

**PAPER NO.11**

# **COMPANY LAW**

**STUDY TEXT**

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# PART A





# CHAPTER ONE



## NATURE AND CLASSIFICATION OF COMPANIES





# CHAPTER ONE

## NATURE AND CLASSIFICATION OF COMPANIES

### ► OBJECTIVES

By the end of this chapter, the student should be able to:

- Explain the various forms of business organisations
- Distinguish the company from other forms of business organisations
- Explain the law relating to other form of business organisations such as cooperatives

### ► INTRODUCTION

This chapter starts by appreciating that besides the company there are other forms of business associations, such as cooperatives, partnerships and sole proprietorships. It then distinguishes these other forms of business associations from the company, which is our main focus. The chapter then goes ahead to look at the law governing other forms of business associations with special attention to cooperative societies.

### ► KEY DEFINITIONS

- **Sole proprietorship:** Simplest form of business what is also called one man business
- **Partnership:** A business owned by a minimum of two and a maximum of twenty people
- **Cooperative:** An association in which people pool their resources for their common good
- **Incorporated association:** An artificial person that has a legal identity
- **Limited liability:** This is a company whereby any liability members in times of liquidation of the company is limited to the amounts if any unpaid on member's shares

### ► EXAM CONTEXT

This is one of the new chapters that the examiner has added to the revised curriculum. It is important that the student understands the various forms of business associations and how they differ from the company. This will enable the student to be in a position to respond to any question in the form of differences or even similarities that exist among the various forms of business. The student will also be able to identify what laws govern the other forms of business associations

## ► INDUSTRY CONTEXT

This is a very practical chapter as it recognises that there are other forms of business organisations other than the company. These different forms of business associations are a part and parcel of our daily lives. There are so many companies, sole traders, partnerships and even co-operatives in existence. The cooperative bank is a good example of a cooperative society, while mobile services provider Safaricom is an example of a limited company.

### 1.1 FORMS OF BUSINESS ORGANISATIONS

#### >>>>> Fast forward

- Sole proprietorship also sole trader- one man business
- Partnership - business consisting of between two to 20 people owned business
- Company- A legal person has duties and rights
- Cooperative – “Harambee” (Pooling resources)

**A business is any activity carried on for the purpose of making a profit. A business may include the following activities:**

- Commercial e.g. running a shop or kiosk
- Agricultural e.g. farming
- Direct services e.g. barber, tailor

**There are four main forms of business associations in Kenya, though there may be others in existences, which are beyond the scope of this book. These forms are:**

- Sole proprietorship/sole trader
- Partnership
- Companies
- Cooperative

## 1. SOLE TRADER

This business is owned and controlled by one person. The owner is in complete control and thus receives all profits and suffers all losses. It's very easy to start as all that one needs is capital and a trading license obtained from the relevant local authority. This form of business is found in retail trade and service industries such as hair cutting, plumbing, painting, kiosks, and vegetables among others.



### ■ ADVANTAGES

1. Owner receives all profits and is in complete control of the business
2. It has no major legal and administrative formalities in starting as all one requires is a trading license
3. A sole trader is his own master and thus makes all decisions, he does not have to consult another person, which tends to delay decision making in other business entities.

### ■ DISADVANTAGES

1. Owner has to provide all the capital
2. Owner bears and suffers all the losses
3. Owner has to work for long hours to increase profits and this in the long run affects his health
4. There is no scope in sharing ideas for the improvement of the business

## ■ 2. PARTNERSHIP

This is a business is owned by at least two people or more but not more than 20 people. Section 3 (1) of the Partnership Act defines a Partnership as the relationship, which subsists between persons carrying on a business in common with a view to make a profit.

Under Kenyan law there are two types of Partnerships, namely General and Limited. The General partnership operates quite similarly to a sole trader but in a Limited partnership the liability of the partners is limited. A partnership deed regulates the relationships among the partners.

### ■ ADVANTAGES

1. Partners provide capital on terms agreed. They share the net profit or bear the losses in proportions as set out in the partnership agreement
2. More capital is available and there is a scope of expanding business
3. Sharing of ideas by the partners leads to growth and improvement of business

### ■ DISADVANTAGES

1. Disagreement among partners sometimes can ruin the business
2. Business may stop temporarily after death of one of the partners.

## ■ 3. COOPERATIVE SOCIETIES

This is an association of people who come together with a common objective. It is a form of self-help organisation. It's formed by at least 10 people and there is no maximum membership is open to any number of people required to start a cooperative society. Members hold shares in the society

## STRUCTURAL FRAMEWORK OF THE COOPERATIVE MOVEMENT IN KENYA

The structural framework of the cooperative is organised in a four-tier system consisting of:

- **The Primary** this has been defined as a cooperative society whose membership is restricted to individual persons. Examples include
  1. Harambee Cooperative Savings and Credit Society Limited, formed by the employees of the Office of the President
  2. Afya Cooperative Savings and Credit Society Limited, formed by employees of the Ministry of Health
- **The secondary** this is a cooperative whose membership comprises Primary societies.
- **The National Cooperative Movement (NACOS)** The NACCOS offer specialised services to their affiliates.

**The services include insurance and banking currently there are nine NACCOS, namely:**

- Cooperative Bank of Kenya
- Kenya Union of Savings and Credit Cooperative Limited (KUSCCO)
- National Housing cooperative union Limited (NACHU)
- Kenya Cooperative Creameries (KCC)
- Kenya Planters Cooperative Union Ltd. (KPCU)
- Kenya Farmers Cooperative Association Limited (KFA)
- Cooperative Data and Information Centre (CODIC)
- Cooperative Insurance Company Limited (CIC)
- **The Apex organisation:** The apex organisation in Kenya is the Kenya National Federation of Cooperatives. It is the mouthpiece for Kenyan cooperatives to preserve and propagate (both in the country and abroad) the cooperative principles and values on which the movement was founded.

The movement cuts across all sectors including finance, agriculture, livestock, housing, transport, construction and manufacturing and consumer industry. The concentration is however within agriculture and finance sectors. In the agriculture sector cooperatives are largely involved in marketing of Agricultural produce. The financial sub-sector provides savings and credit facilities to their members. Cooperatives also provide transportation, bookkeeping, stores for resale, education and training.

## BENEFITS OF COOPERATIVE ORGANISATIONS

Basically cooperatives are vehicles for social economic development. They contribute to economic growth and development in many ways. The major benefits that come out of cooperative organisations can be summarised as follows:

1. Collection, transportation, processing and marketing agricultural produce.
2. Mobilisation of savings and channelling the income of individual members to specific development projects
3. Support to agricultural production through distribution of farm inputs



4. Dissemination of applied technology to members
5. Assisting in income distribution by participation through enabling large sections of the population to engage in various income generating economic activities
6. Provision of credit to members for defraying urgent expenses at affordable rates and costs
7. Creating employment directly through hiring of various cadres of staff besides providing self-employment for farmers, artisans among others.

## 1.2 DISTINCTION BETWEEN COMPANIES AND OTHER FORMS OF BUSINESS ORGANISATIONS

### Fast Forward

The main distinction between a company and other forms of business organisations is to be found in the two fundamental principles of company law as discussed below:

- Legal/Corporate personality
- Theory of limited liability

### 1. Legal/Corporate personality

#### Fast forward:

- ∅ A company is a legal person distinct and separate from the subscribers to the memorandum
- ∅ A company thus has rights and duties similar to those of human beings

This principle holds that when a company is incorporated it becomes a legal person distinct and separate from its members and managers. It becomes a body corporate with an independent legal existence with limited liability, perpetual succession, capacity to contract, own property and sue or be sued. The principle of legal personality was first formulated by the House of Lords in its famous case of **Salomon v Salomon and Company limited** where Lord Macnaghten was emphatic that the company is at law a different person from the subscribers to the memorandum. This principle is now contained in section 16(1) of the Companies Act which provides *inter alia* that from the date of incorporation, the subscribers to the memorandum together with such other persons that may become members of the company are a body corporate by the name contained in the memorandum capable of exercising the functions of an incorporated company with power to hold and having perpetual succession and a common seal.

The decision in **Salomon's case** lay to rest certain principles:

1. That even the so called one man companies were legal persons distinct and separate from the members and managers
2. That incorporation was available not only to large companies but to partnerships and sole proprietorships as well
3. That in addition to membership, it was possible for a member to subscribe to the company's debentures

## 2. Theory of limited liability

Liability means the extent to which a person may be called upon to contribute to the assets of the company in the event of winding up. In company law, the liability of members may be limited or unlimited. If limited it may be limited by shares or by guarantee as shall be explained later in this chapter.

We then pay attention to the main differences between a company and a partnership. The basic differences between registered companies and partnerships are as follows:

**(a) Formation**

Registration is the legal pre-requisite for the formation of a registered company: **Fort Hall Bakery Supply Co v Wangoe** (1).

The Partnership Act does not prescribe registration as a condition precedent to partnership formation. A partnership may therefore be formed informally or, if the partners deem it prudent, in writing under a Partnership Deed or Articles.

**(b) Legal Status**

A registered company enjoys the legal status of a body corporate, which is conferred on it by the Companies Act.

A partnership is not a body corporate and is non-existent in the contemplation of the law. Such business as appears to be carried on by it is, in fact, carried on by the individual partners.

**(c) Number of Members**

A registered private company must have at least two members under section 4 of the Companies Act and a maximum of 50 members (excluding current and former employees of the company who are also its members), under section 30 of the Act. A public registered company must have at least seven members under section 4 of the Companies Act but without a prescribed upper limit. A partnership cannot consist of more than 20 partners.

**(d) Transfer of Shares**

Shares in a registered company are freely transferable unless the company's articles incorporate restrictive provisions.

A partnership has no shares as such but a partner cannot transfer his interest in the firm to a third party unless all the partners have agreed to the proposed transfer.

**(e) Management**

A company's members have no right to participate in the company's day-to-day management. Such management is vested in the board of directors.

Partners have the right to participate in the firm's day-to-day management since section 3 of the Partnership Act requires the business to be carried on "in common". The right





of participation in the firm's management is, however not given to a partner who has limited his liability for the firm's debts.

**(f) Agency**

A member is not, *per se*, an agent of the company (**Salomon v Salomon & Co Ltd** (3)). A partner is an agent of the firm because the business is carried on "in common" by the partners themselves. The Partnership Act, section 7 also expressly provides that every partner is an agent of the firm and his other partners for the purpose of the partnership.

**(g) Liability of members**

A company's member is not personally liable for the company's debts because, legally, they are not his debts.

A partner is personally liable for the firm's debts. This rule has been codified by section 11 of the Partnership Act, which provides that "every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner", unless the partner is a limited partner.

**(h) Powers**

The ultra vires doctrine limits a company's powers to the attainment of the company's objects under its memorandum of association. Partnerships are not affected by the ultra vires doctrine and partners enjoy relative freedom to diversify the firm's operations.

**(i) Termination**

A member's death, bankruptcy or insanity does not terminate the company's legal existence whereas a partner's death, bankruptcy or insanity may terminate the partnership unless the partnership agreement provides otherwise.

**(j) Borrowing money**

A company can borrow on the security of a "floating charge". A partnership cannot borrow on a "floating charge".

**(k) Ownership of property**

A company's property does not belong to the shareholders, either individually or collectively. Consequently, a member cannot insure the property since he has no insurable interest therein: **Macaura v Northern Assurance Co** (4). A firm's property is the property of the partners who can, therefore, insure it and, in the case of cash, make drawings from it.

## 1.3 LAW RELATING TO OTHER ORGANISATIONS

### COOPERATIVES

Cooperatives in Kenya are governed by the Cooperative Societies Act Chapter 490 of the laws of Kenya enacted in 1966. They are also governed by the Cooperative Society Rules enacted in 1969. The rules provided for the following matters:

1. Registration of cooperatives and maintenance of related documents
2. Contents of by-laws and amendment procedures
3. Society membership
4. Maintenance of books
5. Services to be rendered by district cooperative unions
6. Financial control through meetings
7. Property and funds of the society
8. Arbitration

### PARTNERSHIPS

The law relating to partnerships in Kenya is contained in the Partnership Act Chapter 29 of the laws of Kenya and the Limited Partnership Act chapter 30 of the laws of Kenya. The Partnership Act is based on the English Partnership Act 1890. These two statutes codify the law on partnerships in Kenya.

## CHAPTER SUMMARY

There are four main forms of business associations in Kenya, though there may be others in existence, which are beyond the scope of this book. These forms are:

- Sole proprietorship/sole trader
- Partnership
- Companies
- Cooperative



The structural framework of the cooperative is organised in a four-tier system consisting of:

**The primary**

**The secondary**

**The National Cooperative Movement (NACOS)**

**The apex organisation**

**The major benefits that come out of cooperative organisations can be summarised as follows:**

8. Collection, transportation, processing and marketing agricultural produce.
9. Mobilisation of savings and channelling the income of individual members to specific development projects
10. Support to agricultural production through distribution of farm inputs
11. Dissemination of applied technology to members
12. Assisting in income distribution, by participation, through enabling large sections of the population to engage in various income generating economic activities.
13. Provision of credit to members for defraying urgent expenses at affordable rates and costs
14. Creating employment directly through engaging various cadres of staff besides creating self-employment for farmers, artisans among others.

The main distinction between a company and other forms of business organisations is to be found in the two fundamental principles of company law

## Legal/Corporate personality

### Theory of limited liability

Cooperatives in Kenya are governed by the Cooperative Societies Act Chapter 490 of the laws of Kenya enacted in 1966

The law relating to partnerships in Kenya is contained in the Partnership Act Chapter 29 of the laws of Kenya and the Limited Partnership Act Chapter 30 of the laws of Kenya

## CHAPTER QUIZ

1. Name two forms of business organisations
2. What are the two fundamental principles of company law?
3. What is the maximum number of persons in a sole trader?
4. What chapter number of the laws of Kenya is the Cooperatives Societies Act?

## ANSWERS TO QUIZ

1. Sole proprietorship and partnership
2. Limited liability and Legal personality
3. One (1)
4. 490

## SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Discuss any four forms of business associations present in Kenya today

### QUESTION TWO

What are the main differences between a partnership and a company in Kenya?

### QUESTION THREE

Discuss the various laws governing cooperatives and partnerships.

# CHAPTER TWO



## REGISTRATION OF A COMPANY





# CHAPTER TWO

## REGISTRATION OF A COMPANY

### ► OBJECTIVES

By the end of this chapter, the student should be able to:

- Appreciate the legal principles relating to the nature and registration of companies
- Describe the contents and nature of the Memorandum and Articles of Association
- Explain the effect of legal personality
- Give instances when the veil of incorporation is lifted
- Explain the role and duties of promoters
- Explain the liability of promoters for pre-incorporation contracts
- Explain the doctrine of *ultra vires*

### ► INTRODUCTION

This chapter mainly deals with formation of a company that is the procedures that those who wish to form a company should follow in order to be incorporated. It outlines all the formalities including documents to be prepared. It later focuses on promoters who, simply put, are charged with the responsibility of ensuring all the formalities are in place.

### ► KEY DEFINITIONS

- **Incorporated association:** An artificial person that has a legal identity
- **Limited liability:** liability of members is limited to the amounts if any unpaid on their shares
- **Ultra vires** - A Latin term which means beyond the contracting powers of a company
- **Articles of Association** - A document which regulates the internal affairs of a company
- **Memorandum of association** - A document which regulates the affairs of the company and outsiders
- **Natural person** - An individual/ human being
- **Artificial person** - A person created by law through the process of incorporation in other words incorporated associations.

## ► EXAM CONTEXT

The examiner has tended to be very fond of this topic in certain years than in others. Being the topic that brings the company into existence understanding it will be crucial in understanding of the other chapters as well. Between 2000 and 2002 the examiner set many questions from this area. A brief analysis showed that the topic was being featured in the following sittings 12/01; 12/00; 07/00; 12/00; 06/12; 05/02; 06/01 (year, month)

## ► INDUSTRY CONTEXT

Apart from Memorandum and Articles of Association, Statement of Nominal capital and Declaration of Compliance. The documents identified below them, must in law, be delivered to the registrar within 14 days after the registration of the company.

### 2.1 REGISTRATION PROCEDURES

Under section 4(1) of the Companies Act any seven or more persons, or where the company to be formed is Private any two or more persons, associated for any lawful purpose may by subscribing their names to the Memorandum of Association and by complying with the provisions of the Act form an incorporated company with or without limited liability.

### PRIVATE COMPANY

In order to secure the registration of a private company, the procedure described above is followed except that the Memorandum of Association will be signed by at least two of the company's promoters.

- (b) Form No 209 and 210 are not delivered for registration because section 182 (5) of the Act exempts promoters of a private company from the obligation to deliver them for registration.
- (c) If Articles of Association are not delivered for registration, the provisions of Part I of Table A will become the company's Articles, as modified by Part II thereof.

**Under Section 30 (1) a private company has the following characteristics:**

- Number of members is limited to 50 excluding current and former employees of the company who are members
- Transfer of shares is restricted
- Any invitation to the Public to subscribe for shares is prohibited
- Must have at least one director
- It's entitled to start business operations on the date of incorporation





- It's empowered to give loans to its directors
- It's not entitled to publish annual accounts
- It's not obliged to hold statutory meetings

## SIGNIFICANCE OF REGISTRATION

Section 389 provides that “no company, association or partnership consisting of more than 20 persons shall be formed... unless it is registered as a company under this Act”. The provision has been interpreted by the English and Kenyan courts to the effect that registration is the condition precedent to the formation of a registered company and failure to register a proposed company will mean that it does not legally exist: **Fort- Hall Bakery Supply Co v Wangoe** (1).

## EFFECT OF REGISTRATION

Section 16 (2) of the Act provides that “from the date of incorporation mentioned in the certificate of incorporation the subscribers to the Memorandum of Association... shall be a body corporate by the name contained in the Memorandum”. This section has been judicially explained as follows:

- (a) The date mentioned (i.e. written) in the certificate of incorporation is the date from which the company's legal existence commences. Consequently, if an incorrect date were written in the certificate, that date would be regarded as the actual date on which the company was registered. This legal position was explained by the House of Lords, under the English Companies Act whose provisions in this regard are identical to section 16(2) of the Kenya Companies Act, in the case of **Jubilee Cotton Mills v Lewis** (2)
- (b) The company's registration constitutes it as “a body corporate”. It becomes “a legal person”, or “corpora corporata”, whose name is the name chosen for it by its promoters and written in its Memorandum of Association. The certificate of incorporation may, therefore, be regarded as the company's birth certificate and the date written therein as the company's birthday.

The concept of a registered company as “a person” was consummated in the celebrated case of **Salomon v Salomon & Co Ltd** (3).

## 2.2 THE COMPANY'S CONSTITUTION

The constitution of a registered company consists of two documents, namely, the Memorandum of Association and the Articles of Association. The contents of these documents will now be examined in detail.



## THE MEMORANDUM OF ASSOCIATION

### Definition

In relation to companies registered under the Companies Act, a Memorandum of Association was judicially defined by Lord Cairns in **Ashbury Railway Carriage Co Ltd v Riche** as “the charter” which “defines the limitation of the powers of a company to be established under the Act”.

### Contents

The contents of a Memorandum of Association are prescribed by Section 5 of the Companies Act and comprise the following six clauses:

- (a) Name clause
- (b) Registered office clause
- (c) Objects clause
- (d) Limitation of liability clause
- (e) Capital clause
- (f) Association clause

The “Association clause” is not prescribed by Section 5 but is mentioned as one of the clauses in Table B in the first Schedule to the Act.

### Statutory Form

Section 14 of the Act provides that the form of the Memorandum of Association of a company that is limited by shares shall be in accordance with the form set out in Table B, or as near there to as circumstances admit. Table B is reproduced on the next page.

## TABLE B

### FORM OF MEMORANDUM OF ASSOCIATION OF A COMPANY LIMITED BY SHARES

1st — The name of the company is “The Lake Victoria Steam Packet Company Limited”.

2nd — The registered office of the company will be situate in Kenya.

3rd — The objects for which the company is established are, “the conveyance of passengers and goods in ships or boats between such places as the company may from time to time determine, and the doing all such other things as are incidental or conducive to the attainment of the above object”.

4th — The liability of the members is limited.

5th — The share capital of the company is two hundred thousand shillings divided into one thousand shares of two hundred shillings each.



We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company, in pursue of this memorandum of association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names.

<i>Names, Postal Addresses, and Signature of subscriber</i>	<i>Number of shares Taken by each Subscriber</i>
<b>Occupation of Subscribers</b>	
1	
2	
3	
4	
5	
6	
7	
Total Shares taken	_____
Dated the ..... day of ....., 19.....	
Witness to the above signatures	

Table B is taken from the English Companies Act 1862 and has been modified in practice, especially as regards the 3rd clause.

## THE NAME CLAUSE

### Choice of Name

The promoters of a proposed company have freedom to choose its name but the freedom is limited by section 19 (2) of the Act, which provides that a proposed name must not, in the opinion of the registrar, be undesirable. The registrar of companies has not issued a circular explaining the criteria he is likely to use when deciding, in a particular case, whether a proposed name is undesirable under the section. However, it might be relevant to note that the registrar of English companies, pursuant to his powers under the corresponding section of the English Companies Act 1948, issued Practice Note No C 186 in which he stated that he would normally regard a proposed name as undesirable if:

- i. It is too similar to the name of an existing company.
- ii. It is misleading, for example, if the name of a company likely to have small resources suggests that it is going to trade on a great scale over a wide field.
- iii. It suggests some connection with the crown or members of the Royal Family or royal patronage, including names containing such words as “Royal”, “King”, “Queen”, “Princess” and “Crown”.
- iv. It suggests connection with a government department or any municipality or other local authority or any body incorporated by Royal Charter or by statute or with the government of any part of the Commonwealth or of any foreign country.
- v. It contains the words “British”, unless the undertaking is British-controlled and entirely or almost entirely British-owned and is also of substantial size and importance in its particular field of business.
- vi. It includes “Imperial”, “Commonwealth”, “National”, “International”, “Corporation”, “Co-operative”, “Building Society”, “Bank”, “Bankers”, “Banking”, “Investment Trust”, or “Trust”, unless the circumstances justify the inclusion.
- vii. It includes a surname, which is not that of a proposed director, unless the circumstances justify the inclusion.
- viii. It includes words, which might be trade marks, unless a trade mark clearance has been obtained.  
It is probably that the registrar of Companies in Kenya is guided by the above rules, modified *mutatis mutandis*, when deciding on the desirability of any proposed name.

## Reservation of Name

To obviate the risk of choosing a name that ultimately turns out to be undesirable, the promoters should enquire from the registrar whether the name they intend to give the company is “too like” that of a company already in the register of companies. After obtaining confirmation that the name is a registerable one they should immediately make a written application for its reservation under section 19 (1) (a) of the Act. Any such reservation shall remain in force for a period of 30 days or such longer period, not exceeding 60 days, as the registrar may, for special reasons, allow. No other company shall be entitled to be registered with the reserved name.

These statutory provisions regarding the choice of a company’s name are intended to confer, on the company, legal monopoly of its name. Because it lacks physical attributes, which could assist its customers to differentiate it from another company with a similar name, a company can only rely on the legal monopoly of its name as its ultimate protection against what might constitute unfair instances of passing-off. They also avoid a situation in which two or more companies use one name with the resultant problem of identifying the company that is the contracting party in a commercial transaction.



### Name to end with the word “Limited”

Section 5(1)(a) provides that the word “limited” must be the last word of the name of a company which is to be limited by shares or by guarantee. In **Durham Fancy Goods Ltd v Michael Jackson (Fancy Goods) Ltd** Donaldson, J, it is stated:

“The word “Limited” is included in a company’s name by way of “description” and not identification. Accordingly, a generally accepted abbreviation will serve this purpose as well as the word in full. The rest of the name, by contrast, serves as a means of identification”.

The use of the mystic word ‘limited’ as the last word of a company’s name is explicable only in the context of the historical evolution of English Company law. It was prescribed for the first time for English companies in 1856 by the Joint Stock Companies Act of that year and, in the words of Professor Gower, “was intended to act as a red flag warning the public of the dangers which they ran if they had dealings with the dangerous new invention”. A member of the public dealing with a business organisation whose name ended with “Ltd” was to be made aware that he was not dealing with a partnership and so could only blame himself if he burnt his fingers in the process. Its function may be likened to that of the ring on a married person’s finger.

### Power to dispense with the word “Limited”

Although section 5 provides that the last word of the name of a limited company must be “limited”, this would not be so if the Minister empowers the company to dispense with it. The Minister would do so “by licence” if he is satisfied that an association about to be formed as a limited company is to be formed for promoting commerce, art, science, religion, charity or any other useful object, and it is intended that its profits, if any, or other income would be used in promoting its objects and the payment of any dividends to the association’s members is prohibited.

An existing registered company may obtain a licence to make, by special resolution, a change in its name so as to omit the word “Limited”. This can be done only after proving, *inter alia*, that the company is formed to promote charity and is prohibited from paying dividends to its members.

A licence may be granted on such conditions as the Minister thinks fit and may, upon the recommendation of the registrar, be revoked by him subject to the company’s right to be heard in opposition to the revocation. A company granted exemption under section 21 of the Act is also exempt from the requirements of section.109 (1) which relate to the publication of the company’s name.

## Change of Name

### A company’s name may be changed voluntarily or compulsorily

#### (a) Voluntary Change

#### A company’s name may be changed voluntarily:

- i. Under section 20 (1) if a special resolution is passed by the company for that purpose after obtaining the written approval of the registrar. The registrar’s approval is required to ensure that he does not later on reject the proposed name on the ground that it is undesirable.

- ii. Under section 20(2) if the name was inadvertently registered by a name which, in the opinion of the registrar, is too like the name by which a company in existence is previously registered. No particular type of resolution is prescribed by the section and the change may, therefore, be made by ordinary resolution.

Although the section does not make it mandatory for the company to change its name, it is advisable for the company to take immediate steps to effect the change as soon as it becomes aware of the situation. Any delay entails the risk of a passing-off action being instituted against the company.

- iii. Under Section 21(2) if the Minister, by licence, authorises a company to make a change in its name. The change has to be made by special resolution so as to omit the word “limited” from the company’s name.

### **(b) Compulsory Change**

Section 20(2) of the Act provides that within six months of registration under a particular name, the registrar may direct a change in name if, in his opinion, the name is “too like” that of a pre-existing company. In the event of such direction, the change shall be made within a period of six weeks from the date of the direction or such longer period as he may think fit to allow. A change of name under this section may be made by ordinary resolution.

Failure to comply with the registrar’s directive is an offence punishable by a fine not exceeding Kshs.100 for every day during which the default continues.

After a company changes its name under any of the above provisions, it shall give to the registrar notice within 14 days. Upon receipt of the notice, the registrar shall -

- i. Enter the new name on the register in place of the former name,
- ii. Issue to the company a certificate of change of name
- iii. Publish the change of name in the Kenya Gazette.

Where a company changes its name either voluntarily or compulsorily, the change will not affect any of its rights or obligations or render defective any legal proceedings by or against it, and any such proceedings may be continued or commenced against it by its new name.

### **■ Publication of Name**

Section 109(1) requires every company (except one exempted under section 21):

- (a) To paint or affix its name in a conspicuous position on the outside of every office or place in which its business is carried on and to keep it so painted or affixed;
- (b) To mention its name on all letters, notices, official publications, bills of exchange, promissory notes, endorsements, cheques, bills of parcels, orders, invoices, receipts and letters of credit of the company; and



- (c) To engrave its name on its seal, this shall be in the form of an embossed metal die.

If a company does not paint or affix its name as prescribed, the company and every officer in default are liable to a fine not exceeding one hundred shillings and if the company does not keep its name painted or affixed as prescribed, the company and the officer in default shall be liable to a default fine.

In the event of failure to comply with (b) or (c) above, the company and the officer responsible shall be liable to a fine not exceeding Kshs.1000 and the officer may be made personally liable to any creditor who has relied on the document, if the company fails to pay. This personal liability has been explained in paragraph 1.10.1(b) above, under "lifting the veil of incorporation".

## ■ Business Names

If a company has a place of business in Kenya and carries on business under a business name which does not consist of its corporate name without any addition, the company must, within 28 days after commencing business under the business name, submit to the registrar of business names a statement, called the Statement of Particulars, which contains the following particulars-

- (a) The business name.
- (b) The general nature of the business.
- (c) The full address of the principal place of business and the postal address of the company.
- (d) The full address of every other place of business.
- (e) The company's corporate name and registered and principal office.
- (f) The date of the commencement of business.

Changes in the registered particulars (other than (e) and (f)) must be notified on the appropriate form within 28 days after such change.

If there is a default in registration, the persons in default are liable to a fine and, unless the court gives relief, the rights of the defaulter in relation to the business in question are unenforceable by the defaulter by action: Registration of Business Names Act, section 10 - 11.

## ■ Restricted Names

**Section 17(1) of the Registration of Business Names Act provides that no company shall be registered under a business name:**

- (a) Which contains any word which, in the opinion of the registrar, is likely to mislead the public as to the nationality, race, or religion of the person by whom the business is wholly or mainly owned or controlled;
- (b) Which includes any of the words "Imperial", "Royal", "Crown", "Empire", "Government", "Municipal" or any other word, which imports or suggests that the business enjoys the Queen's patronage or the patronage of any member of the Royal Family or of the government;
- (c) Which includes the word "Co-operative" or its equivalent in any other language or any abbreviation thereof, or
- (d) Which is identical with or is similar to that of a business or corporation existing, or is already registered under the Act or under the Companies Act, if in the opinion of the registrar, such registration would be likely to mislead the public.

## ■ Change of Business Name

### Section 17(4) of the Registration of Business Names Act provides that if -

- (a) Any company is, through inadvertence or otherwise, registered under a business name under which registration under the Act ought to have been refused; or
- (b) Any change of ownership of a business occurs as a result of which a company carrying on a business under a business name, which, on an application for registration under the Act, ought to have been refused, the registrar shall, by notice in writing, require the company to change such business name within a time specified in the notice.

The registrar is empowered to cancel the registered business name if the company fails to change it after he directed it to do so.

## ■ Prohibition

Section 18 of the Registration of Business Names Act provides that the registration of a company's business name under the Act shall not be construed as authorising the use of a business name if, apart from such registration, the use thereof could be prohibited.

## ■ Publication of True Names

Section 23(1) of the Registration of Business Names Act provides that a company using a business name distinct from its corporate name must disclose its corporate name in all trade circulars and business letters on or in which the business name appears and which are issued or sent by the company to any person. Failure to comply with this provision renders the company guilty of an offence punishable by a fine not exceeding Kshs.1000.





## THE REGISTERED OFFICE CLAUSE

Section 5(1) (b) provides that the Memorandum of Association shall state that “the registered office of the company is to be situate in Kenya”. The situation of the registered office in Kenya fixes the company’s nationality as Kenyan and its domicile as Kenya, though not its residence. Residence is decided by ascertaining where the company’s centre of management and control is. Thus, a company may be resident in a number of countries where it has several centres of control in different countries. The residence of a company is important in connection with its liability to pay taxation to the Government of Kenya.

### Function of the Registered Office

Section 107(1) provides that a company shall, as from the day on which it begins to carry on business or as from the fourteenth day after the date of its incorporation, whichever is the earlier, have a registered office and a registered postal address to which all communications and notices may be addressed. Section 108 (1) requires notice of the situation of the registered office and the registered postal address, and of any change therein, to be given within 14 days after the date of incorporation of the company or of the change, as the case may be, to the registrar for registration.

Failure to comply with the requirements of these sections renders the company, and every officer of the company who is in default, liable to a default fine.

The primary function of the registered office is to act as the company’s official address. It provides a convenient place where legal documents, notices, and other communications can be served. Section 391(1) provides that a document may be served on a company by; *inter alia*, leaving it at the registered office of the company.

### The following registers and documents are also kept at the company’s registered office:

- i. The register of members, and if the company has one, the index of members, unless the register is made up elsewhere, in which case they can be kept where they are made up. Where the register and index (if any) are made up by an agent, they may be kept at the agent’s office (Section 112 - 113).
- ii. The register of directors and secretaries (Section 201 (1)).
- iii. The company’s register of charges (if the company is a limited company) (Section 105 (1)).
- iv. A copy of any instrument creating any charge requiring registration under Part IV of the Act (Section 104).
- v. The register of debenture holders (Section 88 (1)).
- vi. The register of directors’ interests in shares in, or debentures of, the company or associated companies (Section 196 (1)).
- vii. The minute books of general meetings (Section 146 (1)).

### The registers and documents are then subject to the following rights of inspection:

- (a) The company's members are entitled to inspect them, free of charge, during business hours for at least two hours each day.
- (b) Debenture holders of the company are entitled to inspect, free of charge, the register of debenture holders and, during the period beginning 14 days before the date of the company's annual general meeting and ending three days after the date of its conclusion, the register of directors' shareholding.
- (c) Any member of the public is entitled to inspect the register of directors and secretaries and the register of debenture holders on payment of a prescribed fee not exceeding two shillings for each inspection.

## THE OBJECTS CLAUSE

### Reasons for Stating Objects

Section 5 (1) (c) requires the Memorandum of Association to state the objects of the company. The section does not, however, indicate why a company's objects have to be stated in the company's Memorandum of Association. In **Cotman v Brougham** (21) Lord Parker stated that the statement of a company's objects in its Memorandum of Association is intended to serve the following purposes:

- (a) To protect subscribers who learn from it the purpose to which their money can be applied.
- (b) To protect persons who deal with the company and who can infer from it the extent of the company's powers.

These propositions will become clearer after a study of the doctrine of *Ultra Vires*.

## The Doctrine of 'Ultra Vires'

### Fast forward

- ∅ These are instances when the company acts beyond the powers in its objects clause
- ∅ The instances are either common law or judicial

The doctrine of *Ultra Vires* is a legal rule that was articulated by the House of Lords in the case of **Ashbury Railway, Carriage and Iron Co Ltd v Riche** (22) to the effect that, where a contract made by a company (usually by the directors on its behalf) is beyond the objects of the company as written in the company's Memorandum of Association, it is beyond the powers of the company to make the contract. The contract is void, illegal and unenforceable. Lord Cairns stated in an



obiter dictum that such a contract cannot be ratified even by the unanimous consent of all the shareholders of the company. His Lordship observed that any purported ratification would mean that “the shareholders would thereby, by unanimous consent, have been attempting to do the very thing which, by Act of Parliament, they were prohibited from doing”.

A company’s objects are stated pursuant to the provisions of an Act of Parliament. It must therefore be deduced, for example, that a company whose object has been stated to be “gold mining” cannot engage in “fried fish” business. This is because: -

- (a) Prospective investors who read the objects clause realised that the company was formed to mine gold. If they bought the company’s shares they did so because they intended their money to be used in pursuance of the gold mining business. They did not give the money for any other business and the company does not have their consent to use it on any other business. If the company tries to use the money on a different venture, such as frying fish and chips, they can go to court for an injunction to restrain it from doing so.
- (b) The statutory requirement that a company must state its objects in its Memorandum of Association would be rendered purposeless if, despite having stated the objects, the company was legally entitled to embark on any other activity. To prevent this happening, the courts concluded that the statement of objects would be taken to mean that what is not stated as an object cannot be pursued, or undertaken, by the company. In other words, the statutory requirement that the objects are to be stated implies that what has not been stated as an object cannot become a legitimate activity of the company.

## IMPLIED POWERS

The statement of Lord Cairns in 1875 in **Ashbury Rail Co Ltd v Riche (22)** to the effect that a contract beyond the objects of the company “in the Memorandum of Association” is “beyond the powers” of the company gives the impression that a company has no legal power to do anything which is not written in the Memorandum of Association. That would be a startling proposition because, in practice, companies have to do so many things in the course of their business that if all those things were to be written down in the Memorandum of Association, the Memorandum would be such a gigantic document that nobody would print or read. It was, therefore, a welcome clarification of the legal position when, in 1880, Lord Selborne, L C, stated in **Attorney-General v Great Eastern Railway Co** that the doctrine of *Ultra Vires*, as explained in the **Ashbury** case, “ought to be reasonably, and not unreasonably, understood and applied”. His Lordship then explained that it is not necessary for a company to write down in its memorandum everything that it would or could do in the course of its business because whatever may fairly be regarded as incidental to, or consequential upon, those things which have been stated in the memorandum ought not, and would not, be held by the courts to be *Ultra Vires*. The courts would regard such things as impliedly within the company’s powers unless they are “expressly prohibited” by the memorandum. The range of transactions that could be encompassed within the “implied powers rule” was illustrated by Lord Buckley in 1907 when, in **Attorney - General v Mersey Railway Co**, he stated:

“To ascertain whether any particular act is *Ultra Vires* or not the (stated objects) must first be ascertained; then the special powers for effectuating those (objects) must be looked for, and then, if the act is not within either the (stated objects) as described in the memorandum, the inquiry remains whether the act is incidental to or consequential upon the (stated objects) and is a thing reasonably to be done for effectuating it ... By way of illustration, let me suppose that the (stated object) found in the Memorandum of Association of a (registered) company is to establish and carry on a hotel, and that express power is given to buy land at a particular place and to build and that as to anything further the... Memorandum of Association is silent. It is quite clear that all such acts as are reasonably necessary for effectuating that purpose are *intra vires*, such, for instance, as the purchase of furniture, and of linen, of provisions, and of wines and spirits, the hiring of servants, the payment of licences, the ownership probably of horses and carriages, the maintenance and working of an omnibus which shall attend at the railway station to take intending guests to the hotel and the like. In a large number of cases the maintenance of a garden and pleasure grounds would be *intra vires*... The maintenance of tennis lawns or of a bowling green would, in many circumstances, be legitimate. Under circumstances such as presently put, a golf links might be *intra vires*. All these and the like will without express mention be within the company's powers. Then I may instance other acts as to which it would be a question of fact in the case of the particular hotel whether it was such an act as was reasonably incidental or consequential. If, for instance, the hotel were at Bundoran or Rosapenna or elsewhere in the country it might be *intra vires* to lay out and maintain in good order a golf links or to acquire rights of fishing and to own boats and supply gullies for the purpose of fishing upon the lakes. It may be that in the particular locality, customers could only be reasonably expected or obtained by offering these attractions, and they might be as necessary as a smoking-room or a bowling green elsewhere. If the hotel in question were the Savoy Hotel in the Strand or the Great Central Hotel in the Marylebone Road, the proposition would cease to be true. So, again, if the hotel were situated in a place inaccessible unless special means of communication were provided say, at a lovely spot at the end of a Scotch Loch to which there is no road, or at a place to which there is access by road but which is not served by any coach or mail cart service it might be *intra vires* for that hotel to run a steam launch or a motor-car to bring its guests to their destination. It would in such a case be analogous to the omnibus, which the hotel in the country town sends to the railway station. The question is in each case a question of fact. Is the particular act in that case incidental to or consequential upon or reasonably necessary for effectuating the object, which the Memorandum defines?”

The gist of Lord Buckley's statement, above, may be summarised as follows: The judges will not regard a transaction undertaken by a company as *Ultra Vires* merely because it is not written in the company's Memorandum of Association as one of the company's objects. They would in fact regard the transaction as *intra vires* by implication if:

- i. It was reasonably incidental to any of the objects which have been written in the company's Memorandum of Association, and
- ii. It was undertaken for the sole purpose of effectuating, or achieving, the written objects, or any of them.

Regarding the criteria to be used when deciding on whether a proposed transaction is “reasonably incidental” to the objects written in the memorandum, it was stated in **Henderson v Bank of Australia (1888)** that what other companies with similar objects do may be a good guide for a company regarding its implied powers. But it appears that, provided a transaction is decided



on by the company (at a board or general meeting) in the *bona fide* belief that its pursuit would enable the company to get more customers or do more business, the court would not regard the transaction as *ultra vires* even though it may doubt its “reasonableness”.

**It has also been clarified in numerous English cases that a trading company has implied power:**

- i. To borrow money and mortgage its property as security for the loan.
- ii. To institute and defend legal proceedings;
- iii. To sell the company’s assets (but not the entire undertaking).
- iv. To pay gratuities and pensions to employees and ex-employees and their dependants whilst the company is a going concern.

## The Doctrine of “Constructive Notice”

The doctrine of “Constructive Notice” is a rule of company law to the effect that a person transacting business with a company is taken to be aware of the contents of the company’s public documents. “Public documents” in this context are those documents which a company is required by the Companies Act to deliver to the Registrar of Companies for registration at the Companies Registry. Examples of such documents are:

- (a) The Memorandum of Association
- (b) The Articles of Association
- (c) The annual return
- (d) Special resolutions

Because the Companies Registry is a “public office” the documents kept therein are generally referred to as “public documents” since the public is free to inspect them on payment of a prescribed fee.

For purposes of the *ultra vires* doctrine, a person transacting business with a company will be taken to have read the objects clause in the company’s Memorandum of Association. Consequently, if he concludes a contract with the company and it turns out that the contract was for a purpose which is neither expressly nor impliedly within the company’s objects and hence *ultra vires*, he is regarded as having entered into an *ultra vires* contract knowingly even though he was not actually aware of its being *ultra vires*. He cannot successfully sue the company for breach of the contract, as illustrated by the facts of, and the decision in, **Ashbury Railway & Carriage Co v Riche (22)**.

The legal justification for this rule is that since the company’s public documents in its file at the Companies Registry are available for inspection by any interested member of the public, he should have gone to the Registry, asked for the Company’s file, inspect the contents and, having found the Memorandum of Association, read the objects clause in order to ascertain whether the proposed contract is consistent with the company’s objects. He would then have realised that the contract was not within the company’s objects. If he fails to do so and it happens that the concluded contract was neither expressly nor impliedly within the company’s objects, he will be regarded as having been aware that the contract was *ultra vires*. He cannot therefore be allowed to enforce it. The “constructive notice” rule may be likened to the old adage, “you can take a donkey to the river but you cannot force it to drink”, but with the addition that, on your way back

home, you would be entitled to tell the donkey: "Since you have simply refused to drink for no apparent reason, I will, take it that you have drunk for today. I will, therefore, not take you to the river again today but will do so tomorrow when the drinking time comes".

There appears to be no moral justification for allowing a person contracting with a company to rely on his own inaction as the basis for instituting legal proceedings against the company. It is rather tempting to say that the law, like God, protects only those who also protect themselves.

The only plausible criticism that could be made against the constructive notice rule is its assumption that a potential contracting party who reads a company's objects will be able to make the correct legal conclusion regarding the *vires* of the proposed transaction, and its refusal to validate the transaction in cases where the party mistakenly believed the proposed contract to be *intra vires* the company.

The fact that a perusal of the company's objects clause does not guarantee its correct interpretation is amply demonstrated by a number of English cases in which judges of the High Court, having read a disputed clause, concluded that the transaction was *intra vires* but the decision was later on reversed by the Court of Appeal or the House of Lords. If such senior judges can differ over the *vires* of a particular transaction, why should an ordinary businessman, or his legal advisor, be expected to decide the matter correctly?

A close study of some of the relevant English cases pertaining to this issue, particularly the **Ashbury case**, seems to indicate that the decision of the higher court which finally disposed of the case was "correct" only in the sense that the higher court, being constitutionally mandated to make the final decision, also made the "correct" decision.

There seems to be no legal justification for retention of the constructive notice rule. The fact that a person intending to contract with a company read the company's objects does not guarantee that he will interpret it correctly. And there appears to be no moral justification for blaming a person for not making a decision that was beyond his technical competence to make.

## Effect of *Ultra Vires* Transaction

**An *ultra vires* transaction with a company may result in:**

- (a) A transfer of specific property to the company, or
- (b) Money being lent to the company.

**The remedies available against the company will be as follows.**

### 1. Property Transferred

If specific property is transferred to a company pursuant to a transaction, which, unknown to the transferor, is *ultra vires* to the company, the ownership of the property is not transferred. The property remains the property of the transferor while the company only acquires possession of it. This is because an *ultra vires* transaction cannot constitute a "contract" which, pursuant to the Sale of Goods Act, Section 3, is capable of vesting or transferring the ownership of the property in the transferee company. The transferor, on becoming aware of the legal position, would be



entitled to trace his property and, on finding it, take possession of it. This remedy is known as “tracing”.

The company has no right to retain the property and its attempt to do so would constitute the tort of detinue.

The other consequence of this rule is that, since there was no contract of sale, the transferor cannot sue the company for breach of contract, or the agreed price. The legal position in the converse situation is not clear. It is probable that the company cannot recover its property by tracing if the transferee is willing to pay the agreed price. However, the company might be able to recover it if the transferee has failed or refused to pay for it because to allow him to retain it after refusing to pay for it would constitute “unjust enrichment” which a court of equity is unlikely to condone.

## 2. Money Lent

According to the decision in **Re: David Payne & Co Ltd (23)**, a person lending money to a company is not bound to enquire as to why the company requires the money. He is entitled to assume that the money is being borrowed for the company’s legitimate objects. His legal right to enforce the transaction will not be affected by the company’s application of the borrowed funds to a *ultra vires* purpose. However, if the lender is told the purpose of the loan, he must read the company’s Memorandum of Association to ascertain if the stated purpose is consistent with the company’s objects, expressly or by implication. If he does not do so and the purpose turns out to be an *ultra vires* one, he will be deemed to have financed an ultra vires transaction knowingly: **Re Introductions Ltd (25)**. He would not be entitled to sue the company for breach of contract.

## Remedies of the Ultra Vires Lender

In **Sinclair v Brougham (26)** the House of Lords explained that no action or suit lies at law or in equity to recover money lent to a company which has borrowed for an *ultra vires* purpose. This means that the *ultra vires* lender cannot sue, as lender, to recover the money he lent to the company. However, he might avail himself of one or other of the following remedies which were summarised by Buckley, J. in **Re Birkbeck Permanent Benefit Building Society**:

- i. If the result of the transaction is that the indebtedness of the company is not increased because the new loan was applied in discharging an old debt, the invalid lender can be treated as standing in the place of those whose debts have been paid off. In such a case the *ultra vires* loan “is not to be regarded as a borrowing transaction”.
- ii. The aforesaid remedy would also be available if the loan was applied in discharging a future debt (i.e. an indebtedness that was incurred after the money was borrowed).

The basis of this remedy is that, since the company could legally become indebted in respect of the future debt, the lender whose money discharged it would be subrogated to the rights of the discharged creditor. However, he would be entitled to rank as a creditor of the company only to the extent to which his money was applied in discharging the *intra vires* debt and would not obtain the benefit of any security held by the *intra vires* creditor (although he would be entitled to enforce any security that was given to him).

- iii. If the lender can identify his money or the investment of his money in the hands of the borrowing company, he can call for its return.  
The basis of this remedy was explained by Lord Parker in **Sinclair v Brougham (26)** as follows:  
“A company or other statutory association cannot by itself or through an agent be party to an *ultra vires* act. If its directors or agents affecting to act on its behalf borrow money which it has no power to borrow, the money borrowed is in their hands the property of the lender.”
- iv. If the lender cannot bring himself within any of the above propositions he would have no remedy except to participate in the division of the company’s surplus assets, if any, which would be divisible among the *ultra vires* creditors rateably during the company’s liquidation after all the company’s members have received back their capital in full.

## ■ Alteration of Objects

Section 7 of the Act provides that a company shall not alter the “conditions” (i.e. contents) of its memorandum except in the cases, in the mode and to the extent for which express provision is made in the Act. This provision confers a special status on the Memorandum of Association as the basic document of the company whose contents are statutorily prescribed and protected.

Regarding alteration of objects, Section 8 provides that a company may, by special resolution alter the provisions of its memorandum with respect to its objects if the alteration would enable the company:

- i. To carry on its business more economically or more efficiently.  
In **Re: Cyclists Touring Club (27)** Warrington, J. stated that the alteration which is contemplated in this clause “seems ... to be an alteration which will leave the business of the company substantially what it was before, with only such changes in the mode of conducting it as will enable it to be carried on more economically or more efficiently”. The clause does not permit alterations in the type of business, which the company is conducting.
- ii. To attain its main purpose by new or improved means.  
This provision is not clear. It seems to be intended to facilitate the introduction of new powers, which would assist in the achievement of the company’s main “purpose” or object. If so, it would be a superfluous provision since a company has implied power to do anything, which would enable it to achieve its main (i.e. stated) objects.
- iii. To enlarge or change the local area of its operations.  
If a proposed alteration under this clause was opposed by the prescribed number of the company’s members, the court could make it a condition of its confirmation that the company alters its name as well: **Re: Egyptian Delta Land and Investment Co Ltd (28)**.
- iv. To carry on some business, which under existing circumstances may conveniently or advantageously be combined with the business of the company.  
In **Re: Cyclists Touring Club (27)** it was held that, for a proposed alteration to fall under this clause, it must be “a proposal to combine a business of one kind with a business of another kind”. The businesses must be of different kinds so that they may be “combined” and carried on by the company. If they were of the same kind the company would merely have enlarged or expanded the existing business. The key word in this clause is “combined”.





- v. To restrict or abandon any of the objects specified in the memorandum: See **Re: Hampstead Garden Suburb Trust Ltd** (29).
- vi. To sell or dispose of the whole, or any part, of the undertaking of the company.
- vii. To amalgamate with any other company or body of persons.

In order to effect a proposed alteration, the company's directors would have to convene an extraordinary general meeting of the company to consider and, if approved, pass a special resolution that the company's objects be altered as proposed. The general meeting may however change the text of the resolution so as to conform to its wishes provided that it falls within one or other of the specified clauses. The resolution would be effective immediately it is passed if it was voted for by the holders of at least 86% in nominal value of the company's issued share capital or any class thereof or, if the company is not limited by shares, at least 86% of the members (assuming that the company does not have debenture holders who are entitled to object to alterations of its objects). This would be so even if the purpose of the alteration does not fall within the restrictions prescribed by the Act since no application could be made to the court to cancel the alteration. Such an application can only be made by or on behalf of: -

- (a) The holders of not less in the aggregate than 15% in nominal value of the company's issued share capital or any class thereof or, if the company is not limited by shares, not less than 15% of the company's members; or
- (b) The holders of not less than 15% of the company's debentures entitling the holders to object to alterations of its objects.

An application to the court cannot, however, be made by a person who consented to or voted in favour of the alteration.

In the event of the application for cancellation being made, the court is empowered to make an order:

- i. Cancelling the alteration. This is illustrated by **Re: Cyclists Touring Club** (27) in which the court refused to confirm the proposed alteration because it did not fall within any of the prescribed exceptions.
- ii. Confirming the alteration either wholly or in part and on such terms and conditions as it thinks fit. The power to confirm in part was exercised in **Re: Parent Tyre Co** (30), while the power to confirm on conditions was exercised in **Re: Egyptian Delta Land and Investment Co Ltd** (28).
- iii. Adjourning the proceedings in order that an arrangement may be made for the purchase of the interests of the dissenting members. In such a case, the court may give such directions and make such orders as it may think expedient for facilitating or carrying the arrangement into effect. However, no part of the capital of the company can be expended in any such purchase.

Where a company passes a resolution altering its objects and no application is made to the court for its cancellation it shall, within 14 days from the end of the period allowed for making such an application, deliver to the registrar a printed copy of its altered memorandum. If an application is made the company shall: -

- (a) Forthwith give notice of that fact to the registrar, and
- (b) Within 14 days from the date of the order cancelling or confirming the alteration wholly or in part, (or within such extended time as the court may allow) deliver to the registrar a certified copy of the order and, if the alteration is confirmed wholly or in part, a printed copy of the memorandum as altered.

## LIMITED LIABILITY CLAUSE

### Contents of the Clause

**Section 5(2) provides that the memorandum of a company limited by shares or by guarantee shall also state that “the liability of its members is limited”.**

### Companies limited by shares

Most registered companies, both public and private, are companies limited by shares. Such a company is defined by Section 4 (2) (a) as “a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them”. It should be noted that it is the liability of the company’s members which is limited and not the company’s own liability. To that extent, the word “Ltd” at the end of the name of such a company is actually misleading.

In such a company the capital is divided into shares of a specified amount, for example, capital of Kshs 100,000 divided into 10,000 shares of Kshs 10 each. Every member of the company is liable to pay 10/- for every share he holds and if, he has already paid the Kshs.10, he is not liable. If he has not paid the whole amount, he will be liable to pay the balance only.

### Companies limited by guarantee

Section 4(2)(b) defines a company limited by guarantee as “a company having the liability of its members limited by the memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its being wound up”. The memorandum of such a company would have a clause stating that “every member of the company undertakes to contribute to the assets of the company in the event of its being wound up while he is a member... such amount as may be required, not exceeding (so many) shillings”. The member’s liability is contingent and he can only be called upon to pay the amount “guaranteed” if the company is in liquidation.

A company limited by guarantee may also have a share capital. The model Memorandum and Articles of Association of such a company is Table D in the First Schedule to the Companies Act. The members of such a company have dual liability, that is, to pay the amount unpaid on their shares and the amount of the guarantee. The model Memorandum and Articles of Association of a company limited by guarantee and not having a share capital is Table C in the First Schedule to the Companies Act.

### Unlimited companies

Section 4 (2) (c) defines an “unlimited company” as a company not having any limit on the liability of its members”. In such a case, although the company is a separate legal entity, the members’



liability resembles that of partners except that, technically, their liability is to the company itself and not to the creditors.

An unlimited company may also have a share capital. The Memorandum and Articles of Association of such a company would substantially correspond to Table E in the First Schedule to the Companies Act.

## CAPITAL CLAUSE

Section 5(4) (a) provides that, in the case of a company having a share capital, the memorandum shall also (unless the company is an unlimited company) state “the amount of share capital with which the company proposes to be registered and the division thereof into shares of a fixed amount”. Table B in the First Schedule to the Act, in pursuance of this provision, states that “The share capital of the company is Kshs.200,000 divided into one thousand shares of Kshs.200 each”.

### ■ Reasons for stating capital

The Act does not expressly state the reasons why the capital of a company should be stated. However, there is a clue in the qualifying words “unless the company is an unlimited company”. This means that if a company has a share capital but is registered as an unlimited company, the amount of the capital need not be stated in the memorandum. This is so because the company’s creditors would NOT rely on that capital as their primary security. They need not, therefore, be informed about its quantum. The creditors of such a company would rely primarily on the members’ private assets and their personal liability as their security for any money they lend to the company. It may, therefore be said that the proposed capital of a limited company is stated in its Memorandum of Association so that the company’s potential creditors may read the memorandum in order to ascertain the amount of the capital as stated therein. Having ascertained the amount they could then decide on the amount to lend to the company. This is so because, legally, the capital is their primary security for any money they lend to the company. In **Ooregum Gold Mining Co of India Ltd v Roper** Lord Halsbury stated that “the capital is fixed and certain and every creditor of the company is entitled to look to that capital as his security”.

## THE ASSOCIATION CLAUSE

What has generally come to be known as “the association clause” is not provided for in Section 5 of the Companies Act, which prescribes the contents of the Memorandum of Association. It is, however, the popular or academic designation of the last paragraph of Table B, which contains a declaration that the subscribers to the Memorandum of Association “are desirous of being formed into a company, in pursuance of this Memorandum of Association and ... agree to take the number of shares in the company” set opposite their respective names.

The declarants then sign the memorandum and their signatures are then witnessed by at least one person who is not a subscriber.

## OTHER CLAUSES

The clauses enumerated and explained above form part of the Memorandum of Association pursuant to the provisions of Section 5 of the Companies Act. However, other clauses may be included in the memorandum, such as a clause providing special rights for different classes of shares. Such a clause is usually placed in the Articles of Association but is occasionally incorporated into the memorandum if it is the intention of the promoters that it should, as it were, be “entrenched” (i.e. one which is more difficult to alter or is unalterable).

### Alteration of the Memorandum Generally

Every clause of the memorandum may be altered except the registered office clause. In addition to the methods of alteration of the name clause and the objects clause, which have already been explained in paragraph 3.1.5.5 and paragraph 3.1.7.7, respectively, section 25 allows a company to alter clauses that are included in its memorandum but could lawfully have been contained in the articles. Such clauses can be altered by special resolution except where the memorandum itself provides for or prohibits the alteration of all or any of the said conditions. Holders of 15% of the issued shares have 30 days to apply to the court to challenge the alteration. In the event of such application, the alteration shall not have effect except in so far as it is confirmed by the court.

## THE ARTICLES OF ASSOCIATION

The Articles of Association are the regulations for the management of a company. The heading to Table A is “regulations for management of a company”.

## FORM OF ARTICLES

Table A, Part I is the model form of articles for a public company limited by shares. Part II thereof:

- (a) Declares Part I to be applicable to a private company as well, with the exceptions of articles 24 and 53;
- (b) Incorporates the provisions which, under Section 30 of the Act, must be incorporated in the Articles of a company in order to constitute the company as a private company, and
- (c) Modifies articles 24 and 53 of Part I in order to make them applicable to a private company.

Part I of Table A has 136 paragraphs which, pursuant to Section 12, are divided into paragraphs, which are numbered consecutively. Section 11(2) provides that if articles are not registered in the case of a company limited by shares, Table A shall be the regulations of the company in the same manner and to the same extent as if they were contained in duly registered articles. In practice,



advocates acting for company promoters usually copy nearly all the provisions of Table A and merely change a few clauses here and there to suit the requirements of the proposed company.

## STATUTORY REQUIREMENTS

Section 12 provides that articles shall be -

- (a) In the English language;
- (b) Printed;
- (c) Divided into paragraphs numbered consecutively and
- (d) Dated; and
- (e) Signed by each subscriber to the Memorandum of Association in the presence of at least one witness, who shall attest the signature and add his occupation and postal address.

## Legal effect of articles

Section 22 provides that “the Memorandum and Articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member, to observe all the provisions of the memorandum and of the articles”. The English courts have interpreted this section as follows:

- (a) The articles constitute a statutory contract, which binds the members to the company, and also binds the company to the members. Consequently:
  - i. A company may sue a member to restrain an imminent breach of the articles. This is illustrated by **Hickman v Kent or Romney Marsh Sheep breeders Association** (31) in which the company obtained an injunction restraining a member (Hickman) from going to court in breach of the articles, which provided for arbitration proceedings.
  - ii. A member may sue the company for any actual or ‘imminent’ breach of the articles. This is illustrated by **Wood v Odessa Waterworks Ltd** (32) in which a member (Wood) successfully sued for an injunction restraining the company from paying dividends in the form that was not provided for by the articles.
- (b) The members are bound to the company, and the company is bound to the members, only in their capacity as members. This is illustrated by the following cases:
  - i. **Eley v Positive Life Assurance Co** (34) in which Eley failed in his contention that the company had committed a breach of the contract in the articles which appointed him as the company’s lawyer for life because he was, in the court’s view, suing qua lawyer and not qua member.
  - ii. **Beattie v E F Beattie Ltd and Another** (33) in which the company failed to restrain Mrs Beattie from suing in alleged breach of the articles which provided for arbitration. The court explained that Mrs Beattie was suing qua director and not qua member. She was, therefore, not bound by the arbitration clause, which required members to refer disputes between them and the company to arbitration.

- (c) The articles also constitute a statutory contract, which binds the members inter se (i.e. a member is bound to other members). In **Hickman's case** (31) Ashbury J. stated, inter alia: "In my judgment, general articles dealing with the rights of members 'as such' are treated as a statutory agreement between them and the company as well as between themselves inter se". This is illustrated by **Rayfield v Hands** (35) in which it was held that the defendants were bound, qua members, to buy the shares of the plaintiff (another member) as provided by the company's articles of association.

Members are also bound inter se by the pre-emption clauses in the company's Articles of Association, which require members intending to sell their shares to offer them first to existing members who are given a right to buy the shares in preference to third parties. This is illustrated by **Lyle & Scott Ltd v Scott's Trustees** (36)

## ALTERATION OF ARTICLES

Section 13 (1) provides that a company may by special resolution alter or add to its articles. Section 13 (2) provides that any alteration or addition so made in the articles shall be as valid as if originally contained therein and subject to alteration in like manner by special resolution.

## LIMITATIONS ON POWER TO ALTER ARTICLES

The following are the legal restrictions on a company's power to alter its articles:

- (a) Section 13 (1) provides that the alteration is subject to the conditions contained in the company's memorandum of association. This means that an alteration to include a clause which contravenes a provision in the company memorandum is of no effect.
- (b) Under Section 13 (1) a proposed alteration is subject to the provisions of the Act. An alteration that contains a clause which contravenes a provision in the Act is null and void.
- (c) Section 24 provides that no member of a company shall be bound by an alteration made in the articles after the date on which he became a member if and so far as the alteration requires him to take or subscribe for more shares than the number held by him at the date on which the alteration is made, or in any way increases his liability as at that date to contribute to the share capital of, or otherwise to pay money to, the company. It should be noted that the alteration is valid but does not bind members who have not agreed in writing to be bound by it.
- (d) An alteration that varies the rights attached to any class of shares is invalid unless the variation of rights clause, if any, in the company's articles has been complied with. In addition, Section 74 permits the holders of not less in the aggregate than 15% of the issued shares of that class who did not vote in favour of the resolution for the variation to apply to the court to have the variation cancelled. Once such an application has been made the variation will not have effect unless and until it is confirmed by the court.
- (e) Section 211 (3) provides that where an order made by the court under Section 211(2) makes any alteration in or addition to a company's articles, the company concerned shall not have power without leave of the court to make any further alteration in or addition to the articles which are inconsistent with the provisions of the order.



- (f) In **Allen v Gold Reefs of West Africa** (37) Lindley, M R stated:  
“Wide, however, as the language of Section 13 is, the power conferred by it must, like all other powers, be exercised subject to the general principles of law and equity which are applicable to all powers exercised not only in the manner required by law, but also bona fide for the benefit of the company as a whole”.

To be valid, therefore, a proposed alteration of articles must also be made *bona fide* and for the benefit of the company as a whole. Examples are:

- i. **Sidebottom v Kershaw, Leese & Co Ltd** (38) in which the alteration was held to be for the benefit of the company.
- ii. **Dafen Tinsplate Co Ltd V Llanelly Steel Co Ltd** (39) in which the alteration was declared to have been made “mala fides” and was not for the benefit of the company as a whole.

## 2.3 PROMOTION

### Fast forward

- Ø The steps that are taken before a company is formed
- Ø Promoters duties fall into fiduciary and common law duties

A company comes is formed from the moment of its registration by the registrar of companies. However, the registration is preceded by what is called “promotion”. The promotion consists in taking the necessary steps to incorporate the company and ensuring that it has sufficient capital to commence its operations.

## PROMOTERS

There is no general statutory or judicial definition of the word “promoter”. This is so because the lawmakers in England as well as the English judges were of the view that a comprehensive definition of the word would be limiting, and might prevent the court from catching “the next ingenious rogue” who might be brought to the court to account for his actions as promoter. Kenya has adopted the applicable English law.

English judges have, however, described the word ‘promoter’ in varying terminology of which the following may be quoted:

- (a) 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” (per Cockburn, J): **Twycross v Grant**.
- (b) “The term ‘promoter’ is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence”, (per Bowen, J): **Whaley Bridge Calico Printing Co v Green**.

It should be noted that Section 45 (5) of the Companies Act does not contain a general definition of 'promoter'. It merely defines the word for purposes of sub-section (1) of Section 45 by excluding from the category of promoters persons who give professional services in connection with the formation of a company.

The answer to the question "who is a 'promoter?'" must, therefore, depend on the facts of a particular case.

## Legal Status

A promoter is not an agent of the company he promotes as it does not exist and at common law one cannot be an agent of a non-existent principal. A promoter is not a trustee of the company in formation as it does not exist. However, the English courts have held that he stands in a fiduciary relationship to the company he promotes, just as an agent stands in a fiduciary relationship to his principal: In **Erlanger v New Sombrero Phosphates company limited** Lord Cairns stated "they stand in my opinion in a fiduciary position they have in their hands the moulding and creation of a company." This is an equitable relationship based on trust, confidence and good faith. It imposes on promoters certain equitable obligations.

## Duties/obligations of promoters

**A promoter's duties fall into two main categories:**

- Fiduciary
- General/common law duties

### Fiduciary duties

1. Bona fide - Promoters are bound to act in good faith for the benefit of the company in formation. Their acts must be guided by the principle of utmost fairness.
2. Proper accounting: - A promoter is bound to explain the application of money or assets coming to his hands from the date he becomes a promoter. The account must be complete and honest.
3. Disclosure: - As a fiduciary promoter must avoid conflict of interest by disclosing any personal interest in contracts made on behalf of the company in formation. The disclosure may be made to an independent board of directors or to all members in the prospectus. Any secret profit made without disclosure must be accounted to the company. If a promoter makes a secret profit without disclosure the company is entitled to rescind the contract or sue for the recovery of the profit.

### General/common law duties

1. To determine and settle the company's name
2. To prepare the constitutive and other documents necessary for incorporation
3. To cause registration of the company
4. To secure the services of directors
5. To meet the preliminary expenses





6. To ensure that the company in formation has an independent board of directors
7. To prepare the prospectus, if any
8. To acquire the assets for the use by the company
9. To enter into business transactions on behalf of the company.

## PRE-INCORPORATION CONTRACTS

A pre-incorporated contract is an agreement that is entered into, usually by a promoter or promoters, on behalf of a company at a time when the company's formation has not been completed by its registration. As a general rule, a pre-incorporation contract is generally unenforceable. Few cases have been contested in English courts regarding the effect of such agreements. The following rules were enunciated by the judges in the course of deciding the said cases:

1. Before incorporation a company has no legal existence it can't contract or have agents (it was so held in **Kelner v Baxter**)
2. At common law a person who purports to contract as an agent but who at the time has no principle is personally liable on the contract. This is necessary to give effect to the contract. In **Kelner v Baxter**, it was held that where a contract is signed by one who professes to be signing as an agent but who has no principle existing at the time the contract would altogether be inoperative unless made binding upon the person who signed it. A stranger cannot by a subsequent ratification relieve him from the responsibility.
3. At common law, a contract purporting to have been entered into by or with a non-existent person is void. For a contract to exist there must be at least two parties.
4. At common law a company can't, after incorporation, ratify a pre-incorporation contract, this is because it could not have entered into the contract before it was formed. It was so held in **Price v Kelsal**.
5. At common law the mere adoption or confirmation by directors of a pre-incorporation contract creates no contractual relationship between the company and the other party
6. At common law, a pre-incorporation is enforceable by or against the company if after incorporation, the company enters into a new contract similar to the previous agreement. The new contract may be express or implied from the conduct of the company when incorporated.



## REMUNERATION OF PROMOTERS

A promoter is not entitled to remuneration for incorporating a company nor is he entitled to recover the expenses incurred in the process. This is because there is no contractual relationship between him and the company hence the company could not have contracted for the services. However, in practice the articles provide for the recovery of the expenses. For instance Article 80 of Table A provides that the directors may recover the expenses of incorporating the company. This article is unenforceable by a promoter by reason of Section 22 of the Act. However, promoters may be rewarded in other ways:

1. Upon disclosure, the promoter may sell the undertaking to the company at a profit.
2. Upon disclosure, a promoter may sell an undertaking to the company in return for fully paid shares.

3. A promoter may facilitate a transaction between a third party and the company for a commission, which must be disclosed.
4. A promoter may be afforded the option to take up extra shares at their par value after the market price has risen.
5. Traditional promoters have been rewarded by being offered deferred or founders or management shares,
6. A promoter may be appointed one of the first directors,

## INCORPORATION

### FORMAL STEPS OF INCORPORATION

#### A. RESERVATION OF NAME

Under Section 19(1) of the Act, the registrar may on written application reserve a name ending the registration or change of name of a company. The name is reserved for 30 days at first instance during which time it is unavailable to other persons. However, the registrar is empowered to extend the reservation by any number of days not exceeding thirty. Under Section 19 (2), the registrar can't reserve a name or register a company by a name, which in his opinion is undesirable.

#### B. PREPARATION OF CONSTITUTIVE AND OTHER DOCUMENTS

To facilitate company registration the following documents must be prepared:

(i) **Memorandum of Association**

Section 2 (1) of the Companies Act provides Memorandum means Memorandum of Association of a company as originally framed or as altered from time to time. This is the primary document for purposes of incorporation. It's one of the constitutive documents and must be prepared in all cases. It's the company's charter or external constitution. It regulates the relations between the company and third parties. Its contents include:

- Name of the company
- Objects
- Capital
- Liability
- Association
- Particulars of subscribers
- Date

The memorandum of a company may be limited by shares or by guarantee must state that the liability of the company's members is limited. The memorandum of a company limited by guarantee shall also state the amount "guaranteed" by each member of the company.

**(ii) Articles of Association**

This document contains the regulations for management of a company. Under section 2(1) of the Companies Act, Article means Articles of association of a company as originally framed or as altered by special resolution including so far as they apply to the company the regulations contained in Table A of the First schedule to the Act. Table A is a sample of the articles of a company limited by shares.

If the proposed company is to be limited by shares, the promoters need not deliver it for registration. The provisions of Part I of Table A in the First Schedule to the Act will be automatically applicable to the company.

The Articles of Association is thus a constitutive document that contains the rules of regulation. It contains the rules of internal management hence it is the internal constitution of the company. It regulates the relations between the company and its members.

**(iii) Statement of the Nominal Share Capital**

This statement is delivered for taxation purposes pursuant to Section 39 of the Stamp Duty Act. It sets out the name of the company and the capital with which the company purposes to be registered. It facilitates assessment and payment of duty for the purpose of incorporation.

**(iv) Declaration of Compliance (Form No 208)**

Form No 208, when duly completed and signed, constitutes the statutory declaration by the advocate engaged in the formation of the proposed company, or by the person named in the articles as a director or secretary of the company, that all the requirements of the Companies Act in respect of matters precedent to the registration of the company and incidental thereto have been complied with.

**NOTE**

The documents identified here in below must in law be delivered to the registrar within 14 days after registration of the company but which in practice must accompany the constitutive documents.

**(v) Consent to act as director (Form No 209)**

Under Section 182 (1) any person who has been appointed director must deliver to the registrar for registration his written consent to act as such; which must be signed by him in person or by an agent authorised in writing. This is a personal commitment by the director to act as such.

**(vi) List of persons who have consented to be directors (Form No 210)**

This form, when duly completed and signed, constitutes the statutory list of persons who have given their individual consents. It is to be delivered for registration only if the prospective directors have been appointed by the articles delivered for registration in lieu of Table A, or as complementary thereto. The document sets out:

- The names of directors
- Their postal addresses
- Occupation
- Date of birth
- Other directorships, if any

These particulars enable the registrar to ascertain whether the persons qualify as directors.

## C. STAMPING OF DOCUMENTS

The memorandum, articles and statement of nominal capital must be delivered for stamping i.e. payment of the tax payable for the purposes of incorporation. On payment, the duty imprint is fixed on the documents.

## D. PRESENTATION OF DOCUMENTS TO THE REGISTRAR

Under Section 15 of the Companies' Act the constitutive and other documents must be lodged with the registrar for registration of the company. The registrar must satisfy himself that the documents have been reared in accordance with the law.

## E. REGISTRATION OF THE COMPANY AND ISSUE OF CERTIFICATION OF INCORPORATION

Under Section 16 (1), if the registrar is satisfied with the documentation, he registers the memorandum and issues a certificate of incorporation under his name and seal. Thereby certifying that the company is duly incorporated. Under Section 16 (2) from the date of incorporation mentioned in the certificate of incorporation, the subscribers to the memorandum and other persons who become members are a body corporate.

### CERTIFICATE OF INCORPORATION

This is a document issued by the registrar on registration of a company .it is the birth certificate or right of the company .its contents include:

1. Name of the company
2. Serial number
3. Signature of the registrar
4. Seal of the registrar's office

### PRACTICAL CONSEQUENCES OF INCORPORATION

In the course of delivering his judgment in **Salomon's case**, Lord Halsbury stated that "once the company is incorporated, it must be treated like any other independent person with rights and liabilities appropriate to itself". This means that the company is an independent person, has rights and obligations, which are not the same as the rights and obligations of the subscribers to its memorandum and the other persons who will join it later as its members. This is the fundamental attribute of corporate personality, which is given practical effect in the following ways:



## 1. Limited liability

The fact that a registered company is a different person altogether from the subscribers to its memorandum and its other members means that the company's debts are not the debts of its members. If the company has borrowed money, it and it alone is under an obligation to repay the loan. The members are under no such obligation and cannot be asked to repay the loan. This is illustrated by the case of **Salomon v Salomon & Co Ltd** (3) in which it was held that Salomon, as a member, was not under an obligation to repay the company's debts.

In case a company is unable to pay its debts the creditors, or a creditor, may petition the High Court for an order to wind it up. During the winding up the members will be called upon to pay the amount which is unpaid on the shares they hold, if any, in the case of a company limited by shares, or the amount prescribed by the memorandum, in the case of a company limited by guarantee, as provided for in section 4(2) of the Act.

It should be noted that, in the case of a company limited by shares, what the members are paying are the amounts they owe to the company as its debtors in respect of shares that were sold to them on credit and have not been paid for in full. The company's liquidator will in turn use the money so paid to pay off, or reduce, the company's debts.

The other point to be noted is that a company's creditor cannot institute legal proceedings against a company's member in order to recover from him what he owes the company. This is because the member does not, legally, become his debtor merely because the company is his debtor.

## 2. Perpetual succession

According to the Concise Oxford Dictionary, "perpetual" means, *inter alia*, "applicable, valid, forever or for indefinite time" while "succession" means "a following in order". When used in relation to registered companies the phrase "perpetual succession" denotes a process whereby a company's membership changes in a definite order prescribed by the company's articles and goes on for an indefinite period of time until the company's liquidation. The "perpetual succession" occurs because a company and its members are separate persons and so the company's legal life is not terminated by a member's death.

## 3. Owning of property

Under Section 16 (2) of the Act, a registered company, as a person, has power to own movable and immovable property. It can actually do so if it can afford to buy them, or receives them as a gift. But it is important to note that, legally, the company's property does not belong to the members, either individually or as a group. It belongs to the company alone. This rule has been explained by the English courts in numerous cases among which **Macaura v Northern Assurance Co** (4) may be referred to as an example. It was also explained in **A L Underwood Ltd v Bank of Liverpool** (5) that a company's money is not members' money. Any member who uses the company's money to purchase personal items or discharge personal obligations will be liable to the company for conversion. This rule applies irrespective of whether the company is of a class popularly referred to as 'a one-man company'.

## 4. Suing and being sued

Because a company is in law a different person altogether from its members, it follows that a wrong to, or by, the company does not legally constitute a wrong to, or by, the company's members. Consequently:

- (a) A member or members cannot institute legal proceedings to redress a wrong to the company. The company as the injured party is, generally speaking, the proper plaintiff. This is illustrated by the facts of, and the decision in, Foss v Harbottle (6).
- (b) A member cannot be sued to redress a wrong by the company. This is illustrated by Salomon v Salomon & Co Ltd (3) in which it was held that Salomon was not liable for the company's debts and should not, therefore, have been sued to recover them.

## 5. Capacity to contract

As a legal person, a registered company has capacity to enter into contractual relationships in furtherance of its objects. In addition it's empowered to hire and fire. It was so held in Lee v Lee's Air Farming Company Limited where Mr. Lee formed a company with a capital of 3,000 shares of \$1 each. Mr. Lee held 2,999 of the shares the other share was held by a solicitor on his behalf. Mr. Lee was the governing director and the company chief pilot. He died in a crash while working for the company. Mrs. Lee sued for compensation under the Workman's Compensation Act and she was entitled as to compensation.

## 6. Common seal

Under Section 16 (1) of the Companies Act an incorporated company has a common seal to authenticate its transactions.

## LIFTING THE VEIL OF INCORPORATION

### Fast forward

- Exceptions to the rule in Salomon v Salomon constitute lifting the veil of incorporation.
- There are common law and judicial exceptions.

The decision in Salomon v Salomon established that when a registered company is incorporated it becomes a legal person distinct and separate from its members and managers. It becomes a body corporate with an independent legal existence. This is referred to as the veil of incorporation. As a general rule the law does not go behind the veil to the individual members. However, in exceptional circumstances the law ignores the separate legal personality of the company in favour of the realities behind the facade. These circumstances are collectively referred to as lifting the veil of incorporation. They are exceptions or modifications to the rule in Salomon's case. Such instances may arise under statutory provisions or case law.

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## Statutory provisions/legislative/parliamentary

The following are the sections of the Kenya Companies Act which correspond to those sections of the English Companies Act 1948 which are usually listed in English Company law textbooks as the instances in which the veil of incorporation will be lifted under express statutory provisions:

### (a) Section 33: Reduction of number of members

This section provides that a company's member is personally liable for the company's debts incurred after the six months during which the company's membership had fallen below the statutory minimum, provided he was cognisant of the fact that the membership had so fallen. The section is regarded as an instance of "lifting the veil" because it modifies the principle established in Salomon v Salomon & Co Ltd that a member is not liable for the company's debts, and permits the company's creditors to sue him directly in order to recover the debts. Liability under the section may arise on the death of a member if the death reduces the membership below the statutory minimum for the particular company and:

- (i) No transferee is registered as a new member, and
- (ii) The personal representative of the deceased member does not elect to be registered as a member, within the prescribed six months.

It should be noted that the section limits a member's liability to debts contracted after the six months. It does not make the member liable for any debts incurred during the six months, which follow the reduction of membership. Neither does it make a member liable for any  tort committed by the company during the relevant time.

### (b) Section 109 (4): Non-publication/Mis-description of a company's name

Subsection (1) of Section 109 of the Act requires a company's officers and other agents to write its name on its seal, letters, business documents and negotiable instruments. This is to be done primarily for the benefit of third parties who might contract with a limited company without realising that it is a limited company.

Subsection (4) of the section provides that any officer or agent of the company who does not comply with the aforesaid statutory requirements shall be liable to a fine not exceeding Kshs.1000, and shall further be personally liable to the holder of any bill of exchange, promissory note, cheque or order for goods which did not bear the company's correct name, unless the amount due thereon is duly paid by the company. The imposition of personal liability on the company's agent is what is regarded, in a somewhat loose sense, as "lifting the veil of incorporation". A probably better view would be to regard the section as a codification of the common law rule which makes an agent personally liable under a contract which he enters into with a third party without disclosing that he is acting for a principal. That, in effect, is what happens if a company's agent does not comply with the statutory requirement.

Liability under this section is illustrated by Nasau Steam Press v Tyler & Others (7) and Penrose v Martyr (8). In the latter case the plaintiff told the court that she was NOT aware that the company was limited till after the bills were accepted. She had,

therefore, been misled as to the legal status of the company. It should, however, be noted that the section does not require that the third party suing the company's officer should have been misled by the officer's failure to write the company's name correctly.

**(c) Section 150: Group accounts**

Section 150 requires a company which has subsidiaries to lay before the company in general meeting accounts or statements dealing with the state of affairs and profit or loss of the company and the subsidiaries at the time when the company's own balance sheet and profit and loss account are laid before the company's general meeting. The group accounts are to be prepared in accordance with the provisions of Sections 150-154 and paragraphs 17-18 of the Sixth Schedule to the Companies Act so as to appear "as the accounts of an actual company".

These provisions constitute what is regarded in a loose sense as an instance of "lifting the veil" because a member (the holding company) is obliged to incorporate into its balance sheet the assets and liabilities of the company of which it is a member (the subsidiary company) as if they were its own assets and liabilities. This is a modification of the general principle that a company's assets and liabilities are not a member's assets and liabilities and would not, therefore, be incorporated into the member's own balance sheet.

**(d) Section 167: Investigation of Company's Affairs**

Section 167 gives an inspector appointed by the court powers to investigate the affairs of that company's subsidiary, or holding company, if the inspector thinks it necessary to do so for the purpose of his investigation. An investigation instituted pursuant to this power would be regarded, in a loose sense, as an instance of "lifting the veil" because the order to investigate a company sufficed to investigate the company's member, or vice versa, as if they were one entity.

Generally speaking, a company and its member (in this case, the holding company) are altogether separate entities and a court order to investigate the affairs of a subsidiary company would not authorise an investigation of its holding company, and vice versa.

**(e) Section 173 (5): Investigation of Company's Membership**

Section 173(1) empowers the registrar to appoint one or more competent inspectors to investigate and report on the membership of any company for the purpose of determining the true persons who are or have been financially interested in the success or failure of the company or able to control or materially to influence the policy of the company.

For the purpose of that investigation, Subsection 5 of the section confers on the inspector, or inspectors, power to investigate the membership of the company's subsidiary or holding company for the same purpose. A company and its subsidiary, or subsidiaries, are thereby regarded as one entity for the purpose of the investigation, and the veil of incorporation thereby lifted.

**(f) Section 210: Take-over Bids**

Section 210 provides that where a scheme or contract involving the transfer of shares





or any class of shares in a company to another company has been approved by the holders of not less than nine-tenths in value of the shares whose transfer is involved, the transferee company may, at any time within two months after the expiration of four months after the making of the offer by the transferee company, give notice in the prescribed manner to any dissenting shareholder that it desires to acquire his shares. The dissenting shareholder must then apply to the court within one month from the date on which the notice was given for an order restraining the transferee company from compulsorily acquiring his shares. The court order may, in an appropriate situation, lift the veil of incorporation. This is illustrated by **Re: Bugle Press Ltd** (9) in which an offer made by a company was regarded as having been made, in substance, by the company's members. The court thereby lifted the veil of incorporation by treating the company and its members as one entity for purposes of acceptance of the offer.

**(g) Section 323: Fraudulent Trading**

Section 323 provides that if, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the court, on the application of the official receiver or the liquidator or any creditor or contributory of the company may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

The personal liability of the person concerned for the company's debts is what constitutes, in an extremely loose sense, an instance of lifting the veil of incorporation. The corresponding section of the English Companies Act is invariably cited in English company law textbooks as an instance of lifting the veil. The citation, though hallowed by English academic tradition, is logically untenable.

No Kenya case appears to have been decided under the section. However, the relevant English cases do suggest that to be "knowingly parties" to fraudulent trading under the section some positive step must have been taken by those concerned: **Re: Maidstone Building Provisions Ltd** (10).

It should be noted that, on its literal construction, Section 323 appears to be wider than Section 33 because it also covers liabilities other than debts, such as liability in tort, or damages for breach of contract. It can also be invoked against directors, members or anybody else who participated in the fraudulent trading. However, the obvious limitation of the section is that it can only be invoked on a winding up and the applicant must prove fraud.

If the liquidator applies to the court any money received is distributed to creditors generally and forms part of the general assets of the company: **Re William C Leitch Ltd** (No 2) (11). However, if a creditor applies the court may award him his actual loss or, alternatively, order the defendants to pay his actual debt: **Re: Cyona Distributors Ltd** (12).



## COMMON LAW OR JUDICIAL EXCEPTIONS

Numerous English cases have been variously classified by English writers as instances of “lifting the veil of incorporation”. A few of these cases are summarised below. But it should be noted that the particular judges were merely ascertaining the facts of the case before them and making the appropriate decision rather than consciously or deliberately “lifting the veil of incorporation”. It is the writers who have categorised the said cases as instances of lifting the veil because the decisions in those cases appeared to them to be a modification of the principle in Salomon’s case. These cases may be explained under the following headings.

### (a) Agency/Trustee/Nominee

One of the *ratio decidendi* in **Salomon’s case** was stated by Lord Macnaghten that “the company is not in law the agent of the subscribers”. This proposition was affirmed by the English Court of Appeal and extended to associated companies in **Ebbw Vale Urban District Council v South Wales Traffic Area Licensing Authority** when Lord Cohen stated:

“Under the ordinary rules of law, a parent company and a subsidiary company, even a 100% subsidiary company, are distinct legal entities, and in the absence of an agency contract between the two companies, one cannot be said to be the agent of the other. That seems to me to be clearly established by **Salomon v Salomon & Co Ltd** (3).

From this statement, it can be inferred that, if a court held that a company acted in a particular instance as an agent of its holding company, the veil of incorporation would have been lifted. This is illustrated by the decision in **Firestone Tyre & Rubber Co v Llewellyn** (12) in which it was held, on the basis of the trading arrangements between the holding company and its subsidiary, that the subsidiary was the agent of the holding company.

### (b) Fraud or Improper Conduct

English courts have intervened on numerous occasions and lifted the veil of incorporation in order to circumvent a fraudulent or improper design by a bunch of scheming promoters or shareholders. This is illustrated by the decisions in **Jones and Another v Lipman and Another** (13) and **Gilford Motor Co Ltd v Horne** (14). The court’s order in the latter case is usually cited as an instance of lifting the veil but it should be noted that the defendant (Horne) was not a member of the company and, in principle; no veil existed between him and the company, which would have been lifted by the court. It is rather an instance of the court regarding the company as Mr Horne in another form (“alter ego”).

### (c) Enemy Character

A company may be regarded as an enemy if, *inter alia*, all or substantially all of its shares are held by alien enemies. This is illustrated by **Daimler Co Ltd v Continental Tyre & Rubber Co (Great Britain) Ltd** (15). Since there appears to be no Kenya case on the point, the principles summarised by Lord Parker may be useful guidance to a Kenyan who might have to determine, in a given case, whether a particular company is to be regarded as a friend or enemy of Kenya.



**(d) Ratification of Corporate Acts**

A number of English cases which are regarded as instances of lifting the veil are those relating to informal ratification by the members of acts done on behalf of the company. In each of these cases the court regarded a decision of the members as the decision of the company itself and thereby lifted the veil of incorporation. This is illustrated by **Re: Duomatic Ltd** (16) and **Re: Express Engineering Works Ltd** (17).

**(e) Group Enterprises**

Numerous cases have been decided by English courts the general tenor of which is to regard a subsidiary and its holding company as one entity. There is no basic principle governing the lifting of the veil in these instances and each decision was based on the facts of the particular case. Examples are **Harold Holdsworth & Co Ltd v Caddies** (18), **Hellenic and General Trust Ltd** (19) and **DHN Food Distributors v London Borough of Tower Hamlets** (20).

**(f) Determination of Residence**

Like an individual, a company has a residence where it carries on business and keeps on house. To ascertain a company's residence entails lifting the veil of incorporation. This is because a company resides in the country in which its affairs are controlled and managed from. In **DeBeers Consolidated Mines Ltd. V Howe**, the court was emphatic that a company's residence is the country in which its central management and control actually abides.

## SUMMARY OF CHAPTER TWO

A company's constitution consists of two documents, namely, Memorandum and Articles of Association

The doctrine of *ultra vires* limits the capacity of a company to contract.

In exceptional circumstances the law ignores the separate legal personality of the company in favour of the realities behind the facade. These circumstances are collectively referred to as lifting the veil of incorporation

The series of acts which precede company registration are referred and generally summarised as "promotion".

A promoter forms a company and is charged with the duty of reasonable care and skill and disclosure. It should, however, be noted that there is no general statutory or judicial definition of promoter.

Pre-incorporation contracts is null and void unless the company enters into a similar contract after incorporation. A pre-incorporation contract is an agreement, which is entered into usually by a promoter on behalf of the company at a time when the company's formation has not been completed.

The company is under no obligation to re-imburse the promoter A promoter has no legal rights against the company he promotes; but can reward him in other ways such as giving him founder member shares or appointing him as a director.

**The consequences of incorporation are as follows:**

1. Limited liability
2. Perpetual succession
3. Owning of property
4. Suing and being sued
5. Capacity to contract
6. Common seal



## CHAPTER QUIZ

1. Explain the expression “lifting the veil”
2. Who is a promoter?
3. Name the constitutive documents of a company
4. What is *Ultra Vires*?

## ANSWERS TO QUIZ

1. This is an exception to the legal rule that a company has legal personality. This is where the company and its member's even subsidiaries are treated as one
2. A promoter is a person who undertakes to form a company with reference to a given purpose and to set it going
3. Articles and memorandum of association
4. This is a Latin term that literally means beyond the powers. They are those transactions that are outside the contracting capacity of the company.

## A SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Janet and Jackson Onyango are forming a Limited Liability Company. They are seeking your legal advice on the issues listed below. Respond to the enquiries by Janet and Jackson Onyango on:

- a) What are the Memorandum and Articles of Association and is there a difference between the two? (5 marks)
- b) What details would you expect the two documents in (a) above to contain and what other information might you be able to give about these details? (15 marks)

### QUESTION TWO

- a) Outline the rules that govern pre-incorporation contracts. Cite a relevant case law to support your answer. (12 marks)
- b) Kioko, an Under Secretary in the Ministry of Viwandani was entrusted with the responsibility of selling the Ministry's boarded motor vehicles. He invited bids from members of the public to buy two Lorries. He also bid, through a nominee. Mwangangi, his own brother.

Subsequently, he sold the lorries to Mwangangi, at Ksh.80, 000 each. Kioko then formed Kima Company Ltd and instructed Mwangangi to sell the lorries to the company at Ksh.350, 000 each. A prospectus as issued to the public to subscribe for shares to Kima Company Ltd. The prospectus gave Mwangangi as the vendor of the lorries and did not disclose the profit Kioko was making. Musembi, a shareholder of the company,



has learnt of the sale of the lorries to the company and the profit Kioko made and seeks your advice on the company's rights in respect of the same.

**Advise Musembi.**

### QUESTION THREE

The courts and also statutory provisions have provided justifications for ignoring the fundamental principle of legal personality through the so-called doctrine of lifting the veil. Discuss

Discuss

(20 marks)

**Kindly refer to the following sittings:** - 12/01; 12/00; 07/00; 12/00; 06/12; 05/02; 06/01; 1/06; 06





# PART B



# CHAPTER THREE



## SHARE CAPITAL





# CHAPTER THREE

## SHARE CAPITAL

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Explain the meaning of capital and what it consists of
- Examine liability in respect of prospectuses
- State when shares may be issued at a discount and at a premium
- Explain how capital may be altered
- Explain when and how to issue a prospectus

### ► INTRODUCTION

Capital is introduced to the public through floatation. This chapter concerns itself with the floatation procedures and the formalities to be met. It gives the classes into which capital is divided. It should be noted that floatation is restricted to public companies since private companies are prohibited by their articles.

### ► KEY DEFINITIONS

- **Capital** - amount of money which a company raises from issuing shares
- **Premium** - The money received in excess over the par value of shares
- **Discount** - The difference between the nominal value and the issue price; its normally lower than the nominal value
- **Prospectus** - Document issued by a public company which wants to raise capital
- **CA** - Companies Act chapter 486
- **Void** - Means the contract cannot be enforced it confers no rights and imposes no obligations
- **Voidable** - Can be enforced at the option of the innocent party

### ► EXAM CONTEXT

The examiner in this area has tended to confine himself on testing the student's understanding on the statutory provisions. Questions likely to be asked include what requirements the company should meet before issuing a certain securities; or when can a company issue shares at a discount, at premium? Some questions from this area can be found in the following sittings: 05/02; 06/01; 12/00; 07/00

## ► INDUSTRY CONTEXT

This is a very practical chapter in the industry. In the current year and even the previous year, many companies have made floatation for instance Safari Com, Eveready East Africa, Kengen just to mention but a few. Through this chapter one is able to understand the formalities and procedures to be followed in floating shares. The prospectus, for instance, is a vital document that brings to light many issues such as its contents and liability in respect of it.

### 3.1 RAISING AND MAINTENANCE OF CAPITAL

#### Fast forward

- ∅ The ways in which a company raises capital
- ∅ There are statutory rules relating to capital, bonus, discounts and premiums to ensure the company does not deplete its capital

#### RAISING OF CAPITAL

#### ■ MEANING OF CAPITAL

In commercial speech, the word `capital' is generally used to denote the amount by which the assets of a business exceed its liabilities. However, in legal speech, the word "capital" is used to denote the amount of money which a company raises from a sale of its shares, or what represents that money.

#### ■ TYPES OF CAPITAL

**A company's capital at any given moment may consist of:**

##### a) **NOMINAL OR AUTHORISED CAPITAL**

This is the capital that is stated in the Memorandum of Association pursuant to Section 5 (4) a) of the Act. It is called "nominal capital" because it is calculated on the basis of the "nominal" or book value of the shares into which it is divided. It is "authorized" in the sense that, once the Memorandum of Association is registered, the company can take immediate steps to raise the capital from the public without applying for a permit or license to collect the money.

**b) ISSUED CAPITAL**

The issued capital is that portion of the nominal capital which is constituted by the nominal value of the shares which have been issued by the company. It is also known as the “subscribed capital” or “allotted capital”. It may be less than, or equal to, the nominal capital but cannot exceed it.

**c) PAID-UP CAPITAL**

The paid-up capital is constituted by the aggregate of the amount of money that is paid-up on each share issued by the company. It may be equal to or less than, the issued capital but cannot exceed it.

**d) CALLED-UP CAPITAL**

A company’s called-up capital is constituted by the amount due in respect of calls made by the directors on issued shares.

**e) UNCALLED CAPITAL**

The uncalled capital is the amount not called up on shares which a company has issued. It is the nominal capital minus the called up and the paid-up capital.

**f) RESERVE CAPITAL**

The reserve capital is defined by Section 62 of the Act as the portion of the issued but uncalled capital of a limited company which the company’s members, by special resolution, have resolved that the company shall not call up unless and until it is in liquidation. It is to be called up only for purposes of the liquidation. As soon as the resolution is passed, the capital is, as it were, “put on reserve”. The directors’ power under the articles to make calls on shares will not be exercisable in respect of that capital, unless the company is being wound up. It is referred to in the marginal note to Section 62 as “the reserve liability” of a limited company.

**METHODS OF PUBLIC ISSUE****Fast forward**

Placing, offer for sale and prospectus issue are the main methods

A company’s authorised capital may be raised in one or the other of the following ways:

**a) PLACING**

A ‘placing’ occurs if the company, instead of selling its shares directly to the public, arranges with a broker to sell them on its behalf.

Company ..... Broker ..... sells the shares to ..... Public  
*(Acts as the Company's agent)*

The shares are said to be “placed” with the broker. A placing may be “a private placing” if the shares are to be offered for sale to selected customers of the broker (usually institutional investors) rather than made available to the general public.

#### b) OFFER FOR SALE

An “offer for sale” is an arrangement whereby a company sells some of its shares to a financial institution called “Issuing House”. The issuing house will prepare and issue a prospectus then re-sell the shares to the public.

Company ..... sells shares to Issuing House ..... Resells the shares ..... to Public  
*(Issues a document called “Offer for sale”)*

The company normally issues renounce able allotment letters to the issuing house to facilitate the transfer of specific shares to designated purchasers. This obviates the necessity of having to register the name of the issuing house in the company’s register of members when shares are allotted to it and having its name removed from the register shortly afterwards when the public buy the shares.

#### c) PROSPECTUS ISSUE (DIRECT OFFER TO THE PUBLIC)

Under a prospectus issue the company sells the shares directly to the public rather than selling them through intermediaries.

Company ..... sells shares to ..... Public  
*(Issues a document Called “prospectus”)*



## THE PROSPECTUS ISSUE AND STATUTORY PROVISIONS

### Fast forward

- A document that invites the public to subscribe to the shares of a company.
- Liability in respect of prospectuses can either be civil or criminal.
- People likely to be liable are those who take part in its preparation.

## PURPOSE OF THE STATUTORY PROVISIONS

A company’s shares are legally regarded as goods. Consequently, the common law rule known as “caveat emptor” applied to their sale. In particular, the company as a seller was not bound to say anything to potential buyers which would enable them to assess the risks involved. Buyers were therefore left without a legal remedy if they bought shares which they would not have bought if the relevant material facts had been disclosed by the company’s agents. In an attempt to remedy this situation the Companies Act incorporated a number of statutory provisions which must be complied with. The provisions are as follows:





## ■ THE STATUTORY PROVISIONS

### i) Definition of “Prospectus”

A prospectus is defined by Section 2 of Companies Act as “any prospectus, notice, circular, advertisement or other invitation offering to the public for subscription or purchase any shares or debentures of a company” This particular definition was intended to prevent companies from evading the legal duties pertaining to the issue of a prospectus by issuing a prospectus under such name as “notice”, “circular” or “advertisement”. Whether a particular document is a prospectus will ultimately depend on the function it fulfils rather than the name given to it by its authors. Regarding the word “offering” in the definition it should be remembered that the issue of a prospectus by a company is not an offer as such but is a mere “invitation to treat”. It is the application made in response to the prospectus that will constitute the “offer”

### ii) Dating of the prospectus

Section 39 Companies Act provides that a prospectus shall be dated. The date shall, unless the contrary is proved, be taken as the date on which the prospectus was issued to the public.

### iii) Contents of the prospectus

The authors of a prospectus are legally free to state therein whatever they deem appropriate to state but the contents must include, where applicable, the eighteen matters specified in Part I of the Third Schedule to the Act and the three reports specified in Part II of the said Schedule. Section 40(3) provides that, except as provided therein, it shall not be lawful for a company to issue any form of application for shares in or debentures of a company unless the form is issued with a prospectus which complies with the statutory requirements. However, a form of application for shares need not be issued with a prospectus if the form was issued either:

- i) In connection with a *bona fide* invitation to a person to enter into an underwriting agreement with respect to the shares or debentures; or
- ii) In relation to shares or debentures which were not offered to the public; or
- iii) To existing members or debenture holders of the company (irrespective of whether the applicant had the right to renounce in favour of other persons); or
- iv) In relation to shares or debentures which are or are to be in all respects uniform with shares or debenture previously issued.

## ■ THE MATTERS AND REPORTS

The matters and reports to be stated in a prospectus may be summarized as follows:

## 1. The Matters

The matters to be stated in a prospectus are:

- i) Directors' and Auditors of the company
  - a) Directors' names, addresses and occupations.
  - b) Directors' qualification shares, if any, and their remuneration (if there is a provision in the articles).
  - c) Directors' interest in the company's promotion.
  - d) Auditors' names and postal addresses.
- ii) Formation expenses
  - a) Preliminary expenses.
  - b) Promoters' remuneration.
  - c) Particulars of options on shares or debentures.
  - d) Underwriting commission and brokerage.
- iii) Investor information
  - a) The minimum subscription.
  - b) The time of the opening of the subscription lists.
  - c) Amount payable on application and allotment.
  - d) Voting and class rights
  - e) Deferred shares.
- iv) Company's property and business
  - a) Particulars of shares and debentures issued otherwise than for cash.
  - b) Particulars of material contracts.
  - c) Vendors of property to the company.
  - d) Amount paid for property to be bought by the company, stating the amount paid for goodwill.
  - e) Length of time the business has been carried on, if less than three years.

## 2. The Reports

- i) An auditor's report showing:
  - a) Profits or losses in each of the last FIVE years.
  - b) Rate of dividend during the last five years.
  - c) Assets and liabilities at the date of the last accounts.
  - d) Similar details with regard to subsidiary companies, if any.
- ii) Where the proceeds of the issue are to be used to buy a business, a report by named accountants on the profits or losses of the business for the last five years, and its assets and liabilities at the date of the last accounts.
- iii) Where the proceeds of the issue are to be used to buy shares in a subsidiary, a similar report as in (ii) above.



## MEANING OF “PUBLIC”

For the purposes of the prospectus issue the word “public” is declared by Section 57 (1) to include “any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner.”

In **Re: South of England Natural Gas Co. Ltd** (40) it was held that a document inviting applications for shares in certain gas companies was an offer to the public even though it was marked “for private circulation only.” However, a “circular” by which a company offered to acquire the shares of another company in exchange for its own shares was held not to be a “prospectus” within the statutory definition: **Government Stock and other Securities Investment Co. Ltd v Christopher** (41)

## REGISTRATION OF PROSPECTUS

Section 43 (1) provides that no prospectus shall be issued by or on behalf of a company unless, on or before the date of its publication, there has been delivered to the registrar for registration a copy thereof signed by every person who is named therein as a director or proposed director of the company, or by his agent authorised in writing and having endorsed thereon or attached thereto

- a) An expert’s consent to its issue (if the prospectus contains a statement by him), and
- b) A copy or memorandum of every “material contract” and a written statement signed by the named accountants or auditors indicating any adjustments to their report and the reasons for the adjustments (if the prospectus was issued generally).

## LIABILITIES IN RESPECT OF PROSPECTUSES

### 1. CRIMINAL LIABILITIES

- i) Issuing a form of application unaccompanied by a full prospectus: a fine not exceeding Kshs.10, 000/- (Section 40 (4).
- ii) Where a prospectus “includes any UNTRUE STATEMENTS”:
  - a) Fine not exceeding KShs 10,000 or
  - b) Imprisonment for a term not exceeding two years, or
  - c) Both such fine and imprisonment S.46 (1)
- iii) Knowingly issuing a prospectus containing a statement purporting to be made by an expert without the expert’s consent to the issue thereof: fine not exceeding Kshs 10,000/- (Section 42 (2).
- iv) Section 43 (5) imposes a fine not exceeding Kshs.100/- per day for:
  - a) Issuing a prospectus without delivering a signed copy thereof to the registrar for registration.
  - b) Issuing a prospectus containing an expert’s statement and delivering a signed copy thereof to the registrar for registration, but the copy so delivered does not have endorsed thereon (or attached thereto) the expert’s consent to the issue of the prospectus.

- c) Issuing a prospectus and delivering a signed copy thereof to the registrar for registration, but the copy so delivered does not have endorsed thereon (or attached thereto):
  - i) A copy of every material contract (or a memorandum thereof) or
  - ii) A written statement signed by the named accountants or auditors indicating any adjustments to their reports and the reasons for the adjustments.

## 2. CIVIL LIABILITIES

### i) LIABILITY FOR FAILURE TO STATE ANY MATTER OR REPORT

At Common Law, a contract of allotment is not a contract *Uberimae Fidei*. The company is therefore not under a legal obligation to disclose or state in its prospectus any relevant matter or report. The allottee of shares has; therefore, no remedy against the company if he bought the shares which he would not have bought had the company made the relevant disclosure. This rule has not been changed by the disclosure requirements of the Companies Act.

However, the allottee may have a remedy for an omission if the failure to state any relevant fact had the indirect effect of rendering a stated fact untrue, with Section 48 (a) of the Act. For example, in **COLES v WHITE CITY (MANCHESTER) GREYHOUND ASSOCIATION LTD** the prospectus stated that the land to be acquired by the company was “eminently suitable” for greyhound racing. No mention was made of the fact that approval of the local council was required in order to build public stands and kennels. This was held by the Court of Appeal to be a ground for rescission by the plaintiff.

### ii) LIABILITY FOR MISSTATEMENT OR MISREPRESENTATION

This will be governed by the general principles of the law of contract, depending on whether the misstatement was:

a) A FRAUDULENT MISREPRESENTATION because the company made it:

- i) Knowingly, or
- ii) Recklessly, careless whether it be true or false, or
- iii) Without belief in its truth: **DERRY v PEEK** (42)

b) AN INNOCENT MISREPRESENTATION because the company made it honestly, believing what was stated to be true: **DERRY v PEEK** (42)

- 1 If the statement amounted to a fraudulent misrepresentation, the allottee may sue for damages; **DERRY v PEEK**. But the House of Lords held in **HOULDSWORTH v CITY OF GLASGOW BANK** that the allottee can only get damages if he is also in a position to rescind the contract of allotment. If the rescission is no longer possible, there will be no remedy. This is an exception to the general principle of the law of contract that a person who has been induced to enter in a contract by a fraudulent misrepresentation has the option of affirming the contract but suing for damages.
- 2 If the statement amounted to an INNOCENT misrepresentation, the allottee CAN ONLY SUE FOR RESCISSION (i.e. asking the court to order the company



to remove his name from the members' register and refund the money he paid for the shares and he in turn returning the shares to the company). Damages cannot be awarded for an innocent misrepresentation. This was held by the House of Lords in **DERRY v PEEK (42)**

However, the allottee's right of rescission (whether for innocent or fraudulent misrepresentation) will be lost if:

- a) He did not institute rectification proceedings within a reasonable time after becoming aware of the misrepresentation: **FIRST NATIONAL REINSURANCE CO. V. GREENFIELD (43)**. A seven months' delay was held to be unreasonable delay.
- b) He affirmed, or is deemed to have affirmed the contract after discovering the truth (e.g. by accepting dividends, attending and voting at meetings, selling or attempting to sell the shares).
- c) Third party rights acquired in the meantime would be interfered with, or
- d) The company has gone into liquidation and so the rights of creditors have crystallised and precede other claims: **HOULDSWORTH Vs CITY OF GLASGOW BANK.**

## EFFECT OF RESCISSION

Where a contract of allotment is rescinded, the former shareholder will be entitled to his money back (normally with interest) and to a refund of any expenses to which he has been put: **RE: BRITISH GOLD FIELDS OF WEST AFRICA LTD.** The plaintiff will also be entitled to have the company's registers RECTIFIED by deleting his name there from, and he can prove in the company's liquidation for the amount due to him:

**RE: BRITISH GOLD FIELDS OF W. AFRICA.**

### ■ iii) CIVIL LIABILITY OF DIRECTORS AND PROMOTERS

Any person who subscribed for any shares or debentures on the faith of the prospectus may sue for compensation under Section 45 of the Companies Act.

The section is limited to prospectuses issued by or on behalf of the company and will afford no relief on an offer for sale or placing by existing holders (unless the company has made the allotment with that in view, so that Section 47 applies).

The section cannot be invoked by market purchasers of securities after the original allotment.

**The only persons who can be made liable under the section are:**

- a) Directors at the time of the issue of the prospectus;
- b) Persons who consented to be named in the prospectus as directors or future directors;
- c) Promoters of the company, and
- d) Every person who authorised the issue of the prospectus.

Section 45 (2) states that “no person shall be liable... if he proves...” This means that the directors or promoters are *prima facie* liable there under unless they successfully avail themselves of the statutory defences under the subsection, (i.e. they are presumed to be liable until they prove their innocence).

In **CLARK V URQUHART** (44), the court explained that the amount of compensation payable under Section 45 of the Act is calculated or measured in the same way as damages for fraudulent misrepresentation is measured. The court also explained that the word “compensation” was chosen in order to avoid the “invidious association” of damages with dishonesty in such a situation”. The specified persons were to be made liable as a matter of policy, irrespective of their moral innocence.

**A person sued under S.45 can rebut the presumption of liability by proving that:**

- i) Having consented to become a director he withdrew his consent before the issue of the prospectus and that it was issued without his authority or consent; or
  - ii) the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue he forthwith gave reasonable public notice that it was issued without his knowledge or authority; or
  - iii) After the issue of the prospectus and before allotment there under he, on becoming aware of the untrue statement, withdrew his consent to the prospectus and gave reasonable public notice that he had done so and why; or
  - iv) As regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe that the statement was true; or
  - v) The statement was made by an expert and the expert consented to the inclusion of his statement in the prospectus and that he believed the expert to be competent to make the statement; or
  - vi) The statement was taken from a public official document or was made by an official, and was a correct and fair representation of the document or statement.
- If an expert consented to the inclusion of his report in the prospectus and the report is false he would not be liable if he proves:

- i) That he withdrew his consent in writing before the prospectus was delivered for registration; or
- ii) That after the prospectus was delivered for registration but before the allotment, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal, and the reason therefore; or
- iii) That he was competent to make the statement and up to the time of allotment believed on reasonable grounds that it was true.

**Section III (1) provides that a public company which has issued a prospectus cannot commence business or exercise any borrowing powers unless:-**

- a) The minimum subscription has been raised;
- b) Every director of the company has paid to the company on each of the shares taken or contracted to be taken by him and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares offered for public subscription; and



- c) No money is or may become liable to be repaid to applicants for any shares or debentures which have been offered for public subscription by reason of any failure to apply for or to obtain permission for the shares or debentures to be dealt in on any stock exchange;
- d) There has been delivered to the registrar a statutory declaration by the secretary or one of the directors, in Form No. 211, that the aforesaid conditions have been complied with.

**If the minimum subscription was not raised, the company can only commence business or exercise borrowing powers if:**

- a) There has been delivered to the registrar for registration a statement *in lieu* of prospectus;
- b) Every director of the company has paid to the company, on each of shares taken or contracted to be taken by him and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares payable in cash;
- c) There has been delivered to the registrar for registration a statutory declaration in Form No. 212 by the secretary or one of the directors that condition (b) above has been complied with.

The registrar shall, on delivery to him of the relevant form, or statement *in lieu* of prospectus, certify that the company is entitled to commence business. The certificate is conclusive evidence that the company is entitled to commence business.

Section III (4) provides that any contract made by a company before the date at which it is entitled to commence business shall be provisional only, and shall not be binding on the company until that date. This provision is somewhat ambiguous and it is not clear whether the “provisional” contract binds the other party.

In **Re “Otto” Electrical Manufacturing Co** (Clinton’s Claim), it was held that the company was not liable to pay for the goods which had been sold to it before it obtained the trading certificate. Since it was put into liquidation before obtaining the certificate, the contract did not “become binding” and the liquidator had, therefore, rightly rejected the claim.

Section 219 (c) provides that a company which does not commence its business within a year from its incorporation may be wound up by court.

Section III does not apply to a private company which may, therefore, legally commence its business as soon as it is incorporated.



## MAINTENANCE OF CAPITAL

The issued share capital of a company limited by shares is the primary security for the company’s creditors. In **Re: Exchange Banking Co (Flitcroft’s Case)** Jessel, M.R. stated: “A limited company by its Memorandum of Association declares that its capital is to be applied for the purpose of the business. It cannot reduce its capital except in the manner and with the safeguards provided by statute. One reason for this is that there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. The

creditor has no debtor but that palpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business...”

The Companies Act, therefore, incorporated various provisions which are intended to ensure that a company's capital:

- i) Is not “watered down” as it comes into the company; and
- ii) Does not go out of the company once it has been received.



## PROVISIONS WHICH PREVENT CAPITAL BEING “WATERED DOWN”

The following are the provisions which are intended to prevent a company's capital being “watered down” as it comes into the company:

### 1. Issuing shares at a discount

In Ooregum Gold Mining Co of India Ltd v Roper (45) the House of Lords held that it is illegal for a limited company to issue its shares at a discount. This decision was made on the basis of what is now Section 5 (4) of the Act which provides that the memorandum shall state the amount with which the company will be registered and “the division thereof into shares of a fixed amount”. Since the nominal value of a share is fixed by the Memorandum, the company cannot issue the share at a discount.

After the above case was decided, Section 59 of the Act was incorporated so as to permit a company to issue its shares at a discount if:-

- a) **The shares are of a class already issued**  
If the shares are of a class already issued, they will most likely have a market value. The market value would provide a basis upon which the company's directors would recommend, and the members resolve on, the amount of the discount. In the absence of such a market value any amount decided on as the new price for the shares would be as arbitrary as the original nominal value.
- b) **The issue is authorised by a resolution passed in general meeting**  
This provision places upon the company's member's ultimate responsibility for the issue at a discount.
- c) **The resolution specifies the maximum rate of discount**  
It is the members who determine, to a large extent, the market value of the shares. They can therefore jointly decide on the amount below which they would not be willing to sell their shares in the market. The amount so decided on would guide the directors on the maximum amount of discount at which they would be willing to issue the remaining shares, or some of them.
- d) **Not less than one year has elapsed since the company was entitled to commence business.**  
This provision obviates the risk of a hasty or premature issue at a discount. The statutory assumption appears to be that, having been in business for at least one year, the company would most likely have published its first balance sheet and declared a dividend, which could induce a greater demand for its shares.





e) **The issue is sanctioned by the court.**

Although the grounds upon which the court is to exercise its discretion to sanction or reject the proposed issue are not spelt out, it appears that it would primarily be acting as the creditors' watchdog to protect their interests. This is so because creditors were not represented at the general meeting which passed, the resolution authorising the company to issue the shares at a discount and so the court steps in to protect their interests. If the issue of shares at a discount would adversely affect any creditor, the court would probably not sanction the issue.

f) **The issue is made within one month after the court's sanction.**

This provision acknowledges the fact that the stock exchange market is a highly fluid market. If a company's members pass a resolution authorising an issue at a discount because of the prevailing market conditions, the directors must act on the resolution before the market conditions change. The statutory assumption appears to be that the market conditions would have materially changed within one month after the court's confirmation. If the directors were to issue the shares at a discount despite the changed conditions, the issue could not be justified.

Another general meeting should be held to enable the members to reconsider their decision in the context of the changed conditions. However, the directors may ask the court to extend the time for issuing the shares at the prescribed discount if they are of the view, and the court concurs, that the market conditions have not materially changed. The flaw with this provision is that it does not provide a time limit for applying to the court for its sanction.

## ■ 2. Payment of Underwriting Commission

Commission "is defined by Osborn's Concise Law Dictionary as, inter alia" an agent's remuneration. For purposes of company law, it denotes the amount of money paid by a company to a person "in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in the company, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company"

### **Section 55 (1) Companies Act allows a company to pay the commission if:-**

- a) The payment is authorised by the company's articles;
- b) The commission paid or agreed to be paid does not exceed 10% of the price at which the shares are issued or the amount or rate authorised by the articles, whichever is the less; and
- c) The amount or rate per cent of the commission paid or agreed to be paid is:
  - i) In the case of shares offered to the public for subscription, disclosed in the prospectus; or
  - ii) In the case of shares not offered to the public for subscription, disclosed in the statement in lieu of prospectus, or in Form No. 225 signed by all the directors or their agents authorised in writing; and
- d) The number of shares which it has been agreed to subscribe absolutely is disclosed in manner aforesaid.

Section 55 (2) of the Companies Act provides that, except as provided by subsection (1), no company shall apply any of its shares or capital money, either directly or indirectly, in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe, whether absolutely or conditionally, or procuring

or agreeing to procure subscriptions, absolute or conditional, for any shares in the company, whether the shares or money be applied by being added to the purchase money of any property acquired by the company or to the contract price of any work to be executed for the company, or the money be paid out of the nominal purchase money or contract price, or otherwise.

In **Andréa V Zinc Mines of Great Britain Ltd** (45) it was explained that any agreement to pay commission in contravention of Section 55 is null and void.

The effect of payment of underwriting commission is that the company's shares will have been issued at a discount. Section 55 is, therefore, intended to provide some measure of statutory control over a company's power to pay commission.

### 3. Brokerage

Brokerage is a payment made by a company to a broker, or brokers, in consideration for "placing" the company's shares. It differs from underwriting commission in that it is a payment made to an agent who is selling the company's shares on its behalf without undertaking to buy the shares which he fails to sell. In **Andréa V Zinc Mines of Great Britain Ltd** (45) Bailhache, J. explained that a payment is brokerage only if it is made to "stockbrokers, bankers and the like, who exhibit prospectuses and send them to their customers, and by whose mediation the customers are induced to subscribe". Consequently, a payment which was made to a lady of a percentage on the amount of capital which she induced third parties to subscribe for shares in the defendant company was held not to be brokerage. The lady could not be regarded as a "broker" on the basis of such an isolated transaction. The person to whom the payment is made must be one who carries on the business of a broker, either exclusively or as part of his general business, as in the case of a banker.

Subsection (3) provides that nothing in Section 55 "shall affect the power of any company to pay such brokerage as it has heretofore been lawful for a company to pay". It was previously held in **Metropolitan Coal Consumers' Association V Scrimgeour** (1895) that brokerage of a reasonable amount paid by a company in the ordinary course of its business was legal. In that case the brokerage was 2.5%. The usual brokerage varies between 0.25% - 0.5%. The reasonableness of the commission does not depend on mere percentages but on what it would cost the company to sell the shares by itself. If, by paying the brokerage, the company would spend less money in selling the shares, then the payment would be regarded as a reasonable one. Although the payment of brokerage is a derivation from mercantile usage, it is usual for companies to incorporate in their articles a clause which expressly authorises the company to pay brokerage. For example, Article 6 of Table A provides that "the company may also on any issue of shares pay such brokerage as may be lawful".

Although payment of brokerage means that the company will ultimately receive less money for the shares it has issued, the payment is not prohibited by the Act. It is essentially an expense which is incidental to the issue of the shares and a company cannot avoid incurring such an expense.



## PROVISIONS THAT PREVENT CAPITAL GOING OUT OF THE COMPANY

In **Trevor v Whitworth** (1887) Lord Watson stated:

“Paid-up capital may be diminished or lost in the course of the company’s trading; that is a result which no legislation can prevent, but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at a call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business”.

As Lord Watson acknowledged, no legislation can prevent a company’s capital from being lost or diminished in the course of the company’s business. However, various provisions of the Companies Act, and case law, are intended to ensure that no part of the company’s paid-up capital is paid out by the company except in the legitimate course of its business. They are:

### i) SHARES ISSUED AT A PREMIUM

A company may at times issue its shares at a price above their nominal value, i.e. at a premium. This may be necessitated by the fact that the company’s shares which have already been issued are being sold in the open market at a price which is above their nominal value. Since such an issue does not jeopardise the position of the company’s creditors, there is no legal requirement that the issue be confirmed by the court. However, Section 58 (1) provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account called “the share premium account”. The section further provides that the share premium account shall be governed by the provisions of the Companies Act relating to the reduction of the share capital of a company as if the share premium account were paid share capital of the company. This means, in effect, that the funds credited to the share premium account are not paid out by the company except in the legitimate course of its business.

**Sub-section 2 provides that the share premium account may, however, be applied by the company:**

- a) To pay up unissued shares of the company which are to be issued to members of the company as fully paid bonus shares;
- b) To write off the preliminary expenses of the company;
- c) To write off the expenses of any issue of shares or debentures of the company, or the commission paid or discount allowed on such issue, or
- d) To provide for the premium payable on redemption of any redeemable preference shares or debentures of the company.

## ■ MERGER ACCOUNTING

It may happen that, during a “take-over” of one company (A) by another company (B), shares in the latter company are issued to shareholders of the former company in exchange. Company A would then be dissolved and company B would acquire its shares. Should a share premium account be established by company B when the assets of company A exceed the nominal value of company A’s shares? If a share premium account is opened the pre-acquisition profits of company A would not be distributed by company B. It may therefore be decided that no share premium account is to be opened. This method of accounting is known as “merger accounting”.

## ■ ACQUISITION ACCOUNTING AND “MERGER RELIEF”

In **SHEARER V BERCAIN** (1980), it was held that “merger accounting” is illegal and that a “true value” must be attributed to the non-cash assets acquired and the excess of the “true value” over the nominal value of the shares must be transferred to a share premium account. This method of accounting is known as “acquisition accounting” and means that the pre-acquisition profits of company A cannot be distributed by company B. It is yet unclear as to whether Kenya courts will adopt the decision in **Shearer v Bercain**. The Kenya Companies Act does not provide “merger relief” that was introduced by the English Companies Act of 1981.

### ii) PURCHASE OF OWN SHARES

Another possible way in which a company’s paid-up capital may leave the company other than in the ordinary course of the company’s business would be if the company purchased its own shares. It was, therefore, held in **Trevor v Whitworth** (48) that it is illegal for a limited company to purchase its own shares. Such a purchase, if permitted, would constitute an indirect reduction of the paid-up capital without compliance with the statutory provisions relating to reduction of capital. This is the general rule that is applicable in Kenya. This decision was said to be based on the implied provisions of the English Companies Act of 1862. The said provisions were incorporated in the English Companies Act of 1948 which in turn became our Companies Act (Cap. 486). It may, however, be criticised for its assumption that whenever a company buys its shares, it would do so by utilising its paid-up capital. It is, in fact, possible for a company to buy its shares without using its paid-up capital but using the money from a reserve fund, which was constituted for that purpose. Such a purchase might, in fact, be beneficial to the company, which could use it as a mechanism for propping up the market value of its shares at a time when there is panic selling by its shareholders, which has been precipitated by adverse rumours about the company. The company would later resell the shares in such a way as to prevent high fluctuations in their market prices.

Despite the rule in **Trevor V Whitworth**, a company may purchase or acquire its own shares in the following cases:

- a) Where it acquires its own fully paid shares otherwise than for valuable consideration, as in **Re: Castiglione’s Will Trusts** (49).
- b) Where it is a purchase of redeemable shares under Section 60 of the Act. This is



permitted because the redemption “shall not be taken as reducing the amount of the company’s authorised share capital” if it is done in accordance with the provisions of the section.

- c) Where the shares are acquired pursuant to the resolution for reducing the company’s capital under Section 68 of the Act. Such acquisition is permitted because the interests of the company’s creditors would have been protected by the court at the time of confirming the proposed reduction.
- d) Where the shares are purchased in pursuance of a court order under Section 211 (2) on an application by the oppressed members, the shares purchased would be cancelled and the company’s capital reduced accordingly.
- e) Where the shares are forfeited for non-payment of a call, or where they are surrendered *in lieu* of forfeiture.

### iii) FINANCIAL ASSISTANCE FOR PURCHASE OF OWN SHARES

Section 56 (1) of the Act renders it unlawful for a company to give, whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or, where the company is a subsidiary company, in its holding company. The consequences of a contravening the section are:

- a) The contract for the financial assistance is void and illegal, and cannot be enforced against a party thereto: **Standard Bank v Mehotoro Farm** (50);
- b) The company and every officer of the company who is in default shall be liable to a fine not exceeding Kshs 20,000;
- c) Every director who is a party to the contravention is guilty of a breach of trust and is liable to recoup any losses which the company suffers as a result: **Waller Steiner v Moir** (51)

### Exceptions

Section 56 (1) permits a company to give financial assistance for a purchase of, or subscription for, its shares in the following circumstances:

- a) Where the lending of money is part of the ordinary business of the company and the money is lent by the company in the ordinary course of its business. In **Steen v Law** (52) the Privy Council explained that this provision does not validate a loan given for the express purpose of enabling the loanee to purchase the lending company’s shares. This is so because no company can be constituted for the sole purpose of lending money to persons who would be buying its shares so that a loan it gives for any other purpose would be regarded as an “unusual” or “extraordinary”, loan. To be valid, therefore, the loan must have been given for one of the purpose for which the company ordinarily or usually lends money but was diverted (wholly or partly) to a purchase of the lending company’s shares.

- b) Where the loan is to trustees to enable them to purchase fully paid shares in the company to be held under an employees' share scheme.
- c) Where the loan is to employees (other than directors) to enable them to purchase or subscribe for fully-paid shares in the company or its holding company to be held by themselves by way of beneficial ownership. If a company gives a loan to an employee to purchase shares in the company, the employee must have the shares registered in his own name and not the name of a spouse or child. This is intended to induce the employee to be more motivated and productive by ensuring that he personally and directly reaps the fruits of his increased productivity.

## ALTERATION OF CAPITAL

A company is empowered by Section 63 Companies Act to alter the provisions of its Memorandum of Association which relates to its registered or authorised capital. However, the power is exercisable subject to the following conditions:

- a) The articles must confer the authority to alter the capital. If they do not, they may be altered by special resolution and the authority incorporated therein.
- b) The company must hold a general meeting for the purpose of altering the capital.
- c) The alteration must be authorised by an ordinary resolution (See Table A, Article 45).

## MODE OF ALTERATION

**The alteration of capital may be made by:**

- 1) Increasing the company's share capital by new shares of such amount as the resolution prescribes;
- 2) Consolidating and dividing all or any, of the company's share capital into shares of larger amount than the existing shares;
- 3) Converting all, or any, of the company's paid-up shares into stock, or reconverting the stock into paid-up shares of any denomination;
- 4) Subdividing all, or any, of the shares into shares of smaller amount than is fixed by the memorandum;
- 5) Canceling shares which have not been taken or agreed to be taken by any person, and diminish the amount of the capital. This mode of alteration is also known as diminution of capital. Subsection (3) provides that it shall not be deemed to be a reduction of share capital within the meaning of the Act.

The registrar must be notified of an alteration of capital within 30 days after the passing of the resolution authorising the alteration. In the event of a failure to do so, the company and every officer of the company who is in default shall be liable to a fine.



## REDUCTION OF CAPITAL

The general rule is that it is illegal for a company to reduce its capital. This is so because such a reduction would be tantamount to reducing the security available to the company's creditors: **Trevor v Whitworth** (48). However, Section 68 (1) authorises a company to reduce its capital if:

- a) The company's articles authorise it to do so. If the articles do not confer the authority they can be amended by the inclusion therein of the requisite authority.
- b) The company passes a special resolution to that effect. The resolution is defined by Section 68 (2) as "a resolution for reducing share capital".
- c) The court confirms the proposed reduction. The court's confirmation is required in order to protect the interests of the company's creditors, minority members and the general public, as explained below.

### MODE OF REDUCTION

Section 68 (1) expressly states that a company may reduce its capital "in any way". There is, therefore, no statutorily prescribed mode of reduction and the actual scheme adopted by the company will depend on the ingenuity of its directors or accountants. However, the Act gives the company an option of reducing its capital in one of the following ways:

- a. **By extinguishing the liability on any of its shares in respect of share capital not paid up: Section 68 (1) (a)**

**Example:**

The company's memorandum reads:

**"... Kshs.1, 000,000 divided into 100,000 Ordinary Shares of Kshs 10 each."**

- Amount already paid per share is Kshs. 5
- Amount unpaid per share is Kshs. 5

The company passes a special resolution to reduce the capital to Kshs.500, 000. The resolution is confirmed by the court.

The amended memorandum will read as follows:

**"... Kshs.500, 000 divided into 100,000 Ordinary Shares of Kshs 5 each."**

- Amount already paid per share is Kshs. 5
- The unpaid amount of Kshs. 5 per share ceases to be payable and the liability thereon is "extinguished."

- b. **By reducing the liability on any of its shares in respect of share capital not paid up: Section 68 (1) (a)**

**Example:**

The company's memorandum reads:

**"... Kshs. 1, 000,000 divided into Kshs. 100,000 Ordinary Shares of Kshs.10each."**

- Amount already paid per shares is Kshs.5
- Amount unpaid per share is Kshs.5

The company passes a special resolution to reduce the capital to Kshs.750, 000. The resolution is confirmed by the court.

The amended memorandum will read as follows:

**"... Kshs.750,000 divided into 100,000 Ordinary Shares of Kshs.7.50 each."**

- Amount already paid per share is Kshs.5
- Amount unpaid per share becomes Kshs.2.50 (i.e. the liability on unpaid shares has been reduced from Kshs.5 to Kshs.2.50).

- c. **By cancelling any paid-up share capital, which is lost or unrepresented by available assets without extinguishing or reducing liability on any shares: Section 68 (1) (b):**

**Example:**

The company's memorandum reads:

**"... Kshs.1, 000,000 divided into 100,000 Ordinary Shares of Kshs.10 each..."**

- Amount already paid per share is Kshs.5
- Amount unpaid on each share is Kshs.5

- d. The Kshs.500, 000 received from the shareholders was banked by the company. Kshs.100, 000/- was later withdrawn from the bank and used to buy goods for resale. After the goods were paid for and received, they were kept in the company's store pending delivery to customers the following day. The directors felt that it was unnecessary to insure the goods for one night only. A fire completely destroyed the goods during the night. The Kshs.100, 000 used to buy the goods represents the capital which, according to the Act, "is lost or unrepresented by available assets."

The company passes a special resolution to reduce its capital by Kshs.100, 000. The resolution is confirmed by the court.

The amended memorandum will read:





**“...Kshs 900, 000 divided into 100,000 Ordinary Shares of Kshs 9.”**

- Amount unpaid on each share is Kshs.5 (i.e. the liability on unpaid shares has not been reduced or extinguished).
- Amount paid per share becomes Kshs.4 (by consent of shareholders).

This mode of reduction is legally possible but may be questioned from a practical point of view. The truth is that it is the shareholders who have in fact lost their capital. It should be noted that, despite the above reduction, the members will receive the same amount of dividend from the company as they would have received if, for psychological reasons, the directors did not ask them to reduce the capital so that the shares retained their Kshs.10 nominal value.

**d. By canceling any paid up share capital, which is lost or unrepresented by available assets and also reducing liability on any shares: Section 68 (1) (b).**

**Example:**

The company's memorandum reads:

**“...Kshs.1, 000,000/- divided into 100,000 Ordinary Shares of Kshs.10each.”**

- Amount already paid per share is Kshs.5
- Amount unpaid per share is Kshs.5

Assume that the same type and quantity of goods are destroyed by fire in the same circumstances as in example (c) above.

The company passes a special resolution to reduce its capital by Kshs.200, 000. The resolution is confirmed by the court.

The amended memorandum will read:

**“...Kshs. 800,000/- divided into 100,000 Ordinary Shares of Kshs.8 each.”**

- Amount already paid per share is Kshs.5
- Amount unpaid per share becomes Kshs.3

**e. By cancelling any paid-up share capital, which is lost or unrepresented by available assets and also extinguishing liability on any shares: Section 68 (1) (b)**

**Example:**

The company's memorandum reads:

**“...Kshs.1, 000,000/- divided into 100,000/- Ordinary Shares of Kshs.10”**

- Amount paid per share is Kshs.9
- Amount unpaid per share is Kshs.1

The Kshs.900, 000/- received by the company from the shareholders is banked. Kshs.100, 000/- is later withdrawn to buy goods for resale.

The goods are destroyed by fire in circumstance identical with those in example (c) above.

The company can reduce its capital by Kshs. 200, 000 so that the amended memorandum will read as follows:

**“...Kshs.800, 000/- divided into 100,000 Ordinary Shares of kshs.8”**

- Amount paid per share becomes Kshs.8
- Amount unpaid per share is NIL (i.e. the liability of Kshs.1 has been extinguished).

f. **By paying off paid-up share capital which is in excess of the wants of the company without extinguishing or reducing liability on any shares**

**Example:**

i) The company's memorandum reads:

**“...Kshs.10, 000,000 divided into 1,000,000 Ordinary Shares of Kshs.10each.”**

- Kshs.5 has been paid on each share
- Kshs.5 is unpaid on each share

The company can pass a special resolution to reduce the capital to Kshs.7,500,000 by paying back to the shareholders Kshs.2, 500,000 out of the Kshs.5, 000,000 they have already paid to the company if the directors convince the members that the paid-up amount of shs.5, 000,000 is in excess of the company's current needs and it will take a long time before the company would require more capital.

The company's memorandum will be amended to read:

**“...Kshs.7, 500,000 divided into 1,000,000 Ordinary Shares of Kshs.7.50 each.”**

- Amount paid on each share becomes Kshs. 2.50;
- Amount unpaid on each share remains Kshs.5.

ii) Study the scheme adopted by the British and American Trustee & Finance Corporation Ltd.

g. **By paying off paid-up capital which is in excess of the company's needs by extinguishing liability on any shares.**

**Example:**

Read the scheme of reduction that was adopted by the British and American Trustee and Finance Corporation Ltd. and confirmed by the House of Lords.



- h. **By paying off paid-up capital which is in excess of the company's needs and reducing liability on any shares**

**Example:**

A company's authorised and issued capital is Kshs.10,000,000 divided into 1,000,000 Ordinary Shares of Kshs.10 each. Kshs.5 has been paid on each share.

The company can pass a special resolution to reduce the capital to Kshs.5 million paying to the shareholders Kshs.2.5 million out of the Kshs.5 million which they have already paid to the company if the directors tell the members that the paid up amount of shs.5m/- is in excess of the company's current needs.

The company's amended memorandum will read as follows:

**"...Kshs.5,000,000 divided into 1,000,000 Ordinary Shares of Kshs.5 each." Amount paid on each share becomes Kshs.2.50 and the unpaid amount of Kshs.5 is reduced to Kshs.2.50"**.



## THE FUNCTION OF THE COURT

In **Scottish Insurance Corporation Ltd v. Wilson's & Clyde Coal Co.** Lord Simmons stated:

"But important though its task is to see that the procedure by which a reduction of capital is carried through is formally correct and that creditors are not prejudiced, it has the further duty of satisfying itself that the scheme is fair and equitable between the different classes of shareholders". The court would therefore, not confirm a scheme of reduction if it is of the view that it is not "fair and equitable" to any of shareholders.

### a) PROTECTION OF CREDITORS

Where the reduction of capital involves diminution of unpaid capital or repayment to shareholders of paid-up capital, creditors have a statutory right under Section 69 (2) to object to the proposed reduction and, upon objection; a list of creditors must be given to the court. The court will then confirm the reduction if satisfied that the creditors:

- i) Have consented thereto;
- ii) Have been secured (i.e. given alternative security so that they will no longer rely on the reduced capital as their security),
- iii) Have been discharged or paid off (Section 70 (1)).

## b) PROTECTION OF MEMBERS

1. A majority of the company's members are protected by the requirement that a special resolution must be passed by the company's members in order to initiate the reduction process. It is most unlikely that a three-fourths majority of members could freely pass a resolution to reduce capital if the resolution is detrimental to their interests.
2. A minority of the company's members are protected by their judicially acknowledged right to seek the court's protection where they are of the view that the resolution passed by the majority is not "fair and equitable": **British and American Trustee and Finance Corporation Ltd, and Reduced V Cooper** (53) and **Re: Thomas de la Rue and Co. Ltd and Reduced** (55).

## c) PROTECTION OF GENERAL PUBLIC

It may happen that a resolution reducing a company's capital was passed in circumstances which indicate that the shareholders had not been properly and correctly informed about the real causes of the reduction. In such a case, it is desirable that the general public, as potential members of the company, should be told the truth about the reduction. Section 70 (2) (b) empowers the court where appropriate, to make an order requiring the company to publish, as the court directs, the reason for reduction or such other information in regard thereto as the court may think expedient with a view to giving proper information to the public, and, if the court thinks fit, the causes which led to the reduction.

The court order confirming the reduction and the relevant minute as approved by the court, must be delivered to the registrar for registration. Section 71 (2) provides that, on the registration of the order and minute, and not before, the resolution for reducing share capital as confirmed by the order so registered shall take effect.

## ■ ■ ■ LIABILITY OF MEMBERS

Section 72 (1) provides that in the case of a reduction of share capital, a member of the company, past or present, shall not be liable in respect of any share to any call or contribution exceeding in amount the difference, if any, between the amount of the share as fixed by the minute and the amount paid, or the reduced amount, if any, which is deemed to have been paid on the shares.



## REDEMPTION OF SHARES

Section 60 (1) empowers a company limited by shares to issue preference shares which are, or at the option of the company are to be liable, to be redeemed, if the articles authorise such an issue. It, however, provides that:

- a) No such shares shall be redeemed except out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;
- b) No such shares shall be redeemed unless they are fully paid;
- c) The premium, if any, payable on redemption must have been provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed;
- d) Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend be transferred to a reserved fund, to be called the capital redemption reserve fund, a sum equal to the nominal amount of the shares redeemed. The provisions of the Act relating to the reduction of the share capital of a company shall apply to the reserve fund as if it were paid-up share capital of the company, but Subsection 5 provides that the capital redemption reserve fund may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. These provisions are intended to prevent a company's authorised capital from being reduced by any redemption of the redeemable preference shares of the company.

## DIVIDENDS

As a commercial term, the word "dividends" has a variable meaning, which depends on the context in which it is used. For purposes of company law, it denotes the payments that a company makes out of its profits to the shareholders in the company.

## BASIC RULE

The basic rule is that "dividends must not be paid out of capital": **Verner v General & Commercial Investment Trust** (per Lindley, J). For purposes of this rule, "Capital" means the money subscribed pursuant to the Memorandum of Association, or what represents that money: **Verner v General & Commercial Investment Trust**.

## DECLARATION AND PAYMENT

There is no provision in the Act dealing with payment of dividends. It is, therefore, governed by the provisions of the company's articles, failing which the provisions of Table A, which are as follows:

- i) **Article 114**  
The company at a general meeting may declare dividends, but no dividend shall exceed the amount recommended by the directors. The use of the word “may” means that the company at a general meeting is not bound to declare dividends even if the directors have recommend a particular amount. On the other hand, no dividend can be declared if the directors have recommended none.
- ii) **Article 115**  
The directors may, from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company. A resolution passed at a general meeting directing the directors to pay interim dividends is invalid. **Scott v Scott** (56).
- iii) **Article 116**  
No dividend shall be paid otherwise than out of profits. In **Vernerv General & Commercial Investment Trust** Lindley, J. expressed the view that, because the word “profits” is somewhat ambiguous, this provision should be understood to mean that “dividends must not be paid out of capital”. Provided the dividend is not paid out of capital, it does not matter from whatever fund it is paid, whether called profits or otherwise.
- iv) **Article 118**  
Subject to the rights of persons, if any, entitled to shares with special rights as to dividend, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend paid. This provision modifies the common law rule that dividends are paid on the nominal value of the shares: **Oak Bank Co. v Cram**.
- v) **Article 120**  
Any general meeting declaring a dividend may direct payment of such dividend wholly or partly by the distribution of specific assets and in particular of paid-up shares, debentures or any one or more of such ways. This article gives the company power to pay dividend in kind. In the absence of such a provision, dividend is payable in cash and the company may be restrained from paying it in any other form: **Wood v Odessa Waterworks Co.** (57)
- vi) **Article 121**  
Any dividend, interest or other moneys payable in cash in respect of shares may be paid by cheque or warrant sent through the post directed to the registered address of the holder or, in the case of joint holders, to the registered address of that one of the joint holders who is first named on the register of members or to such person and to such address as the holder or joint holders may in writing direct. Every such cheque or warrant shall be made payable to the order of the person to whom it is sent.

This provision gives the company express authority to remit the dividend cheque or warrant by post. If the dividend cheque or warrant is lost in transit, the loss *prima facie* falls on the shareholder. In the absence of such a provision, the company would have no authority to remit the dividends by post and, if it does and the dividend cheque is lost in transit, it must issue a fresh cheque to the shareholder: **Thairwall v Great Northern Rly.**

**vii) Article 122**

No dividend shall bear interest against the company. At common law, the declaration of a dividend creates a simple contract debt due from the company to the shareholder, which will be time-barred in six years from the date of declaration.

**CASE LAW RELATING TO DIVIDENDS**

The above provisions of Table A supplement the following common law rules:

- 1) Losses in previous years need not be provided for. A dividend can be paid if there is a profit on the current year's trading: Re: National Bank of Wales (1899).
- 2) Profits of previous years can be brought forward and distributed even if there is a revenue loss in the current trading year: Re: Hoare & Co (1904)
- 3) Losses on fixed assets in the current year need not be made good by provision for depreciation before treating a revenue profit as available for dividend: Lee v Neuchatel Asphalte Co (1889)
- 4) Unrealised capital profits on a revaluation of assets can be distributed by way of a dividend, or used to pay a bonus issue of fully paid shares: Dimbula Valley (Ceylon) Tea Co v Laurie (1961).
- 5) Dividends must not be paid out of capital: Verner v General & Commercial Investment Trust.

**SUMMARY OF THE CHAPTER**

**Capital refers to the amount that a company raises from selling shares to the public**

**A company's capital may consist of:**

- Nominal or authorised capital
- Issued capital
- Paid-up capital
- Called up capital
- Uncalled capital

Placing, offer for sale and prospectus issue are the main ways through which capital may be raised

Liability in respect of prospectuses can either be criminal or civil

**As a general rule shares should not be issued at a discount. This rule is, however, subject to the following exceptions:**

1. If the shares are of a class already in issue.
2. The issue is authorised by a resolution passed at a general meeting
3. The resolution specifies the maximum rate of discount
4. The issue is sanctioned by a court and is made within one month of the sanction
5. Not less than a year has passed since the company was entitled to start business
6. Particulars of the discount on the shares must be disclosed on every prospectus of the company.

A company may purchase its own shares as an exception to the rule in **Trevor v Whitworth** in the following circumstances:

1. Redemption of redeemable preference shares in accordance with the articles and the Companies Act
2. Purchase of validly surrendered shares
3. If compelled by the court pursuant to a court order

**Provisions relating to the payment of dividends are:**

1. The company at a general meeting may declare dividends
2. The directors may pay interim dividends,
3. Dividends may only be paid out of profits,
4. The company must be solvent and a going concern,
5. Directors recommend dividends and members declare the same,
6. Directors are empowered to deduct from a member's share any amount due,
7. Generally, dividend is payable within 42 days of declaration.
8. Dividend does not earn interest against the company
9. A company can't pay dividends if it results in its inability to pay debts
10. Losses on fixed assets need not be made good before treating revenue as available for paying dividends
11. A company is not legally obliged to make provision for depreciation before paying dividends
12. A realised profit on the sale of fixed assets may be treated as revenue available for paying dividends





## CHAPTER QUIZ

1. What is capital?
2. List the various classes of capital.
3. List the methods of public issue.
4. What document is prepared before shares are floated?

## ANSWERS TO QUIZ

- 1 Amount of money which a company raises from a sale of its shares.
2.
  - (i) Nominal capital
  - (ii) Issued capital
  - (iii) Paid up capital
  - (iv) Called-up capital
  - (v) Uncalled capital
- 3
  - (i) Placing
  - (ii) Offer for sale
  - (iii) Prospectus issue
4. Prospectuses

## A SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

- a) Outline the contents of a register of members of a company. (6 marks)
  - b) Njoroge, a member of Tusonge Company Ltd., inspected the register of members of the company and noted that his name had been omitted therein.  
Advise Njoroge on how he should proceed to have his name entered in the register. (4 marks)
  - c) It is a fundamental principle of company law that the share capital of a company must be maintained.  
Discuss the legal consequences of this principle. (10 marks)
- (Total: 20 marks)**

### QUESTION TWO

- a) Explain three ways in which a company may raise capital. (6 marks)
  - b) Explain five circumstances when shares may be issued at a discount. (10 marks)
  - c) Explain two terms implied in a contract of sale of shares between a seller and purchaser. (4 marks)
- (Total: 20 marks)**



### QUESTION THREE

- a) "The capital of a company may no doubt be diminished by the expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorised. Of this, all persons trusting the company are aware and take the risk. But creditors have the right to rely and were intended by the legislature to have the right to rely on the capital remaining undistributed by any expenditure outside these limits or by the return of any of it to the shareholders".

Per Lord Herchell L.J. in Trevor v Whitworth (1837) 12 App. Cap 409 at 415.

Discuss this statement outlining the circumstances and conditions under which companies may reduce their capital. (14 marks)

- b) State what is meant by underwriting commission and distinguish it from brokerage.

(6 marks)

**(Total: 20 marks)**

**Kindly refer to the following sittings also: - 05/02; 06/01; 12/00; 07/00**



# CHAPTER FOUR



## DEBT CAPITAL





# CHAPTER FOUR

## DEBT CAPITAL

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Define what a debenture is and explain the various types in existence
- Differentiate a debenture from a share
- Have a clear understanding of charges and their registration
- Define the various types of charges and their order of priority
- Discuss the borrowing powers of a company

### ► INTRODUCTION

This is a chapter that was initially part of the dividends and debentures chapter in the previous syllabus. The main focus of this chapter is the capital that is obtained from non owners. These are the current and long term liabilities obtained from non owners. Its capital in the sense that is used in expansion of the business. It focuses on debentures and charges and later the borrowing powers of a company.

### ► KEY DEFINITIONS

- **Debenture** - A long-term loan.
- **Share** - A unit of ownership.
- **Trust deed:** An agreement entered into between a company and trustees
- **Charge** - This is an encumbrance that secures a debt.
- **Crystallisation:** this is when a charge becomes payable.

### ► EXAM CONTEXT

The main focus of the examiner in this chapter is on charges, thus, a clear understanding of charges their registration and how they are ranked is vital. There are no questions in the previous question bank on this chapter exclusively as the questions tend to have been mixed with dividends. It's a relatively short chapter and can be easily read and understood.

## ► INDUSTRY CONTEXT

In today's world, various businesses, in a bid to expand, borrow funds from outsiders. Various companies have floated debentures; loan stock and bonds. Companies even prefer debt to shares as they are less costly in terms of floatation.

### 4.1 DEBENTURES

Section 2 of the Act defines “debenture” as including “debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not”.

There is no precise legal definition of a “debenture”. In **Levy v Abercorris Slate & Rubber Co** Chitty, J stated that he could not find any precise legal definition of the term “debenture” and went on to observe that the word “is not, either in law or commerce, a strictly technical term, or what is called a term of art”. He also stated that, etymologically, the word is a derivation from the Latin *Debenture mihi*, which were the opening words of certain documents, which used to be issued by English companies in the 1860s as an acknowledgement of a loan the companies had received from the person to whom the document was issued. With the passage of time the word “debenture” acquired the meaning it generally has today, namely, a document issued by a registered company to acknowledge, or evidence, an indebtedness. Primarily, the word “debenture” is applied not to the indebtedness itself but to the document evidencing it.

#### 4.1.1 DEBENTURES AND DEBENTURE STOCK

**A debenture is usually a formal document in printed form. The main types, which a company can issue, are:**

(a) **A Single Debenture**

A single debenture is usually a formal document in printed form and sealed. It is usually issued when a company obtains a loan from a single lender, such as its bank. The bank would normally insist that the company signs and seals one of the bank's standard forms of debenture which would not only create a charge in favour of the bank but would also give it certain powers in relation to the charged property.

(b) **Debentures Issued as a Series**

Debentures are issued as a series if the company decides to borrow money from different lenders on different dates but in such a way that the lenders would rank equally in their right to repayment and in any security given to them. Each lender receives a debenture in identical form in respect of his loan and the debentures are expressed to form a series ranking *pari passu*.





(c) **Debenture Stock**

“Debenture stock” is created when a public company issues “debenture stock certificates” to a class of debenture holders, evidencing the portion of the total to which each one of them is entitled. Each lender has a right to be repaid his capital at the due time and, before that time, to receive interest on it at the agreed rate. Each debenture will be for a specified sum, e.g. Kshs.100 or Kshs.1, 000, as stipulated in the conditions of issue.

## Types of debentures

Debentures may be issued as:

- i. Redeemable or irredeemable
- ii. Registered or bearer
- iii. Secured or unsecured (naked)

## Subordinated debentures

Under American law, these are obligations often referred to as subordinated debts, junior debts or inferior debts, upon which the right to receive payment is subordinated or deferred by a subordination agreement or clause, to the prior payment of certain other indebtedness, sometimes referred to as senior, superior or prior debts. The subordination may be incomplete or complete. If complete, the payment of principal and interest on the subordinated debt is deferred until the obligations on the senior debt are satisfied. The subordination is valid as between the parties.

### 4.1.2 ISSUE OF DEBENTURES

Debentures are usually issued by a resolution of the board of directors under powers conferred by the company’s Articles of Association. Table A, Article 79 provides that “the directors may exercise all the powers of the company to borrow money ... and to issue debentures, debenture stock, and other securities”. Such authority is, however, not required in the case of a trading company, which has implied power to borrow money for the purposes of its business and to give security for the loan by creating a mortgage or charge over its property.

## Debentures and Shares

Debentures and shares have the following similarities and differences.

(a) **Similarities**

- i. A debenture is usually one of a “series” or “class” which is similar to a “class”, of shares.

- ii. Debentures, as well as shares are long-term investments in the company and are transferable in the same manner.
- iii. Debentures and shares may be issued in the same way through a prospectus issue.

**(b) Differences**

- i. A shareholder is a member (i.e. an insider) whereas a debenture holder is a creditor (i.e. an outsider).
- ii. A shareholder has an interest in the company but not in the company's property. A debenture holder has no interest in the company but has an interest in the company's property, which constitutes his security. Consequently:  
A shareholder can attend a meeting of the company and vote at the meeting whereas a debenture holder cannot do so.  
A shareholder cannot insure the company's property whereas a debenture holder can do so (unless the debenture is a 'naked' one).
- iii. Interest on debentures must be paid even if the company does not make a profit and can therefore be paid out of capital. Dividends on shares are payable only if profits are made and cannot be paid out of capital.
- iv. A company can purchase its own debentures but cannot, as a general rule, purchase its own shares.
- v. As a general rule, shares cannot be issued at a discount, whereas debentures may be issued at a discount.

### 4.1.3 DEBENTURE CERTIFICATES

Section 82(1) provides that debentures or debenture stock certificates must be completed and ready for delivery within 60 days after allotment or after the lodging of a transfer, unless the conditions of issue otherwise provide.

### 4.1.4 DEBENTURE TRUST DEED

When debentures are offered for public subscription, the company usually enters into a trust deed with trustees (usually a trust corporation). The trustees are appointed and paid by the company to act on behalf of the debenture holders. The charge securing the debentures is made in favour of the trustees who hold it on trust for the debenture stockholders.

A debenture stockholder, unlike debenture holder, is not a creditor of the company. He cannot therefore present a petition to wind up the company: **Re Dunderland Iron Co Ltd**. The trustees are technically the creditors of the company for the whole debenture debt while the stockholder is an equitable beneficiary of the trust.

#### 4.1.4 - i Contents of a Trust Deed

The main terms of a trust deed are usually some or all of the following:



- i. A covenant (promise) by the company to pay to the debenture holders the agreed instalments of the loan and accrued interest.
- ii. A description of the property charged, whether specifically or by way of a floating charge.
- iii. The events in which the security is to become enforceable, such as failure to pay the principal sum or interest as agreed.
- iv. A clause empowering the trustees to take possession of the property charged in the event of the security becoming enforceable, and to carry on the business and to sell the property charged.
- v. Appointment of a receiver
- vi. Meetings of debenture holders.
- vii. Covenants by the company to insure the property charged and to keep the property charged in good repair.

#### 4.1.4 - ii Advantages of a Trust Deed

A trust deed has several advantages some of which are:

- (a) The circumstances in which the principal sum may become repayable are clearly spelt out.
- (b) The appointment of trustees facilitates the efficient administration of the trust since they are there to exercise continuous supervision of the debenture holders' rights and to take prompt action if the need arises.
- (c) The trustees are empowered to appoint a receiver to carry on the business in case of urgency.
- (d) Covenants are entered into by the company for insurance, repair and other matters, which can be enforced by the trustees.
- (e) The trustees have a legal mortgage over the company's land.

#### 4.1.4 - iii Liability of Trustees

Trustees for debenture holders owe the same duties to their beneficiaries as are owed by trustees in general. In particular, they cannot purchase the debentures without the consent of all the debenture-holders. Section 90 (1) provides that any provision in a trust deed, or in a contract with the holders of debentures secured by a trust deed, for exempting a trustee from, or indemnifying him against, liability for breach of trust where he fails to show the degree of care and diligence required of him as trustee (having regard to the provisions of the trust deed) shall be void. This provision does not, however, invalidate:

- i. Any release given after the liability has arisen,
- ii. A provision in a trust deed for the giving of such a release by a majority of not less than three-fourths in value of the debenture holders present and voting in person or by proxy at a meeting summoned for the purpose
- iii. A provision in a trust deed for the giving of such a release either with respect to specific acts or omissions or on the trustee dying or ceasing to act.

## 4.2 REGISTER OF DEBENTURE HOLDERS

Section 88 (1) requires every company, which issues a series of debentures to keep at its registered office a register of holders of such debentures. If the work of making up the register is done at some other office of the company, or of another person, it may be kept at that other office. The registrar shall be notified of such place and of any change thereof.

## 4.3 CHARGES SECURING DEBENTURES

**A charge on the assets of a company given by a debenture or a trust deed may be either a specific (fixed) charge or a floating charge.**

### i. Fixed Charges

A charge is a “fixed charge” if it is a mortgage of ascertained or specific property such as plant and machinery, freehold or leasehold land, or uncalled capital. It may also be legal or equitable.

### ii. Floating Charges

According to the decision of Romer, L J in **Re: Yorkshire Wool combers Association Ltd** a charge is a “floating charge” if it has the following three characteristics:

- It is a charge on a class of assets of a company, present and future;
- The class is one which changes from time to time in the ordinary course of the company’s business;
- It is contemplated by the charge that, until some event occurs, which causes the charge to crystallise, the company may use the assets charged in the ordinary course of its business.

Because the charge does not attach or fix at the time of its creation upon any particular asset, it is equitable by nature. Under the current Kenya and English law, a floating charge cannot be issued by a partnership or sole trader.



## ☐ CRYSTALLISATION OF FLOATING CHARGES

A floating charge is a charge on a class of assets of a company. The actual assets in that class owned by the company change from time to time. The assets that the chargee is entitled to utilise for payment of the secured debt are the assets in the class that the company owns at the time when the charge crystallises. On crystallisation, a floating charge becomes a fixed or specific equitable charge.

### ■ A floating charge crystallises:

- (i) When the chargee appoints an administrative receiver. The power to do so exists only by virtue of the charge contract, which must, therefore, specify the circumstances in which the power is exercisable. e.g.
  - 1 Liquidation or winding up
  - 2 Appointment of a receiver
  - 3 Levy of execution or distress
  - 4 Insolvency
  - 5 Cessation of business
- (ii) When the company goes into liquidation.
- (iii) When the company ceases to carry on business.
- (iv) If the charge contract so provides, when the chargee gives notice that the charge is converted into a fixed charge on whatever assets of the charged class are owned by the company at the time the notice is given.
- (v) When another floating charge on the company's assets crystallises it causes the company to cease business.
- (vi) When there is Commencement of recovery proceedings against the company.
- (vii) Occurrence of an event, which under the terms of the debenture causes crystallisation.

### ■ (a) Advantages of floating charges

**From the company's point of view, a floating charge may be regarded as conferring the following advantages:**

- i. The company is free to deal with the assets charged as if they had not been charged.
- ii. Enables companies without fixed assets to borrow.
- iii. It enables the company to charge property which otherwise would not have been charged since such property cannot be subject to a fixed charge.
- iv. Enhances the borrowing capacity of a company of floating charges.

### ■ (b) Disadvantages of floating charges

**From the lender's point of view, a floating charge has the following disadvantages:**

- i. The value of the assets charged is uncertain since no particular assets are charged.
- ii. A floating charge created within six months before the commencement of winding up is deemed to be a fraudulent preference and is void.
- iii. It is postponed to a later fixed charge.
- iv. The charge may be avoided, during the company's liquidation, under Section 314 of the Act; unless it is proved that the company immediately after the creation of the charge was solvent.
- v. Where a seller of goods reserves title until payment, a floating charge will not, on crystallisation, attach to these goods. This is illustrated by **Aluminium Industries Vaassen v Romalpa Aluminium (647)**.
- vi. Certain other interests e.g. landlord's distress for rent has priority over floating charges.

## PRIORITY OF CHARGES

### The priorities between charges are as follows:

- (a) Legal fixed charges rank according to their order of creation.
- (b) If an equitable fixed charge (i.e. an informal mortgage created by a deposit of title deeds to land or a share certificate with the lender) is created first and a legal charge over the same property is created later, the legal charge takes priority over the equitable charge.
- (c) A floating charge will be postponed to a later fixed charge over the same property. This is so because the fixed charge attaches to the charged property at the time of its creation whereas the floating charge attaches at the time of crystallisation.

### The floating charge would, however, have priority over the later fixed charge if:

- i. The floating charge contained a "negative pledge" clause, which prohibited the company from later on creating fixed charges with priority over it, and
- ii. The holder of the fixed charge actually knew of the prohibition. In **Re: Valletort Sanitary Co** it was explained that registration of the floating charge would be constructive notice of the charge itself but not constructive notice of the contents of the charge, including the negative pledge clause.
- (d) If two floating charges are created over the general assets of the company, they rank in order of creation.
- (e) If a company creates a floating charge over a particular kind of assets, e.g. book debts, the charge will rank before an existing floating charge over the general assets: **Re Automatic Bottle makers**.



### 4.3 REGISTRATION OF CHARGES

Section 96(1) requires the prescribed particulars of specified charges on a company's property or undertaking to be delivered to the registrar for registration within 42 days after the date on which the charge was created. The specified charges are:

- a) A charge to secure an issue of debentures;
- b) A charge on uncalled share capital;
- c) A charge created by an instrument, which, if executed by an individual, would require registration as an instrument under the Chattels Transfer Act (e.g. a Letter of hypothecation);
- d) A charge on land;
- e) A charge on book debts of the company;
- f) A floating charge;
- g) A charge on calls made but not paid;
- h) A charge on a ship or any share in a ship;
- i) A charge on goodwill, a patent, a copyright or a trademark.

#### THE PRESCRIBED PARTICULARS

The "prescribed particulars" of registered charges are enumerated in Form No 214 and are:

- i. The date and description of the instrument creating or evidencing the mortgage or charge;
- ii. The amount secured by the mortgage or charge;
- iii. Short particulars of the property charged;
- iv. Names, postal addresses and descriptions of the persons entitled to the charge; and
- v. Amount of rate per cent of commission, allowance or discount (if any) paid.

#### GENERAL AIM

The purpose of registering the aforesaid particulars is to enable a would-be creditor to know the company's existing indebtedness and the assets available for their settlement.

#### CERTIFICATE OF REGISTRATION

Section 99 requires the registrar to give a certificate, under his hand, of the registration of any of the specified charges. The certificate shall be conclusive evidence that the statutory requirements, as to registration, have been complied with. Consequently, the charge would not be rendered void on the grounds that one of the prescribed particulars, such as the date of the creation of the charge, is later found to be incorrect: Re **C.L. NYE LTD** (66).

## EFFECT OF NON-REGISTRATION

Registration of charge cures all defects characterising the charge. The charge is deemed to have been made in due compliance with the provisions of the Companies Act. As was the case in **National Provincial and Union Bank of England V. Charnley**.

- i. The money secured becomes immediately repayable. This means that the lender is not bound by the terms of the charge and can take immediate steps to recover his money; and
- ii. The court is empowered by Section 102 to extend the time for registration of the charge on being satisfied that the omission to register the charge within the prescribed time was accidental or was due to inadvertence or other sufficient cause, provided that neither creditors nor shareholders would be prejudiced by the extension.  
Although it is the company's duty to effect the registration Section 97 (1) permits the registration to be effected on the application of any person interested in the charge. The person shall be entitled to recover from the company the amount of any fees properly paid by him to the registrar on registration.

## REGISTER OF CHARGES

Section 105 (1) provides that every limited company shall keep at its registered office a register of charges and enter therein:

- (a) A short description of the property charged;
- (b) The amount of the charge; and
- (c) The names of the persons entitled to the charge.

Failure to comply with Section 105 (1) does not invalidate the charge but the officers of the company responsible for the omission shall be liable to a fine not exceeding Kshs.1,000

### 4.4 REMEDIES OF DEBENTURE HOLDERS

The remedies of debenture holders are generally conferred by the trust deed but will usually include the power:

- i. To appoint a receiver to carry on the business or sell the charged property
- ii. To sue as creditors for arrears of interest or principal, or both
- iii. To petition the High Court for a winding up order (on grounds of the company's inability to pay its debts), and
- iv. To apply to the court for the appointment of a receiver or for an order for sale if there is no power in the trust deed.





## 4.5 BORROWING BY COMPANIES

It has been observed that most companies, like individuals, require to borrow from time to time for the exigencies of their business. To entitle a company to borrow, it must have power to borrow given to it by its constitution. Whether a company has or has no power to borrow depends on its objects and powers specified in the objects and powers specified in the objects clause of the memorandum. Usually, the objects clause contains an express power to borrow. However, an implied power is sufficient. An implied power arises whenever the objects are such that a power to borrow may fairly be regarded as incidental to the company's objects. This is the case with a non-trading company. There must be something in the Memorandum or Articles to show expressly or inferentially that the company is to have power to borrow. If a company has no power by its Memorandum to borrow, it can remedy the defect by altering its objects pursuant to Section 8(1) of the Companies Act.

A newly registered public company must not exercise any borrowing powers unless the registrar of companies has issued it with a certificate of trading pursuant to Section 111 (3) of the Act.

Sometimes, borrowing powers of a company are restricted by the Memorandum or Articles e.g. to a specific sum or to a sum not exceeding the paid up capital. However, in the vast majority of cases no limit is imposed. It, therefore, follows that if a company has an express or implied power to borrow, it may from time to time borrow as much as it wants subject to any restrictions in its articles.

The power to borrow is generally exercised by directors. Article 79 of Table A is emphatic that "the directors may exercise all the powers of the company to borrow money and to mortgage or charge its undertaking, property and uncalled capital, or any part thereof and to issue debentures, debenture stock and other securities whether outright or as security for any debt, liability or obligation of the company or of any third party."

If a company has power to borrow, it has an incidental power there to secure the repayment of borrowed money by mortgage or charge of all or any of its property, real or personal present or future.

Directors' power to borrow may be general as above or special i.e. a clause empowering the directors to borrow or raise money.

A company with power to borrow may borrow in such manner as it thinks fit. It can therefore raise money on a legal mortgage of any specific portions of its property or by equitable charge by bonds, promissory notes or by debentures or debenture stocks.

Where a company has no borrowing power or where the Memorandum of Association fixes a limit to the borrowing powers of the company – a rare thing altogether – any borrowing in the one case and any borrowing in excess of such limit in the other case is potentially *Ultra Vires* the company.

If the company has unlimited powers of borrowing but the directors having only limited powers, exceed them the borrowing is irregular for want of authority. It is *intra vires* the company and may be ratified by shareholders. Additionally, the lender is protected by the rule in **Turquands Case**

The lender of money borrowed *ultra vires* the company has in some cases a right against the directors personally for breach by them of their implied warranty of authority, if their acts amount to an implied representation of fact and it makes no difference as to the liability of the directors in such a case that they did not know that they were exceeding their powers.

## CHAPTER SUMMARY

A debenture is a document issued by a registered company to acknowledge or evidence indebtedness.

**Debentures may be issued as:**

- Redeemable or irredeemable
- Registered or bearer
- Secured or unsecured

**A charge is issued to secure a debenture and may either be fixed or floating.**

**A floating charge crystallises when:**

- The chargee appoints an administrative receiver
- The company goes into liquidation
- The company ceases to carry on a business

**The remedies of debenture holders are generally conferred by the trust deed but will usually include the power:**

1. To appoint a receiver to carry on the business or sell the charged property
2. To sue as creditors for arrears of interest or principal, or both
3. To petition the High Court for a winding up order (on grounds of the company's inability to pay its debts),
4. To apply to the court for the appointment of a receiver or for an order for sale if there is no power in the trust deed.



## CHAPTER QUIZ

1. State two types of debentures
2. A charge may be
3. A floating charge may crystallise when a company goes into liquidation (TRUE OR FALSE)
4. Give an instance when a charge crystallises

## ANSWERS TO QUIZ

1. Redeemable and registered
2. Fixed and floating
3. TRUE
4. When a company ceases business.

## A SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Discuss the crystallisation of floating charges and the advantages of a floating charge. (20 marks)

### QUESTION TWO

What are trust deeds? (20 marks)

### QUESTION THREE

Discuss the various types of debentures. How do they differ from shares? (20 marks)

# CHAPTER FIVE



## MEMBERSHIP OF A COMPANY





# CHAPTER FIVE

## MEMBERSHIP OF A COMPANY

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Explain the acquisition and cessation of company membership
- Explain the register of members and its contents
- Define the rights and liabilities of members

### ► INTRODUCTION

This chapter deals with ways through which a person ceases to be a member of a company. It later looks at the register of members and its contents. The chapter ends by looking at various rights and liabilities of members.

### ► KEY DEFINITIONS

- **Member:** a person who subscribes to the memorandum or whose name is entered in the register of members
- **Right:** This simply refers to entitlement.
- **Liability:** This is a duty owed to the company by a member, and by a member to other members
- **Acquisition:** Process by which a person becomes a member of a company
- **Termination:** Process by which a person loses membership in a company.

### ► EXAM CONTEXT

The examiner has tended to test the students, understanding on acquisition and cessation of member ship. Some of the questions found in this area have been set in the following sittings 12/07; 06/06; 05/02; 12/00

### ► INDUSTRY CONTEXT

The current trend in the industry is to embrace of the Central Depository System. The Central Depository System Act was put in place in 2000. Companies are now encouraging investors to

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- ▶ open CDSC accounts in a bid to hasten transactions and enhance accuracy. Most companies are keen to phase out share certificates. During Initial Public Offers in Kenya including the recent one by Safaricom, investors were encouraged to open CDSC accounts.

## 5.1 DEFINITION OF MEMBER

Although the marginal note to Section 28 is “definition of member”, the section does not define the word “member”. Rather, it states the two basic ways in which a person may become a member of a company, namely:

- (a) By subscribing to the memorandum of the company, or
- (b) By agreeing to become a member and the entry of his name in the company’s register of members.

## 5.2 WHO MAY BECOME A MEMBER?

Capacity to be a member of a company is governed by the rules of the common law relating to contracts. Anyone who has the capacity to make a contract may become a member of a company. The following are some of the special cases, which require some explanation:

### (a) Infants

An infant is any person who has not attained the age of 18 years; the Age of Majority Act 1974. An infant has a common law right to enter into a contract to buy shares in a company, and thereby become a member of the company. The contract, is however voidable at his option, and the infant may avoid it at any time during his infancy or within a reasonable time after attaining the age of 18 years. However, it was explained in **Steinberg v Scala (Leeds) Ltd** (59) that although the infant has a right to repudiate the contract, he would only be entitled to get back the amount already paid if there has been a total failure of consideration because the shares have become valueless. A company’s articles may, however, restrict membership of the company to adults only, in which case an infant would not become a member of the company.

### (b) Personal Representatives

On a shareholder’s death, ownership of the shares previously held by him is transmitted to his personal representative, who may be an executor or administrator. The personal representative would be entitled to be registered as a member of the company unless the company’s articles provide otherwise.





## (c) Corporations

A corporation, whether a registered company or not, may, if authorised by its memorandum (expressly or impliedly), take shares in a registered company and become a member of it. It would authorise “such person as it thinks fit to act as its representative at any meeting of the company”. The authorisation would be made by a resolution of its directors or other governing body under Section 139 (1) (a).

Section 29(1) provides that a body corporate cannot be a member of a company, which is its holding company. Any allotment or transfer of shares in a company to its subsidiary shall be void except:

1. Where the subsidiary is concerned as personal representative or trustee, unless the holding company or its subsidiary is beneficially interested under the trust and is not so interested only by way of security for the purposes of a transaction entered into by it in the ordinary course of business which includes the lending of money.

**This somewhat lengthy provision may be explained with the aid of some examples:**

- i. M, who is a member of Z Bank Ltd, appoints its subsidiary, Z Bank (Executor & Trustee) Ltd, as his executor. On M’s death, the subsidiary may be registered as a member of the holding company in respect of M shares.
  - ii. M transfers his shares to the subsidiary (in the above example) on trust for a beneficiary B, who borrows money from the holding company and secures repayment by mortgaging his interest in the shares to the company.
2. Where the subsidiary was a member of the holding company at the commencement of the Act on January 1, 1962. Such a member would have no right to vote at meetings of the holding company or any class of members thereof except in respect of shares it holds as personal representative or trustee.

## (d) A person, upon whom shares have devolved pursuant to the Provisions of Bankruptcy Act, may become a member of the company

### 5.3 METHODS OF BECOMING A MEMBER

A person may become a member of a company in one or other of the following ways:

### i. Subscribing to the Memorandum

Section 28 (1) provides that the subscribers to the company's Memorandum shall be deemed to have agreed to become members of the Company and on the registration of the memorandum shall have their names entered in the company's register of members.

The provision regarding entry in the register is an administrative directive for the company's implementation and non-compliance with it does not affect the pre-existing membership.

### ii. Allotment

A person to whom a company's shares have been allotted acquires his membership by virtue of sub-section 2 of Section 28, being a person who has agreed to become a member. However, it was held in NICOL'S case that the membership commences from the moment the name is entered in the members' register. If the company wrongfully refuses to enter the name in the register, the allottee must take rectification proceedings for a court order directing the company to enter the name in its members' register.

### iii. Transfer

A transfer is a purchase of shares from a company's shareholder and not from the company itself.

A transferee also acquires his membership by virtue of sub-section 2 of Section 28, being a person who has agreed to become a member. The principle in NICOL'S case applies to transferees as well, and a transferee becomes a member from the moment his name is entered in the register of members.

### iv. Transmission on death of a member

A transmission is a legal process by which ownership of shares in a company changes automatically on the death of a member to his personal representative. This is acknowledged by Table A, Article 29, which provides that "in case of the death of a member ... the personal representatives of the deceased where he was a sole holder shall be the only persons recognised by the law as having any title to his interest in the shares".

If the personal representative elects or decides to be registered himself as the holder of the shares, the election constitutes the agreement to be a member and the provisions of Section 28 (2) become applicable, namely, he will become a member from the moment his name is entered in the register of members.



### v. Transmission on bankruptcy of member

A bankrupt member's shares in a company will be transmitted to his trustee in bankruptcy according to the principles of bankruptcy law. The company's articles may give the trustee an option of being personally registered as a member, as is provided for by Table A, Article 30. If the trustee elects or decides to be registered as the holder of the shares the election constitutes the agreement to be a member and the provisions of sub-section 2 of Section 28 become applicable—i.e. the trustee in bankruptcy will become a member from the moment his name is entered in the register of members.

### vi. Compliance with Section 182 (2)

A person who has consented to be a director, and has given the statutory undertaking to take and pay for his qualification shares, is declared by Section 182(2) to be, "in the same position as if he had signed the memorandum."

The provisions of Section 28 (1) accordingly apply to him, and he becomes a member of the company when the Memorandum of Association is registered.

### vii. Estoppel

A person who, without having agreed to be a company's member, is aware that his name is wrongly entered in its register of members but takes no steps to have his name removed there from, may be estoppel from denying his apparent membership to somebody who relied on it and extended credit to the company.

## 5.4 THE REGISTER OF MEMBERS

Section 112(1) requires every company to keep a register of its members and prescribes the contents of the register.

### Contents

**The register of members must contain the following particulars:**

- a. The names and postal addresses of the members;

- b. A statement of the shares held by each member, distinguished by its number if it has one;
- c. The amount paid or agreed to be considered as paid on the shares of each member;
- d. The date at which each person was entered in the register as a member;
- e. The date at which any person ceased to be a member.

Where the company has converted any of its shares into stock, the register shall show the amount of stock held by each member instead of the amount of shares and the aforesaid particulars relating thereto.

Failure to keep a register of members renders the company and every officer of the company who is in default liable to a default fine [Section 112 (4)].

Section 120 provides that the register of members shall be *prima facie* evidence of the matters it contains.

## Location

Section 112(2) requires the register of members to be kept at the registered office of the company. If it is made up at another office of the company, or at some other office, it may be kept at that other office provided the office is not at a place outside Kenya.

The registrar must be informed of the place, other than the registered office, where the register is kept. Any change in that office must be notified to the registrar within 14 days failing which the company and every officer of the company who is in default shall be liable to a default fine.

## Index of Members

Section 113(1) provides that a company with more than 50 members must, unless the register of members constitutes an index, keep an index (which may be in the form of a card index) of the names of the members of the company, and must alter the index within 14 days after any alteration in the register. The index shall in respect of each member contain a sufficient indication to enable the account of that member in the register to be readily found and shall be at all times kept at the same place as the register of members.

Closure of Register: Under Section 117 of the Act, a company may, on giving notice by advertisement in some newspaper circulating in Kenya, or in that area of Kenya in which the registered office of the company is situate, close the register for any time or times not exceeding 30 days in each year.



## Inspection of Register

Section 115(1) provides that the register and index of members shall during business hours be open to the inspection of any member without charge, and of any other person on payment of a fee, not exceeding two shillings for each inspection, as the company may prescribe. Any person may require a copy of the register or any part thereof, on payment of one shilling or such fewer sums as the company may provide, for 100 words or fractional part thereof required to be copied. The copy must be supplied within a period of 14 days commencing on the day next after the day on which the requirement is received by the company.

If a company officer refuses an inspection or fails to provide a required copy, the company and every officer of the company who is in default shall be liable in respect of each offence to a fine not exceeding Kshs.40 and further to a default fine of Kshs.40. The court may by order:

- i. Compel an immediate inspection of the register and index, or
- ii. Direct that the copies required shall be sent to the person requiring them.

The court order may also be made against the company's agent who keeps the company's register of members if the company's failure to provide a copy, or permit an inspection, is due to his default.

Section 117 permits a company, on giving notice by advertisement in some newspaper circulating in Kenya or in that area of Kenya in which the registered office of the company is situate, to close the register of members for any time or times not exceeding in the whole 30 days in each year. The purpose of this provision is to keep the register static so that members' holdings may be extracted as at a particular date for the purpose of computing dividends.

## Rectification of the Register

**Section 118(1) empowers the High Court to rectify the register of members in two cases, namely:**

- i. If the name of any person is, without sufficient cause, entered in or omitted from the company's register of members; or
- ii. Default is made or unnecessary delay takes place in entering on the register the fact of any person having ceased to be a member.

**The application to the court to rectify the register may be made by:**

- i. The aggrieved person;
- ii. Any member;
- iii. The company.

### Where an application is made the court may:

- i. Refuse the application;
- ii. Order rectification of the register and payment by the company of any damages sustained by any party aggrieved.

An order rectifying the register can be made even when the company is being wound up: **Re Sussex Brick Co** (59).

The case of **Burns v Siemens Bros Dynamo Works Ltd** (60) shows that the circumstances set out in Section 118(1), above, are not the only ones in which the court can order rectification. It may also do so where a name stands on the register without sufficient cause.

The court may also order rectification of the register by deleting a reference to some only of the registered shareholder's shares. It need not delete his name entirely. This is illustrated by **Re Transatlantic Life Assurance Co Ltd (1979)** in which the court deleted an additional number of shares, which had been issued to the applicant in breach of the prevailing Exchange Control Regulations but left the register intact as regards his previous shareholding.

By Section 118(4), if an order is made in the case of a company required to send a list of its members to the registrar, the court, when making an order for rectification of the register, shall by its order direct notice of the rectification to be given to the registrar.



### Notice of Trusts

Section 119 provides that no notice of any trust, expressed, implied or constructive, shall be entered on the register, or be receivable by the registrar. The consequences of this provision are as follows:

- a. The company is entitled to treat every person whose name appears on the register as the beneficial owner of the shares even though he may, in fact, hold them in trust for another. In particular, if the company registers a transfer of shares held by a trustee, it is not liable to the beneficiaries under the trust even if the sale of the shares by the trustee was made in breach of the trust: **Simpson v Molson's Bank (61)**.
- b. The company is not a trustee for persons claiming the shares under equitable titles: *Societe Generale de Paris v Walker* (62). The owner of an equitable interest in shares, such as an equitable mortgagee or the recipient of a bequest of shares, may protect his interest by serving on the company a stop notice (or what is sometimes called a notice in *lieu of distringas*), informing the company that he is interested in the shares and requiring the company to notify him of a receipt of a transfer of the said shares to a transferee other than himself. When the company eventually informs him of the proposed transfer, he would then apply to the court for an injunction restraining the transfer.



## Branch Register

Section 121(1) empowers a company having a share capital, if authorised by its articles, to keep a branch register in any part of the Commonwealth outside Kenya of its members resident in that part of the Commonwealth. A branch register shall be deemed to be part of the company's register of members, which shall be known as the principal register, and must be kept in the same manner (Section 122). The registrar of companies must be informed of the situation of the office where the branch register is kept within one month of its opening. A similar notice must also be given of its change or discontinuance [Section 121 (2)].

## 5.5 RIGHTS OF SHAREHOLDERS

### Primary Rights

The ownership of at least a share of one or other of the aforesaid classes constitutes the "holder" a member of the company which has issued the shares. As a member, the shareholder will enjoy certain rights in the company which, unless modified or excluded by the company's articles, will generally comprise the right to:

- Attends general or class meetings of the company,
- Vote at the said meetings,
- Receive a properly declared dividend.

### Secondary Rights

- Notices of general meetings
- Copies of balance sheet lay before the general meeting
- Copies of memorandum and articles
- Inspection of minutes of general meetings and registers
- Petition for the alternative remedy.

## 5.6 CESSATION OF MEMBERSHIP

A person's membership of a company may cease or come to an end in many ways, some of which are:

### i. Transfer

A "transfer" of shares occurs if an existing member sells them to a third party. If the third party is not yet a member, he will become a member from the moment his name is entered in the company's register of members.

However, the transferee does not automatically cease to be a member as a consequence of the transfer. A member is not bound to sell all of his shares whenever he contemplates a sale. Table A, Article 23, permits members to transfer all or any of their shares. A member, therefore, ceases to be a member only if he transfers ALL of his shares.

### ii. Forfeiture

Where a company's articles authorise the directors to forfeit a member's shares and the director's forfeit ALL of the shares held by a member, the member will cease to be a member from the date specified in the articles as the effective date for forfeiture.

Table A, Article 38 provides that "a statutory declaration in writing that the declaring is a director or the secretary of the company, and that a share in the company has been duly forfeited on a date stated in the declaration, shall be conclusive evidence of the facts therein stated."

Article 37 provides that a person whose shares have been forfeited shall cease to be a member in respect of the forfeited shares.

He, therefore, ceases to be a member of the company only if all of the shares previously held by him are forfeited.

### iii. Surrender of Shares

The precise nature of surrender and the machinery by which it is effected are not clear since it is not provided for by the Companies Act or Table A. However, in Trevor v Whitworth, the judge stated that a surrender "does not involve any payment out of the funds of the company," and that "if it were accepted in a case where the company were in a position to forfeit the shares the transaction would seem to me perfectly valid," presumably even if not expressly authorised by the articles.

A person's membership will, therefore, come to an end if he surrenders all his shares to the company with the approval of the directors.



**iv. Death**

When a person dies, his membership of a company will come to an automatic end by virtue of the provisions of the Law of Succession. The shares previously held by him become, legally, the property of his personal representative. (See Table A, Article 29)

**v. Bankruptcy**

When a person becomes bankrupt, his membership of a company will come to an end under the provisions of the Bankruptcy Act, which vest a bankrupt's property in his trustee in bankruptcy (see Table A, Article 32).

**vi. Sale by a company in exercise of lien**

A company, like an unpaid seller under the Sale of Goods Act, has a right of lien on its shares as security for the balance of their price. For example, Table A Article 11 gives the company "a first and paramount lien" on every unpaid share.

If the company sells ALL the shares held by a member, the membership will come to an end from the moment the buyer's name is entered in the register. Table A, Article 12 gives the company power to sell "any shares on which the company has a lien".

**vii. Redemption of redeemable preference shares**

If a member's entire holding consist exclusively of redeemable preference shares and all of these shares are redeemed by the company under the provisions of Section 60 of the Companies Act, he will cease to be a member from the date on which his name is removed from the register of members.

**viii. Repudiation by an infant**

An infant member has a common law right to repudiate his membership of a company if there has been a total failure of consideration because the shares have become worthless: *Steinberg v Scala (Leeds) Ltd* (58).

**ix. Liquidation or winding up**

A company's liquidation terminates membership of all former members, from the moment it becomes effective.

#### x. Rescission of contract

A shareholder who rescinds a contract of purchase of shares or allotment by reason of a vitiating element or otherwise ceases to be a member

#### xi. Disclaimer by trustee in bankruptcy

Under English law, if a trustee in bankruptcy refuses to take up the shares of an undischarged bankrupt, he ceases to be a member of the company.

## SUMMARY OF CHAPTER

The following are the ways of becoming a member:

- Subscribing to the memorandum
- Allotment
- Transfer
- Transmission on death of a member
- Transmission on bankruptcy of member
- Estoppel
- Minimum qualification of a director

The main rights and liabilities of members are:

### Primary Rights

They will generally comprise the right to:

- Attend general or class meetings of the company;
- Vote at the said meetings
- Receive a properly declared dividend.

### Secondary Rights

- Notices of general meetings
- Copies of balance sheet lay before the general meeting
- Copies of memorandum and articles



- Inspection of minutes of general meetings and registers
- Petition for the alternative remedy.

■ **The main ways of terminating membership are:**

- Transfer
- Forfeiture
- Surrender of shares
- Death
- Bankruptcy
- Sale in exercise of company's lien
- Repudiation of an infant
- Liquidation
- Recession of a contract
- Disclaimer by a trustee in bankruptcy

■  
■ **CHAPTER QUIZ**  
■

1. An infant can become a member of a company  
A TRUE  
B FALSE
2. Give one way in which a person can cease being a member of a company
3. In what two ways may shares be transmitted?

## ANSWERS TO QUIZ

1. TRUE
2. Transfer of shares
3. By Death and by bankruptcy

## SAMPLE OF EXAMINATION QUESTIONS

### QUESTION ONE

Highlight the circumstances under which a person can acquire membership of a company.

### QUESTION TWO

Discuss the various ways in which a member may cease being a member of a company.

### QUESTION THREE

Discuss the salient features of the register of members.

# CHAPTER SIX



## SHARES





# CHAPTER SIX

## SHARES

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Explain the transfer and mortgage of shares
- Explain the various classes of shares
- Explain issue and allotment of shares
- Explain the mortgage, transfer and transmission of shares
- Explain pertinent issues to share warrants

### ► INTRODUCTION

The main security looked at is the share and all the formalities relating to its issue and allotment. The chapter also focuses on transfer and transmission of shares.

### ► KEY DEFINITIONS

- **Share:** A unit of ownership in a company
- **Stock:** Consolidation of many shares
- **Mortgage:** A transaction whereby shares are used as collateral security for loans
- **Lien:** An equitable charge on the shares of a member to secure sums owing by the member to the company.

### ► EXAM CONTEXT

In this chapter the examiner in this chapter is interested in knowing whether the student understands the various classes of shares, their issue and allotment. Mortgage of shares and share warrants are also often tested.

### ► INDUSTRY CONTEXT

Shares are growing in acceptance as more and more companies are using them as a form of raising funds.

A look at the financial markets shows an existence of other classes of shares as opposed to the common shares known to many. A share is an asset and thus many banks are accepting shares as security for the loans they issue.

## INTRODUCTION

Section 75 provides that “the shares or other interest of any member in a company shall be movable property”. This provision creates more problems than it solves although it may be regarded as the statutory definition of a share.

The definition of a share which is generally quoted in English text-books on Company Law is that of Farwell, J. in **Borland’s Trustee v Steel Brothers** to the effect that “a share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with (Section 22 of the Companies Act ). The contract contained in the Articles of Association is one of the original incidents of the share. A share is not a sum of money. but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount”.

### It should be noted from this definition that a share:

- (a) Is a yardstick of the holder’s liability to the company (if the company is limited by shares);
- (b) Is the yardstick of the holder’s right in the company, particularly the dividends payable by the company to the shareholders, voting rights and return of capital on a winding up;
- (c) Is the foundation, as it were, of the bundle of rights and liabilities arising from the statutory contract contained in the Articles of Association. It should also be noted that a share is a form of property which, being transferable, can be bought, sold, given as security for a loan or disposed of under a will. A person who owns one or more shares in a company is *ipso facto*, a member of the company (unless the company did not enter his name in its register of members as a consequence of which he is technically not regarded as a member of the company: Nicoll’s case).

**Note:** Companies limited by guarantee and not having a share capital have members who do not own shares in the company.





## 6.1 CLASSES OF SHARES

The classes or types of shares, which can be created and issued by a company, are not prescribed by the Companies Act. They depend on the provisions of the company's constitution, usually the Articles of Association, or the contract pursuant to which they are issued. Legally, therefore, a company can create any type or class of shares it pleases but in practice the following are the classes of shares generally issued by registered companies:

1. Ordinary shares
2. Preference shares
3. Participating preference shares
4. Redeemable preference shares
5. Deferred or founders or management shares
6. Employee shares

### PREFERENCE SHARES

The nature of "preference" shares and the rights attached to them have been explained by the English courts in various cases. The decisions may be summarised as follows:

1. The essential characteristic of a preference share is that it carries a prior right to receive an annual dividend of a fixed amount, e.g. 7 1/2% dividends. This is the only preferential right that it would have over the other shares, particularly the ordinary shares. If the share is to have any other preferential right, such a right must be expressly conferred by the contract under which it was issued or, exceptionally, the company's memorandum or articles of association.
2. As regards the priority dividend entitlement, four points should be noted:
  - (a) The right is merely to receive a dividend at the specified rate before any dividend may be paid on ordinary or other classes of shares. It is a priority right to whatever dividend may be declared. It is not a right to compel the company to pay the dividend if it declines to do so. This issue is likely to arise if the company decides to transfer profits to reserve or makes a provision in its accounts for a liability or loss instead of using the profits to pay the preference dividend.

In **BOND v BARROW HAEMATITE STEEL CO (1902)**, The company did not pay (i.e. "passed") its preference dividend. Bond and other preference shareholders contended that the company had available reserves of 240,000 pounds from which it could have declared the dividend on their shares. The company replied that it had suffered realised losses of 200,000 pounds on the disposal or demolition of current assets and, in addition, its retained fixed assets had diminished in value generally by 50,000 pounds. It, therefore, decided to retain the funds in question to make good losses. It was held that the court could

not overrule the directors in their decision that the “state of the accounts did not admit of any such payment” (of preference dividend).

It was also held in **Re Buenos Aires Great Southern Rly Co Ltd** that if the company’s articles entitle the preference shareholders to receive a fixed dividend for each year “out of the profits of the company”, the words “profits of the company” means the profits available for dividend after setting aside such reserves as the directors think fit. If the whole of the profits are transferred to reserve the preference shareholders are NOT entitled to any dividends.

- (b) The right to receive a preference dividend is deemed to be cumulative unless the contrary is stated. If, therefore, a 7% dividend is not paid in year 1, the priority entitlement is normally carried forward to year 2, increasing the priority right for that year to 14% and so on. When arrears of cumulative dividend are paid, the holders of the shares at the time when the dividend is declared are entitled to the whole of it even though they did not hold the shares in the year to which the arrears relate. An intention that preference shares could not carry forward an entitlement to arrears is usually expressed by the word “non-cumulative”. But words such as “a dividend of X% payable out of the net profits of each year” sufficiently indicate that arrears may not be paid in a later year. If nothing is expressed (though cumulative preference shares are usually described as “cumulative” to remove all possible doubt) they are deemed to be cumulative: **Webb v Earle (1875).**
- (c) If the company which has arrears of unpaid cumulative preference dividends goes into liquidation, the preference shareholders cease to be entitled to the arrears unless:
- i. A dividend has been declared though not yet paid when liquidation commences;
  - ii. The articles (or other terms of issue) expressly provide that in liquidation arrears are to be paid in priority to return of capital to members.
- (d)  Holders of preference shares have no entitlement to participate in any additional dividend over and above their specified rate. If, for example, a 7% dividend is paid on 7% preference shares, the entire balance of available profit may then be distributed to the holders of ordinary shares. But this rule also may be expressly overridden by the terms of issue. For example, the articles may provide that the preference shares are to receive a priority 7% dividend and are also to participate equally in any dividends payable after the ordinary shares have received a 7% dividend. The company might then distribute, say, 9% to its ordinary shareholders and an extra 2% (making 9% in all) to its preference shareholders. These preference shares are called participative preference shares. Since there is no limit on the amount of dividend, which may be paid on them, they are a form of “equity share capital” even if their entitlement to capital is restricted.
3. In all other respects, preference shares carry the same rights as ordinary shares unless otherwise stated. If they do rank equally, they carry the same rights, no more and no less, to return of capital and distribution of surplus assets and to vote. In practice, it is



usual to issue preference shares on this basis. It is more usually expressly provided that:

- (a) The preference shares are to carry a priority right to return of capital; and
  - (b) They are not to carry a right to vote except in specified circumstances, such as failure to pay the preference dividend, variation of their rights or on a resolution to wind up.
4. When preference shares carry a prior right to a return of capital the result is that:
- (a) The amount paid up on the preference shares, e.g. 1 pound on each 1 pound share, is to be paid in liquidation or reduction of capital before anything is repaid to ordinary shareholders; but
  - (b) Unless otherwise stated, the holders of the preference shares are not entitled to share in surplus assets when the ordinary share capital has been repaid.
5. On a reduction of share capital (where the preference shares carry an entitlement to priority in repayment) it is in accordance with the rights of preference shareholders to pay them off first. They cannot object that to do this is a variation of their rights; it is strict observance of them (unless their rights are so expressed as to prevent it): **Scottish Insurance Corporation Ltd v Wilson's & Clyde Coal Co Ltd.**
6. If preference shares carry no right to attend and vote at general meetings, the preference shareholders are still entitled to receive a copy of the annual accounts since these must be sent to "every member" and they are members.
7. The advantages obtained by holders of preference shares are greater security of income and (if they carry priority in repayment of capital) greater security of capital. But in a period of persistent inflation, the entitlement to a fixed income and to capital fixed in money terms is an illusion. A number of drawbacks and pitfalls, e.g. loss of arrears in winding up and enforced repayment, have been indicated above. The type of investor to whom preference shares were attractive is better protected by investing in debentures since he then has a contractual right to his interest (whether or not the company makes profits) and as a creditor he is entitled to repayment of his capital before any class of shares is repaid. It is also advantageous to a company for tax reasons to issue debentures rather than preference shares.



## REDEEMABLE PREFERENCE SHARES

A company with a share capital may, if authorised by its articles, issue preference shares, which are redeemable: Companies Act Section 60 (1)

## 6.2 TRANSFER OF SHARES

A share is, by its nature, transferable property. But to obtain transfer of the legal ownership of shares, two conditions must be satisfied:

- (a) A “proper instrument of transfer” must be delivered to the company, which may not enter the transfer in its register until this is done: Companies Act Section 77
- (b) If, as is the general practice with private companies, the articles give to the directors power to refuse to register a transfer and the directors exercise their power in a proper way, the restriction imposed by the articles will prevent a transfer of legal ownership.

Both principles, especially (b), require some explanation in detail.

### TRANSFER PROCEDURE

It was explained in **Re Greene** (63) that the rule which requires a “proper instrument” of transfer enforces the payment of stamp duty, normally at *ad valorem rate* on the consideration or (in the case of a gift) on the nominal value of the shares transferred. A company must reject an unstamped transfer under the provisions of Stamp Duty Act.

This rule does not, however, apply to registration of shares in the names of personal representatives or trustees in bankruptcy since they are merely asserting powers of control and disposal of the shares of members whom they represent given to them by law under the rules of transmission. A member, however, cannot arrange for the direct transfer of his shares to a beneficiary after his death without a proper transfer (signed by his executors): **Re Greene** (63).

#### ■ The articles usually provide that:

- (a) The instrument of transfer must be “in any usual or common form” (i.e. the forms used by stockbrokers);
- (b) The transferor’s share certificate must accompany the transfer when presented for registration: Table A, Articles 23 and 25.

The basic transfer procedure is that the transferor and transferee complete and sign the transfer form and have it stamped before delivering it to the company (with the transferor’s share certificate) for registration. The transferee becomes a member and legal owner of the shares only when his name is entered in the register of members. The company issues to the transferee a new share certificate and cancels the old one.



## CERTIFICATION OF TRANSFERS

If the holder is not transferring his entire holding by a single transfer, it would be inappropriate for him to hand to the transferee a share certificate for a larger number of shares than are comprised in the transfer.

In such a case the holder sends his signed transfer with his share certificate to the company for cancellation and the transfer form is returned to the transferor who then delivers it to the transferee for stamping and representation to the company. If the transferor is retaining some shares the company sends him a new share certificate for the reduced number of shares still registered in his name. This procedure is called “certification” of a transfer. It is explained by the following diagram:

The transfer of registered debentures or of debenture stock is subject to the same rules as transfer of shares.

Certification is a representation by the company to any person acting on the faith of the certification that documents have been produced to the company which on the face of them show a *prima facie* title of the transferor to the shares comprised in the transfer. It is not a representation that the transferor has any title to them but it does imply that the certificate will be retained: Companies Act Section 81; **Bishop v. Balkis Consolidated Ltd.**

Under Section 81(2), any person who acts on a negligent certification can claim damages from the company for his loss if the company did not either receive or fail to retain the share certificate. But the company has no duty and no liability to anyone else. If, for example, the company returns the certified transfer form and the share certificate to the holder who sells the shares to A giving him the certified transfer form and also to B, giving B a second transfer form of the same shares with the transferor’s certificate and A’s transfer is then registered first, B has no claim against the company if it refuses to register the second transfer to him. B does not in this case rely on the certified transfer (of which he is unaware) and the share certificate was correct when first issued to the holder.

### In **LONGMAN v BATH ELECTRIC TRAMWAYS**

A transfer of shares to B was registered and a certificate was prepared in his name. Before the certificate was issued, B signed a transfer of the shares to H and this transfer was sent to the company for certification. The company certified the transfer (as it still had B’s new share certificate) and returned the certified transfer to B. By mistake the company then sent to B the share certificate in his name. B deposited the share certificate with L as security for a loan. L later claimed that he was entitled to the shares.

It was Held L’s claim must fail. He had never seen (and therefore did not rely on) the certified transfer to H and mere possession of B’s share certificate gave him no claim against the company since the certificate at the time of issue correctly described B as still the registered holder of the shares (i.e. the transfer to H had not at that point been delivered for registration).

If to vary the facts of Longman’s case L had been able to secure registration as holder of the shares and the company had then rejected the transfer to H, H could claim compensation from the company since the certified transfer delivered to him would have been a representation by the company that it held B’s certificate and that the transfer to H was valid.

If identified shares are sold under a preliminary contract the rights and obligation incidental to ownership of the shares pass at once to the purchaser under the contract unless otherwise agreed. Thereafter, any dividend received by the vendor (pending registration of his transfer) must be paid over to the purchaser (unless the shares are sold “ex-div”). The purchaser must indemnify the vendor against any calls made on the shares before registration of the transfer. The vendor is, however, free to vote at meetings as he wishes until the purchase price has been paid to him.

A vendor of shares has a duty (implied by the contract of sale) to deliver a transfer of the shares (in exchange for the price) which will give the purchaser good title to the shares. If he fails to deliver such a transfer, he is liable to pay damages. But the vendor does not (unless the contract expressly so provides) guarantee that the company will register the transfer. If the company rejects the transfer, the vendor as registered shareholder holds the shares in trust for the purchaser as his nominee.

## RESTRICTIONS ON TRANSFER

Section 30 of the Companies Act requires the articles of private companies to restrict the right to transfer the company’s shares. The model articles Table A contains provisions which give the directors power to refuse to register a transfer of any share, whether fully or partly paid. The articles of a public company may also restrict the right to transfer the company’s shares usually if the shares are not fully paid or if the company has a lien on them.

Unless the directors have power under the articles to refuse a transfer and exercise that power properly, the transfer must be registered and the court may order rectification of the register for that purpose. The rules on the restriction of transfer are:

- (a) To exercise their power, the directors must consider the transfer and take a decision to refuse to register it.

### In RE HACKNEY PAVILION

A transfer of shares was sent in by the executors of a deceased director and shareholder. The two surviving directors held a board meeting and disagreed as to whether the transfer should be registered. There was no casting vote. The secretary wrote to the executors to inform them that the directors had declined to register the transfer.

#### **Held:**

This was incorrect since a positive act of refusal was necessary and there had been none. The register must be rectified by registering the transfer.

- (b) The directors in reaching their decision must act *bona fide* in what they consider to be the best interests of the company: **RE: Smith & Fawcett** (64)
- (c) Where the articles specify grounds of refusal, the directors may be required to identify the grounds of refusal. However, they are not obliged to disclose the detailed reasons



for their decision (unless the articles so provide). If nonetheless the directors do disclose their reasons, the court will consider whether the directors acted *bona fide* or whether their reasons accord with the grounds specified in the articles (if that is the case).

#### In RE BEDE SS CO LTD (1971)

The directors were authorised to refuse transfers if in their opinion it was contrary to the interests of the company that the transferees should be members. The directors rejected transfers of small numbers of shares (and of single shares) on the ground that it was prejudicial to the company that its issued share capital should be fragmented.

#### **Held:**

The reason given could be challenged and was invalid. The power to refuse registration must (on the formula used in the articles) be confined to cases of objection to the transferees on personal grounds. In this case the directors were objecting to the small amount of shares transferred which was not an objection to the transferees personally.

- (d) The power of refusal must be exercised within a reasonable time from the receipt of the transfer. Under Section 80, a company is required to give notice of any refusal within 60 days. If the power is not exercised within a reasonable time it lapses and can no longer be used. The requirement of notice of refusal within 60 days effectually makes that the “reasonable” period.

#### In RE SWALEDALE CLEANERS LTD (1968)

On August 3, 1967, transfers of shares were presented. There was only one director then in office and he purported to refuse to register the transfers in exercise of a power of refusal given by the articles. But a quorum for meetings of the directors was two and so the one director was not competent to exercise the powers of the board. On December 11, 1967 proceedings were begun for rectification of the register, i.e., a court order that the transfers should be entered in the register. On December 18, 1967 a second director was appointed and there was a board meeting at which the two directors refused to register the transfers (4 months, 14 days).

#### **Held:**

The attempt to exercise the power of refusal on December 18, 1967 was invalid since, in the interval of 4 1/2 months (since the transfers were presented), the power had expired (as regards those transfers). Since the power of refusal had not been exercised, the transfers must be entered in the register.

The articles may also restrict the right to transfer shares by giving to members a right of first refusal of the shares, which other members may wish to transfer. Any such rights are strictly construed, i.e. a member who wishes to accept must observe the terms of the articles and a member will not be permitted to evade his obligation to make the offer.

### In LYLE & SCOTT v SCOTT'S TRUSTEES

The articles required any member who might be “desirous of transferring” his shares to give notice to the company secretary so that the shares could be offered to other members. Certain members agreed to sell their shares to an outsider and, while remaining the registered holders, gave the purchaser their proxies so that he could secure control of the company.

#### **Held:**

These members were indeed “desirous of transferring” their shares and must give formal notice as the articles required.

The cases cited above show that when there is a dispute over refusal to register, the proper remedy is to apply to the court for rectification. A member who applied for an order for compulsory winding up of the company on the just and equitable ground was refused (**Charles Forte {Investments} v Amanda**) as “a winding up petition is not a proper remedy” in such a case because to liquidate the company would be unfair to other members not involved in the dispute.



## SHARE CERTIFICATES

- (a) Section 82 (1) provides that within 60 days of allotting shares or receiving a transfer, a company must have ready for delivery a certificate of the shares allotted or transferred (unless the transfer is rejected). This is a formal written declaration (usually issued under the seal of the company) that the person named is entered in the register as the holder of the shares specified.
- (b) A share certificate is a document on which is printed the name of the shareholder and the number of shares held (with any particulars such as “1 pound ordinary”) is written (or typed). The seal of the company is affixed and witnessed by signatures (unless dispensed with). The standard printed wording on a share certificate reads:

“This is to certify that (name of shareholder) is the holder of (number and any description) shares fully paid of (nominal value) each numbered ... to ... inclusive in the above named company subject to the memorandum and articles of association thereof.”

The distinguishing numbers may be omitted. The reference to the memorandum and articles is a reminder of the statutory rule that every member is bound by these documents as a contract with the company, under Section 22 of the Companies Act.





## ■ Contents of the share certificate

- a. Name of the company
- b. Common seal of the company
- c. Registered holder of the shares
- d. Number of shares held
- e. Serial number
- f. Date of issue
- g. Signature of directors

A share certificate is not a document of title but is *prima facie* evidence of ownership. The company therefore requires the holder to surrender his certificate for cancellation when he transfers all or any of his shares. If the company issues a share certificate, which is incorrect it is estoppel from denying that it is correct but only against a person who has relied upon it and thereby suffered loss.

## ■ Estoppel by Share Certificate

Although the share certificate is only *prima facie* evidence of title, its contents may render the company liable under the equitable doctrine of estoppel. This is because the contents of the share certificate are a representation by the company to third parties and a bona fide third party who suffers loss or damage by reason of relying upon the representation will hold the company liable. The company cannot be heard to say that it never made the representation or that it was false.

### RE BAHIA & SAN FRANCISCO RAILWAY CO

T was the registered holder of five shares. S and G forged a transfer of the shares to themselves and presented it for registration with T's share certificate, which they held as her brokers. The transfer was registered and a new share certificate was issued to S and G as shareholders. S and G sold the shares to B and another person who were duly registered as holders. T had the shares re-registered in her name since the forged transfer was a nullity. B and the other purchaser claimed the value of the shares from the company as damages.

#### Held:

The claim was valid since the share certificate in the name of S and G was "a declaration by the company to all the world that the person in whose name the certificate is made out and to whom the certificate is given, is a shareholder of the company ... with the intention that it shall be acted upon in the sale and transfer of shares". (NB In this case, the share certificate issued to S and G was genuine (although obtained by a forged transfer) and the claimants had not themselves presented a forged transfer since the transfer to them by S and G was genuine (although it related to shares to which S and G had no title).

**The principle of estoppel which applied in the case cited above is that if a person:**

- (a) Makes a statement of fact with the intention that it shall be relied on; and
- (b) The person to whom it is made does act in reliance on it and would suffer loss if the statement were subsequently denied as untrue, then the person who made the statement is estoppel, i.e., is not permitted to deny his own statement by asserting the true facts. The position must remain or be resolved as if the statement made had been true.

Apart from ownership, the company may be similarly estoppel from denying the correctness of the certificate in other respects. For example, if the certificate states that the shares are fully paid, the company cannot deny that this is so.

#### **In BLOOMENTHAL v FORD (1897)**

The company borrowed money from B and as security gave him share certificates for 10,000 shares of 1 pound each in his name in which the shares were described as fully paid. B believed that the amount due on shares had been paid by a previous holder. But this was not true. The company went into liquidation and the liquidator claimed from B the amount due on his shares.

#### **Held:**

The company was estopped by its own statement on the certificate that the shares were fully paid. The claim must fail. Read also the case of **Burkinshaw v Nicolls**. (65)

- (c) A person who is in possession of a share certificate in his name or the name of another person may have a valid claim (i.e. the company may be estoppel from denying that the certificate is valid). But the claimant will fail in any of the following circumstances:
  - i. If he has not relied on the share certificate in a transaction from which he will incur loss if the share certificate is repudiated by the company. In **Tompkinson's case** below, the claim only succeeded because T had re-sold the shares in reliance on the certificate.

#### **In BALKIS CONSOLIDATED v TOMPKINSON**

P sold shares to T (but P had no title to the shares) and the company was induced by fraud on the part of P to issue a share certificate to T in the name of T. T later re-sold the shares. The company refused to register the transfers by T to the persons who had bought the shares from him on the ground that T had no title (like P before him). T purchased other shares to satisfy the claims of those to whom he had sold and claimed damages from the company. The company said that it was not estoppel from denying that T had any title to his shares.

#### **Held:**

T could rely on the principle of estoppel since, in reliance on the share certificate



issued to him, he had incurred liabilities by reselling the shares. (NB. T himself was not implicated, even indirectly, in procuring the issue of the certificate, which was arranged by P.)

- ii. If he has obtained the certificate by presenting a forged transfer to himself for registration.
- iii. If the certificate is a forgery or issued without authority.

#### In **RUBEN v GREAT FINGALL CONSOLIDATED**

The company secretary forged the necessary signature of a director on a share certificate and issued it.

#### **Held:**

The company was not estoppel from denying that the certificate was worthless. It was not a certificate issued by the company.

## STOLEN CERTIFICATES AND FORGED TRANSFERS

Most of the case-law is concerned with share certificates issued as a result of the delivery to the company of a forged transfer together with a stolen or misappropriated share certificate of the registered holder. The company accepts the transfer for registration and issues a new certificate to the transferee who then re-sells the shares to another person. The result is then as follows:

- (a) The original registered holder (A) can usually require the company to restore his name to the register since a forged transfer is a nullity which cannot deprive him of his title to the shares;
- (b) The person (B) who obtained registration of the forged transfer of shares to himself cannot rely on the share certificate issued to him since he obtained it by presenting a forged transfer. On the contrary, he is liable to compensate the company for its liability. This is so even if B is unaware of the forgery;
- (c) The second purchaser (C) has relied upon the share certificate issued to B. C is not disqualified from making the company liable on the certificate since C has not delivered a forged transfer to the company (Bahia case above). C is not the owner of the shares (since his claim is based on forged transfer by A to the person (B) who purported to transfer the shares to him. But as the company cannot deny that B's share certificate is correct, it must compensate C either by paying C the amount which C paid to B for the shares or by buying other shares in order to be able to register those shares in the name of C. (Alternatively, the company may leave C's name on the register and buy other shares to register in the name of A as in the following Barclay's case).

### In SHEFFIELD CORPORATION v BARCLAY

Stock was registered in the joint names of T and H. T forged H's signature on a transfer and added his own. T delivered the transfer to B (who was unaware of the forgery) and B obtained registration of the transfer to himself. B later transferred the shares to C to whom B delivered a transfer and the certificate issued to him. When the forgery was discovered, H claimed to be restored to the register as holder of the shares (T had died meanwhile) and the corporation, being estoppel against C, purchased shares in the market for registration as replacement in the name of H. The corporation claimed compensation from B.

#### **Held:**

B was liable to compensate the corporation since he had caused it to issue a false share certificate by delivering a forged transfer to himself for registration.

In the example given above, it is assumed that the original registered holder has not contributed to the fraud. But if he does so, even innocently, he may be estoppel from asserting his ownership of the shares. He is not estoppel in this way merely because he leaves his share certificate in the possession of another person (see Bahia case above). But if he delivers a signed transfer to another person for a limited purpose, he gives him apparent authority to use the transfer and so may be unable to repudiate an unauthorised use of the transfer.

### In FRY v SMELLIE

The registered holder of shares gave to an agent a blank transfer (i.e. a transfer signed by transferor but without the name of a transferee inserted) with a view to the agent borrowing a specified sum of money using the shares as security. The agent exceeded his authority by mortgaging the shares for a larger sum. The shareholder denied that the transfer was valid since it had been used in a transaction, which exceeded the actual authority given to his agent.

#### **Held:**

The shareholder was estoppel from asserting that the agent had exceeded his authority.

The private limitation of authority could not be pleaded against a third party who was not aware of it.

Some companies in Kenya issue a "transfer notice" to the registered holder to the effect that a transfer of his shares had been presented for registration. However, if the registered holder ignores the notice (as happened in the Bahia case) he is not estoppel from later asserting that the transfer was not signed or authorised by him. Hence the issue of a transfer notice is of no value to the company and so in England the practice has been generally abandoned. It would however be advisable for public companies to insure against liability arising from accepting a forged transfer.



## STOCK

A company may, if authorised by its articles, convert its issued shares into stock (or reconvert stock into shares). But shares must be allotted as shares ranking *pari passu* and be made fully paid before they can be converted into stock. The effect of conversion is that, for example, one hundred one pound shares become a single block of 100 pound stock owned and transferable in units of defined value (usually the same amount as the value of the shares from which they are derived). It used to be common practice to convert fully paid shares to stock to dispense with use of identifying numbers for shares. But this result can now be achieved in other ways. It should be noted that reference to shares in the Companies Act includes stock unless otherwise indicated. (Companies Act Section 2)

### 6.3 MORTGAGE OF SHARES

This is a transaction whereby shares are used as collateral security for loans. The transaction is either legal or equitable.

Under a legal mortgage, the borrower transfers his shares to the mortgagee who becomes the registered holder subject to a separate agreement by which he undertakes to re-transfer the shares to the mortgagor on repayment of the loan. The agreement also determines who is entitled to the dividends and gives the mortgagee the right to sell the shares if the mortgagor defaults on the loan. As registered holder, the mortgagee can transfer the shares to a purchaser who buys from him.

The essential feature of an equitable or informal mortgage is that the borrower deposits his share certificate with the mortgagee but remains the registered holder of the shares. There is again an agreement containing the terms of the loan and the mortgage. The mortgagee may protect himself by serving a "stop notice" on the company but his possession of the share certificate is an effectual bar to dealings with the shares by the borrower.

The equitable mortgagee's other potential difficulty is that since he is not a registered shareholder he has no direct means of transferring the shares to a purchaser if the borrower defaults and he decides to sell. He usually obtains from the mortgagor a "blank transfer", i.e. a transfer signed by the mortgagor as registered holder but without the name of a transferee inserted. This usually gives the mortgagee an implied power to insert his own name as transferee in case of default. He can then dispose of the shares after transferring them into his name. Alternatively, the mortgagee may obtain from the mortgagor a power of attorney giving him power to insert the name of a purchaser on the transfer.

## CALLS ON SHARES

Unless shares are already fully paid for, the registered holder is liable to pay the balance due when called on to do so. The power of the directors to make calls is defined by the articles. The procedure must be correctly applied. The rules or principles governing calls are embodied in Articles 15 – 21 of Table A. If a shareholder defaults in the payment of calls, the company may, if the articles so provide, forfeit his shares. Articles 33—39 of Table A contain provisions which will apply if the company's articles do not provide for forfeiture.

## LIEN ON SHARES

A lien is an equitable charge on the shares of a member to secure sums owing by the member to the company. The company has a lien only if its articles so provide and to the extent that the articles provide.

Private companies, however, usually have a lien over fully paid as well as partly paid shares to secure sums owing by members whether in respect of their shares or other liabilities such as loans. The articles also give the company a power to enforce its lien (in case of the member's default) by sale of the shares.

The company's lien gives it a first claim on the shares unless the company has notice of some existing claim to the shares before the holder becomes indebted to the company.

### **BRADFORD BANKING COMPANY v BRIGGS & CO (1886)**

A member deposited his share certificate with the bank as an equitable mortgage of the shares to secure a loan to him by the bank. The bank gave notice to the company of its interest as mortgagee. Later, the member became indebted to the company.

#### **Held:**

As the company had prior notice of the bank's mortgage, its lien (although the right to a lien existed when the notice was received) was postponed to the mortgage since the company's claim under the lien arose after the bank's notice was received.



## VALUATION OF SHARES

The articles of private companies often provide that a member who wants to sell his shares must first offer them to the existing members at a price to be fixed by the auditors. Similar provisions are often applicable in the case of a member's death. In valuing the shares for this purpose, the auditor is not obliged to explain the basis of his valuation or to give his reasons for it, and he is not liable to an action by a party who is dissatisfied with it unless he is dishonest. If, however, he does give an explanation, the court can inquire into it and, if satisfied that the valuation has been made on the wrong basis, can declare that it is not binding, i.e. the valuation can be impeached for fraud, mistake or miscarriage, but on matters of opinion the court will not interfere. In **Arenson v Casson Beckman Rutley & Co.**, it was held that for a valuer to establish immunity from suit, he must show that a dispute between at least two parties was sent to him to resolve in such a way that he had to exercise a judicial discretion. An auditor of a private company who, on request, values its shares in the knowledge that this valuation will determine the price to be paid under a contract owes a duty of care to both the vendor and the purchaser. Accordingly, on the facts of the case, the plaintiff's statement of claim disclosed a cause of action.

### 6.4 SHARE WARRANTS

Section 114(1) provides that on the issue of a share warrant, the company shall strike out of its register of members the name of the member to whom the warrant has been issued and shall enter in the register:

- (a) The fact of the issue of the warrant;
- (b) A statement of the shares included in the warrant, distinguishing each share by its number; and

- (c) The date of the issue of the warrant

The bearer of the warrant shall, subject to the articles of the company, be entitled, on surrendering it for cancellation, to have his name entered as a member in the register of members. If the articles so provide, the bearer of a share warrant shall be deemed to be a member of the company either to the full extent or for any purposes defined in the articles.

## SUMMARY OF THE CHAPTER

Mortgage of shares is a transaction whereby shares are used as collateral security for loans. The transaction is either legal or equitable

**The following are the classes of shares generally issued by registered companies:**

7. Ordinary shares
8. Preference shares
9. Participating preference shares
10. Redeemable preference shares
11. Deferred or founders or management shares
12. Employee shares

A share certificate is a document on which is printed the name of the shareholder and the number of shares held (with any particulars such as “1 pound ordinary”) is written (or typed).

A share is by its nature transferable but to obtain transfer, a proper instrument (of transfer) must be delivered to the company and the directors must authorise the transfer

A mortgage may either be legal or equitable. In a legal mortgage the borrower transfers his ownership but for an equitable mortgage, the shareholder remains the registered holder.





## CHAPTER QUIZ

1. Name any two classes of shares
2. A mortgage may either be legal or
3. A transaction whereby shares are used as collateral is referred to as
4. Preference shares are of types namely

## ANSWERS TO QUIZ

1. Ordinary and Preference Shares
2. Equitable
3. Mortgage
4. Participating or irredeemable

## SAMPLE OF EXAMINATION QUESTIONS

### QUESTION ONE

Discuss the procedure used to effect a transfer of shares. (20 marks)

### QUESTION TWO

What is a mortgage on shares and discuss how they work (20 Marks)

### QUESTION THREE

Discuss the rules that are put in place for restriction of transfer of shares (20 Marks)

# PART C



# CHAPTER SEVEN



## MEETINGS





# CHAPTER SEVEN

## MEETINGS

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- State and explain the different types of meetings
- Define the different types of resolutions that may be passed at meetings
- Explain the rule in **Sharp v Dawes**

### ► INTRODUCTION

This chapter deals with the various meetings that a company holds and the business operations conducted at those meetings. It is in these meetings resolutions are made which affect the company. The chapter later introduces resolutions which final decisions on motions that are moved in the various meetings.

### ► KEY DEFINITIONS

- **Quorum:** The requisite number of members who must be present for a meeting to take place
- **Proxy:** A person appointed by a shareholder to vote on behalf of that shareholder at a company meeting
- **Meeting:** coming together of two or more people to discuss an agenda

### ► EXAM CONTEXT

The examiner mainly seeks to test the student's understanding of the different types of meetings. A clear understanding of the statutory meeting is useful. A clear interpretation of the resolutions and what they are used for is encouraged. Past papers show this chapter has appeared in the following sittings: Kindly refer to the following sittings: - 05/02; 12/01; 12/00; 07/00; 05/02;06/98  
12/00; 07/00;

### ► INDUSTRY CONTEXT

Meetings are very important in an industry. This can be shown from case study like **Sharp v**

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**Dawes**, which emphasised that one man cannot constitute a meeting. For a meeting to take place it must be constituted as prescribed by the Act. Meetings also result in passing of resolution, which is used as a tool for making decisions.

## 7.1 CLASSIFICATION OF MEETINGS

### Company General Meetings

Neither the Companies Act nor case law has attempted to define the term meeting. However, *prima facie* the term means coming together of two or more persons. It denotes an assembly of persons.

**Company general meetings are held from time to time in order:**

- (a) To comply with statutory provisions which require certain general meetings to be held in order to transact specified business. Such meetings include the statutory meeting, the annual general meeting and class meetings.
- (b) To transact business that may only be transacted at a general meeting of the members or shareholders, such as alteration or reduction of the company's capital.
- (c) To enable the directors and members to exchange views regarding the running of the company's affairs or resolve some existing dispute.

### ■ Types of General Meetings

#### ■ The Statutory Meeting

**Fast forward:**

- ∅ The main agenda of this meeting is the statutory report
- ∅ It is held once in the life of a company

According to section 130 every public company limited by shares and every public company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than three months from the date when the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called the statutory





meeting. The statutory meeting is held for the specific purpose of enabling the members of the company to consider the statutory report. However, Section 130(7) provides that “the members of the company present at the meeting shall be at liberty to discuss any matter relating to the formation of the company, or arising out of the statutory report, whether previous notice has been given or not.” But no resolution of which notice has not been given in accordance with the articles may be passed at the meeting.

**Contents of the statutory report: Section 130(3) provides that the statutory report shall be certified by not less than two directors of the company and shall state: -**

- (a) The total number of shares allotted, distinguishing shares allotted as fully or partially paid up otherwise than in cash, the consideration for which the shares have been allotted and, in the case of shares partly paid up, the extent to which they are so paid up;
- (b) The total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
- (c) An abstract of the receipts of the company and of the payments made therein, up to a date within seven days of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made and particulars concerning the balance remaining in hand and an account or estimate of the preliminary expenses of the company;
- (d) The names, postal addresses and descriptions of the directors, auditors, if any, managers if any, and the secretary of the company; and
- (e) The particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with particulars of the modification or proposed modification.

By Section 130(4) the statutory report shall, so far as it relates to the shares allotted by the company, the cash received in respect of such shares and the receipts any payments of the company on capital account, be certified as correct by the auditors, if any, of the company.

By Section 130 (2) a copy of the statutory report is to be forwarded by the directors to every member of the company at least 14 days before the day on which the statutory meeting is to be held. However, there is a proviso that if the report is forwarded later than prescribed, it shall be deemed to have been duly forwarded if it is so agreed by all the members entitled to attend and vote at the meeting.

The directors shall cause a certified copy of the statutory report to be delivered to the registrar for registration forthwith after the sending thereof to the members of the company (Section 130 (5)).

### List of Members

Section 130(6) provides that the directors shall cause a list showing the names and postal addresses of the members of the company, and the number of shares held by them respectively,

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to be produced at the commencement of the meeting and to remain open and accessible to any member of the company during the continuance of the meeting.

By Section 130(9) if there is any default in complying with the provisions of Section 130, every director of the company who is knowingly and willfully guilty of the default shall be liable to a fine not exceeding one thousand shillings.

It should be noted that the statutory meeting is not held by a private company, and that it is held only once in the lifetime of a public company. It is the first official coming-together of the company's members and is held within a very short time after the company is entitled to commence business. Its timing is important because the members are in fact being given a chance to ascertain, before it is too late, whether the minimum subscription was raised and, in the event of the minimum subscription not having been raised, to decide on whether to avoid the contract of allotment. These are matters in respect of which any procrastination could be financially disastrous for the members since the company could be put into liquidation before the members had come together to ascertain what had happened since the time the prospectus was issued.

### The Annual General Meeting

Section 131(1) provides that "every company shall in each year hold a general meeting as its annual general meeting in addition to any other meetings in that year, and shall specify the meeting as such in the notices calling it".

Not more than 15 months must elapse between the date of one annual general meeting and the next. The word "year" was defined in *Gibson v Barton* as "calendar year", i.e. the period January 1 to December 31.

Section 131 (1) has a proviso to the effect that, so long as a company holds its first annual general meeting within 18 months of its incorporation, it need not hold it in the following year. Thus a company incorporated on October 1, 1992, need not hold its first annual general meeting until March 1994.

Subsection (2) provides that if default is made in holding an annual general meeting in accordance with the aforesaid provisions, the registrar may, on the application of any member of the company, call or direct the calling of a general meeting of the company and give such ancillary or consequential directions as he thinks expedient, including a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

The registrar is not bound to call or direct the calling of the meeting but, in the event of his refusing to do so, the aggrieved member may apply to the court for an order: *Re: El Sombrero Ltd* (88), in which the court made an order after the registrar had declined to do so. Section 131 does not provide for the business which may be transacted at the annual general meeting but Table A, Article 52 mentions the following as the "ordinary" or usual business at an annual general meeting:

- i. Declaring a dividend;
- ii. The consideration of the accounts, balance sheets and the reports of the directors and auditors;



- iii. The election of directors in the place of those retiring, and
- iv. The appointment of, and the fixing of the remuneration of, the auditors.

Subsection 5 makes it a criminal offence punishable with a fine not exceeding two thousand shillings for the company and every officer of the company to fail to hold the annual general meeting or comply with any directions of the registrar regarding the calling and conduct of the meeting.

### Extraordinary General Meetings

Section 132 (1) provides for the convening of “extraordinary” general meeting but does not define it. Neither is the word “extraordinary” defined in any other section of the Act. However, Table A, Article 48 provides that all general meetings other than annual general meetings shall be called extraordinary general meetings.

Table A, Article 49 further provides that the directors may, whenever they think fit, convene an extraordinary general meeting. Further, by Section 132 (1), despite anything in the articles of a company, the directors are bound to convene an extraordinary general meeting of the company on the requisition of the holders of not less than one-tenth of the paid-up capital of the company carrying the right of voting at general meetings of the company, or, if the company has no share capital, of members representing not less than one-tenth of the total voting rights. Section 132 (2) provides that the requisition must state the objects of the meeting, and must be signed by the requisitioners and deposited at the registered office of the company. Section 132 (3) provides that if the directors do not within 21 days **from** the date of the deposit of the requisition proceed to convene a meeting, the requisitioners, or any of them representing more than one-half of the total voting rights of all of them, may themselves convene a meeting, so long as they do so within three months of the requisition.

Section 32(5) entitles the requisitioners to recover any reasonable expenses incurred in convening the meeting from the company, and the company may in turn recover these from the fees or other remuneration of the defaulting directors.

The company’s articles cannot deprive the members of the right to requisition a meeting under Section 132 because the section requires the directors to proceed to convene a meeting on requisition “notwithstanding anything” in the company’s articles. However, the section is defective in the sense that, although the directors are required to **convene** the meeting, they need not **hold** it within any particular limit of time. They may therefore defeat the purposes of the section by calling the meeting for a date, say, six months ahead, provided they do so within the 21-day period. In the event of their doing so the requisitioners cannot convene another meeting, as illustrated by *Re: Windward Islands Enterprises (U.K) Ltd (1982)*. The Jenkins Committee recommended that the requisitioners should be empowered to call the meeting themselves if the directors call the meeting to be held **later than** 28 days after the notice convening it was sent out. The company’s articles may also contain such a provision although the current Table A lacks one.

Section 135(1) provides that, if for any reason it is impracticable to call or conduct a meeting of a company in accordance with the articles or the Act, the court may, either of its own motion or on application by any director or any member entitled to vote at the meeting, order a meeting to be called, held and conducted in such manner as the court thinks fit. Where the court makes an order, it may give such ancillary or consequential directions as it thinks expedient including a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting. The power of the court in this regard is illustrated by *Re: El Sombrero Ltd* (88).

## Class Meetings

“Class meetings” are not provided for by the Companies Act. However, a class meeting may be held pursuant to the provisions of the company Articles of Association, if any.

Table A, Article 4 allows a company to vary the rights attached to any class of shares if the variation is consented to in writing by the holders of three-fourths of the issued shares of that class or is sanctioned by a special resolution passed at “a separate general meeting of the holders of the shares of the class”.

The provisions of Table A in relation to general meetings shall apply to every such separate general meeting, except that the necessary quorum shall be two persons at least holding or representing by proxy one-third of the issued shares of the class.

It should be noted that, although holders of other classes of shares may attend the meeting as happened in *Carruth v I.C.I. Ltd*, infra, they cannot vote thereat.

## Convening of General Meetings

General meetings are normally convened by the Board of Directors pursuant, to the relevant provision of the company’s articles, such as Table A, Article 49.

- a) Table A, Article 49 empowers any director or any two members of the company to convene an extraordinary general meeting if at any time there are not within Kenya sufficient directors capable of acting to form a quorum. Such a meeting is to be convened in the same manner as nearly as possible as that in which meetings may be convened by the directors.
- b) Section 132(3) empowers members holding not less than one-tenth of the paid-up capital of a company, or representing not less than one-tenth of the total voting rights of all the members, to convene an extra-ordinary general meeting of the company if the directors have failed to do so despite their requisition.



- c) Section 134 (b) empowers two or more members holding not less than one-tenth of the issued share capital, not less than five per cent in number of the members of the company, to call a meeting of the company if the articles do not provide otherwise.

The company secretary or other officer of the company has no power to call a general meeting: Re: State of Wyoming Syndicate (89). However, the directors may ratify the unauthorised act.

## Good Faith

The directors must act in good faith when calling a meeting, thus, in *Cannon v Tasks*, the directors called the annual general meeting at an earlier date than was usual for the company to hold it. Their intention in doing so was to ensure that transfers of shares to certain persons who were likely to oppose some of their proposals would not be registered in time so that they would be unable to vote. An injunction stopping the meeting from being held was granted. However, once the directors have called the meeting they cannot postpone or cancel it. For example, in *Smith v paring a Mines Ltd*, a notice was issued purporting to postpone the holding of a general meeting of shareholders which had previously been duly convened. One of the directors of the company who was in disagreement with the remainder of the board attended the meeting together with several shareholders. It was held that resolutions passed at the meeting were valid and effective. The purported postponement of the meeting was inoperative since the articles pursuant to which the meeting had been convened did not give specific power to postpone a convened meeting. The proper course is for the meeting to be held and, with the consent of the majority of those present and voting, adjourned.

## 7.2 NOTICE OF MEETINGS

### LENGTH OF NOTICE

Section 133 (1) provides that any provision of a company's articles shall be void in so far as it provides for the calling of a meeting of the company (other than an adjourned meeting) by a shorter notice than 21 days. The notice must be in writing.

Section 133(2) provides that, except in so far as the articles of a company make other provision in that behalf (not being a provision avoided by Section 133(1)), a meeting of the company (other than an adjourned meeting) may be called giving 21 days notice in writing. This in effect means that a company's articles may provide for a longer period of notice than twenty-one days but cannot provide for a shorter period.

By Section 133 (3) a meeting of a company, if called by a shorter period of notice than that prescribed in Section 133(1) or by the company's articles, shall be deemed to have been duly called if it is so agreed: -

- a) In the case of the annual general meeting, by all the members entitled to attend and vote at the meeting; and
- b) In the case of any other meeting, by a majority in number of the members having a right to attend and vote at the meeting, being a majority together holding not less than 95% in nominal value of the shares giving a right to attend and vote at the meeting; or in the case of a company not having a share capital, a majority together representing no less than 95% of the total voting rights at that meeting of all the members.

It was explained in **Re: Pearce Duff & Co. Ltd** that the mere fact all the members are present at the meeting and pass a particular resolution, either unanimously or by a majority holding 95% of the voting rights, does not imply consent to short notice. Anyone who voted for the resolution can, therefore, change his mind afterwards and challenge it.

Section 133 does not indicate whether the days of notice must be "clear days". However, Table A, Article 50 provides that the notice "shall be exclusive of the day on which it is served or deemed to be served and of the day for which it is given".

## SERVICE OF NOTICE

Section 134 (a) provides that, unless the articles of the company make other provision in that behalf, notice of the meeting of a company shall be served on every member of the company in the manner in which notices are required to be served by Table A. Where the company's articles provides, as Section 134 (a) does, that notice of the meeting shall be served on every member, a failure to give notice to a single member would render the meeting a nullity at common law: *Re: West Canadian Collieries Ltd (90)* in which Plowman, J. stated: "It is well settled that as regards a general meeting, failure to give notice to a single person entitled to receive notice renders the meeting a nullity".

The primary purpose of the common law rule appears to be to impose on the company's officers who are entrusted with the power of convening its meetings the obligation of acting fairly towards every member of company. They must invite all the members to the meeting and not just those whom they believe are likely to support private property to be run according to their personal whims.

Although it might at first sight appear unfair to invalidate a meeting at which a majority of the company's members passed relevant resolutions, it should be borne in mind that those who attended the meeting and voted might not, after all, have voted the way they did if the aggrieved member had been present and drawn their attention to some aspect of the matter which they did not advert to during their deliberations. Needless to say, a single member can influence the entire general meeting without necessarily having to be a Mark Anthony. And it is vital for the proper management of the company's affairs that no decision of its members should be adopted as its own, and implemented, unless there is some reasonable assurance that, as it were, 'no stone was left unturned' during the process of arriving at the particular decision.



The common law rule applies irrespective of whether the failure to give notice of the meeting was deliberate or unintentional. However, it is competent for the company's members to reflect on the matter and, if they deem it appropriate, amend the company's articles by incorporation, therein of a suitable provision. For example, Table A, Article 51 provides that "the accidental omission to give notice of a meeting to.... any person entitled to receive notice shall not invalidate the proceedings at that meeting". In such a case, notice of the meeting would be deemed to have been given despite an "accidental omission" to give the notice: **Re: West Canadian Collieries Ltd** (90) commenting on the apparent attempt of the article to validate "the proceedings at" the meeting rather than the meeting itself, Plowman, J. stated:

"It must, I think, be implicit... that a meeting, the proceedings of which are to be taken to be valid notwithstanding the omission to be deemed to have been duly convened for the purposes of the articles... in the absence of such an implication, there would be no meeting the proceedings of which would be validated by the articles".

In **Musselwhite v C. H. Musselwhite & Son Ltd** (91) it was explained that a deliberate failure to give notice of a meeting to a member on the mistaken grounds that the member was not entitled to the notice would not be regarded as an "accidental omission" within the relevant article, since it was a mistake of the law. The meeting, was therefore, declared null and void.

**Table A, Article 134 provides that notice of every general meeting shall be given to:**

- a) Every member of the company except those members who (having no registered address within Kenya) have not supplied to the company an address within Kenya for the giving of notices to them;
- b) The personal representative or trustee in bankruptcy of a member who, but for his death or bankruptcy, would be entitled to receive notice of the meeting, and
- c) The auditor for the time being of the company.

## METHOD OF SERVICE

Article 131 provides that a notice may be given by the company to any member either personally or by sending it by post to him at his registered address or at the address, if any, for the giving of notice to him. Where a notice is sent by post, service of the notice shall be deemed to be effected within 72 hours of properly addressing, prepaying and posting a letter containing the notice.

Article 132 provides that a notice may be given by the company to the joint holders of a share by giving the notice to the joint holder first named in the register of members in respect of the share.

Under Article 133, a notice may be given to the personal representative or trustee in bankruptcy by sending it through the post in a prepaid letter addressed to them by name, or by any official description, at the address, if any, within Kenya-supplied by them for the purpose, if no address has been supplied, the notice shall be given in any manner in which it might have been given if the death or bankruptcy of the registered holder had not occurred.

## □ CONTENTS OF THE NOTICE

The notice convening a meeting must be clear and explicit so that the person receiving it may be in a position to decide whether or not he ought in his own interest to attend the meeting: **Tiessen v Henderson** (92). This is the fundamental legal requirement.

In practice, however, the articles generally mention some of the items that have to be stated in the notice. For example, Table A, Article 50 states that the notice “shall specify the place, the day and the hour of meeting and, in case of special business, the general nature of that business”. If the meeting is the annual general meeting, the notice must “specify the meeting as such” as prescribed by Section 131 (1). If the meeting is convened to pass a special resolution, the notice must specify “the intention to propose the resolution as a special resolution” (Section 141(1)).

### 7.3 AGENDA

The word literally means ‘things to be done,’ but in practice, it is commonly applied to the agenda paper, which lists the items of business to be dealt with at a meeting. The agenda is an important document since matters of which appropriate notification have not been given cannot be dealt with at a meeting unless they are of an informal character and then only under the heading of ‘any other business’. An agenda paper is thus matters to be transacted at a meeting and is known as the order paper or the order of business.

#### An agenda may take the following forms:

- A skeleton form agenda  
This kind of agenda is a bare outline or summary form, giving headings only to be dealt with. As a rule, this form is used when it is to be included as part of the notice circulated to those intended to attend the meeting.
- A detailed form of agenda  
This form of agenda has a complete heading to identify the meeting and sets out, in draft form the resolutions to be submitted to the chairman.
- The chairman’s copy of agenda  
This may be supplied with more details than the copies issued to those attending the meeting and a wide margin may also be left on his copy for the purpose of note-taking.





## □ CONTENTS OF AN AGENDA

The following are the important contents of an agenda paper:

- **Heading**  
The agenda paper should be suitably headed, to indicate the kind of meeting where and when it is to be held.
- **Arrangement**  
Items of the agenda should be arranged in the order, if any, indicated in the rules governing the meeting.
- **Items of business included**  
No business should be placed on the agenda paper unless it comes within the scope of the notice convening the meeting and is within the power of the meeting to deal with it.
- **Any other business**  
It is not advisable to use this term, however, where used, the chairman must confine its use to the consideration of informal and unimportant matters.
- **Ease of reference**  
Ease of reference in an agenda paper is very important.

### 7.4 QUORUM

A quorum is the minimum number of persons who must be present at a meeting in order that it may validly transact the business for which it was convened.

Under Table A, article 53, no business is to be transacted at a general meeting unless a quorum of members is present “at the time when the meeting proceeds to business”. In *Re: Hartly Baird Ltd* it was held that the words “of the time when the meeting proceeds to business” mean that the quorum is required only at the time when the meeting begins. There need, therefore, be no quorum after the meeting has begun and it may be legally continued - provided there are at least two persons present who would constitute a valid meeting at common law.

**Section 134(c) provides that, unless the articles otherwise provide: -**

- (a) The quorum for a private company shall be two members present in person. This provision is modified by Table A, part II, Article 4, which states that the members may be present in person or by proxy.

- (b) The quorum for a public company shall be three members. Table A, Article 53, adopts this provision.

Where the articles prescribe a quorum of at least two members, and there is no quorum, there would also be no valid meeting. This is so because as was explained in **Sharp v Dawes** (93), “the word ‘meeting’ *prima facie* means a coming together of more than one person”.

### >>> EXCEPTIONS

**A valid meeting may be constituted by the presence of one person in the following cases:**

1. If the meeting is an annual general meeting which was called by, or on the direction of, the registrar pursuant to Section 131 (2). In such a case, the section empowers the registrar to direct “that one member of the company present in person or by proxy shall be deemed to constitute a meeting”.
2. If the meeting is one which has been called pursuant to a court order under Section 135 (1). The section empowers the court to direct that “one member of the company present in person or by proxy shall be deemed to constitute a meeting”. This is illustrated by **Re: El Sombren Ltd** (88)
3. If the meeting is a class meeting held pursuant to the provisions of the articles for the purpose of authorising a variation of a right to those shares and all the shares are held by one member, as in *East v Bennett Brothers Ltd* (94).
4. If the meeting is an adjourned meeting and the articles provide that “the member or members present shall be a quorum”.
5. If a private company has only one director pursuant to section 177 of the Act, such a director constitutes a valid board meeting for purposes of exercise of powers conferred upon the board by the articles
6. If in the course of liquidation a creditor has proved its debt pursuant to section 309, such a creditor constitutes a valid creditor’s meeting for purposes of winding up.



### ADJOURNMENT

Table A, Article 54 provides that if within half an hour from the time appointed for the meeting a quorum is not present, the meeting, if convened upon the requisition of members, shall be dissolved, in any other case it shall stand adjourned to the same day in the next week, at the same time and place or to such other day and at such other time and place as the director may determine.



## 7.5 PROXIES

By Section 136 (1), any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him. A proxy appointed to attend and vote instead of a member of a private company shall also have the same right as the member to speak at the meeting.

**However, unless the articles otherwise provide: -**

- (i) No proxy shall be appointed by a member of a company not having a share capital;
- (ii) A member of a private company shall not be entitled to appoint more than one proxy to attend on the same occasion;
- (iii) A proxy shall not be entitled to vote except on a poll.

By Section 136 (2), every notice of a meeting must state the member's right to appoint a proxy or proxies and those they need not be members. If default is made in complying with this subsection as respects any meeting every officer of the company who is in default shall be liable to a fine not exceeding Kshs.1, 000.

Section 136 (3) renders void any provision contained in a company's article requiring the instrument appointing a proxy to be received by the company or any other person more than 48 hours before a meeting or adjourned meeting in order that the appointment may be effective

## RIGHTS OF A PROXY

1. To attend general meetings
2. To join other members or proxy to demand voting by poll
3. To participate in the deliberations in case of private company

## 7.6 PROCEEDINGS AT MEETINGS

- (a) Each item of business contained in the notice of meetings should be taken separately, discussed and put to the vote. Members may propose amendments to the resolutions. The chairman should reject any amendment, which is outside the limits set by the notice convening the meeting. With ordinary business, this rule may present no difficulty with special business, which has necessarily been described in details in the notice; there are only limited possibilities of amendment. If the special business is an ordinary

resolution it may be possible to amend it so as to reduce its effect to something less (provided that the change does not entirely alter its character) e.g. an ordinary resolution authorising the directors to borrow 100,000 pounds might be amended to substitute a limit of 50,000 pounds (but not to increase it to 150,000 pounds as 100,000 pounds would have been stated in the notice). It is not possible to pass a special resolution, which differs in substance from the text set out in the notice.

**Case: RE MOORGATE MERCANTILE HOLDINGS (1980)**

A special resolution set out in the notice provided for the total cancellation of a share premium account balance of 1,356,900.48 pounds since the assets which it represented had been lost (form of reduction of share capital). At the meeting, the resolution was amended, for technical reasons, to reduce the balance to 321.17 pounds and it was passed in that form.

**Held:**

The resolution as passed was invalid since it was not the special resolution of which notice had been given. Even the retention of 321 pounds out of 1.4m pounds is a change of substance.

- (b) If the chairman wrongly rejects an amendment and the resolution is carried in its original form, it is invalid. If he allows the amendment to be discussed it should be put to the vote before the original resolution. If the amendment is carried out, the resolution as amended is then put to the vote.
- (c) The rights of members to vote and the number of votes to which they are entitled to in respect of their shares are fixed by the articles. One vote per share is normal but some shares, e.g. preference shares, may carry no voting rights in normal circumstances. To shorten the proceedings at meetings the procedure is:
  - i. On putting a resolution to the vote the chairman calls for a show of hands, i.e. one vote may be given by each member present in person: proxies do not vote. The chairman declares the result. Unless a poll is then demanded, the chairman's declaration (duly recorded in the minutes) is conclusive. No one can re-count hands after the meeting
  - ii. 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 forthwith but may be postponed so that arrangements to hold it can be made.

Although the chairman's declaration of the result of a vote on a show of hands is made "conclusive" (by the articles {Table A Art 58} and by Companies Act Section 141(2) as regards special resolutions) unless a poll is demanded, this is not as absolute and final a decision as the word "conclusive" suggests. It prevents subsequent argument about the count of hands raised on a show of hands. But it is still possible to challenge the chairman's declaration on the ground that it was fraudulent or manifestly wrong.

**Case: RE CARATAL (NEW) MINES LTD (1902)**

A special resolution was put to the vote on show of hands. The chairman counted the hands raised “for” and “against” and said “6 for and 23 against but there were 200 voting by proxy and I declare the resolution carried”. This declaration was later challenged in court.

**Held:**

The declaration invalid since on the chairman’s own figures there was no majority on a show of hands. Proxies may vote on a poll (which had not been held) but not on show of hands and should have been disregarded.

**(d) Any provision in the articles is void insofar as its effect is:**

- (a) To exclude the right to demand a poll on any question other than the election of a chairman by the meeting or an adjournment;
  - (b) To make ineffective a demand for a poll:
    - i. By not less than five members
    - ii. By member(s) representing not less than one-tenth of the total voting rights;
    - iii. By member(s) holding shares which represent not less than one-tenth of the paid-up capital;
- I.e., the articles may well say that three people may demand a poll but cannot validly say that at least six people are required - such a rule would be void and five people could demand a poll. (Section 137)
- (e) When a poll is held, it is usual to appoint “scrutinisers” and to ask members and proxies to sign voting cards or lists. The votes cast are checked against the register of members and the chairman declares the result.
  - (f) In voting, either by show of hands or on a poll, it is the number of votes cast which 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.

**7.7 RESOLUTIONS**

**A meeting reaches a decision by passing a resolution. There are three kinds of resolutions:**

- i. **An ordinary resolution**, which is carried by a simple majority of votes cast. Where no other kind of resolution is specified “resolution” means an ordinary resolution;

- ii. **A special resolution** which requires both a three-quarters majority of votes cast and 21 days notice: (Section 142).
- iii. **Resolution requiring special notice**, This is a resolution created by Section 142 of the Act a 28-day notice of intention to move it must be given.

**Apart from the required size of the majority and period of notice, the main differences between the types of resolutions are:**

- (a) The text of special resolutions must be set out in full in the notice convening the meeting (and it must be described as special resolution): Companies Act Section 142. This is not necessary for an ordinary resolution if it is ordinary business; and
- (b) A signed copy of every special resolution (and equivalent decisions by unanimous consent of members) must be delivered to the registrar for filing. Some ordinary resolutions, particularly those relating to share capital, have to be delivered for filing but many companies do not do so.

The prescribed 21 days notice for **a special resolution** may be waived with the consent of a majority of members holding not less than **95%** of issued shares carrying voting rights (unless of course it is to be proposed at an Annual General Meeting when 100% consent is required).

A special resolution is required for major changes in the company such as a change of name, alteration of objects or of the articles, reduction of share capital, and winding up the company voluntarily (except on grounds of insolvency or under the provisions of the articles) or presenting a petition by the company for an order for compulsory winding up.

## 7.8 MINUTES

Separate minutes or proceedings of directors and general meetings must be kept; the latter are open to inspection by members. The minutes when signed by the chairman of the meeting or next succeeding meeting, are *prima facie* evidence of the proceedings (Sections 145 - 146).



## WHEN A MEETING IS UNNECESSARY

The purpose of holding general meetings with all the formality, which this entails is to give to each member the opportunity of voting (in person or by proxy) on the resolutions before the meeting. If the meeting is not properly convened and held, its purported decisions are not binding on any member who disagrees with and challenges them. **His right to do so exists whether he was absent from the meeting or attended it but was in the minority.** But this is a protection given to a **dissenting** member. If every member, in fact, agrees it would be pointless and wrong to allow any non-member to dispute the validity of the unanimous decision because unanimity was achieved in some informal way.



Accordingly, an unanimous decision of the members is treated as a substitute for a formal decision at a general meeting properly convened and held and is equally binding.

**Case: RE EXPRESS ENGINEERING WORKS (1920)**

The five individuals who were both the directors and all the members of the company held a directors' meeting and resolved unanimously to issue debentures. For technical reasons, their decision as directors was invalid but could be ratified by a general meeting.

**Held:**

The decision was valid since it had been agreed on by everyone who could have voted on it at a general meeting.

In the above case, there was a meeting. But the principle was later extended to cases where, without holding any meeting at all, the members had all, even if informally, agreed to the relevant decision.

**Case: RE DUOMATIC (1969)**

The company was in liquidation and the liquidator sought to recover three payments, which he asserted had not been properly approved at a general meeting as was required. These were:

- (a) Compensation paid to a director for loss of office. The payment had been approved by three directors who were also the only ordinary shareholders entitled to attend and vote but it had not been disclosed (as is required by Companies Act Section 192) to the holders of non-voting preference shares;
- (b) Remuneration paid to directors and later sanctioned by all shareholders through approval of the accounts in which these payments were disclosed.
- (c) The remuneration paid in advance of approval by shareholders was made in accordance with previous practice. It was irregular but the directors would be excused (under Companies Act Section 402).

Finally the assent principle of unanimity of the members has been extended to cover cases where every member had the opportunity to object and either voted in favour or merely abstained.

**Case: RE BAILEY HAY & CO LTD (1971)**

All five members of the company attended a general meeting, which had not been validly convened owing to a **defective notice**. At the meeting, two members voted in favour of a resolution to wind up the company and the other three abstained.

**Held:**

There was sufficient “unanimity” to validate the resolution since all members had been present and none had dissented.

By this means, **informal decisions which would otherwise be invalid are valid**. The same principle may be given formal recognition by articles which provide that a written resolution signed by all the members should have the same effect as a resolution duly passed at a general meeting. Articles in this form substitute one formality (a resolution signed by all members) for another (a resolution passed in general meeting). The assent principle is more flexible since it recognises as valid an unanimous agreement of the members reached without any meeting or other formality at all.

**REGISTRATION OF RESOLUTIONS**

**By Section 143 (1), a printed copy of the following resolutions shall, within 30 days after the passing thereof, be delivered to the registrar for registration:**

- (a) Special resolutions.
- (b) Resolutions agreed to by all the members which would otherwise not have been effective unless passed as special resolutions.
- (c) Resolutions agreed to by all the members of a class of shareholders.
- (d) Resolutions requiring a company to be wound up voluntarily.

**By Section 144 where a resolution is passed at an adjourned meeting of: -**

- (a) A company.
- (b) The holders of any class of shares in a company.
- (c) The directors of a company; the resolution is treated as having been passed on the date on which it was, in fact, passed on the date of the original meeting.





## SUMMARY OF THE CHAPTER

### A company can hold the following meetings:

- Statutory
- Annual general meeting
- General meeting
- Class meeting

### The statutory report has the following matters:

- a) The total number of shares allotted.
- b) The total amount of cash received.
- c) The names, postal addresses, and description of directors if any.
- d) The particulars of any contract entered into.

### A quorum is the minimum number of persons who must be present at a meeting for it to take place

### A proxy is a person appointed by any person to attend and vote at a meeting to represent him.

### There are three types of resolutions:

- A special resolution may be passed for major changes in the company.
- An ordinary resolution is passed by a simple majority of the votes cast.
- Resolution requiring special notice.

### The following resolutions are registerable:

- a. Special resolutions.
- b. Resolutions agreed to by all the members which would otherwise not have been effective unless passed as special resolutions.
- c. Resolutions agreed to by all the members of a class of shareholders.
- d. Resolutions requiring a company to be wound up voluntarily.

## CHAPTER QUIZ

1. Which case is for the authority that one person cannot constitute a meeting?
2. Which meeting is held once in the life of a company?
3. What is the main agenda of the meeting referred to in 2 above?
4. Which type of meeting is not provided for in the Companies Act?

## ANSWERS TO QUIZ

1. Sharp v Dawes
2. Statutory meeting
3. Statutory reports
4. Class meeting
5. Resolutions

## SAMPLE OF EXAMINATION QUESTIONS

### QUESTION ONE

In relation to company law, explain and distinguish the following:

- A) Annual general meeting.
- b) Other general meetings.
- c) Class meeting.

### QUESTION TWO

- a) In relation to the provisions of the Companies Act (Cap.486) of the Laws of Kenya, outline general provisions relating to meetings and votes.
- b) Highlight the requirements to be met before a notice of meeting served on members can be held to be valid.

### QUESTION THREE

Who is a chairman? Discuss his powers and functions

# CHAPTER EIGHT



## DIRECTORS





# CHAPTER EIGHT

## DIRECTORS

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Explain the appointment and restrictions on appointment of directors.
- Explain the duties of directors.
- Explain Rule in **Turquand's case** and the organic theory.
- Explain the division of powers between board of directors and general meeting.

### ► INTRODUCTION

A company, being an artificial person, cannot manage its own affairs. It is, therefore, not surprising to find that the articles of every registered company have provisions regarding the delegation of powers pertaining to the company's management. For example, Table A, Article 80 provides that "the business of the company shall be managed by the directors". This, therefore, is the main concern of this chapter to determine how these directors are appointed and what their duties are.

### ► KEY DEFINITIONS

- **Director:** This is a person who runs of the day to day affairs of a company
- **Compensation:** These are the total payments that are made to a person
- **Indemnity:** This is a payment that reinstates an aggrieved person to the position he was in before a loss occurred

### ► EXAM CONTEXT

The examiner has a tendency to test the student's understanding on director's duties, appointment and restriction on director's appointment. Other areas that have been tested are on compensation and loans to directors. Sittings that have recorded questions from this chapter are 05/02; 12/01; 12/00; 07/00; 05/02

## ► INDUSTRY CONTEXT

Directors are charged with the responsibility of managing company affairs. In recent times, directors have been taken to court for breach of their duties. Therefore, it is vital that directors exercise their duties with care and skill. In this chapter, various powers and duties of certain officers, including directors, and qualifications that are used in the industry today are given.

### 8.1 APPOINTMENT OF DIRECTORS

#### NUMBER OF DIRECTORS

Section 177 Companies Act provides that every company (other than a private company) shall have at least two directors. Every private company shall have at least one director. Under Table A, Article 75, the actual number of directors would initially be decided upon by the subscribers of the Memorandum of Association, or a majority of them, and until so determined, the signatories to the Memorandum of Association shall be the first directors. Table A, Article 94 empowers the company from time to time by an ordinary resolution to increase or reduce the number of its directors.

#### APPOINTMENT OF DIRECTORS

In the absence of other provisions in a company's articles, the directors of the company would be appointed in accordance with the following provisions of Table A.

#### FIRST DIRECTORS

The names of the first directors shall be decided in writing by the subscribers of the Memorandum of Association or a majority of them. If there is a deadlock, all the signatories to the Memorandum of Association shall be the company's first directors.

#### SUBSEQUENT DIRECTORS

The subsequent directors are appointed by the members at a general meeting beginning from the first annual general meeting at which all the first directors retire from office and the members are given the first opportunity to elect directors of their own choice. The retiring directors are, however, eligible for election under Article 89. At the second annual general meeting, one-third of



the directors are to retire from office, the ones to retire being the ones who have been longest in office since their last election. As between persons who became directors on the same day, those to retire shall (unless they otherwise agree among themselves) be determined by lot. One-third of the board shall thereafter retire annually.

## CASUAL APPOINTMENTS

Article 95 permits the board of directors to fill a vacancy in the board or to get an additional director to join the board for practical reasons provided that the appointment does not cause the number of directors to exceed the limit imposed by the articles. The person appointed director in this way shall hold office until the next annual general meeting. He will then be eligible for re-election, but his appointment will not be taken into account when deciding on the directors who shall retire from office.

## RESTRICTIONS ON APPOINTMENT

The following are the restrictions which the Act imposes on appointment of directors:

### 1. Section 182 (1): Appointment by the Articles

Section 182(1) provides that a person shall not be capable of being appointed director of a company by the articles unless, before the registration of the articles, he has by himself or by his agent authorized in writing:

- i. Signed and delivered to the registrar for registration a consent in writing to act as such director; and
- ii. Either:
  - a) Signed the memorandum for a number of shares not less than his qualification, if any;
  - b) Taken and paid or agreed to pay for his qualification shares, if any;
  - c) Signed or made and delivered to the registrar for registration an undertaking to take and pay for his qualification shares, if any, or the statutory declaration that a number of shares not less than his qualification, if any, are registered in his name.

### 2. Section 183: Qualification Shares

Section 83(1) provides that it shall be the duty of every director who is by the articles of the company required to hold a specified qualification, and who is not already qualified, to obtain his qualification within two months after his appointment, or within the shorter time (if any) fixed by the articles.

Subsection (3) further provides that if the director fails to obtain his share qualification, or ceases to hold the required number of shares, he shall vacate his office. If he does not actually do so but continues to act as director he becomes a de facto director: **Rv Ivan Arthur Camps** (67).

**3. Section 186: Age Limit**

Section 186 provides that no person shall be capable of being appointed a director of a public company or a private company which is a subsidiary of a public company if at the time of his appointment:-

(a) He has not attained the age of twenty-one years or is more than 70 years.

**This provision does not apply if:**

- (a) The company's articles provide otherwise or
- (b) A "Special notice" of the resolution to appoint the director was given to the company.

The company must also have given notice of it (i.e. the special notice) to its members and stated the age of the proposed director.

Section 142 defines "special notice" as a notice given to the company not less than 28 days, before the meeting at which the relevant resolution is to be moved.

**4. Section 188: Undischarged Bankrupts**

Section 188 provides that if an undischarged bankrupt acts as director of any company without leave of the court he shall be liable to imprisonment for a term not exceeding two years or to a fine not exceeding Kshs.10,000 or both.

**5. Section 189: Fraudulent Persons**

Section 189(1) empowers the court to make an order restraining a person from being appointed, or acting, as a company's director for a period not exceeding five years if—

- i. The person is convicted of any offence in connection with the promotion, formation or management of a company;
- ii. In the course of a winding up, it appears that the person has been guilty of fraudulent trading (under Section 323) or has otherwise been guilty, while an officer of the company, of any fraud or breach of duty to the company.

**6. Section 184: Individual Voting**

Section 184(1) provides that appointment of directors is to be voted on individually unless a motion for the appointment of two or more persons as directors by a single resolution was agreed upon by the meeting without any vote being given against it.

A resolution moved in contravention of this provision is void {Section 184 (2)}.

**DEFECTS IN APPOINTMENT**

Section 181 provides that a director's acts shall be valid despite any defect that may afterwards be discovered in his appointment or qualification. This provision applies to technical defects in appointment or qualification, such as a failure to obtain the director's share qualification within the prescribed time. An example is **R v Camps (67)**.





## DISQUALIFICATION OF DIRECTORS

Table A, Article 88 provides, under the heading “disqualification of directors”, that the office of director shall be vacated if the director:

- a) Ceases to be a director by virtue of s.183 (i.e. failure to obtain a share qualification) or Section 186 (i.e. age limit); or
- b) Becomes bankrupt or makes any arrangement or composition with his creditors generally; or
- c) Becomes prohibited from being a director by reason of any order made under Section 189 of the Act
- d) Becomes of unsound mind
- e) Resigns his office by notice in writing to the company
- f) Shall for more than six months have been absent without permission of the directors from meetings of the directors held during that period.
- g) Is removed from office by an ordinary resolution of members.

Regarding clause (e) above, it was held in **Latchford Premier Cinema Co. V Ennion** that a verbal notice of resignation which is given to, and is accepted by, the general meeting is effective and cannot be withdrawn. This is so because the general meeting would be deemed to have amended the company’s articles by deleting the words “in writing”. By implication, a purported oral notice of resignation which is given to, and purportedly accepted by, the board of directors would be invalid since the directors cannot legally alter the company’s articles of association.

Regarding clause (f), it should be noted that it does not say that the director in question shall vacate office if he “absents himself”. Such a provision would have disqualified the director only if the absence in question was voluntary, as in cases where he was ill and could not attend the board meetings. On the other hand, the office would be vacated if the director was absent because his doctor had advised him to go abroad on medical grounds: **McConnell’s Claim**.

## VACATION OF OFFICE

In addition to vacating office under the aforesaid provisions of Article 88, a person may cease to be a director for various reasons, such as:

- (a) Death
- (b) Retirement by rotation under the articles
- (c) Court order restraining him from acting as director
- (d) Dissolution of the company.

## REMOVAL OF DIRECTORS

By Section 185(1) a company may by ordinary resolution remove a director before the expiration of his period of office, notwithstanding anything in the articles or in any agreement between him and the company. Special notice must be given of any resolution to remove the director, or to appoint another director in his place.

On receipt of the special notice, the company must send a copy to the director concerned who is entitled, if he so wishes, to make written representations (not exceeding a reasonable length) to the company. If the director so requests, the company must send the representations to the members with notice of the meeting unless the representations are received by it too late for it to do so. In such a case, the representations would be read out at the meeting at which the director would also be entitled to be heard. The representations need not be sent out by the company or read out at the general meeting if, on the application, either of the company or of any other person who claims to be aggrieved, the court is satisfied that they have been made in order to secure needless publicity for defamatory matter.

The removal will be effective if it is decided on by an ordinary resolution. In **Bushell v Faith and Another** (67) Harman, L J defined “an ordinary resolution” as “a resolution depending for its passing on a simple majority of votes validly cast in conformity with the articles”.

## COMPENSATION FOR REMOVAL

Subsection (6) provides that nothing in Section 185 shall be taken as depriving a removed director of compensation or damages payable to him in respect of the termination of his appointment as director or of any appointment terminating with that as director. This provision which restates the common law rule, would enable a managing director to sue the company for damages for wrongful dismissal if the effect of his removal as director was to prematurely terminate his appointment as managing director, and was inconsistent with the contract. The director might also, if he is a member of the company, be entitled to an order for the winding up of the company by the court on the “just and equitable” ground: **Ebrahimi v Westbourne Galleries Ltd.**

## DIRECTORS' REMUNERATION

For technical reasons, the directors are not regarded as servants or employees of the company of which they are directors. They, therefore, have no right to be paid for their services unless there is a provision for payment in the articles. In the case of companies which have adopted Table A, Article 76 provides that “the remuneration of the directors shall from time to time be determined by the company in general meeting.” In **Re: Duomatic Ltd** it was explained that a provision in the articles authorising payment of directors' remuneration does not, per se, give the right to be paid any specific amount. There must also be a resolution passed by the company in general meeting authorising the payment.

Provided the resolution has been passed, the remuneration is payable whether profits are earned or not: **Re: Lundy Granite Co.** Article 76 provides that “the remuneration shall be deemed to accrue from day to day”. This means that a director who vacates office before completing a year or a month in office is entitled to a proportionate part of his yearly or monthly salary: **Moriarty v Regent's Garage Co.**

Section 190 (1) provides that “it shall not be lawful for a company to pay a director remuneration (whether as a director or otherwise) free of income tax or surtax”, except under a contract which was in force two years before the commencement of the Act on January 1, 1962 which provides expressly (and not by reference to the articles) for payment of tax-free payments. Any provision



in the articles regarding tax-free payments “shall have effect as if it provided for payment, as a gross sum subject to income tax and surtax, of the net sum for which it actually provides”.



## COMPENSATION FOR LOSS OF OFFICE

- (a) Section 192 makes it unlawful for a company to make a director any payment by way of compensation for loss of office or as consideration for or in connection with his retirement, unless particulars of the proposed payment, including the amount, are disclosed to the members of the company and the proposal is approved by the company in general meeting. If the payment is not disclosed and approved, the director to whom it is paid shall be deemed to have received it in trust for the company. The directors who paid the money are liable to repay the money to the company: Re: Duomatic.
- (b) Section 193 makes it unlawful, in connection with the transfer of the whole or any part of the undertaking or property of a company, for any payment to be made to any director of the company by way of compensation for loss of office or on retirement unless particulars are disclosed and approved. If such a payment is not disclosed, the director holds it upon trust for the company.
- (c) Section 194 deals with the situation where the shares of the company are being transferred. It applies where the transfer results from:
  - i. An offer made to the general body of shareholders.
  - ii. An offer made by another company with a view to the company becoming its subsidiary or a subsidiary of its holding company.
  - iii. An offer made by an individual with a view to his acquiring at least one-third of the voting power at any general meeting of the company
  - iv. Any other offer, which is conditional on acceptance to a given extent.

If a payment is made to a director as compensation for loss of office or on his retirement in any of the aforesaid circumstances, he must take reasonable steps to ensure that the particulars of the proposed payments are disclosed in the offer. If this is not done, the director holds the payment on trust for the persons who have sold their shares as a result of the offer.

Section 195(3) provides that references under sections 192, 193 and 194 to payments made to any director by way of compensation for loss of office do not include any *bona fide* payment by way of damages for breach of contract or by way of pension in respect of past services.



## LOANS TO DIRECTORS

Section 191(1) renders unlawful any loan made by a company to a director of the company or its holding company. It is also unlawful for the company to guarantee a loan given to its director by any other person. These restrictions do not apply to:

- (a) A private company
- (b) A subsidiary whose director is its holding company
- (c) Payments made to a director to meet expenses incurred or to be incurred by him for purposes of the company, or to enable him properly to perform his duties as an officer of the company
- (d) A loan given by a money lending company, such as a bank, in the ordinary course of its business.



## DUTIES OF DIRECTORS

The duties of directors are usually considered under two broad headings, namely:

- i. Duties of care and skill at common law
- ii. Fiduciary duties as enunciated by courts of equity.

### 1. Duties of Care and Skill

The directors' duties of care and skill have been formulated in a series of cases brought against directors in order to make them liable in negligence for the manner in which they conducted the company's affairs. These duties were summarised by Romer, J. in **RE CITY EQUITABLE FIRE INSURANCE CO LTD** as follows:

- i. A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.

This rule prescribes a duty which is partly objective (the standard of the reasonable man) and partly subjective (the reasonable man is deemed to have the knowledge and experience of the particular director). It may also be expressed by saying that, if a foolish director makes foolish decisions resulting in loss to the company, he cannot be liable for negligence. It would be unreasonable to expect a foolish director to make wise decisions. However, if the director made very foolish decisions resulting in loss to the company, he will be liable in negligence since it is not reasonable to expect a foolish director to make very foolish decisions. On the other hand, a wise director will be liable if he makes unwise decisions, since it is unreasonable to expect him, a wise man, to make unwise or foolish decisions. Reference may also be made to **Re Brazilian rubber Plantation Company**

A directorship is not a professional job with a legally prescribed qualification. In the circumstances, anybody (even a six-months-old baby) can become a director. All that the law can expect him to do is to serve the company honestly and to the best of his ability. In **RE: MARQUIS OF BUTE'S CASE** the director became the director at the age of six months by inheriting the office from his father who had died.

- ii. A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever,



in the circumstances, he is reasonably able to do so.

In **RE MARQUIS OF BUTE'S CASE** a director who had attended only one board meeting in 38 years was exonerated from liability for alleged negligence on the ground that “neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings” (per Sterling, J.) A similar holding was made in **Re Denham Company limited**

A company is, however, free to impose a duty on its directors to attend board meetings within a certain period of time and to prescribe the consequences of a breach of the duty. See, for example, Table A, Article 88(f).

- iii. In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

If a director is to be made liable, it can only be on the basis of his personal negligence, and it is not negligence to delegate some responsibilities to officials or employees of the company whose previous conduct has given no grounds for distrust or suspicion.

In **DOVEY v CORY**, a director was held not liable for negligence merely because he had failed to verify false information regarding the company's accounts which he had been given by the company's manager and managing director. The court stated:

“Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as by those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust.”

## 2. Fiduciary Duties

The fiduciary duties of directors arising from their fiduciary relation to the company have been the subject of consideration in an enormous body of case law's but the *ratio decidendi* of the cases can be reduced to two fundamental propositions:

- (a) **A director is not allowed to put himself in a position where his interest and duty conflict.**

The application of this rule is illustrated by the following cases:

1. **Aberdeen Rly Co v Blaikie Brothers** (68). Section 200(5) adopts this rule by providing that nothing in Section 200(5) shall be taken to prejudice the operation of “any rule of law” restricting directors of a company from having any interest in contracts with the company”.

Section 200 requires a director who is in any way interested in a contract with the company to declare the nature of his interest at a board meeting. He must disclose the interest at the first board meeting at which the contract is to be discussed or, if he did not have an interest at that time, at the first board meeting after his interest arose. This provision is supplemented by Article 84 of Table A which provides that:

- i. The director shall not vote in respect of the contract. If he does vote, his vote shall not be counted
  - ii. The director shall not be counted in the quorum present at the meeting.
2. **Industrial Development Consultants Ltd v Cooley** (69) in which the director became personally interested in a contract he had been assigned to negotiate for the company.
3. **Cook v Deeks** (70) in which some of the company's directors diverted to themselves a contract that was intended to be for the company. It was held that they had to surrender the benefit of the contract to the company. In law the benefit of the contract belonged to the company which the directors had formed for the purpose of obtaining the contract but in equity the contract belonged to the company for which it was intended.

In **Bray v Ford** Lord Herschell stated that the aforesaid rule is not "founded upon principles of morality" but is based on the consideration that human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty and thus prejudicing those whom he was bound to protect".

- (b) A director is not, unless otherwise expressly provided, entitled to make a profit: **Boston Deep Sea Fishing Co v Ansell** (71). This rule is essentially a restatement of the fundamental rule of the law of agency that an agent must not make a secret profit. The cases in company law are just examples of how a particular agent (the company director) committed a breach of his duties to a particular principal (the company).

In **Percival v Wright** (72) it was held that the directors owe their fiduciary duties to the company alone and not to the members. The decision raises a problem that has become known as "insider dealing".



## RELIEF FROM LIABILITY

Under Section 402 (1), the court has power in an action against an officer for breach of duty to grant relief where, although the officer is in breach, it appears that he has acted honestly and reasonably and, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust.



## DIRECTORS' POWERS

Equity regards directors as holding their powers on trust for the company. They can only exercise those powers for the benefit of the company; otherwise the purported exercise will be regarded as "ultra vires" and invalid. In such cases, the court would regard the transaction as having been entered into for an "extraneous purpose". This is illustrated by:



- i. **Re Roith Ltd** (73). The extraneous purpose was consideration of the widow's welfare rather than the company's benefit.
- ii. **Hutton v West Cork Railway Co.** (74). The resolutions had not given adequate consideration to the question whether the company would benefit from the proposed payments.
- iii. **Hogg v Cramp horn** (75). The extraneous purpose was the desire to pre-empt the take-over bid. The directors had not exercised their power for the benefit of the company.



## REGISTER OF DIRECTORS' SHAREHOLDINGS

Section 196(1) requires every company to keep a register showing the number, description and amount of any shares or debentures which are held by or in trust for the director, or of which he has any right to become the holder (whether on payment or not) in:-

- (a) The company
- (b) The company's subsidiary or holding company
- (c) A subsidiary of the company's holding company.

The register shall be kept at the company's registered office and shall be open to the inspection of any member or debenture holder during business hours during the period beginning 14 days before the date of the company's annual general meeting and ending three days after the conclusion of the meeting (a day which is a Saturday, Sunday or public holiday being disregarded in computing the 14 days).

## THE RULE IN ROYAL BRITISH BANK V TURQUAND

### Fast forward:

- ∅ A company will be bound by its indoor management as outsiders are in position to know the internal rules of management
- ∅ The general rule is the rule in Turquand's case though it has exceptions

In **Royal British Bank v Turquand** (80), a company was ordered to repay a loan which its directors had borrowed on its behalf without the authority of an ordinary resolution prescribed by the Articles of Association. In the course of delivering his judgment, Jervis, C J stated:

"The dealings with these companies are not like dealings with other partnerships, and the parties dealing with them are bound to read the statute and the deed of settlement. But they are not bound to do more. And the party here, on reading the deed of settlement, would find, not a prohibition from borrowing, but a permission to do so on certain conditions. Finding that the authority might be made complete by a resolution, he would have a right to infer the fact of a resolution authorising that which on the face of the document appeared to be legitimately done".

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This statement can be reduced to two propositions which constitute what is compositely known as “the rule in Turquand’s case”, namely:

- i. A person dealing with a company is bound to read the relevant restrictive provisions of the Companies Act, the company’s Memorandum of Association and the company’s Articles of Association. If he does not do so, he will be deemed to have read them and, as a consequence, to have been aware of their provisions.
- ii. In so far as the articles provide that a transaction may be effected by some internal procedure, the person dealing with the company (called “outsider”) may assume that the procedure has been duly complied with.

The effect of these propositions is that the company will be bound by the transaction even if the prescribed procedure was in fact not followed or complied with. An “internal procedure” for this purpose would usually be a decision of the company which is made by an ordinary resolution passed by the company in general meeting, or a resolution of the directors passed at a board meeting. Such a resolution is not register able at the Companies Registry pursuant to Section 143 or any other section of the Companies Act and the outsider who goes to the Registry would not be in a position to ascertain whether it had, in fact, been passed. Rather than compel him to go to the relevant office of the company to make enquiries, the courts decided to, as it were, “give him the benefit of the doubt” by holding that the resolution will be deemed to have been passed even if it had not actually been passed.

## Examples

The following cases are some of the leading examples of the application of “the rule in Turquand’s case:”

(a) **Mahoney v East Holy ford Mining Co**

The company “secretary” sent the company’s bank what purported to be a final copy of a resolution of the board authorising the payment of cheques signed by two of three named “directors” and by the named “secretary”. The bank, relying on the “resolution”, honoured cheques signed in accordance with its provisions. The company later went into liquidation and it was then realised that neither the “directors” nor the “secretary” had been properly appointed and no general or board meetings had ever been held. The liquidator’s contention that the cheques, which had been signed by the “directors” and the “secretary” had been wrongly paid and the bank must refund the money that was rejected. The bank was not bound to enquire whether the “directors” and the “secretary” had been properly appointed and could rely on the rule in Turquand’s case.

(b) **Freeman & Lockyer v Buckhurst Park Properties Ltd**

The articles of a company formed to purchase and resell an estate empowered the directors to appoint one of their body managing director. Kapoor, a director, was never appointed managing director but, to the knowledge of the board, he acted as such. On behalf of the company he instructed the plaintiffs, a firm of architects and surveyors, to





apply for planning permission with a view to developing the estate. The company later refused to pay the plaintiffs' fees on the ground that Kapoor had no authority to engage them.

**Held**, the company was bound by the contract and liable for the plaintiffs' fees. The act of engaging architects was within the apparent authority of a managing director of a property company and the plaintiffs were not obliged to enquire whether the person they were dealing with (Kapoor) was properly appointed. It was sufficient that under the articles there was a power to appoint a managing director, and that the board of directors had allowed one of them (Kapoor) to act as such. In any case, a resolution of the board appointing a managing director is not register able under Section 143 and so its passing cannot be ascertained by a visit to the companies' registry.

(c) **HelyHutchinson v Brayhead Ltd (81)**

## Exceptions

### The rule in Turquand's case will not apply if:

- i. The person suing the company is, in fact, an insider, such as a director of the company:

**Howard v Patent Ivory Co (82)**. Such a person has access to the company's documents from which he may discover the lack of authority. Exceptionally, he may succeed against the company if he proves that he was a recently-appointed director and had not fully acquainted himself with the internal procedures of the company.

- ii. The company's articles prescribed a special resolution, which had not been passed, as illustrated by **Irvine v Union Bank of Australia (83)**.

A special resolution is register able under Section 143 of the Companies Act and if it had been passed a copy thereof would have been delivered for registration and would have been found among the company's documents at the companies' registry. Its absence shall have warned the outsider that it had not been passed.

- iii. There were special circumstances which should have put the outsider on inquiry: **Underwood Ltd v Bank of Liverpool** (case No 5); **Liggett v Barclays Bank (84)**.
- iv. The transaction is *ultra vires* the company, since a company's agent cannot have authority to transact a business which the company itself lacks capacity to transact.
- v. The transaction relates to the issue of a forged document, such as a forged share certificate issued by the secretary without the authority of the board, as illustrated by **Ruben v Great Fingall Consolidated Ltd**.
- vi. Knowledge of irregularity: **Liggett v Barclays Bank**

## INSIDER TRADING OR DEALING

Insider dealing occurs where an individual or organisation buys or sells securities while knowingly in possession of some piece of confidential information which is not generally available and which is not likely, if made available to the general public, to materially affect the price of the securities. For example, where a company director who is aware that the company is in a bad financial state sells his shares knowing that this information will be made public with an announcement of a cut in dividend payment.

It is argued that the use of insider information is unfair to those who deal with the insider, though it is difficult to identify the loser since the transaction takes place on the stock exchange. However, a person who buys something which turns out to be worthless than the price paid for it may feel aggrieved. In principle, dealings in a market generally reflect the value of the security if all the information used in valuation is available to both buyers and sellers. Information generally used by those involved in company securities relate to:

- (i) World trade in the particular market in which the company is trading
- (ii) Economy of the country
- (iii) How the company is handling its affairs.

With the expansion of dealings in stock exchange, it has become evident that taking advantage of inside information is fraudulent on other investors and could lower public confidence in the stock exchange, and for officers of the company, this amounts to a breach of trust since the information is obtained in the course of their employment.

### CASE FOR REGULATION

In the realm of company law, it may be necessary to regulate insider trading or dealing since the insider with access to confidential information is in potential conflict of interest situation, in particular where his position in the company enables him to dictate or influence when the public disclosure of price-sensitive information is to be made.

In such a case, the officer's decision and his own desire to trade advantageously in the company's shares may conflict and such conduct is likely to bring the company into disrepute. It is therefore recognised that it is wrong for a director or another to deal in a company's securities knowing of some development which is likely to affect the price of the securities, which other members of the public are generally privy to.

**In conclusion, insider trading should be regulated for the following reasons:**

1. It spoils the reputation of the company.
2. There is no equality in information access.
3. Breach of director's duties.
4. Lack of confidence in the market.



## Liability

Under the United States Law, persons involved in insider dealings are bound to account to the company or to the individual dealt with. In Britain, the problem is dealt with by the provisions of the Companies Act, Company Securities (Insider Dealing) Act, 1985 and the Criminal Justice Act, 1993.

At common law, officers of the company are free to hold and deal in the shares of the company. However, use of confidential information is actionable. This legal position is traceable to the decision in **Percival v Wright** where joint holders of some shares of an unlisted colliery company offered them for sale to the chairman of the company and two other directors at a price determined by an independent value at £12 10s but after conclusion of the sale, it was discovered that while negotiating the purchase, the chairman was involved in discussions of the possible sale of the whole colliery at a price that would have made each share in the company worth more than £12 10s. However, the colliery was never sold. In an action by Percival and his co-shareholders to have the sale set aside on the ground of non-disclosure by the chairman, it was held that since the directors owed their duties to the company, there was no duty to disclose.

### In the words of Swinfen Eady J.

“The contrary view would place directors in a most invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interest of the company. I am of the opinion that directors are not in that position.”

The decision in **Percival v Wright** was upheld in **Tent v Phoenix Property & Invest Co. Ltd. (1984)**. In **Multinational gas & Petrochemical Co. v Multinational Gas and Petrochemical Services Ltd. (1983)**, Dillon L. J. observed:

“The directors stand in a fiduciary relationship to the company and they owe fiduciary duties to the company though not to individual shareholders”.

However, in **Allen v Hyatt 1914** where shareholders had engaged directors to investigate on their behalf and the directors benefited, it was held that since the directors were agents of the shareholders, they were liable to account to the shareholders.

In Kenya, the problem of insider trading is addressed by Section 33 of the Capital Markets Authority Act; Cap 485 A Under Section 33 (1) of the Act, insider trading is a criminal offence. Under the section:

- (1) A person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of that body corporate he is in possession of information that is not generally available but, if it were, would be likely to materially affect the price of those securities.
- (2) A person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of any body corporate if by reason of

his so being, or having been, connected with the first mentioned body corporate he is in possession of information that: –

- (a) Is not generally available but, if it were, would be likely materially to affect the price of those securities; and
  - (b) Relate to any transaction (actual or expected) involving both bodies corporate or involving one of them and securities of the other.
- (3) Where a person is in possession of any such information as is mentioned in subsection (1) and (2) that if generally available would be likely materially to affect the price of securities but is not precluded by either of those subsections from dealing in those securities, he shall not deal in those securities if:-
- (a) He has obtained the information, directly or indirectly, from another person and is aware, or ought reasonably to be aware, of facts or circumstances by virtue of which that other person is himself precluded by subsection (1) or (2) from dealing in those securities;
  - (b) When the information was so obtained, he was associated with that other person or had with him an arrangement for the communication of information of a kind to which those subsections apply with a view to dealing in securities by himself and that other person or either of them.
- (4) A person shall not, at any time when he is precluded by subsections (1), (2) or (3) from dealing in any securities, cause or procure any other person to deal in those securities.
- (5) A person shall not, at any time when he is precluded by subsections (1), (2) or (3) from dealing in any securities by reason of his being in possession of any information, communicate that information to any other person if –
- (a) Trading in those securities is permitted on any securities exchange;
  - (b) He knows, or has reason to believe, that the other person will make use of the information for the purpose of dealing or causing or procuring another person to deal in those securities.
- (6) Without prejudice to subsection (3) but subject to subsections (7) and (8), a body corporate shall not deal in any securities at a time when any officer of that body corporate is precluded by subsections (1), (2) or (3) from dealing in those securities.
- (7) A body corporate is not precluded by subsection (6) from entering into a transaction at any time by reason only of information in the possession of an officer of that body corporate if:
- (a) The decision to enter into the transaction was taken on its behalf by a person other than the officer.
  - (b) It had in operation at that time arrangements to ensure that the information was not communicated to that person and that no advice with respect to the transaction was given to him by a person in possession of the information;
  - (c) The information was not so communicated and such advice was not so given.



- (8) A body corporate is not precluded by subsection (6) from dealing in securities of another body corporate at any time by reason of only of information in the possession of an officer of that first-mentioned body corporate, being information that was obtained by officer in the course of the performance of his duties as an officer of that first mentioned body corporate and that relates to proposed dealings by that first-mentioned body corporate in securities of that other body corporate.
- (9) For the purpose of this section, a person is connected with a body corporate if, being a natural person: –
- (a) He is an officer of that body corporate or of a related body corporate.
  - (b) He is a substantial shareholder in that body corporate or in a related body corporate
  - (c) He occupies a position that may reasonably be expected to give him access to information of a kind to which subsection (1) and (2) apply by virtue of:
    - (i) Any professional or business relationship existing between himself (or his employer or a body corporate of which he is an officer) and that body corporate or a related body corporate; or
    - (ii) His being an officer of a substantial shareholder in that body corporate or in a related body corporate.
- (10) This section does not preclude the holder of a broker's or dealer's licence from dealing in securities, or rights or interests in securities, of a body corporate, being securities or rights or interests that are permitted by a securities exchange to be traded on the stock market of that securities exchange, if:
- (a) The holder of the licence enters into the transaction concerned as agent for another person pursuant to a specific instruction by that other person to effect that transaction;
  - (b) The holder of the licence has not given any advice to the other person in relation to dealing in securities, or rights or interests in securities, of that body corporate that are included in the same class as the first-mentioned securities;
  - (c) The other person is not associated with the holder of the licence.
- (11) For the purpose of subsection (8), "officer", in relation to a body corporate, includes –
- (a) A director, secretary, executive officer or employee of the body corporate;
  - (b) A receiver, receiver manager of property of the body corporate;
  - (c) An official manager or a deputy official manager of the body corporate;
  - (d) A liquidator of the body corporate
  - (e) A trustee or other person administering a compromise or arrangement made between the body corporate and another person or other persons.
- (12) A person who contravenes this section shall be guilty of an offence and shall be liable:-
- (a) On a first conviction:
    - (i) In the case of a person being a body corporate, to a fine not exceeding Kshs.1.5 million
    - (ii) In the case of any other person, including a director or officer of a body

corporate, to a fine not exceeding Kshs 500,000 or to imprisonment for a term not exceeding five years or to both;

(b) On any subsequent conviction:

- (i) In the case of a person being a body corporate, to a fine not exceeding Kshs.3 million or
- (ii) In the case of any other person, including a director or officer of a body corporate, to a fine not exceeding Kshs.1 million or to imprisonment for a term not exceeding seven years or to both.

(13) An action under this section for the recovery of a loss shall not be commenced after the expiration of six years after the date of completion of the transaction in which the loss occurred.

(14) Nothing in subsection (12) affects any liability that a person may incur under any other section of this Act or any other law.

## SUMMARY OF THE CHAPTER

Insider trading occurs when a person buys or sells company securities uses information that is not available to the public to trade in the company's securities or when the person has a relationship with the company to an extent that he is likely to have access to material information about the company.

**The restriction on directors' appointments is as follows:**

- Appointment by the articles.
- Qualification of shares.
- Age limit.
- Undischarged bankrupts.
- Persons disqualified by the court.
- Individual voting.

**The office of the director shall be vacated if the director:**

- Fails to obtain the share qualification
- Becomes bankrupt or makes any arrangement or composition with his directors
- Is prohibited by the court
- Is of unsound mind
- Resigns his office in writing
- Has been absent for more than six months without permission

**It is unlawful for the company to issue a loan to its director unless:**

- It's a private company.



- It's a subsidiary whose director is its holding company.
  - It's payment to meet expenses incurred by him on behalf of the company.
  - It's a loan given by a money lending company.

### Director's act as trustees, agents but their real position is that of a fiduciary

### Director's duties are divided into two broad categories namely:

- Duties of care and skill at common law.
- Fiduciary duties as enunciated by courts of equity.

The rule in *Turquand's case* is the rule of indoor management which holds that a company will be bound by a transaction even if the prescribed procedure was in fact not followed or complied with.

The rule in **Turquand's case** will not apply if:

- § The person suing the company is in fact an insider
- § The company prescribed a special resolution, which had not been passed
- § There were special circumstances, which would have put the outsider on inquiry
- § The transaction is ***ultra vires*** the company.
- § The transaction refers to a forged document.

## CHAPTER QUIZ

1. What is the minimum and maximum age of a director?
2. Give four reasons that are under Article 88 of Table A for office vacation of office
3. What is the true legal position of directors?
4. Indoor management rule is explained by which case?
5. A private company has at least how many directors?

## ANSWERS TO QUIZ

1. Minimum is 21 and maximum is 70
2. Death, Retirement by rotation, Court order restraining him, Dissolution of the company.
3. Directors are fiduciaries
4. **Royal British bank v Turquand**
5. Two

## SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

- a) Discuss the rules relating to appointment and vacation of office of directors. (10 marks)
- b) Triple H, Undertaker Austin and Flair are directors of Mieleka Ltd, a company regulated by Table A. Fair is the managing director and Undertaker is the chairperson of the company. Sometime ago the directors meeting as a board decided to:
  - i) Lend Triple H Kshs.500,000 to purchase a car for his wife Stephane for her personal use;
  - ii) Advance Kshs.500, 000 to Austin to cover his expenses on a worldwide (promotional tour on behalf of the company).

Booker T, the company secretary informs you that Stone Cold a shareholder claims that this transaction should have been approved by the members and that he intends to raise the matter during the next general meeting.

#### Required

- i) Advise Booker T, which of the transactions need approval by members in the general meeting (4 marks)
  - ii) What are the consequences of the necessary approval not being obtained? (6 marks)
- (Total: 20 marks)**

### QUESTION TWO

Birds Limited has three directors: Peacock, Sparrow and Vulture. Explain the legal implication of each of the following situations:





- a) Vulture's son has recently come of age and Vulture wishes to appoint him a director of the company. (4 marks)
- b) The company is considering the purchase of a substantial quantity of goods from Fly Ltd., in which sparrow has a large shareholding through he is not a director Peacock and vulture are unaware of sparrow's interest in Fly Ltd. (4 marks)
- c) Because of adverse publicity about Peacock's private life, vulture and sparrow wish to remove him as a director, since he refuses to resign. (4 marks)
- d) In view of the adverse publicity, Vulture and Sparrow decide to exclude Peacock from participation in the company's affairs. (4 marks)
- e) The directors are advised by Wise & co., the company's auditors, that there is no possibility of the company trading at a profit in the foreseeable future and no reasonable prospect of its paying its debts. (4 marks)

**(Total: 20 marks)**

### QUESTION THREE

Discuss the restrictions that are imposed on appointment of directors and directors' legal position.



# CHAPTER NINE



## THE SECRETARY





# CHAPTER NINE

## THE SECRETARY

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

1. Explain the qualification, appointment and removal of a secretary
2. Discuss the position and duties of the secretary
3. Explain the liability of the secretary
4. Discuss the register of directors and secretaries as provided for in the Companies Act

### ► INTRODUCTION

This chapter describes the appointment, qualifications for appointment and removal of the company secretary. It later describes the secretary's duties and their legal position.

### ► KEY DEFINITIONS

- **Ordinary resolutions:** Used for all routine business
- **Extraordinary resolution:** This is passed by a majority of not less than three-fourths of members entitled to vote and actually voting (in person or by proxy)
- **Special resolution:** This is defined in the Companies Act as "a resolution passed by the same majority as required for an extraordinary resolution at a general meeting of which not less than 21 days notice has been given"

### ► EXAM CONTEXT

This is a chapter has been separated from the original topic of directors, secretaries and auditors under the old syllabus. Most of the questions from the past papers focus on directors and auditors. However, a clear understanding of the chapter is important. At the end of the chapter there is a sample of possible exam questions from other sources.

### ► INDUSTRY CONTEXT

This chapter discusses a very important company official, the secretary. This official is charged simply with taking care of the legal matters that the company, a juridical person, may be involved in various legal transactions. Today, many companies are hiring company secretaries who work as part of the legal department thus if any legal representation is required, they take up this role.

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## 9.1 APPOINTMENT OF THE SECRETARY

By section 178, every company must have a secretary. However, a sole director cannot be a secretary as well (Section 179). Section 179 also provides that a corporation cannot be a secretary if its sole director is also the sole director of the company.

Section 178A (1) states that every company secretary shall hold a qualification prescribed by Section 20 of the Certified Public Secretaries Act. However, subsection 2 provides that the Minister may on the advice of the Council and the Registration Board; exempt certain classes of companies, non-profit organisations and charitable organisations from the provisions of that section. All public companies, all private companies with a nominal capital of at least Kshs.100,000 and all companies of public nature registered as limited by guarantee are supposed to comply with the provision of Section 178.

Table A, Article 110, provides that the secretary shall be appointed by the directors on such terms and conditions as they think fit and may be dismissed by them.

No person shall qualify for appointment as a company secretary unless he is registered under the Certified Public Secretaries Act. Section 20 of the Certified Public Secretaries Act provides that subject to this section, a person is qualified to be registered as a Certified Public Secretary if:

- He has been awarded by the Examinations Board a certificate designated the Final Certificate of the Certified Public Secretaries Examination.
- He holds a qualification approved by the Registration Board
- He is at the commencement of this Act, both a citizen of Kenya and a member of the professional body known as the Institute of Chartered Secretaries and Administrators
- He is at the commencement of this Act both ordinarily resident in Kenya, and a member of the professional body known as the Institute of Chartered Secretaries and Administrators
- He is at the commencement of this Act, registered as an accountant under Section 24(1) of the Accountants Act he is qualified as an advocate of the High Court of Kenya.

Section 21(1) provides for disqualification from being registered as a company secretary. The following are disqualified from being registered

- If convicted by a court of competent jurisdiction in Kenya or elsewhere of an offence involving fraud or dishonesty.
- If an undischarged bankrupt
- If he is of unsound mind, and has been certified to be so by a medical practitioner.
- If during the period when the Registration Board has determined under section 28(1)(d) that he shall not be registered or during any such period as varied by the High Court under Section 29.



- Section 28 gives the Registration Board power to cancel the registration of a member amongst other penalties if found guilty of professional misconduct. However, an aggrieved person may appeal such a decision to the High Court.



## STATUS OF THE SECRETARY

- He is a servant of the company.
- He is also an officer of the company, according to Section 2 of the Companies Act and therefore, liable to penalties in that capacity.
- If acting within the scope of his duties as secretary and if expressly authorised by the directors, he is also to some extent, an agent of the company with power to bind the company.

The traditional view was that a company was a “mere servant; his position is that he is to do what he is told, and no other person can assume that he has any authority to represent anything at all.” Lord Esther M.R. in **Barnett Hoares and Co. v. South London Tramways co.** (1887).

However, in **Panorama Development (Guilford) Ltd. v. Fidelis Furnishing Fabrics Ltd** (1971) it was recognised that a company secretary is the company’s chief administrative officer, and, as such, has apparent authority to act on behalf of the company. “Times have changed. A company secretary is a much more important person nowadays than he was in 1887. He is an officer of the company with extensive duties and responsibilities. This appears not only in the modern Companies Act, but also by the role which he plays in the day-today business of a company. He is no longer a mere clerk. He regularly makes representations on behalf of the company and enters into contracts on its behalf, which come within the day to day running of the company’s business. So much so that he may be regarded as held out as having the authority to do such things on behalf of the company. He is certainly entitled to sign contracts connected with the administrative side of a company’s affairs, such as employing staff, and ordering cars, and so forth. All such matters now come within the ostensible authority of a company secretary.”

If the office of the secretary is vacant, or if for any other reason, there is no secretary capable of acting e.g. due to illness, his functions and responsibilities may be undertaken by:

1. An Assistant or Deputy Secretary
2. Any Officer of the Company authorized generally or specifically for the purpose by the directors, if there is no assistant or deputy secretary capable of acting.



## THE SECRETARY’S SIGNATURE

The secretary’s signature is an important feature on many documents and in the case of the Annual Return he is one of the recognised signatures.

The secretary should be careful when signing documents on behalf of the company to negate his own personal liability, by signing in a representative capacity. He should also ensure that the company is correctly described by name, as a slight variation in the name, or even an omission of the word “limited” from the name may render him as a signatory, personally liable.

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## 9.2 POWERS AND DUTIES

The powers and duties of the secretary depend on the size and nature of the company and the personal contractual arrangements that it makes with him. However, a company secretary usually has the following powers and duties:

- To be present at all meetings, including board meetings and take minutes of such proceedings.
- On the instructions of the board, to issue notices of meetings to members and others.
- To countersign instruments to which the company seal has been affixed (see Article 113 of Table A).
- To conduct and record transfer of shares and conduct correspondence with shareholders as regards calls, transfers, forfeiture, e.t.c.
- To keep the books of the company, particularly those relating to the internal administration of the company, e.g. the shares register and register of charges.
- To make all the returns of the company, e.g. the annual returns, notice of special resolutions, etc.
- For quoted companies, he ensures compliance with Nairobi Stock Exchange and Capital Markets Authority Requirements.
- For banks he ensures compliance with Central Bank of Kenya statutory requirements.

Section 180 provides that a provision requiring or authorising a thing to be done by or to a director and the secretary is not satisfied by it being done by or to the same person acting as secretary and director.

### Bridging the Information Gap between the Executive and Non-Executive Directors

The developing role of the Company Secretary was first recognised in the Cadbury Report, made by the Cadbury Committee in 1992, which stated:

“The Chairman and the Board will look to the Company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how these responsibilities should be discharged.”

All directors should have access to the advice and services of the Company Secretary who is responsible to the Board for ensuring that the Board procedures are followed and applicable rules and regulations are complied with.

The Company Secretary’s role is to protect the interests of the company as a whole. Often referred to as “the conscience of the company” the company secretary has the task of informing, advising and supporting the directors both individually and collectively, endeavouring to ensure that they are fully aware of the restrictions, responsibilities and obligations imposed upon them and the company by the company’s own constitution, company law, other relevant legislation and any applicable codes of best practice standards. He should constantly monitor the internal activities of the company, take responsibility for internal disclosure, interpret the decisions of the Board and help to ensure that they are properly implemented throughout the organisation.





A qualified Company Secretary has a clear responsibility to protect the probity of the organisation and would have a major impact, for example, in guarding against directors acting, consciously or otherwise, in their own interest rather than those of the company. In protecting the interests of the company, the company secretary not only serves the interests of the third party shareholders who may be involved but is also able to represent the interests of numerous other stakeholders such as creditors, employees and local communities.

## STATUTORY REGISTERS

The Company Secretary must ensure that all Statutory Registers/Books required to be kept by the Companies Act are kept.

### They include:

1. Register of Member Section 112
2. Register of Directors and Secretaries, Section 201
3. Register of Directors' Shareholdings, debentures Section 196
4. Register of Mortgages and Charges, Section 105
5. Minute Books of all proceedings of general meetings and of all proceedings at the meetings of its directors. Section 145 only the meeting books of general meetings are open for inspection by shareholders and, therefore, it is advisable to have separate minute books.
6. Books of Account
7. Register of Debenture holders, Section 88(1): This is only necessary for a company that issues debentures.

## REGISTER OF DIRECTORS AND SECRETARIES

### Section 21

- (1) Every company shall keep at its registered office a register of its directors and secretaries.
- (2) The said register shall contain the following particulars with respect to each director, that is to
  - (a) in the case of an individual, his present Christian name and surname, any former Christian name or surname, his postal address his nationality and, if that nationality is not his nationality of origin, his nationality of origin, his business occupation, if any, particulars of all other directorships held by him and, in the case of a company subject to Section 186, the date of his birth
  - (b) In the case of a corporation, its corporate name and registered or principal office and postal address.

Provided that it shall not be necessary for the register to contain particulars of directorships held by a director in companies of which the company is the wholly-

owned subsidiary, or which are the wholly-owned subsidiaries either of the company or of another company of which the company is the wholly-owned subsidiary; and for the purposes of this proviso:

- (i) "company" includes any body corporate incorporated in Kenya;
- (ii) a body corporate shall be deemed to be the wholly-owned subsidiary of another if it has no members except that other and that other's wholly-owned subsidiaries and its or their nominees.

(3) The said register shall contain the following particulars with respect to the secretary or, where there are joint secretaries, with respect to each of them, that is to say:

- (a) in the case of an individual, his present Christian name and surname any former Christian name and surname and his postal address
- (b) in the case of a corporation, its corporate name and registered or principal office and postal address:

Provided that where all the partners in a firm are joint secretaries, the name and postal address of the principal office of the firm may be stated instead of the said particulars.

(4) The company shall, within the periods respectively mentioned in subsection

(5) deliver to the registrar for registration a return in the prescribed form containing the particulars specified in the said register and a notification in the prescribed form of any change among its directors or in its secretary or in any of the particulars contained in the register, specifying the date of the change.

**The periods referred to in subsection (4) are the following, namely:**

- (a) the periods within which the said return is to be sent shall be a period of 14 days from the appointment of the first directors of the company; and
- (b) the period within which the said notification of a change is to be sent shall be 14 days from the happening thereof:

Provided that, in the case of a return containing particulars with respect to any person who is the company's secretary on the appointed day the period shall be 14 days from the appointed day.

(6) The register to be kept under this section shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) be open to the inspection of any member of the company without charge and of any other person on payment of two shillings, or such less sum as the company may prescribe, for each inspection.



(7) If any inspection required under this section is refused or if default is made in complying with subsection (1), subsection (2), subsection (3) or subsection (4), the company and every officer of the company who is in default shall be liable to a default fine.

(8) In the case of any such refusal, the court may by order compel an immediate inspection of the register.

(9) For the purposes of this section:

- (a) A person in accordance with whose directions or instructions the directors of a company are accustomed to act shall be deemed to be a director and officer of the company;
- (b) "Christian name" includes a forename
- (c) In the case of a peer or person usually known by a title different from his surname, "surname" means that title;
- (d) References to a former Christian name or surname do not include: -
  - (i) In the case of a peer or a person usually known by a British title different from his surname, the name by which he was known previous to the adoption of or succession to the title; or
  - (ii) In the case of any person, a former Christian name or surname where that name or surname, was changed or disused before the person bearing the name attained the age of eighteen years or has been changed or disused for a period of not less than 20 years
  - (iii) In the case of a married woman, the name or surname by which she was known previous to the marriage.

**Non-statutory books may be purchased and kept. These include:**

- Register of documents sealed (or Seal Book): This is for recording particulars of documents issued under seal.
- Register of Important Documents: e.g. Power of Attorney, Probates and Letters of Administration, etc.

## Annual Returns and other Forms

### Annual Return to be made by a company having a share capital

Section 125 provides that every company having a share capital shall at least once in every year (calendar year), make an annual return and failure to comply with this section renders the company and every officer of the company who is in default liable to a default fine. An annual return is made up to the 14<sup>th</sup> day after the Annual General Meeting.

A company need not make a return under this either in the year of its incorporation or, if it is not required by Section 131 to hold an AGM during the following year after its incorporation.

Download more free notes at [www.kasnebnote.co.ke](http://www.kasnebnote.co.ke)

## ■ Contents of Annual Return

The Annual Return's contents are specified in Part I of the Fifth Schedule and they include:

- The situation of the registered office of the company and the company's registered postal address.
- If the register of members is kept in a place other than the Registered Office of the company, the address of the place where it is kept.
- A summary, distinguishing between shares issued for cash and shares issued as fully or partly paid up, and debentures specifying the following particulars:
  1. Amount of share capital
  2. Number of shares taken from the commencement of the company up to the date of the return
  3. The amount called upon each share
  4. The total amount of calls received
  5. The total amount of calls unpaid
  6. The total amount of the sums (if any) paid by way of commission in respect of any shares or debentures
  7. The discount allowed on the issue of any shares issued at a discount or so much of that discount as has not been written off at the date on which the return is made.
  8. The total amount of the sums (if any) allowed by way of discount in respect of any debentures since the date of the last return
  9. The total amount of shares forfeited.
  10. The total amount of shares for which share warrants are outstanding at the date of the return and of share warrants issued and surrendered respectively since the date of the last return, and the number of shares comprised in each warrant.
  11. Particulars of the total indebtedness of the company as at the date of this return in respect of all mortgages and charges which are required to be registered with the registrar under this Act.
    - A list of past and present members, giving:
      - A list of names and addresses of members, as at the fourteenth day after the day of the Annual General Meeting for the year and of members who have ceased to be members since the date of the last return, or in the case of the first return, since the incorporation of the company.
      - Number of shares held by each of the existing members at the date of the return, specifying shares transferred since the date of the last return by persons who are still members and have ceased to be members respectively and the dates of registration of the transfers.
      - If the names above are not in alphabetical order, an index should be annexed.
      - Particulars of the directors and secretaries holding office as at the date of return.
      - Section 125(1) (ii) provides that where the company has converted any of its shares into stock particulars required in the List of Members will relate to stock instead of shares.
      - If full particulars of members and their holdings have been given in one year, it will only be necessary to give particulars of persons ceasing to be members since the date of the last return and to shares transferred since that date or to changes as compared with that date in the amount of stock held by a member. Section 125 (1)(iii)



Section 125(2) provides that if in the case of a company keeping a branch register, particulars from the branch are received at the registered office after the returns have been made, then such particulars must be included in the next or subsequent annual return.

### **Annual Return to be made by a Company not having a share capital, Section 126(1)**

Every company not having a share capital shall once, at least in every calendar year, make a return stating:

- The situation of the registered office of the company and its registered postal address
- In a case in which the register of members is kept elsewhere than at the registered office, the address of the place where it is kept.
- In a case in which any register of holders of debentures of a company or part of any such register is kept in Kenya, elsewhere than at the registered office, the address of the place where it is kept and
- All particulars of directors and secretaries occupying their respective positions at the date of the return.

There shall be *annexed* to the annual return, a statement giving particulars of indebtedness in respect of all mortgages and charges.

Section 127(1) provides that the Annual Return must be completed within 42 days after the AGM for the year and the company shall within such period deliver to the registrar a copy signed both by a director and by the secretary to the company.

Section 128 provides that a copy of every balance sheet laid before the company in general meeting during the period to which the return relates and certified as a true copy by a director and the secretary shall be annexed to the annual return. Certified copies of the Auditors Report, Directors Report shall also be annexed.

Section 129 provides that the annual return required by Section 125 shall in the case of a private company be accompanied by a certificate signed by both a director and the secretary to the effect that the company has not, since the date of incorporation of the company issued any invitation to the public to subscribe for any shares or debentures of the company; and where the annual return discloses the fact that the number of members of the company exceeds 50, a certificate so signed that the excess consists wholly of persons who are not to be included in reckoning the number of 50.

**Apart from Annual Returns, other forms of returns required to be made to the Registrar of Companies include:**

1. Change of Name: Registrar must be notified within 14 days.
2. Alteration of Memorandum and Articles of Association: Registrar must be notified within 14 days.
3. Return as to Allotments: Must be made within 60 days.
4. Increase of Share Capital: Return must be made within 30 days.

5. Registration of Charges: Particulars of a charge created must be delivered within 42 days of creation.
6. Directors and Secretaries: Changes in the particulars of directors and secretaries must be submitted to the Registrar within 14 days from the happening thereof.

## Responsibilities regarding meetings and minute books

### Board and committee meetings

Board and committee meetings must be convened and conducted in accordance with the company's Articles of Association and the Companies Act. Failure to do so would entitle those entitled to attend or any other interested person to challenge the legitimacy or validity of the decisions made at such meetings. It is particularly important to observe the period of notice if this is prescribed in the Articles.

As Secretary of the Board, the Company Secretary should ensure that the agenda and the papers containing the business to be discussed are dispatched well before the date of the meeting. The secretary should also ensure that the agenda is properly drawn up and well arranged as this will facilitate smooth deliberations at the meeting.

The Secretary should also ensure that there is a quorum prior to the commencement of the meeting. Only persons competent to take part in the business of a meeting should constitute a quorum. A quorum should be present throughout the duration of the meeting.

## GENERAL MEETINGS

General meetings are either classified as annual general meetings or extraordinary general minutes.

In convening general meetings, it is also important to comply with requirements to serve notice to those entitled to attend as prescribed by the Act and the company's Memorandum and Articles of Association. While Table (Article 50) provides for waiver of notice, it is important to remember that the Act (Section 158) provides that a company's accounts must be dispatched to members at least 21 clear days before the date of the meeting. This requirement will not apply if it is so agreed by all the members entitled to attend and vote at the meeting. It is, however, difficult to achieve such unanimous agreement in the case of public companies with thousands of shareholders.

**The Act also provides that special notice (i.e. not less than 28 days) is required in the following cases: -**

1. To remove a director before the expiry of his period of office.
2. To appoint a director who is over 70.
3. To appoint an auditor, a person other than a retiring auditor; or fill a casual vacancy in the office of the auditor; or re-appoint an auditor who was appointed by the directors to fill a casual vacancy or remove an auditor before the expiration of his term in office.



Before the commencement of the meeting, the Secretary should ensure that there is a quorum and this can be established by the number of proxies received and number of members present at the meeting.

The business transacted at the general meetings will determine the type of resolutions to be adopted. The following resolutions are referred to in the Act:

- **Ordinary resolutions:** Used for all routine business. It is passed by a simple majority of members entitled to vote (in person or by proxy) and actually voting.
- **Extraordinary resolution:** This is passed by a majority of not less than three-fourths of members entitled to vote and actually voting (in person or by proxy). It is a requirement that notice specifying the intention to propose the resolution as an extra-ordinary resolution be given.
- **Special resolution:** This is defined in the Act as “a resolution passed by the same majority as required for an extraordinary resolution at a general meeting of which not less than 21 days notice specifying the intention to propose the resolution as a special resolution has been given.” Some of the instances where a special resolution is required are:
  1. To alter the “objects” clause of the Memorandum of Association.
  2. To alter the Articles of Association.
  3. To change the name of the company.
  4. To reduce the share capital.
  5. To effect a voluntary winding up.



## Preparation for meetings

- Fixing the date and time.
- Fixing the venue.
- Make logistical arrangements (catering, stewards, audio visuals, print signs for AGM, design the stage, setting tables and name boards)
- Plan the mailing list of invitations to the meeting
- Draft the notice and the agenda for the meeting and agenda
- Hold a Board meeting to authorise the convening of an AGM and approve the following:
  - i. Balance Sheet and Profit and Loss Account
  - ii. Directors report signed by two directors/chairman
  - iii. Auditors report signed by the auditors
  - iv. 21 day Notice of the AGM signed by the Secretary and the agenda
  - v. Send out the notice of the meeting accompanied by proxy forms to all members giving a specific date by which proxies must be received by the secretary.
- Prepare schedule of proxies appointed and the number of votes held by them for use. The chairman is to be advised on voting instructions to be observed when proxies are handed to be authorised voters at the meeting.

### Immediately before the AGM

#### Preparations include:

- Arranging “proposers” and “seconders” of resolutions
- Finalise the chairman’s brief on the agenda and hold briefing session with him/her.
- Consider questions and answers on matters likely to be raised by members
- Allocate staff duties for:
  - a. Registration
  - b. Polling
  - c. Roaming microphone
  - d. Stewards
  - e. Reconfirm arrangements at the venue.

### Day of the AGM

- How to assist the chairman conduct an effective meeting.
- Things to take to it:
  - Spare copies of notice, report and accounts and minutes
  - Memorandum and Articles of Association
  - Companies Act
  - Register of members
  - Voting cards
  - Calculators and printing rolls for counting votes on a poll
  - Name plates for top table and name badges for staff
  - Note pads, pens and pencils
  - Copies of the chairman’s speech.

### Ensure registration process is working smoothly

- Check whether a quorum is present and advise the chairman
- Read the notice of the meeting
- Ensure that the Auditors Report is read at the meeting
- Assist the chairman in identifying “proposers” and “seconders” of motions/resolutions during the meeting
- Keep detailed notes of the proceedings to prepare the minutes
- Ensure that the directors are present and seated in front at the AGM
- For those directors standing for re-election, make available brief details of their ages, relevant experience, dates of their first appointment and details of any committee they have served on





## Enhancing the AGM

At least one of the top executives of the company should make an oral report to the AGM on important areas of the company business

The company should provide an updated Income and Expenditure statement during the AGM to show progress made during the current trading period.

Companies should encourage shareholders to submit questions in advance for response during the AGM.

## Preparations for the voting process

**Voting can be carried out in at least three ways:**

- **By show of hands** – Needs a chief registrar to be appointed assisted by stewards who will do the physical count of those in favour of a resolution and those against. The results will be recorded in the Register and handed over to the chairman of the meeting to declare them to all present.
- **By ballot at the AGM** – Requires that sufficient voting cards be printed and made available for distribution to each member present at a meeting. For each resolution different colours, cards should be selected for use on voting. One card is issued to each member to vote for a resolution, by marking it for or against. Voting boxes that are lockable must be available for casting of votes. The Returning Officer will supervise the process of votes casting and the counting by a team of at least four scrutinisers. The Company Secretary should assist him. It would be useful if at least one “proposer” is invited to act as scrutinsier during the counting of votes. The results are tabulated by the returning officer and presented to the Chairman to declare. The Secretary should be prepared for a recount if this is requested at the close of the exercise especially in elections.
- **By postal ballot**-Requires the person entitled to vote to send his vote through post. The member should however send the vote in good time to reach the secretary by the day that the meeting scheduled to take place.

### To make meetings effective:

- There is a need to strike a balance between time for interaction at meetings and time for action
- The purpose of the meeting must be clear and well put in the agenda.
- One must ensure that clear decisions are made and a specific person made accountable for action within a specified time frame.

## Minute Books

Minute books should be maintained as a record of meetings of the company's directors and its members. For the sake of good order, separate minute books should be maintained of the company's board meetings and where there are Board Committees, each committee should have a separate minute book as well.

A separate minute book should also be maintained as well into which minutes of all the company's general meetings should be filed. When a Secretary is taking minutes, it is important to consider the following:

1. Minutes must give a precise account of the discussions at the meeting.
2. Minutes must provide adequate information to enable those who are not at the meeting to understand fully the business that was transacted.
3. Minutes must be concise and free from any ambiguity.
4. Minutes being a record of what was decided in the past should be in the past tense.

In practice, minutes of the previous meetings are confirmed at the subsequent meeting and signed by the chairperson as a true record of the deliberations.

## Company/Common Seal

Section 109 provides that every company must have a Company Seal with its name engraved in legible roman letters.

Article 113 provides that the directors shall provide for the safe custody of the seal, which shall only be used by the authority of the directors (or of a committee of the directors authorised by the directors on that behalf) and every instrument to which the seal shall be affixed shall be signed by a director and shall be countersigned by the secretary or by a second director or by some other person appointed by the directors for the purpose.

## Official Seal

Section 37(1) provides that a company whose objects require or comprise the transaction of business outside Kenya may, if authorised by its articles, have for use in any place outside Kenya, an official seal, which shall be a facsimile of the common seal of the company, with the addition on its face of the name of the place where it is to be used.

A deed or other document to which an official seal is duly affixed shall bind the company as if it had been sealed with the common seal of the company.



### When the seal is required to be used

Although the seal is a company's official signature, it is not necessary to use it on all contract documents. It is most commonly used in documents where it is legally required to affix the company seal, such as:

- Section 36: A Power of Attorney to allow for execution of deeds on its behalf abroad.
- Section 83: Share Certificates require the common seal
- Section 85: Share warrants to bearer

### The Law of Contract requires the common seal to be used:

- On contracts without consideration
- Leases of land for more than three years

## CHAPTER SUMMARY

### A person is qualified to be registered as a Certified Public Secretary if:

- He has been awarded by the Examinations Board a certificate designated the Final Certificate of the Certified Public Secretaries Examination.
- He holds a qualification approved by the Registration Board,
- He is at the commencement of this Act, both a citizen of Kenya and a member of the professional body known as the Institute of Chartered Secretaries and Administrators,
- He is at the commencement of this Act both ordinarily resident in Kenya and a member of the professional body known as the Institute of Chartered Secretaries and Administrators,
- He is at the commencement of this Act, registered as an accountant under Section 24(1) of the Accountants Act
- He is qualified as an advocate of the High Court of Kenya.

### Status of the Secretary

- He is a servant of the company.
- He is also an officer of the company, according to Section 2 of the Companies Act and therefore liable to penalties in that capacity.
- If acting within the scope of his duties as secretary and if expressly authorised by the directors, he is also to some extent, an agent of the company with power to bind the company.

**The powers and duties of the secretary depend on the size and nature of the company and the personal contractual arrangements that it makes with him. However, a company secretary usually has the following powers and duties:**

- To be present at all meetings, including board meetings and take minutes of such proceedings.
- On the instructions of the board, to issue notices of meetings to members and others.
- To countersign instruments to which the company seal has been affixed (see Article 113 of Table A).
- To conduct and record transfer of shares and conduct correspondence with shareholders as regards calls, transfers, forfeiture, e.t.c.
- To keep the books of the company, particularly those relating to the internal administration of the company, e.g. the shares register and register of charges.
- To make all the returns of the company, e.g. the annual returns, notice of special resolutions, etc.
- For quoted companies, he ensures compliance with Nairobi Stock Exchange and Capital Markets Authority Requirements.
- For banks, he ensures compliance with Central Bank of Kenya statutory requirements.

**The Company Secretary must ensure that all Statutory Registers/Books required to be kept by the Companies Act are kept.**

**They include:**

- i. Register of Members, Section 112
- ii. Register of Directors and Secretaries, Section 201
- iii. Register of Directors' shareholdings, Debentures etc, Section 196
- iv. Register of Mortgages and Charges, Section 105
- v. Minute Books of all proceedings of general meetings, and of all proceedings at the meetings of its directors. According to Section 145 only the meeting books of general meetings are open for inspection by shareholders, and therefore it is advisable to have separate minute books.
- vi. Books of Account
- vii. Register of Debenture holders, Section 88(1): This is only necessary for a company that issues debentures.

**CHAPTER QUIZ**

1. Powers of the secretary can also be described as
2. A secretary is also an Advocate. TRUE or FALSE?
3. A company has two seals namely
4. Vote can be carried out in how many ways?

## ANSWERS TO QUIZ

1. Duties
2. TRUE
3. Common and Official
4. Three

## SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Discuss the position and duties of the Company Secretary

### QUESTION TWO

What are the main qualifications of a secretary?

### QUESTION THREE

Discuss the register of directors and secretaries.

# CHAPTER TEN



## AUDITORS







# CHAPTER TEN

## AUDITORS

### ► OBJECTIVES

By the end of this chapter, the student should be able to:

- Explain the appointment and subsequent removal of Auditors from office
- Explain the duties of an auditor.
- Determine who may be appointed an auditor and the penalty for improper appointment

### ► INTRODUCTION

This chapter takes a quick look at the various financial statements that should be prepared by a company. It then goes on to bring the familiar topic of an audit and a summarized version of some of the concepts tested in Section 2 of CPA Part 1.

### ► KEY DEFINITIONS

- **Audit:** This is an independent examination of the financial statements as to whether they show a true and fair view
- **Auditor:** This a person appointed by the company to carry out an audit
- **Annexure:** Attachments or documents fixed/attached to another

### ► EXAM CONTEXT

The examiner in this chapter has tended to test the student's understanding on group accounts; rights and duties of an auditor. An understanding of the appointment procedure of an auditor is useful. This chapter has appeared in the following sittings; 06/01; 12/00; 07/00

### ► INDUSTRY CONTEXT

An audit is one of THE most complied with formality. Most companies conduct the examination through independent audit firms like Deloitte and Touché. Audited financial statements are published in the newspapers when companies want to float shares or borrow loans from banks.

**Fast forward:**

- Ø An auditor is an officer of the company who performs an audit of the financial statements of a company
- Ø An auditor owes a legal duty of care and the standard set is that of a competent auditor in the circumstances
- Ø An auditor is appointed by the board of directors, registrar or members at a general meeting

## 10.1 QUALIFICATION, APPOINTMENT AND REMOVAL

### APPOINTMENT

Section 159 (1) of the Companies Act provides that “every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the subsequent annual general meeting”.

### REAPPOINTMENT

By Section 159 (2) a retiring auditor shall be deemed to be reappointed without any resolution being passed unless:

- a) He is not qualified for reappointment
- b) A resolution has been passed at that meeting (i.e. annual general meeting) appointing somebody instead of him or providing expressly that he shall not be appointed
- c) He has given the company notice in writing of his unwillingness to be reappointed.

### APPOINTMENT BY REGISTRAR

“Where at an annual general meeting no auditors are appointed or are deemed to be reappointed, the Registrar may appoint a person to fill the vacancy” (Section 159 (3)).



## APPOINTMENT BY DIRECTORS

The first auditors of a company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until the conclusion of that meeting.

In default of appointment of the first auditors by directors the company may do so. Where the directors have appointed the first auditors, the company may “at a general meeting remove such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company. Notice of nomination to be given to the members at least 14 days before the date of the meeting.

## CASUAL VACANCIES

By Section 159 (6) “The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act”.

## QUALIFICATIONS

By Section 161 (1) “A person or firm shall not be qualified for appointment as auditor of a company unless he or, in the case of a firm, every partner in the firm is the holder of a practicing certificate issued pursuant to Section 21 of the Accountants Act

## PERSONS WHO CANNOT BE APPOINTED

Under Section 161 (2) none of the following persons shall be qualified for appointment as auditor of a company

- a) An officer or servant of the company.
- b) A person who is a partner of or in the employment of an officer or servant of the company (unless the company is a private company).
- c) A body corporate.
- d) Persons who are disqualified for appointment as auditor of the company’s subsidiary or holding company or subsidiary of the company’s holding company.

## PENALTY FOR IMPROPER APPOINTMENT

Section 161 (4) provides that if any unqualified person is appointed as auditor, the person appointed, the company and every officer in default, shall be liable to a fine not exceeding Kshs.4,000.

## 10.2 DUTIES OF AUDITORS

The duties of auditors are explained in the following cases:

### 1. RE: KINGSTON COTTON MILL CO. (1896) (CHANCERY)

For some years before a company was wound up, balance sheets signed by the auditors were published by the directors to the shareholders in which the value of the company's stock-in-trade at the end of each year was **grossly overstated**. The auditors relied on certificates, **wilfully false**, given by J., one of the directors who was also manager, as to the value of the stock-in-trade. Dividends were paid for some years on the footing that the balance sheets were correct but if the stock-in-trade had been stated at its true value it would have appeared that **there were no profits out of which a dividend could be paid**.

#### NOTE:

- i) In each case the amount of stock-in-trade at the end of the year was entered in the balance sheet "as per manager's certificate".
- ii) The manager was a man of great business ability and of high repute, and up to the stoppage of the company was trusted by everyone; but he had designedly exaggerated the value of the stock-in-trade in order to make the company appear prosperous.

#### QUESTION:

Was it the duty of the auditors to **test** the accuracy of the manager's certificate by a comparison of the **figures in the books**, and were they liable for the dividends which had been paid in consequence of the erroneous balance sheets?

#### HELD:

It being **not part of the duty of the auditors to take stock**, they were justified in relying on the certificates of the manager, a person of acknowledged competence and high reputation, and they were **not bound to check his certificates** in the absence of anything to raise suspicion. They were not liable for the dividends wrongfully paid.

#### NOTE:

- i) An auditor is not bound to be suspicious where there are no circumstances to arouse suspicion; he is only bound to **exercise a reasonable amount of care and skill**.
- ii) Where an officer of a company has committed a breach of his duty to the company, the direct consequence of which has been a misapplication of its assets, for which he could be made responsible in an action, such breach of duty is a "misfeasance" for which he may be **summarily** proceeded against under the Companies Act, and it is not necessary that an action should be brought.



The object of the section is to facilitate the recovery by the liquidator of assets of a company **improperly dealt with** by its promoters, directors and other officers. The section applies to **breaches** of trust and to **misfeasances** by such persons, but is inapplicable to cases of breach of contract, trespass, negligence, etc.

**LINDLEY, LJ stated:**

...To decide this question, it is necessary to consider:

- 1) What their duty was;
- 2) How they performed it, and in what respects (if any) they failed to perform it.

The duty of an auditor generally was very carefully considered by this court in **RE: LONDON AND GENERAL BANK (1895)** and I cannot usefully add anything to what will be found there. It was pointed out that an auditor's duty is to examine the books, ascertain that they are right, and to prepare a balance sheet showing the true financial position of the company at the time to which the balance sheet refers. But it was also pointed out that **an auditor is not an insurer** and that **in the discharge of his duty, he is only bound to exercise a reasonable amount of care and skill**. It was further pointed out that what in any particular case is a reasonable amount of care and skill depends on the circumstances of the case; that if there is nothing which ought to excite suspicion, less care may or ought to have been aroused. These are **the general principles which have to be applied to cases of this description**.

I protest, however, against the notion that an auditor is **bound to be suspicious** as distinguished from **reasonably careful**. To substitute the one expression for the other may easily lead to serious error. Auditors are, however, in my opinion bound to see what **exceptional duties**, if any, **are cast upon them by the articles of the company whose accounts they are called upon to audit**. **Ignorance of the articles and of exceptional duties imposed by them would not afford any legal justification for not observing them...** (Such as taking stock). The complaints made against the auditors in this particular case... is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not **honestly believe to be true**. It is said, however, that they were culpably careless... frauds were committed by the manager, who in order to bolster up the company and to make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills.... I confess I cannot see that their omission to check his (i.e. manager's) returns was a breach of their duty to the company. **It is no part of an auditor's duty to take stock...** He must rely on other people for details of the stock in trade **on hand**. In the case of a cotton mill, he must rely on **some skilled person** for the materials necessary to enable him to enter the stock-in-trade at its **proper value** in the balance sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestionable competence. He was trusted by every one who knew him.... the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade **in hand**, and they trusted him accordingly in that matter. But it is said that they ought not to have done so. The stock journal showed the quantities, that is, the weight in pounds of the cotton and yarn **at the end of each year**. **Other books** showed the quantities of cotton **bought during the year** and the quantities of yarn **sold during the year**. If these

books had been compared by the auditors, they would have found that the quantity of cotton and yarn in hand **at the end of the year** ought to be **much less** than the quantity shown in the stock journal, and so **much less** that the value of the cotton and yarn entered in the stock journal could not be right, or at all events was so abnormally large as to **excite suspicion** and demand **further inquiry**... But although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were **wanting in reasonable care not thinking it necessary to test the managing director's return**? I cannot bring myself to think they were not, nor do I think that any jury of businessmen would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one **before** suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to **matters on which information from such a person was essential**. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who was to account for the cash which he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry.

**LOPES, LJ.”... (1) What is a misfeasance within the meaning of Section 324(1)?**

Have the auditors in the circumstances of this case committed a misfeasance? It has been held that an auditor is an officer within the meaning of the Section:- In **RE LONDON AND GENERAL BANK**. But has there been any misfeasance by the auditors? This depends upon what meaning is to be assigned to the word “misfeasance” as used in this section. The learned judge in the court below held that misfeasance covered any misconduct by an officer of the company as such for which such officer might have been sued apart from the section. In my judgment, this is too wide. It would cover any act of negligence - any actionable wrong by an officer of a company which did not involve any misapplication of the assets of the company. The object of this section of the Act is to enable the liquidator to recover any assets of the company **improperly dealt with** by any officer of the company, and **must be interpreted bearing that object in mind**. It doubtless covers any breach of duty by an officer of the company in his capacity of officer resulting in any improper misapplication of the assets or property of the company... It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a blood bound. He is justified in believing, tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and so rely upon their representations, provided, he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. It is not the duty of an auditor to take stock; he is not a stock expert; there are many matters in respect of which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all frauds... The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the



remuneration moderate. I should be sorry to see the liability of auditors extended any further than in **RE LONDON AND GENERAL BANK....**

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable...

KAY, LJ. "... The words of the section are "any misfeasance or breach of trust in relation to the company... misfeasance means something other than a breach of trust... it does not mean mere non-feasance: **RE WEDGWOOD COAL AND IRON CO....** I think the only safe interpretation to adopt is that it includes all cases other than breaches of trust in which an officer of the company has been guilty of a breach of his duty as such officer which has caused pecuniary loss to the company by misapplication of its assets, and for which he might have been made liable in an action..."

## 2. RE LONDON AND GENERAL BANK

An auditor represented a confidential report to the directors calling their attention to the insufficiency of the securities in which the capital of the company was invested, and the difficulty of realising them, but in his report to the shareholders merely stated that the value of the assets was dependent on realization, and in the result the shareholders were deceived as to the condition of the company and a dividend was declared out of capital and not out of income.

### HELD:

The auditors had been guilty of misfeasance under Section 10 of the Companies (winding-up) Act, 1890, and was liable to make good the amount of dividend paid (amounting to \$14,433.3s).

LINDLEY, LJ.: "... it is the duty of the directors, and not of the auditors, to recommend to the shareholders the amounts to be appropriated for dividends and it is the duty of the directors to have proper accounts kept, so as to show the true state and condition of the company... It is for the shareholders, but only on the recommendation of the directors, to declare a dividend. It is impossible to read the section of the Companies Act without being struck with the importance of the enactment that the auditors are **to be appointed by the shareholders, and are to report to them directly**, and not to or through the directors. The object of this enactment is obvious. It evidently is to secure to the shareholders **independent and reliable** information respecting the true financial position of the company at the time of the audit... It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is **to ascertain and state the true financial position of the company** at the time of the audit, and his duty is confined to that. But then comes the question, how is he to ascertain that position? The answer is, by examining the books of the

company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this, his audit would be worse than idle farce. Assuming the books to be so kept as to show the company's true financial position, the auditor has to frame a balance showing that position **according to the books** and to certify that the balance sheet represented is correct **in that sense**. But his first duty is to examine the books, not merely for the purposes of ascertaining what they do show, but also for the purposes of satisfying himself that they show the true financial position of the company... An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries, and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not as onerous as this.

Such I take to be the duty of the auditor; he must be honest... i.e. **he must not certify what he does not believe to be true**, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case depends upon the circumstances of that case.

Where there is nothing to excite suspicion, very little inquiry will be reasonably sufficient, and in practice I believe businessmen select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused, more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required... It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognised as correct by businessmen... A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.... The auditor is to make a report to the shareholders, but the **mode of doing** so and the form of the report are not prescribed... an auditor who gives shareholders means of information instead of information respecting a company's financial position does so at his peril and runs the very serious risk of being held judicially to have failed to discharge his duty. In this case, I have no hesitation in saying that Mr. Theo bald did fail to discharge his duty to the shareholders in certifying and laying before them the balance sheet... **without any reference to the report which he laid before the directors** and with no other warning than is conveyed by the words, "The value of the assets as shown on the balance sheet is dependent upon realization". It is a mere truism to say that the value of loans and securities depends on their realization. We were told that a statement to that effect, is so unusual in an auditor's certificate that the mere presence of those words was enough to excite suspicion. But, as already stated, the duty of an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicion aroused by a similar statement, if, as in this case, its language expresses no more than any ordinary person would infer without...the balance sheet and profit and loss account being true and correct in the sense that they were in accordance with the books. But they were, nevertheless, entirely misleading,





and misrepresented the real position of the company. Under these circumstances, I am compelled to hold that Mr. Theo Bald failed to discharge his duty to the shareholders... Possibly he did not realize the extent of his duty to the shareholders as distinguished from the directors and he unfortunately consented to leave the Chairman to explain the true state of the company to the shareholders instead of doing so himself. The fact, however, remains, and cannot be got over, that the balance sheet and certificate of February 1892 did not show the true position of the company at the end of 1891 and that this was owing to the omission by the auditor **to lay before the shareholders** the material information, which he had obtained in the course of his employment as auditor of the company and to which he called the attention of the directors.... Where did the money come from with which the dividends were paid? The money came from **cash** at the bankers or in hand; but this cash could not be properly treated as **profit** and the directors and auditors knew this perfectly well....”

RIGBY, LJ. “.... The Articles of Association cannot absolve the auditors from any obligation imposed upon them by the statute.... Under the statute the members of the company are entitled to have the safeguard of an expression of opinion of the auditors to the effect, first, that the balance sheet, is properly drawn up so as to exhibit a true and correct view of the state of the company’s affairs.

The words “**as shown by the books of the company**” seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the balance sheet with entries in the books. A full and fair balance sheet must be such a balance sheet as to convey any known causes of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.”

### 3. RE ALLEN CRAIG & CO. (LONDON) LTD. (1934) Chapter 483

The reports and balance sheets for the years ending June 30, 1925, and, June 30, 1926, were signed by two directors. The reports annexed to these balance sheets were signed by the auditors. The question was: What was the duty of auditors in respect of these two balance sheets?

The auditors merely sent the reports and balance sheets to the secretary of the company, and they never got beyond the secretary. The directors never called a general meeting to consider these balance sheets and reports.

By Section 162 (1) of the Companies Act, “The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office...”

**BENNET, J:**

“.... Does the statute impose on the auditors the duty of making their report to **every member of the company**?

Now if you give the words their plain meaning, it would seem that that obligation is

imposed on them. But when you begin to reflect on the question, it cannot, I think, have been the intention of the legislators to impose that duty on the auditors and it certainly has never been the practice, since the obligation has been imposed, for auditors themselves to send their reports to every member of the company... **I do not think it is possible to hold that the words “the members”.... mean “all the members”**. It cannot be that the auditors are to be at the expense and trouble not merely of sending their report through the post but of delivering a copy to every member. It seems that **one is forced by circumstances to limit the meaning of the words “the members” and I hold that they mean “the members assembled in the general meeting”....** if the report is to be made to the members in general meeting, then it would not be right, I think, to hold that the duty of the auditors is to make that report themselves to the members in general meeting unless they can themselves call a general meeting or can compel someone else to call a general meeting. **There are no means by which they can call a general meeting or compel other persons to convene a general meeting.** The only persons who can call a general meeting are the directors or **the meeting who have called upon the directors to do so and they have failed to do so.** The audience themselves are powerless.

In my judgment, the duty of the auditors, after having affixed their signatures to the reports annexed to a balance sheet, is confined to forwarding that report to the secretary of the company, leaving the secretary or the directors to perform the duties which the statute imposes of **convening a general meeting to consider the report....** The statute compels directors to convene a meeting once a year and compels directors to present reports to the general meeting and it is for the shareholders to see that the directors do their duty...**the duty of the auditors is discharged by sending the report to the secretary of the company...**”

## SUMMARY OF CHAPTER

Every company shall at each annual general meeting appoint an auditor(s) to hold office from the conclusion of that Annual General Meeting

A retiring auditor shall be deemed to be re-appointed unless he is not qualified for re-appointment, a resolution has been passed at that meeting and he is given the company a notice for his resignation

- . An auditor may be appointed by the registrar or by the directors

**Persons who cannot qualify for appointment as auditors are:**

- An officer or servant of the company
- A person who is a partner, employee or servant of an officer of the company
- A person disqualified to act as an auditor of the subsidiary of the holding company

The main duty of an auditor is to examine the accounts for a financial year and to make a report on those accounts.



## CHAPTER QUIZ

1. What is the primary duty of an auditor?
2. Who may appoint an auditor?
3. An auditor may be appointed by directors. TRUE or FALSE

## ANSWERS TO QUIZ

1. To examine the accounts for a financial year and to make a report on those accounts
2. Director, Registrar and the AGM
3. TRUE

## SAMPLE OF EXAMINATION QUESTIONS

### QUESTION ONE

Explain the role of public company auditors paying particular regard to their appointment and removal (20 marks)

### QUESTION TWO

State and then explain with reference to case law the duties of an Auditor of a company. (20 marks)

### QUESTION THREE

Describe the categories of persons who do not qualify to be appointed auditors of a company. (4 marks)

Kindly refer to the following sittings: - 07/00; 12/99

# PART D



# CHAPTER ELEVEN



COMPANY ACCOUNTS,  
AUDIT AND INSPECTION







# CHAPTER ELEVEN

## COMPANY ACCOUNTS, AUDIT AND INSPECTION

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

1. Explain the form and contents of company accounts
2. Discuss group accounts, auditor's and director's report
3. Discuss the appointment of inspectors, their powers and report

### ► INTRODUCTION

This chapter deals with the main forms of company accounts, it introduces an important aspect of inspector who are charged with investigating company affairs and compiling reports on the status of company affairs.

### ► KEY DEFINITIONS

1. **Balance sheet** - This is an account that shows the financial position of a company
2. **Profit and Loss account** - This gives the income that is generated by a business and the expenses incurred by a business
3. **Group accounts** - These are accounts of the holding company and its subsidiaries

### ► EXAM CONTEXT

This chapter has been split from the original topic on directors, auditors and secretaries in the old syllabus. Questions from the past papers thus tend to test the general topic in the old syllabus. However, a sample of exam questions from other sources is provided at the end of the chapter.

### ► INDUSTRY CONTEXT

This is a very practical chapter. Its application is inevitable in the numerous companies in existence today. Most companies prepare and even publish their financial statements, especially when they want to float shares.

## 11.1 BOOKS OF ACCOUNT

By Section 147 (1), every company shall cause to be kept in the English language “proper books of account” with respect to:

- (a) All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place.
- (b) All sales and purchases of goods by the company.
- (c) The assets and liabilities of the company.

Section 147(2) provides that “proper books of account” shall be deemed not to have been kept with respect to the matters aforesaid if there are not kept such books as are necessary to give a true and fair view of the state of the company’s affairs and to explain its transactions.

By Section 147(3) (a) the books of account are to be kept at the registered office of the company or, with the consent of the registrar and subject to such conditions as he may impose, at such other place as the directors think fit, and shall at all times be open to inspection by the directors.



## CONTENTS OF PROFIT AND LOSS ACCOUNT

### Part I of the Sixth Schedule provides there shall be shown:

1. The amount charged to revenue by way of provision for depreciation, renewals or depreciation of fixed assets.
2. The amount of the interest on the company’s debentures and other fixed loans.
3. The amount of the charge for income tax and any other taxation on profits to date
4. The amounts respectively provided for redemption of share capital and loans
5. The amount, if material, set aside or proposed to be set aside to reserves.
6. The amount of income from investments, distinguishing between trade investments and other investments.
7. The aggregate amount of the dividends paid and proposed.
8. If the remuneration of the auditors is not fixed in general meeting, the amount shall be shown under a separate heading.
9. The following matters shall be stated by way of notes, if not otherwise shown:
10. If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.
11. The basis on which the amount, if any, set aside for income tax is computed.
12. Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.



13. Except in the case of the first profit and loss account laid before the company after the commencement of the Companies Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.
14. Any material respects in which any items shown in the profit and loss account are affected by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or by any change in the basis of accounting.

## 11.2 GROUP ACCOUNTS

Section 150(1) provides that if, at the end of its financial year, a company has subsidiaries, then it must include in its annual accounts “group accounts” dealing with the affairs of the subsidiaries as well.

By Section 150 (2)(b) group accounts need not deal with a subsidiary of the company if the company’s directors are of the opinion that:

- It is impracticable, or would be of moral value to the members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company
- The result would be misleading or the result would be harmful to the business of the company or any of its subsidiaries
- The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

The approval of the registrar shall be required for not dealing in group accounts with a subsidiary on grounds (iii) or (iv).

By Section 150 (2)(a), a company is exempt from the obligation to prepare group accounts if it is a wholly owned subsidiary of another body corporate incorporated in Kenya.

### Form of Group Accounts

Section 151(1) provides that the group accounts laid before a holding company shall be consolidated accounts comprising:

- A consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;
- A consolidated Profit and Loss account dealing with the profit or loss of the company and those subsidiaries.

However, the group accounts need not be prepared in this form if the directors are of the view that they could be prepared in another form which would be readily appreciated by the company's members (Section 151 (I)).

## ■ Contents of Group Accounts

By Section 152 (I), the group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

Section 153(1) further provides that the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Sixth Schedule to the Act, so far as applicable thereto and if not so prepared, shall give the same or equivalent information.

## ■ Financial Year of Holding Company and Subsidiary

Section 153(I) provides that a holding company's directors shall ensure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year.

By Section 153(2), the registrar is empowered to postpone the submission of a company's accounts to a general meeting from one calendar year to the next for purposes of enabling the company's financial year to end with that of the holding company.

Part III of the Sixth Schedule provides that so long as any licensed bank or any scheduled bank complies with the requirements of any enactment in force in the country of the incorporation of such bank relating to keeping of accounts by a banking company it shall not be subject to the requirements of Part I of the Sixth Schedule. However, if the Minister is satisfied that any licensed bank or any scheduled bank is not complying with the requirements of any such enactment of its country of incorporation, or if there are no such requirements in such enactment, he may order that such bank shall comply with the requirements of Part I of the Sixth Schedule.

## ■ 11.3 DIRECTOR'S REPORT

As stated earlier, Section 157 requires that the directors' report must be attached to the balance sheet of the company.

**The disclosure requirements for the directors' report are:**

1. A fair review of the development of the business of the company and its subsidiaries during the financial year and of their position at the end of it.
2. Proposed dividend (Section 157(1))
3. Proposed transfers to reserves (Section 157(1))
4. Names of directors at any time in the period concerned.
5. Principal activities of the company and of its subsidiaries during the period and any significant changes therein.
6. Significant changes in the fixed assets of the company or of any subsidiaries during the



- period.
7. An indication of the difference between the book and market values of land and buildings of the company or any of its subsidiaries
  8. Interests in shares or debentures of group companies as recorded in the register of directors' interests.

Section 157(2) provides that the said directors' report shall deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries.

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the bank as at the end of the financial year and of the profit of the bank for that period. In preparing those financial statements the directors are required to:

- State whether applicable accounting standards have been followed and, if not, give a statement of the reasons for any significant departure from standard accounting practices.
- Make judgments and estimates that are reasonable and prudent.
- Indicate whether anything has come to their attention of the directors to indicate that the company and its subsidiaries will not remain a going concern for at least the next 12 months.

This information is stated in a statement of directors' responsibilities, which is also contained in the annual report.



## 11.4 AUDITORS' REPORT

Section 162 provides that the auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting.

### Matters to be expressly stated in Auditors' Report

This is provided for in the seventh schedule to the Companies Act and includes the following:

1. The auditors should state whether they have obtained all the information and explanations which to best of their knowledge and belief were necessary for the purposes of their audit.
2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
3. Whether the company's balance sheet and (unless it is framed as a consolidated Profit and Loss account) Profit and Loss account dealt with by the report are in agreement with the books of account and returns.

4. Whether, in the auditors' opinion and to the best of their information and according to the explanations given to them, the said accounts give the information required by the Companies Act in the manner so required and give a true and fair view:
5. In the case of the balance sheet, of the state of the company's affairs as at the end of its financial year
6. In the case of the profit and loss account, the profit or loss for its financial year,
7. Or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.
8. In the case of a holding company submitting group accounts whether in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof.

The report drawn up by the auditors must be attached to the accounts when sent to the members (Section 156) and it shall be read before the company in general meeting and shall be open to inspection by any member. (Section 162(2)).

## 11.5 INVESTIGATION BY THE REGISTRAR

Where the registrar has reasonable cause to believe that the provisions of this Act are not being complied with, or where, on perusal of any document which a company is required to submit to him under the provisions of this Act, he is of the opinion that the document does not disclose a full and fair statement of the matters to which it purports to relate, he may, by a written order, call on the company concerned to produce all or any of the books of the company or to furnish in writing such information or explanation as he may specify in his order.

Such books shall be produced and such information or explanation shall be furnished within such time as may be specified in the order.

On receipt of an order it shall be the duty of all persons who, are or have been, officers of the company to produce such books or to furnish such information or explanation so far as lies within their power.

If any such person refuses or neglects to produce such books or to furnish any such information or explanation he shall be liable to a fine not exceeding Kshs 200,000 in respect of each offence.

If after examination of such books or consideration of such information or explanation the registrar is of the opinion that an unsatisfactory state of affairs is disclosed or that a full and fair statement has not been disclosed, the registrar shall report the circumstances of the case in writing to the court.



## 11.6 APPOINTMENT AND POWERS OF INSPECTORS

Where it appears to the registrar that there is good reason so to do, he may appoint one or more competent inspectors to investigate and report on the membership of any company and otherwise with respect to the company for the purpose of determining the true persons who are or have been financially interested in the success or failure (real or apparent) of the company or able to control or materially to influence the policy of the company.

The appointment of an inspector under this section may define the scope of his investigation, whether as respects the matter or the period to which it is to extend or otherwise and in particular may limit the investigation to matters connected with particular shares or debentures.

Where an application for an investigation under this section with respect to particular shares or debentures of a company is made to the registrar by members of the company and the number of applicants or the amount of shares held by them is not less than that required for an application for the appointment of an inspector, the registrar shall appoint an inspector to conduct the investigation unless he is satisfied that the application is vexatious, and the inspector's appointment shall not exclude from the scope of his investigation any matter which the application seeks to have included therein, except in so far as the registrar is satisfied that it is unreasonable for that matter to be investigated:

Provided that the registrar may refuse to appoint an inspector under this subsection unless, in any case in which he considers it reasonable so to require, the applicants give sufficient security for the payment of the costs of the investigation.

Subject to the terms of an inspector's appointment, his powers shall extend to the investigation of any circumstances suggesting the existence of an arrangement or understanding which, though not legally binding, is or was observed or likely to be observed in practice and which is relevant to the purposes of his investigation.

The AFORESAID shall apply in relation to all persons who are, or have been, or whom the inspector has reasonable cause to believe to be or have been financially interested in the success or failure, or the apparent success or failure, of the company or any other body corporate whose membership is investigated with that of the company, or able to control or materially to influence the policy thereof, including persons concerned only on behalf of others, as they apply in relation to officers and agents of the company or of the other body corporate, as the case may be; and

The registrar shall not be bound to furnish the company or any other person with a copy of any report by an inspector appointed under this section or with a complete copy thereof if he is of opinion that there is good reason for not divulging the contents of the report or of parts thereof, but shall keep a copy of any such report or, as the case may be, the parts of any such report, as respects which he is not of that opinion.

The expenses of any investigation under subsection (1) shall be defrayed by the registrar. The expenses of any investigation under subsection (3) shall be defrayed by the applicants unless the registrar certifies that it is a case in which he might properly have acted under subsection (1).

## 11.7 INSPECTOR'S REPORT

An inspector may, and, if so directed by the court, shall, make interim reports to the court, and on the conclusion of the investigation shall make a final report to the court. Any such report shall be written or, if the court so directs, printed. The Court shall:

- (a) Forward a copy of any report made by an inspector to the company and to the registrar
- (b) If the court thinks fit, forward a copy thereof on request and on payment of the prescribed fee to any other person who is a member of the company or of any other body corporate dealt with in the report by virtue of Section 167, or whose interests as a creditor of the company or any such other body corporate as aforesaid appear to the court to be affected;
- (c) Where any inspector is appointed under Section 165, furnish, at the request of the applicants for the investigation a copy to them and may also cause the report to be printed and published

## CHAPTER SUMMARY

By Section 147 (1), every company shall cause to be kept in the English language "proper books of account" There shall be shown:

1. The amount charged to revenue by way of provision for depreciation, renewals or depreciation of fixed assets.
2. The amount of the interest on the company's debentures and other fixed loans.
3. The amount of the charge for income tax and any other taxation on profits to date
4. The amounts respectively provided for redemption of share capital and loans
5. The amount, if material, set aside or proposed to be set aside to reserves.
6. The amount of income from investments, distinguishing between trade investments and other investments.
7. The aggregate amount of the dividends paid and proposed.
8. If the remuneration of the auditors is not fixed in general meeting, the amount shall be shown under a separate heading.
9. The following matters shall be stated by way of notes, if not otherwise shown.
10. If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.
11. The basis on which the amount, if any, set aside for income tax is computed.
12. Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.





13. Except in the case of the first profit and loss account laid before the company after the commencement of the Companies Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.
14. Any material respects in which any items shown in the profit and loss account are affected by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or by any change in the basis of accounting.

By Section 150 (2)(b) group accounts need not deal with a subsidiary of the company if the company's directors are of the opinion that:

- It is impracticable, or would be of no real value to the members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or
- The result would be misleading
- The result would be harmful to the business of the company or any of its subsidiaries
- The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

#### **The disclosure requirements for the directors' report are:**

1. A fair review of the development of the business of the company and its subsidiaries during the financial year and of their position at the end of it.
2. Proposed dividend (Section 157(1))
3. Proposed transfers to reserves (Section 157(1))
4. Names of directors at any time in the period concerned.
5. Principal activities of the company and of its subsidiaries during the period and any significant changes therein.
6. Significant changes in the fixed assets of the company, or of any subsidiaries during the period.
7. An indication of the difference between the book and market values of land and buildings of the company or any of its subsidiaries
8. Interests in shares or debentures of group companies as recorded in the register of directors' interests.

#### **Matters to be expressly stated in Auditors' Report**

This is provided for in the seventh schedule to the Companies Act and includes the following:

9. The auditors should state whether they have obtained all the information and explanations which to best of their knowledge and belief were necessary for the purposes of their audit.
10. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
11. Whether the company's balance sheet and (unless it is framed as a consolidated Profit and Loss account) Profit and Loss account dealt with by the report are in agreement with the books of account and returns.
12. Whether, in the auditors' opinion and to the best of their information and according to the explanations given to them, the said accounts give the information required by the

Companies Act in the manner so required and give a true and fair view:

13. In the case of the balance sheet, of the state of the company's affairs as at the end of its financial year
14. In the case of the profit and loss account, the profit or loss for its financial year,
15. Or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.
16. In the case of a holding company submitting group accounts whether in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof.

The report drawn up by the auditors must be attached to the accounts when sent to the members (Section 156) and it shall be read before the company in general meeting and shall be open to inspection by any member. (Section 162 (2)).



## CHAPTER QUIZ

1. Every company must keep...
2. Consolidated accounts comprise of...
3. A holding company should always prepare group accounts. TRUE or FALSE?
4. Which two reports are prepared by companies?

## ANSWERS TO QUIZ

1. Proper books of account.
2. Balance sheet and Profit and Loss account
3. False.
4. Auditor's and Director's report.

## SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Discuss the matters expressly outlined in the auditor's report (20 marks)

### QUESTION TWO

Discuss the appointment and powers on the inspector (20 marks)

### QUESTION THREE

Discuss the form and content of books of account (20 marks)

# CHAPTER TWELVE



## CORPORATE INSOLVENCY





# CHAPTER TWELVE

## CORPORATE INSOLVENCY

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- To explain the different types of winding up.
- Explain the appointment and powers of the liquidator.
- Explain the offences relating to liquidation.
- Explain the appointment of liquidators, their duties and release from their duties.

### ► INTRODUCTION

This chapter deals with, literary put, the death of a company. In other words the procedure that results in a company, ceasing to exist. Simply called winding up, the main types are compulsory winding up and voluntary winding up. It then looks at liquidators, their appointment, duties and release from their duties.

### ► KEY DEFINITIONS

- **Winding up:** Process by which a company is dissolved and ceases to exist
- **Secured creditor:** This is a creditor whose debt is secured on a fixed or floating asset of the company
- **Liquidator:** A person appointed by court to take control of the company's assets and realise them
- **Receiver:** A representative of secured creditors to enforce their security

### ► EXAM CONTEXT

The examiner tends to test the student's understanding of the different types of winding up and will ask questions on differences of the various winding up. There is also need to understand the powers of the liquidator. The following questions have been tested in past papers: 05/02; 12/01; 06/01; 12/00; 07/00:

## ► INDUSTRY CONTEXT

There are many companies that have been incorporated so far and as hence this is a very relevant chapter in the industry. Many know the procedure involved to register a company but few are aware of the procedures taken to dissolve. Creditors and even members are unaware of what to do when the company starts making losses. This chapter shows what happens in the industry behind closed doors.

### Fast forward:

- Winding up can be said to be the death of a company.
- They are mainly compulsory, voluntary (members and creditors) and subject to the court's supervision.

## 12.1 WINDING-UP

### METHOD OF DISSOLUTION

- (a) A company is dissolved, i.e. ceases to exist, when its name is removed from the register. It is usually necessary, before it can be dissolved, to liquidate or wind up of companies (“liquidation” and “winding up” have the same meaning); i.e. the assets are realized, the debts are paid, the surplus (if any) is returned to members, and the company is then **dissolved**. But the registrar has power, if it appears to him that the company is defunct to strike it off the register summarily without a previous liquidation: Companies Act Section 339. There is also an obsolete procedure for voluntary winding up under the supervision of the court: Companies Act Section 304.
- (b) Liquidation begins with a formal decision to liquidate. If the members in general meeting resolve to wind up, the company that is a voluntary winding up, which may be either a members’ or creditors’ voluntary winding up depending on the creditors’ expectation that the company will or will not be able to pay its debts in full. Creditors have a decisive part in the liquidation of an insolvent company since the remaining assets belong to them.
- (c) Although voluntary liquidation is simpler, quicker and less expensive, it is possible only if a majority of votes is cast in general meeting on a resolution to liquidate. A company may, however, be obliged to wind up by a compulsory liquidation ordered by the court on a petition usually presented by a creditor or a member.





- (d) Whether liquidation is voluntary or compulsory, it is in the hands of the liquidator (or joint liquidators) who take over control of the company from its directors. Although liquidation may begin in different ways and there are differences of procedure, the working method is much the same in every type of liquidation and the same legal problems can arise.
- (e) The sequence of topics below is the procedure by which compulsory, members' voluntary and creditors' voluntary liquidation begins. The legal problems, with which the liquidator may be concerned, are considered in the next following session.



## COMPULSORY LIQUIDATION/WINDING UP BY THE COURT

A petition is presented to the High Court under Section 218 of the Companies Act. The petition will specify one of the seven grounds for compulsory winding up and be presented (usually) either by a creditor or by a member (called a "contributory" in the context of liquidation).

**The nine standard grounds for compulsory winding up are listed in Section 219 as follows:**

- (a) The company has by, special resolution, resolved that it should be wound up **by the court**
- (b) The company does not deliver the statutory report to the registrar or defaults in holding the statutory meeting.
- (c) The company has not commenced its business within a year from its incorporation or has suspended its business for a whole year.
- (d) The company is unable to pay its debts; (see Section 220).
- (e) The number of members of the company has reduced, in the case of a private company, below two, or, in the case of a public company, below seven.
- (e) The court considers that it is just and equitable to wind up the company.
- (f) In the case of a company incorporated outside Kenya and carrying on business in Kenya, liquidation proceedings have been commenced in respect of it in the country of its incorporation or territory in which it has established a place of business.
- (g) The company has failed to hold the statutory meeting in accordance with Section 130 (5)
- (h) The company has suspended its business for a whole year.

## WHO MAY PETITION FOR WINDING UP?

Under Section 221 of the Act, a winding up petition may be presented to court by any of the following persons:

1. The company: A company may petition for its winding up if members have so resolved by special resolution. Such petitions are not common
2. Creditors: - A creditor may petition for the winding up of a company on the ground that it's unable to pay its debts. Such a petitioner must prove that the company is insolvent.
3. Contributory: Under Section 214 of the Act, contributory means every person liable to contribute to the assets of the company in the event of its being wound up. At common law, every contributory has a right to petition for winding up.
4. Member/shareholder other than a contributory: This is a petition by a fully paid up member. Such a member has no **Locus standi** to petition for winding up and it is granted only on exceptional basis
5. Attorney general: Under Section 221(1) (iv) of the Act, the Attorney general may petition for winding up in circumstances prescribed by Section 170 (2) of the Act
6. Official receiver: He may petition where winding up proceedings have been started outside Kenya against a company incorporated outside Kenya but carrying on business in Kenya. And for continuation of a voluntary winding up or a winding up subject to the supervision of the court as a compulsory winding up.
7. Commissioner of Insurance: Under Section 123 (1) of the Act, the commissioner may present a winding up petition to wind up an insurance company in certain circumstances.

## COMPANY UNABLE TO PAY ITS DEBTS

By Section 220, a creditor who petitions on grounds of the company's insolvency may rely on any of the following situations to show (as he is required to do) that the company is unable to pay its debts:

- (a) A creditor (or creditors) to whom the company owes more than Kshs.1,000 serves on the company at its registered office a written demand for payment and the company neglects, within the ensuing 21 **clear** days, either to pay the debt or to offer reasonable security for it. If, however, the company denies on apparently reasonable grounds that it owes the money, the court will dismiss the petition and leave the creditor to establish his claim by taking legal proceedings for debt.
- (b) A creditor obtains judgment against the company for debt, attempts to enforce the judgment but is unable to obtain payment, i.e. no assets of the company have been found and seized.
- (c) A creditor satisfies the court that taking account of the contingent and prospective liabilities of the company it is unable to pay its debts. The petition may be based on a statement of estimated assets and liabilities or the creditor may show that the company is no longer paying its trade debts as they fall due. But this is the residual category and any suitable evidence of actual or prospective insolvency may be adduced.



Although no minimum amount is specified for (b) or (c) a Kshs 1,000 minimum is in practice applied (it need not all be owed to one creditor if others support his petition and together they claim (Kshs.1, 000 or more). The debt claimed must be a specified amount, i.e. a claim for general damages or for a specific sum less a deduction of uncertain amount will not do.

The petitioner need not be the original creditor but may have acquired the debt, e.g. a debt collection agency may petition if the debt then owes to it.

At the hearing, other creditors of the company may oppose the petition. If so, the court is likely to decide in favour of those to whom the larger amount is owing. But the court may also consider the reasons for the differences between the creditors:

#### Case: RE SOUTHARD & CO. (1979)

A holding company arranged for its subsidiary, of which it was the largest creditor, to go into **voluntary** liquidation. The holding company, as a creditor, later petitioned for the **compulsory** winding up of the subsidiary in order to oust the original liquidator. The trade creditors, to whom the subsidiary owned smaller sums, wished the voluntary liquidation to continue.

#### Held:

The court might consider the reasons for the petition and the opposition to it and was not bound to accede to the wishes of the larger creditor. The petition was dismissed.

## WINDING UP ON

### ■ “THE JUST AND EQUITABLE GROUND”

Unlike the other five grounds, this one is widely interpreted and it is no objection that the petition is based on facts unlike the other grounds, (i.e. the ejusdem generis rule does not apply) or facts without precedent (as regards the just and equitable ground itself. **The just and equitable ground is usually relied on by a member (contributory) who is dissatisfied with or is at loggerheads with the directors or controlling shareholders over the management of the company.** But something more than dissatisfaction is needed to make it just and equitable that the company should be wound up. Although the court has a wide discretionary power, winding up **orders have been made** in the following **situations**:

- a) **The substratum of the company has gone**, i.e. the only main object(s) of the company (its underlying basis or substratum) cannot be or can no longer be achieved:

**Case: RE GERMAN DATE COFFEE CO. (1882)**

The objects clause specified with much particularity 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 German. A contributory petition for **compulsory winding up**.

**Held:**

The company existed only to “work a particular patent” and as it could not do so it should be wound up.

But if there are two or more alternative objects (in the proper sense objects rather than ancillary powers) inability to achieve one of them does not justify winding up: (**Re Kitson & Co.** (1946) two businesses - one was sold - petition dismissed):

- b) There is a complete **deadlock** in the management of the company’s affairs.

**Cases:**

**(i) RE YENIDJE TOBACCO CO. (1946)**

Two sole traders merged their businesses in a company of which they were the only directors and shareholders. 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, which was opposed by the other member.

**Held:**

“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 liquidation.

- c) The members or directors are associated in the company on the basis of certain understandings but one (or more) exercises his legal rights against another in breach of those understandings with results which are **unfair**. Such situations are sometimes referred to as a “fraud on the minority”

**Case: EBRAHIM v. WESTBOURNE GALLERIES (1973)**

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 the Companies Act 1948 Section 184 (Kenya, Section 185). E sued to have the company wound up.

**Held:**

**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 liquidation. E's petition for relief on grounds of oppression of minority failed since he failed to make out a strong enough case for such relief.

**d) Loss of confidence**

It's just and equitable to wind up a company if members have justifiably lost confidence in the manner in which it's being managed. The petitioner must prove that there has been a consistent course of conduct on the part of the management, which justifies the winding up.

The company is a bubble

A company will be wound up on this ground if it's shown that there was no *bona fide* intention to pursue the declared objects of the company or pursue them lawfully. It was so held in **Re London and County Coal company limited**

**e) Oppression on the minority**

It's just and equitable to wind up a company if its affairs are being carried on in a manner oppressive to the minority. The petitioner must prove oppression and other requirements prescribed by Section 211 of the Act

**f) Expulsion or Exclusion from management**

If a member is unfairly excluded from participating in the affairs of the company as a director, it becomes just and equitable to wind up the company as was the case in **Re Westbourne Galleries limited.**

**PROCEEDINGS FOR COMPULSORY LIQUIDATION**

When the petition is presented to the court **a copy is delivered to the company in case it objects, and it is advertised so that other creditors may intervene if they wish.** At the hearing, a creditor whose debt is unpaid is likely to secure an order for compulsory liquidation (as his remedy of last resort) unless the company (paragraph 8) or opposing creditors (paragraph 9) persuade the court to dismiss the petition.

If the petition is presented by a member (contributory) he must show (in addition to suitable grounds for compulsory liquidation) that:

- (a) The company is solvent or alternatively refuses to supply information of its financial position. The court will not order compulsory liquidation 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 then take all the assets.
- (b) He has been a registered shareholder for at least six of the 18 months up to the date of his petition. But this rule is not applied if the petitioner acquired his shares by allotment direct from the company or by inheritance from a deceased member or if the petition is based on the number of members having fallen below two: Companies Act Section 221.

A personal representative of a deceased shareholder may petition but he must first obtain a grant of probate etc. to establish his authority to represent the estate: Companies Act Section 216. The trustee in bankruptcy of a bankrupt contributory may also petition on his behalf: Companies Act, Section .217.



## EFFECTS OF AN ORDER FOR COMPULSORY LIQUIDATION

**The effects of the order are as follows:**

- (a) The Official Receiver (an Official of the High Court whose duties relate mainly to bankruptcy of individuals) becomes provisional liquidator; Section 236
- (b) The liquidation is deemed to have begun at the time (possibly several months earlier) when the petition was first presented. If the compulsory liquidation follows voluntary liquidation already in progress (see Southard Case above) liquidation runs from the commencement of the voluntary liquidation: Section 226.
- (c) Any disposition of the company's property and transfer of its shares subsequent to the commencement of liquidation is void unless the court orders otherwise, Section 224.
- (d) 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 liquidation is void: Sections 225 and 228.
- (e) The employees of the company are automatically dismissed. The provisional liquidator assumes the powers of management previously held by the directors.

The assets of the company 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, e.g. by sale as a going concern. Any floating charge crystallises. Liquidation may invalidate charges and other previous transactions.

Within 14 days of the making of the order for winding up a statement of affairs must be delivered



to the liquidator (Official Receiver) 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 which creditors may hold: Companies Act, Section 232.

The Official Receiver may require that others concerned in the recent management of the company shall join in submitting the statement of affairs. These may be (at the Official Receiver's discretion unless the court has given directions):

- (a) Present or past officers of the company, i.e. its management,
- (b) Employees who are or who have been in the service of the company within the previous year if it is considered that they can provide the information required,
- (c) Persons who have taken part in the formation of the company within the previous year.

The Official Receiver makes a preliminary report to the court on the causes of the company's failure and states whether in his opinion he should make further investigation and report on suspected fraud; Section 233. If he does so, this may lead on to the public examination in open court of those believed to be implicated (a much-feared sanction).

The Official Receiver also calls separate meetings of creditors and of contributories within one month of the order for liquidation: Section 236. Each meeting may nominate a permanent liquidator to replace the Official Receiver and also representatives to serve as members of a committee of inspection (to work with the liquidator). The Official Receiver reports to the court, which may appoint a permanent liquidator and a committee of inspection. If no other liquidator is appointed (or if the post falls vacant) the Official Receiver continues to act as liquidator. A liquidator must be an individual and may not be an undischarged bankrupt.

Notice of the order for compulsory liquidation and of the appointment of a liquidator is given to the registrar and in the Kenya Gazette. When the liquidator completes his task, he reports to the court, which examines his accounts, and makes an order for dissolution of the company. The order is sent to the registrar who gives notice of it in the Kenya Gazette and dissolves the company: Sections 247 and 269.

If while the liquidation is in progress the liquidator decides to call meetings of contributories or creditors, he may arrange to do so under powers vested in the court: Section 336.



## RESOLUTION TO WIND UP VOLUNTARILY

The type of resolution to be passed varies with the circumstances of the case, as provided in Section 271 (1):

- (a) If the articles provide for liquidation at the end of a specified period or on the happening of an event, e.g. the completion of the transaction for which the company was formed, **an ordinary resolution** (referring to the articles) suffices; or
- (b) A company may, by special resolution (giving no reason), resolve to wind up **voluntarily**

The winding up commences on the passing of **the resolution**. The company must within 14 days after the passing of the resolution give notice of it by advertisement in the Kenya Gazette, and also in some newspapers circulating in Kenya: Section 272(1).

## DECLARATION OF SOLVENCY

A voluntary winding up is a **members' voluntary winding up** only if the directors make and deliver to the registrar a declaration of solvency: Section 276 (4).

This is a statutory declaration that the directors have made a full inquiry 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.

The declaration is made by all the directors or, if there are more than two directors, by a majority of them.

The declaration includes a statement of the company's assets and liabilities as at the latest practicable date before the declaration is made.

### The declaration must be:

- (a) Made within the 30 days immediately preceding the date of the passing of the resolution for winding up, and
- (b) Delivered to the registrar for registration before that date: Section 276 (2)

If the liquidator later concludes that the company will be unable to pay its debts he shall further notify the registrar accordingly and call a meeting of creditors and lay before them a statement of assets and liabilities: Section 281(1)

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, i.e. if the company proves to be insolvent, he will have to justify his 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. There is no committee of inspection (on which creditors would be represented). The liquidator calls special and annual meetings of members to whom he reports:

- (a) Within three 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: Section 282.
- (b) When the liquidation 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 the registrar who dissolves the company three months later by removing its name from the register: Section 283(4).

## CREDITORS' VOLUNTARY WINDING UP

If no declaration of solvency is made and delivered to the registrar, the liquidation process is 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 member to pass a special resolution. They also convene a meeting of creditors, sending notices to creditors individually and advertising the meeting once in the Kenya Gazette and once at least in a newspaper circulating in Kenya: s.286 (2).

**The meeting of members is held first and its business is:**

- (a) To resolve to wind up.
- (b) To appoint a liquidator
- (c) To nominate representatives to be members of **the committee of inspection**.

The creditors' meeting is convened for the same day at a later time than the members' meeting or it is held the following day. 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 creditors' meeting nominates a liquidator and up to five representatives of creditors 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 (subject to a right of appeal to the court).

It is no longer possible to prevent the creditors from appointing the first liquidator by failing to call a creditors' meeting after holding a members' meeting (to appoint a liquidator of their choice) on short notice. (This device was first developed in **Re Centrebond** (1966) and is colloquially called "centre binding"). Any meeting of members called to initiate a winding up must be convened with not less than seven days notice.

**The main differences between a member's and a creditor's voluntary winding up are that:**

- (a) In a creditors' voluntary winding up, the liquidator, although responsible to members as well as creditors, is selected by the creditors. In a members' voluntary winding up he is appointed by the members;
- (b) In a creditors' voluntary winding up, the liquidator must obtain the approval (usually) of the committee of inspection for the exercise of certain statutory powers. In a members' voluntary winding up, he obtains approval from the members in general meeting;
- (c) There is a committee of inspection in a creditors' voluntary winding up with up to five members, a majority of whom being appointed by the creditors: Section 288 (1). There is no committee in a members' voluntary winding up.

The effect is that the creditors have a decisive influence on the conduct of the liquidation. This is reasonable since it is assumed (in the absence of a statutory declaration of solvency) that the company is unable to pay its debts in full. The remaining assets will, therefore, be realised for the benefit of the creditors and the members get nothing (unless the company proves to be solvent after all).

Meetings are held in the same sequence as in a members' voluntary winding up but the meetings of creditors are called at the same intervals as the meetings of members and for similar purposes.



## THE EFFECT OF VOLUNTARY WINDING UP

**The main difference in legal consequences between a compulsory and voluntary winding up are:**

- (a) A voluntary winding up commences on the day when the resolution to wind up is passed. It is not retrospective,
- (b) The Official Receiver does not become provisional liquidator. The members or creditors select and appoint the liquidator and he is not an officer of the court,
- (c) There is no automatic stay of legal proceedings against the company nor are previous dispositions or seizure of its assets void. But the liquidator in a voluntary winding up has a general right to apply to the court to make any order which the court can make in a compulsory liquidation. He would do so to prevent any creditor obtaining an unfair advantage over other creditors,
- (d) The liquidator replaces the directors in the management of the company (unless he decides to retain them). The employees are not automatically dismissed by



commencement of voluntary liquidation. But insolvent liquidation may amount to repudiation of their contracts of employment (and provisions of the statutory employment protection code apply).

## WINDING UP SUBJECT TO THE SUPERVISION OF THE COURT

A hybrid category of winding up created by Section 304 of the Act. Under this Section, after the resolution for voluntary winding up is passed, the court may on application order that the winding up continue as voluntary but subject to such supervision and with such liberty of creditors, contributories and others to apply as the court may deem fit.

Under Section 306 of the Act, the court may while making the continuation order or by a subsequent order, appoint an additional liquidator. However, such a liquidator has the same powers and is subject to the same obligations as one appointed in a voluntary winding up but may be removed by the court if reasonable cause is shown the court has jurisdiction to fill the vacancy arising.

## LIQUIDATORS

### APPOINTMENT AND DUTIES

- a) The official receiver shall by virtue of his office become the provisional liquidator and shall continue to act as such until he or another person becomes liquidator and is capable of acting as such.
- (b) The official receiver shall summon separate meetings of the creditors and contributories of the company for the purpose of determining whether or not an application is to be made to the court for appointing a liquidator in the place of the official receiver.

Provided that where the court has dispensed with the settlement of a list of contributories it shall not be necessary for the official receiver to summon a meeting of contributories.

- (c) The court may make any appointment and order required to give effect to any such determination and, if there is a difference between the determinations of the meetings of the creditors and contributories in respect of the matter aforesaid, the court shall decide the difference and make such order thereon as the court may think fit.

- (d) In a case where a liquidator is not appointed by the court, the official receiver shall be the liquidator of the company.
- (e) The official receiver shall by virtue of his office be the liquidator during any vacancy.
- (f) A liquidator shall be described, where a person other than the official receiver is liquidator, by the style of "the liquidator", and, where the official receiver is liquidator, by the style of "the official receiver and liquidator", of the particular company in respect of which he is appointed and not by his individual name.



## THE LIQUIDATORS' POWERS

The liquidator (in any type of liquidation) has numerous statutory powers but in the exercise of some of them, he must obtain the approval of the court or of the committee of inspection or of meetings of members or creditors. He may always apply to the court for an order to resolve any unusual difficulty.

### ■ The more important statutory powers of the liquidator are:

- (a) To conduct legal proceedings in the name and on behalf of the company.
- (b) To carry on the business of the company so far as may be necessary for the beneficial winding up thereof.
- (c) To appoint an advocate and to assist him in the performance of his duties.
- (d) To pay any classes of creditors in full.
- (e) To make any compromise with creditors.
- (a) To compromise calls: Section 241 (1).



## RELEASE OF LIQUIDATORS

- (1) When the liquidator of a company, which is being wound up by the court has realised all the property of the company, or so much thereof as can, in his opinion, be realised without needlessly protracting the liquidation, and has distributed a final dividend, if any, to the creditors, and adjusted the rights of the contributories among themselves, and made a final return, if any, to the contributories, or has resigned, or has been removed from his office, the court shall, on his application, cause a report on his accounts to be prepared, and, on his complying with all the requirements of the court, shall take into consideration the report and any objection which may, be urged by any creditor or contributory or person interested against the



release of the liquidator, and shall either grant or withhold the release accordingly.

- (2) Where the release of a liquidator is withheld, the court may, on the application of any creditor or contributory or person interested, make such order as it thinks just, charging the liquidator with the consequences of any act or default which he may have done or made contrary to his duty.
- (3) An order of the court releasing the liquidator shall discharge him from all liability in respect of any act done or default made by him in the administration of the affairs of the company or otherwise in relation to his conduct as liquidator, but any such order may be revoked on proof that it was obtained by fraud or by suppression or concealment of any material fact.
- (4) Where the liquidator has not previously resigned or been removed, his release shall operate as a removal of him from his office.

## COMMITTEE OF INSPECTION

A committee of inspection is appointed in a compulsory liquidation and in a creditors' voluntary liquidation. It usually comprises such number of representatives of members and of creditors as may be agreed on by the meeting of creditors and contributories. If they disagree, the court decides the number (in a creditors' voluntary liquidation limited to a maximum of five). The committee meets once a month unless otherwise agreed and may be summoned at any time by the liquidator or by a member of the committee: Section 249.

The general function of the committee is to work with the liquidator, to supervise his accounts, to approve the exercise of certain of his statutory powers and to fix his remuneration. Like the liquidator himself, members of the committee are in a fiduciary position and may not secure unauthorised personal advantages, e.g. by purchase of the company's assets.

## CALLS ON CONTRIBUTORIES

Every person who is a member of the company at the commencement of winding up and every past member are in principle liable to contribute to the company's assets whatever may be required to enable it to pay its debts in full. Present and past members are therefore called "contributories". This serves to give present and past members the status of contributories with, for example, the right to petition for compulsory winding up. But if the company is limited by shares and its issued shares are fully paid, the contributories have no liability to contribute anything in normal circumstances.

**A contributory may be liable to contribute in the following circumstances:**

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- (a) If the shares which he holds or previously held are partly paid or if it is, found that the rules on consideration have been breached in the allotment of shares as fully paid.
- (b) If the company is limited by guarantee.
- (c) If the company is unlimited.

As explained below the persons who are members at the time when liquidation commences are primarily liable (when there is any liability). The liability of past members is very restricted.

If it is necessary to make calls on contributories, the liquidator draws up **a list "A"** of contributories who were members at the commencement of the winding up and **a list "B"** of contributories who were members within the year preceding the commencement of winding up. A list B contributory has liability limited by the following principles:

- (a) He is only liable to pay what is due on the shares which he previously held and only so much of the amount due on those shares as the present holder (a list A contributory) is unable to pay.
- (b) He can only be required to contribute (within the limits stated in (a) above) in order to pay those debts of the company incurred before he ceased to be a member which are still owing.

As stated above, a past member ceases to be liable altogether (on partly paid shares) if the company continues (without going into liquidation) for a year.



## TRANSACTIONS ARISING IN LIQUIDATION

In collection in and realisation of assets in order to pay the company's debts and then to distribute any surplus to members the liquidator will have dealings with creditors, secured and unsecured, with members and others. He may have to enforce claims on behalf of the company against those who previously managed its business. He has also to consider whether the charges on the company's assets on which secured creditors rely are still valid. This topic is concerned with the legal aspects of these problems and transactions of the liquidator.



## ASSETS IN THE POSSESSION OF CREDITORS

If the creditor has seized assets in the course of executing a judgment for debt against the company and at the commencement of the winding up or on receiving notice that it is about to begin the creditor has not completed the process of recovering what is owed to him, the liquidator may compel him to return the asset to the company.

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## DISCLAIMER OF ASSETS

**The liquidator has a statutory right of disclaimer of assets: Section 135. The rules are:**

- (a) He must obtain leave of the court.
- (b) The right of disclaimer is limited to property of the following kinds:
  - (i) Land burdened with onerous covenants.
  - (ii) Shares.
  - (iii) Unprofitable contracts.
  - (iv) Other property which is difficult to sell because of the burdens attached to it.
- (c) The liquidator must disclaim within a period of 12 months (unless the court extends the period). The period is reckoned from commencement of winding up or the date when the liquidator became aware of the property if this was more than one month after that commencement. Moreover, the other party may serve on the liquidator a notice requiring him within 28 days, to state whether he intends to disclaim. If the liquidator does not within that period declare an intention of disclaimer, he loses the right to do so.
- (d) Any person who suffers loss by the disclaimer becomes a creditor of the company for the amount of his loss. If the property disclaimed is a lease which has been mortgaged or sub-let the court may vest the property disclaimed in the mortgagee or sub-lessee.

## PROOF OF DEBTS

Many of the rules of bankruptcy apply to the discharge of the company's debts: Section 310. The liquidator must obviously require satisfactory evidence that a creditor's claim is properly admissible as a liability. This is done (where necessary) by a procedure for "proof of debts".

If the company is solvent, every kind of debt which is legally enforceable may be admitted. If it is insolvent, unliquidated claims in tort are not admissible. But the injured party may be permitted to bring an action against the company in tort so that his claim may be converted by the award of damage into a liquidated sum so long as it is liquidated when the claimant comes into prove.

A statute-barred debt should be rejected since it is not legally enforceable. But in a members' voluntary winding up, the liquidator may with the consent of all contributories pay such a debt. The general rules on statute-barred debts are:

- (a) In a normal case, a debt becomes statute-barred (i.e. the creditor may no longer take legal proceedings to enforce payment) if it remains unpaid for six years and the creditor does not within that time commence legal proceedings to recover it.
- (b) The company becomes liable again to pay a statute-barred debt (after six years) if it

issues to the creditor a written acknowledgement of its indebtedness.

The liquidator must also consider whether any debts of the company arise from contracts, which are *ultra vires* or *ultra vires* the company but made by the directors without authority. The liquidator must according to his judgment of the legal position either.

- (a) Reject the creditor's claim as invalid if that is possible.
- (b) Consider claiming compensation from the directors who made the unauthorised contract on the grounds of their misfeasance under Section 323.



## SECURED CREDITORS

**A secured creditor may:**

- (a) Realise his security and prove as an unsecured creditor for the balance (if any) of his debt.
- (b) Value the security and prove for any balance. In this case, the liquidator may either redeem the security at the creditor's value or require it to be sold.
- (c) Rely on his security and not prove at all; the liquidator may then redeem by payment in full.
- (d) Surrender his security and prove for the whole debt.

A secured creditor who proves his debt must disclose his security and prove only for the balance as an unsecured creditor.

The liquidator may find that the security given by a **floating charge** over the undertaking and assets of the company has been enforced (before liquidation began) by the appointment of a receiver and manager who is in charge of the entire business and property of the company. The liquidator should consider whether the charge has become invalid by reason of the commencement of **liquidation** (paragraph 10 below). If, however, it is valid the liquidator must wait to see whether there will be any surplus from the company's assets, which the receiver will pay over to him when the secured creditors who appointed the receiver have been paid in full. The sequence of events may be reversed i.e. the liquidator causes a floating charge to crystallise and a **receiver is appointed after the liquidator has taken control**. In that case, the liquidator must hand over the business to the receiver since he represents creditors who have a prior claim.

The liquidation itself may render a charge over the company's assets **void** in any of the following circumstances:





- (a) The charge was not registered within 42 days of creation as required by Section 96;
- (b) The charge is a floating charge created within the period of 12 months before commencement of liquidation (paragraph 24 below).
- (c) The charge is void as a fraudulent preference (paragraph 28 below).

If the charge is void, the receiver's powers and appointment lapse and he must account to the liquidator for his transactions and the assets of the company still under his control.

If there are not sufficient other assets to pay preferential debts those debts are paid out of property subject to a floating charge in priority to that charge. It is the duty of the liquidator to ensure that debts are paid in their due order of priority.

## UNSECURED ORDINARY DEBTS

A secured creditor obtains payment (to the extent that his security is adequate i.e. if it exceeds in value the amount owing to him) because he has a valid prior claim to that security. Unsecured creditors are paid out of the remaining assets, i.e. the aggregate of:

- (a) Any surplus value obtained by secured creditors in realising the assets, which are their security and paid over to the liquidator.
- (b) Any assets which are not subject to charges given to secured creditors.

**But two special claims have to be given their due priority, i.e.**

- (a) Costs of winding up including the legal expenses and liquidator's remuneration.
- (b) Preferential unsecured debts.

**The order of application of assets is, therefore, as follows:**

- (a) Secured creditors who have fixed charges are entitled to be paid out of their security so far as it suffices. If the security is insufficient in value to pay the debt in full, the creditor rank as an unsecured creditor for the balance;
- (b) The costs of winding up are paid next, i.e. they rank before floating charges.
- (c) Preferential unsecured debts (paragraph 15 below) are paid next, i.e. they rank before

floating charges in so far as there are no other assets available to pay preferential debts. If the floating charge covers the entire undertaking and property of the company (as is normal in modern practice) there will be no uncharged assets.

- (d) Debts secured by floating charges come next in order.
- (e) Unsecured non-preferential debts come next.
- (f) Deferred debts come last in order.

## PREFERENTIAL DEBTS

**These unsecured debts which rank ahead of a floating charge and non-preferential debts are:**

- (a) One year's taxes, i.e. corporation tax, Pay As You Earn income tax deducted, rates, Value Added Tax unpaid at the "relevant date". The relevant date is defined as:
  - (i) The date of the order for compulsory liquidation (or any earlier order for appointment of a provisional liquidator).
  - (ii) The date of passing the resolution to wind up voluntarily.

If more than one year's tax is outstanding, the Income Tax Department may select whichever year yields the largest amount of corporation tax; in other cases it is the latest year's tax which is a preferential debt.
- (b) Wages and salary of an employee, i.e. clerk, servant, workman or labourer (including commission or piece work payments) of the four months up to the relevant date limited to a maximum of Kshs.4,000 owed to each individual employee, accrued holiday pay and employer's National Social Security Fund (NSSF) contributions. A director is not an employee in respect of a claim for unpaid fees - but he may be in respect of salary if he has a contract of service.

**Loan creditors and landlords are subject to special rules in certain circumstances:**

- (a) If a person (usually a bank) lends money to the company to enable it to pay wages which, if unpaid, would be preferential debts, he himself becomes a preferential creditor in respect of that part of his loan, which is used to pay preferential wage debts.
- (b) A landlord's remedy if rent is unpaid is to seize and sell the tenant's goods on the premises (called "levying distress"). If he does not within six months before compulsory liquidation commence, he must give up the proceeds if the liquidator requires them for payment of preferential debts. The rule does not apply in a voluntary liquidation: Companies Act, Section 311 (7).



## DEFERRED DEBTS

A debt owed to a member as member, i.e. an unpaid dividend, is a deferred debt paid only when ordinary debts have been paid in full.

## RIGHTS OF EMPLOYEES

The effect of liquidation is often to terminate the contracts of service of employees of the company. The company may owe them arrears of wages or salaries, which can be preferential debts wholly or in part.

If the debts are paid in full, the liquidator should apply what remains in repayment of capital paid on shares and then distribute any residue to those entitled to the surplus. Unless otherwise stated, all shares rank equally. But the articles often provide that preference share capital is to be repaid in priority (with the implication that preference shares do not carry a right to participate in any surplus left after all paid up share capital has been paid).

A company may (by its memorandum or articles or by a resolution passed in general meeting) authorise distribution of assets (after payment of debts, which must have priority) not to members but to, for example, a charity or to employees of the company. Payments to employees made after the company has ceased to carry on or has sold its business are not within its powers:

## AVOIDANCE OF FLOATING CHARGES

Under Section 314, liquidation automatically renders void any floating charge created within the period of 12 months before commencement of liquidation subject to the following exceptions:

- (a) Valid if the company was solvent, at the time when the charge was created. A company is not solvent unless it can pay its debts in full as they fall due.
- (b) If the company was not solvent the floating charge is still valid as security for cash paid to the company (with interest at six per cent per annum) after the charge was created and in consideration of the loan.

The general purpose of the rule is to prevent an unsecured creditor of an insolvent company from getting advantage over other creditors by obtaining a floating charge to secure an existing debt at a time when the company is heading towards insolvent liquidation. It is only the charge (**as security**) not the debt itself which becomes void.

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If the charge is created to secure a loan of new money, the rule is generously interpreted.

■ **Case: RE F AND E STANTON (1929)**

A lender agreed to lend money to a company on the security of a floating charge. The money was lent but the charge was not created until afterwards. A few days after the creation of the charge, the company went into liquidation.

**Held:**

The charge was valid since the loan was made in consideration of the promise of security. It was not material that the money was lent before the charge was created.

On the other hand, if money is lent after a floating charge is created but is used (as was intended) to pay off an unsecured debt (of the same creditor) existing when the charge was created, this will not be treated as a new loan and the charge will be void (as security for the later loan).

In determining the date when money is lent through transactions on running account the **rule in Clayton's Case** is applied, i.e. any repayment is applied to pay off the earliest advance.

■ **Case: RE YEOVIL GLOVE CO (1965)**

At the time when the floating charge was created, the company had a bank overdraft of about 68,000 pounds. Over the next few months, it paid in cheques totaling 111,000 pounds and drew cheques totaling 110,000 pounds. At the commencement of liquidation (within 12 months of creating the charge) the debt balance on the account was 67,000 pounds, i.e. almost the same as when the charge was created.

**Held:**

The loan of 68,000 pounds at the date when the charge was created had been repaid by the subsequent credits of 111,000 pounds to the account. The balance of 67,000 pounds owing at the commencement of liquidation was "new money" lent after the charge was created (i.e. part of the 110,000 pounds drawn out) and so **the charge was a valid security for that loan.**

## Fraudulent Preference

Under Section 312, any disposition of the company's property and any creation of a charge, fixed or floating, effected during the period of six months before commencement of liquidations void as a fraudulent preference if:

- (a) Done voluntarily
- (b) Done with the intention of preferring one creditor (or surety) over another.



- (c) At a time when the company was insolvent, i.e. unable to pay its debts in full.

A “disposition” includes the payment of a debt. Payment of one creditor with the intention of preferring him to others is a common example of fraudulent preference (if the other conditions are met).

**Case: RE M KUSHLER LTD (1943)**

The directors had given personal guarantees of the company’s bank overdraft. They arranged that the company should pay its **trade receipts** into the account but should not pay its **trade debts** as they fell due with the result that the bank overdraft was paid off. Shortly afterwards, the company went into insolvent liquidation.

**Held:**

This was fraudulent preference and the bank must repay the sums received.

A payment made or charge created under threat of legal proceedings is not voluntary and so it cannot be treated as fraudulent preference even though its purpose and effect is to treat one creditor more favourable than the rest.

An ordinary commercial payment of debts made without intention of giving an advance may not amount to fraudulent preference: **Re Paraguassu Steam Tramway Co** (1974). However, it has recently been held that a payment will constitute a fraudulent preference if the debtor, at the time of making it, knew that he could not pay his debts as they arose and intended to pay one of his creditors in full ahead of the others.

**Case: RE MATHEWS (1982)**

The proprietors of an insolvent small company (who were aware of the insolvency) paid cheques into the company’s bank account. Two days later, the company ceased trading and two days after that the proprietors notified the bank of the termination of their personal guarantees of the company’s borrowing.

**Held:**

Banking cheques after a decision to stop trading was a fraudulent preference in favour of the bank since at that time the proprietors knew that the other creditors would not be paid (even though they honestly believed that they would eventually be paid).

When a transaction is void as a **fraudulent preference** any charge created is void and any cash paid or property transferred by the company must be returned to the liquidator. There can be complications when a third party, usually a creditor, has given security (e.g. deposit with the lender of the title deeds of the director’s house) as security for the company’s debt. The purpose of the fraudulent preference (as in the Kushler Case above) is often to release a third party from his involvement in the company’s debt. When the debt is paid (as a fraudulent preference) the lender returns to the guarantor whatever security the latter has given. When the lender has to return to the liquidator the payment received he cannot require the guarantor to reinstate his security but the latter continues to be (or if there is no previous personal guarantee by him becomes) personally liable to the lender as a guarantor of the debt: Companies Act Section 313

## Fraudulent Trading

Under Section 323, if the court finds that the business of a company in liquidation has been carried on with intent to defraud creditors or for any fraudulent purpose, it may declare that any persons who were knowingly parties to carrying on the business in this fashion shall be liable for debts of the company as the court may decide.

It has been said that “if a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors, no reasonable prospect of the creditors receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with intent to “defraud” (per **Maugham J. in William C Leitch Bros (No 1)** (1932). But in another case, the same judge said that there must be evidence of “real dishonesty”. No Kenyan case has been decided on the section.

**Various rules have been established to determine what is fraudulent trading:**

- (a) Only persons who take the decision to carry on the company’s business in this way or play some active part are liable. An employee who is aware that the debts incurred may not be paid and who merely fails to inform the directors of the situation is not a “party” to carrying on business since it is not a decision or action on his part.

### Case: **RE MAIDSTONE BUILDING PROVISIONS** (1971)

The secretary of the company also acted as a financial adviser to the directors. The secretary was aware but did not tell the directors that in carrying on its business, the company was incurring debts which it was not likely to pay. Proceedings were brought against the secretary for fraudulent trading.

#### **Held:**

As the secretary did not take the decision to continue trading, he was not a “party” to fraudulent trading. In so far as he had failed to provide information and advice which it was his duty to give, he might have been negligent but that was not an issue in these proceedings.

- (b) “Carrying on business” can include a single transaction and also the mere payment of debts as distinct from making trading contracts.

### Case: **RE SARFLAX** (1979)

The company owed money to trade creditors and also had outstanding against it a large claim for breach of contract which it disputed (though the claimant had obtained judgment in his favour in the Italian courts). The directors used the remaining assets to discharge the trade debts. When the company went into liquidation, the liquidator sought a declaration that the directors had carried on business with intent to defraud the Italian creditor.

**Held:**

In paying the other debts, the directors had “carried on business” but this was not a case of “intent to defraud” the Italian claimant, whose claim they did not accept. (The issue of possible fraudulent preference of the trade creditors was not raised).

If the liquidator considers that there has been fraudulent trading, he should apply to the court for an order that those responsible (usually the directors) are liable to make good to the company all or some specified part of the company’s debts. If the liquidator does not do this a creditor, might be able to obtain an order that those at fault must pay the creditor direct: **Re Cyone Distributors** (1967). The liquidator should also report the facts to the Attorney General so that he may institute criminal proceedings.

**Misfeasance**

Under Section 324, misfeasance proceedings may be instituted against a director, promoter, manager, liquidator or “officer” (including an auditor) of a company in liquidation either to recover the company’s property from him or to claim compensation for the loss to the company caused by his misfeasance.

The most obvious case of misfeasance is where a director or other officer of the company is found to have misappropriated property of the company. He can be compelled by misfeasance proceedings to return it. His conduct may also be criminal misappropriation of property for which he can be prosecuted.

The other type of misfeasance case is where the company has suffered loss owing to the incompetence or neglect of a director or other officer. It is not, however, easy to establish that there has been breach of a fiduciary duty such that an order should be made (on grounds of misfeasance) for payment of compensation. For some lesser default, the liquidator could bring an action for negligence.

In the context of misfeasance proceedings, an auditor is exceptionally an “officer” who can be liable: he is not an “officer” in any other situation since he has no management functions.

A receiver is not an “officer” who can be held liable (if the company later goes into liquidation) for misfeasance.

**Case. RE B JOHNSON & JOHNSON CO (BUILDERS) (1955)**

Misfeasance proceedings were brought against a receiver on the ground that he had in his management of the company’s business taken decisions which were “detrimental from the company’s point of view”, e.g. closing down parts of its business.

**Held:**

A receiver is a representative of the secured creditors by or for whom he is appointed. He is not an officer of the company who can be liable for misfeasance. If, however, a receiver does not act bona fide (i.e. honestly) the company might have a claim against him but not misfeasance.



## OTHER LEGAL PROCEDURES

The court may order the examination in private or public (i.e. open court) of an officer of a company in liquidation or of any person known or suspected to have its property or information about it in his possession. Public examination is ordered only in cases of suspected fraud.

Concealment of information from a liquidator, falsification of company records and wrongful disposal of property of a company in liquidation may give rise to criminal proceedings against the person at fault.

### Revival of a Dissolved Company

Liquidation leads on to dissolution of the company. The court may, however, within the ensuing two years order that dissolution be rescinded and the company restored to the register - usually because some asset or liability previously overlooked has come to light: Companies Act, Section 338.

### Liquidators and Receivers

**The distinction between liquidators and receivers must be kept clear:**

- (a) A receiver is a representative of secured creditors appointed by them (or by the court on their behalf) to enforce their security, i.e. to take control of the company's assets subject to a charge and to raise money from those assets to pay the secured debt. If the debt is paid, the receiver vacates office **and the directors resume full control**.
- (b) A liquidator is appointed by the court (compulsory liquidation) or by members and creditors (creditors' voluntary liquidation). His task is to take control of all the company's assets with a view of their realisation and the payment of all debts of the company and distribution of any surplus to members. At the end of liquidation, the company is dissolved.





### There are a number of points of similarity:

- (a) In a compulsory (but not a voluntary) liquidation the directors have to submit a statement of affairs to the Official Receiver as provisional liquidator. If a receiver is appointed under a floating charge covering the company's undertaking as a whole he too is entitled to be given a statement of affairs.
- (b) Accountants who specialise in insolvency may be appointed as liquidators or as receivers (sometimes they combine these positions in the same company but professional opinion in the U.K. has hardened against this position since there can be difficult conflicts of interest to resolve between unsecured creditors and members on one side and secured creditors on the other).
- (c) A receiver appointed under a floating charge is also a manager of the business (or a manager is appointed to assist him). His function is to continue to carry on the business on a going concern basis. The liquidator's function is to sell the company's assets on the best terms he can get. As closure costs (redundancy payments to employees etc.) can be heavy a liquidator may decide to carry on the business with a view to selling it as a going concern. But this is only one of the alternatives open to him;
- (d) Neither liquidator nor receiver usually has the assets of the business vested in his legal ownership (though a liquidator may obtain a court order for assets to be vested in him under Companies Act, Section 240 - but this is not common). Both liquidator and receiver have control of the company's assets.

### There are also significant differences:

- (a) A liquidator has numerous statutory powers. A receiver must rely on the few powers given by the debenture under which he is appointed (or by the court).
- (b) A receiver is personally liable on the contracts which he makes for the company. A liquidator has no such liability. But either, if he fails to perform his duties properly, may be called to account in various ways.

### Offences Antecedent to or in Course of Winding Up

**Section 318(1)** states that If any person, being a past or present officer of a company which at the time of the commission of the alleged offence is being wound up, whether by or under the supervision of the court or voluntarily, or is subsequently ordered to be wound up by the court or subsequently passes a resolution for voluntary winding up:

- (a) Does not to the best of his knowledge and belief fully and truly discover to the liquidator all the property, movable and immovable of the company, and how and to whom and for that consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary way of the business of the company

- (b) Does not deliver up to the liquidator, or as he directs, all such part of the movable and immovable property of the company as is in his custody or under his control, and which he is required by law to deliver up
- (c) Does not deliver up to the liquidator, or as he directs, all books and papers belonging to the company and which he is required by law to deliver up.
- (d) Within 12 months before the commencement of the winding up or at any time thereafter conceals any part of the property of the company to the value of Kshs.200 or upwards, or conceals any debt due to or from the company.
- (e) Within 12 months next before the commencement of the winding up or at any time thereafter fraudulently removes any part of the property of the company to the value of Kshs 200 or upwards.
- (f) Makes any material omission in any statement relating to the affairs of the company.
- (g) Knowing or believing that a false debt has been proved by any person under the winding up, fails for the period of a month to inform the liquidator thereof.
- (h) After the commencement of the winding up prevents the production of any book or paper affecting or relating to the property or affairs of the company.
- (i) Within twelve months next before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies, or is privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to the property or affairs of the company.
- (j) Within 12 months next before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company.
- (k) Within 12 months next before the commencement of the winding up or at any time thereafter fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with altering or making any omission in, any document affecting or relating to the property or affairs of the company.
- (l) After the commencement of the winding up or at any meeting of the creditors of the company within twelve months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses.
- (m) Has within 12 months next before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtained any property for or on behalf of the company on credit which the company does not subsequently pay for.
- (n) Within 12 months next before the commencement of the winding up or at any time thereafter, under the false pretence that the company is carrying on its business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for.



- (o) Within 12 months next before the commencement of the winding up or at any time thereafter pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging or disposing is in the ordinary way of the business of the company.
- (p) Is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them to an agreement with reference to the affairs of the company or to the winding up.
- (q) Has within 12 months next before the commencement of the winding up been privy to the carrying on of the business of the company knowing that the company was unable to pay its debts.
- (r) Has been privy to the contracting by the company of any debt provable in the liquidation without having at the time when the debt was contracted any reasonable or probable ground of expectation (proof whereof shall lie on him) that the company would be able to pay that debt, he shall, in the case of the offences mentioned respectively in paragraphs (m), (n) and (o), be liable to imprisonment for a term not exceeding five years and in the case of any other offence shall be liable to imprisonment for a term not exceeding three years:
  - (1) Provided that it shall be a good defence to a charge under any of paragraphs (a), (b), (c), (d), (f), (n), (o), (q) and (r) if the accused proves that he had no intent to defraud, and to a charge under any of paragraphs (h), (i) and (j) if he proves that he had no intent to conceal the state of affairs of the company or to defeat the law.
  - (2) Where any person pawns, pledges or disposes of any property in circumstances which amount to an offence under paragraph (O) of Subsection (1), every person who takes in pawn or pledge or otherwise receives the property knowing to be pawned, pledged or disposed of in such circumstances as aforesaid shall be liable to be punished in the same way as if he had been convicted of an offence under subsection (1) of Section 322 of the Penal Code.
  - (3) For the purposes of this Section, "officer" includes any person in accordance with whose directions or instructions the directors of a company have been accustomed to act.

## SUMMARY OF CHAPTER

**Winding up or dissolution is the dissolution of a company i.e. it ceases to exist.**

**The three main forms of liquidation are:**

- Compulsory winding up.
- Members' voluntary winding up of an insolvent company.
- Creditors' voluntary winding up of a solvent company and winding up subject to the supervision of the company.

**Once winding up proceedings have been commenced:**

- Official receiver becomes provisional liquidator.
- Director's powers become *functus officio*.
- Servants of the company are *ipso facto* dismissed.
- Any disposition of the company's property and transfer of its shares become void.
- The company ceases to carry on business

The main difference between a members' voluntary winding up and creditors winding up is that a member's winding up is characterised by a declaration of solvency but in a creditor's voluntary winding up there is no declaration of solvency

**Powers of a liquidator:**

- To conduct legal proceedings in the name of and on behalf of the company
- To carry on the business of the company for beneficial winding up
- Appoint an advocate to assist him
- To pay any class of creditors in full
- To make any compromise with creditors
- To comprise all calls
- A liquidator is appointed by the court whereas a receiver is a representative of secured creditors appointed by them.

Under Section 221 of the Act, a winding up petition may be presented to court by any of the following persons:

- The company
- Creditors



- Contributory
- Member/shareholder
- Attorney general
- Official receiver
- Commissioner of Insurance

**The main difference in legal consequences between a compulsory and voluntary winding up are:**

- (a) In a voluntary winding up winding up commences on the day when the resolution to wind up is passed. It is not retrospective as in a compulsory winding up.
- (b) In a voluntary winding up the Official Receiver does not become a provisional liquidator; as in a compulsory winding up. The members or creditors select and appoint the liquidator and he is not an officer of the court;
- (c) In a compulsory winding up there is no automatic stay of legal proceedings against the company nor are previous dispositions or seizure of its assets void. But the liquidator in a voluntary winding up has a general right to apply to the court to make any order which the court can make in a compulsory liquidation. He would do so to prevent any creditor obtaining an unfair advantage over other creditors;
- (d) In a compulsory winding up the liquidator replaces the directors in the management of the company (unless he decides to retain them). The employees are not automatically dismissed by commencement of voluntary liquidation. But insolvent liquidation may amount to repudiation of their contracts of employment (and provisions of the statutory employment protection code apply).

## CHAPTER QUIZ

1. Voluntary winding up may be either by----- or -----
2. A representative of secured creditors appointed by them is called
3. A creditor may petition for winding up. TRUE or FALSE?
4. What document constitutes a member's voluntary winding up?
5. Compulsory liquidation is also referred to as-----

## ANSWERS TO QUIZ

1. Members or creditors
2. A receiver
3. TRUE
4. Statement of declaration
5. Winding up by the court

## SAMPLE OF EXAMINATION QUESTIONS

### QUESTION ONE

- a) In relation to corporate insolvency:
- i) Explain what is meant by a contributory. (5 marks)
  - ii) Distinguish between fraudulent and wrongful trading. Against who may proceedings be brought for breaches of provisions against fraudulent trading and wrongful trading? (10 marks)
- b) Highlight the powers of the court on hearing a petition. (5 marks)

### QUESTION TWO

In the context of voluntary winding up, explain the statutory provisions regarding the powers of the liquidator which may be exercisable:

- i) With the court sanction. (10 marks)
- ii) Without the court sanction. (10 marks)

### QUESTION THREE

- a) What are the different types of Liquidation and who may commence proceedings? (6 marks)
- b) How does a creditor demonstrate that the company is unable to pay its debts? (8 marks)
- c) What courses are open to a secured creditor in liquidation? (6 marks)

Please also refer to the following sittings for further practice:

05/02; 12/01; 06/01; 12/00; 07/00; 06/99; 12/98

# CHAPTER THIRTEEN



## ALTERNATIVES TO WINDING UP







# CHAPTER THIRTEEN

## ALTERNATIVES TO WINDING UP

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

- Explain alternatives to winding up such as reconstruction, amalgamation and mergers.
- Discuss the rights of share holders.
- Discuss the rights of creditors.

### ► INTRODUCTION

This chapter has been split from the previous chapter on corporate insolvency under the old syllabus. The chapter recognizes the fact that liquidation is not always the solution. Other methods referred to as alternatives to winding up may be employed to ensure the company is back on its feet again. This chapter, therefore, looks at reconstruction, amalgamation and mergers and even scheme of arrangements as alternatives.

### ► KEY DEFINITIONS

- **Reconstruction-** An alteration of the capital structure of a single company
- **Amalgamation** - Is a transaction whereby two or more companies are combined in some way in a united ownership
- **Merger-** The uniting of two companies
- **Scheme of arrangement-** Essentially, it is suitable for making a change in the rights of shareholders or creditors of an existing and continuing company
- **Take over-** The acquisition by one company of sufficient shares in another company

### ► EXAM CONTEXT

As has been pointed out, this chapter has been split from the original chapter of corporate insolvency. The questions therefore, are likely to concentrate more on liquidation. Nonetheless, at the end of this chapter there is a sample of exam questions from different sources.

## ► INDUSTRY CONTEXT

In the industry today, liquidation is always taken as a last resort as it has many procedures and thus very expensive. Many companies are opting for the alternatives that will be discussed in this chapter. A very good example is Uchumi Supermarket, which instead of being wound up was placed under receivership.

## INTRODUCTION

Schemes involving reconstruction, amalgamation, take-overs, arrangements, and other forms of reorganisation are carried out for the following reasons:

1. To overcome the company's financial difficulties
2. To make arrangements with creditors
3. To reorganise the company's capital structure
4. To extend the company's objects.

Reconstructions, mergers and takeovers are not defined terms. A reconstruction may be an alternative of the structure of a group of companies or an alteration of the capital structure of a single company.

The conventional meaning of “**take-over**” is the acquisition by one company (the bidder) of sufficient shares in another company (the target) to give the purchaser control of that other company.

“**Merger**”, on the other hand, means the uniting of two companies but, as this is possibly done through an acquisition by one company of a controlling holding of shares in another. Merger and takeover have almost become synonymous.

A merger (also called an amalgamation) is a transaction whereby two or more companies are combined in some way in united ownership. The simplest method is a takeover bid whereby Company A acquires the issued share capital of Company B so that they form a single group in which A is the holding company and B is the subsidiary. A more complex type of merger entails the transfer of a business (and the assets employed in it) from one company to another. If the acquiring company (in either a take-over bid for shares or a purchase of assets) allots its own shares as consideration for the acquisition the members of the company whose business or share capital is acquired will become additional members of the acquiring company.

A company may absorb a minority shareholding in its partly owned subsidiary in exchange for cash or shares.

A company may seek to alter the rights of its creditors, e.g. by variation of the rights of debenture holders or by mutual agreement.



In these transactions, it is first necessary to select the only available (or if more than one) the most convenient method to effect the proposed change. The advantages and disadvantages of each method are explained below in connection with the method itself. The essential elements of every method are that if a decisive majority of members or creditors can be obtained by the correct procedure, the minority (if any) who dissent will be bound by the majority decision. But in each case the minority is given safeguards or rights of objection to the court to balance the element of compulsion. Although a minority cannot frustrate the change by their opposition, they are entitled to a fair deal.

### ■ There are three statutory methods to be considered

Where one company offers to acquire the shares of another company and its offer is accepted by holders of 90 per cent or more of the shares for which the offer is made the acquiring company may compel the non-accepting minority to transfer their shares on the same terms. This is the standard procedure for “mopping up a minority” and achieving complete success in a **take-over bid**. It is no objection that the acquiring company already owns (directly or through subsidiaries) some shares of the other company. Accordingly this method is also available to acquire the outstanding minority shareholding of a partly owned subsidiary (Section 210).

Where one company transfers its undertaking (and assets) to another company in exchange for shares to be allotted direct or distributed to the members of the company, the company which makes the transfer must go into voluntary liquidation and the transfer must be approved by special resolution passed in general meeting. The acquiring company may be a new company formed for the purpose. There is then a change of company but the same shareholders as a group own the same business (through a company). It is a form of **reconstruction**. If however the acquiring company already has a business and a different group of members this method effects an amalgamation so that the two groups of shareholders join together in holding the shares of a single company which owns both businesses, Section 280.

A **scheme of arrangement** may be used in many different situations. Essentially, it is suitable for making a change in the rights of shareholders or creditors of an existing and continuing company. But it can also be used to effect a take-over (as described in (a) above) or to carry out a reconstruction involving changes of company structure (Section 207).

It will be seen that methods (a) and (b) relate to specific types of transaction. They can only be used in those transactions. The flexibility of a scheme of arrangement has led to its extended use though there is some doubt whether it is correct to use it in a situation where company law affords some other and more specific procedures.

Where there is a choice of method, the choice is usually between a scheme of arrangement and some more specific alternative method. The considerations affecting the choice are explained overleaf.



## 1. SCHEME OF ARRANGEMENT

### The following sequence of action is necessary:

1. Application is made to the court (usually by the company itself) for an order that one or more meetings of members and or of creditors (if the scheme will affect the rights of creditors (if the scheme will affect the rights of creditors) shall be held. With the application the company submits a document setting out in detail the terms of the scheme of arrangement and also an explanatory statement to be issued with the notice(s) convening the meeting(s). If the court is satisfied that the scheme is generally suitable for consideration as a “scheme of arrangement” under Section 207, it will order that a meeting of meetings be held to consider it. The court is not at this stage concerned with the details of the scheme or with the issue (which may arise later) as to whether there are conflicts of interest, which require that separate meetings should be held. The court merely looks at the outline of the scheme and if it seems suitable orders that meeting(s) be held.
2. A meeting or several meetings is or are held as the court has ordered. A substantial quorum, say members (present in person or by proxy) holding one-third of the shares, is required and the scheme must be approved by members (or, as the case may be, creditors) voting at each meeting who:
  - (i) Are a majority in number, and
  - (ii) Represent three-quarters in value of the shares (or at a creditors’ meeting, of the amounts owing).

Requirement (ii) is imposed to safeguard a minority in numbers who have a larger financial stake than the numerical majority following approval of the scheme at meeting(s) where application is made to the court for an order to approve and implement the scheme. At this stage, any minority which opposes the scheme may state its objections for consideration by the court

3. A copy of the court order approving the scheme is delivered to the registrar and the scheme then takes effect, i.e., the changes are made automatically as soon as this is done.
4. A scheme of arrangement is very flexible since it may be used to effect any “compromise or arrangement” with members or a class of members with creditors or a class of creditors. It has been used to vary the rights attached to debentures or preference shares (when there are obstacles to a straightforward reduction of capital or variation of class rights) or to reorganise the capital structure of a company or to acquire shares of a company (instead of a take-over bid to which Section 210 will apply). But if there is a specific procedure, such as a reduction of capital or a variation of class rights, which can be used, the court would not permit the use of a scheme of arrangement to avoid some safeguard of minority interests available under that specific procedure.



Section 207 refers to a “class” of members or of creditors. Obviously if two or more companies are involved or if one company has two classes of shares, e.g. preference and ordinary, or is proposing a compromise with different classes of creditors, e.g. debenture holders and unsecured trade creditors, it must ask the court to order that separate meetings be held of each group and it must obtain the required majority approval at each meeting. But the principle is carried even further. If within say one class of shareholders there are groups whose interests in the proposed scheme are clearly different, the court must be asked to order that separate meetings be called of each group. It has been said that each meeting “must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest” (***Sovereign Life Assurance Co v Dodd***).

If those who propose the scheme do not, in their application to the court, distinguish each such group (to be consulted separately) the court will at the final decision stage withhold its approval on the ground that there has not been fair and proper consultation.

**In *Re: Hellenic and General Trust (1976)***, a scheme of arrangement was agreed between Hambros and Hellenic whereby the shareholders of Hellenic were to have their shares in the company cancelled in return for cash compensation. Hambros was to pay the compensation and then receive the same number of shares in Hellenic. The scheme was approved at a meeting of Hellenic by a majority in number of the shareholders holding three quarters in value of the shares involved. But a wholly owned subsidiary of Hambros (MIT) held 53% of the shares in Hellenic and voted for the scheme. Hellenic applied for approval of the scheme and was opposed by a Greek Bank, a 14% shareholder in Hellenic. Its objections were that it wished to retain its membership and also that the cash received for its shares would be subject to heavy capital gains tax liability in Greece.

The Greek bank opposed the approval of the scheme before the court on two grounds. First, MIT as a subsidiary of Hambros had a different interest in the scheme from the other shareholders of Hellenic. MIT was Hambros indirectly; it was seeking to acquire the 47% of Hellenic, which it did not (through MIT) already own. There should therefore have been a separate meeting of the holders of the 47% of Hellenic shares not already under the Hambros’ control through MIT. At such a meeting, the Greek bank (with 14% out of 47%) could have prevented approval by the required three quarters majority.

Secondly, the purpose of the scheme was to enable Hambros to acquire 47% of the shares of Hellenic. (The device of canceling the shares for cash and issuing new ones to Hambros was to save the stamp duty payable on a straightforward transfer of the shares - an example of the advantages of a scheme of arrangement.)

It was argued that a scheme of arrangement should not be used in a situation for which the take-over bid procedure was appropriate. Under take-over bid rules, the required 90% acceptance (from the independent shareholders) would not have been obtained since the Greek bank held more than one-tenth of the outstanding 47% minority shareholdings.

When the scheme is before the court for final approval, a minority may object on any of the various grounds indicated above i.e. that Section 207 procedure is inappropriate or has not been correctly observed, or that approval has not been obtained in a proper way or that the court in its discretion should reject the scheme since it would be unfair.

**If the court approves the scheme and makes an order providing for any of the following under Section 209(1):**

- The transfer of the whole or part of the undertaking and property or liabilities to the “new” company
- The allotment of shares and debentures e.t.c. in that company without winding up;
- The continuation of any legal proceedings.
- The dissolution of the old company without winding up.
- Provision for dissentients.
- Such incidental and consequential matters necessary to secure the scheme to be effective.

An official copy of the order must be delivered to the registrar.

■ **A scheme of arrangement under Section 207 offers the following advantages:**

- (i) It can be used in circumstances to which Section 210 and Section 280 do not apply. As explained above, it has only to be an “arrangement or compromise” of some sort with members or creditors.
- (ii) In circumstances where Section 207 is an alternative procedure a scheme of arrangement only requires approval by three quarters of the votes cast at each meeting. This is a less stringent requirement than Section 210 imposes since Section 210 operates only if holders of 90 per cent of all the shares for which the offer is made accept the offer. If there is doubt whether 90 per cent acceptance is obtainable a Section 207 scheme is to be preferred. But if (as in the *Hellenic & General Trust Case*) the court concludes that an identified minority has been denied the veto which Section 210 would have given it is unlikely to give its approval under Section 207. Apart from technical points it would be unfair to do so.
- (iii) The court order to implement the approved scheme under Section 209(1) often saves substantial expense, which could otherwise be incurred if the arrangement were effected in some other way.

The Company need not be wound up in order to carry out this scheme of arrangement under this section.

The disadvantage of a scheme of arrangement is that it requires the preparation of elaborate documents and the observance of a strict procedure, including an initial and final application to the court and the holding of meetings. All this is expensive. Hence a scheme of arrangement is only suitable for large companies where substantial values or assets are affected. Otherwise it is uneconomical.



If a company, which is or is about to be in voluntary liquidation proposes to make a composition with its creditors it has a choice between the following alternatives:

- A scheme of arrangement under Section 207;
- An arrangement sanctioned by three quarters (in number and in value) of the creditors under Section 300. This liquidation procedure is binding on a minority unless the court on the application of a creditor or contributory (member) orders otherwise.
- A compromise made by the liquidator in exercise of statutory powers under section 241 or Section 297(l)(a). For this purpose, he must obtain approval of members, creditors, committee of inspection or the court according to the circumstances of the case.

It is usual to proceed under Section 207 as there are technical difficulties over Section 300 procedure. The liquidator's powers to reach a compromise with creditors are restricted to cases where all creditors (of the same class) are treated alike, e.g. a uniform payment of Kshs.15 in 1 pound to be accepted in full settlement. But if their rights are to be varied a scheme of arrangement is required, i.e. Section 207 is the correct procedure.



## 2. RECONSTRUCTION UNDER SECTION 280

Section 280 provides that where a company is proposed to be, or is in course of being wound up voluntarily, and the whole or part of its business or property to be transferred or sold to another company, the liquidator of the first-mentioned company (transferee company) may with the sanction of a special resolution conferring either a general authority on the liquidator or an authority in respect of any particular arrangement, receive in compensation or part compensation for the transfer or sale, shares, policies or other like interests in the transferee company for distribution among the members of the transferor company, or may enter into any other arrangement whereby the members of the transferor company may, *in lieu* of receiving cash, shares or other like interests, participate in the profits of or receive any other benefit from the transferee company.

This form of reconstruction is often used when additional working capital is needed and other means of raising it are not available. It has also been used for alteration of the company's objects; variation of shareholders rights and effecting a compromise with creditors.

Reconstruction under this section is subject to several disadvantages and is little used. But when a reconstruction takes this form Section 280 procedure must be followed so that a dissenting minority does have the appropriate safeguard.

This procedure also applies to a company, which is proposed to be, or is in course of being wound up voluntarily. A company in liquidation must dispose of its assets (other than cash) by sale in order to pay its debts and distribute any surplus to its members. The special feature of a Section 280 reconstruction is that the business or property of Company P is transferred to Company Q in exchange for shares of the latter company which are allotted direct or distributed by the liquidator to members of Company P. Obviously, the creditors of Company P will have to be paid in cash. A dissenting minority of members of Company P can also require to be paid in cash. Hence substantial sums may have to be found in cash. This is one of the drawbacks.

A company in (or about to go into) members' voluntary liquidation may, by special resolution, authorise the liquidator to sell the business or property for shares (of some other company) to be distributed to members. But any member who did not vote in favour of the special resolution (**dissentient member**) may in the ensuing seven days deliver to the registered office a notice addressed to the liquidator requiring him either to pay that member the value of his interest in cash or to abandon the proposed sale; Section 280.

If the company is in a creditors voluntary liquidation a special resolution to approve the sale must be passed and it is also necessary for the sale to be approved by the court or by the committee of inspection: Section 292. Moreover, a creditor can at any time within a year of the passing of the special resolution (in a members' voluntary winding up) render it invalid by obtaining a court order for compulsory liquidation; Section 280(5). It is, therefore, prudent to dispose of possible objections by creditors before the company enters into the transaction.

### Hence the usual procedure is

First, to dispose of possible objections by creditors by paying their debts or providing security for their due payment of their debts. Alternatively, the company may seek to obtain the consent of the creditors to the transfer of liability for their debts to the transferee company (as part of the terms on which the business is sold);

Then to convene a general meeting and propose a special resolution to approve the sale of the business in exchange for shares of the purchasing company. It thus becomes evident how many members may demand to be bought out for cash since only members who did not vote in favour of the resolution can opt for the cash payment. If it is clear that the cash expenditure will be prohibitive, the scheme can be abandoned before the company goes into liquidation;

Finally (as the second step at the same general meeting) to move a resolution to go into liquidation. If it is to be a creditors' voluntary liquidation then a committee of inspection must be appointed and asked to approve the sale under Section 292.

If a dissentient member claims to be paid the value of his interest in cash, the amount (if it cannot be agreed) is to be determined by an arbitrator. The member must make out his own case before the arbitrator in support of his claim; the company is not under a duty to answer his questions. If a member fails to give notice within the seven days period to the liquidator of his demand for cash, he is entitled to his proportion of the transferee company's shares or if he refuses to accept them they may be sold and the proceeds paid over in settlement since (by failing to observe Section 280 procedure) he has forfeited his entitlement under Section 280.

The disadvantages of Section 280 are that cash may have to be provided to pay off creditors and dissenting members or alternatively the sale may have to be abandoned. Secondly, the company must go into liquidation, which is an irreversible process. But Section 280 procedure is obligatory in the situation to which it relates. It may be preferable to make the desired reconstruction in





some other way. For example, the company to which the business is to be transferred might make a take-over bid (using Section 210 to achieve 100 per cent success) for the share capital of the company whose business it wishes to acquire. When the latter company is a wholly owned subsidiary, there is no procedural difficulty in transferring its business to the holding company. There is no obligatory cash alternative in a Section 210 transaction though it is sometimes provided as an extra inducement.

The advantage of transferring a business from one company to another (with the same shareholders in the end) is that by this means the business may be moved away from a company with a tangled history to a new company which makes a fresh start. This procedure can also be used to effect a merger of two companies each with an existing business.

## TAKE-OVER BID

If Company A (“the transferee company”) offers to acquire shares of Company B (“the transferor”) and the scheme or contract to which the offer relates is accepted by holders of nine-tenths of the shares for which the offer is made Company A may then compulsorily acquire the remaining 10 per cent (or less) of the shares so as to achieve a complete 100 per cent acquisition of the shares: Companies Act, Section 210.

It is standard procedure in making a take-over bid to state that if 90 per cent acceptance is attained compulsory acquisition under Section 210 will follow. Company A may resort to Section 210 whether it offers its own shares or cash for shares of Company B. The procedure is available if Company A already owns shares of Company B and offers to acquire those which it does not already own (but see Para 22 below.) The non-accepting minority may however apply to the court to prevent Company A from acquiring their shares. The rules of procedure are explained below.

The offer must be made by a company to acquire shares of another. Section 210 is not available to an individual who makes a take-over bid (but he can always form a company for the purpose: provided no fraud or improper conduct is involved: **Re Bugle Press Ltd.** (see paragraph 8.4.11)

If Company B has two or more classes of shares and Company A makes an offer for shares of both classes, this is treated as two separate offers. Section 210 applies separately to shares of each class for which 90 per cent acceptance is obtained. In such cases it is usual (but not legally necessary) for Company A to reserve the right to withdraw its offer for either class if acceptance from the other class does not reach the 90 per cent level which makes Section 210 applicable.

If Company A directly or through subsidiaries owns more than one-tenth of the shares of Company B, then (in order to be able to use Section 210) Company A must:

- (a) Offer the same terms for all the shares which it does not already own.
- (b) Obtain acceptances from holders who are three-quarters in number as well as holders of 90 per cent of the shares.

The wording of Section 210 is ambiguous but it is generally taken that Company A must offer to acquire all of the shares of Company B which it does not already own if it is then to use Section 210 to acquire the remaining shares in Company B (or all the shares of the class) for which the offer is made.

**Acceptance on the required scale must be obtained within a maximum of four months from the date of the offer. The position then is that:**

- a. At the end of the **four month period** (not earlier than that even if 90 per cent acceptance is attained before the period expires) Company A may (but it need not do so if it does not wish-however see paragraph 25 below) serve notice on the non-accepting shareholders of its intention to acquire their shares on the same terms as have been accepted by the majority. This notice may be given at any time within a **two - month period** following the four-month period.
- b. On receiving the notice from Company A each non-accepting shareholder of Company B has one month in which he may apply to the court to order that Company A shall not acquire his shares (see paragraphs 27-28 below).
- c. One month after serving notice on non-accepting shareholders (or if they apply to the court but fail then as the court has disposed of their application) Company A may require Company B
  - (i) To transfer the shares of its non-accepting shareholders to Company A, and
  - (ii) To receive the purchase consideration to hold in trust for the non-accepting shareholders.

By this means the outstanding shares are transferred without any further action on the part of the non-accepting shareholders.

The non-accepting shareholders have a further statutory safeguard. Company A is not obliged to serve notice of intention to acquire their shares. But as soon as Company A's total ownership of shares in Company B reaches 90 per cent (or 90 per cent of a class) it must within **one month** give notice of that fact to the holders of the outstanding shares. Those shareholders may then **within the ensuing three months** require Company A to acquire their shares on the same terms as have been accepted by the approving shareholders. By this means the shareholders who at first did not accept the offer for their shares may accept it in order to escape from the unsatisfactory position or remaining as a very small minority of members in a company (B) dominated by a single shareholder (A): Companies Act, Section 210(2).



The minority whose shares are acquired compulsorily under Section 210 are entitled to all the benefits included in the original offer and accepted by the holders of 90 per cent or more of the shares. Company A must not only pay the same price (or other consideration); it must repeat all other inducements such as a cash alternative. When Company A offers its own shares in exchange for shares of Company B it is a common practice to make the offer more attractive by arranging with a third party that the latter will make a simultaneous offer (for a limited period only) to purchase from shareholders of Company B their consideration shares (allotted by Company A) if they do not wish to retain them. A holder of shares of Company B then has the choice of (i) retaining his new shares in Company A or (ii) selling them (the “cash alternative”) immediately at a stated price to a third party. When Section 210 is used to acquire the outstanding shares of Company B, the bidder (Company A) must arrange for a cash alternative to be provided since that was part of the terms (although it came from a third party) which induced a high level of acceptance: **Re Carlton Holdings** (1971)

A non-accepting shareholder who applies to the court to set aside the proposed compulsory acquisition of his shares under Section 210 will fail unless he can make out a very strong case. Acceptance by holders of 90 per cent or more of the shares indicates that the terms offered are fair. This is so even if the objector contends that he had need of more information in order to reach a decision or that Company A in acquiring control of Company B will obtain special advantages (e.g. elimination of a competitor) which are not reflected in the price offered for his shares. Objection on those grounds only are likely to fail.

But the court will not permit Section 210 to be used in an artificial and oppressive manner.

Case: **RE BUGLE PRESS** (1900)

X, Y and Z held 4,500, 4,500 and 1,000 one-pound shares respectively, of Company B. They were the only shareholders and X and Y were the directors. X and Y wished to eliminate Z. Section 210 however is not available to individuals. So X and Y formed a new company (Company A) in which they were the only two shareholders. Company A then offered to acquire all the shares of Company B. X and Y accepted the offer but Z did not. Company A served notice on Z that it has secured 90 per cent acceptance (the shares of X and Y) and intended to acquire Z's 1,000 shares under Section 210. Z applied to court.

Held:

Company A was a sham since (lifting the veil of incorporation) it was merely the majority shareholders (X and Y) in Company B seeking to expropriate the shares of the minority (Z). Section 210 could not be used in these circumstances. Z's objections were upheld.

The alternative to acquisition under Section 210 (in a take-over bid) is a scheme of arrangement under Section 207. The choice may be determined by comparative costs (see paragraphs 8.3.7(c) and 8.3.8). Stamp duty is payable (at the two per cent ad valorem rate) on transfers of shares of Company B in a transaction to which Section 210 applies. It can be avoided under Section 207. But under Section 210 procedure,

there is usually no expense of court proceeds as few minority shareholders persist in their objections to the point of making application to the court (at some expense to themselves).

On the other hand, if there is uncertainty about obtaining 90 per cent acceptance and a scheme of arrangement is not excessive in costs it is an easier route to the intended result. It is particularly useful when Company A is seeking to acquire those shares of a partly-owned subsidiary (Company B) which it does not own. In such cases, some minority shareholders of B may be indifferent or passively opposed; Company A cannot count on their acceptances (to achieve 90 per cent) but reckons that they cannot or will not deny it a three quarters majority at a meeting. There is often a delicate balance of conflicting risks and considerations in choosing between Section 207 and Section 210 in such situations.

## MERGER OR AMALGAMATION

Merger or amalgamation is not defined in the Act. It is generally used to denote instances in which the property or business of a company is transferred to another company which is already in existence. Alternatively a new company can be incorporated to acquire the business of two or more existing companies. In either case, procedure followed is the same as that followed in a reconstruction.

## RIGHTS OF DISSENTING SHAREHOLDERS

Although a company that makes a takeover bid has a statutory power to buy out dissenting shareholders, it does not mean that any minority of shareholders has to tolerate oppression from the majority. Section 210(1) provides that a dissenting shareholder can apply to courts within one month after the notice is given to the company. The court may make a winding up order or sanction some arrangement at its discretion if satisfied that:

- A minority shareholder is oppressed.
- The scheme will not benefit the company as a whole.
- The transferee company is the same as the majority shareholding in the transferor company.

## RIGHTS OF DISSENTING CREDITORS

The creditor must pay the creditors of the transferor company in the usual way as in a winding up. But if the creditors dissent from the arrangement they may petition for the company to be wound up compulsorily under supervision. The section provides that if an order is made for winding up by the courts or subject to supervision, a special resolution authorizing the arrangement within a year will not be valid unless sanctioned by the courts or committee of inspection.



## CHAPTER SUMMARY

**Schemes involving reconstruction, amalgamation, take-overs, arrangements, and other forms of reorganisation are carried out:**

1. To overcome the Company's financial difficulties
2. To make arrangements with creditors
3. To reorganize the company's capital structure
4. To extend the company's objects.

**In mergers or amalgamations the rights of creditors and shareholders must always be protected**

## CHAPTER QUIZ

1. A merger is also referred to as-----
2. Name any alternative to winding up-----
3. Whose rights must be protected?

## ANSWERS TO QUIZ

1. Amalgamation
2. Reconstruction
3. Share holders and creditors

## A SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

Describe the procedure followed to effect a scheme of arrangement (20 marks)

### QUESTION TWO

Discuss reconstructions under section 280 (20 marks)

### QUESTION THREE

Discuss take over bids (20 marks)

# CHAPTER FOURTEEN



## COMPANIES INCORPORATED OUTSIDE KENYA







# CHAPTER FOURTEEN

## COMPANIES INCORPORATED OUTSIDE KENYA

### ► OBJECTIVES

At the end of this chapter, the student should be able to:

1. Explain provisions relating to the establishment of a place of business in Kenya.
2. Discuss the procedure for incorporating a foreign company.
3. Discuss cessation of business for a foreign company and penalties for non-conformity.

### ► INTRODUCTION

This chapter is a new addition into the new syllabus. The chapter is nearly similar to incorporation but with special attention given to foreign companies. It looks at the procedure for incorporation of a foreign entity, what documents are required and eventually penalties for non-compliance.

### ► KEY DEFINITIONS

- Foreign companies: companies incorporated outside Kenya which, after the appointed day, establish a place of business within Kenya and companies incorporated outside Kenya which have, before the appointed day established a place of business within Kenya
- **Cessation:** Dissolution or stopping to carryout business

### ► EXAM CONTEXT

As mentioned earlier, this is an addition and as such there are no questions from the past paper sittings. A sample of possible exam questions has been compiled at the end of the chapter. The examiner might just test to see whether the student have thoroughly understood and complied to the new syllabus

### ► INDUSTRY CONTEXT

It has been said that no man is an island and the company being a juridical person is no exception. There is need to incorporate foreign companies to encourage healthy competition .In the recent past, various foreign companies have been incorporated in Kenya including Oilibya from Libya.

Covered by part X of the Companies Act cap 486 of the Laws of Kenya

## 14.1 PROVISIONS AS TO ESTABLISHMENT OF PLACE OF BUSINESS IN KENYA

The sections in part X shall apply to all foreign companies, that is to say, companies incorporated outside Kenya which, after the appointed day, establish a place of business within Kenya and companies incorporated outside Kenya which have, before the appointed day established a place of business within Kenya and continue to have a place of business within Kenya on and after the appointed day: A foreign company shall not be deemed to have a place of business in Kenya solely on account of its doing business through an agent in Kenya at the place of business of the agent.

## 14.2 DOCUMENTS TO BE PRESENTED TO THE REGISTRAR

Foreign companies which, after the appointed day establish a place of business within Kenya shall, within 30 days of the establishment of the place of business deliver to the registrar for registration: -

- (a) A certified copy of the charter, statutes or memorandum and articles of the company or other instrument constituting or defining the constitution of the company, and, if the instrument is not written in the English language, a certified translation thereof;
- (b) A list of the directors and secretary of the company containing the particulars mentioned in subsection (2);
- (c) A statement of all subsisting charges created by the company, being charges of the kinds set out in subsection (2) of Section 96 and not being charges comprising solely property situate outside Kenya;
- (d) the names and postal addresses of some one or more persons resident in Kenya authorised to accept on behalf of the company service of process and any notices required to be served on the company; and
- (e) The full address of the registered or principal office of the company.



### 14.3 CERTIFICATE OF REGISTRATION AND POWER TO HOLD LAND

Where a foreign company has delivered to the registrar the documents, the registrar shall, if such documents and particulars are so delivered after the appointed day, certify under his hand that the company has complied with the requirements; and such certificate, and any certificate given by the registrar of companies before the appointed day that a foreign company has delivered to him the documents and particulars required by any provision of any of the repealed Ordinances corresponding to the said section, shall be conclusive evidence that the company is registered as a foreign company for the purposes of this Act.

Where a foreign company has, after the appointed day, delivered to the registrar the documents and particulars mentioned in Section 366, it shall have the same power to hold land in Kenya as if it were a company incorporated under this Act.

Where a foreign company has, before the appointed day, delivered to the registrar of companies, the documents and particulars required by any provision of any of the repealed Ordinances corresponding to Section 366 of this Act and to the like effect, it shall, subject to the provisions of that one of the repealed Ordinances in accordance with which such documents and particulars were so delivered and of this Act, have the same power to hold land in Kenya as if it were a company incorporated under this Act

### 14.4 RETURNS

#### If any alteration is made in

- (a) the charter, statutes or memorandum and articles of a foreign company or any such instrument as aforesaid
- (b) The directors or secretary of a foreign company or the particulars contained in the list of the directors and secretary
- (c) The names or postal addresses of the persons authorised to accept service on behalf of a foreign company
- (d) The address of the registered or principal office of a foreign company, the company shall, within sixty days, deliver to the registrar for registration a return containing the prescribed particulars of the alteration.

**Where in the case of a company to which this Part applies:**

- (a) A winding-up order is made by; or
- (b) Proceedings substantially similar to a voluntary winding up of the company under this Act are commenced in, a court of the country in which such company was incorporated, the company shall within thirty days of the date or the making of such order or the commencement of such proceedings, as the case may be, deliver to the registrar a return containing the prescribed particulars relating to the making of such order or the commencement of such proceedings and shall cause the prescribed advertisements in relation thereto to be published

## 14.5 REGISTRATION OF CHARGES CREATED

**369.** The provisions of Part IV shall extend to charges on property in Kenya which are created, and to charges on property in Kenya which is acquired, after the commencement of this Act, by a foreign company which has an established place of business in Kenya:

Provided that in the case of a charge executed by a foreign company out of Kenya comprising property situate both within and outside Kenya -

- (i) It shall not be necessary to produce to the registrar the instrument creating the charge if the prescribed particulars of it and a copy of it, verified in the prescribed manner, are delivered to the registrar for registration; and
- (ii) The time within which such particulars and copy are to be delivered to the registrar shall be 60 days after the date of execution of the charge by the company or, in the case of a deposit of title deeds, the date of the deposit.

## 14.6 ACCOUNTS OF FOREIGN COMPANIES

**370.**

- (1) Every foreign company shall, in every calendar year, make out a balance sheet and profit and loss account and, if the company is a holding company, group accounts, in such form, and containing such particulars and including such documents, as under the provisions of this Act (subject, however, to any prescribed exceptions) it would, if it had been a company within the meaning of this Act, have been required to make out and lay before the company in general meeting, and deliver copies of those documents to the registrar for registration:

Provided that a foreign company shall not be obliged to comply with the provisions of this section if -



- (i) It was incorporated in the Commonwealth
  - (ii) It would, had it been incorporated in Kenya, have been exempt from the provisions of section 128 by virtue of subsection (4) of that section
  - (iii) In every calendar year there is delivered to the registrar for registration a certificate signed by a director and the secretary of the company verifying the conditions requisite for such exemption.
- (2) **If any such document as is mentioned under subsection (1) is not written in the English language there shall be annexed to it a certified translation thereof.**

## 14.7 NAME OF FOREIGN COMPANIES

371.

(1) **Every foreign company shall:**

- (a) in every prospectus inviting subscriptions for its shares or debentures in Kenya state the country in which the company is incorporated; and
- (b) Conspicuously exhibit in easily legible roman letters on every place where it carries on business in Kenya the name of the company and the country in which the company is incorporated; and
- (c) cause the name of the company and of the country in which the company is incorporated to be stated in legible roman letters in all bill-heads and letter paper, and in all notices and other official publications of the company; and
- (d) if the liability of the members of the company is limited, cause notice of that fact to be stated in the English language in legible roman letters in every such prospectus as aforesaid and in all bill-heads, letter paper, notices and other official publications of the company in Kenya and to be affixed on every place where it carries on its business.

(2) **Every foreign company shall, in all trade catalogues, trade circulars, showcards and business letters on or in which the company's name appears and which are issued or sent by the company to any person in Kenya, state in legible roman letters, with respect to every director being a corporation, the corporate name, and with respect to every director, being an individual, the following particulars:-**

- (a) his present Christian name or the initials thereof, and present surname;
- (b) any former Christian names and surnames;
- (c) his nationality, if he is not a Kenya citizen:

Provided that, if special circumstances exist which render it in the opinion of the registrar expedient that such an exemption should be granted, the registrar may grant, subject to such conditions as may be specified, exemption from the obligations imposed by this subsection

## 14.8 SERVICE OF FOREIGN COMPANIES

### 372.

Any process or notice required to be served on a foreign company shall be sufficiently served if addressed to any person whose name has been delivered to the registrar under the foregoing provisions of this Part and left at or sent by registered post to the address which has been so delivered:

**Provided that:**

- (i) Where any such company makes default in delivering to the registrar the name and address of a person resident in Kenya who is authorised to accept on behalf of the company service of process or notices; or
- (ii) If at any time all the persons whose names and addresses have been so delivered are dead or have ceased so to reside, or refuse to accept service on behalf of the company, or for any reason cannot be served, any process or notice may be served on the company by leaving it at or sending it by registered post to any place of business established by the company in Kenya

## 14.9 CESSATION OF BUSINESS

### 373.

- (1) If any foreign company ceases to have a place of business in Kenya, it shall forthwith give notice in writing of the fact to the registrar for registration and as from the date on which notice is so given the obligation of the company to deliver any document to the registrar shall cease and the registrar shall strike the name of the company off the register.
- (2) Where the registrar has reasonable cause to believe that a foreign company has ceased to have a place of business in Kenya, he may send by registered post to the person authorised to accept service on behalf of the company and, if more than one, to all such persons, a letter inquiring whether the company is maintaining a place of business in Kenya.
- (3) If the registrar receives an answer to the effect that the company has ceased to have a place of business in Kenya or does not within three months receive any reply, he may strike the name of the company off the register.



## 14.10 PENALTIES

### 374.

If any foreign company fails to comply with any of the foregoing provisions of this Part, the company and every officer or agent of the company who knowingly and wilfully authorises or permits the default shall be liable to a fine not exceeding Kshs.1,000, or, in the case of a continuing offence, Kshs 100 for every day during which the default continues

## CHAPTER SUMMARY

A foreign company shall not be deemed to have a place of business in Kenya solely on account of its doing business through an agent in Kenya at the place of business of the agent

Foreign companies which, after the appointed day establish a place of business within Kenya shall, within 30 days of the establishment of the place of business deliver to the registrar for registration: -

- (a) A certified copy of the charter, statutes or memorandum and articles of the company or other instrument constituting or defining the constitution of the company, and, if the instrument is not written in the English language, a certified translation thereof;
- (b) A list of the directors and secretary of the company containing the particulars mentioned in subsection (2);
- (c) A statement of all subsisting charges created by the company, being charges of the kinds set out in subsection (2) of section 96 and not being charges comprising solely property situate outside Kenya;
- (d) the names and postal addresses of some one or more persons resident in Kenya authorised to accept on behalf of the company service of process and any notices required to be served on the company; and
- (e) The full address of the registered or principal office of the company.

### Documents to be presented to the registrar

Every foreign company shall, in every calendar year, make out a balance sheet and profit and loss account and, if the company is a holding company, group accounts, in such form, and containing such particulars and including such documents, as under the provisions of this Act every foreign company shall-

- (a) in every prospectus inviting subscriptions for its shares or debentures in Kenya state the country in which the company is incorporated.
- (b) Conspicuously exhibit in easily legible roman letters on every place where it carries on business in Kenya the name of the company and the country in which the company is incorporated.
- (c) Cause the name of the company and of the country in which the company is incorporated to be stated in legible roman letters in all bill-heads and letter paper, and in all notices and other official publications of the company.
- (d) If the liability of the members of the company is limited, cause notice of that fact to be stated in the English language in legible roman letters in every such prospectus as aforesaid and in all bill-heads, letter paper, notices and other official publications of the company in Kenya and to be affixed on every place where it carries on its business.





- (2) Every foreign company shall, in all trade catalogues, trade circulars, showcards and business letters on or in which the company's name appears and which are issued or sent by the company to any person in Kenya, state in legible roman letters, with respect to every director being a corporation, the corporate name, and with respect to every director, being an individual, the following particulars:
- (a) his present Christian name, or the initials thereof, and present surname;
  - (b) any former Christian names and surnames;
  - (c) his nationality, if he is not a Kenya citizen.

## CHAPTER QUIZ

1. What part of the Companies Act relates to foreign companies?
2. Imprisonment is one of the penalties for non-compliance. TRUE or FALSE?
3. How many months do accounts of foreign companies reflect?

## ANSWERS TO QUIZ

1. Part X
2. FALSE
3. 12-calender year

## SAMPLE OF EXAM QUESTIONS

### QUESTION ONE

What documents must be presented to the registrar of companies (20 marks)

### QUESTION TWO

Discuss returns made to the registrar (20 marks)

### QUESTION THREE

Discuss provisions relating to the name of foreign companies (20 marks)

# PART E



# CHAPTER FIFTEEN



ANSWER BANK





# CHAPTER FIFTEEN

## ANSWER BANK

### CHAPTER ONE

#### QUESTION ONE

There are four main forms of business associations in Kenya. Though there may be others in existences which are beyond the scope of this book. These forms are:

- Sole proprietorship or sole trader
- Partnership
- Companies
- Cooperative

#### 1. SOLE TRADER

This business is owned and controlled by one person. The owner is in complete control and thus receives all profits and suffers all losses. It's very easy to start as all that one needs is capital and a trading license obtained from the relevant local authority. This form of business is found in retail trade and service industries such as hair cutting, plumbing, painting, kiosks, and vegetables and so on.

#### ADVANTAGES

1. Owner receives all profits since he is in complete control of the business
2. It has no formalities in starting as all one requires is a trading license
3. A sole trader is his own master and thus makes all decisions alone he does not have to consult any person which tends to delay decision making in other business forms

#### DISADVANTAGES

1. He has to provide all the capital
2. He bears and suffers all the losses
3. He has to work for long hours to increase profits and this in the long run affects his health
4. There is no scope in sharing ideas for the improvement of the business

#### 2. PARTNERSHIP

This is business owned by at least two people or more but not more than 20 persons. Section 3 (1) of the Partnership Act defines a partnership as the relation which subsists between persons carrying on a business in common with view to making a profit.

Under Kenyan law, there are two types of Partnerships namely General and Limited. The general partnership operates quite similarly to a sole trader but in a limited partnership the liability of the partners is limited. For a partnership there is a deed called a partnership deed that regulates the relationships among the partners.

### ADVANTAGES

- Partners provide capital on terms agreed. They share the net profit or bear the losses in proportions as set out in the partnership agreement
- More capital is available and there is a scope of expanding business
- Sharing of ideas by the partners leads to growth and improvement of business

### Its main DISADVANTAGES are:

- Disagreement among the partners often ruins the business
- Business may stop temporarily after death of one of the partners.

## 3. COOPERATIVE SOCIETIES

This is an association of people who come together with a common objective or aim. It is a form of self-help organisation. It's formed by at least 10 people and membership is open to maximum number of people with the same interest. Members hold shares in the society.

### QUESTION TWO

The main distinction between a company and other forms of business organisations is to be found in the two fundamental principles of company law as discussed below:

- Legal/Corporate personality
- Theory of limited liability

#### 1. Legal/Corporate personality

This principle is to the effect that when a company is incorporated it becomes a legal person distinct and separate from its members and managers. It becomes a body corporate with an independent legal existence with limited liability, perpetual succession, capacity to contract, own property and sue or be sued. The principle of legal personality was first formulated by the House of Lords in its famous case of **Salomon v Salomon and company limited** where Lord Macnaghten was emphatic that the company is at law a different person from the subscribers to the memorandum. This principle is now contained in Section 16(1) of the Companies Act which provides *inter alia* that from the date of incorporation, the subscribers to the memorandum together with such other persons that may become members of the company, are a body corporate by the name contained in the memorandum capable of exercising the functions of an incorporated company with power to hold and having perpetual succession and a common seal.

The decision in **Salomon's case** laid to rest certain principles:





1. That even the so-called one-man companies were legal persons distinct and separate from the members and managers.
2. That incorporation was available not only to large companies but to partnerships and sole proprietorships as well.
3. That in addition to membership, it was possible for a member to subscribe to the company's debentures.

## 2.Theory of limited liability

Liability means the extent to which a person may be called upon to contribute to the assets of the company in the event of winding up. In company law the liability of members may be limited or unlimited. If limited it may be limited by shares or by guarantee as

We then pay special attention to the main differences between a company and a partnership. The basic differences between registered companies and partnerships are as follows:

(a) Formation

Registration is the legal pre-requisite for the formation of a registered company: Fort Hall Bakery Supply Co v Wangoe (1).

The Partnership Act does not prescribe registration as a condition precedent to partnership formation. A partnership may, therefore, be formed informally or, if the partners deem it prudent, in writing under a Partnership Deed or Articles.

(b) Legal Status

A registered company enjoys the legal status of a body corporate which is conferred on it by the Companies Act.

A partnership is not a body corporate and is non-existent in the contemplation of the law. Such business as appears to be carried on by it is, in fact, carried on by the individual partners.

(c) Number of Members

A registered private company must have at least two members under Section 4 of the Companies Act and a maximum of fifty members (excluding current and former employees of the company who are also its members), under Section 30 of the Act. A public registered company must have at least seven members under Section 4 of the Companies Act but without a prescribed upper limit. A partnership cannot consist of more than 20 partners.

(d) Transfer of Shares

Shares in a registered company are freely transferable unless the company's articles incorporate restrictive provisions.

A partnership has no shares as such but a partner cannot transfer his interest in the firm to a third party unless all the partners have agreed to the proposed transfer.

## (e) Management

A company's members have no right to participate in the company's day-to-day management. Such management is vested in the board of directors.

Partners have the right to participate in the firm's day-to-day management since Section 3 of the Partnership Act requires the business to be carried on "in common". The right of participation in the firm's management is however not given to a partner who has limited his liability for the firm's debts.

## (f) Agency

A member is not, per se, an agent of the company: Salomon v Salomon & Co Ltd (3). A partner is an agent of the firm because the business is carried on "in common" by the partners themselves. The Partnership Act, Section 7 also expressly provides that every partner is an agent of the firm and his other partners for the purpose of the business of the partnership.

## (g) Liability of Members

A company's member is not personally liable for the company's debts because, legally, they are not his debts.

A partner is personally liable for the firm's debts. This rule has been codified by Section 11 of the Partnership Act which provides that "every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner", unless the partner is a limited partner.

## (h) Powers

The *ultra vires* doctrine limits a company's powers to the attainment of the company's objects under its Memorandum of Association. Partnerships are not affected by the *ultra vires* doctrine and partners enjoy relative freedom to diversify the firm's operations.

## (i) Termination

A member's death, bankruptcy or insanity does not terminate the company's legal existence whereas a partner's death, bankruptcy or insanity terminates the partnership unless the partnership agreement provides otherwise.

## (j) Borrowing Money

A company can borrow on the security of a "floating charge". A partnership cannot borrow on a "floating charge".

## (k) Ownership of Property

A company's property does not belong to the shareholders, either individually or collectively. Consequently, a member cannot insure the property since he has no insurable interest therein: Macaura v Northern Assurance Co (4). A firm's property is the property of the partners who can, therefore, insure it and, in the case of cash, make drawings from it.



## QUESTION THREE

### LAW RELATING TO OTHER ORGANISATIONS

#### COOPERATIVES

Cooperatives in Kenya are governed by the Cooperative Societies Act chapter 490 of the laws of Kenya enacted in 1966. They are also governed by the cooperative society rules enacted in 1969. The rules provided for the following matters:

1. Registration of cooperatives and maintenance of related documents.
2. Contents of by-laws and amendment procedures.
3. Society membership.
4. Maintenance of books.
5. Services to be rendered by district cooperative unions.
6. Financial control through meetings.
7. Property and funds of the society.
8. Arbitration

#### PARTNERSHIPS

The law relating to partnerships in Kenya is contained in the Partnership Act Chapter 29 of the laws of Kenya and the Limited Partnership Act chapter 30 of the laws of Kenya. The partnership act is based on the English Partnership Act 1890. These two statutes codify the law on partnerships in Kenya.

## CHAPTER TWO

### QUESTION ONE

#### a) Memorandum of Association

- 1 This is one of the constitutive documents. It is the external constitution of the company. It provides for the relationship between the company and third parties.
- 2 It is a mandatory document – every company must have it.
- 3 Its contents are prescribed by Section 5 and 6 of the Companies Act e.g. name, object, and capital.

#### Articles of Association

- 1 This is one of the constitutive documents. It provides for the internal constitution. It contains the rules for the internal management of the company's affairs. It regulates the relations between the company and its members.

#### Main difference between the two

- 2 The Memorandum of Association provides for the relationship between the company and the outside world while the Articles of Association provides for the rules of internal management of the company's affairs.

## b) Details in the Memorandum of Association

Contains the following clause:

1. **Name clause** – name of the company with limited as the last word thereof.
2. **Objects clause** – the purposes for which the company is incorporated.
3. **Registered office clause** – this is the domicile of the company.
4. **Capital clause** – this is the authorised or nominal capital.
5. **Liability clause** – states that the company is limited by shares or guarantee.
6. **Association clause/declaration clause** – states the desire of members to be incorporated.
7. Particulars of subscribers and signature
8. **Date** - the memorandum must be dated.

### Details in the Articles of Association

Assuming the company adopts the model article in Table A of the first schedule to the Companies Act, the Articles of Association must contain *inter alia*.

1. Transfer and transmission of shares.
2. Calls.
3. Meetings generally.
4. Declaration and payment of dividend.
5. Powers of directors.
6. Office of the managing director.
7. Bonus issues.
8. Winding up.
9. Voting.
10. Lien on shares.

## QUESTION TWO

- a) A pre-incorporation contract is a contract entered into before a company is incorporated.

### Rules governing pre-incorporation contracts

- A pre-incorporation contract does not bind the company.

#### Kelner v Baxter

Company cannot ratify a pre-incorporation contract

#### Natal Land Co. v Pauline Colliery Syndicate

#### Price v Kelsal

- A promoter is personally liable on a pre-incorporation contract

#### Kelner v Baxter

#### R v Kyslant

- The company may be bound by a pre-incorporation contract if it enters into a new contract similar to the previous agreement.

#### Mawagola Farmers Co. v Kayanja and others

- Before incorporation the company lacks contractual capacity and cannot have agents



- b) Kioko was a promoter of the company and he stood in a fiduciary position towards the company he was promoting. Therefore he was bound to disclose any secret profits made in the course of the promotion which he did not.

Therefore my advice to Musembi as to the company's rights is:

- The company can rescind the contract.
- To recover the secret profit made by Kioko.
- To sue for damages for breach of fiduciary duties.

My advice is based on the decisions in Erlanger v New Sombrero Phosphate Co., Gluckstein V Barnes

## QUESTION THREE

### Statutory Provisions

The following are the sections of the Kenya Companies Act which correspond to those sections of the English Companies Act 1948, which are usually listed in English Company law textbooks as the instances in which the veil of incorporation will be lifted under express statutory provisions:

- (a) Section 33: Membership fallen below statutory minimum

This section provides that a company's member is personally liable for the company's debts incurred after the six months during which the company's membership had fallen below the statutory minimum, provided he was cognisant of the fact that the membership had so fallen. The section is regarded as an instance of "lifting the veil" because it modifies the principle established in *Salomon v Salomon & Co Ltd* that a member is not liable for the company's debts, and permits the company's creditors to sue him directly in order to recover the debts. Liability under the section may arise on the death of a member if the death reduces the membership below the statutory minimum for the particular company and:

- (i) No transferee is registered as a new member
- (ii) The personal representative of the deceased member does not elect to be registered as a member, within the prescribed six months.

It should be noted that the section limits a member's liability to debts contracted after the six months. It does not make the member liable for any debts incurred during the six months which follow the reduction of membership. Neither does it make a member liable for any tort committed by the company during the relevant time.

- (b) Section 109 (4): Non-publication/Misdescription of a Company's Name

Subsection (1) of Section 109 of the Act requires a company's officers and other agents to write its name on its seal, letters, business documents and negotiable instruments. This is to be done primarily for the benefit of third parties who might contract with a limited company without realising that it is a limited company.

Subsection (4) of the section provides that any officer or agent of the company who does not comply with the aforesaid statutory requirements shall be liable to a fine not exceeding Kshs 1,000, and shall further be personally liable to the holder of any bill of exchange, promissory note, cheque or order for goods, which did not bear the company's correct name, unless the amount due thereon is duly paid by the company. The imposition of personal liability on the company's agent is what is regarded, in a somewhat loose sense, as "lifting the veil of incorporation". A probably better view would be to regard the section as a codification of the common law rule which makes an agent personally liable under a contract which he enters into with a third party without disclosing that he is acting for a principal. That, in effect, is what happens if a company's agent does not comply with the statutory requirement.

Liability under this section is illustrated by Nassau Steam Press v Tyler & Others (7) and Penrose v Martyr (8). In the latter case, the plaintiff told the court that she was NOT aware that the company was limited till after the bills were accepted. She had, therefore, been misled as to the legal status of the company. It should, however, be noted that the section does not require that the third party suing the company's officer should have been misled by the officer's failure to write the company's name correctly.

(c) Section 150: Group Accounts

Section 150 requires a company which has subsidiaries to lay before the company in general meeting accounts or statements dealing with the state of affairs and profit or loss of the company and the subsidiaries at the time when the company's own balance sheet and profit and loss account are laid before the company's general meeting. The group accounts are to be prepared in accordance with the provisions of Sections 150 - 154 and paragraphs 17 - 18 of the Sixth Schedule to the Companies Act so as to appear "as the accounts of an actual company".

These provisions constitute what is regarded in a loose sense as an instance of "lifting the veil" because a member (the holding company) is obliged to incorporate into its balance sheet the assets and liabilities of the company of which it is a member (the subsidiary company) as if they were its own assets and liabilities. This is a modification of the general principle that a company's assets and liabilities are not a member's assets and liabilities and would not, therefore, be incorporated into the member's own balance sheet.

(d) Section 167: Investigation of Company's Affairs

Section 167 gives an inspector appointed by the court powers to investigate the affairs of that company's subsidiary, or holding company, if the inspector thinks it necessary to do so for the purpose of his investigation. An investigation instituted pursuant to this power would be regarded, in a loose sense, as an instance of "lifting the veil" because the order to investigate a company sufficed to investigate the company's member, or vice versa, as if they were one entity.

Generally speaking, a company and its member (in this case, the holding company) are altogether separate entities and a court order to investigate the affairs of a subsidiary company would not authorise an investigation of its holding company, and vice versa.



(e) Section 173 (5): Investigation of Company's Membership

Section 173(1) empowers the registrar to appoint one or more competent inspectors to investigate and report on the membership of any company for the purpose of determining the true persons who are or have been financially interested in the success or failure of the company or able to control or materially to influence the policy of the company.

For the purpose of that investigation, subsection 5 of the section confers on the inspector, or inspectors, power to investigate the membership of the company's subsidiary or holding company for the same purpose. A company and its subsidiary, or subsidiaries, are thereby regarded as one entity for the purpose of the investigation and the veil of incorporation thereby lifted.

(f) Section 210: Take-over bids

Section 210 provides that where a scheme or contract involving the transfer of shares or any class of shares in a company to another company has been approved by the holders of not less than nine-tenths in value of the shares whose transfer is involved the transferee company may, at any time within two months after the expiration of four months after the making of the offer by the transferee company, give notice in the prescribed manner to any dissenting shareholder that it desires to acquire his shares. The dissenting shareholder must then apply to the court within one month from the date on which the notice was given for an order restraining the transferee company from compulsorily acquiring his shares. The court order may, in an appropriate situation, lift the veil of incorporation. This is illustrated by Re: Bugle Press Ltd (9) in which an offer made by a company was regarded as having been made, in substance, by the company's members. The court thereby lifted the veil of incorporation by treating the company and its members as one entity for purposes of acceptance of the offer.

(g) Section 323: Fraudulent Trading

Section 323 provides that if, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the court, on the application of the official receiver or the liquidator or any creditor or contributory of the company may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

The personal liability of the person concerned for the company's debts is what constitutes, in an extremely loose sense, an instance of lifting the veil of incorporation. The corresponding section of the English Companies Act is invariably cited in English company law textbooks as an instance of lifting the veil. The citation, though hallowed by English academic tradition, is logically untenable.

No Kenya case appears to have been decided under the section. However, the relevant English cases do suggest that to be "knowingly parties" to fraudulent trading under the section some positive step must have been taken by those concerned: Re: Maidstone Building Provisions Ltd (10).

It should be noted that, on its literal construction, Section 323 appears to be wider than Section 33 because it also covers liabilities other than debts, such as liability in tort, or damages for breach of contract. It can also be invoked against directors, members or anybody else who participated in the fraudulent trading. However, the obvious limitations of the section are that it can only be invoked on a winding up and the applicant must prove fraud.

If the liquidator applies to the court any money received is distributed to creditors generally and forms part of the general assets of the company: Re William C Leitch Ltd (No 2) (II). However, if a creditor applies, the court may award him his actual loss or, alternatively, order the defendants to pay his actual debt: Re: Cyona Distributors Ltd (12).

## Lifting the veil under Case Law

Numerous English cases have been variously classified by English writers as instances of “lifting the veil of incorporation”. A few of these cases are summarised below. But it should be noted that the particular judges were merely ascertaining the facts of the case before them and making the appropriate decision rather than consciously or deliberately “lifting the veil of incorporation”. It is the writers who have categorised the said cases as instances of lifting the veil because the decisions in those cases appeared to them to be a modification of the principle in Salomon’s case. These cases may be explained under the following headings.

### (a) Agency/Trustee/Nominee

One of the ratio decidendi in Salomon’s case was stated by Lord Macnaghten that “the company is not in law the agent of the subscribers”. This proposition was affirmed by the English Court of Appeal and extended to associated companies in Ebbw Vale Urban District Council v South Wales Traffic Area Licensing Authority when Lord Cohen stated:

“Under the ordinary rules of law, a parent company and a subsidiary company, even a 100% subsidiary company, are distinct legal entities, and in the absence of an agency contract between the two companies, one cannot be said to be the agent of the other. That seems to me to be clearly established by Salomon v Salomon & Co Ltd (3).”

From this statement, it can be inferred that, if a court held that a company acted in a particular instance as an agent of its holding company, the veil of incorporation would have been lifted. This is illustrated by the decision in Firestone Tyre & Rubber Co v Llewellyn (12) in which it was held, on the basis of the trading arrangements between the holding company and its subsidiary, that the subsidiary was the agent of the holding company.

### (b) Fraud or improper conduct

English courts have intervened on numerous occasions and lifted the veil of incorporation in order to circumvent a fraudulent or improper design by a bunch of scheming promoters





or shareholders. This is illustrated by the decisions in Jones and Another v Lipman and Another (13) and Gilford Motor Co Ltd v Horne (14). The court's order in the latter case is usually cited as an instance of lifting the veil but it should be noted that the defendant (Horne) was not a member of the company and, in principle; no veil existed between him and the company which would have been lifted by the court. It is rather an instance of the court regarding the company as Mr Horne in another form ("alter ego").

(c) Enemy Character

A company may be regarded as an enemy if, inter alia, all or substantially all of its shares are held by alien enemies. This is illustrated by Daimler Co Ltd v Continental Tyre & Rubber Co (Great Britain) Ltd (15). Since there appears to be no Kenya case on the point, the principles summarised by Lord Parker may be useful guidance to a Kenyan who might have to determine, in a given case, whether a particular company is to be regarded as a friend or enemy of Kenya.

(d) Ratification of Corporate Acts

A number of English cases which are regarded as instances of lifting the veil are those relating to informal ratification by the members of acts done on behalf of the company. In each of these cases the court regarded a decision of the members as the decision of the company itself and thereby lifted the veil of incorporation. This is illustrated by Re Duomatic Ltd (16) and Re: Express Engineering Works Ltd (17).

(e) Group Enterprises

Numerous cases have been decided by English courts the general tenor of which is to regard a subsidiary and its holding company as one entity. There is no basic principle governing the lifting of the veil in these instances and each decision was based on the facts of the particular case. Examples are Harold Holdsworth & Co Ltd caddies (18), Hellenic and General Trust Ltd (19) and DHN Food Distributors v London Borough of Tower Hamlets (20).

## CHAPTER THREE

### QUESTION ONE

- a) Contents of the Register of Members
1. Name and address of every shareholder.
  2. Number of shares or stocks held.
  3. Date of entry of the name.
  4. Date of removal of the name.
  5. Amount paid on each share.
  6. Postal address of every member.
- b) My advice to Njoroge is that he should apply to the High Court for an order of rectification of the register to include his name. My advice is based on the Provisions of the Companies Act.

- c) The principle has the following consequences:
1. A company cannot purchase its own shares.
  2. A company must not give financial assistance for the purchase of its own shares.
  3. Dividends must not be paid except out of distributable profits.
  4. Where a public company suffers a serious loss of capital, a meeting of the company must be called to discuss the issue.
  5. Shares must not be issued at a discount.
  6. Reduction of capital must strictly comply with the provisions of the Companies Act.

## QUESTION TWO

- a) Ways of raising capital
1. Offer of shares through the issue of a prospectus, offer for sale, placing etc.
  2. Borrowing.
  3. Bonus issues.
  4. Issues on take-overs.
- b) Issue of shares at a discount
1. The shares must belong to a class already issued by the company.
  2. One year must have elapsed from the date the company was entitled to commence business.
  3. It must be authorised by a resolution of members in general meeting
  4. The resolution must fix the maximum rate of discount at which the shares are to be issued.
  5. The issue must be approved by the court.
  6. The issue must be made within one month from the date of approval by the court or such extended time as the court may permit.
  7. The issue must be disclosed in the prospectus of the company.
- c) Terms implied in a contract of sale of shares between a seller and purchaser.
- 1 That the buyer will pay the price of the shares.
  - 2 That the seller has the right to sell.
  - 3 That the purchaser shall indemnify the seller against any calls made after the date of the contract.
  - 4 The seller will give to the purchaser a genuine share certificate required to enable the purchaser to be registered as member.
  - 5 The seller will not do anything preventing the buyer from having the transfer registered or delay the process.
  - 6 The seller will compensate the buyer for any calls or liability which may arise in respect of the shares sold.

## QUESTION THREE

- a)
1. The issued capital of the company whether paid up or not must be maintained.
  2. It is in principal regarded as a permanent fund or a fund of last resort available to all creditors in the event of default by the company.
  3. The capital of a registered company must remain certain. It acts as a guarantee that creditors will be paid. Creditors are entitled to insist that no part of the company's



- capital is wasted or returned to members.
4. Creditors and other persons who deal with companies are aware that the companies have an amount of capital and are entitled to insist no part thereof is returned to members without due compliance with law.
  5. It is, therefore, a fundamental principle of company law that capital be maintained.
  6. Company Law has evolved both statutory provisions and prepositions of common law to facilitate the raising and maintenance of capital. One of these provisions is that the company should only reduce capital in accordance with the provisions of the Companies Act. These provisions of the Companies Act prescribe the circumstances and conditions under which a company may reduce capital.

i) Authority of the Articles

Under Section 68 (1) of the Companies Act, a company limited by shares or guarantee and having a share capital may reduce its capital of authorised by its articles.

ii) Special Resolutions

Under Section 68(1) of the Act reduction of capital of capital by a company must be authorised by a special, resolution of members in general meeting. This resolution is referred to as “resolution for reducing share capital”. The reduction of capital may take the form of:

Reducing or extinguishing liability on any unpaid up capital.

Cancellation of any paid up capital, which is lost or unrepresented by available assets.

Paying off any paid up capital, which is in excess of the wants of the company.

iii) Application to court for confirmation

Under Section 69(1) of the Act, after the special resolution is passed, an application must be made to the High Court for confirmation of the reduction. The essence of the application is for the court to satisfy itself that the reduction does not unfairly prejudice the position of any class of members or creditors. In particular the court must settle a list of all creditors and must satisfy itself that any creditor entitled to object to the reduction has either objected or consented to the same. In the case of an objection, the court must be satisfied that the creditors claim or debt has been discharged, determined or secured. If the court is so satisfied, it may confirm the reduction.

iv) Confirmation of the reduction

Under Section 71 (1) of the Act, if the court is satisfied that creditors entitled to object to have consented or in the case of an objection, the creditors claim or debt has been discharged, determined or secured it may make an order confirming the reduction on such terms and conditions as it deems fit. The court may for any special reason if it deems fit order the company to add the words “and reduced” to it’s name for a specified duration. Such words form part of the company’s name for the duration of the order.

v) Registration of the reduction

Under Section 71 (1) of the Act, upon production of a certified court order approving the reduction and the minute of the same the registrar registers the

reduction and issues a certificate of registration, which is conclusive evidence that the requirements of the act relating to reduction of capital have been complied with. A reduction of capital by a company take effect when registered and notice of registration must be published in accordance with the courts direction

### Underwriting Commission

This is the amount or sum paid by the company to a person who agrees to underwrite the company's shares i.e. take up all the shares or a specified number of the shares not taken up by the public. It's payable whether the person (Underwriter) takes up the shares or not. It must be disclosed in the company's prospectus.

### Brokerage

This is an amount paid by the company to a person (or persons) who agrees to place the company's shares i.e. exhibits the company's prospectus in their premises or send copies to their clients, but without incurring any liability on the shares.

It is an amount only payable to brokers.

It must be disclosed in the company's prospectus.

## CHAPTER FOUR

### QUESTION ONE

#### Crystallization of Floating Charges

A floating charge is a charge on a class of assets of a company. The actual assets in that class owned by the company change from time to time. The assets that the chargee is entitled to utilise for payment of the secured debt are the assets in the class that the company owns at the time when the charge crystallises. On crystallisation a floating charge becomes a fixed or specific equitable charge.

#### A floating charge crystallises:

- (i) When the chargee appoints an administrative receiver.  
The power to do so exists only by virtue of the charge contract, which must, therefore, specify the circumstances in which the power is exercisable. e.g.
  - 1 Liquidation or winding up
  - 2 Appointment of a receiver
  - 3 Levy of execution or distress
  - 4 Insolvency
  - 5 Cessation of business



- (ii) When the company goes into liquidation.
- (iii) When the company ceases to carry on business.
- (iv) If the charge contract so provides, when the chargee gives notice that the charge is converted into a fixed charge on whatever assets of the charged class are owned by the company at the time the notice is given.
- (v) When another floating charge on the company's assets crystallises, it causes the company to cease business.
- (vi) When there is Commencement of recovery proceedings against the company.
- (vii) Occurrence of an event, which under the terms of the debenture causes crystallisation.

#### (a) Advantages of floating charges

From the company's point of view, a floating charge may be regarded as conferring the following advantages:

- i. The company is free to deal with the assets charged as if they had not been charged.
- ii. Enables companies without fixed assets to borrow.
- iii. It enables the company to charge property which otherwise would not have been charged since such property cannot be subject to a fixed charge.
- iv. Enhances the borrowing capacity of a company of floating charges.

#### (b) Disadvantages of floating charges

From the lender's point of view, a floating charge has the following disadvantages:

- i. The value of the assets charged is uncertain since no particular assets are charged.
- ii. A floating charge created within six months before the commencement of winding up is deemed to be a fraudulent preference and is void.
- iii. It is postponed to a later fixed charge.
- iv. The charge may be avoided, during the company's liquidation, under Section 314 of the Act; unless it is proved that the company immediately after the creation of the charge was solvent.
- v. Where a seller of goods reserves title until payment, a floating charge will not, on crystallisation, attach to these goods. This is illustrated by Aluminium Industries Vaassen v Romalpa Aluminium (647).
- vi. Certain other interests e.g. landlords distress for rent have priority over floating charges.

## QUESTION TWO

### Debenture Trust Deed

When debentures are offered for public subscription, the company usually enters into a trust deed with trustees (usually a trust corporation). The trustees are appointed and paid by the company to act on behalf of the debenture holders. The charge securing the debentures is made in favour of the trustees who hold it on trust for the debenture stockholders.

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A debenture stockholder, unlike debenture holder, is not a creditor of the company. He cannot therefore present a petition to wind up the company: Re Dunderland Iron Co Ltd. The trustees are technically the creditors of the company for the whole debenture debt while the stockholder is an equitable beneficiary of the trust.

## Contents of a Trust Deed

**The main terms of a trust deed are usually some or all of the following:**

- i. A covenant (promise) by the company to pay to the debenture holders the agreed instalments of the loan and accrued interest.
- ii. A description of the property charged, whether specifically or by way of a floating charge.
- iii. The events in which the security is to become enforceable, such as failure to pay the principal sum or interest as agreed.
- iv. A clause empowering the trustees to take possession of the property charged in the event of the security becoming enforceable, and to carry on the business and to sell the property charged.
- v. Appointment of a receiver
- vi. Meetings of debenture holders.
- vii. Covenants by the company to insure the property charged and to keep the property charged in good repair.

## Advantages of a Trust Deed

**A trust deed has several advantages some of which are:**

- (a) The circumstances in which the principal sum may become repayable are clearly spelt out.
- (b) The appointment of trustees facilitates the efficient administration of the trust since they are there to exercise continuous supervision of the debenture holders' rights and to take prompt action if the need arises.
- (c) The trustees are empowered to appoint a receiver to carry on the business in case of urgency.
- (d) Covenants are entered into by the company for insurance, repair and other matters, which can be enforced by the trustees.
- (e) The trustees have a legal mortgage over the company's land.

## Liability of Trustees

Trustees for debenture holders owe the same duties to their beneficiaries as are owed by trustees in general. In particular, they cannot purchase the debentures without the consent of all the debenture-holders. Section 90 (1) provides that any provision in a trust deed, or in a contract with the holders of debentures secured by a trust deed, for exempting a trustee from, or indemnifying him against, liability for breach of trust where he fails to show the degree of care and diligence required of him as trustee (having regard to the provisions of the trust deed) shall be void. This provision does not, however, invalidate:



- i. Any release given after the liability has arisen
- ii. A provision in a trust deed for the giving of such a release by a majority of not less than three-fourths in value of the debenture holders present and voting in person or by proxy at a meeting summoned for the purpose
- iii. A provision in a trust deed for the giving of such a release either with respect to specific acts or omissions or on the trustee dying or ceasing to act.

## QUESTION THREE

Section 2 of the Act defines “debenture” as including “debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not”.

There is no precise legal definition of a “debenture”. In Levy v Abercorris Slate & Rubber Co Chitty, J stated that he could not find any precise legal definition of the term “debenture” and went on to observe that the word “is not, either in law or commerce, a strictly technical term, or what is called a term of art”. He also stated that, etymologically, the word is a derivation from the Latin Debenture mihi which were the opening words of certain documents, which used to be issued by English companies in the 1860s as an acknowledgement of a loan the companies had received from the person to whom the document was issued. With the passage of time the word “debenture” acquired the meaning it generally has today, namely, a document issued by a registered company to acknowledge, or evidence, an indebtedness. Primarily, the word “debenture” is applied not to the indebtedness itself but to the document evidencing it.

### Debentures and debenture stock

**A debenture is usually a formal document in printed form. The main types, which a company can issue, are:**

(a) A Single Debenture

A single debenture is usually a formal document in printed form and sealed. It is usually issued when a company obtains a loan from a single lender, such as its bank. The bank would normally insist that the company signs and seals one of the bank’s standard forms of debenture which would not only create a charge in favour of the bank but would also give it certain powers in relation to the charged property.

(b) Debentures Issued as a Series

Debentures are issued as a series if the company decides to borrow money from different lenders on different dates but in such a way that the lenders would rank equally in their right to repayment and in any security given to them. Each lender receives a debenture in identical form in respect of his loan and the debentures are expressed to form a series ranking *pari passu*.

(c) Debenture Stock

“Debenture stock” is created when a public company issues “debenture stock certificates” to a class of debenture holders, evidencing the portion of the total to which each one of them is entitled. Each lender has a right to be repaid his capital at the due time and, before that time, to receive interest on it at the agreed rate. Each debenture will be for a specified sum, e.g. Kshs.100 or Shs.1,000, as stipulated in the conditions of issue.

## Types of debentures

### Debentures may be issued as:

- i. Redeemable or irredeemable
- ii. Registered or bearer
- iii. Secured or unsecured (naked)

## Subordinated debentures

Under American law, these are obligations often referred to as subordinated debts, junior debts or inferior debts, upon which the right to receive payment is subordinated or deferred by a subordination agreement or clause, to the prior payment of certain other indebtedness, sometimes referred to as senior, superior or prior debts. The subordination may be incomplete or complete. If complete, the payment of principal and interest on the subordinated debt is deferred until the obligations on the senior debt are satisfied. The subordination is valid as between the parties.

## Issue of Debentures

Debentures are usually issued by a resolution of the board of directors under powers conferred by the company's articles of association. Table A, Article 79 provides that "the directors may exercise all the powers of the company to borrow money ... and to issue debentures, debenture stock, and other securities". Such authority is however not required in the case of a trading company which has implied power to borrow money for the purposes of its business, and to give security for the loan by creating a mortgage or charge over its property.

## Debentures and Shares

### Debentures and shares have the following similarities and differences.

- (a) Similarities
  - i. A debenture is usually one of a "series" or "class", which is similar to a "class" of shares.
  - ii. Debentures, as well, as shares are long-term investments in the company and are transferable in the same manner.
  - iii. Debentures and shares may be issued in the same way through a prospectus issue.
- (b) Differences
  - i. A shareholder is a member (i.e. an insider) whereas a debenture holder is a creditor (i.e. an outsider).
  - ii. A shareholder has an interest in the company but not in the company's property. A debenture holder has no interest in the company but has an interest in the company's property, which constitutes his security. Consequently:

A shareholder can attend a meeting of the company and vote at the meeting whereas a debenture holder cannot do so.





A shareholder cannot insure the company's property whereas a debenture holder can do so (unless the debenture is a 'naked' one).

- iii. Interest on debentures must be paid even if the company does not make a profit and can, therefore, be paid out of capital. Dividends on shares are payable only if profits are made and cannot be paid out of capital.
- iv. A company can purchase its own debentures but cannot, as a general rule, purchase its own shares.
- v. As a general rule, shares cannot be issued at a discount, whereas debentures may be issued at a discount.

## CHAPTER FIVE

### QUESTION ONE

#### Methods of becoming a member

A person may become a member of a company in one or other of the following ways:

i. Subscribing to the Memorandum

Section 28 (1) provides that the subscribers to the company's Memorandum shall be deemed to have agreed to become members of the Company and on the registration of the memorandum shall have their names entered in the company's register of members.

The provision regarding entry in the register is an administrative directive for the company's implementation and non-compliance with it does not affect the pre-existing membership.

ii. Allotment

A person to whom a company's shares have been allotted acquires his membership by virtue of sub-section 2 of Section 28, being a person who has agreed to become a member. However, it was held in NICOL'S case that the membership commences from the moment the name is entered in the members' register. If the company wrongfully refuses to enter the name in the register, the allottee must take rectification proceedings for a court order directing the company to enter the name in its members' register.

iii. Transfer

A transfer is a purchase of shares from a company's shareholder, and not from the company itself.

A transferee also acquires his membership by virtue of sub-section 2 of Section 28, being a person who has agreed to become a member. The principle in NICOL'S case applies to transferees as well, and a transferee becomes a member from the moment his name is entered in the register of members.

iv. Transmission on death of a member

A transmission is a legal process by which ownership of shares in a company changes automatically on the death of a member to his personal representative. This is acknowledged by Table A, Article 29, which provides that “in case of the death of a member ... the personal representatives of the deceased where he was a sole holder shall be the only persons recognized by the law as having any title to his interest in the shares”.

If the personal representative elects or decides to be registered himself as the holder of the shares, the election constitutes the agreement to be a member, and the provisions of Section 28 (2) become applicable, namely, he will become a member from the moment his name is entered in the register of members.

v. Transmission on bankruptcy of member

A bankrupt member’s shares in a company will be transmitted to his trustee in bankruptcy according to the principles of bankruptcy law. The company’s articles may give the trustee an option of being personally registered as a member, as is provided for by Table A, Article 30. If the trustee elects or decides to be registered as the holder of the shares the election constitutes the agreement to be a member and the provisions of sub-section 2 of s.28 become applicable—i.e. the trustee in bankruptcy will become a member from the moment his name is entered in the register of members.

vi. Compliance with Section 182 (2)

A person who has consented to be a director, and has given the statutory undertaking to take and pay for his qualification shares, is declared by Section 182(2) to be, “in the same position as if he had signed the memorandum.”

The provisions of Section 28 (1) accordingly apply to him, and he becomes a member of the company when Memorandum of Association is registered.

vii. Estoppel

A person who, without having agreed to be a company’s member, is aware that his name is wrongly entered in its register of members but takes no steps to have his name removed there from, may be estoppel from denying his apparent membership to somebody who relied on it and extended credit to the company.

## QUESTION TWO

### Cessation of Membership

A person’s membership of a company may cease or come to an end in many ways, some of which are:

i. Transfer

A “transfer” of shares occurs if an existing member sells them to a third party. If the third party is not yet a member, he will become a member from the moment his name is entered in the company’s register of members.

However, the transferee does not automatically cease to be a member as a consequence of the transfer. A member is not bound to sell all of his shares whenever he contemplates



a sale. Table A, Article 23, permits members to transfer all or any of their shares. A member, therefore, ceases to be a member only if he transfers ALL of his shares.

ii. Forfeiture

Where a company's articles authorise the directors to forfeit a member's shares and the director's forfeit ALL of the shares held by a member, the member will cease to be a member from the date specified in the articles as the effective date for forfeiture.

Table A, Article 38 provides that "a statutory declaration in writing that the declaring is a director or the secretary of the company, and that a share in the company has been duly forfeited on a date stated in the declaration, shall be conclusive evidence of the facts therein stated."

Article 37 provides that a person whose shares have been forfeited shall cease to be a member in respect of the forfeited shares.

He therefore ceases to be a member of the company only if all of the shares previously held by him are forfeited.

iii. Surrender of Shares

The precise nature of surrender and the machinery by which it is effected are not clear since it is not provided for by the Companies Act or Table A. However, in Trevor v Whitworth, the judge stated that a surrender "does not involve any payment out of the funds of the company," and that "if it were accepted in a case where the company were in a position to forfeit the shares the transaction would seem to me perfectly valid," presumably even if not expressly authorised by the articles.

A person's membership will therefore come to an end if he surrenders all his shares to the company with the approval of the directors.

iv. Death

When a person dies, his membership of a company will come to an automatic end by virtue of the provisions of the Law of Succession. The shares previously held by him become, legally, the property of his personal representative. (See Table A, Article 29)

v. Bankruptcy

When a person becomes bankrupt, his membership of a company will come to an end under the provisions of the Bankruptcy Act, which vest a bankrupt's property in his trustee in bankruptcy (see Table A, Article 32).

vi. Sale by a company in exercise of lien

A company, like an unpaid seller under the Sale of Goods Act, has a right of lien on its shares as security for the balance of their price. For example, Table A Article 11 gives the company "a first and paramount lien" on every unpaid share.

If the company sells ALL the shares held by a member, the membership will come to an end from the moment the buyer's name is entered in the register. Table A, Article 12 gives the company power to sell "any shares on which the company has a lien".

- vii. Redemption of redeemable preference shares  
If a member's entire holding consist exclusively of redeemable preference shares and all of these shares are redeemed by the company under the provisions of Section 60 of the Companies Act, he will cease to be a member from the date on which his name is removed from the register of members.
- viii. Repudiation by an infant  
An infant member has a common law right to repudiate his membership of a company if there has been a total failure of consideration because the shares have become worthless: *Steinberg v Scala (Leeds) Ltd* (58).
- ix. Liquidation or winding up  
A company's liquidation terminates membership of all former members, from the moment it becomes effective.
- x. Rescission of contract: A shareholder who rescinds a contract of purchase of shares or allotment by reason of a vitiating element or otherwise ceases to be a member
- xi. Disclaimer by trustee in bankruptcy: Under English law if a trustee in bankruptcy refuses to take up the shares of an undischarged bankrupt he ceases to be a member of the company.

## QUESTION THREE

### THE REGISTER OF MEMBERS

Section 112(1) requires every company to keep a register of its members and prescribes the contents of the register.

#### Contents

**The register of members must contain the following particulars—**

- i. The names and postal addresses of the members;
- ii. A statement of the shares held by each member, distinguished by its number if it has one;
- iii. The amount paid or agreed to be considered as paid on the shares of each member;
- iv. The date at which each person was entered in the register as a member; and
- v. The date at which any person ceased to be a member.

Where the company has converted any of its shares into stock the register shall show the amount of stock held by each member instead of the amount of shares and the aforesaid particulars relating thereto.

Failure to keep a register of members renders the company and every officer of the company who is in default liable to a default fine [s.112 (4)].

Section 120 provides that the register of members shall be *prima facie* evidence of the matters it contains.



## Location

Section 112(2) requires the register of members to be kept at the registered office of the company. If it is made up at another office of the company, or at some other office, it may be kept at that other office provided the office is not at a place outside Kenya.

The registrar must be informed of the place, other than the registered office, where the register is kept. Any change in that office must be notified to the registrar within 14 days failing which the company and every officer of the company who is in default shall be liable to a default fine.

## Index of Members

Section 113(1) provides that a company with more than 50 members must, unless the register of members constitutes an index, keep an index (which may be in the form of a card index) of the names of the members of the company, and must alter the index within fourteen days after any alteration in the register. The index shall in respect of each member contain a sufficient indication to enable the account of that member in the register to be readily found and shall be at all times kept at the same place as the register of members.

Closure of Register: Under Section 117 of the Act, a company may, on giving notice by advertisement in some newspaper circulating in Kenya, or in that area of Kenya in which the registered office of the company is situate, close the register for any time or times not exceeding 30 days in each year.

## Inspection of Register

Section 115(1) provides that the register and index of members shall during business hours be open to the inspection of any member without charge, and of any other person on payment of a fee, not exceeding Kshs.200 for each inspection, as the company may prescribe. Any person may require a copy of the register or any part thereof, on payment of one shilling or such fewer sums as the company may provide, for every hundred words or fractional part thereof required to be copied. The copy must be supplied within a period of 14 days commencing on the day next after the day on which the requirement is received by the company.

If a company officer refuses an inspection or fails to provide a required copy, the company and every officer of the company who is in default shall be liable in respect of each offence to a fine not exceeding Kshs.40 and further to a default fine of Kshs.40. The court may by order—

- (a) Compel an immediate inspection of the register and index, or
- (b) Direct that the copies required shall be sent to the person requiring them.

The court order may also be made against the company's agent who keeps the company's register of members if the company's failure to provide a copy, or permit an inspection, is due to his default.

Section 117 permits a company, on giving notice by advertisement in some newspaper circulating in Kenya or in that area of Kenya in which the registered office of the company is situate, to close the register of members for any time or times not exceeding in the whole 30 days in each year. The purpose of this provision is to keep the register static so that members' holdings may be extracted as at a particular date for the purpose of computing dividends.

## Rectification of the Register

Section 118(1) empowers the High Court to rectify the register of members in two cases, namely:

- i. If the name of any person is, without sufficient cause, entered in or omitted from the company's register of members; or
- ii. Default is made or unnecessary delay takes place in entering on the register the fact of any person having ceased to be a member.

**The application to the court to rectify the register may be made by:**

- i. The aggrieved person.
- ii. Any member.
- iii. The company.

**Where an application is made the court may:**

- i. Refuse the application;
- ii. Order rectification of the register and payment by the company of any damages sustained by any party aggrieved.

An order rectifying the register can be made even when the company is being wound up: Re Sussex Brick Co (59).

The case of Burns v Siemens Bros Dynamo Works Ltd (60) shows that the circumstances set out in Section 118(1), above, are not the only ones in which the court can order rectification. It may also do so where a name stands on the register without sufficient cause.

The court may also order rectification of the register by deleting a reference to some only of the registered shareholder's shares. It need not delete his name entirely. This is illustrated by Re Transatlantic Life Assurance Co Ltd (1979) in which the court deleted an additional number of shares, which had been issued to the applicant in breach of the prevailing Exchange Control Regulations but left the register intact as regards his previous shareholding.

By Section 118(4), if an order is made in the case of a company required to send a list of its members to the registrar, the court, when making an order for rectification of the register, shall by its order direct notice of the rectification to be given to the registrar.

## CHAPTER SIX

### QUESTION ONE

#### TRANSFER PROCEDURE

It was explained in Re Greene (63) that the rule which requires a "proper instrument" of transfer enforces the payment of stamp duty, normally at *ad valorem rate* on the consideration or (in the case of a gift) on the nominal value of the shares transferred. A company must reject an unstamped transfer under the provisions of Stamp Duty Act.



This rule does not, however, apply to registration of shares in the names of personal representatives or trustees in bankruptcy since they are merely asserting powers of control and disposal of the shares of members whom they represent given to them by law under the rules of transmission. A member, however, cannot arrange for the direct transfer of his shares to a beneficiary after his death without a proper transfer (signed by his executors): *Re Greene* (63).

**The articles usually provide that:**

- (a) The instrument of transfer must be “in any usual or common form” (i.e. the forms used by stockbrokers);
- (b) The transferor’s share certificate must accompany the transfer when presented for registration: Table A, Articles 23 and 25.

The basic transfer procedure is that the transferor and transferee complete and sign the transfer form and have it stamped before delivering it to the company (with the transferor’s share certificate) for registration. The transferee becomes a member and legal owner of the shares only when his name is entered in the register of members. The company issues to the transferee a new share certificate and cancels the old one. This is explained by the following diagram:

## CERTIFICATION OF TRANSFERS

If the holder is not transferring his entire holding by a single transfer, it would be inappropriate for him to hand to the transferee a share certificate for a larger number of shares than are comprised in the transfer.

In such a case the holder sends his signed transfer with his share certificate to the company for cancellation and the transfer form is returned to the transferor who then delivers it to the transferee for stamping and representation to the company. If the transferor is retaining some shares the company sends him a new share certificate for the reduced number of shares still registered in his name. This procedure is called “certification” of a transfer. It is explained by the following diagram:

The transfer of registered debentures or of debenture stock is subject to the same rules as transfer of shares.

Certification is a representation by the company to any person acting on the faith of the certification that documents have been produced to the company which on the face of them show a prima facie title of the transferor to the shares comprised in the transfer. It is not a representation that the transferor has any title to them but it does imply that the certificate will be retained: Companies Act. Section 81; *Bishop v. Balkis Consolidated Ltd.*

Under Section 81(2), any person who acts on a negligent certification can claim damages from the company for his loss if the company did not either receive or fails to retain the share certificate. But the company has no duty and no liability to anyone else. If, for example, the company returns the certified transfer form and the share certificate to the holder who sells the shares to A giving

him the certified transfer form and also to B, giving B a second transfer form of the same shares with the transferor's certificate and A's transfer is then registered first, B has no claim against the company if it refuses to register the second transfer to him. B does not in this case rely on the certified transfer (of which he is unaware) and the share certificate was correct when first issued to the holder.

#### In LONGMAN v BATH ELECTRIC TRAMWAYS

A transfer of shares to B was registered and a certificate was prepared in his name. Before the certificate was issued, B signed a transfer of the shares to H and this transfer was sent to the company for certification. The company certified the transfer (as it still had B's new share certificate) and returned the certified transfer to B. By mistake the company then sent to B the share certificate in his name. B deposited the share certificate with L as security for a loan. L later claimed that he was entitled to the shares.

#### Held:

L's claim must fail. He had never seen (and therefore did not rely on) the certified transfer to H and mere possession of B's share certificate gave him no claim against the company since the certificate at the time of issue correctly described B as still the registered holder of the shares (i.e. the transfer to H had not at that point been delivered for registration).

If to vary the facts of Longman's case L had been able to secure registration as holder of the shares and the company had then rejected the transfer to H, H could claim compensation from the company since the certified transfer delivered to him would have been a representation by the company that it held B's certificate and that the transfer to H was valid.

If identified shares are sold under a preliminary contract, the rights and obligation incidental to ownership of the shares pass at once to the purchaser under the contract unless otherwise agreed. Thereafter, any dividend received by the vendor (pending registration of his transfer) must be paid over to the purchaser (unless the shares are sold "ex-div"). The purchaser must indemnify the vendor against any calls made on the shares before registration of the transfer. The vendor is, however, free to vote at meetings as he wishes until the purchase price has been paid to him.

A vendor of shares has a duty (implied by the contract of sale) to deliver a transfer of the shares (in exchange for the price) which will give the purchaser good title to the shares. If he fails to deliver such a transfer, he is liable to pay damages. But the vendor does not (unless the contract expressly so provides) guarantee that the company will register the transfer. If the company rejects the transfer, the vendor as registered shareholder holds the shares in trust for the purchaser as his nominee.





## QUESTION TWO

### MORTGAGE OF SHARES

This is a transaction whereby shares are used as collateral security for loans. The transaction is either legal or equitable.

Under a legal mortgage, the borrower transfers his shares to the mortgagee who becomes the registered holder subject to a separate agreement by which he undertakes to re-transfer the shares to the mortgagor on repayment of the loan. The agreement also determines who is entitled to the dividends and gives the mortgagee the right to sell the shares if the mortgagor defaults on the loan. As registered holder, the mortgagee can transfer the shares to a purchaser who buys from him.

The essential feature of an equitable or informal mortgage is that the borrower deposits his share certificate with the mortgagee but remains the registered holder of the shares. There is again an agreement containing the terms of the loan and the mortgage. The mortgagee may protect himself by serving a “stop notice” on the company but his possession of the share certificate is an effectual bar to dealings with the shares by the borrower.

The equitable mortgagee's other potential difficulty is that since he is not a registered shareholder he has no direct means of transferring the shares to a purchaser if the borrower defaults and he decides to sell. He usually obtains from the mortgagor a “blank transfer”, i.e. a transfer signed by the mortgagor as registered holder but without the name of a transferee inserted. This usually gives the mortgagee an implied power to insert his own name as transferee in case of default. He can then dispose of the shares after transferring them into his name. Alternatively, the mortgagee may obtain from the mortgagor a power of attorney giving him power to insert the name of a purchaser on the transfer.

### CALLS ON SHARES

Unless shares are already fully paid for the registered holder is liable to pay the balance due when called on to do so. The power of the directors to make calls is defined by the articles. The procedure must be correctly applied. The rules or principles governing calls are embodied in Articles 15 – 21 of Table A. If a shareholder defaults in the payment of calls, the company may, if the articles so provide, forfeit his shares. Articles 33-39 of Table A contain provisions which will apply if the company's articles do not provide for forfeiture.

## QUESTION THREE

### RESTRICTIONS ON TRANSFER

Section 30 of the Companies Act requires the articles of private companies to restrict the right to transfer the company's shares. The model articles Table A contains provisions which give the directors power to refuse to register a transfer of any share, whether fully or partly paid. The articles of a public company may also restrict the right to transfer the company's shares usually if the shares are not fully paid or if the company has a lien on them.

Unless the directors have power under the articles to refuse a transfer and exercise that power properly, the transfer must be registered and the court may order rectification of the register for that purpose. The rules on the restriction of transfer are:

- (a) To exercise their power, the directors must consider the transfer and take a decision to refuse to register it.

**In RE HACKNEY PAVILION**

A transfer of shares was sent in by the executors of a deceased director and shareholder. The two surviving directors held a board meeting and disagreed as to whether the transfer should be registered. There was no casting vote. The secretary wrote to the executors to inform them that the directors had declined to register the transfer.

**Held:**

This was incorrect since a positive act of refusal was necessary and there had been none. The register must be rectified by registering the transfer.

- (b) The directors in reaching their decision must act *bona fide* in what they consider to be the best interests of the company: RE: Smith & Fawcett (64)
- (c) Where the articles specify grounds of refusal, the directors may be required to identify the grounds of refusal. However, they are not obliged to disclose the detailed reasons for their decision (unless the articles so provide). If nonetheless the directors do disclose their reasons, the court will consider whether the directors acted *bona fide* or whether their reasons accord with the grounds specified in the articles (if that is the case).

**In RE BEDE SS CO LTD (1971)**

The directors were authorised to refuse transfers if in their opinion it was contrary to the interests of the company that the transferees should be members. The directors rejected transfers of small numbers of shares (and of single shares) on the ground that it was prejudicial to the company that its issued share capital should be fragmented.

**Held:**

The reason given could be challenged and was invalid. The power to refuse registration must (on the formula used in the articles) be confined to cases of objection to the transferees on personal grounds. In this case the directors were objecting to the small amount of shares transferred, which was not an objection to the transferees personally.

- (d) The power of refusal must be exercised within a reasonable time from the receipt of the transfer. Under Section 80, a company is required to give notice of any refusal within 60 days. If the power is not exercised within a reasonable time it lapses and can no longer be used. The requirement of notice of refusal within sixty days effectually makes that the “reasonable” period.

**In RE SWALEDALE CLEANERS LTD (1968)**

On August 3, 1967, transfers of shares were presented. There was only one director then in office and he purported to refuse to register the transfers in exercise of a power of refusal given by the articles. But a quorum for meetings of the directors was two and so the one director was not competent to exercise the powers of the board. On December 11, 1967 proceedings were begun for rectification of the register, i.e., a court



order that the transfers should be entered in the register. On 18th December 1967 a second director was appointed and there was a board meeting at which the two directors refused to register the transfers (4 months, 14 days).

**Held:**

The attempt to exercise the power of refusal on December 18, 1967 was invalid since, in the interval of 4 1/2 months (since the transfers were presented), the power had expired (as regards those transfers). Since the power of refusal had not been exercised, the transfers must be entered in the register.

The articles may also restrict the right to transfer shares by giving to members a right of first refusal of the shares, which other members may wish to transfer. Any such rights are strictly construed, i.e. a member who wishes to accept must observe the terms of the articles and a member will not be permitted to evade his obligation to make the offer.

**In LYLE & SCOTT v SCOTT'S TRUSTEES**

The articles required any member who might be "desirous of transferring" his shares to give notice to the company secretary so that the shares could be offered to other members. Certain members agreed to sell their shares to an outsider and, while remaining the registered holders, gave the purchaser their proxies so that he could secure control of the company.

**Held:**

These members were indeed "desirous of transferring" their shares and must give formal notice as the articles required.

The cases cited above show that when there is a dispute over refusal to register the proper remedy is to apply to the court for rectification. A member who applied for an order for compulsory winding up of the company on the just and equitable ground was refused (Charles Forte {Investments} v Amanda) as "a winding up petition is not a proper remedy" in such a case because to liquidate the company would be unfair to other members not involved in the dispute.

## CHAPTER SEVEN

### QUESTION ONE

#### The Annual General Meeting

Section 131(1) provides that "every company shall in each year hold a general meeting as its annual general meeting in addition to any other meetings in that year, and shall specify the meeting as such in the notices calling it".

Not more than 15 months must elapse between the date of one annual general meeting and the next. The word "year" was defined in *Gibson v Barton* as "calendar year", i.e. the period January 1 to December 31.

Section 131(1) has a proviso to the effect that, so long as a company holds its first annual general meeting within 18 months of its incorporation, it need not hold it in the following year. Thus a company incorporated on October 1, 1992, need not hold its first annual general meeting until March 1994.

Subsection (2) provides that if default is made in holding an annual general meeting in accordance with the aforesaid provisions, the registrar may, on the application of any member of the company, call or direct the calling of a general meeting of the company and give such ancillary or consequential directions as he thinks expedient, including a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

The registrar is not bound to call or direct the calling of the meeting but, in the event of his refusing to do so, the aggrieved member may apply to the court for an order: *Re: El Sombrero Ltd* (88), in which the court made an order after the registrar had declined to do so. Section 131 does not provide for the business which may be transacted at the annual general meeting but Table A, Article 52 mentions the following as the “ordinary” or usual business at an annual general meeting:

- i. Declaring a dividend;
- ii. The consideration of the accounts, balance sheets and the reports of the directors and auditors;
- iii. The election of directors in the place of those retiring, and
- iv. The appointment of, and the fixing of the remuneration of, the auditors.

Subsection 5 makes it a criminal offence punishable with a fine not exceeding two thousand shillings for the company and every officer of the company to fail to hold the annual general meeting or comply with any directions of the registrar regarding the calling and conduct of the meeting.

## Extraordinary General Meetings

Section 132(1) provides for the convening of “extraordinary” general meeting but does not define it. Neither is the word “extraordinary” defined in any other section of the Act. However, Table A, Article 48 provides that all general meetings other than annual general meetings shall be called extraordinary general meetings.

Table A, Article 49 further provides that the directors may, whenever they think fit, convene an extraordinary general meeting. Further, by Section 132(1), despite anything in the articles of a company, the directors are bound to convene an extraordinary general meeting of the company on the requisition of the holders of not less than one-tenth of the paid-up capital of the company carrying the right of voting at general meetings of the company, or, if the company has no share capital, of members representing not less than one-tenth of the total voting rights. Section 132(2) provides that the requisition must state the objects of the meeting, and must be signed by the requisitionists and deposited at the registered office of the company. Section 132(3) provides that if the directors do not within 21 days from the date of the deposit of the requisition proceed to convene a meeting, the requisitionists, or any of them representing more than one-half of the total voting rights of all of them, may themselves convene a meeting, so long as they do so within three months of the requisition.



Section 132(5) entitles the requisitionists to recover any reasonable expenses incurred in convening the meeting from the company, and the company may in turn recover these from the fees or other remuneration of the defaulting directors.

The company's articles cannot deprive the members of the right to requisition a meeting under Section 132 because the section requires the directors to proceed to convene a meeting on requisition "notwithstanding anything" in the company's articles. However, the section is defective in the sense that, although the directors are required to convene the meeting, they need not hold it within any particular limit of time. They may therefore defeat the purposes of the section by calling the meeting for a date, say, six months ahead, provided they do so within the 21-day period. In the event of their doing so the requisitionists cannot convene another meeting, as illustrated by *Re: Windward Islands Enterprises (U.K) Ltd (1982)*. The Jenkins Committee recommended that the requisitionists should be empowered to call the meeting themselves if the directors call the meeting to be held later than 28 days after the notice convening it was sent out. The company's articles may also contain such a provision although the current Table A lacks one.

Section 135(1) provides that, if for any reason it is impracticable to call or conduct a meeting of a company in accordance with the articles or the Act, the court may, either of its own motion or on application by any director or any member entitled to vote at the meeting, order a meeting to be called, held and conducted in such manner as the court thinks fit. Where the court makes an order, it may give such ancillary or consequential directions as it thinks expedient including a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting. The power of the court in this regard is illustrated by *Re: El Sombrero Ltd (88)*.

## Class Meetings

"Class meetings" are not provided for by the Companies Act. However, a class meeting may be held pursuant to the provisions of the company Articles of Association, if any.

Table A, Article 4 allows a company to vary the rights attached to any class of shares if the variation is consented to in writing by the holders of three-fourths of the issued shares of that class or is sanctioned by a special resolution passed at "a separate general meeting of the holders of the shares of the class".

The provisions of Table A in relation to general meetings shall apply to every such separate general meeting, except that the necessary quorum shall be two persons at least holding or representing by proxy one-third of the issued shares of the class.

## QUESTION TWO

a)

- 1 The notice must be issued with the requisite authority of the board, court, members or registrar.
- 2 The requisite number of days must be given.
- 3 It must specify the business of the meeting with clarity.
- 4 Must specify all resolutions proposed and passed, as a special and notice of their intention to be passed as such must be given.

- 5 Must specify the date, time and place of the meeting.

**b) The Companies Act, recognises the following meetings:**

1. Statutory Meeting.
2. Annual General Meeting.
3. Extra Ordinary General Meeting.
4. Class Meetings.
5. Directors meetings
6. Creditors meeting.

**Generally, the following constitutes the requisites of a meeting:**

1. Notice of the meeting.
2. Proper authority to convene the meeting.
3. Quorum for the meeting.
4. Chairman of the meeting.
5. Taking of minutes of the meeting.

**c)**

- Voting in a company meeting can either be on a poll or by show of hands. By show of hands – one member has one vote. By Poll depends on the number of shares a member holds. Under Table A one share is one vote.
- The results of the voting are declared by the Chairman.
- Members are free to appoint a proxy who can only vote by a poll.

### QUESTION THREE

The person legally endowed with authority to control and superintend the conduct of a meeting is generally styled “the chairman”. He derives his authority from his appointment, and the mode of his appointment will depend upon the type of meeting over which he is called upon to preside.

**In the case of National Dwellings Society v Sykes Chitty, J. stated:**

“It is the duty of the chairman, and his function, to preserve order, and to take care that the proceedings are conducted in a proper manner, and that the sense of the meeting is properly ascertained with regard to any question which is properly before the meeting”. From this dictum and other judicial decisions the principal powers and duties of a chairman emerge as the following:

- (i) Determining that the meeting is properly constituted and that a quorum is present.
- (ii) Informing himself as to the business and objects thereof
- (iii) Preserving order in the conduct of those present.
- (iv) Containing discussion within the scope of the meeting and reasonable limits of time.
- (v) Deciding whether proposed motions and amendments are in order.



- (vi) Formulating for discussion and decision questions which have been moved for the consideration of the meeting.
- (vii) Deciding points of order and other incidental matters which require decision at the time.
- (viii) Ascertaining the sense of the meeting by-
  - (a) Putting relevant questions to the meeting and taking a vote on them (and, where authorised, giving a casting vote.)
  - (b) Declaring the result, and
  - (c) Causing a poll to be taken if duly demanded
- (ix) In the case of a meeting, which is recurrent or is one of a series, to deal with the record or minutes of the proceedings.
- (xi) Declaring the meeting closed when business has been completed.

Regarding this point, it should be noted that the chairman has no power to adjourn a meeting merely because the proceedings have taken a turn which he himself does not like: *National Dwellings Society v Sykes* (95). However, he may adjourn the meeting if it becomes disorderly or if the members present agree.

## CHAPTER EIGHT

### QUESTION ONE

a)

#### Appointment

The names of the first directors are determined in writing by the subscribers or a majority of them failing which the signatories to the memorandum are the first directors.

Directors are elected by members in general meeting by an ordinary resolution.

#### To qualify for appointment as a director one must:

- Be between the ages of 21-70
- Be of sound mind.
- Not be an undischarged bankrupt or insolvent.
- Not have been disqualified by the court.

A person appointed director must sign and deliver to the registrar for registration a written memorandum.

If the articles require a director to hold any share qualification a person must take them up within two months of appointment or such shorter time as the articles may prescribe.

Under Section 184 (1), in the case of a public company meeting a motion for the appointment of two or more persons as directors by a single resolution must not be made unless a resolution to that effect has been agreed to by the meeting without any vote against it.

## Vacation

### The office of director must be vacated if the director:

- 1 Is disqualified by the court pursuant to Section 189 of the Act.
- 2 Fails to acquire share qualification.
- 3 Is declared bankrupt or makes an arrangement or composition with his creditors generally.
- 4 Becomes of unsound mind.
- 5 Resigns his office by notice in writing to the company.
- 6 Attains the age of 70 unless re-appointed.
- 7 Is removed by an ordinary resolution of members in general meeting absents himself from directors meeting held in over six months without permission of the other directors.
- 8 Dies
- 9 If the company goes into liquidation.

### b)

- The transaction to advance Kshs.500, 000 to Austin to cover his expenses on worldwide promotional tour on behalf of the company required prior approval by members in general meeting pursuant to the proviso to Section 191 (1) of the Act which permits a company to provide funds to a director to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an office of the company.
- Under Section 191 (3) of the Act if the requisite approval is not given by the company in general meeting the directors authorizing the making of the loan are jointly and severally liable to indemnify the company against any loss arising therefrom.

## QUESTION TWO

**Birds Limited has three directors: Peacock, Sparrow and Vulture. Explain the legal implication of each of the following situations:**

### a)

- Appointment of directors is a power vested in the general meeting by the articles and directors have no power to appoint other directors let alone their own sons.
- The appointment of a director is effected by the passage of an ordinary resolution in a general meeting.
- Vultures wish to appoint his son a director is untenable since he has no power to do so.

### b)

- Since directors stand in a fiduciary position in relation to the company whose board they form, they are bound to avoid conflict of interest.
- In this case Sparrow is bound to disclose the nature of his interest at board meeting failing which the contract is voidable at the option of the company. As was the case in Aberdeen Railway Co. v Blaikie Brothers. Additionally, it is a criminal offence for which sparrows is liable to a fine not exceeding Kshs.2, 000.





c)

- Removal of a director from office is a power vested in the general meeting by the companies act.
- Directors cannot remove one of their number from the office of director.
- In the case Sparrow and Vulture cannot remove Peacock from directorship since they have no power to do so.

d)

- Being a director of the company, Peacock has the right to take part in the affairs of the company.
- Vulture and Sparrow cannot legally exclude Peacock from participating in the affairs of the company.
- Peacock has the right to sue the other directors for an order to restrain them from excluding him from the affairs of the company.
- Additionally, Peacock may petition for the winding up of the company on the ground that it is just and equitable to do so. As was the case in Re: Lundie Brothers Ltd.

e)

- Based on the advice of the auditor, the company is insolvent and should cease to carry on business.
- The company may, therefore, be wound up compulsorily or voluntarily by creditors.

### QUESTION THREE

The following are the restrictions which the Act imposes on appointment of directors:

1. Section 182 (1): Appointment by the Articles  
Section 182(1) provides that a person shall not be capable of being appointed director of a company by the articles unless, before the registration of the articles, he has by himself or by his agent authorized in writing:-
  - i. Signed and delivered to the registrar for registration a consent in writing to act as such director; and
  - ii. Either:-
    - a) Signed the memorandum for a number of shares not less than his qualification, if any
    - b) Taken and paid or agreed to pay for his qualification shares, if any
    - c) Signed or made and delivered to the registrar for registration an undertaking to take and pay for his qualification shares, if any, or the statutory declaration that a number of shares not less than his qualification, if any, are registered in his name.
2. Section 183: Qualification Shares  
Section 183(1) provides that it shall be the duty of every director who is by the articles of the company required to hold a specified qualification, and who is not already qualified,

to obtain his qualification within two months after his appointment, or within the shorter time (if any) fixed by the articles.

Subsection (3) further provides that if the director fails to obtain his share qualification, or ceases to hold the required number of shares, he shall vacate his office. If he does not actually do so but continues to act as director he becomes a de facto director: R v Ivan Arthur Camps (67).

3. Section 186: Age Limit

Section 186 provides that no person shall be capable of being appointed a director of a public company or a private company which is a subsidiary of a public company if at the time of his appointment:-

- (a) He has not attained the age of 21; or
- (b) He has attained the age of 70.

**This provision does not apply if:**

- (a) The company's articles provide otherwise
- (b) "Special notice" of the resolution to appoint the director was given to the company.

The company must also have given notice of it (i.e. the special notice) to its members and stated the age of the proposed director.

Section 142 defines "special notice" as a notice given to the company not less than 28 days, before the meeting at which the relevant resolution is to be moved.

4. Section 188: Undischarged Bankrupts

Section 188 provides that if an undischarged bankrupt acts as director of any company without leave of the court he shall be liable to imprisonment for a term not exceeding two years or to a fine not exceeding Kshs.10,000, or both.

5. Section 189: Fraudulent Persons

Section 189 (1) empowers the court to make an order restraining a person from being appointed, or acting, as a company's director for a period not exceeding five years if:

- i. The person is convicted of any offence in connection with the promotion, formation or management of a company
- ii. In the course of a winding up, it appears that the person has been guilty of fraudulent trading (under Section 323) or has otherwise been guilty, while an officer of the company, of any fraud or breach of duty to the company.

6. Section 184: Individual Voting

Section 184(1) provides that appointment of directors is to be voted on individually unless a motion for the appointment of two or more persons as directors by a single resolution was agreed upon by the meeting without any vote being given against it.

A resolution moved in contravention of this provision is void {Section 184 (2)}.

The duties of directors are usually considered under two broad headings, namely:



- i. Duties of care and skill at common law
- ii. Fiduciary duties as enunciated by courts of equity.

1. Duties of Care and Skill

The directors' duties of care and skill have been formulated in a series of cases brought against directors in order to make them liable in negligence for the manner in which they conducted the company's affairs. These duties were summarised by Romer, J. in RE CITY EQUITABLE FIRE INSURANCE CO LTD as follows:

- i. A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. This rule prescribes a duty which is partly objective (the standard of the reasonable man) and partly subjective (the reasonably man is deemed to have the knowledge and experience of the particular director). It may also be expressed by saying that, if a foolish director makes foolish decisions resulting in loss to the company, he cannot be liable for negligence. It would be unreasonable to expect a foolish director to make wise decisions. However, if the director made very foolish decisions resulting in loss to the company, he will be liable in negligence since it is not reasonable to expect a foolish director to make very foolish decisions. On the other hand, a wise director will be liable if he makes unwise decisions, since it is unreasonable to expect him, a wise man, to make unwise or foolish decisions.  
A directorship is not a professional job with a legally prescribed qualification. In the circumstances, anybody (even a six-months-old baby) can become a director. All that the law can expect him to do is to serve the company honestly and to the best of his ability. In RE: MARQUIS OF BUTE'S CASE the director became the director at the age of six months by inheriting the office from his father who had died.
- ii. A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.  
In RE MARQUIS OF BUTE'S CASE a director who had attended only one board meeting in 38 years was exonerated from liability for alleged negligence on the ground that "neglect or omission to attend meetings is not, in my opinion, the same thing as neglect or omission of a duty which ought to be performed at those meetings" (per Sterling, J.) A company is, however, free to impose a duty on its directors to attend board meetings within a certain period of time and to prescribe the consequences of a breach of the duty. See, for example, Table A, Article 88(f).
- iii. In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. If a director is to be made liable, it can only be on the basis of his personal negligence, and it is not negligence to delegate some responsibilities to officials or employees of the company whose previous conduct has given no grounds for distrust or suspicion. In DOVEY v CORY a director was held not liable for negligence merely because he had failed to verify false information regarding the company's accounts which he had been given by the company's manager and managing director. The court stated:

“Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as by those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust.”

## 2. Fiduciary Duties

The fiduciary duties of directors arising from their fiduciary relation to the company have been the subject of consideration in an enormous body of case law but the ratio decidendi of the cases can be reduced to two fundamental propositions:

- (a) A director is not allowed to put himself in a position where his interest and duty conflict.

### **The application of this rule is illustrated by the following cases:**

1. Aberdeen Rly Co v Blaikie Brothers (68). Section 200(5) adopts this rule by providing that nothing in section 200(5) shall be taken to prejudice the operation of “any rule of law” restricting directors of a company from having any interest in contracts with the company”.

Section 200 requires a director who is in any way interested in a contract with the company to declare the nature of his interest at a board meeting. He must disclose the interest at the first board meeting at which the contract is to be discussed or, if he did not have an interest at that time, at the first board meeting after his interest arose. This provision is supplemented by Article 84 of Table A which provides that:

- i. The director shall not vote in respect of the contract. If he does vote, his vote shall not be counted
  - ii. The director shall not be counted in the quorum present at the meeting.
2. Industrial Development Consultants Ltd v Cooley (69) in which the director became personally interested in a contract he had been assigned to negotiate for the company.
3. Cook v Deeks (70) in which some of the company’s directors diverted to themselves a contract that was intended to be for the company. It was held that they had to surrender the benefit of the contract to the company. In law, the benefit of the contract belonged to the company which the directors had formed for the purpose of obtaining the contract but in equity the contract belonged to the company for which it was intended.

In Bray v Ford Lord Herschell stated that the aforesaid rule is not “founded upon principles of morality” but is based on the consideration that human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty and thus prejudicing those whom he was bound to protect”.

- (b) A director is not, unless otherwise expressly provided, entitled to make a profit: Boston Deep Sea Fishing Co v Ansell (71). This rule is essentially a restatement of the fundamental rule of the law of agency that an agent must not make a secret profit. The cases in company law are just examples of how a particular agent (the company



director) committed a breach of his duties to a particular principal (the company).

In Percival v Wright (72) it was held that the directors owe their fiduciary duties to the company alone and not to the members. The decision raises a problem that has become known as “insider dealing”.

## CHAPTER NINE

### QUESTION ONE

#### Powers and Duties

The powers and duties of the secretary depend on the size and nature of the company and the personal contractual arrangements that it makes with him. However, a company secretary usually has the following powers and duties:

- To be present at all meetings, including board meetings and take minutes of such proceedings.
- On the instructions of the board, to issue notices of meetings to members and others.
- To countersign instruments to which the company seal has been affixed (see Article 113 of Table A).
- To conduct and record transfer of shares and conduct correspondence with shareholders as regards calls, transfers, forfeiture, e.t.c.
- To keep the books of the company, particularly those relating to the internal administration of the company, e.g. the shares register and register of charges.
- To make all the returns of the company, e.g. the annual returns, notice of special resolutions, etc.
- For quoted companies, he ensures compliance with Nairobi Stock Exchange and Capital Markets Authority Requirements.
- For banks, he ensures compliance with Central Bank of Kenya statutory requirements.

Section 180 provides that a provision requiring or authorising a thing to be done by or to a director and the secretary is not satisfied by it being done by or to the same person acting as secretary and director.

#### Bridging the Information Gap between the Executive and Non-Executive Directors

The developing role of the Company Secretary was first recognised in the Cadbury Report, made by the Cadbury Committee in 1992, which stated:

“The Chairman and the Board will look to the Company Secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and on how these responsibilities should be discharged.”

All directors should have access to the advice and services of the Company Secretary who is responsible to the Board for ensuring that the Board procedures are followed and applicable rules and regulations are complied with.

The Company Secretary's role is to protect the interests of the company as a whole. Often referred to as "the conscience of the company" the company secretary has the task of informing, advising and supporting the directors both individually and collectively, endeavouring to ensure that they are fully aware of the restrictions, responsibilities and obligations imposed upon them and the company by the Company's own constitution, company law, other relevant legislation, and any applicable codes of best practice standards. He should constantly monitor the internal activities of the company, take responsibility for internal disclosure, interpret the decisions of the Board and help to ensure that they are properly implemented throughout the organization.

A qualified Company Secretary has a clear responsibility to protect the probity of the organization and would have a major impact, for example, in guarding against directors acting, consciously or otherwise, in their own interest rather than those of the company. In protecting the interests of the company, the company secretary not only serves the interests of the third party shareholders who may be involved but is also able to represent the interests of numerous other stakeholders such as creditors, employees and local communities.

## QUESTION TWO

No person shall qualify for appointment as a company secretary unless he is registered under the Certified Public Secretaries Act. Section 20 of the Certified Public Secretaries Act provides that subject to this section, a person is qualified to be registered as a Certified Public Secretary if:

- He has been awarded by the Examinations Board a certificate designated the Final Certificate of the Certified Public Secretaries Examination.
- He holds a qualification approved by the Registration Board
- He is at the commencement of this Act, both a citizen of Kenya and a member of the professional body known as the Institute of Chartered Secretaries and Administrators
- He is at the commencement of this Act both ordinarily resident in Kenya, and a member of the professional body known as the Institute of Chartered Secretaries and Administrators
- He is at the commencement of this Act, registered as an accountant under Section 24(1) of the Accountants Act
- He is qualified as an advocate of the High Court of Kenya.

Section 21(1) provides for disqualification from being registered as a company secretary. The following are disqualified from being registered

- If convicted by a court of competent jurisdiction in Kenya or elsewhere of an offence involving fraud or dishonesty.
- If an undischarged bankrupt
- If he is of unsound mind, and has been certified to be so by a medical practitioner.
- If during the period when the Registration Board has determined under Section 28(1)(d) that he shall not be registered or during any such period as varied by the High Court under Section 29.
- Section 28 gives the Registration Board power to cancel the registration of a member amongst other penalties if found guilty of professional misconduct. However, an aggrieved person may appeal such a decision to the High Court.

**QUESTION THREE****REGISTER OF DIRECTORS AND SECRETARIES****201.**

- (1) Every company shall keep at its registered office a register of its directors and secretaries.
- (2) The said register shall contain the following particulars with respect to each director
  - (a) In the case of an individual, his present Christian name and surname, any former Christian name or surname, his postal address his nationality and, if that nationality is not his nationality of origin, his nationality of origin, his business occupation, if any, particulars of all other directorships held by him and, in the case of a company subject to Section 186, the date of his birth; and
  - (b) in the case of a corporation, its corporate name and registered or principal office and postal address:  
Provided that it shall not be necessary for the register to contain particulars of directorships held by a director in companies of which the company is the wholly-owned subsidiary, or which are the wholly-owned subsidiaries either of the company or of another company of which the company is the wholly-owned subsidiary; and for the purposes of this proviso
    - (i) "Company" includes any body corporate incorporated in Kenya; an
    - (ii) A body corporate shall be deemed to be the wholly-owned subsidiary of another if it has no members except that other and that other's wholly-owned subsidiaries and its or their nominees.
- (3) The said register shall contain the following particulars with respect to the secretary or, where there are joint secretaries, with respect to each of them, that is to say
  - (a) in the case of an individual, his present Christian name and surname, any former Christian name and surname and his postal address
  - (b) In the case of a corporation, its corporate name and registered or principal office and postal address:  
  
Provided that where all the partners in a firm are joint secretaries, the name and postal address of the principal office of the firm may be stated instead of the said particulars.
- (4) The company shall, within the periods respectively mentioned in subsection
- (5) deliver to the registrar for registration a return in the prescribed form containing the particulars specified in the said register and a notification in the prescribed form of any change among its directors or in its secretary or in any of the particulars contained in the register, specifying the date of the change.

- (6) The periods referred to in subsection (4) are the following, namely:-
- (a) The periods within which the said return is to be sent shall be a period of 14 days from the appointment of the first directors of the company
  - (b) The period within which the said notification of a change is to be sent shall be 14 days from the happening thereof:  
Provided that, in the case of a return containing particulars with respect to any person who is the company's secretary on the appointed day the period shall be fourteen days from the appointed day.
- (6) The register to be kept under this section shall during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) be open to the inspection of any member of the company without charge and of any other person on payment of two shillings, or such less sum as the company may prescribe, for each inspection.
- (7) If any inspection required under this section is refused or if default is made in complying with subsection (1), subsection (2), subsection (3) or subsection (4), the company and every officer of the company who is in default shall be liable to a default fine.
- (8) In the case of any such refusal, the court may by order compel an immediate inspection of the register.
- (9) For the purposes of this section:-
- (a) a person in accordance with whose directions or instructions the directors of a company are accustomed to act shall be deemed to be a director and officer of the company;
  - (b) "Christian name" includes a forename;
  - (c) In the case of a peer or person usually known by a title different from his surname, "surname" means that title;
  - (d) References to a former Christian name or surname do not include -
    - (i) In the case of a peer or a person usually known by a British title different from his surname, the name by which he was known previous to the adoption of or succession to the title
    - (ii) In the case of any person, a former Christian name or surname where that name or surname was changed or disused before the person bearing the name attained the age of 18 years or has been changed or disused for a period of not less than 20 years
    - (iii) In the case of a married woman, the name or surname by which she was known previous to the marriage.

**Non-statutory books may be purchased and kept. These include:**

- Register of documents sealed (or Seal Book): This is for recording particulars of documents issued under seal.
- Register of Important Documents: e.g. Power of Attorney, Probates and Letters of Administration, etc.





## CHAPTER TEN

### QUESTION ONE

#### APPOINTMENT:

Section 159 (1) provides that “every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the subsequent, annual general meeting”.

#### REAPPOINTMENT:

By Section 159 (2) a retiring auditor shall be deemed to be reappointed without any resolution being passed unless:

- a) He is not qualified for reappointment
- b) A resolution has been passed at that meeting (i.e. annual general meeting) appointing somebody instead of him or providing expressly that he shall not be appointed
- c) He has given the company notice in writing of his unwillingness to be reappointed.

#### APPOINTMENT BY REGISTRAR

“Where at an annual general meeting no auditors are appointed or are deemed to be reappointed, the Registrar may appoint a person to fill the vacancy” (Section 159 (3)).

#### APPOINTMENT BY DIRECTORS

The first auditors of a company may be appointed by the directors at any time before the first annual general meeting and auditors so appointed shall hold office until the conclusion of that meeting.

In default of appointment of the first auditors by directors the company may do so. Where the directors have appointed the first auditors, the company may “at a general meeting remove such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company. Notice of nomination to be given to the members at least 14 days before the date of the meeting.

#### CASUAL VACANCIES

By Section 159 (6) “The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act”.

## QUESTION TWO

### DUTIES OF AUDITORS

The duties of auditors are explained in the following cases:

#### 1. RE: KINGSTON COTTON MILL CO. (1896) (CHANCERY)

For some years before a company was wound up, balance sheets signed by the auditors were published by the directors to the shareholders in which the value of the company's stock-in-trade at the end of each year was **grossly overstated**. The auditors relied on certificates, **wilfully false**, given by J., one of the directors who was also manager, as to the value of the stock-in-trade. Dividends were paid for some years on the footing that the balance sheets were correct but if the stock-in-trade had been stated at its true value it would have appeared that **there were no profits out of which a dividend could be paid**.

#### NOTE:

- i) In each case the amount of stock-in-trade at the end of the year was entered in the balance sheet "as per manager's certificate".
- ii) The manager was a man of great business ability and of high repute, and up to the stoppage of the company was trusted by everyone; but he had designedly exaggerated the value of the stock-in-trade in order to make the company appear prosperous.

#### QUESTION:

Was it the duty of the auditors to **test** the accuracy of the manager's certificate by a comparison of the **figures in the books**, and were they liable for the dividends which had been paid in consequence of the erroneous balance sheets?

#### HELD:

It being **not part of the duty of the auditors to take stock**, they were justified in relying on the certificates of the manager, a person of acknowledged competence and high reputation, and they were **not bound to check his certificates** in the absence of anything to raise suspicion. They were not liable for the dividends wrongfully paid.

#### NOTE:

- i) An auditor is not bound to be suspicious where there are no circumstances to arouse suspicion; he is only bound to **exercise a reasonable amount of care and skill**.
- ii) Where an officer of a company has committed a breach of his duty to the company, the direct consequence of which has been a misapplication of its assets, for which he could be made responsible in an action, such breach of duty is a "misfeasance" for which he may be **summarily** proceeded against under the Companies Act, and it is not necessary that an action should be brought.



The object of the section is to facilitate the recovery by the liquidator of assets of a company **improperly dealt with** by its promoters, directors and other officers. The section applies to **breaches** of trust and to **misfeasances** by such persons, but is inapplicable to cases of breach of contract, trespass, negligence, etc.

**LINDLEY, LJ stated:**

...To decide this question, it is necessary to consider -

- 1) What their duty was;
- 2) How they performed it, and in what respects (if any) they failed to perform it.

The duty of an auditor generally was very carefully considered by this court in RE: LONDON AND GENERAL BANK (1895) and I cannot usefully add anything to what will be found there. It was pointed out that an auditor's duty is to examine the books, ascertain that they are right, and to prepare a balance sheet showing the true financial position of the company at the time to which the balance sheet refers. But it was also pointed out that **an auditor is not an insurer**, and that **in the discharge of his duty he is only bound to exercise a reasonable amount of care and skill**. It was further pointed out that what in any particular case is a reasonable amount of care and skill depends on the circumstances of the case; that if there is nothing which ought to excite suspicion, less care may or ought to have been aroused. These are **the general principles which have to be applied to cases of this description**.

I protest, however, against the notion that an auditor is **bound to be suspicious** as distinguished from **reasonably careful**. To substitute the one expression for the other may easily lead to serious error... Auditors are, however, in my opinion bound to see what **exceptional duties**, if any, **are cast upon them by the articles of the company whose accounts they are called upon to audit**. **Ignorance of the articles and of exceptional duties imposed by them would not afford any legal justification for not observing them...** (Such as taking stock). The complaints made against the auditors in this particular case... is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not **honestly believe to be true**. It is said, however, that they were culpably careless... frauds were committed by the manager, who in order to bolster up the company and to make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills.... I confess I cannot see that their omission to check his (i.e. manager's) returns was a breach of their duty to the company. **It is no part of an auditor's duty to take stock...** He must rely on other people for details of the stock in trade **on hand**. In the case of a cotton mill he must rely on **some skilled person** for the materials necessary to enable him to enter the stock-in-trade at its **proper value** in the balance sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestionable competence. He was trusted by every one who knew him.... the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade **in hand**, and they trusted him accordingly in that matter. But it is said that they ought not to have done so, and for this reason. The stock journal showed the quantities that is, the weight in pounds of the cotton and yarn **at the end of each year**. **Other books** showed the quantities of cotton **bought during the year** and the quantities of yarn **sold during the year**. If these books had been compared by the auditors they would have found that the quantity of cotton and yarn in hand **at the end of the year** ought to be **much less** than the quantity shown in the stock journal, and so **much less** that the value

of the cotton and yarn entered in the stock journal could not be right, or at all events was so abnormally large as to **excite suspicion** and demand **further inquiry**... But although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were **wanting in reasonable care not thinking it necessary to test the managing director's return**? I cannot bring myself to think they were not, nor do I think that any jury of businessmen would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one **before** suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to **matters on which information from such a person was essential**. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who was to account for the cash which he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry.

#### **LOPES, LJ.”... (1) What is a misfeasance within the meaning of Section 324(1)**

Have the auditors in the circumstances of this case committed a misfeasance? It has been held that an auditor is an officer within the meaning of the Section: - In RE LONDON AND GENERAL BANK. But has there been any misfeasance by the auditors? This depends upon what meaning is to be assigned to the word “misfeasance” as used in this section. The learned judge in the court below held that misfeasance covered any misconduct by an officer of the company as such for which such officer might have been sued apart from the section. In my judgment this is too wide. It would cover any act of negligence - any actionable wrong by an officer of a company which did not involve any misapplication of the assets of the company. The object of this section of the Act is to enable the liquidator to recover any assets of the company **improperly dealt with** by any officer of the company, and **must be interpreted bearing that object in mind**. It doubtless covers any breach of duty by an officer of the company in his capacity of officer resulting in any improper misapplication of the assets or property of the company... It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a blood bound. He is justified in believing, tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and so rely upon their representations, provided, he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful. It is not the duty of an auditor to take stock; he is not a stock expert; there are many matters in respect of which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all frauds... The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than in RE LONDON AND GENERAL BANK...

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by



tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable...

KAY, LJ. "... The words of the section are "any misfeasance or breach of trust in relation to the company.... misfeasance means something other than a breach of trust... it does not mean mere non-feasance: RE WEDGWOOD COAL AND IRON CO.... I think the only safe interpretation to adopt is that it includes all cases other than breaches of trust in which an officer of the company has been guilty of a breach of his duty as such officer which has caused pecuniary loss to the company by misapplication of its assets, and for which he might have been made liable in an action..."

## 2. RE LONDON AND GENERAL BANK

An auditor represented a confidential report to the directors calling their attention to the insufficiency of the securities in which the capital of the company was invested, and the difficulty of realizing them, but in his report to the shareholders merely stated that the value of the assets was dependent on realization, and in the result the shareholders were deceived as to the condition of the company, and a dividend was declared out of capital and not out of income.

### HELD:

The auditors had been guilty of misfeasance under S.10 of the Companies (winding-up) Act, 1890, and was liable to make good the amount of dividend paid (amounting to \$14,433.3s).

LINDLEY, LJ.: "... it is the duty of the directors, and not of the auditors, to recommend to the shareholders the amounts to be appropriated for dividends and it is the duty of the directors to have proper accounts kept, so as to show the true state and condition of the company... It is for the shareholders, but only on the recommendation of the directors, to declare a dividend. It is impossible to read the section of the Companies Act without being struck with the importance of the enactment that the auditors are **to be appointed by the shareholders, and are to report to them directly**, and not to or through the directors. The object of this enactment is obvious. It evidently is to secure to the shareholders **independent** and **reliable** information respecting the true financial position of the company at the time of the audit... It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is **to ascertain and state the true financial position of the company** at the time of the audit, and his duty is confined to that. But then comes the question, how is he to ascertain that position? The answer is, by examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this, his audit would be worse than idle farce. Assuming the books to be so kept as to show the company's true financial position, the auditor has to frame a balance showing that position **according to the**

**books** and to certify that the balance sheet represented is correct **in that sense**. But his first duty is to examine the books, not merely for the purposes of ascertaining what they do show, but also for the purposes of satisfying himself that they show the true financial position of the company... An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries, and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not as onerous as this.

Such I take to be the duty of the auditor; he must be honest.... i.e. **he must not certify what he does not believe to be true**, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case depends upon the circumstances of that case.

Where there is nothing to excite suspicion, very little inquiry will be reasonably sufficient, and in practice I believe businessmen select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused, more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required... It is satisfactory to find that the legal standard of duty is not too high for business purposes, and is recognised as correct by businessmen... A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.... The auditor is to make a report to the shareholders, but the **mode of doing** so and the form of the report are not prescribed... an auditor who gives shareholders means of information instead of information respecting a company's financial position does so at his peril and runs the very serious risk of being held judicially to have failed to discharge his duty. In this case, I have no hesitation in saying that Mr. Theo bald did fail to discharge his duty to the shareholders in certifying and laying before them the balance sheet... **without any reference to the report which he laid before the directors** and with no other warning than is conveyed by the words, "The value of the assets as shown on the balance sheet is dependent upon realisation". It is a mere truism to say that the value of loans and securities depends on their realization. We were told that a statement to that effect, is so unusual in an auditor's certificate that the mere presence of those words was enough to excite suspicion. But, as already stated, the duty of an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicion aroused by a similar statement, if, as in this case, its language expresses no more than any ordinary person would infer without...the balance sheet and profit and loss account being true and correct in the sense that they were in accordance with the books. But they were, nevertheless, entirely misleading, and misrepresented the real position of the company. Under these circumstances I am compelled to hold that Mr. Theo Bald failed to discharge his duty to the shareholders... Possibly he did not realise the extent of his duty to the shareholders as distinguished from the directors, and he unfortunately consented to leave the Chairman to explain the true state of the company to the shareholders instead of doing so himself. The fact, however, remains, and cannot be got over, that the balance sheet and certificate of February 1892 did not show the true position of the company at the end of 1891 and that this was owing to the omission by the auditor **to lay before the shareholders** the material information which he had obtained in the course of his employment as auditor of the company, and to which he called the attention of the directors.... Where did the money come from with which the dividends were



paid? The money came from **cash** at the bankers or in hand; but this cash could not be properly treated as **profit** and the directors and auditors knew this perfectly well....”

RIGBY, LJ. “... The Articles of Association cannot absolve the auditors from any obligation imposed upon them by the statute.... Under the statute the members of the company are entitled to have the safeguard of an expression of opinion of the auditors to the effect, first, that the balance sheet, is properly drawn up so as to exhibit a true and correct view of the state of the company’s affairs.

The words “**as shown by the books of the company**” seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the balance sheet with entries in the books. A full and fair balance sheet must be such a balance sheet as to convey any known causes of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.”

### 3. RE ALLEN CRAIG & CO. (LONDON) LTD. (1934) Chapter 483

The reports and balance sheets for the years ending June 30, 1925, and, June 30, 1926, were signed by two directors. The reports annexed to these balance sheets were signed by the auditors. The question was: What was the duty of auditors in respect of these two balance sheets?

The auditors merely sent the reports and balance sheets to the secretary of the company, and they never got beyond the secretary. The directors never called a general meeting to consider these balance sheets and reports.

By Section 162 (1) of the Companies Act “The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office...”

#### BENNET, J:

“... Does the statute impose on the auditors the duty of making their report to **every member of the company**?

Now if you give the words their plain meaning it would seem that that obligation is imposed on them. But when you begin to reflect on the question, it cannot, I think, have been the intention of the legislators to impose that duty on the auditors and it certainly has never been the practice, since the obligation has been imposed, for auditors themselves to send their reports to every member of the company... **I do not think it possible to hold that the words “the members”... mean “all the members”**. It cannot be that the auditors are to be at the expense and trouble not merely of sending their report through the post but of delivering a copy to every member. It seems that **one is forced by circumstances to limit the meaning of the words “the members” and I hold that they mean “the members assembled in the general meeting”**.... if the report is to be made to the members in general meeting, then it would not be right, I think, to hold that the duty of the auditors is to make that report themselves to the members in general meeting

unless they can themselves call a general meeting or can compel someone else to call a general meeting. **There are no means by which they can call a general meeting or compel other persons to convene a general meeting.** The only persons who can call a general meeting are the directors or **the meeting who have called upon the directors to do so and they have failed to do so.** The audience themselves are powerless.

In my judgment, the duty of the auditors, after having affixed their signatures to the reports annexed to a balance sheet, is confined to forwarding that report to the secretary of the company, leaving the secretary of the company or the directors to perform the duties which the statute imposes of **convening a general meeting to consider the report....** The statute compels directors to convene a meeting once a year and compels directors to present reports to the general meeting and it is for the shareholders to see that the directors do their duty...**the duty of the auditors is discharged by sending the report to the secretary of the company...**"

## CHAPTER ELEVEN

### QUESTION ONE

#### Matters to be expressly stated in Auditors' Report

This is provided for in the seventh schedule to the Companies Act and includes the following:

1. The auditors should state whether they have obtained all the information and explanations which to the best of their knowledge and believe were necessary for the purposes of their audit.
2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
3. Whether the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.
4. Whether, in the auditors' opinion and to the best of their information and according to the explanations given to them, the said accounts give the information required by the Companies Act in the manner so required and give a true and fair view:
5. In the case of the balance sheet, the state of the company's affairs as at the end of its financial year
6. In the case of the profit and loss account, the profit or loss for its financial year,
7. Or as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Sixth Schedule are not required to be disclosed.
8. In the case of a holding company submitting group accounts whether in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof.

The report drawn up by the auditors must be attached to the accounts when sent to the members (Section 156) and it shall be read before the company in general meeting and shall be open to inspection by any member. (Section 162(2)).





## QUESTION TWO

### APPOINTMENT AND POWERS OF INSPECTORS

Where it appears to the registrar that there is good reason so to do, he may appoint one or more competent inspectors to investigate and report on the membership of any company and otherwise with respect to the company for the purpose of determining the true persons who are or have been financially interested in the success or failure (real or apparent) of the company or able to control or materially to influence the policy of the company.

The appointment of an inspector under this section may define the scope of his investigation, whether as respects the matter or the period to which it is to extend or otherwise and in particular may limit the investigation to matters connected with particular shares or debentures.

Where an application for an investigation under this section with respect to particular shares or debentures of a company is made to the registrar by members of the company and the number of applicants or the amount of shares held by them is not less than that required for an application for the appointment of an inspector, the registrar shall appoint an inspector to conduct the investigation unless he is satisfied that the application is vexatious, and the inspector's appointment shall not exclude from the scope of his investigation any matter which the application seeks to have included therein, except in so far as the registrar is satisfied that it is unreasonable for that matter to be investigated:

Provided that the registrar may refuse to appoint an inspector under this subsection unless, in any case in which he considers it reasonable so to require, the applicants give sufficient security for the payment of the costs of the investigation.

Subject to the terms of an inspector's appointment, his powers shall extend to the investigation of any circumstances suggesting the existence of an arrangement or understanding which, though not legally binding, is or was observed or likely to be observed in practice and which is relevant to the purposes of his investigation.

The AFORESAID shall apply in relation to all persons who are or have been, or whom the inspector has reasonable cause to believe to be or have been financially interested in the success or failure, or the apparent success or failure, of the company or any other body corporate whose membership is investigated with that of the company, or able to control or materially to influence the policy thereof, including persons concerned only on behalf of others, as they apply in relation to officers and agents of the company or of the other body corporate, as the case may be; and

The registrar shall not be bound to furnish the company or any other person with a copy of any report by an inspector appointed under this section or with a complete copy thereof if he is of opinion that there is good reason for not divulging the contents of the report or of parts thereof, but shall keep a copy of any such report or, as the case may be, the parts of any such report, as respects which he is not of that opinion.

The expenses of any investigation under subsection (1) shall be defrayed by the registrar.

The expenses of any investigation under subsection (3) shall be defrayed by the applicants unless the registrar certifies that it is a case in which he might properly have acted under subsection (1).

## QUESTION THREE

### Books of Account

By Section 147 (1) every company shall cause to be kept in the English language “proper books of account” with respect to: -

- (a) All sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place
- (b) All sales and purchases of goods by the company;
- (c) The assets and liabilities of the company.

Section 147(2) provides that “proper books of account” shall be deemed not to have been kept with respect to the matters aforesaid if there are not kept such books as are necessary to give a true and fair view of the state of the company’s affairs and to explain its transactions.

By Section 147(3) (a) the books of account are to be kept at the registered office of the company or, with the consent of the registrar and subject to such conditions as he may impose, at such other place as the directors think fit, and shall at all times be open to inspection by the directors.

### Contents of Profit and Loss Account

**Part I of the Sixth Schedule provides there shall be shown:**

1. The amount charged to revenue by way of provision for depreciation, renewals or depreciation of fixed assets.
2. The amount of the interest on the company’s debentures and other fixed loans.
3. The amount of the charge for income tax and any other taxation on profits to date
4. The amounts respectively provided for redemption of share capital and loans
5. The amount, of material, set aside or proposed to be set aside to reserves.
6. The amount of income from investments, distinguishing between trade investments and other investments.
7. The aggregate amount of the dividends paid and proposed.
8. If the remuneration of the auditors is not fixed in general meeting, the amount shall be shown under a separate heading.
9. The following matters shall be stated by way of notes, if not otherwise shown:
10. If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.
11. The basis on which the amount, if any, set aside for income tax is computed.
12. Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.
13. Except in the case of the first profit and loss account laid before the company after the commencement of the Companies Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.
14. Any material respects in which any items shown in the profit and loss account are affected by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or by any change in the basis of accounting.



## Group Accounts

Section 150(1) provides that if, at the end of its financial year, a company has subsidiaries, then it must include in its annual accounts “group accounts” dealing with the affairs of the subsidiaries as well.

By Section 150(2)(b) group accounts need not deal with a subsidiary of the company if the company’s directors are of the opinion that:

- It is impracticable, or would be of no real value to the members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company
- The result would be misleading
- The result would be harmful to the business of the company or any of its subsidiaries
- The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

The approval of the registrar shall be required for not dealing in group accounts with a subsidiary on grounds (iii) or (iv).

By Section 150 (2)(a), a company is exempt from the obligation to prepare group accounts if it is a wholly owned subsidiary of another body corporate incorporated in Kenya.

## Form of Group Accounts

Section 151(1) provides that the group accounts laid before a holding company shall be consolidated accounts comprising:

- A consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;
- A consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.

However, the group accounts need not be prepared in this form if the directors are of the view that they could be prepared in another form which would be readily appreciated by the company’s members (Section 151 (1)).

## Contents of Group Accounts

Section 152 (1), the group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

Section 153(1) further provides that the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Sixth Schedule to the Act, so far as applicable thereto and if not so prepared, shall give the same or equivalent information.

## CHAPTER TWELVE

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## QUESTION ONE

a)

- (i) Under Section 214 of the Companies Act “contributory” means “every person liable to contribute to the assets of a company in the event of its being wound up.”
1. The liability of a contributory creates a debt from him to the company.
  2. These are persons who owe the company in respect of shares held.
  3. A contributory may be a present or past member of the company.
    - i) Under Section 323 (1) (a) of the Act, if in the course of winding up a company, it appears that any business of the company has been carried on,
      - 1 With intent to defraud its creditors or creditors of any other person
      - 2 For any fraudulent purpose.

the court may, on application of the official receiver or liquidator or creditor or contributory of the company, declare that any person who was knowingly party to the carrying on of the company’s business as such personally responsible without any limitation of liability, for any debts or other liabilities of the company as the court may direct.

- 1 All persons who are knowingly parties to the carrying on of the company’s business are liable to an imprisonment for a term not exceeding two years or a fine not exceeding Kshs.10, 000 or both.
- 2 If the person(s) is a creditor to the company, the court may order that he ranks behind all other creditors in the satisfaction of claims.
- 3 If the person(s) is a creditor to the company, his claim against the company is offset against the amount due from him to the liquidator.

b)

Under Section 222 of the Companies Act, on hearing a winding up petition the court may:

- 1 Dismiss it.
- 2 Adjourn the hearing conditionally or unconditionally.
- 3 Make an interim order.
- 4 Make such other or further order as it may deem fit.

However, the court cannot refuse to make a winding up order on the ground only that the assets of the company have been mortgaged to an amount equal to or in excess of those assets or that the company has no assets.

## QUESTION TWO

- i) In a compulsory winding up, the liquidator including a provisional liquidator exercises the following powers *with the sanction of the court or committee of inspection*.
- To bring or defend actions and legal proceedings in the name and on behalf of the company.
  - To carry on the business of the company so far as may be necessary for beneficial winding up.
  - To appoint an advocate to assist him in the performance of his duties.
  - To pay any classes of creditors in full.



- To make any compromise or arrangement with creditors.
- To compromise all calls and liabilities to calls, debts and other liabilities.

**i) On his own responsibility and *without obtaining any sanction the liquidator can:***

- Sell the property of the company by public auction or private contract.
- Do all act as and execute, in the name and on behalf of the company all deeds and documents and use the company's seal therefore.
- Prove, rank and claim in the bankruptcy or insolvency or any contributory.
- Draw, accept, make and endorse any bill of exchange or promissory note in the name and on behalf of the company.
- Raise money on the security of the company's assets.
- Take out letters of administration to any deceased contributory and to do any other act necessary for obtaining payment of money from a contributory or his estate.
- Appoint an agent to do any business which the liquidator cannot do himself.
- Do all such other things as are necessary for winding up the affairs of the company and distribution its assets

### QUESTION THREE

**a) Types of winding-up**

- i) Compulsory winding up or winding up by the court.
- ii) Winding up subject to the supervision of the court.
- iii) Voluntary winding up.

### Who may commence proceedings?

#### Compulsory winding up

1. The company
2. Creditors
3. Contributories
4. The attorney general
5. The official receiver
6. Members other than contributories.

#### Winding up under the supervision of the court

1. The creditors
2. The official receiver
3. Members

#### Voluntary winding-up

1. Shareholders
2. Creditors

### b) How the creditor can prove insolvency

1. That a debt of Ksh.1,000 or more remain unpaid three weeks after demand
2. Execution or other process has been returned unsatisfied wholly or in part.
3. That taking into account the prospective and contingent liabilities the court is satisfied that the company is unable to pay its debts.

### c) Course of action open to a secured creditor in liquidation

1. Value the security and prove the balance, if any.
2. Sell the security and prove the balance, if any.
3. Surrender the security and prove the entire debt.
4. Rely on the security and not prove at all.

## CHAPTER THIRTEEN

### QUESTION ONE

The following sequence of action is necessary:

1. Application is made to the court (usually by the company itself) for an order that one or more meetings of members and or of creditors (if the scheme will affect the rights of creditors) shall be held. With the application the company submits a document setting out in detail the terms of the scheme of arrangement and also an explanatory statement to be issued with the notice(s) convening the meeting(s). If the court is satisfied that the scheme is generally suitable for consideration as a “scheme of arrangement” under Section 207, it will order that a meeting of meetings be held to consider it. The court is not at this stage concerned with the details of the scheme nor with the issue (which may arise later) as to whether there are conflicts of interest, which require that separate meetings should be held. The court merely looks at the outline of the scheme and if it seems suitable orders that meeting(s) be held.
2. A meeting or several meetings is or are held as the court has ordered. A substantial quorum, say members (present in person or by proxy) holding one-third of the shares, is required and the scheme must be approved by members (or, as the case may be, creditors) voting at each meeting who:
  - (i) Are a majority in number, and
  - (ii) Represent three-quarters in value of the shares (or at a creditors’ meeting, of the amounts owing).

Requirement (ii) is imposed to safeguard a minority in numbers who have a larger financial stake than the numerical majority following approval of the scheme at meeting(s) where application is made to the court for an order to approve and implement the scheme. At this stage any minority which opposes the scheme may state its objections for consideration by the court



3. A copy of the court order approving the scheme is delivered to the registrar and the scheme then takes effect, i.e., the changes are made automatically as soon as this is done.
4. A scheme of arrangement is very flexible since it may be used to effect any “compromise or arrangement” with members or a class of members with creditors or a class of creditors. It has been used to vary the rights attached to debentures or preference shares (when there are obstacles to a straightforward reduction of capital or variation of class rights) or to reorganize the capital structure of a company or to acquire shares of a company (instead of a take-over bid to which section 210 will apply). But if there is a specific procedure, such as a reduction of capital or a variation of class rights, which can be used, the court would not permit the use of a scheme of arrangement to avoid some safeguard of minority interests available under that specific procedure.

Section 207 refers to a “class” of members or of creditors. Obviously if two or more companies are involved or if one company has two classes of shares, e.g. preference and ordinary, or is proposing a compromise with different classes of creditors, e.g. debenture holders and unsecured trade creditors, it must ask the court to order that separate meetings be held of each group and it must obtain the required majority approval at each meeting. But the principle is carried even further. If within say one class of shareholders there are groups whose interests in the proposed scheme are clearly different, the court must be asked to order that separate meetings be called of each group. It has been said that each meeting “must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest” (***Sovereign Life Assurance Co v Dodd***).

If those who propose the scheme do not, in their application to the court, distinguish each such group (to be consulted separately) the court will at the final decision stage withhold its approval on the ground that there has not been fair and proper consultation.

***In Re: Hellenic and General Trust (1976)***, a scheme of arrangement was agreed between Hambros and Hellenic whereby the shareholders of Hellenic were to have their shares in the company cancelled in return for cash compensation. Hambros was to pay the compensation and then receive the same number of shares in Hellenic. The scheme was approved at a meeting of Hellenic by a majority in number of the shareholders holding three quarters in value of the shares involved. But a wholly owned subsidiary of Hambros (MIT) held 53% of the shares in Hellenic and voted for the scheme. Hellenic applied for approval of the scheme and was opposed by a Greek Bank, a 14% shareholder in Hellenic. Its objections were that it wished to retain its membership and also that the cash received for its shares would be subject to heavy capital gains tax liability in Greece.

The Greek bank opposed the approval of the scheme before the court on two grounds. First, MIT as a subsidiary of Hambros had a different interest in the scheme from the other shareholders of Hellenic. MIT was Hambros indirectly; it was seeking to acquire the 47% of Hellenic, which it did not (through MIT) already own. There should therefore have been a separate meeting of the holders of the 47% of Hellenic shares not already under the Hambros’ control through MIT. At such a meeting, the Greek bank (with 14% out of 47%) could have prevented approval by the required three quarters majority.

Secondly, the purpose of the scheme was to enable Hambros to acquire 47% of the shares of Hellenic. (The device of cancelling the shares for cash and issuing new ones to Hambros was to save the stamp duty payable on a straightforward transfer of the shares - an example of the advantages of a scheme of arrangement.)

It was argued that a scheme of arrangement should not be used in a situation for which the take-over bid procedure was appropriate. Under take-over bid rules the required 90% acceptance (from the independent shareholders) would not have been obtained since the Greek bank held more than one-tenth of the outstanding 47% minority shareholdings.

When the scheme is before the court for final approval a minority may object on any of the various grounds indicated above i.e. that a section 207 procedure is inappropriate or has not been correctly observed, or that approval has not been obtained in a proper way or that the court in its discretion should reject the scheme since it would be unfair.

If the court approves the scheme and makes an order providing for any of the following under section 209(1):-

- The transfer of the whole or part of the undertaking and property or liabilities to the “new” company;
- The allotment of shares and debentures etc. in that company without winding up;
- The continuation of any legal proceedings;
- The dissolution of the old company without winding up;
- Provision for dissentients;
- Such incidental and consequential matters necessary to secure the scheme to be effective;

An official copy of the order must be delivered to the registrar.

## **1 A scheme of arrangement under Section 207 offers the following advantages:**

It can be used in circumstances to which Section 210 and Section 280 do not apply. As explained above it has only to be an “arrangement or compromise” of some sort with members or creditors;

In circumstances where Section 207 is an alternative procedure a scheme of arrangement only requires approval by three quarters of the votes cast at each meeting. This is a less stringent requirement than Section 210 imposes since Section 210 operates only if holders of 90 per cent of all the shares for which the offer is made accept the offer. If there is doubt whether 90 per cent acceptance is obtainable a Section 207 scheme is to be preferred. But if (as in the Hellenic & General Trust Case) the court concludes that an identified minority has been denied the veto which Section 210 would have given it is unlikely to give its approval under Section 207. Apart from technical points it would be unfair to do so;





The court order to implement the approved scheme under Section 209(1) often saves substantial expense, which could otherwise be incurred if the arrangement were effected in some other way.

The Company need not be wound up in order to carry out this scheme of arrangement under this section.

The disadvantage of a scheme of arrangement is that it requires the preparation of elaborate documents and the observance of a strict procedure, including an initial and final application to the court and the holding of meetings. All this is expensive. Hence a scheme of arrangement is only suitable for large companies where substantial values or assets are affected. Otherwise it is uneconomical.

If a company, which is or is about to be in voluntary liquidation proposes to make a composition with its creditors it has a choice between the following alternatives:

- A scheme of arrangement under Section 207;
- An arrangement sanctioned by three quarters (in number and in value) of the creditors under Section 300. This liquidation procedure is binding on a minority unless the court on the application of a creditor or contributory (member) orders otherwise;
- A compromise made by the liquidator in exercise of statutory powers under section 241 or Section 297(l)(a). For this purpose he must obtain approval of members, creditors, committee of inspection or the court according to the circumstances of the case.

It is usual to proceed under Section 207 as there are technical difficulties over Section 300 procedure. The liquidator's powers to reach a compromise with creditors are restricted to cases where all creditors (of the same class) are treated alike, e.g. a uniform payment of Shs.15 in 1 pound to be accepted in full settlement. But if their rights are to be varied a scheme of arrangement is required, i.e. Section 207 is the correct procedure.

## QUESTION TWO

### Reconstruction under Section 280

Section 280 provides that where a company is proposed to be, or is in course of being wound up voluntarily, and the whole or part of its business or property to be transferred or sold to another company, the liquidator of the first-mentioned company (transferee company) may with the sanction of a special resolution conferring either a general authority on the liquidator or an authority in respect of any particular arrangement, receive in compensation or part compensation for the transfer or sale, shares, policies or other like interests in the transferee company for distribution among the members of the transferor company, or may enter into any other arrangement whereby the members of the transferor company may, *in lieu* of receiving cash, shares or other like interests, participate in the profits of or receive any other benefit from the transferee company.

This form of reconstruction is often used when additional working capital is needed and other means of raising it are not available. It has also been used for alteration of the company's objects; variation of shareholders rights and effecting a compromise with creditors.

Reconstruction under this section is subject to several disadvantages and is little used. But when

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a reconstruction takes this form Section 280 procedure must be followed so that a dissenting minority does have the appropriate safeguard.

This procedure also applies to a company, which is proposed to be, or is in course of being wound up voluntarily. A company in liquidation must dispose of its assets (other than cash) by sale in order to pay its debts and distribute any surplus to its members. The special feature of a Section 280 reconstruction is that the business or property of Company P is transferred to Company Q in exchange for shares of the latter company which are allotted direct or distributed by the liquidator to members of Company P. Obviously, the creditors of Company P will have to be paid in cash. A dissenting minority of members of Company P can also require to be paid in cash. Hence substantial sums may have to be found in cash. This is one of the drawbacks.

A company in (or about to go into) members' voluntary liquidation may, by special resolution, authorise the liquidator to sell the business or property for shares (of some other company) to be distributed to members. But any member who did not vote in favour of the special resolution (**dissentient member**) may in the ensuing seven days deliver to the registered office a notice addressed to the liquidator requiring him either to pay that member the value of his interest in cash or to abandon the proposed sale; Section.280.

If the company is in a creditors voluntary liquidation a special resolution to approve the sale must be passed and it is also necessary for the sale to be approved by the court or by the committee of inspection: Section 292. Moreover a creditor can at any time within a year of the passing of the special resolution (in a members' voluntary winding up) render it invalid by obtaining a court order for compulsory liquidation; Section 280(5). It is therefore prudent to dispose of possible objections by creditors before the company enters into the transaction.

## 2.1 Hence the usual procedure is:

First to dispose of possible objections by creditors by paying their debts or providing security for their due payment of their debts. Alternatively, the company may seek to obtain the consent of the creditors to the transfer of liability for their debts to the transferee company (as part of the terms on which the business is sold);

Then to convene a general meeting and propose a special resolution to approve the sale of the business in exchange for shares of the purchasing company. It thus becomes evident how many members may demand to be bought out for cash since only members who did not vote in favour of the resolution can opt for the cash payment. If it is clear that the cash expenditure will be prohibitive, the scheme can be abandoned before the company goes into liquidation;

Finally (as the second step at the same general meeting) to move a resolution to go into liquidation. If it is to be a creditors voluntary liquidation then a committee of inspection must be appointed and asked to approve the sale under Section 292.

If a dissentient member claims to be paid the value of his interest in cash the amount (if it cannot be agreed) is to be determined by an arbitrator. The member must make out his own case before the arbitrator in support of his claim; the company is not under a duty to answer his questions. If a member fails to give notice within the seven days period to the liquidator of his demand for cash, he is entitled to his proportion of the transferee company's shares or if he refuses to accept them they may be sold and the proceeds paid over in settlement since (by failing to observe Section 280 procedure) he has forfeited his entitlement under section 280.



The disadvantages of Section 280 are that cash may have to be provided to pay off creditors and dissenting members or alternatively the sale may have to be abandoned. Secondly, the company must go into liquidation, which is an irreversible process. But Section 280 procedure is obligatory in the situation to which it relates. It may be preferable to make the desired reconstruction in some other way. For example the company to which the business is to be transferred might make a take-over bid (using Section 210 to achieve 100 per cent success) for the share capital of the company whose business it wishes to acquire. When the latter company is a wholly-owned subsidiary, there is no procedural difficulty in transferring its business to the holding company. There is no obligatory cash alternative in a Section 210 transaction though it is sometimes provided as an extra inducement.

The advantage of transferring a business from one company to another (with the same shareholders in the end) is that by this means the business may be moved away from a company with a tangled history to a new company which makes a fresh start. This procedure can also be used to effect a merger of two companies each with an existing business.

### QUESTION THREE

If Company A (“the transferee company”) offers to acquire shares of Company B (“the transferor”) and the scheme or contract to which the offer relates is accepted by holders of nine-tenths of the shares for which the offer is made Company A may then compulsorily acquire the remaining 10 per cent (or less) of the shares so as to achieve a complete 100 per cent acquisition of the shares: Companies Act, Section 210.

It is standard procedure in making a take-over bid to state that if 90 per cent acceptance is attained compulsory acquisition under Section 210 will follow. Company A may resort to Section 210 whether it offers its own shares or cash for shares of Company B. The procedure is available if Company A already owns shares of Company B and offers to acquire those which it does not already own (but see Para 22 below.) The non-accepting minority may however apply to the court to prevent Company A from acquiring their shares. The rules of procedure are explained below.

The offer must be made by a company to acquire shares of another. Section 210 is not available to an individual who makes a take-over bid (but he can always form a company for the purpose: provided no fraud or improper conduct is involved: **Re Bugle Press Ltd.** (see paragraph 8.4.11)

If Company B has two or more classes of shares and Company A makes an offer for shares of both classes this is treated as two separate offers. Section 210 applies separately to shares of each class for which 90 per cent acceptance is obtained. In such cases it is usual (but not legally necessary) for Company A to reserve the right to withdraw its offer for either class if acceptance from the other class does not reach the 90 per cent level which makes Section 210 applicable.

If Company A directly or through subsidiaries owns more than one-tenth of the shares of Company B then (in order to be able to use Section 210) Company A must:

- (a) Offer the same terms for all the shares which it does not already own;
- (b) Obtain acceptances from holders who are three-quarters in number as well as holders of 90 per cent of the shares.

The wording of Section 210 is ambiguous but it is generally taken that Company A must offer to acquire all of the shares of Company B which it does not already own if it is then to use Section 210 to acquire the remaining shares in Company B (or all the shares of the class) for which the offer is made.

Acceptance on the required scale must be obtained within a maximum of four months from the date of the offer. The position then is that:

- (a) At the end of the **four month period** (not earlier than that even if 90 per cent acceptance is attained before the period expires) Company A may (but it need not do so if it does not wish-however see paragraph 25 below) serve notice on the non-accepting shareholders of its intention to acquire their shares on the same terms as have been accepted by the majority. This notice may be given at any time within a **two month period** following the four month period;
- (b) On receiving the notice from Company A each non-accepting shareholder of Company B has one month in which he may apply to the court to order that Company A shall not acquire his shares (see paragraphs 27-28 below);
- (c) One month after serving notice on non-accepting shareholders (or if they apply to the court but fail then as the court has disposed of their application) Company A may require Company B
  - (i) To transfer the shares of its non-accepting shareholders to Company A, and
  - (ii) To receive the purchase consideration to hold in trust for the non-accepting shareholders.

By this means the outstanding shares are transferred without any further action on the part of the non-accepting shareholders.

The non-accepting shareholders have a further statutory safeguard. Company A is not obliged to serve notice of intention to acquire their shares. But as soon as Company A's total ownership of shares in Company B reaches 90 per cent (or 90 per cent of a class) it must within **one month** give notice of that fact to the holders of the outstanding shares. Those shareholders may then **within the ensuing three months** require Company A to acquire their shares on the same terms as have been accepted by the approving shareholders. By this means the shareholders who at first did not accept the offer for their shares may accept it in order to escape from the unsatisfactory position or remaining as a very small minority of members in a company (B) dominated by a single shareholder (A): Companies Act, Section 210(2).

The minority whose shares are acquired compulsory under Section 210 are entitled to all the benefits included in the original offer and accepted by the holders of 90 per cent or more of the shares. Company A must not only pay the same price (or other consideration); it must repeat all other inducements such as a cash alternative. When Company A offers its own shares in exchange for shares of Company B it is a common practice to make the offer more attractive by arranging with a third party that the latter will make a simultaneous offer (for a limited period only) to purchase from shareholders of Company B their consideration shares (allotted by Company A) if they do not wish to retain them. A holder of shares of Company B then has the choice of (i) retaining his new shares in Company A or (ii) selling them (the "cash alternative") immediately at a stated price to a third party. When Section 210 is used to acquire the outstanding shares



of Company B the bidder (Company A) must arrange for a cash alternative to be provided since that was part of the terms (although it came from a third party) which induced a high level of acceptance: **Re Carlton Holdings** (1971)

A non-accepting shareholder who applies to the court to set aside the proposed compulsory acquisition of his shares under Section 210 will fail unless he can make out a very strong case. Acceptance by holders of 90 per cent or more of the shares indicates that the terms offered are fair. This is so even if the objector contends that he had need of more information in order to reach a decision or that Company A in acquiring control of Company B will obtain special advantages (e.g. elimination of a competitor) which are not reflected in the price offered for his shares. Objection on those grounds only are likely to fail.

**But the court will not permit s.210 to be used in an artificial and oppressive manner.**

#### **Case: RE BUGLE PRESS (1900)**

X, Y and Z held 4,500, 4,500 and 1,000 one-pound shares respectively, of Company B. They were the only shareholders and X and Y were the directors. X and Y wished to eliminate Z. Section 210 however is not available to individuals. So X and Y formed a new company (Company A) in which they were the only two shareholders. Company A then offered to acquire all the shares of Company B. X and Y accepted the offer but Z did not. Company A served notice on Z that it has secured 90 per cent acceptance (the shares of X and Y) and intended to acquire Z's 1,000 shares under Section 210. Z applied to court.

#### **Held:**

Company A was a sham since (lifting the veil of incorporation) it was merely the majority shareholders (X and Y) in Company B seeking to expropriate the shares of the minority (Z). Section 210 could not be used in these circumstances. Z's objections were upheld.

The alternative to acquisition under Section 210 (in a take-over bid) is a scheme of arrangement under Section 207. The choice may be determined by comparative costs (see paragraphs 8.3.7(c) and 8.3.8). Stamp duty is payable (at the two per cent ad valorem rate) on transfers of shares of Company B in a transaction to which s.210 applies. It can be avoided under Section 207. But under Section 210 procedure there is usually no expense of court proceeds as few minority shareholders persist in their objections to the point of making application to the court (at some expense to themselves).

On the other hand if there is uncertainty about obtaining 90 per cent acceptance and a scheme of arrangement is not excessive in costs it is an easier route to the intended result. It is particularly useful when Company A is seeking to acquire those shares of a partly-owned subsidiary (Company B) which it does not own. In such cases some minority shareholders of B may be indifferent or passively opposed; Company A cannot count on their acceptances (to achieve 90 per cent) but reckons that they cannot or will not deny it a three quarters majority at a meeting. There is often a delicate balance of conflicting risks and considerations in choosing between Section 207 and Section 210 in such situations.

## CHAPTER FOURTEEN

### QUESTION ONE

#### DOCUMENTS TO BE PRESENTED TO THE REGISTRAR

Foreign companies which, after the appointed day establish a place of business within Kenya shall, within 30 days of the establishment of the place of business deliver to the registrar for registration:-

- (a) a certified copy of the charter, statutes or memorandum and articles of the company or other instrument constituting or defining the constitution of the company, and, if the instrument is not written in the English language, a certified translation thereof;
- (b) a list of the directors and secretary of the company containing the particulars mentioned in subsection (2);
- (c) a statement of all subsisting charges created by the company, being charges of the kinds set out in subsection (2) of section 96 and not being charges comprising solely property situate outside Kenya
- (d) the names and postal addresses of some one or more persons resident in Kenya authorised to accept on behalf of the company service of process and any notices required to be served on the company; and
- (e) the full address of the registered or principal office of the company.

### QUESTION TWO

#### RETURNS

If any alteration is made in:-

- (a) the charter, statutes or memorandum and articles of a foreign company or any such instrument as aforesaid
- (b) the directors or secretary of a foreign company or the particulars contained in the list of the directors and secretary
- (c) the names or postal addresses of the persons authorised to accept service on behalf of a foreign company
- (d) the address of the registered or principal office of a foreign company, the company shall, within 60 days, deliver to the registrar for registration a return containing the prescribed particulars of the alteration.

Where in the case of a company to which this Part applies:-

- (a) a winding-up order is made by
- (b) proceedings substantially similar to a voluntary winding up of the company under this Act are commenced in, a court of the country in which such company was incorporated, the company shall within 30 days of the date of the making of such order or the commencement of such proceedings, as the case may be, deliver to the registrar a return containing the prescribed particulars relating to the making of such order or the commencement of such proceedings and shall cause the prescribed advertisements in relation thereto to be published



### QUESTION THREE

The sections in part X shall apply to all foreign companies, that is to say, companies incorporated outside Kenya which, after the appointed day, establish a place of business within Kenya and companies incorporated outside Kenya which have, before the appointed day established a place of business within Kenya and continue to have a place of business within Kenya on and after the appointed day: A foreign company shall not be deemed to have a place of business in Kenya solely on account of its doing business through an agent in Kenya at the place of business of the agent.

### CERTIFICATE OF REGISTRATION AND POWER TO HOLD LAND

Where a foreign company has delivered to the registrar the documents, the registrar shall, if such documents and particulars are so delivered after the appointed day, certify under his hand that the company has complied with the requirements; and such certificate, and any certificate given by the registrar of companies before the appointed day that a foreign company has delivered to him the documents and particulars required by any provision of any of the repealed Ordinances corresponding to the said section and to the like effect, shall be conclusive evidence that the company is registered as a foreign company for the purposes of this Act.

Where a foreign company has, after the appointed day, delivered to the registrar the documents and particulars mentioned in Section 366, it shall have the same power to hold land in Kenya as if it were a company incorporated under this Act.

Where a foreign company has, before the appointed day, delivered to the registrar of companies the documents and particulars required by any provision of any of the repealed Ordinances corresponding to section 366 of this Act and to the like effect, it shall, subject to the provisions of that one of the repealed Ordinances in accordance with which such documents and particulars were so delivered and of this Act, have the same power to hold land in Kenya as if it were a company incorporated under this Act.

### REGISTRATION OF CHARGES CREATED

#### 369.

The provisions of Part IV shall extend to charges on property in Kenya which are created, and to charges on property in Kenya which is acquired, after the commencement of this Act, by a foreign company which has an established place of business in Kenya:

Provided that in the case of a charge executed by a foreign company out of Kenya comprising property situate both within and outside Kenya:-

- (i) it shall not be necessary to produce to the registrar the instrument creating the charge if the prescribed particulars of it and a copy of it, verified in the prescribed manner, are delivered to the registrar for registration; and
- (ii) the time within which such particulars and copy are to be delivered to the registrar shall be 60 days after the date of execution of the charge by the company or, in the case of a deposit of title deeds, the date of the deposit.





# GLOSSARY



STUDY TEXT





# GLOSSARY

## A

**Annexure:** Attachments or documents fixed to another

**Auditor:** This is a person appointed by the company to carry out an audit

**Audit:** This is an independent examination of the final statements as to whether they show a true and fair view

**Allotment:** It is, legally speaking, the company's acceptance of an offer to buy its shares

**Articles of association:** A document which regulates the internal affairs of a company

**Artificial person:** A person recognised by law in the form of companies

## B

**Balance sheet:** This is a financial statement that shows the company's state of affairs

**Bankrupt:** This is a person adjudicated by a court as unable to pay his debts

**Bearer:** This is a person in possession of a particular thing

**Body corporate:** This is an artificial which comes into existence through incorporation

**Brokerage:** This is the commission paid to a broker

## C

**Capital:** amount of money which a company raises from issuing shares

**Central depository system:** A computerised ledger that enables the transfer and holding of securities without need for physical movement

**Caveat emptor:** A Latin term that means buyer beware

**Class:** refers to people whose rights are so similar that it is hard to separate

**Cessation:** This refers to loss of company membership or to share entitlement

## D

**Discount:** The difference between the nominal value and the issue price; it's normally lower than the nominal value

**Derivative action:** A suit brought by a person in the name of and behalf of the **company** to remedy a wrong

**Director:** This is a person with running of the day to day affairs of the company

**Compensation:** These are the total payments that are made to a person

**Debenture:** A long term loan

**E**

**Equitable mortgage:** This is a share certificate deposited without executing transfer

**Equity:** This is capital provided by shareholders

**Estoppel:** This is an equitable doctrine that prevents a person from going against his word

**Extra ordinary general meetings:** These are all other meetings other than general meetings

**F**

**Financial Year:** This is the duration within which a company specifies as a time when an audit should reflect normally one year

**Floating charge:** This is a charge that hovers over all the assets of a company

**Floatation:** This is an invitation from a company to the public to subscribe for its shares

**Foreign companies:** These are companies that are incorporated outside Kenya

**Forfeiture:** This is the cessation of a person's membership for failure to pay a call

**G**

**General meetings:** These are meetings chaired by a chairman held annually to discuss matters affecting the company's management

**Good faith:** This is doing a deed with good intentions and no malice

**Group accounts:** These are financial statements which consist those of a holding company and its subsidiaries

**Group enterprises:** This is an enterprise that consists of a holding company and its subsidiaries

**Guarantee:** This is an agreement whereby a person undertakes to pay the creditor should the debtor default

**I**

**Insider trading:** This is dealing in company securities with information that is not available in the public domain

**Incorporated association:** An artificial person that has a legal identity

**Indemnity:** This is a payment that reinstates the aggrieved to the position he was in before the loss occurred

**Infant:** This is a person who has not attained the age of majority

**Intra vires:** This is a transaction within the contracting capacity of a company

**L**

**Limited liability:** liability of members is limited to the amounts if any unpaid on their shares

**Liquidator:** a person appointed by court to take control of the company's assets and realize them



**Lien:** An equitable or legal charge on the shares of a member

**Mortgage:** A transaction whereby an asset is used as collateral for a loan

## M

**Memorandum of Association:** A document which regulates the affairs of the company and outsiders

**Member:** a person who subscribes to the memorandum or whose name is entered in the register of members

**Merger:** Denotes instances in which the property of the company is transferred to another which is already in existence

**Minority:** A share holder who holds the least number of shares

**Meeting:** coming together of two or more people

## N

**Natural person:** An individual human being

**Name clause:** This is a clause in the memorandum that gives the name of the incorporated association

**Negligence:** This is failing to do what a reasonable man given those circumstances would have done

**Nullity:** Means a transaction which is unenforceable

## O

**Oppression:** A situation where those in power take unfair advantage of the minority

**Oral transfer:** This is a transfer by word of mouth

**Objects clause:** This is a clause that the purposes for which a company is formed

## P

**Premium:** The money received in excess over the par value of shares

**Prospectus:** Document issued by a public company which wants to raise capital

**Proxy:** A person appointed by a shareholder to vote on behalf of that shareholder at a company meeting

**Pre-incorporation contract:** This is a contract entered into on behalf of a company before it comes into existence

**Prima facie:** A Latin term which means on the face of it

**Q**

**Quorum:** The requisite number of members to be present for a meeting to take place

**Qualification shares:** These are the shares that are prescribed in the articles for the director to take up before he can qualify as one

**R**

**Receiver:** A representative of secured creditors to enforce their security

**Reconstruction:** Recreation of a company building it a new

**Redeemable preference shares:** these are shares that rank above ordinary shares and are bought back by the company during its existence

**S**

**Share:** The basic unit of ownership in a company

**Secured creditor:** This is a creditor whose debt is secured on a fixed or floating asset of the company

**Stock:** This is a block of shares

**T**

**Transfer:** Occurs when shares are bought from a member rather than the company

**U**

**Ultra vires:** A Latin term which means beyond the contracting powers of a company

**V**

**Void:** Means the contract cannot be enforced it confers no rights and imposes no obligations

**Voidable:** A contract that can be enforced at the option of the innocent party

**W**

**Warrant:** This is a warranty that the bearer is the owner of the shares specified there insurance

**Winding up:-** Process by which a company is dissolved and ceases to exist

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STUDY TEXT







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