannot* be achieved by ordinary resolution?
  - A the approval of company accounts
  - B the dismissal of a director
  - C an alteration of a company's articles of association
  - D the dismissal of an auditor

- 8 Which of the following statements regarding general meetings is **incorrect**?
- A the directors have power under the articles to convene a general meeting whenever they see fit
  - B where the members requisition the directors to call a general meeting, a signed requisition must be deposited at the registered office by the requisitioners stating the objects of the meeting
  - C where the members requisition the directors to call a general meeting, the notice for an unlisted company must give at least 28 days' notice
  - D if there is no quorum at a general meeting requisitioned by the members, the meeting is adjourned
- 9 The directors of a company allot 100 000 unissued shares to a third party, in order to thwart a takeover bid. A general meeting is called one month later, at which an ordinary resolution is passed, with the support of the votes of the newly-issued shares, ratifying the allotment. A group of minority shareholders challenge the validity of the ratification. What is the position?
- A the ratification is valid
  - B the ratification is invalid, but only because a special resolution is required, not an ordinary one
  - C the ratification is invalid but only because the holder of the new shares should have been excluded from voting
  - D the ratification is invalid, but only because the general meeting was called outside the required period after the allotment



## Chapter 13

- 1 Before making an administration order the court must be satisfied not only that the company is (or likely to become) unable to pay its debts, but also that the order is likely to achieve at least one of the various objectives.

Which three of the following objectives would be sufficient for that purpose?

- A the prevention of unemployment among the workforce
- B to achieve better results for creditors than an immediate winding-up
- C the survival of the company as a going concern
- D the more advantageous realisation of assets than in a liquidation
- E a speedier resolution than under a winding up

- 2 Which three of the following statements are accurate descriptions of what is meant by the liquidation of a company?

- A all the company's assets are realised
- B the members will receive nothing
- C the company's debts are paid out of the assets
- D the company is dissolved and will no longer exist
- E the directors are liable for unpaid debts of the company

- 3 Which three of the following terms described the different types of winding up which are possible?

- A members' voluntary winding up
- B creditors' voluntary winding up
- C directors' voluntary winding up
- D automatic liquidation
- E compulsory liquidation

- 4 In a distribution following liquidation, in which order of preference are payments made?

- A 1 Fixed chargeholders, 2 Floating chargeholders, 3 Unsecured creditors, 4 Preferential creditors, 5 Ordinary members
- B 1 Fixed chargeholders, 2 Preferential creditors, 3 Floating chargeholders, 4 Unsecured creditors, 5 Ordinary members
- C 1 Floating chargeholders, 2 Fixed chargeholders, 3 Preferential creditors, 4 Unsecured creditors, 5 Ordinary members
- D 1 Ordinary members, 2 Unsecured creditors, 3 Floating chargeholders, 4 Preferential creditors, 5 Fixed chargeholders

- 5 The aim of administration is described by way of a primary objective and, in the event that the primary objective is not reasonably practicable, a secondary objective, and in the event that this is also not reasonably practicable, an application for an administration will only be successful where a third objective is likely to be satisfied. These *three* objectives are as follows:

- I To realise the company's assets to make a distribution to one or more preferential or secured creditors, without unnecessarily harming the interests of the creditors as a whole
- II To rescue the company in whole or in part as a going concern
- III To achieve a better result for the company's creditors as a whole, than would be likely if the company were wound-up without first going into administration

In which order are these stated (so that the primary objective is first, followed by the second and third objectives)?

- A I, III, II
- B II, I, III
- C II, III, I
- D III, II, I

- 6 What is the primary role of a receiver?
- A to rescue the company as a going concern
  - B to realise the charged assets and pay off the appointing chargeholder's debt
  - C to pay off creditors with preferential rights
  - D to manage the company pending the appointment of an administrator or liquidator
- 7 With regard to a members' voluntary winding up of a company:
- The declaration of solvency should be made by:
- A the directors, acting unanimously
  - B a majority of the directors
  - C the liquidator
  - D a majority of the shareholders
- 8 The members of Recycle Co resolve to wind up the company. Since it is not possible to make a declaration of solvency, a creditors' meeting is called. At that meeting, who may appoint a liquidator?
- I The members
  - II The creditors
- A I only
  - B II only
  - C both I and II
  - D neither I nor II
- 9 On a compulsory winding up of a company, who will the court usually appoint?
- A the secured creditor owed the greatest amount of money by the company
  - B the auditor of the company
  - C the official receiver/liquidator
  - D a qualified insolvency practitioner
- 10 In distributing a company's assets in a compulsory winding up, in which order will the following receive any payments due to them?
- I Creditors whose debts are secured by floating charges
  - II Members
  - III Employees who are owed accrued holiday pay
- A I, II, III
  - B II, III, I
  - C III, I, II
  - D III, II, I



# Answers to revision questions



## Chapter 1

- 1 B A common law system. The common law is named after the historic system developed in the UK. Civil law (A) and Sharia law (D) systems are different types of system found in other countries. The criminal law system (C) is part of the legal system in any country, dealing with offences against the state rather than relations between persons.
- 2 B National law and written constitutions together are known as positive law.
- 3 A Public international law (B) reflects the interrelationships between sovereign states, while private international law (D) regulates how entities in different states may deal with each other. National law (A) regulates how entities relate to each other and to the state. Positive law (C) includes as well the country's written constitution.
- 4 A,C In a civil system of law we see a plaintiff and a defendant (C) and the lighter burden of proof (A – on the balance of probabilities). In a criminal system we see the prosecution and the accused (D), with a higher burden of proof (B – beyond reasonable doubt). A conviction leads to punishment (E).
- 5 B While administrative regulations (C) and the constitution (D) in particular are important sources of law in France, codified statute (B) is the key source. Custom (A) is a minor source of law.
- 6 B The Quran(A), plus the Sunnah (C), are the main sources of Sharia law. Imam (D) are judges; the Madhab (B) are secondary sources of law.
- 7 D The law is there as a mechanism to sort out problems as they arise in a democratic system, whereas in more dictatorial political systems the law is there to enforce and support the political system.
- 8 C There is a stronger emphasis on the restrictive rule of law in a dictatorial political system (C). Both *laissez faire* (A) and democratic (B) systems have a rule of law with a lighter touch; a market system (D) is an economic rather than a political system, but is probably more likely to have a *laissez faire* i.e. a lighter touch for the law.
- 9 B Separation of powers refers to the degree of separation and the balance of power between the three main political organs: the judiciary, the executive and the legislature. It can also refer to the degree of separation and the balance of power between the head of state and the head of the executive. It does not refer to the balance between the head of state and the head of the judiciary only, nor between the heads of the executive and legislature only. Finally, note that the police are part of the legal system, not the political system.

## Chapter 2

- 1 C For a precedent to be applied it must have formed part of the *ratio decidendi* of the earlier case, i.e. the reasons for the case being decided in the way it was, not the *obiter dicta* (things said in passing). The decision must have been a question of law rather than fact, but the facts of the two cases must be substantially the same. The earlier court needs to have superior or sometimes equal status to the current court.
- 2 A The presumptions of statutory interpretation relate to what the statute as a whole is intended to achieve, and what it is not intended to achieve, while the rules of statutory interpretation relate to how the particular words in a statute should be interpreted. Thus it is a presumption that a statute does not aim to deprive a person of his property. It is a rule that words in a statute should be given the plain, ordinary meaning; if a statute states it relates to cars it does not automatically extend to motorbikes; words in a statute should be construed in their context.
- 3 B That a statute relating to offices does not automatically extend to hotels is the application of the *expressio unius est exclusio alterius* rule. Compensation for deprivation of assets, clear expression of a person losing his liberty, and a guilty intention in criminal liability are all presumptions of statutory interpretation, which may be rebutted.
- 4 A Under this approach the words of a statute should be interpreted with reference to the context and purpose of legislation, ie what the legislation is trying to achieve.
- 5 C '*Stare decisis*' means to stand by a decision, which denotes consistency in applying the law and hence the foundation of precedent.
- 6 D When an earlier case is overruled, the outcome of the earlier judgment remains the same but it will not be followed in future.
- 7 D The earlier court had made its decision without taking into account some essential point of law.
- 8 A Legislation is reviewed by the court and overturned if it conflicts with the country's constitution.
- 9 C Rules of law that are often of a detailed nature and that are made by bodies to whom the power to do so has been given by statute are called subordination legislation.
- 10 B Anything that does not actually form part of the Act but that is set out in the document containing the text of the Act as printed by the Government Printer.

## Chapter 3

- 1 D A summary *offence* is clearly a criminal case, and unlike indictable offences, summary offences tend to be tried by lower courts e.g. Magistrates' courts.
- 2 C The superior court in Australia, in both the federal and the state/territory systems, is the High Court of Australia.
- 3 B Court-based adjudication is often more expensive and slower, but it does generally have the advantage of offering better and more enforceable solutions and remedies.
- 4 A Arbitration involves determination by an independent person selected by the parties themselves.
- 5 C Courts may intervene if it is in the public interest, and there is scope for appeal to the court system.
- 6 D The minimum relationship they must have is one based on trade; it need not be a contractual relationship, but it cannot just be a non-trade relationship such as a family one.
- 7 B Japan has unilaterally recognised the ICJ's compulsory jurisdiction.
- 8 C The highest court of appeal for Singapore is the Court of Appeal which is part of the Supreme Court. Therefore C, Supreme Court is the correct answer.

## Chapter 4

- 1 B Only a clear statement of intention that the offer is intending to be binding if accepted is actually an offer. This must be distinguished from a mere supply of information, a declaration of intent or an invitation to treat.
- 2 C Consideration must be sufficient to qualify as consideration, but it need not be adequate consideration for the promise being made; the law leaves people free to make a bad bargain. It may not be past and it must move from the promisee (the person receiving the promise), not the promisor.
- 3 A A contract for the assignment of a debt is void if it is not in writing and signed by the parties. Contracts of guarantee must be evidenced in writing to be enforceable. There is no requirement for a sub-contracted obligation, or for a sale of goods, to be anything other than oral.
- 4 B A voidable contract is one which one party may choose to set aside.
- 5 B It is not essential for most contracts to be in written form.
- 6 A An offer may only be rejected by the offeree, not the offeror; the latter may revoke his offer but cannot reject it.
- 7 B A revocation is not actioned until received, whereas an acceptance is actioned as soon as it is sent (the postal rule).
- 8 B (I) is not good consideration as it is no more than one would be expected to do in the circumstances. (III) is past consideration.
- 9 A A request for service carries an implied duty to pay. The amount can be fixed later.
- 10 B Revocation of an offer may be communicated by a reliable informant (*Dickinson v Dodds*) but communication of acceptance of an offer may only be made by a person actually authorised to do so: *Powell v Lee*. Hence Neil's brother's purported acceptance for Neil is invalid (Option D), but the lodger's communication of revocation to Neil is valid since his presence at the deal makes him a reliable informant (Option B). Tim's promise to keep the offer open was not supported by a separate option agreement and so he was free to sell before such time as he received acceptance (Option C). Since the offer was expressed to be kept open for a week, there is no question that Neil failed to accept within a reasonable time so that the offer lapsed (Option A).



## Chapter 5

- 1 B Breach of warranty does not cause the contract to be discharged. Terms implied by statute may be conditions.
- 2 B *Poussard v Spiers; Bettini v Gye*. Failure to sing on an opening night breaks a condition of the contract. Missing rehearsals does not.
- 3 C A warranty is a minor term in the contract. Breach of a minor term does not entitle the injured party to repudiate the contract. The injured party must continue with the contract, but may claim damages.
- 4 B The facts in this case are very similar to *Thompson v LMS Railway* where it was held that the conditions of carriage were adequately communicated in the train timetables and the exclusion clause was valid.
- 5 D Most exclusion clauses aim either to restrict liability in the event of breach of contract or to limit the person's obligation to perform some or all of what he took on.
- 6 A A representation is a statement of fact made before a contract is entered into. It is usually incorporated as a contractual term (condition or warranty) but it could still be a representation even if a contract is not ultimately formed. A representation is made with the intention that the other party should place reliance on it. Howard's statement is one of simple fact. It is not an extravagant claim and so cannot be said to be 'advertiser's puff'.
- 7 C Literally this phrase translated means 'against he who is relying'. Anything ambiguous in an exclusion clause is interpreted against the person who is seeking to rely on it. The rules stated in Options A and D are true but do not refer to *contra proferentem*. Option B is now wholly true since in many consumer contracts an exclusion clause is rendered void by statute. In most standard term contracts the person imposing the exclusion clause must show reasonableness in order that a term restricting liability for breach or claiming entitlement to render substantially different or no performance should be binding.
- 8 B Statute can imply a term either by overriding an express term or by providing a term which applies unless overridden. The latter method is also the way in which custom and trade practice imply terms. In order to give 'business efficacy' to an agreement which is only deficit because the parties have failed to provide expressly for something because it was so obvious, the court may also imply terms: *The Moorcock*. But the court will not imply a term to provide for events not anticipated at the time of agreement, (iii), to contradict an express term, (v) nor to remedy a defective agreement.
- 9 C The scenario is similar to *Curtis v Chemical Cleaning Co*, where the plaintiff was misled as to the extent of the exclusion clause. This is an exception to the rule that once a document is signed, the person who signed is bound by any exclusion clauses contained therein.
- 10 B This scenario is similar to *Luna Park (NSW) Ltd v Tramways Advertising Pty Ltd 1938*. This was a breach of a condition of the contract and the contract can therefore be terminated.

## Chapter 6

- 1 A The other statements are all true. Option B was the decision in *Re Vaswani Motors (Sales and Services) Limited*. Option D is true because a contract may subsequently be frustrated.
- 2 D This is not an exception in itself. The exception arises when the promise accepts partial performance.
- 3 C Anticipatory breach or repudiation occurs when one party, expressly or by implication, indicates that he does not intend to be bound by an agreement. The injured party is entitled to sue immediately, though he may elect to allow the contract to continue until there is actual breach: *Hochster v De La Tour*. Because the right to sue is instantaneous, the injured party need not complete his obligations nor wait a reasonable time in order to effect his intentions.
- 4 A The common law remedy of damages is always available for breach of contract. The court will always expect the injured party to mitigate their loss but this is not a remedy. Equitable remedies such as specific performance are discretionary only.
- 5 D Exemplary damages are awarded in tort.
- 6 B Damages are a common law remedy. Option D is incorrect because it actually describes an equitable order of specific performance.
- 7 A The scenario in this question is similar to that in *Hadley v Baxendale*. The loss must have been reasonably foreseeable to the defendant for damages to be awarded.
- 8 B The general rule of privity of contract states that only a person who is party to a contract has enforceable obligations under it. Hence, Options A and C are wrong because F is not a party to the contract and Option D is wrong because Dee is a party to the contract.
- 9 C *Quantum meruit* is a common law remedy.
- 10 A An injunction will not be made merely to restrain acts inconsistent with the contract's obligation.

## Chapter 7

- 1 C,E The UNCISG can never apply to a supply of services. If one party is in a non-contracting state and the national law of that state is chosen by the parties then the CISG does not apply.
- 2 D Although the UNCISG does not apply to goods bought for personal, family or household use, this refers to the use by the buyer; if a consignment of household vacuum cleaners is sold by one trader to another then this is a sale of goods to which UNCISG applies. By contrast auction sales, sales of ships and vessels and sale of electricity can never fall under UNCISG.
- 3 A A sale of goods is a contract by which the seller transfers, or agrees to transfer, the property in goods to a buyer in exchange for monetary compensation, called the price.
- 4 A A contract for the international sale of goods is concluded when acceptance of an offer becomes effective. There is no requirement in UNCISG for a contract to be in writing, or to be evidenced in writing, though if the national laws of contracting states have this requirement then UNCISG can be disapplied in this respect and the state will still be a contracting state.
- 5 B,D,E An offer is a proposal for concluding a contract addressed to one or more specific persons that is sufficiently definite and that indicates the intention of the offeror to be bound by acceptance. The intention to create legal relations is a factor in contract formation under common law. There is no requirement for the bargain to be a reasonable one – *caveat emptor* (let the buyer beware) still applies.
- 6 A The offer becomes effective when it 'reaches' Tori, which first happens when he makes it orally to her: Article 24. All the other methods are also ways of reaching the offeree, but since the oral offer was made first the offer had already reached Tori by the time the other deliveries were made. Note that an offer only needs to be delivered to an habitual residence if there is no business or mailing address.
- 7 A The acceptance becomes effective when it 'reaches' Harold, which first happens when she makes it orally to him: Article 24. All the other methods are also ways of reaching the offeror, but since the oral acceptance was made first the acceptance had already reached Harold by the time the other deliveries were made. Note that an acceptance only needs to be delivered to an habitual residence if there is no business or mailing address.
- 8 D A statement of assent from an offeree which contains modifications to the terms of the offer is a counter-offer. A statement of assent from an offeree cannot be a withdrawal or revocation of an offer, since these relate to the offeror. The fact that there are additions, limitations or other modifications to the terms of the offer means that it is a counter-offer, not an acceptance of the offer.
- 9 D Article 29 states that a contract once formed may be modified by the mere agreement of the parties. It follows that it cannot be modified unilaterally by either buyer or seller. Unless there is a dispute the courts have no role in the contract's terms.
- 10 A,B,C Insurance, carriage costs and customs costs are covered by Incoterms but quality and time of delivery are not; these issues are dealt with in other contract terms, often (though not always) in line with UNCISG.

## Chapter 8

- 1 D The other tests are all applied when establishing whether a duty of care in negligence is owed.
- 2 A Negligence is a tort; bringing a case in tort is quite independent of any case brought in contract. B, C and D describe the three factors that must be established in a negligence case.
- 3 C The most important element is proximity between the parties involved but there must also have been some foreseeable damage. The court must test whether there is sufficient proximity between the parties, such that the harm suffered was reasonably foreseeable.
- 4 A,B,C The person making the statement did so in an expert capacity of which the plaintiff was aware, the context in which the statement was made was such as to make it likely that the plaintiff would rely on it, and in making the statement the defendant foresaw that it would be relied upon by the plaintiff.
- 5 C Auditors do not have a responsibility to the shareholders.
- 6 C This is the 'thin skull rule': you must take your victim as you find them.
- 7 B Children generally owe a lower standard of care than adults.
- 8 B,C Damages in contract are normally calculated to put him in the position he would have been in, had the contract been performed, while the measure of damages in tort is the amount that would put the party in the position he would have been in had the tort not been committed.
- 9 A *Res ipsa loquitur* is an argument by the plaintiff that 'the facts speak for themselves' in pointing to a breach on the part of the defendant. The burden of proof then shifts to the defendant to show that he was not negligent.
- 10 B The defendant's lack of qualification will not be taken into account to reduce the relevant standard of care, which is that of a reasonable (qualified) driver. The fact that the plaintiff is especially vulnerable is only relevant to the standard of care applied, if the defendant is aware of that fact, and such knowledge has the effect of raising the standard of care to be met in discharging the duty of care.

## Chapter 9

- 1 B The company's ability to issue debenture stock is limited to the total amount of its share capital. Companies are liable without limit for their own debts and members may be required to contribute amounts on winding up (companies limited by guarantee) or amounts outstanding on their shares (companies limited by shares).
- 2 A There is no limit set. In the UK, unlike public companies, private companies have no minimum paid up capital. In Australia neither public nor proprietary companies require minimum start-up capital.
- 3 D The agent did not disclose they were acting for the principal. When an agent fails to disclose they are acting for a principal, then they may be jointly liable on the contract. All the other options would leave the agent solely liable on the contract.
- 4 D None of the above
  - I The agent has implied authority to bind the principal.
  - II The principal has given express authority for the contract.
  - III The third party is entitled to rely on the representations of the principal – therefore any contract the agent makes would be binding.
  - IV Failure to notify the revocation to parties whom a principal has had previous dealings with may still create a binding contract.
- 5 D Agents have a relationship between themselves and a principal in which the function of the agent is to form a contract between the principal and a third party. The role of an agent is to form a contract between their principal (with whom they have a contractual relationship) and a third party. Seeking out a third party may be part of the role, but an agent will also negotiate on and conclude the contract.
- 6 A,B,D A private (proprietary) company limited by shares cannot offer its shares or debentures to the public, cannot allow its shareholders to offer their shares direct to the public and cannot be registered with a name which is the same as that of an existing registered company.
- 7 A A company has a separate legal identity: *Salomon v Salomon Ltd*.
- 8 A Option B is untrue; a director can do this. Option C is a true statement, but is governed by the Insolvency Act 1986, not *Salomon's case*. Option D is untrue – this is essentially what Mr Salomon had done, and the transaction was valid.
- 9 B The other options are illustrated by *Gilford Motor Co Ltd v Horne* (Option A) and *Unit Construction Co v Bullock* and *Re F G Films Ltd* (Options C and D).
- 10 B The shareholders are only liable for the amount unpaid, if any, on their shares.

## Chapter 10

- 1 B Company to third party. The company and third parties are not contractually bound to one another by the constitution (S33 CA06).
- 2 B Yes, if either a public or proprietary company. Public and proprietary companies can be formed with one member.
- 3 A A company cannot enforce a contract before it comes into existence (Option C), and cannot ratify a pre-registration contract (Option A). The promoters may be liable (Option B).
- 4 D D only. The Form 101 is the only requirement for an Australian proprietary company.
- 5 B Options A, C and D all relate to the period prior to incorporation, when the company does not exist; therefore he cannot act as agent or trustee, and the articles do not bind the company and third parties. However, statute provides that a third party can be expressly identified in a contract by name even if the third party does not yet exist. This does not feature in the options here, so you must go for one of those that is available.
- 6 A *Eley v Positive Government Security Life Assurance Co*. The articles are a contract between a company and its members in their capacity as members.
- 7 B A company cannot be liable on a pre-incorporation contract as the company does not exist at the time the contract is made.
- 8 A Y Co is entitled to both rescission of the contract and recovery of the profit, though the former may not be possible. Any damages in tort are a separate issue.

## Chapter 11

- 1 D I, II, III and IV only. A co-opted director must stand for re-election at the first AGM after their appointment only.
- 2 A To make major policy decisions of the company such as changing the company's name, restricting the objects of the company and to ratifying amendments to the rights which attach to classes of share. These are functions specifically reserved for the members of the company in general meeting. The roles of the directors are to attend and take part in board meetings, to carry out the day-to-day management functions of the company and to exercise properly the powers of the company.
- 3 D All business matters relating to the running of the business. A managing director has apparent authority to bind the company in all business matters. The apparent authority of a managing director does not extend to all activities of the company. The directors are not agents of the members and cannot be instructed on how they should exercise their powers by members in a general meeting.
- 4 B Where directors exceed their powers the company may be liable on contracts with third parties.
- 5 D A public company secretary is required to have qualifications (by good practice in Australia). Every public company is required to have a company secretary. A company secretary can bind the company in some contracts: *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* but not if they act outside their actual or apparent authority.
- 6 D This is still counted as obtaining a personal advantage through being a director.
- 7 D The transaction is not voidable because there has been sufficient disclosure elsewhere. The auditors have a statutory duty to remedy disclosure deficiencies but need not resign.

## Chapter 12

- 1 D A special resolution must be passed by at least 75% of members entitled to vote (or by proxy). .
- 2 B,C,D Appoint directors; Remove directors from office; Alter the articles to re-allocate powers to general meetings. Because the directors have general management powers the members cannot breach this agreement by instructions or resolutions in general meeting, but must alter the articles first by special resolution. Otherwise, their only ways of controlling the board are by appointing or removing directors.
- 3 C Statutory. It is statutory pursuant to S324 CA06. A proxy is a persona appointed by a shareholder to vote on their behalf.
- 4 B 28 days. At least 28 days' notice must be given for an Australia company.
- 5 A Any member. Application to the court for a declaration that the decision is void may be made by any of the company's members. This is also one to learn (it is not in the course material).
- 6 D The directors and members only. A company's directors and members may all be involved in making good an unlawful distribution.
- 7 C A special resolution is required to alter the articles.
- 8 C The notice required is 21 days for unlisted companies, not 28.
- 9 C If directors use their powers irregularly to allot shares, the votes attached to the new shares may not be used in reaching a decision in general meeting to sanction it: *Howard Smith Ltd v Ampol Petroleum Ltd*.



## Chapter 13

- 1 B,C,D The survival of the company as a going concern; to achieve better results for creditors than an immediate winding-up; the more advantageous realisation of assets than in a liquidation.  
The objectives of an administration order are to try to achieve:
  - The survival of the company as a going concern, or failing that
  - A better result for creditors than an immediate winding-up, or failing that
  - The realisation of property to distribute among the creditors.
- 2 A,C,D The company is dissolved and will no longer exist; All the company's assets are realised; The company's debts are paid out of the assets. The liquidation of a company involves realisation of the company's assets and payment of the company's debts out of the proceeds. The members are entitled to receive any surplus and the directors will not be liable for unpaid debts except in certain situations where they have been guilty of misconduct. On liquidation the company is formally dissolved and therefore will no longer exist.
- 3 A,B,E Creditors' voluntary winding up; Members' voluntary winding up; Compulsory liquidation. The members in general meeting can resolve to wind up the company and this will be known as a members' voluntary winding up if the company can pay its debts; or a creditors' voluntary winding up if it cannot. The other type is a compulsory liquidation, ordered by the court on a petition. The terms 'directors' voluntary winding up' and 'automatic liquidation' are meaningless.
- 4 B The correct answer is: 1 Fixed chargeholders, 2 Preferential creditors, 3 Floating chargeholders, 4 Unsecured creditors, 5 Ordinary shareholders. Although floating chargeholders are paid in preference to unsecured creditors, this is subject to a ring-fenced amount that is preserved for the unsecured creditors. Preferential creditors relate to wages only, not taxation.
- 5 C The primary purpose of administration is to rescue the company as a going concern, if at all possible.
- 6 B A receiver is typically appointed by a creditor with a fixed charge over property owned by the company.
- 7 B Provided there are two or more directors, the declaration of solvency can be made by a majority of directors.
- 8 C If the appointments made are different, the creditors' appointment prevails. If the creditors do not make an appointment, the members' appointment stands.
- 9 C The official receiver/liquidator is usually appointed, although he may be replaced by a qualified insolvency practitioner at a later date.
- 10 C Accrued holiday pay is a preferential debt, payable second after the costs of liquidation, and it is followed by payment of debts secured by floating charges (subject to the ring-fencing provisions). Members may receive a share of any surplus in the event that the company can, in fact, satisfy all its debts.





# Before you begin

Answers and commentary

# Chapter 1

- 1 The laws of the country and the mechanisms the country has in place for regulating and enforcing the laws.
- 2 Civil law is based on set codes developed through statutes and legislation, common law is based on case law / precedent and legislation.  
There is no recognition of case law or common law in a civil law system.  
Civil law developed from Roman law and common law from English law over time.  
The role of judges is different. Common law judges help to create law through development of precedent; while in civil law judges only apply the law (they do not create it through precedent).
- 3 Federalism is a system of government that has one central government to deal with matters pertaining to the whole nation, as well as state governments to deal with matters pertaining to the states which make up the federation of states.
- 4 This is where power is held in different places so that each arm does not hold too much individual power. Power is generally split between the legislature, the executive and the judiciary.
- 5 Public international law is the system of law regulating the interrelationship of sovereign states and their rights and duties with regard to one another. Private international law regulates cases where there is a conflict of national laws.
- 6 When parties of different nations have a legal dispute this is a conflict of law, and it is necessary to determine which set of national laws best applies. International law governs the conflict of laws between nations.
- 7 Criminal law is conduct prohibited by the law of the sovereign state and tried in the criminal court system. It is punishable by the State.  
Civil law is law governing disputes between private individuals.
- 8 Equity operates to establish the truth of the matter and impose a just solution with no regard to technicalities or procedure.  
Works in co-operation with common law, is made by judges and operates through the same courts.
- 9 The main principle of Sharia law is that it is the divine way ordained for man to follow by Allah. The law, therefore, is sourced directly from Allah and this has a significant impact on how it is interpreted by judges.
- 10 Judges interpret the law, they do not change it. They do have the power of judicial review and of further legal interpretation (Figh).

## Chapter 2

- 1 Binding precedent is where a judge is bound to apply a decision from an earlier case to a later case if there is no material difference between the cases.  
Persuasive precedent can be, but does not have to be, followed in a later case.
- 2 To 'stand by a decision'.
- 3 The core components of a law report are:
  - Name of the plaintiff/claimant or appellant,
  - Name of the defendant or respondent,
  - Court details,
  - Names of the judges,
  - Hearing and judgment dates,
  - Catchwords: this area consists of phrases or keywords that describe the subject matter and legal issues of the case. There is usually a reference to legislation referred to,
  - Headnotes: a summary of the case and decision along with cases cited in the judgment
  - Reasons for judgment, and
  - Orders.
- 4 'The *ratio decidendi* of a case is any rule of law expressly or impliedly treated by the judge as a necessary step in reaching his conclusion, having regard to the line of reasoning adopted by him, or a necessary part of his direction to the jury.'  
*Obiter dicta* are words in a judgment which are said 'by the way'. They do not form part of the *ratio decidendi* and are not binding on future cases, but they may be persuasive.
- 5 Common types of legislation:  
Public acts, private acts and enabling legislation.
- 6 Subordinate legislation are rules of law, often of a detailed nature, that are made by subordinate bodies to whom the power to do so has been given by statute.
- 7 Under the purposive model to statutory interpretation, the words of a statute are interpreted not only in their ordinary, literal and grammatical sense, but also with reference to the context and purpose of the legislation.
- 8 *Eiusdem generis*, *noscitur a sociis* and *in pari materia*

## Chapter 3

- 1 The High Court (full) is the highest appeal court. Next in the hierarchy is the High Court (partial), followed by the Federal Court of Australia. The Family Court is a separate Federal Court but is on the same level as the Federal Court. The Federal Magistrates Court hears lower level Federal and Family Court cases.
- 2 Key courts in the UK civil system are the County Court, which only has civil jurisdiction and which deals with almost every type of civil case at a local level. The High Court, which deals with the most major cases at first instance and is sometimes a court of appeal from the County Court. The Court of Appeal, which is the major appeal court in civil matters.  
  
Key courts in the UK criminal system are Magistrates' Court, Crown Court and the Court of Appeal. The Crown Court hears cases at first instance and is an appeal court from the Magistrates' Court. Cases are appealed from the Crown Court to the Court of Appeal.
- 3 Malaysia has one court system for civil and criminal matters, and for state and federal laws. The subordinate courts are the Magistrates Court, the Sessions Court and the Court for Children. Penghulu Courts are the courts for each Malay village head and they run separately to this court system. They can appeal to the Magistrates Court. The superior courts are the High Court, then the Court of Appeal with the highest court being the Federal Court. The Syariah Court which governs on Sharia law runs outside of this court hierarchy and has limited power and jurisdiction.
- 4 Two disadvantages of court-based adjudication.
  - More expensive than alternative dispute resolution.
  - Can be very slow and a long waiting period before case comes to trial.
- 5 Alternative dispute resolution is any type of procedure or combination of procedures voluntarily used to resolve differences, other than court-based adjudication. ADR procedures may include, but are not limited to, conciliation, facilitation, mediation, early neutral evaluation, adjudication, and arbitration.
- 6 Arbitration is settlement of a dispute or 'determination' by an independent person, usually chosen by the parties themselves.
- 7 The International Court of Arbitration (ICA) is a body that is composed of members from every continent in the world. It has been instrumental in developing the use of international commercial arbitration, which is a useful tool for settling international commercial disputes when parties trade in states where the legal system is very different from their own and legal decisions may not seem fair. The ICA oversees all aspects of the arbitration process, such as appointment of arbitrators, deciding on challenges to arbitrators, approving arbitral awards and fixing arbitrators' fees.
- 8 The ICJ is the International Court of Justice. Countries which recognise its jurisdiction are Australia, UK, Canada, India and Japan.

## Chapter 4

- 1 A legally valid contract is a legally binding agreement, formed by the mutual consent of two parties.
- 2 The three essential elements of a valid contract are:  
Offer and acceptance, consideration and intention to create legal relations.
- 3 If the contract is:
  - By deed.
  - Transfer of shares in a company.
  - A cheque.
  - A sale of disposal of an interest in land.
- 4 An express or implied statement of the terms on which the maker is prepared to be contractually bound if it is accepted unconditionally. The offer may be made to one person, to a class of persons or to the world at large, and only the person or one of the persons to whom it is made may accept it.
- 5 It is generally considered an attempt to induce an offer to contract, it is not a contract in itself.
- 6 Two of the following:
  - Express words.
  - Action.
  - Inferred by conduct.
- 7 Where the offeror (expressly or by implication) indicates that acceptance is expected through letter in the post.
- 8 Valid consideration may be **executed** (an act in return for a promise) or **executory** (a promise in return for a promise). It may not be **past**, unless one of three recognised exceptions applies.
- 9 Consideration is sufficient if it has identifiable value.
- 10 'An agreement will only become a legally binding contract if the parties intend this to be so. This will be strongly presumed in the case of business agreements but not presumed if the agreement is of a friendly, social or domestic nature.'

## Chapter 5

- 1 A term that is clearly agreed to by the parties to a contract to be a term of that contract. In examining a contract, the courts will look first at the terms expressly agreed by the parties.
- 2 A term deemed to form part of a contract even though not expressly mentioned by the parties.
- 3 Yes, they can. The statute may permit parties to the contract to contract out the statutory terms or the statute terms will be obligatory.
- 4 A condition is a vital term that is at the root of the contract and its breach will destroy the agreement.
- 5 A warranty is a term subsidiary or minor to the contract. Its breach does not void the contract but damages may be applicable.
- 6 General hostility to exclusion clauses and they use case law to restrain their effect.
- 7 Where courts can interpret any ambiguity against the person who relies on an exclusion in a contract.



## Chapter 6

- 1 Agreement, frustration, performance and breach.
- 2 A party is in breach when, without a lawful excuse, he does not perform his contractual obligations.
- 3 The four types of repudiatory breach are:
  - Refusal to perform (renunciation).
  - Failure to perform an entire obligation.
  - Incapacitation.
  - Breach of contract condition.
- 4 An anticipatory breach is where one party declares in advance that he will not perform his part of the contract when it is time for the contract to be performed. It is recognised when the person breaking the contract declares in advance they will not perform it or by some other action which makes future action impossible.
- 5 The two components of the remoteness of damage rule.
- 6 No, damages should be paid in order to compensate the injured party for the loss incurred and to put the injured party back in the same position they would have been in if the breach had not occurred.
- 7 Liquidated damages are a fixed sum agreed by parties to a contract and payable in the event of a breach.
- 8 A claim which is available as an alternative to damages. The injured party in a breach of contract may claim the value of his work. This is to restore the plaintiff to the position he would have been in had the contract never been made.
- 9 Specific performance, injunction and rescission.

## Chapter 7

- 1 UN Convention on Contracts for the International Sale of Goods
- 2 An **offer** is a proposal for concluding a contract addressed to one or more specific persons that is sufficiently definite and that indicates the intention of the offeror to be bound by acceptance: Article 14. An offer is **sufficiently definite** when:
  - It indicates the goods in question, and
  - It makes provisions for price and quantity of the goods.
- 3 A counter-offer is a reply to an offer which purports to be acceptance but which contains additions, limitations or other modifications to the terms of the offer.
- 4 The key obligations of the seller relate to **delivery** and **quality**.
- 5 Three specific rights of the buyer under the Convention:
  1. Article 46: Right to require performance.
  2. Article 49: Right to declare the contract avoided.
  3. Article 50: Right to reduce price in relation to non-conformity of goods.
- 6 The buyer has obligations in respect of taking delivery of the goods and making payment.
- 7 An injured party is always entitled to claim damages under the Convention, regardless of any other remedy sought or obtained, though he is required to mitigate, or seek to limit, the extent of his loss made. The amount of damages may not be greater than the loss which the party in breach foresaw, or should have foreseen, at the time of the contract being formed, in the light of known facts then. An injured party to take reasonable measures to mitigate the loss, including loss of profit, resulting from the breach.
- 8 Incoterms (international contract terms) are standard trade definitions used in international sales contracts. They cover issues to do with carriage, insurance, risk, customs documentation and duties / taxes.
- 9 Choose three of the following: EXW, FCA, FAS, FOB, CFR, CIF, CPT, CIP, DAT, DAP, DDP.

## Chapter 8

- 1 A tort is a civil wrong and the person wronged will make a civil claim for compensation or an injunction. The plaintiff's claim generally is that he has suffered a loss such as personal injury at the hands of the defendant, and the defendant should pay damages.
- 2 Choose three of the following:
  - Trespass to land.
  - Nuisance.
  - Trespass to the person.
  - Defamation.
  - Deceit, injurious falsehood and passing-off.
  - Negligence.
- 3 Causing loss by a failure to take reasonable care when there is a duty to do so.
- 4 A plaintiff must prove three factors to effectively succeed in a tort of negligence. These three factors are:
  1. The defendant had a duty of care to avoid causing injury, damage or loss.
  2. There was a breach of that duty by the defendant.
  3. *In consequence* the plaintiff suffered injury, damage or loss.
- 5 In the landmark case of *Donoghue v Stevenson 1932* (where a snail was found in a bottle of ginger beer) the UK House of Lords ruled that a person might owe a duty of care to another with whom he had no contractual relationship at all. The doctrine has been refined in subsequent rulings, but the principle is unchanged.
- 6 The plaintiff must demonstrate the following to rely on this principle:
  1. The thing which caused the injury was under the management and control of the defendant.
  2. The accident was such as would not occur if those in control used proper care.
- 7 Contributory negligence means the court may **reduce** the amount of damages paid to the plaintiff if the defendant establishes that they **contributed** to their own **injury** or **loss**. If the defendant proves that the plaintiff 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 **plaintiff'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%.
- 8 Through consumer protection legislation namely the *Consumer and Competition Act 2010* which introduced the Australian Consumer Law. Australian Consumer Law is the national law enacted by the State, territory, and federal Australian governments ensuring a unified approach to consumer protection law.

## Chapter 9

- 1 This 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 **Unlimited liability:** Members do not have limited liability and in the event of liquidation members are required to contribute as much as needed to repay the company's debt in full.  
**Limited liability:** Limitation of the liability of members to contribute to the assets of a business in the event of a winding up.  
**Public company:** A company registered as such under the Companies Act UK or Corporations Act Australia. The principal distinction between public and private/proprietary companies is that only the former may offer shares to the public.  
**Proprietary company:** A company which may not offer shares to the public, and which has not been registered as a public company. Termed a private company in UK law.
- 3 Three of the following:
  - (a) Capital requirements (UK only).
  - (b) Dealings and issuing shares.
  - (c) Account keeping.
  - (d) Commencement of business (UK only).
  - (e) General meetings.
  - (f) Names and identification.
  - (g) Disclosure requirements.
- 4 The veil of incorporation can be lifted in three ways:
  - (a) By statute to enforce the law.
  - (b) By the court to prevent evasion of obligations.
  - (c) In group situations.
- 5 A small, usually private or proprietary company, where the relationship between the directors is essentially like that of a partnership. The courts have taken into account the existence of such quasi-partnerships when applying the law.
- 6 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 his principal and a third party.
- 7 Yes, where one partner acts as an agent for the other.
- 8 Apparent or ostensible authority usually arises either:
  - (a) Where the principal has represented the agent as having authority even though he has not actually been appointed.
  - (b) Where the principal has revoked the agent's authority but the third party has not received notice.
- 9 Agency theory is present in many company relationships, namely that of the company director and the company promoter. A company director acts as an agent of the company. As agents of the company, company directors are therefore acting to promote the interests of the shareholders of the company and not their own self-interest. A company promoter is acting as an agent in formulating the company structure. One of the core principles of corporate governance is that the existence of agency theory and agency relationships underpins all corporate behaviour.

## Chapter 10

- 1 A company cannot form itself. The person who forms it is called a 'promoter'. 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.
- 2 Choose from two of the following:
  - (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 of their transactions and account for all monies arising from them.
- 3 A pre-registration contract is a contract purported to be made by a company or its agent at a time before the company has been formed.
- 4 Under the common law, the company's promoter as its agent is liable on a contract to which they are deemed to be a party. The agent may also be entitled to enforce the contract against the other party and so they could transfer the right to enforce the contract to the company.
- 5 The steps for registering a proprietary company in Australia are as follows:
  - (a) Complete Form 201 and submit to ASIC.
  - (b) Lodge a written constitution if applicable (not using replaceable rules).
  - (c) Pay the registration fee.
- 6 In Australia, all companies commence operating on the day of registration.
- 7 In the UK, all public companies must have a constitution in place and can use the model articles or their own articles. In Australia, all companies must have a constitution in place unless they are using replaceable rules.
- 8 Replaceable rules are used in Australia instead of, or in conjunction with, the constitution and are derived from sections of the *Corporations Act 2001*. Model articles are issued in the UK as standard template articles that companies can adopt as their own constitution. If no articles are registered then the model articles will apply.
- 9 A company's constitution binds:
  - Members to company,
  - Company to members (but refer below),
  - Members to members, and
  - Company and each director and secretary of the company (Australia).

The company's constitution does not bind the company to third parties.

# Chapter 11

- 1 A **director** is a person who is responsible for the overall direction of the company's affairs. In company law, director means any person occupying the position of director, by whatever name called.  
  
An **auditor** is a person appointed by the company in general meeting to report whether the accounts reflect a true and fair view of the company's affairs.  
  
A **secretary** is an officer of a company appointed to carry out general administrative duties. Every company must have a secretary and a sole director must not also be the secretary.
- 2 The board of directors is the elected representative of the shareholders acting collectively in the management of a company's affairs. The powers which are delegated to the directors under the articles are given to them as a collective body and the board meeting is deemed the proper place for the exercise of the powers.
- 3 A first director is listed on the initial application to register as a company. Once the company can be formed subsequent directors can be added.
- 4 Members have limited power over director remuneration in that they can vote in the AGM on the suggested remuneration, however, this vote is advisory only (but does send a strong signal to the board). Listed companies must publish a remuneration report which outlines each director's remuneration package, the company remuneration policy and the role of the board/remuneration committee in setting remuneration.
- 5 A director can be removed from office by an ordinary resolution at a meeting and can only be removed by members (not by directors).
- 6 The terms of disqualification are very wide and relate mainly to directors who are proved to be negligent in performing their director duties. The articles can also proscribe the automatic disqualification of a director if they are absent from board meetings for a specified period.
- 7
  - 1 The members **appoint** the directors and may **remove** them from office.
  - 2 The members can, by **altering the articles** through a special resolution, re-allocate powers between the board and the general meeting.
  - 3 Articles may allow the members to pass a **special resolution ordering the directors to act, or refrain from acting, in a particular way.**
- 8 A duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflict of interest.
- 9 Select two of the following:
  - (a) Establishing and maintaining the company's statutory registers.
  - (b) Filing accurate returns with relevant authority on time.
  - (c) Organising and minuting company and board meetings.
  - (d) Ensuring that accounting records meet statutory requirements.
  - (e) Ensuring that annual accounts are prepared and filed in accordance with statutory requirements.
  - (f) Monitoring statutory requirements of the company.
  - (g) Signing company documents as may be required by law.

10 Select three of the following:

- (a) **Statutory duty** of auditors is to report to the members whether the accounts give a **true and fair view**.
- (b) **State** whether or not the **directors' report** is **consistent** with the **accounts**.
- (c) For **listed 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 relevant legislation.
- (d) 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.

## Chapter 12

- 1 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 between themselves.
- 2 Shares can be transferred upon the:
  - Sale of some or all of the shares,
  - Death of the member,
  - Permanent mental incapacity of the member, or
  - Bankruptcy of the member.
- 3 The register of members must contain:
  - (a) Name and address.
  - (b) Shareholder class.
  - (c) Number of shares.
  - (d) Date on which each member became and ceased.
  - (e) The registered office of the register.Company members can inspect the member of registers.
- 4 Any member may apply to the court for relief on the grounds that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally or of some part of the members, including at least himself. This means any member can make this petition thereby protecting minority shareholders.
- 5 Under a **derivative claim**, the plaintiff brings an action on behalf of the company to enforce the company's rights or to recover its property. Any benefits received from the claim accrue to the company and not to the member.
- 6 The AGM is held annually and the business of the AGM is generally to receive the annual accounts; receive the director's report, auditor's report and the remuneration report; approve dividends; elect directors and appoint auditors.
- 7

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.

The **directors can also determine that a dividend is payable** and fix the amount, the time of payment and the method of payment.

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 50c paid.

A dividend may be paid **otherwise than in cash**.

**Interest is not payable** on a dividend

- 8
  - 1 The directors are liable if they recommend or declare a dividend which they know is paid out of capital.
  - 2 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 or the liability test can be met.
  - 3 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 member has a right to an **injunction** to restrain a company from paying an unlawful dividend.



## Chapter 13

- 1 Compulsory winding up, members' voluntary winding up and creditors' voluntary winding up.
- 2
  - 1 Declaration of solvency made and delivered
  - 2 Liquidator appointed
  - 3 Liquidator calls a final meeting to lay before it his final accounts
  - 4 Liquidator sends a copy of his accounts to relevant body
  - 5 Relevant body dissolves company three months later.
- 3
  - 1 Directors pass special resolution to begin process
  2. Directors convene meeting of creditors and public notice of meeting
  - 3 Director or creditor appoints liquidator – creditor appointment prevails
  - 4 Normal liquidator procedures begin
- 4
  - 1 Creditor applies to court to commence compulsory winding up.
  - 2 Once the court has been petitioned it appoints a provisional liquidator/official receiver with powers conferred by the court.
  - 3 Official receiver begins investigations.
  - 4 Meeting of contributors and creditors.
  - 5 Receiver reports his findings to the government and can then apply to the Court for company dissolution.
- 5
  - 1 Partnership is dissolved.
  - 2 Partnership assets are realised and proceeds applied in relevant order.
  - 3 If a limited liability partnership is being wound up then the company winding up procedures apply.
- 6
  - 1 Costs.
  - 2 Preferential debt.
  - 3 Debts secured by floating charges, subject to ring-fencing.
  - 4 Unsecured ordinary creditors.
  - 5 Deferred debts.
  - 6 Members.
- 7 A **secured creditor** is a creditor who has registered a charge over the company's assets, which gives the creditor the right to settlement of their debt out of the funds raised by that asset on its sale.  
  
An **unsecured creditor** is one who does not hold a security over the company's assets.  
  
A **receiver** has similar duties and powers to an administrator, but importantly the receiver is only in control of charged assets not the company as a whole, unlike in administration.
- 8 Administration puts an insolvency practitioner in control of the company with a defined program for rescuing the company from insolvency as a going concern.

Legal duties of the administrator

As soon as **reasonably practicable** after appointment he must:

- **Send notice** of appointment to the company the first business day after appointment.
- Convene first creditors' meeting to be held within eight days of appointment.
- Publish notification of first creditors' meeting within three days of appointment with five days' notice in applicable state and territory newspapers.
- Obtain a list of **company creditors** and sent notice of appointment and of the creditors' meeting to each the first business day after appointment.
- Require certain relevant people to provide a **statement of affairs** of the company
- Ensure that every **business document** of the company **bears the identity** of the administrator and a statement that the affairs, business and property of the company are being managed by him.
- Consider the **statements of affairs** submitted to him and set out his **proposals** for achieving the aim of administration. The proposals must be sent to the company's **creditors**, and be made available to **every member of the company** as soon as is reasonably practicable before the second creditors' meeting.
- While preparing their proposals, the administrator must **manage the affairs** of the company.

10 Choose three from the table below:

Advantages of administration

To the company	The company does not necessarily cease to exist at the end of the process, whereas winding up will always result in the company being wound up.
	It provides temporary relief from creditors to allow breathing space to formulate rescue plans.
	It prevents any creditor applying for compulsory winding up.
	It provides for past transactions to be challenged.
To the members	They will continue to have shares in the company which has not been wound up. If the administration is successful, regenerating the business should enhance share value and will restore any income from the business.
To the creditors	Creditors should obtain a return in relation to their past debts from an administration.
	Unsecured creditors will benefit from asset realisations.
	Any creditor may apply to the court for an administration order, while only certain creditors may apply for other forms of relief from debt. For example, the use of receivers or an application for winding up.
	Floating chargeholders may appoint an administrator without reference to the court.
	It may also be in the interests of the creditors to have a continued business relationship with the company once the business has been turned around.



# Glossary of terms



## Glossary of terms

**Acceptance** An unqualified agreement to the terms of the offer.

**Administration** A moratorium is imposed by the court on creditors' actions against the company while an insolvency practitioner attempts to rehabilitate the business or realise the company's assets.

**Administrative receiver** A person defined by statute under a *floating charge* to manage or realise the assets which are the security with a view to paying out of those assets what is due to the debenture holders whom he represents.

**Administrator** A person appointed by the court to carry out an *administration*.

**Agent** A person authorised to act for another (the principal) and bring that other into legal relations with a third party.

**Annual general meeting (AGM)** Every public company is required to hold a meeting of each its members each (calendar) year, at intervals of not more than 15 months, at which it is usual, but not obligatory to transact the 'ordinary business' of the company. Such business may include consideration of the accounts, declaration of a dividend and appointment of auditors.

**Anticipatory breach** Renunciation by party to a contract of his contractual obligations before the date for performance.

**Arbitration** A means of settling a dispute outside the courts.

**Articles of association** Rules governing the internal conduct of a company's affairs, such as appointment, powers and proceedings of directors, alteration of capital structure, dividends and so on.

**ASIC** Australian Securities and Investment Commission

**Auditor** A person appointed by the company in general meeting to report whether the accounts reflect a true and fair view of the company's affairs.

**Business name** A name used by a company other than the registered one.

**Capacity** The ability or power of a person to enter into legal relationships or carry out legal acts.

**Care, duty of** The care owed by one person to another which, if broken, may give rise to an action for negligence.

**Centrebinding** The sale of assets in a winding up to a new company formed by the members of the insolvent company. This is achieved by members appointing a liquidator before the creditors' meeting at which the members can appoint representatives. It is named after *Re Centrebind 1966*.

**Certificate of registration** A certificate issued by ASIC (Australia) on the registration of a company. The certificate is conclusive evidence that the company has been registered and that all the statutory requirements in respect of registration have been complied with.

**Civil law** Law governing disputes between private individuals.

**Civil law system** System of law developed from the Roman empire and used in parts of Europe (France and Germany) and Asia. A feature is codification of law and an inquisitorial system of trial.

**Claimant** The person who complains or brings an action asking the court for relief in the UK (used to be called the plaintiff – still plaintiff in Australia).

**Codification** The replacement of common law rules by statute which embodies those rules.

**Common law** The body of legal rules developed by the common law courts and now embodied in legal decisions.

**Compulsory winding up** A liquidation initiated when a creditor petitions the court.

**Conciliation** The process whereby a third person, called a conciliator, listens to the two parties to a dispute and makes suggestions in an attempt to reach agreement.

**Condition** Term which is vital to a contract. Breach of a condition destroys the basis of the contract which is itself then breached.

**Consideration** Consists either in some right, interest, profit or benefit accruing to one party contract, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other. Broadly, what each part contributes to the contract.

**Constitution (company)** A document which sets out the rules for governing a company and includes the articles of association and member resolutions. In Australia, it also includes the memorandum of association (this is a separate document in the UK). The term 'constitution' has now replaced the term 'memorandum and articles of association' in Australia.

**Constitution (national)** A document which sets out the rules whereby laws may be made in a sovereign state.

**Contra proferentem** Courts can interpret any ambiguity against the person who relies on an exclusion in a contract.

**Contract** An agreement which legally binds the parties.

**Contract of service/employment** A contract of employment is 'a contract of service or apprenticeship, whether express or implied, and (if it is express) whether it is oral or in writing.'

**Contributory** A person liable to contribute to the assets of a company in a winding up. This includes present and certain past members, personal representatives of deceased members and trustees of bankrupt members.

**Convention** An international multilateral treaty (between three or more parties), named a convention due to its importance, subject matter and/or number of signatories.

**Creditors' voluntary winding up** A form of liquidation where a company does not provide a declaration of solvency. If no such declaration is made, the liquidation proceeds as a creditors' voluntary winding up even if in the end the company pays its debts in full.

**Criminal law** A crime is conduct prohibited by the law of the sovereign state and tried in the criminal court system. It is punishable by the State.

**Custom** Unwritten law which formed the basis of common law.

**Damages** The sum claimed or awarded in a civil action in compensation for the loss or injury suffered by the claimant.

**Defendant** The person against whom a civil action is brought or who is prosecuted for a criminal offence.

**Delegated legislation** Rules of law made by subordinate bodies to whom the power to do so has been given by statute (also referred to as **subordinate legislation**).

**Derivative claim** A remedy available to a minority shareholder to redress a wrong done to the company. Such an action is brought where those who have committed the offence control the company, and thus, under *Foss v Harbottle* could prevent it from taking action. Any benefit obtained will accrue to the company since the claim is derived from and made on behalf of the company.

**Director** A person who takes part in making decisions and managing a company's affairs.

**Distributable profit** Accumulated realised profits less accumulated realised losses.

**Dividend** A distribution of profits to members made in proportion to their shareholdings.

**Equity** A source of English law consisting of those rules which emerged from the Court of Chancery.

**Exclusion clause** Contract clause purporting to exclude or restrict liability.

**Executed consideration** A performed, or executed, act in return for a promise.

**Executory consideration** A promise given for a promise, not a performed act.

**Express term** Term that is clearly agreed to by the parties to a contract to be a term of that contract. In examining a contract, the courts will look first at the terms expressly agreed by the parties.

**Federation** A system of government that has one central government to deal with matters pertaining to the whole nation, as well as state governments to deal with matters pertaining to the states which make up the federation. Australia, Malaysia and the USA are federal systems.

**Fiduciary duty** A duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflict of interest.

**Fixed charge** A *charge* attaching to a particular asset on creation. The asset in question is usually a fixed asset, which the company is likely to retain for a long period. If the company defaults in payment of the debt the holder can realise the asset to meet the debt. Fixed charges rank first in order of priority in a liquidation.

**Floating charge** A *charge* on a class of assets of a company, present and future which changes in the ordinary course of the company's business. Until the holders enforce the charge the company may carry on business and deal with the assets charged. It attaches to the assets only on *crystallisation*.

**Fraud** Using misrepresentation to obtain an unjust advantage in the knowledge that it is untrue, without belief in its truth or recklessly, not caring whether it be true or false.

**Fraud on the minority** Discrimination by the majority shareholders against the minority. The minority may have a remedy at common law.

**Fraudulent trading** Carrying on business and incurring debts when there is to the knowledge of the directors no reasonable prospect that these debts will be repaid, i.e. with intent to defraud the creditors. Persons so acting may be liable for the debts of the company as the court may decide.

**Freedom of contract** Principle that parties may contract on the terms which they choose.

**Fundamental breach** Doctrine developed by the courts as a protection against unreasonable exemption clauses in contracts.

**Gazette** An official publication from the Commonwealth Office (Australia) in which certain notices must be inserted as prescribed by statute, for example the appointment of a liquidator.

**Good faith** Fair and open action without any attempt to deceive or take advantage of knowledge of which the other party is unaware.

**ICA** International Court of Arbitration.

**ICC** International Chamber of Commerce.

**ICJ** International Court of Justice.

**Implied term** Term deemed to form part of a contract even though not expressly mentioned by the parties.

**Incoterms** International contract terms developed by the ICC which are standard trade definitions commonly used in international sales contracts.

**Indemnity** Security against or compensation for loss.

**Indictable offences** Are serious offences that can be tried by a judge or jury.

**Injunction** An equitable remedy in which the court orders the other party to a contract to observe negative restrictions.

**Intention to create legal relations** Element necessary for an agreement to become a legally binding contract.

**International law** The system of law which governs relationships between sovereign states. There are two types of international law – public and private. Public law regulates the interrelationship of sovereign states and their rights and duties with regard to one another. Private international law regulates between conflicts of national laws.

**Insolvency** The inability to pay creditors in full after realising all the assets of a business.

**Insolvency practitioner** Persons acting as a liquidator, administrative receiver, administrator or supervisor of a voluntary arrangement must be insolvency practitioners, authorised by the professional body to which they belong or the relevant government department.

**Invitation to treat** Indication that someone is prepared to receive offers with a view to forming a binding contract. It is not an offer in itself.

**Istihān** Concept of equity in Sharia law.

**Judgment** A sentence or order of the court.

**Judicial review** Application to the High Court (or the highest court in the country if not called the High Court) for relief from a wrongful act.

**Jurisdiction:** The area over which a court has authority, which can be geographical or subject-based.

**Laissez-faire** Non-interference by governments in negotiations between citizens.

**Law Reports** The principal reports of decided cases.

**Lifting the veil (of incorporation)** A company is normally to be treated as a separate legal person from its members. 'Lifting the veil' means that the company is identified with its members or directors or that a group of companies is to be treated as a single commercial entity. An example of this is to prevent fraud.

**Limited liability** Limitation of the liability of members to contribute to the assets of a business in the event of a winding up.

**Liquidated damages** Fixed sum agreed by parties to a contract and payable in the event of a breach.

**Liquidator** A person who organises a company's liquidation or *winding up*. His task is to take control of the company's assets with a view to their realisation and the payment of all debts of the company and distribution of any surplus to members.

**Listed** Quoted on a recognised stock exchange.

**Madhab** These are the five **major secondary sources** of law in Sharia law. These are schools of thought based on **writings and thoughts of major jurists** formed in the years immediately following the death of the Prophet and are named after those jurists.

**Managing director** One of the directors of the company appointed to carry out overall day-to-day management functions.

**Mediation** A process of solving disputes where a third party, a mediator, listens to the parties in dispute and assists them in reaching agreement.

**Member** Shareholder of a company.

**Members' voluntary winding up** A form of liquidation where the directors have made a declaration of solvency and either the members have passed a resolution that the company be wound up, or the company has come to the end of a period fixed for its existence.

**Memorandum of association** Together with the *articles of association*, this defines what the company is and how its affairs are to be conducted. It gives details of the company's name, objects, capital and registered office. Used in the UK only.

**Minutes** A written, indexed record of the business transacted and decisions taken at a meeting. Company and Corporations law requires minutes to be kept of all company meetings. Minutes of general meetings should be available for inspection by members.

**Misrepresentation** False statement made with the object of inducing the other party to enter into a contract.

**Mitigate** To lessen the effect of any action or omission to act by the injured party.

**Negligence** This may refer to the way in which an act is carried out, that is carelessly, or to the tort which arises when a person breaches a legal duty of care that is owed to another, thereby causing loss to that other.



**No liability** An Australian public company where members are not required to pay calls. It is restricted to Australian mining companies only.

**Novation** Transaction whereby a creditor agrees to release an existing debtor and substitute a new one in his or her place.

**Obiter dicta** Statements made by a judge 'by the way'.

**Objects** The aims and purposes of a company.

**Offer** A definite promise to be bound on specific terms.

**Ordinary resolution** A resolution carried by a simple majority of votes cast. Where no other resolution is specified, 'resolution' means an ordinary resolution.

**Ordinary share** A share which gives the holder the right to participate in the company's surplus profit and capital. The dividend is payable only when preference dividends, including arrears, have been paid.

**Partnership** The relation which subsists between persons carrying on a business in common with a view of profit. Every partner is liable without limit for the debts of the partnership.

**Past consideration** Something already done at the time that a contractual promise is made.

**Penalty clause** In a contract providing for a specific sum to be payable in the event of a subsequent breach.

**Perpetual succession** The company continues to exist despite the death, insolvency, or insanity of any member or director, any change in membership or any transfer of shares.

**Plaintiff** The person who complains or brings an action asking the court for relief in Australia and other jurisdictions. Termed claimant under UK law.

**Precedent** A previous court decision.

**Pre-registration contract** A contract purported to be made by a company or its agent before the company has received its certificate of registration. An agent may be made personally liable on such a contract which will be unenforceable against the company.

**Proprietary company** A company which may not offer shares to the public, and which has not been registered as a public company. Termed a private company in the UK, Singapore and Malaysia.

**Private company** A company which may not offer shares to the public, and which has not been registered as a public company. Termed a proprietary company in Australian law.

**Privity of contract** The relation between two parties to a contract.

**Promoter** Person who undertakes to form a company by making the appropriate business preparations.

**Public company** A company registered as such under Corporations Act Australia (or Companies Acts of the UK, Singapore and Malaysia). The principal distinction between public and private/proprietary companies is that only the former may offer shares to the public.

**Quantum meruit** 'As much as he has deserved'. May be awarded in cases of breach of contract to reflect the value of the work done.

**Quasi partnership** A small, usually private company, where the relationship between the directors is essentially like that of a partnership. The courts have taken into account the existence of such quasi-partnerships when applying the law.

**Quorum** Minimum number required to be present for a valid meeting to take place.

**Quran** The primary source of Sharia law and is Allah's divine revelation to his Prophet, Muhammad.

**Ratio decidendi** The reason for the decision. The core of a legal judgment.

**Re** In the matter of. Seen in some case names.

**Registered office** A business address to which all communication with a company must be sent.

**Registration** Process by which a company comes into being, which involves the filing of documents with the relevant authority and the issuance of a certificate of registration.

**Remoteness of damage** Relationship between a wrongful act and the resulting damage which determines whether or not compensation may be recovered. Different principles apply in contract and in tort.

**Replaceable rules** Selected sections of the Australian Corporations Act 2001 which can be used by most public and proprietary companies instead of a company constitution or in combination with a company constitution.

**Representation** Induces the formation of a contract but does not become a term of the contract. The importance of the distinction is that different remedies are available depending on whether a term is broken or a representation turns out to be untrue.

**Repudiation** Rejection or renunciation.

**Rescission** An equitable remedy through which a contract is cancelled or rejected and the parties are restored to their pre-contracted position.

**Riba** Islamic concept of unlawful gain, usually translated as interest, which is strictly forbidden by the Quran.

**Rule of law** The concept that all peoples and institutions in a sovereign state are governed by and subject to the law.

**Sale of goods** A contract whereby the seller transfers or agrees to transfer the property in goods for a money consideration called the price.

**Secretary (company)** An officer of a company appointed to carry out general administrative duties. Every public company must have a secretary and a sole director must not also be the secretary.

**Separation of powers** The distribution of powers between the three arms of government: the legislature, the executive, and the judiciary.

**Shadow director** A person in accordance with whose instructions other directors are accustomed to act.

**Share** A member's stake in a company's share capital.

**Sharia law** Legal system based on the religion of Islam and ordained by Allah as guidance for mankind.

**Specific performance** An equitable remedy in which the court orders the defendant to perform his side of a contract.

**Standard form contract** A standard document prepared by many large organisations and setting out the terms on which they contract with their customers.

**Standard of proof** The extent to which the court must be satisfied by the evidence presented.

**Stare decisis** To stand by a decision.

**Statute** Law made by a legislature or by some other body in exercise of law-making powers delegated by the legislature.

**Subordinate legislation** Rules of law made by subordinate bodies to whom the power to do so has been given by statute (also referred to as **delegated legislation**).

**Subsidiary company** A company under the control of another company, its holding company.

**Summary offences** Are minor crimes, only triable summarily in lower level courts.

**Sunnah** In Sharia law this is the 'the beaten track', in other words, what has come to be the acceptable course of conduct. It is derived from the sayings of the Prophet, known as Ahadith (known in singular as Hadith).

**Takhim** System of arbitration under Sharia law.

**Tort** A wrongful act.

**Treaty** A formal agreement between two or more sovereign states.

**Ultra vires** Beyond their powers. In company law this term is used in connection with transactions which are outside the scope of the objects clause and therefore, in principle at least, unenforceable.

**UNCISG** UN Convention for the International Sale of Goods.

**UNCITRAL** United Nations Commission in International Trade Law.

**Unconscionable** Unfair, harsh, unjust, particularly in relation to contracts.

**Unenforceable contract** Is a valid contract and property transferred under it cannot be recovered even from the other party to the contract if either party refuses to perform the contract, the other party cannot compel him to do so.

**Unlimited liability** Members do not have limited liability and in the event of liquidation members are required to contribute as much as needed to repay the company's debt in full.

**Void contract** Not a contract at all. The parties are not bound by it and if they transfer property under it they can sometimes recover their goods even from a third party.

**Voidable contract** A contract which one party may avoid, that is, terminate at his option. Property transferred before avoidance is usually irrecoverable from a third party.

**Warranty** Minor term in a contract. It does not go to the root of the contract, but is subsidiary to the main purpose of the contract. Breach of a warranty does not give rise to breach of the contract itself.

**Winding up** A process by which a company ceases to exist, otherwise known as a liquidation. May take the form of a *compulsory winding up*, a *members' voluntary winding up* or a *creditors' voluntary winding up*.

**Wrongful trading** The term used where directors of an insolvent company knew or should have known that there was no reasonable prospect that the company could have avoided insolvency and did not take sufficient steps to minimise the potential loss to the creditors.





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