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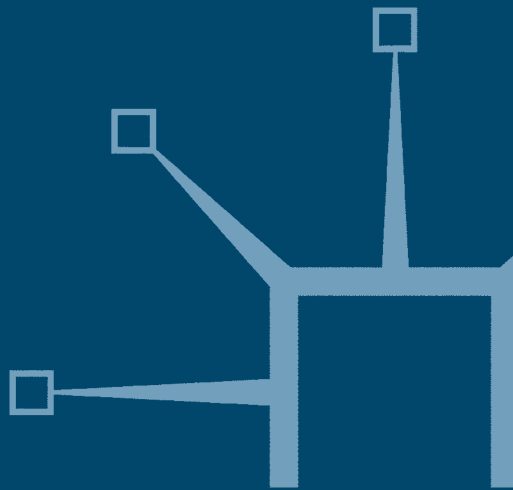
Business Law, Second Edition

Stephen Judge



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Business Law

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Business Law

Second Edition

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First edition 1995
Second edition 1999

Published by
MACMILLAN PRESS LTD
Houndmills, Basingstoke, Hampshire RG21 6XS
and London
Companies and representatives throughout the world

ISBN 0–333–74709–7

A catalogue record for this book is available from the British Library.

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

10 9 8 7 6 5 4 3 2 1
08 07 06 05 04 03 02 01 00 99

Printed in Great Britain
Antony Rowe Ltd
Chippenham, Wiltshire

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Preface to the Second Edition

The book is aimed at business studies students on undergraduate and equivalent courses as well as the business community.

It is almost impossible to define precisely the scope of a book on business law since no such thing exists – there is merely a heading embracing specific aspects of the law generally identified with business activities. And, as business activities cannot be closely defined since they extend to 'any trade, profession or occupation' (s.45, Partnership Act 1890), it is necessary to restrict artificially the scope of what is defined as a business activity to define the scope of business law.

The law in this book will be of central interest to specialists such as bankers, insurers, stockbrokers or debt factors, but it excludes the specific law that governs their particular professions' specialised literature. Business law is largely concerned with the supply of goods and services, and the organisations that undertake this activity.

The book starts with an introduction to the background of the sources of law and resolving legal disputes, including arbitration and alternative dispute resolution (ADR). It continues with the identification and explanation of the law of obligations, with particular reference to contract and tort, before considering the different forms of business organisation and the nature of business assets, including their use as a security for loans. The book then looks at business contracts of agency, employment and the sale and supply of goods and services.

The book then considers consumer credit and methods of payment and has a section devoted to consumer protection, including competition law, since the protection of the consumer is the justification for interference in respect of mergers, monopolies and general restrictive practices. This is looked at from the point of view of English and Community law. Chapters on the law of personal and corporate insolvency conclude the volume.

STEPHEN JUDGE

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Part I

Essentials of the English Legal System

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1 Essentials of the Legal System

Learning Objectives

After reading this chapter you will know about:

1. the difference between natural and legal persons
2. the operation of the doctrine of binding judicial precedent as a source of law
3. the forms of direct and indirect legislation and the principles of statutory interpretation
4. the importance of Community law as a source of law
5. the concepts of direct applicability and direct effectivity of Community law and the supremacy of Community law
6. the importance of the European Convention on Human Rights as a source of law

1.1 The Classification of English Law

In England the main distinction is between criminal and civil law. Criminal and civil liability overlap but criminal law exists to punish criminals and, although compensation payments are made under the Powers of Criminal Courts Act 1973, and the Criminal Injuries Compensation Scheme 1964 makes *ex gratia* payments to victims of violent crime, these will generally sue in civil law for damages.

1.2 Legal Personality

Legal rights attach to legal persons; these can be (i) natural; and (ii) artificial persons or corporations.

Natural persons

Important for natural persons are nationality and domicile, gender and race. Nationality determines a person's public rights, such as allegiance, the right to vote and to sit in Parliament, although the nationals of one member state of the European Community have equal rights with nationals in other member states. A person will normally have only one nationality, but may have dual nationality and can be stateless. Civil law generally treats nationals and aliens alike.

Domicile determines the regulatory legal system of a person. All people are domiciled somewhere and can only have one domicile at any given time. There are three types of domicile: (i) domicile of origin; (ii) domicile

of choice; and (iii) dependent domicile. Domicile of origin attaches to the person at birth. Domicile of choice arises where a person of full age and capacity establishes a permanent home in a country with the intention of remaining there – the *animus manendi*. Anyone abandoning a domicile of choice reverts to their domicile of origin until acquiring a new domicile of choice. Dependent domicile was relevant for minors and married women whose domicile was dependent upon their parents or husband. The Domicile and Matrimonial Proceedings Act (DMPA) 1973 now allows married women to acquire a domicile separate from their husband, s.1, DMPA 1973, and minors to acquire an independent domicile at 16, and for minors to adopt the mother's domicile when parents separate or divorce, ss. 3 & 4, DMPA 1973.

Corporations

The principal corporations are composed of a number of persons and classifiable as (i) chartered; (ii) statutory; and (iii) registered corporations. Chartered corporations are created by royal charter. The earliest trading corporations were created in this way: for example, the Hudson's Bay Company and the East India Company. Today chartered corporations comprise professional bodies such as the Institute of Chartered Secretaries and Administrators (ICSA). The older universities are chartered corporations. Statutory corporations are created by a special Act of Parliament. Local authorities are statutory corporations, as are the nationalised industries, although their number has been reduced through privatisation. Registered corporations are incorporated under the Companies Act 1985 and are the normal trading companies. (See Chapters 6 and 8.)

Unincorporated associations

These have no legal personality and their property is jointly owned by the members, who are also contractually and tortiously liable. Special rules relate to trade unions, employers' associations, and partnerships (see Chapter 7).

1.3 The Sources of English Law

The major sources are (i) case law; (ii) legislation; and (iii) European Community law.

Case law

A statement of the law made by a judge in deciding a case establishes a precedent and will be relevant for future similar disputes depending on the status of the court. The doctrine of binding precedent depends on:

(i) a court hierarchy; and (ii) accurate and efficient law reporting, which were only fully achieved by the end of the nineteenth century.

Civil cases are reported using the names of the plaintiff and the defendant. Criminal cases are general indicated by the letter 'R' standing for *Rex* or *Regina* (king or queen) in place of the plaintiff as the action is brought by the state. The letters DPP (Director of Public Prosecutions) and AG (Attorney General) will also be found. The rest of the reference is an information retrieval code: *Saunders* v. *Anglia Building Society* [1971] AC 1004 or *R* v. *Kylsant* [1932] 1 KB 442. The *Law Reports* has a separate series of reports for each division of the High Court – Ch for Chancery Division; Fam for Family Division; and QB (or KB) for Queen's Bench (or King's Bench) Division. The date in the square bracket indicates the year of the reports to be consulted (it is not necessarily the year of the hearing). The volume number appears before the letters and the page number follows the letters. Court of Appeal cases are reported under the name of the division where they were initially heard and House of Lords cases are reported as Appeal Cases (AC). The Council also publishes Weekly Law Reports, indicated by the letters WLR. A number of private reports exist of which the most famous are the All England Reports, indicated by the letters 'All ER'. Cases are also accessible through computer data bases of which the most well-known is the Lexis system. Unreported cases can be cited, provided they are vouched for by a barrister present when the judgment was delivered.

The binding element in legal decisions

Reports detail facts, names of parties, a statement of the law forming the basis of the decision and the judgment. Only the statement of law forming the basis of the decision is binding. Cases may contain other statements of the law. The binding statement is the *ratio decidendi* (the reason for the decision). Other statements are merely persuasive and are called an *obiter dictum* (a statement of law made by the way).

A *ratio decidendi* is a statement of law applied to the legal problems raised by the material facts of the case as identified by the court upon which the decision is based. To be binding in principle it must comply with this definition in all respects. There are two types of *obiter dictum*: (i) a statement of law based upon facts which were either not found to exist or, if found, were not found to be material; or (ii) a statement of law which, although based on material facts of the case as identified by the court, does not form the basis of the decision. The first is a statement of law based upon a hypothesis. The judge states what he or she believes the law would be if the material facts of the case were different. In *Rondel* v. *Worsley* [1969] 1 AC 191, statements by the House of Lords that a barrister who was negligent when acting other than in connection with litigation might be liable in tort, and that a solicitor would be immune from tortious liability when acting as an advocate are *obiter*, since the case concerned the tortious liability of a barrister acting as an advocate. The second is a dissenting judgment in a court where there is majority decision.

The *ratio* of a case will generally be determined by a later court applying the decision to a new situation. Problems arise where cases have multiple ratios. One of the ratios may be then identified as the real *ratio decidendi* and the other may be regarded as *obiter*. The persuasive worth of *obiter dicta* depends upon the reputation of the judge and his position in the judicial hierarchy.

Precedents which are not binding

These include: (i) persuasive precedents; (ii) precedents which have been overruled; (iii) precedents which have been distinguished; and (iv) *per incuriam* precedents.

Persuasive authorities Precedent operates vertically downwards so that higher courts are not bound by decisions of courts lower in the hierarchical system, which are only persuasive. Decisions of Scottish, Irish, Commonwealth and foreign courts will only be regarded as persuasive.

Precedents which have been overruled A precedent can be overruled by a subsequent decision of a higher court or by an Act of Parliament. Judicial overruling is retrospective, whereas overruling by Act is generally prospective and operates from the date when the Act comes into effect, unless the legislation operates retrospectively. Overruling is an essential guarantee of the development of the law.

Overruling must be contrasted with reversing. Overruling affects the rule of law upon which the overruled decision was based, but not the rights of the parties. Thus a decision made twenty years previously by a lower court can be overruled, effecting a retrospective change in the law, but the position of the original litigants is not affected. Reversing is where a decision of a lower court is overturned on appeal and will affect the parties to the case directly.

Precedents which can be distinguished If the court is prepared to find a material difference in the facts of the case before it and the precedent it is requested to follow, it can refuse to be bound by the precedent. In theory it is possible to distinguish virtually any precedent, since factual situations will almost never duplicate themselves precisely. The possibility of distinguishing is a further factor ensuring the flexibility and adaptability of the law to changing circumstances. Cases which are indistinguishable are regarded as being 'on all fours' with one another

Per incuriam (through lack of care) precedents The Court of Appeal in *Young* v. *Bristol Aeroplane Co. Ltd* [1944] KB 718 established that it was not bound to follow its own earlier decisions if they had been made through lack of care. This refers to decisions made where some relevant statutory provision or precedent had not been brought to the court's attention. In this sense the decisions are flawed. This principle has now been applied to other courts but is of limited application.

The operation of the doctrine

All lower courts are bound by decisions of superior courts, and some courts are bound by horizontal precedents at the same level (see Figure 1.1).

House of Lords The House of Lords is bound by decisions of the European Court of Justice (ECJ) and the Court of First Instance (CFI) in matters of Community Law. Having declared that it was bound by its own decisions (*London Street Tramways Ltd* v. *LCC* [1898] AC 375), it gave itself the right to 'depart from' its own previous decisions 'when it appears right to do so', (*Practice Statement (Judicial Precedent)* [1966] 3 All ER 77).

The Court of Appeal (Civil Division) This court is bound by decisions of the ECJ and CFI and the House of Lords, and by its own decisions subject to the exceptions set out in *Young* v. *Bristol Aeroplane Co. Ltd* [1944] KB 718. Thus: (i) where there are two conflicting decisions, the court may choose which it will follow; (ii) where an earlier decision of the Court is inconsistent with a later decision of the House of Lords, the court must follow the House of Lords; and (iii) where the decision is made *per incuriam*, the court is not bound to follow it.

The Court will not follow a decision subsequently disapproved by the Judicial Committee of the Privy Council (JCPC): *Doughty* v. *Turner Manufacturing Co. Ltd* [1964] 1 QB 518. The division is also bound by the decisions of the criminal division (but not earlier courts of criminal appeal). Decisions by a full court of five or seven judges do not have more weight, and decisions by a two-judge court do not carry less weight: *Langley* v. *North West Water Authority* [1991] 3 All ER 610.

The Court of Appeal (Criminal Division) This court is also bound by the decisions of the ECJ/CFI, the House of Lords and the Court of Appeal civil division, subject to the usual exceptions. The Criminal Division is not bound by its own previous decisions where this would cause injustice: *R* v. *Gould* [1968] 2 QB 65, but see statement by May LJ in *R* v. *Spencer* [1985] 1 All ER 673. The number of judges making up a court seems to be more important in the criminal division and will affect the status of the decision. The court will generally only overrule an established principle of the law by the decision of a court of five or even seven judges.

The divisional courts (appellate and judicial review) These are bound by all the higher courts and their own earlier decisions subject to the rules in *Young* v. *Bristol Aeroplane Co. Ltd* [1944] KB 718. With regard to the judicial review function of the Queen's Bench Divisional Court (QBD), there is greater flexibility, since judicial reviews are regarded as first instance decisions and not as appeals. In criminal cases, the QBD is free to depart from its own decisions in the interests of justice in the same way as the Criminal Division of the Court of Appeal.

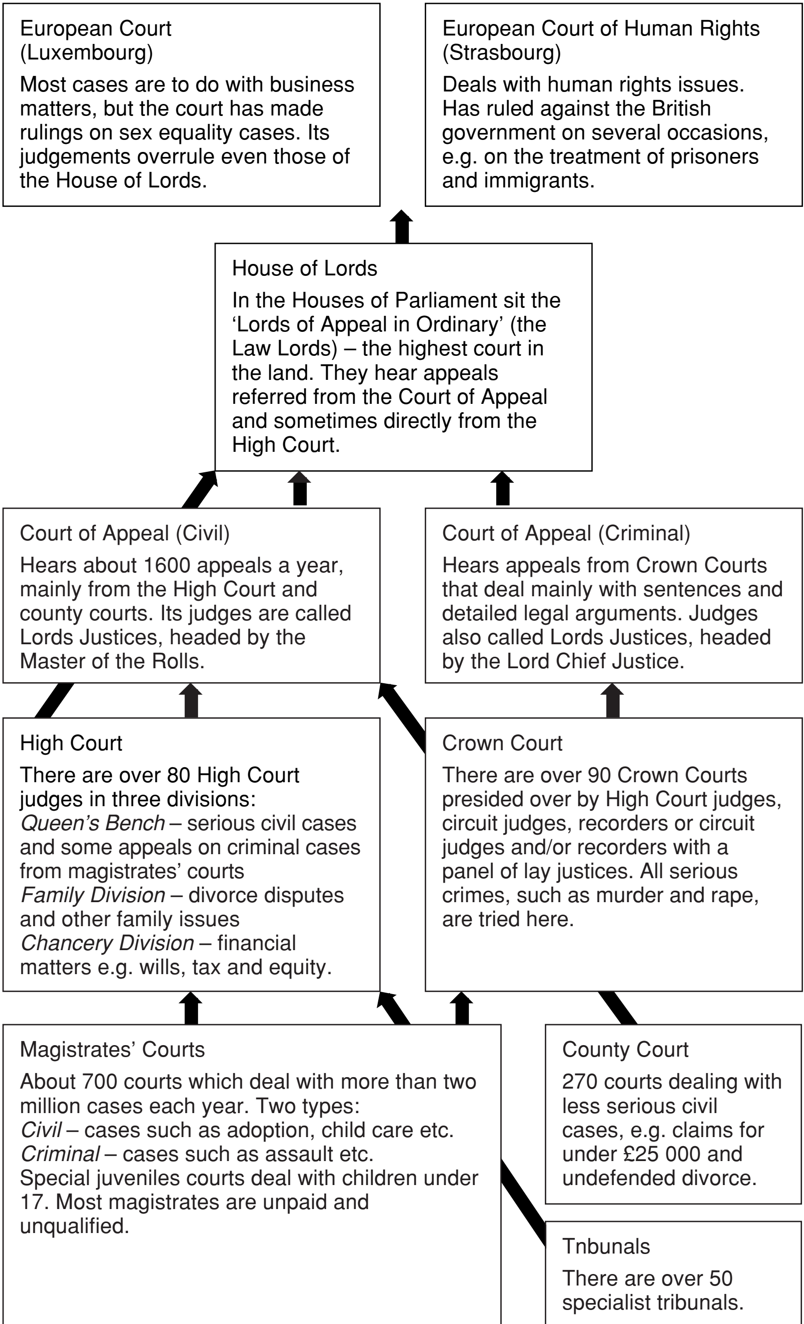

Figure 1.1 The courts in England and Wales

First instance High Courts These are bound by all the higher courts, including their own divisional court, and possibly by decisions of the other divisional courts. They are not bound by their own previous decisions. Whether the failure to wear seat-belts in a car constituted contributory negligence gave rise to fourteen conflicting decisions between 1970 and 1975 until the Court of Appeal decision in *Froom* v. *Butcher* [1976] QB 286. Judges have followed previous judgments even though not bound out of judicial comity: *Poole BC* v. *B & Q (Retail) Ltd* [1983] *The Times*, 29 January. In *Colchester Estates (Cardiff) Ltd* v. *Carlton Industries plc* [1984] 2 All ER 601, Nourse J stated that, faced with two conflicting decisions, the judge should normally treat the second as being correct if made in full knowledge of the previous one.

Inferior courts Magistrates' courts, county courts and other inferior tribunals are bound by the decisions of all the superior courts. The position of the crown court depends on the presiding judge. When presided over by a High Court judge it is presumably equivalent to a first instance High Court. Decisions of the inferior courts have no authority on higher courts or courts at the same level.

European Court of Justice (ECJ) and the Court of First Instance (CFI) The ECJ/CFI are not bound by their own previous decisions, but they are binding on all courts in all the member states.

Advantages and disadvantages of the precedent system

The advantages are said to be certainty, precision and flexibility – the latter through overruling and distinguishing. Obvious disadvantages are the vast and ever-increasing bulk of reported cases, and some claim there is rigidity in spite of overruling and distinguishing. The system also leads to the unstructured development of the law, often dependent upon persons deciding to proceed to an appeal at their own expense. This unstructured development is mitigated by the existence of the Law Commission, whose role is to identify areas where reform is required and to promote the necessary legislation.

Common law and equity

Common law derives from judgments of the common law courts from the thirteenth century. These suffered from inherent defects and litigants petitioned the king, who delegated the petitions to be heard by the Lord Chancellor, leading ultimately to the establishment of the Court of Chancery, which developed rules that supplemented and corrected the defects of the common law, and the development of new remedies complementing the common law remedy of damages, including specific performance, injunctions, rescission and rectification. Chancery also developed areas of exclusive jurisdiction, notably trusts and mortgages.

The systems clashed where equity corrected the common law and recognised new rights. *The Earl of Oxford's Case* (1615) established the supremacy of equity over the common law, now enshrined in the Supreme Court Act 1981. The parallel systems were abolished by the Judicature Acts 1873–5 and replaced by the Supreme Court of Judicature, which transferred the exclusive equitable jurisdiction of the Court of Chancery to the Chancery Division of the High Court. Equity as a body of legal rules continued to exist and to develop with all judges of the Supreme Court being able to apply equitable rules and remedies at their discretion in the unified court system.

Equitable rights and remedies are discretionary, not claimable 'as of right' as with common law rights and remedies. Equity looks beyond legal formalities and enforces the intentions of the parties, as in the recognition of leases and mortgages, lacking the formalities required by the common law. Equity recognises agreements to create leases or mortgages as creating rights between the parties which can be enforced specifically by a decree requiring the drawing up of a formal lease or mortgage and developed a wider notion of fraud restraining people from doing something that would be inequitable: that is, unfair although legal.

The main value of equity today is that judges use their equitable discretion to avoid the rigidity of the doctrine of binding precedent.

Legislation

Legislation, the major source of law, exists in two forms: direct legislation in the form of Acts of Parliament; and delegated legislation, in the form of by-laws, statutory instruments and Orders in Council. Parliament has absolute legislative power through Acts of Parliament to revise substantive rules of law, consolidate existing enactments, codify the law, implement treaties, and introduce social legislation. In principle, no statute can limit the legislative freedom of future parliaments but major limits on this sovereignty arise through Britain's membership of the European Community (see section 1.5 below). A further limitation is in respect of the integration into English law of the European Convention on Human Rights by the Human Rights Act 1998. This affects the interpretation of direct and delegated legislation (see section 1.5 below).

Delegated legislation is enacted by bodies authorised by Parliament. Delegated legislation must be within the powers (*intra vires*) of the body enacting it, otherwise it is *ultra vires* and illegal. By-laws are passed by local authorities and other authorised bodies. Statutory instruments are made by government departments under authority given by direct legislation and introduce detailed regulations under the principal Act. This speeds up the legislative process by enabling regulations to be made and altered quickly without placing them before Parliament. An Order in Council is an order promulgated by the government but through the Privy Council.

1.4 Statutory Interpretation

Problems as to the meaning of legislation can arise from the drafting of the legislation, which causes uncertainty or ambiguity. This can even arise out of the use of a single word where the scope of the word is unclear. Single words such as 'vehicle', 'park' or 'premises' are examples of terms that give rise to uncertainty. In relation to the Employers' Liability (Defective Equipment) Act 1969, the courts have defined 'equipment' as covering a large ship which sank due to defects in construction (*Coltman* v. *Bibby Tankers Ltd* [1968] AC 276) and a defective flagstone handled by an employee (*Knowles* v. *Liverpool City Council* [1993] 4 All ER 321. Uncertainty can also arise where a modifying adjective is used and it is not clear what is modified. In the phrase 'public hospital or school' it is not clear whether the word 'public' applies to both 'hospital' and 'school' or merely the former.

Confusion can also arise out of phrases. Thus the question of whether an accident arises 'out of and in the course of … employment' for the purposes of the Workmen's Compensation Acts (now the National Insurance (Industrial Injuries) Act 1965), has given rise to a great deal of litigation, including whether it applied to an employee injured while overstaying a tea-break (*R* v. *Industrial Injuries Commissioner*, ex.p. AEU (No. 2) [1966] 2 QB 31). In *Customs and Excise Commissioners* v. *Savoy Hotel Ltd* [1966] 2 All ER 299 the court had to decide whether the term 'manufactured beverage' included an orange drink produced by squeezing by hand a fresh orange.

Ambiguity arises where the words are capable of two or more literal meanings, one technical and the other non-technical. In *Fisher* v. *Bell* [1961] 1QB 394 the Restriction of Offensive Weapons Act 1959 made it an offence to 'offer for sale' offensive weapons. The accused was charged under the Act for displaying, for the purposes of sale, a flick-knife in a shop window. This was not an offer for sale for the purposes of the Act but merely an invitation to treat, inviting a member of the public to make an offer for sale.

The court also is required to extend legislation to situations that were unforeseeable when it was passed. In *A-G* v. *Edison Telephone Co*. (1880) 6 QBD 244 the court decided that the Telegraph Act 1869, which pre-dated the invention of the telephone, conferred powers on the Postmaster General over telephone messages.

Judicial approaches to interpretation

To interpret the legislature, the court is aided by a body of presumptions, rules and aids to which they can refer.

Presumptions

Presumption of territorial application There is a presumption that legislation is applicable only within the UK but that, unless otherwise specified, it applies to the whole of the UK.

Presumption that the statute does not bind the Crown An Act which is to bind the Crown must state this fact expressly.

Presumption against any alteration in the common law Legislation can only effect a fundamental change in the common law by express provision, not merely by implication; for example, the Criminal Evidence Act 1898 permitted wives to give evidence against their husbands but the House of Lords held that this did not compel them to give evidence (please note that wives are now compellable in certain cases).

Presumption against imposition of strict liability In interpreting legislation imposing criminal liability, the court proceeds from the basis that there must be evidence of criminal intention (*mens rea*). An Act will only create a strict liability offence by express provision: *Sweet* v. *Parsley* [1969] 1 All ER 347.

Presumption against an Act removing a vested right Acts authorising something which would constitute a nuisance because it interferes with a person's enjoyment of his or her property, does not remove that person's right of action unless expressly stated; for example, statutory authority for siting a sewage works does not prevent residents suing for damages for nuisance. There is also a presumption against statutes having retrospective effect.

The principal rules of interpretation: the literalist and the purposive approach

There are three fundamental rules relating to interpretation: (i) the literal rule; (ii) the golden rule; and (iii) the mischief rule.

The literal rule This rule states that the legislative intention must be found in the ordinary and natural meaning of the words used, and that the Act must be read as a whole, with the words read in their context. In *Fisher* v. *Bell* [1961] 1 QB 394, the literal approach negatived the legislation.

The golden rule The golden rule is a 'gloss on the literal rule', and operates when the literal rule leads to an inconsistency, an absurdity or inconvenience, which indicates that the words used should not be given their ordinary meaning. Thus where the statute permits two or more literal interpretations, the golden rule allows the court to adopt the interpretation that produces the 'least absurd or repugnant effect'.

The mischief rule Derived from *Heydon's Case* (1584) 3 Co. Rep. 7a, 7b, this can be seen as a subsidiary rule followed when pure literalism has failed, or as an alternative to the literal rule. It is the basis of the modern 'purposive' approach to statutory interpretation. The rule has been restated by Lord Diplock in *Jones* v. *Wrotham Park Settled Estates* [1980] AC 74, who identified three necessary conditions: (i) it must be possible

to determine precisely the mischief that the Act was drafted to remedy; (ii) it must be apparent that Parliament had failed to deal with the mischief; and (iii) it must be possible to state the additional words that would have been inserted had the omission been drawn to Parliament's attention. The Law Commission found the mischief rule a 'rather more satisfactory approach' than the golden rule.

The main area of contention in the interpretation of legislation is between the so-called literalist approach and the purposive approach. The literalist approach recognises the fundamental importance of the literal meaning of the words used, and, regarding the function of the judge as an interpreter of the law rather than as a law-maker, takes the view that if the wording is inadequate then the role of the judge is to base his or her decision on the words used and leave it to Parliament to introduce legislation to give effect to what was originally intended.

The purposive view seeks to look to the intention behind the passing of the Act and to seek to interpret the words used in such a way as to effect the legislative intention, even against the strict meaning of the words used. This is often criticised as being a usurpation of the legislative function. The modern approach seems to be more along the lines of the purposive approach.

Although the three fundamental rules are listed in the order of literal rule, golden rule and mischief rule, this does not establish the order in which they are to be applied. Professor John Willis suggested: 'a court invokes whichever of the rules produces a result that satisfies its sense of justice in the case before it. Although the literal rule is the one most frequently referred to in express terms, the courts treat all three as valid and refer to them as the occasion demands, but … do not assign any reasons for choosing one rather than the other.' *'Statute Interpretation in a Nutshell' (1938) 16 Can Bar Rev 1.*

In the past, the pre-eminence of the literal rule has led to judges subjecting Acts to destructive linguistic analysis and refusing to fill in gaps in the legislation or to look behind the literal wording of the Act to enforce the spirit of the legislation. Lord Scarman in *Stock* v. *Frank Jones (Tipton) Ltd* [1978] 1 All ER 948, 955) advocated the literal rule except where 'the consequences are so absurd that, without going outside the statute, one can see that Parliament must have made a drafting mistake'. However, other judges take a broader view of their judicial role, In *Magor and St Melons RDC* v. *Newport Corporation* [1950] 2 All ER 1226, 1236, Denning LJ (as he then was) stated: 'We sit here to find out the intention of Parliament and of Ministers and carry it out, and we do this better by filling in the gaps and making sense of the enactment than by opening it up to destructive analysis.' This statement of the role of the judge was criticised by Lord Simonds as a 'naked usurpation of the legislative function under the thin disguise of interpretation'. He continued: 'If a gap is disclosed the remedy lies in an amending Act.'

This conservative approach was criticised by The Law Commission, which felt that it places 'undue emphasis on the literal meaning of the

words of a provision', which is 'to assume an unattainable perfection in draftsmanship', *The Interpretation of Statutes* (1969) Law Com. No. 21. Their recommendation that more emphasis should be placed on the importance of interpreting an Act in the light of the general purposes behind it was incorporated in the Interpretation of Legislation Bill 1981.

In spite of the language in which it is expressed, the Law Commission found the mischief rule a 'rather more satisfactory approach' than the two other established rules. However, it had already been established in the *Sussex Peerage Case* that the rule should only be applied where the words were ambiguous. Sir Rupert Cross has suggested that it is not a choice between alternatives, but rather a progressive analysis beginning with the consideration of the ordinary meaning of the words used in the context of the statute and moving on to consider other possibilities where the ordinary meaning leads to an absurd result. This so-called contextual approach is based on the literal approach, but much greater attention is paid to the context in which the words appear, and the context is widely defined. It allows for the automatic consideration of the purpose of the statute as part of the context in which the words are to be considered. This tends towards the courts looking beyond the Acts themselves to determine the meaning (see External aids, below).

Other rules of interpretation

The eiusdem generis rule This is a technical rule for interpreting general words which follow two or more specific words forming a genus. The general words are interpreted in the light of the specific words which normally limits their scope; for example, in *Powell* v. *Kempton Park Racecourse Co*. [1899] AC 143 the court held that a prohibition against betting in a 'house, office, room or other place' did not include Tattersalls' enclosure at a racecourse in applying s.1 Betting Act 1853 by interpreting 'other place' as meaning places of the same type as (*eiusdem generis*) 'house, office, room'. There must be at least two specific words to create a genus, in *Allen* v. *Emerson* [1944] KB 362 an Act referring to 'theatres and other places of amusement' extended licensing to fun-fairs, since no genus was established.

Noscitur a sociis 'Words may be better understood from the nature of words and phrases with which they are associated'. In *Pengelley* v. *Bell Punch Co. Ltd* [1964] 1 WLR 691, the word 'floors' in a statute requiring 'floors, steps, stairs, passages and gangways' to be kept clear did not cover a part of a factory floor used for storage.

Expressio unius est exclusio alterius 'The expression of one thing implies the exclusion of another.' Under this rule, where specific words are used and are not followed by general words, the Act applies only to the instances mentioned. An example of this is the case of express repeal of legislation by an Act, which rules out an implied repeal of Acts not specifically mentioned.

Penal provisions are construed narrowly An ambiguous penal provision is construed in favour of the defendant (see the presumption against the imposition of strict liability).

Aids to interpretation

There are internal and external aids. Internal aids are within the body of the Act, of which the most important is the interpretation section found in many Acts which defines words for the purposes of that legislation. External aids are other sources to which judges can refer; dictionaries are an obvious example. The Interpretation Act 1978 prescribes definitions of certain words and phrases which are only presumptive and yield to a contrary intention in the Act being interpreted. The range of external aids includes: Reports of the Law Commission and the various Law Reform Committees; International Conventions where the Act is based upon such a document; EC Directives where the legislation is intended to give effect to the directive; and other Acts of Parliament.

The courts can consult reports of parliamentary proceedings in Hansard, since *Pepper* v. *Hart* [1993] 1 All ER 42, where (a) legislation is ambiguous or obscure or leads to an absurdity; (b) the material relied upon consists of statements by a minister or other promoter; and (c) the statements relied upon are clear.

The European dimension

Special considerations may apply where the legislation to be construed has been passed to implement a directive or to bring English law into line with Community law as a consequence of a decision of the ECJ. Thus, in *von Colson* v. *Land Nordrhein-Westfalen* [1986] 2 CMLR 702, the ECJ stated: 'In applying the national law and in particular the provision of a national law specifically introduced in order to implement [a directive], national courts are required to interpret their national law in the light of the wording and the purpose of the directive in order to achieve the result referred to in [the Treaty]'. In *Pickstone* v. *Freemans plc* [1989] 3 WLR 265 the House of Lords went so far as to read the relevant legislative instrument as if it contained words that were not in fact there. The judgment by Lord Oliver clearly recognises that a statute passed to give effect to obligations under the EEC Treaty are in a special category. In *Marshall* v. *Southampton & South West Hampshire Area Health Authority* [1986] QB 401, the court gave retrospective effect to legislation.

The European dimension has increased since *Marleasing SA* v. *La Comercial Internacional de Alimentacion SA* [1992] 1 CMLR 305, where it was held that even legislation which is not passed to bring into effect a Community directive is subject to the *von Colson* principle and that national courts are required to interpret national law in accordance with Community law whenever possible.

1.5 European Community Law

The sources of Community law are legislation and case law. The legislation is primary for certain Treaty provisions, whereas Regulations, Directives and Decisions of the Council and Commission under Article 189 of the EC Treaty are secondary or delegated legislation. In addition, the decisions of the European Court of Justice (ECJ) and the Court of First Instance (CFI) are binding over the national courts of member states.

The direct applicability and direct effectivity of Community law

Britain is bound by the legislation emanating from the Community institutions. This is recognised in s.2(1) European Communities Act 1972 (ECA 1972). Under this provision, 'not only the Treaty provisions themselves and the secondary legislation made thereunder have to be taken into account, but also interpretations given by the European Court'.

The ECA 1972 s.2.(4) provides for the supremacy of Community legislation by providing that Acts of Parliament are henceforth to be construed and have effect subject to Community provisions. In addition, s.3(1) provides that English courts must interpret Community legislation using European methods. This encourages a purposive approach to interpretation with greater room to interpret the 'spirit' of the legislation with a greater freedom to look to external aids. Section 3(2) provides for judicial notice to be taken of the treaties, the Official Journal of the Communities (OJ) and decisions and opinions of the ECJ on matters of interpretation.

A provision of Community law is directly applicable if it becomes part of the law of the member state automatically without needing to be incorporated into national law by direct or indirect national legislation. It is directly effective if it creates rights that are enforceable by the courts of a member state. Provisions do not need to be directly applicable in order to be directly effective, but all provisions that are directly applicable will be directly effective.

Community provisions that are only directly effective can only be enforced by a person against the member state or a state organ, but not against other persons. They are therefore considered as having vertical direct effect, since the person is enforcing the provision vertically against the state. Provisions have horizontal direct effect where they can be used as the basis of an action by one subject against another.

Legislation

Treaty provisions

The ECJ has established that some treaty provisions are directly applicable and directly effective, both horizontally and vertically. Such provisions must: (i) not simply concern inter-state relations; (ii) be clear and precise;

(iii) be unconditional and unqualified and not subject to any further measures on the part of the member state or the Community; and (iv) not leave any substantial latitude or discretion to member states. It is irrelevant that member states have alternative remedies for breach of the provision in question. An example is Article 119 relating to equal pay, where the UK Equal Pay Act 1970 was found to conflict with EC law (see Chapter 12).

Under Article 189 of the Treaty of Rome, the Commission and the Council have power to create secondary legislation. Draft proposals for such legislation are initiated by the Commission and can be passed or rejected by the Council of Ministers where individual member states are represented. A draft proposal can only be amended by the Council by a unanimous vote. In most of its business the Council proceeds by a qualified majority voting system. Since the Single European Act 1986 a co-operation procedure made the European Parliament a partner with the Commission and the Council in certain areas of legislation including discrimination, free movement of workers and services, and, under the Treaty of Maastricht, Parliament now has a right to veto proposals it finds unacceptable.

Regulations

Defined as having 'general application' and 'being binding in [their] entirety and directly applicable in all member states', regulations 'not only … render automatically inapplicable any conflicting provision of current national law but … also preclude the valid adoption of new national legislative measures to the extent to which they would be incompatible with Community provisions'.

Regulations are used to introduce major changes in Community law applicable throughout the Community. They bind all member states and take precedence over all national legislation. A person living in a member state can enforce rights guaranteed by a regulation in the national courts of the member state.

Directives

Directives are used to enforce harmonisation of systems within the Community and require a member state to introduce legislation to bring about the desired effect within a specified time limit. Examples can be seen in respect of water standards and pollution levels as well as company law. Directives are 'binding as to the result to be achieved upon each member state to which it is directed, but shall leave to the national authorities the choice of form or methods' (art. 189).

Directives cannot be directly applicable but the ECJ has held that where a member state fails to implement a Directive within the period required, an individual could bring an action against the member state in the national courts, *Van Duyn* v. *Home Office* (No. 2) [1975] Ch 358. Thus the Directive is vertically but not horizontally effective. A private individual

or corporation cannot be liable in respect of it, since they cannot be at fault for its non-implementation. In respect of vertical direct effect it is important to note that not only the state itself can be liable. Liability extends to local authorities and organisations which have been made responsible for providing a public service under state control, including regional health authorities and British Gas plc.

Decisions

Decisions are generally addressed to one or more member states or individuals where, on investigation, it has been found that they are in breach of Community law. A decision is 'binding in its entirety upon those to whom it is addressed' (art. 189). The ECJ has held that decisions addressed to member states could give rise to directly effective rights in an individual, which must be protected by national courts.

Case law

Case law arises from decisions of the two courts of the European Community: the European Court of Justice (ECJ) and the Court of First Instance (CFI). The jurisdiction of the ECJ includes:

Art. 169 Actions by the Commission against member states.
Art. 170 Actions between members states.
Art. 173 Review of the legality of the acts of the Council and the Commission at the initiation of member states, the Council or the Commission.
(A natural or legal person may also institute proceedings against a decision addressed to that person or a decision of direct and individual concern to that person (this would be heard by the CFI – see below).)
Art. 175 An action alleging infringement of the Treaty through the failure of the Community institutions to act at the initiation of member states, the Council or the Commission.
Art. 177 Preliminary rulings at the request of courts or tribunals of member states concerning:
- interpretation of the Treaty;
- validity and interpretation of acts of the institutions;
- interpretation of statutes of bodies established by an act of the Council, where those statutes so provide.

The CFI has jurisdiction to hear and determine at first instance, subject to a right of appeal on points of law for certain actions. Its jurisdiction comprises cases brought by natural or legal persons excluding actions brought by member states or by Community institutions or referrals for preliminary rulings. The three following areas have been devolved to the CFI from the ECJ: (i) disputes between the Community and its servants; (ii) applications

for judicial review and some actions for damages regarding implementation of competition rules applicable to undertakings; and (iii) applications for judicial review and in some circumstances for damages against the Commission of the Coal and Steel Community (ECSC) in matters of levies, production quotas, prices, agreements and concentrations.

Preliminary reference to the ECJ for interpretation

To achieve standardisation of Community law throughout the EC, the ECJ has the sole responsibility for interpreting Community legislation by preliminary rulings under Article 177 so that, when required to interpret Community law, a judge may, or in certain cases must, refer a question for interpretation to the ECJ which involves suspending the case, the formulation of a question to the ECJ and awaiting the ECJ's decision when the law, as interpreted, will be applied in the reconvened case. In most cases the judge can decide to refer a question of law for interpretation at his discretion under Article 177. But he is obliged to refer the matter for interpretation: 'Where any such question is raised in a case pending before a court or tribunal of a Member State, against whose decisions there is no judicial remedy under national law'.

Points to note concerning preliminary reference procedure:

(i) The national court alone decides whether or not to refer.

(ii) What is a court or tribunal is a question of Community law. Article 177 obviously applies to courts and to statutory tribunals but whether it includes the JCPC exercising a disciplinary jurisdiction in relation to doctors, or a statutory body such as the Solicitors' Disciplinary Tribunal or the disciplinary committees of such voluntary associations as the Jockey Club or the Football Association is not clear.

(iii) A court or tribunal against whose decision there is no judicial remedy under national law means any court at whatever level whose decision is final, so that in *Costa* v. *ENEL* [1964] ECR 585 a magistrate was obliged to make a reference. As there is no 'right' of appeal from its decision, the Court of Appeal was thought to have a duty to refer. It is now established that there is no such duty; *Chiron Corporation* v. *Murex Diagnostics Ltd* [1995] All ER(EC) 88.

(iv) The ECJ has conceded that the obligation to refer does not apply where the point is sufficiently clear, by accepting that the *acte clair* doctrine is not limited to instances where the legal point has already been the subject of interpretation by the Court.

(v) A ruling binds the court to whom it is addressed and will usually be regarded as creating a generally binding precedent, which results in some courts refusing to refer a question on a text that it has already interpreted, even though the ECJ can change, and sometimes has changed, its mind in a subsequent case. UK courts are bound to treat rulings as precedents by s.3(1) ECA 1972. Rulings on interpretation

will also usually be retrospective, although in exceptional cases the Court is prepared to limit the general retrospective effect.

The supremacy of Community Law

In *Factortame (No. 3)* [1991] 3 All ER 769 concerning the Merchant Shipping Act 1988, which required British-registered fishing boats fishing for British quotas to be British owned and managed, the British statute was held to contravene Article 52 of the Treaty of Rome by discriminating against the nationals of another member state. One aspect of the case concerned the power of the court to grant interim relief where there is an alleged conflict between Community law and national law. The ECJ's response to a House of Lords' reference under Article 177 was to the effect that, where the only obstacle to granting interim relief is some rule of national law, the national court could set aside the rule and grant the relief. Thus Community law prevails. In *R* v. *Secretary of State for Transport*, *ex parte Factortame* (No. 2) [1991] 1 All ER 70, Lord Bridges stated in the case: 'If the supremacy within the European Community of Community law over the national law of member states was not already inherent in the EC Treaty, it was certainly well established long before the UK joined the Community … Under the European Communities Act 1972 it has always been clear that it was the duty of a UK court, when delivering final judgment, to override any rule of national law found to be in conflict with any directly enforceable rule of Community Law. Similarly, when decisions of the Court of Justice have exposed areas of UK law which failed to implement Council Directives, Parliament has always loyally accepted the obligation to make appropriate and prompt amendments. Thus there is nothing in any way novel in according supremacy to rules of Community law.'

Hoffmann J in *Stoke-on-Trent CC* v. *B & Q plc* [1991] 2 WLR 42 stated: 'The EEC Treaty is the supreme law of this country, taking precedence over Acts of Parliament. Our entry into the European Economic Community meant that (subject to our undoubted but probably theoretical right to withdraw from the Community altogether) Parliament surrendered its sovereign right to legislate contrary to the provisions of the Treaty on matters of social and economic policy which it regulated.'

In *Francovich and Bonifaci* v. *Italian State* [1991] IRLR 84, Italian workers claimed damages against the Italian state for its failure to implement a Directive to protect the wages of employees of an insolvent employer. The court held that Italy was 'obliged to pay compensation for harm caused to individuals by breaches of Community law for which they can be held responsible'. There was a causal link between Italy's breach of its obligations and the damage suffered.

The liability for damages of Member States was clarified in two decisions heard together, *Brasserie du Pecheur SA* v. *Germany* and *R* v. *Secretary of State for Transport ex parte Factortame Ltd*. (No. 3) [1996] 1CMLR 889. The *Brasserie du Pecheur* case concerned German laws on

the purity of beer which prevented the French brewery from selling its products in Germany. This was in breach of Article 30 EC Treaty prohibiting 'quantitative restrictions on imports [between Member States] and all measures having equivalent effect'.

The grounds for liability were stated as follows:

- Member States must compensate individuals for losses arising from breaches of Community Law where the legislature, judiciary or executive was responsible, whether or not the provision is directly effective.
- For failure to transpose a Directive into domestic law, failure of the national legislature to take the necessary steps does not affect the Member State's liability.
- Where the Member State has a wide discretion of legislative choices, it is liable in the same way as Community Institutions in comparable situations. Individuals suffering loss … are entitled to reparation:
  - (i) where the rule breached is intended to confer rights upon them;
  - (ii) where the breach is sufficiently serious; and
  - (iii) where there is a direct causal link between the breach and the damage.
- The test of seriousness is whether the Member State manifestly and gravely disregarded the limits on its discretion. In determining this the domestic court may take into consideration:
  - (i) the clarity and precision of the rule;
  - (ii) the amount of discretion allowed to the Member State;
  - (iii) whether the infringement and the damage was intentional or involuntary;
  - (iv) whether any error of law was excusable or inexcusable; and
  - (v) the fact that the position taken by a Community institution may have contributed towards the omission and the adoption or retention of national measures contrary to Community law.

  A breach will be serious if it has persisted despite a judgment, preliminary ruling or precedent of the ECJ from which it is clear that it constituted an infringement.
- The state must compensate the loss in accordance with national law, but the conditions must not be less favourable to those relating to similar domestic claims or framed so as to make it impossible or excessively difficult to obtain compensation.
- Compensation must not be conditional upon fault (intentional or negligent) of the state organ responsible.
- Compensation must be commensurate with the loss. The criteria are set by the domestic legal system but must not be less favourable than for similar claims based on domestic law, or make it impossible or excessively difficult to obtain compensation.
- National legislation limiting compensation to certain, specifically protected individual interests excluding loss of profit is not compatible with Community law (see 'pure economic loss', Chapter 5).

- It must be possible to award specific damages, such as exemplary damages, if such damages may be awarded for similar claims in domestic law (see Chapter 5).
- State liability cannot be limited to damage sustained after the delivery of a judgment of the Court finding the infringement.

The Spanish fishermen were subsequently awarded damages against the British government in an action in the High Court. The government is considering an appeal.

A later decision on incorrect transposition of a Directive is *R* v. *H.M. Treasury, ex parte British Telecommunications plc* [1996] 2 CMLR 217. BT claimed annulment of part of the Utilities Supply and Works Contracts Regulations 1992, which wrongly implemented Article 8 of Directive 90/531, and damages for losses incurred in complying with the regulations. Rejecting the claim for damages, the ECJ stated that the conditions in *Brasserie de Pecheur and Factortame* also applied to an incorrectly transposed Directive. However, the breach was not sufficiently serious, since Article 8 of the Directive was imprecisely worded and reasonably capable of bearing the interpretation given to it by the UK. No guidance on interpretation had been available from decided case law and the Commission had not raised the matter when the Regulations were adopted.

1.6 The European Convention on Human Rights

The Human Rights Act 1998 incorporates the rights guaranteed by the European Convention on Human Rights into English law. This gives English nationals the protection of the Convention under national law before the national courts. There will no longer be the need to bring actions to the Court of Human Rights in Strasbourg. The aim of the legislation is to increase the influence of British judges in the development of Human Rights Law and to save money.

Under the Act, all courts and tribunals must interpret all primary and subordinate legislation 'so far as it is possible to do so' to be compatible with Convention rights: s.3(1). This does not, however, affect the validity, operation or enforcement of any incompatible primary legislation: s.3(2). The definition of primary legislation includes delegated legislation in the form of Orders in Council and Statutory Instruments, which are general regarded as secondary. If a compatible interpretation is not possible, a superior court (High Court and upwards) may make a 'declaration of incompatibility' which is 'not binding on the parties' and which does not affect the validity, operation or enforcement of the primary legislation: s.4. Parliamentary sovereignty is maintained by failure to allow the courts to set aside incompatible Acts of Parliament. In addition, all courts and tribunals in considering questions relating to Convention rights must 'take into account' decisions of the Commission and Court of Human Rights: s.2. It is unlawful for public authorities (including courts and tribunals) to

act in a way that is incompatible with Convention rights, unless primary legislation permits no other course of action: s.6. Actual or likely victims of such an 'unlawful act' make take proceedings in an appropriate court/tribunal; for example, by application for judicial review: s.7. The courts/tribunals may provide 'such relief or remedy of make such an order within its jurisdiction as it considers just and appropriate', but damages are available only in civil courts with power to award damages: s.8.

The Act provides for a 'fast track' procedure for amending primary legislation by statutory instrument ('remedial orders') to remove inconsistencies with Convention rights when either a superior court or the Court of Human Rights has found a breach of the Convention: s.10. Before the second reading in respect of proposed legislation, the government minister responsible for introducing the Bill must either make a statement of his/her view that the Bill is compatible with Convention rights, or state that despite being unable to make that statement, the government nevertheless wishes to proceed with the Bill: s.19.

The rights and freedoms are enshrined in the Convention and a number of Protocols. The freedoms contained in the Convention are: the right to life (Art. 2); freedom from torture or inhuman or degrading treatment or punishment (Art. 3); freedom from slavery, servitude or forced or compulsory labour (Art. 4); the right to liberty and security of the person (Art. 5); the right to a fair trial (Art. 6); freedom from retroactive criminal offences and punishment (Art. 7); the right to respect for private and family life, home and correspondence (Art. 8); freedom of religion (Art. 9); freedom of expression (Art. 10); freedom of assembly and association (Art. 11); the right to marry and to found a family (Art. 12); the right to an effective national remedy (Art. 13); and freedom from discrimination in respect of protected rights (Art. 14). Article 15 allows for derogation of the rights in time of war or other public emergency.

The First Protocol recognises the right to property (Art. 1); the right to education (Art. 2) and the right to free elections (Art. 3). The Fourth Protocol recognises the freedom from imprisonment for non-fulfilment of a contractual obligation (Art. 1); freedom of movement within a state and freedom to leave its territory (Art. 2); the right of a national not to be expelled from and to enter a state's territory (Art. 3); and the freedom of aliens from collective expulsion (Art. 4). The Sixth Protocol provides for freedom from the death penalty. The Seventh Protocol recognises the freedom from expulsion of individual aliens (Art. 1); the right to review in criminal cases (Art. 2); the right to compensation for miscarriages of justice (Art. 3); freedom from further trial or punishment for an offence for which a person has already been finally acquitted or convicted in accordance with the law of that state (*Ne bis in idem*) (Art. 4); and equality of rights of spouses (Art. 5).

The Human Rights Court has made a number of decisions relating to the UK. It held that the sacking of three railwaymen who refused to join a union was a breach of Article 11 (freedom of association), and birching in the Isle of Man violated Article 3 ('inhuman or degrading treatment or

punishment'). The Court upheld the right of prisoners to communicate with and have access to legal advisers for the purposes of instituting legal proceedings and declared that censorship of their letters to solicitors and relatives violated Article 6 (right to a fair and public hearing). The Court also held that legislation in Northern Ireland criminalising homosexual relations between consenting adults contravened Article 8 (respect for private and family life). Other areas in which decisions have been given relate to the discriminatory nature of UK immigration laws, and emergency regulations allowing suspected terrorists to be held without trial in Northern Ireland.

Recommended Further Reading

Legal Method, Ian McLeod (Macmillan Professional Masters, 2nd edn 1996.

Walker and Walker's English Legal System, 7th edn (Butterworths, 1994).

The English Legal Process, Terence Ingman, 7th edn (Blackstone Press, 1998).

European Union Law, Jo Shaw (Macmillan Professional Masters, 2nd edn).

A Guide to European Union Law, P. S. R. F. Mathijsen, 6th edn (Sweet & Maxwell, 1995).

Law of the European Convention on Human Rights, D. J. Harris, M. O'Boyle and C. Warbrick (Butterworths, 1995).

Questions

1 What is the binding element of a legal decision?
2 What do you understand by the vertical and horizontal operation of the doctrine of binding precedent?
3 What aspects of the precedent system maintain flexibility?
4 What particular rule of statutory interpretation typifies the purposive approach?
5 If it is an offence to keep explosives in any factory, workshop or other place without a licence, would an offence be committed by a quarry owner keeping explosives in a caravan adjacent to the quarry?
6 How has the British government chosen to incorporate the European Convention on Human Rights into English Law?
7 Identify some of the Human Rights recognised by the Convention.
8 What is the difference between direct applicability and direct effectivity?
9 What is the normal form of Community legislation for harmonisation of laws throughout the Community?
10 In what circumstances is a judge required to refer a matter of interpretation of Community law to the ECJ?

2 Civil Dispute Resolution

Learning Objectives

After reading this chapter you will know about:

1. the jurisdiction of the courts in relation to civil dispute resolution and the operation of the system of appeals
2. the ways in which civil judgments of the courts can be enforced
3. how commercial civil disputes can be resolved through arbitration
4. the advantages of Alternative Dispute Resolution (ADR) in resolving civil disputes

Different systems exist for the resolution of civil disputes between parties. These can involve (i) tribunals; (ii) the courts; (iii) arbitration; and (iv) alternative dispute resolution (ADR).

2.1 Tribunals

Certain disputes must be referred to specialist statutory tribunals so that claims for unfair dismissal by an employee must be brought in an industrial tribunal; tribunals exist for fixing fair rents (rent tribunal); claims in respect of social security payments (national insurance tribunal); and disputed title to registered land (lands tribunal).

2.2 The Civil Courts

The principal civil courts are the High Court and the county courts. Certain cases must be brought in the county court, others in the High Court, and in other cases there is a choice.

The jurisdiction of the county court

The High Court and County Courts Jurisdiction Order 1991 made under s.1 of the Courts and Legal Services Act 1990 enlarged the jurisdiction of the county courts and provides for the allocation of cases between the High Court and the county courts. County court jurisdiction is of three kinds: (i) exclusive to the county court; (ii) concurrent with the High Court without financial limitation; and (iii) concurrent subject to financial limits.

Exclusive to the county court

This arises under various statutes and includes: (i) recovery of possession proceedings by a landlord against a tenant; (ii) actions in respect of consumer credit agreements regulated by the Consumer Credit Act 1974 ((hire purchase, conditional sale and credit sale agreements and consumer hire agreements for televisions and so on); (iii) claims for unlawful racial and sexual discrimination except in relation to employment which goes to an industrial tribunal; and (iv) mortgage possession proceedings outside London (except foreclosure when a £30 000 limit applies).

Concurrent jurisdiction without financial limits

This includes: (i) contract and tort actions (excluding libel and slander); (ii) actions to recover a sum recoverable by statute; (iii) actions to recover land or involving a dispute as to title; (iv) financial provision applications from a deceased person's estate; and (v) tenants' application against forfeiture for non-payment of rent.

Choice of court is in accordance with Article 7 of the High Court and County Courts Jurisdiction Order 1991 with actions with a value of less than £25 000 tried in the county court unless the court considers they should be transferred to the High Court and the High Court agrees, or they are commenced in the High Court which considers it ought to try the action. An action of a value of £50 000 or more is tried in the High Court unless the High Court considers that it ought to transfer it to the county court, or if the action was commenced in the county court and that court does not consider that it ought to be transferred.

Jurisdiction subject to financial limits

This includes: (i) administration of estates up to £30 000, includes contentious probate; (ii) execution, declaration and variation of trusts up to £30 000; (iii) foreclosure or redemption of mortgages up to £30 000; (iv) specific performance, rectification or cancellation of agreements for the sale, purchase or lease of property up to £30 000; and (v) certain courts outside London may be designated as bankruptcy courts with unlimited jurisdiction for personal insolvency and jurisdiction over company winding-up where the company's paid-up share capital does not exceed £120 000, and for partnerships where the assets do not exceed £30 000.

Small claims

All disputes involving claims for up to £3000 are automatically referred to arbitration by the district judge. This is an informal procedure and parties are discouraged from being legally represented since the successful party cannot recover costs. The Lord Chancellor is considering extending the small claims procedure to personal injury claims and increasing the financial limit.

The jurisdiction of the High Court

The jurisdiction of the divisions of the High Court depends on the division as follows:

Queen's Bench Division

This has concurrent jurisdiction with the county court in contract and tort with exclusive jurisdiction for libel and slander. There are specialist courts relating to admiralty and commercial disputes relates to insurance, bills of lading, negotiable instruments and so on. There is also a Divisional Court of the Queen's Bench Division (QBD), which has an appeal and supervisory jurisdiction function. It deals with appeals by way of cases stated on points of law from magistrates and Crown Courts. It also has an important supervisory function through judicial review.

Chancery Division

This hears actions relating to administration of estates, trusts, mortgages, partnership, patents, trademarks and copyright and revenue matters, and the sale, exchange or partition of land. Within the division there are separate courts: the Companies Court, the Patents Court and the Court of Protection, which assumes care and control of persons of unsound mind and their property.

Family Division

This hears defended matrimonial causes, decrees of death (where a husband or wife has disappeared without trace for a number of years, the other spouse may apply for such a decree in order to be free to remarry or claim against the estate of the 'deceased'), legitimacy and nullity, actions involving the rights of children – such as adoption, wardship and actions between spouses for the ownership of property and occupation of the matrimonial home. The claimant can choose to commence his or her action in the Central Registry of the High Court in London or in the District Registry where the cause of action arose. Actions begun locally take longer to come to trial.

Appeals from civil trial courts

Appeals from county courts

Appeals are to the Court of Appeal (Civil Division) on a point of law (see Figure 2.1). It is possible to appeal on a point of fact, depending upon the size of the claim. Further appeal to the House of Lords is possible with leave of the Court of Appeal or the House of Lords on a point of law of public importance. Bankruptcy appeals from county courts outside London are to the Divisional Court of the Chancery Division.

Appeals from the High Court

Appeals will generally be to the Court of Appeal on matters of fact or law, or a combination of both. There is a further appeal to the House of Lords with leave of the Court of Appeal or the House of Lords but only in respect of a matter of public importance. A special 'leapfrog' procedure allows appeals direct to the House of Lords where the parties agree and the trial judge certifies that the case involves a point of law of public importance concerning either the construction of a statute or statutory instrument or, more usually, a matter upon which the Court of Appeal is bound by a previous ruling and where the House of Lords itself gives leave.

2.3 The Stages of an Action in the High Court

The pleadings

Proceedings in the High Court will normally be commenced by a writ drafted by the plaintiff's lawyers. This identifies the relevant division and the parties, and will usually have a detailed Statement of Claim detailing the plaintiff's claim. The writ must be served on the defendant within twelve months; beyond twelve months it can only be served after renewal by order of the court. The writ is served with an Acknowledgement of Service form containing boxes in which the defendant can either admit the claim or give 'notice of intention to defend' it. S/he must send the form to the court office from which the writ was issued within fourteen days of service. Failure to return it within the period will in certain cases entitle the plaintiff to judgment against the defendant in default.

Where the defendant intends to defend the action, s/he must serve on the plaintiff within fourteen days a formal defence to the claim. A defendant may have a claim against the plaintiff which may be connected with the plaintiff's claim, or totally independent of it. Both are treated as counterclaims and should be made in the defence, which is then a 'Defence and Counterclaim'.

Discovery and inspection of documents

Each side can inspect all documents in the possession of the other party relevant to the action unless they are protected by privilege and cannot be disclosed. Disclosure is 'discovery' and allowing a party to see them is 'inspection'. The defendant may try to defeat the plaintiff's claim by destroying evidence or to frustrate the plaintiff's action by disposing of assets or transferring them abroad out of the jurisdiction so that there is no money or assets available against which the judgment can be executed. There are two interlocutory weapons that can be used in this case. These are the *Mareva injunction* and the *Anton Piller order*.

Mareva injunctions

A Mareva injunction allows the plaintiff to prevent the defendant from disposing of assets pending the hearing and becoming unable to meet any judgment against him/her. Originally limited to cases involving foreign defendants and to prohibiting the removal of assets from the jurisdiction, it is named from the first case in which the Court of Appeal recognised it, in 1975, *Mareva Compania Naviera S.A.* v. *International Bulkcarriers S.A.* [1980] 1 All ER 213. It was soon extended to UK residents and to the prohibition of the dissipation of assets within the jurisdiction: *Rahman (Prince Abdul) bin Turki al Sudairy* v. *Abu-Taha* [1980] 1 WLR 1268. Section 37(3) of the Supreme Court Act 1981 now provides: 'The power of the High Court ... to grant an interlocutory injunction restraining a party to any proceedings from removing from the jurisdiction of the High Court, or otherwise dealing with, assets located within that jurisdiction shall be exercisable in cases where that party is, as well as cases where he is not, domiciled, resident or present within that jurisdiction.' The words 'dealing with' include disposing of, selling or charging assets: *CBS (UK) Ltd* v. *Lambert* [1982] 3 All ER 213.

The application is generally made *ex parte*, sometimes before issuing a writ. The plaintiff swears an affidavit in support of his/her application. In *Third Chandris Shipping Corporation* v. *Unimarine S.A.* [1979] 2 All ER 972, the Court of Appeal set out guidelines that judges should follow on applications: (i) the plaintiff should make a full and frank disclosure of all matters in his/her knowledge which are material for the judge to know; (ii) the plaintiff should give particulars of his/her claim and the amount thereof and of the defendant's case against it; (iii) the plaintiff should give some grounds for believing that the defendant has assets within the jurisdiction; (iv) the plaintiff should give some grounds for believing that there is a risk of the assets of the defendant being removed from (or dissipated within) the jurisdiction before the judgment is satisfied; and (v) the plaintiff should give an undertaking in damages, in certain cases supported by a bond or security.

The High Court may grant an injunction 'in all cases in which it appears to the court to be just and convenient to do so': s.37(1) SCA 1981; however there are principles governing the granting of interlocutory injunctions laid down by the House of Lords in *American Cynamid Co*. v. *Ethicon Ltd* [1975] 1 All ER 504. The plaintiff must establish: (i) that s/he has at least a good arguable case; and (ii) that the refusal of an application would involve a real risk that a judgment or award in the plaintiff's favour would remain unsatisfied because of the defendant's removal of the assets from the jurisdiction or dissipation of assets within the jurisdiction.

The service of the injunction on a bank or other body will freeze an account or assets held by that party. In the case of a bank it will override the customer's instructions to the bank. The courts are vigilant to ensure that such parties do not suffer. Thus in *Searose Ltd* v. *Seatrain UK Ltd* [1981] 1 WLR 894 an injunction was only granted on condition that the

plaintiff undertook to pay the reasonable costs incurred by any person (other than the defendant) to whom notice of the order was given. The injunction may continue after judgment if the court fears that assets may be dissipated and it may grant one for the first time after the judgment: *Orwell Steel* v. *Asphalt & Tarmac* [1981] 1 WLR 1097.

Anton Piller orders

The Anton Piller order imposes on the defendant a duty to permit a plaintiff to enter his/her premises to inspect, remove or make copies of documents belonging to him/her or relating to his/her property; it is named after the case in which it was first sanctioned by the Court of Appeal, *Anton Piller K.G.* v. *Manufacturing Processes Ltd* [1976] 1 All ER 779. It may be obtained *ex parte* where the plaintiff shows that there is a danger of property being smuggled away or vital evidence destroyed, and is most used in relation to infringement of copyright or misuse of confidential information. Failure on the part of the defendant to allow access will constitute contempt of court.

The plaintiff's only risk is paying the defendant's costs and for any damage caused. There are procedural safeguards: the plaintiff's solicitor must attend when the order is executed and, where entry is refused, no force should be used. The defendant must have the opportunity to contact his/her solicitor and be advised of his/her right to obtain legal advice. The applicant must make full disclosure of all matters relevant to his/her application to the court and if material facts are omitted the order will be discharged.

The defendant against whom an *ex parte* order has been made may apply to have it set aside and, pending the appeal, may even refuse to comply, but this is dangerous since, if the application fails, s/he will be in contempt of court and liable to severe penalties if s/he has in the meantime acted in breach of the order by destroying records. In *Rank Film Distributors Ltd* v. *Video Information Centre* [1981] 2 All ER 76 the House of Lords held that a defendant could successfully resist the making of an order on the ground of privilege against self-incrimination but s.72 Supreme Court Act 1981 removes the privilege in relation to High Court proceedings for infringement of rights relating to intellectual property or for passing-off.

Payment into court

A defendant against whom debt or damages are claimed will generally attempt to settle the claim with the plaintiff by offering him/her less money. The payment of money into court puts the plaintiff in a difficult position since, if s/he continues with his/her action and recovers less damages than the defendant paid into court, s/he will have to pay his/her own legal costs and those of the defendant from the date the payment into court was made. The judge does not know how much money has been paid in. Payment is made into the Bank of England, Law Court Branch

with the money credited to the defendant's name and invested. The defendant then serves on the plaintiff a Notice of Payment into Court. Because of this, most actions are settled out of court – more than 50 per cent just before the case is due to go to court.

The trial

The trial begins with an opening speech from the plaintiff's counsel outlining the facts of the case and the relief sought. The witnesses for the plaintiff are then called to give evidence by examination chief; they will then be cross-examined by counsel for the defendant and re-examined by counsel for the plaintiff. Then the defendant's counsel will present his case, with his witnesses being called. They too will be cross-examined by the counsel for the plaintiff and re-examined. This is followed by the plaintiff's counsel's and the defence counsel's closing speeches.

The judge then gives judgment, either immediately or at a later time (a 'reserved judgment'). Normally the successful party will have his/her costs paid by the unsuccessful party, but the court has discretion in the matter.

2.4 The Stages of an Action in the County Court

The majority of county court claims are actions of three types: (i) default actions; (ii) fixed date actions; and (iii) rent actions, of which only the first two are important in this context. Default actions are to recover debts and liquidated and unliquidated damages, and are commenced by a summons which is served upon the defendant together with a plaint note informing him/her that judgment will be given in default after fourteen days if s/he does not pay the amount of the claim or file a defence. Fixed date actions are to claim relief other than the payment of money: for example, possession of land or equitable remedies.

These are begun by summons and the defendant is informed of the return day on which the case will come before the district judge for pre-trial review or, if the claim is for possession of land, the date of the trial itself. The county court arranges for service of the summons, usually by post. In default actions, the defendant is also sent a form of defence and counterclaim on which s/he can admit the claim and offer payment in instalments or state his/her defence and any counterclaim. The principles governing the drafting of pleadings are the same as for the High Court but the 'Statement of Claim' is called the 'Particulars of Claim'.

Interlocutory proceedings

There are similar powers in respect of documents, interrogatories and interpleader. Discovery is not automatic but must be applied for. The court can make any order that can be made by the High Court and they can be absolute or conditional, final or interlocutory: s.3 Courts and Legal

Services Act 1990. However, orders of *mandamus*, *certiorari* or prohibition are restricted to the High Court (Queen's Bench Divisional Court), and county courts may not grant a Mareva injunction (subject to exceptions below) or an Anton Piller order, but they may vary an existing Anton Piller order or Mareva injunction where all the parties are agreed. A county court may impose a Mareva injunction only: (i) in its family proceedings jurisdiction; (ii) for the preservation, custody or detention of property which forms or may form the subject matter of proceedings; or (iii) to preserve assets until execution can be levied upon them. An application to the High Court for an Anton Piller order operates to transfer proceedings to the High Court for this purpose but they will re-transfer afterwards unless the High Court orders otherwise.

The trial

The trial is similar to that at the High Court except that the defence can only make a closing speech with leave of the court if it has previously made an opening speech. Trial will be before a circuit judge or before the district judge with the consent of the parties. The winner usually recovers his/her costs against the loser in the same way as in the High Court. The position can be changed where there has been a payment into court, or in other cases. Costs in the county court are calculated by reference to fixed scales, depending on the amount claimed or recovered in the action.

Small claims

Where the plaintiff commences a default action for £3000 or less and the defendant files a defence, the action is automatically referred to the district judge for informal arbitration. Cases involving larger sums can be referred in the same way if the parties agree. Automatic referral can be rescinded where the case involves a difficult question of law or exceptionally difficult questions of fact, where there is a charge of fraud, where it would be unreasonable, or where the parties agree to rescind the reference.

The case is heard in private by the district judge and the rules which normally apply in respect of procedure and evidence do not apply. The district judge will simply ask the parties about the nature of the dispute. The aim of the procedure was to enable claimants to bring actions in respect of very minor matters without the need to be legally represented. In practice, anybody bringing an action on their own against a business was likely to find themselves at a severe disadvantage because they would be faced with a solicitor or even a barrister instructed by the defence.

The major advantage of this form of proceeding is that whether a party wins or loses s/he will not have to pay the other party's costs or claim recovery of his/her own, except that the successful plaintiff can recover the costs of commencing the action and enforcing the district judge's award. This is to discourage the use of lawyers. The only exception is that, where a party has acted unreasonably, s/he may be ordered to pay the costs of the other.

Future reform to the civil legal system is anticipated which will replace the High Court and the county courts with a single system with a simplified procedure. Proposals in a report by Lord Woolf to the Lord Chancellor in 1994 include a new 'fast-track' procedure with fixed costs and a strict timetable leading to trial in twenty to thirty weeks, limits on disclosure of documents and oral evidence for claims between £3000 and £10 000. Such cases would have hearings limited to three hours. For larger claims, the report suggests a multi-track system with the pace dictated by the judge rather than by the parties. New procedures suggested are aimed at encouraging settlement between the parties and the use of alternative dispute resolution techniques such as mediation and arbitration (see discussion below).

2.5 Enforcement of Civil Judgments

The plaintiff needs to enforce his/her judgment when the defendant is unwilling to pay any damages awarded against him/her. Article 8 of the High Court and County Courts Jurisdiction Order 1991 provides that a judgment or order of a county court for the payment of money which it is sought to enforce by execution against goods shall be enforced: (i) only in the High Court if the sum is £5000 or more; (ii) only in the county court if the sum is less than £2000; and (iii) in either the High Court or a county court if the sum is between £2000 and £4999. Where the judgment was in respect of a regulated consumer credit agreement, the county court may enforce the judgment irrespective of the amount.

The judgment creditor may have little knowledge of the income or capital of the debtor and, since the methods differ according to the position of the debtor, it is necessary for the creditor to find out something about him/her. This can be done through an inquiry agent but the rules provide for the debtor to be summoned for an examination as to his/her means by an officer of the court.

Writ of *fieri facias* (fifa) or warrant of execution

Where the High Court judgment is payment of money, the plaintiff can issue a writ of *fieri facias* addressed to the sheriff of the county where the defendant's goods are situated commanding the seizure of goods sufficient to satisfy the judgment, any costs awarded and the sheriff's costs. The goods will be sold and the sheriff will hand over the proceeds, having deducted his costs. The county court equivalent is the 'warrant of execution' addressed to the county court bailiffs.

Attachment, 'garnishee orders'

If the judgment debtor is owed money, the judgment creditor can obtain a court order diverting payment to him/her by the process of attachment

and a garnishee order. These are frequently directed against the judgment debtor's bank. Application is made *ex parte* and the order *nisi* forbids the person named from paying the judgment debtor. The order is served on the garnishee and the judgment debtor and no less than fifteen days later they all attend the court, when the order will be made absolute unless good reason is shown.

Charging orders

The judgment creditor may obtain a 'charging order' over land, stocks and shares or an interest in partnership property. The property can be disposed of to settle the judgment debt.

Appointment of a receiver

A receiver may be appointed where the debtor is in receipt of income, such as rent from tenants, which must be collected by an independent person.

Bankruptcy and liquidation

The judgment creditor could consider making the judgment debtor bankrupt or, where the judgment creditor is a partnership or registered company, put them into liquidation (see Chapters 18 and 19).

Attachment of earnings

The debtor's employer is ordered to pay into court such part of the earnings of the debtor as it thinks fit. The order can be discharged if the debtor loses or changes his employment. Application must be to the debtor's local county court, Attachment of Earnings Act 1971.

Writ or warrant of specific delivery

A judgment for the delivery of goods or chattels can be enforced by the issue of a writ or warrant of specific delivery depending on whether the claim is in the High Court or the county court. The sheriff or county court bailiff is ordered to seize the goods and deliver them to the successful litigant.

Writ of sequestration

Commissioners seize and retain the judgment debtor's property until the debtor complies with the court order. It is a punishment for contempt of court and has been used against a refusal of trade unions to comply with prohibitory injunctions.

Writ or warrant of possession

This enforces an order for possession of land and commands the sheriff or county court bailiffs to enter upon the land, evict those in unlawful possession and give possession to the plaintiff.

Committal for contempt of court

Where the judgment is an injunction, the court may commit a person to prison for refusing to obey the order.

2.6 Arbitration

Parties can agree that any dispute relating to a particular contract should be settled by a quasi-judicial inquiry rather than the courts. Disputes can be referred to arbitration by written or verbal agreement. The law relating to written agreements is contained in the Arbitration Act 1996, which came into effect on 31 January 1997. Written agreements includes (a) agreements made in writing (whether or not signed by the parties); (b) those made by exchange of communications in writing (for example, by fax or telex); or (c) agreements evidenced in writing: s.5(1) & (2). A party to an arbitration agreement includes an assignee of a contract containing an arbitration clause who is bound by the arbitration clause: s.82(2). An oral arbitration agreement is governed by the common law rules which are saved by s.81(1)(b). This section also preserves any rule of the common law which is consistent with the provisions of Part I of the Act indicating that the Act is not intended as a complete code. The 1996 Act replaces Part I of the Arbitration Act of 1950, and the Arbitration Acts of 1975 and 1979 and the Consumer Arbitration Act 1988, which are repealed.

The new Act restates the existing legislation and codifies principles established by case law, but it is not just a consolidating statute. It introduces changes designed to improve arbitration and enhance the position of the City of London as a world-preferred arbitration centre. It reflects the provisions of the United Nations Commission on International Trade Law (UNCITRAL) as well as 300 years of British expertise. Statutory references throughout this section of the chapter are to the Arbitration Act 1996 unless otherwise stated.

Section 1 sets out three principles as the basis of the interpretation of the Act. The first principle is that the aim of arbitration is the fair resolution of disputes by an impartial tribunal without unnecessary delay or expense. The second asserts party autonomy subject only to safeguards necessary in the public interest. The third restricts the power of the court to intervene to those within the Act.

Part I relates to arbitration where the seat of the arbitration is in England and Wales and Northern Ireland only, but there are sections

which relate to arbitrations outside that area, s.2. The seat of the arbitration is designated (a) by the parties; or (b) by any arbitral or other institution or person vested by the parties with powers in that respect; or (c) by the arbitral tribunal if authorised by the parties: s.3. The Act distinguishes between mandatory and non-mandatory provisions: s.4. The mandatory provisions contained in Part I are listed in Schedule 1 and cannot be excluded.

An arbitration agreement is an agreement to submit to arbitration present or future disputes (whether contractual or not): s.6(1). The term 'dispute' includes a 'difference' (s.82(1)) and covers claims in tort, breaches of a statutory duty or fraud. The Act does not define what disputes are arbitrable and retains the common law rules; s.81(1)(a). Limitations on the tribunal's powers to arbitrate arise from the arbitration agreement which will usually refer to 'dispute' 'in connection with' or 'arising out of' or 'under' the substantive contract. A reference of disputes 'under this contract' excludes tortious claims unless coextensive with a claim for breach of contract. References of all disputes arising 'under or in connection with this contract' extend to tortious claims: *Ashville Investments Ltd* v. *Elmer Contractors Ltd* [1989] 2 QB 488. The words 'arising out of this contract' also cover claims for rectification, *Ethiopian Oilseeds and Pulses Export Corporation* v. *Rio Del Mar Foods Inc.* [1990] 1 Lloyd's Rep 86. The breach of or termination of the main contract will not affect the arbitration agreement. In *Heyman* v. *Darwins Ltd* [1942] AC 356, the defendants appointed the plaintiff as their selling agent under a contract with a clause referring disputes 'in respect of this agreement' to arbitration; the court ordered a stay of proceeding when the plaintiff issued a writ claiming repudiation by the defendants, since the arbitration agreement was unaffected by the breach of contract. Questions concerning the validity of an arbitration agreement cannot be referred to arbitration.

Unless otherwise agreed, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall be regarded as a distinct agreement: s.7. This sets out the principle of separability of the arbitration agreement: that is, that its validity or existence or effectiveness is not dependent upon the validity, existence or effectiveness of the underlying substantive contract. Subject to agreement, an arbitration agreement is not discharged by the death of a party and may be enforced by or against the personal representatives of that party: s.8(1). This is not mandatory. The position of the death of the party appointing the arbitrator is dealt with in s.26 (below).

A party to an arbitration agreement who is sued in respect of something referable to arbitration may apply for a stay of proceedings even where the referral is after the exhaustion of other dispute resolution procedures: s.9(1) & (2). The stay is mandatory unless the court is satisfied that the arbitration agreement is null and void, inoperative or incapable of being performed: s.9(4). This section is mandatory.

Commencement of arbitral proceedings

Where an agreement provides that a claim shall be barred or the claimant's right extinguished unless s/he takes some step within a fixed time: (a) to begin arbitral proceedings; or (b) other dispute resolution procedures to be exhausted before arbitration can be begun, the court may extend the time for taking that step. Any party may apply for such an order on giving notice to the other parties, but only after a claim has arisen and after having exhausted any available arbitral process for gaining an extension. The court shall make the order only if satisfied that the circumstances are such as were outside the reasonable contemplation of the parties when they agreed to the time provision and that it would be just to extend the time; or that one party's conduct makes it unjust to hold the other party to the strict terms of the provision. The court may extend the time for such time and on such terms as it thinks fit whether or not the time fixed has expired: s.12. This section is mandatory. The Limitation Acts apply to arbitral proceedings as to legal proceedings: s.13; but an extension of time for commencement of proceedings under s.12 does not affect the operation of the Limitation Acts. The reference to the Limitation Acts includes the Foreign Limitation Periods Act 1984 which avoids the imposition of an English limitation period where the applicable foreign law imposes a different period. This is a mandatory section.

The parties can agree when arbitral proceedings are to be regarded as having commenced but, failing agreement, they are deemed to have commenced: (i) if the arbitrator is named or designated in the agreement and when one party serves written notice on the other party or parties requiring him/her or them to submit the matter to the person named or designated; (ii) where the arbitrator(s) are to be appointed by the parties, when one party serves written notice on the other party/ies requiring him/her or them to appoint an arbitrator; and (iii) where the arbitrator(s) are to be appointed by a third party, when one party serves written notice to that person requesting him/her to make the appointment: s.14. The use of the word 'matter' and not 'disputes' extends the section to cover 'claims'.

The arbitral tribunal

The parties can agree on the number of arbitrators and whether there is to be a chairman or umpire. Unless otherwise agreed, an agreement that there shall be two (or any other even number of) arbitrators requires the appointment of an additional arbitrator as chairman. Where there is no agreement on the number of arbitrators, the tribunal shall consist of a sole arbitrator: s.15. The parties are free to agree on the procedure for appointing the arbitrator and any chairman or umpire but, failing agreement:

(i) If the tribunal is to comprise one arbitrator, the parties shall jointly appoint the arbitrator not later than twenty-eight days after service of a request in writing by either party.

(ii) If it is to comprise three arbitrators:
  (a) each party shall appoint one arbitrator not later than fourteen days after service of a request in writing by either party; and
  (b) the two appointed shall forthwith appoint a third arbitrator as chairman.

(iii) If the tribunal is to comprise two arbitrators and an umpire:
  (a) each party shall appoint one arbitrator not later than fourteen days following a written request by either party; and
  (b) the two may appoint an umpire at any time after their appointment and shall do so before any substantive hearing or forthwith if they cannot agree on a matter relating the arbitration: (s.16).

If a party refuses to appoint an arbitrator or fails to do so within the specified time, the other party, having already appointed an arbitrator, may serve written notice to the party in default that s/he proposes to appoint his/her arbitrator as sole arbitrator. If that party does not within seven days of that notice (a) make the appointment; and (b) notify the other party of the appointment, the other party may appoint his arbitrator as sole arbitrator whose award shall be binding on both parties as if s/he had been appointed as such by agreement but the party in default may, with notice to the appointing party, apply to the court, which may set aside the appointment: s.17.

The parties can agree what is to happen where there is a procedural failure for the appointment of the tribunal (appointment of a sole arbitrator under s.17 is not a failure of procedure unless it is set aside). Failing agreement, any party may, on giving notice to the other parties, apply to the court to exercise its powers to: (a) give directions as to the making of any necessary appointments; (b) direct that the tribunal shall be constituted by such appointments as have been made; (c) revoke any appointment already made; and (d) make any necessary appointments itself. An appointment made by the court has effect as if made with the agreement of the parties: s.18. In the exercise of its powers, the court take into consideration agreements between the parties regarding the arbitrators' qualifications: s.19.

Where the parties have agreed that there shall be a chairman, they can agree on his/her functions but, failing agreement, decisions, order and awards shall be made by all or a majority of the arbitrators (including the chairman). The chairman's view shall prevail in the absence of unanimity or majority: s.20. The previous legislation did not provide for the office of chairman. Where the parties have agreed that there shall be an umpire, they can agree on his/her functions and, in particular, (a) whether s/he is to attend the proceedings; and (b) when s/he is to replace the other arbitrators at the tribunal with power to make decisions, orders and awards. Failing agreement:

(i) The umpire shall attend the proceedings and be supplied with the same documents as the other arbitrators.

(ii) Decisions, orders and awards shall be made by the other arbitrators unless and until they cannot agree on any matter. In the event of this, they shall serve written notice on the parties and the umpire and the umpire shall replace them as the tribunal with power to make decisions, orders and awards as if s/he were sole arbitrator.
(iii) If the arbitrators cannot agree but fail to give notice of that fact, or if any of them fails to join in the giving of notice, any party may, on serving notice to the tribunal and the other parties, apply to the court which may order that the umpire shall replace the other arbitrators with powers as if s/he were the sole arbitrator: (s.21).

The distinction between an umpire and a chairman is confusing. A chairman should attend all meetings and vote in respect of all the decisions of the tribunal. An umpire only has a role if the two arbitrators cannot agree when s/he makes the decision instead of the arbitrators. Once called in, the umpire replaces the arbitrators for the rest of the arbitration.

Where the parties agree that there shall be two or more arbitrators with no chairman or umpire, they can agree how the tribunal makes decisions, orders and awards but, failing agreement, they shall be made by all or a majority of the arbitrators: s.22. The appointment of a chairman or an umpire is generally preferable.

The parties can agree when the arbitrator's authority may be revoked, but, failing agreement:

(i) the arbitrators authority may only be revoked (a) by the parties acting jointly; or (b) by an arbitral or other institution or person vested with powers in that regard; or
(ii) revocation by the parties acting jointly must be agreed in writing unless the parties also agree (orally or in writing) to terminate the arbitration agreement.

This section does not affect the court's power to revoke an appointment under s.18 or to remove an arbitrator under s.24: s.23.

A party may, on giving notice to the other parties, to the arbitrator concerned and any other arbitrators, apply to the court for the removal of an arbitrator on the grounds:

(i) that circumstances give rise to justifiable doubts as to the arbitrators impartiality;
(ii) that s/he does not have the qualifications required by the agreement;
(iii) that s/he is physically or mentally incapable of conducting the proceedings, or that there are justifiable doubts as to his/her capacity to do so;
(iv) that s/he has refused or failed:
    (a) properly to conduct the proceedings; or
    (b) to use all reasonable despatch in conducting the proceedings or making an award; and
    (c) that substantial injustice has been or will be caused to the applicant.

If there is an arbitral or other institution or person with power to remove the arbitrator, the court shall not exercise its power of removal unless satisfied that the applicant has first exhausted any recourse to that institution or person. The arbitral tribunal may continue the proceedings and make an award while an application is pending. The court can make any order it thinks fit respecting the arbitrator's entitlement to fees or expenses or the repayment of fees or expenses already paid. The arbitrator is entitled to be heard before the court makes an order: s.24. The section is mandatory.

The parties can agree on the consequences of an arbitrator's resignation regarding his/her entitlement to fees or expenses, and any liability incurred by him/her. Failing agreement, an arbitrator who resigns may, on serving notice to the parties, apply to the court for relief from any liability, and for an order respecting to his/her right to fees or expenses or the repayment of fees or expenses already paid. If satisfied that the arbitrator's resignation was reasonable, the court may grant relief on such terms as it thinks fit: s.25. An arbitrator is generally in breach of contract if s/he resigns, but may agree with the parties whether s/he is entitled to do so and the circumstances and consequences of his/her resignation.

The arbitrator's authority is personal and ceases on death: s.26(1). This is a mandatory section. However, unless otherwise agreed, the death of the person who appointed the arbitrator does not revoke his authority; s.26 (2). Where an arbitrator ceases to hold office, the parties can agree (a) whether and how the vacancy is to be filled; (b) whether and to what extent the previous proceedings should stand; and (c) the effect, if any, on persons appointed by the arbitrator. Failing such agreement, the provisions of ss.16 and 18 apply to the filling of the vacancy. The reconstituted tribunal shall then decide whether and to what extent the previous proceedings should stand. An arbitrator's loss of office does not affect the appointment by him or her (alone or jointly) of another arbitrator, umpire or chairman: s.27.

The parties are jointly and severally liable to pay the arbitrators such reasonable fees and expenses as are appropriate. Parties may, on serving notice on the other parties and the arbitrators, apply to the court for an order that the fees and expenses may be considered and adjusted according to its directions. The court may order repayment by the arbitrator of any excessive payment already made. This does not affect the liability of a party to any other party to pay all or any of the costs of the arbitration or any contractual right of the arbitrator regarding fees and expenses: s.28. This mandatory section confirms what was generally regarded as the position in common law.

An arbitrator is not liable for any act or omission in the discharge of his/her functions unless it is in bad faith. This protection extends to the arbitrator's employees but does not affect liability incurred by resignation under s.25: s.29. This mandatory section resolves the uncertainty of the common law. A new provision provides immunity for arbitral institutions and other persons who have been given responsibility for the appointment

or nomination of an arbitrator from anything done or omitted in the discharge of that duty unless it is shown that the act or omission was in bad faith: s.74(1). In addition, the institution or person is not liable for the acts or omissions of the arbitrator or his/her employees or agents in the discharge of his/her arbitral functions: s.74(2). This mandatory section removes an area of uncertainty from the common law.

Jurisdiction of the arbitral tribunal

Subject to agreement between the parties, the tribunal may rule on its own substantive jurisdiction as to (a) whether there is a valid arbitration agreement; (b) whether the tribunal is properly constituted; and (c) what matters have been submitted to arbitration. This may be challenged by any arbitral process of appeal or review, or in accordance with Part I of the Act: s.30. This enacts an internationally recognised doctrine which has already been recognised in English law, but the section is not mandatory. An objection that the tribunal lacks jurisdiction at the outset must be raised by a party not later than the time s/he takes the first step in the proceedings to contest the merits of any matter in relation to which s/he challenges the tribunal's jurisdiction. S/he is not precluded from objecting because s/he has appointed or participated in the appointment of an arbitrator. An objection during the course of proceedings must be notified as soon as possible after the matter allegedly beyond its jurisdiction is raised. The arbitral tribunal may admit an objection later than the time specified if it considers that the delay is justified. Where an objection is raised and the tribunal has power to rule on its own jurisdiction, it may (a) rule on the matter in an award as to jurisdiction; or (b) deal with the objection in its award on the merits. If the parties agree as to which course the tribunal is to take, it shall proceed accordingly. The tribunal may, and shall if the parties agree, stay proceedings while an application under s.32 is made to the court: s.31. This section is mandatory. A party may ask the court to determine the tribunal's jurisdiction. Applications require the written agreement of the other parties, or the tribunal's permission, but subject to the court being satisfied that the determination of the question is likely to produce substantial savings in costs, that it is made without delay and there is a good reason why is should be decided by the court. There is no right of appeal from the court's decision without leave which is only given where the appeal concerns a point of law of general importance or one which for some other special reason should be considered by the Court of Appeal: s.32. This section is mandatory.

The arbitral proceedings

The tribunal's general duty is to act fairly and impartially, giving each party a reasonable opportunity of putting a case and dealing with that of the opponent, and adopt procedures suitable to the circumstances, avoiding unnecessary delay and expense: s.33. The use of the phrase 'reasonable

opportunity' rather than 'full opportunity' gives tribunals scope to exercise more discipline over the parties. This section is mandatory. The tribunal decides all procedural and evidential matters subject to any agreement between the parties. This includes the time and place of the proceedings, the language(s) to be used, the form of written statement, the documents to be produced and the rules of evidence, and so on: s.34. The parties can consolidate proceedings with other arbitral proceedings or to agree that concurrent hearings should be held. The tribunal can only consolidate proceedings if authorised by the parties: s.35. Unless otherwise agreed by the parties, the parties may be represented in the proceedings by a lawyer or other person: s.36. The section does not allow a party to delay proceedings by insisting on being represented by a particular person. A non-lawyer cannot claim professional privilege under this section. A party may be represented by a foreign lawyer in arbitration proceedings but not in an application to court.

Subject to agreement, the tribunal may appoint experts or legal advisers to report to it and the parties, or appoint assessors to assist it on technical matters and allow such persons to attend the proceedings: s.37(1). The arbitrators are liable for the fees and expenses of these persons, which constitute expenses of the arbitrators for the purposes of the Act: s.37 (2). This gives the tribunal greater flexibility. Subsection (2) is mandatory.

The parties can agree on the tribunal's powers and, failing agreement, it may order a claimant to provide security for the costs of the arbitration. It may give directions in relation to any property which is the subject of proceedings, owned or in the possession of a party. It may direct that a party or witness shall be examined on oath and it may give directions to a party for the preservation of any evidence in his/her possession: s.38. The parties can agree to the tribunal making provisional awards relating to the payment of money or the disposition of property between the parties, or an interim payment on account of the costs of the arbitration. The final award shall take account of any interim award: s.39.

The general duty of the parties is to do all things necessary for the proper conduct of the proceedings including complying without delay with any determination of the tribunal regarding procedural or evidential matters or any order or directions and, where appropriate, taking necessary steps to obtain a court decision on jurisdiction or law under ss 32 and 45: s.40. This section is mandatory. The parties can agree on the tribunal's powers (s.41(1)); but, failing agreement, if it believes there has been an inordinate and inexcusable delay on the claimant's part in pursuing his/her claim and the delay gave rise, or is likely to give rise, to the risk that it is not possible to fairly resolve the issues, or has caused or is likely to cause severe prejudice to the respondent, it may dismiss the claim: s.41(3). If, without showing sufficient cause, a party fails to attend or be represented at a hearing, or, where matters are to be determined in writing, fails to submit written evidence or make written submissions, the tribunal may continue the proceedings in that party's absence or without his/her written submissions and make an award on the basis of the evidence before it. If,

without justification, a party fails to comply with the tribunal's orders or directions, it may fix a time for due compliance: s.41(5). If the claimant fails to comply with an order to provide security for costs, the tribunal may dismiss his/her claim: s.41(6). If the party fails to comply with any other order, the tribunal may (a) direct that the party in default cannot rely on an allegation or material which was the subject matter of the order; (b) draw adverse inferences from the non-compliance; (c) make an award on the basis of such materials as have been properly submitted; or (d) make an order as to payment of costs in consequence of the non-compliance: s.41(7).

Powers of the court in relation to arbitral proceedings

Subject to contrary agreement by the parties, the court may order a party to comply with a tribunal's order. An application may be made by the tribunal, a party with the tribunal's permission, or where the parties have agreed that the court's powers under this section shall be available: s.42. The same proceedings may be used by a party to secure the attendance before the tribunal of a witness to give oral testimony or to produce documents or other evidence. This requires either the tribunal's agreement or that of the other parties. The procedures only operate if the witness is in the UK and the proceedings are being conducted in England and Wales or Northern Ireland. The order can only apply to the production of evidence that a person could be compelled to produce in legal proceedings: s.43. Unless otherwise agreed, the court has the same power as in legal proceedings of making orders concerning the following matters: the taking of evidence of witnesses, the preservation of evidence; making orders relating to property that is the subject of the proceedings (i) for the inspection, photographing, preservation, custody or detention of the property, or (ii) ordering that samples be taken from, or any observation be made of or experiment conducted upon, the property, and in that connection authorising persons to enter any premises in the possession or control of parties to the arbitration; the sale of any goods that are the subject of the proceedings; and the granting of an interim injunction or the appointment of a receiver. In cases of urgency, the court may, on the application of a party, make orders for the purpose of preservation of evidence or assets. Except in an emergency, the court shall only act on the application of a party with the tribunal's permission or the written agreement of the other parties. In any case, the court shall only act if and to the extent that the tribunal, and any arbitral or other institution or other person vested with power by the parties, has no power or is, for the time being, unable to act. The court's order can be expressed to cease to have effect, in whole or in part, on the order of the tribunal, arbitral or other institution or person: s.44. Under this section the court can order Mareva or Anton Piller relief: s.44(3). Unless otherwise agreed, the court may on the application of a party determine any question of law which the court is satisfied substantially affects the rights of one or more of the parties. An

agreement to dispense with reasons for the tribunal's award shall be an agreement to exclude the court's jurisdiction. Application must be with the agreement of all the parties or made with the tribunal's permission, with the court satisfied that the determination of the question is likely to produce substantial savings in costs and that it was made without delay. Unless otherwise agreed, the tribunal may continue the proceedings and make an award pending the application. There is no appeal from the court's decision without leave, which will only be given for questions of general importance or ones which for some other special reason should be considered by the Court of Appeal: s.45.

The award

The tribunal shall decide the dispute in accordance with the law chosen by the parties: s.46(1)(a); or if the parties agree, in accordance with such other considerations as are agreed by them or determined by the tribunal: s.46(1)(b). This latter reference allows the parties to agree that their disputes are to be decided in accordance with 'equity clauses', which resolves the uncertainty as to the legality of such clauses. This will exclude any right of appeal to the courts since there is no point of law to appeal against. For this purpose, the choice of the laws of a country shall be understood to refer to its substantive laws and not its conflict of laws rules. If there is no choice or agreement, the tribunal shall apply the law determined by the conflict of law rules that it considers applicable: s.46(3). Guidance in choosing the conflict of laws rules may be obtained from the Contract (Applicable Law) Act 1990 which enacts the EC Convention on the Law Applicable to Contractual Obligations. Unless otherwise agreed, the tribunal may make more than one award at different times on different aspects of the matters to be determined, including, in particular, an award relating to an issue affecting the whole claim, or to a part only of the claims or cross-claims submitted to it: s.47. The parties can agree on the tribunal's powers regarding remedies, but, failing agreement, it may make declarations; or order the payment of a sum of money in any currency. It has the same powers as the court (i) to order a party to do or refrain from doing something; (ii) to order specific performance of a contract (other than one relating to land); and (iii) to order the rectification, setting aside or cancellation of a deed or other document: s.48. The parties may give the tribunal powers that are not available to the courts, but the remedies must not be contrary to public policy if they are to be enforced. The parties can agree with regard to the tribunal's powers regarding the award of interest but, failing agreement, it may award simple or compound interest from such dates, at such rates and with such rests as it considers just: (a) on the whole or part of any amount awarded, in respect of any period up to the date of the award; or (b) on the whole or any amount claimed and outstanding at the commencement of the proceedings but paid before the award was made, in respect of any period up to the date of payment. The tribunal may award simple or compound

interest from the date of the award (or any later date) until payment, at such rates and with such rests as it considers just, on the outstanding amount of any award (including an award of interest) and any award as to costs: s.49.

Where the time for making an award is limited and, subject to agreement of the parties, the court may extend the time on application by the tribunal (with notice to the parties), or by any party (notice to the tribunal and the other parties), but only after exhausting any available arbitral process for agreeing an extension: s.50. If, during the proceedings, the parties settle the dispute, the tribunal shall, unless otherwise agreed, terminate the proceedings and record the settlement in the form of an agreed award. This has the same status and effect as an award on the merits of the case: s.51. The parties can agree to the form of any award but, failing agreement, it shall be in writing signed by all the arbitrators or all those assenting and give the reasons for the award unless it is an agreed award or the parties have agreed to dispense with reasons. The award shall state the seat of the arbitration and the date when the award is made: s.52. The requirement for the award to be signed means that a hard copy rather than an electronic copy must be produced. Unless otherwise agreed by the parties, where the seat of the arbitration is in England and Wales or Northern Ireland, any award shall be treated as being made there, regardless of where it was signed, despatched or delivered: s.53. Unless otherwise agreed, the tribunal may decide what date is to be taken as the date on which the award was made. In the absence of such decision it shall be taken to be the date on which it is signed by the arbitrator or by the last of them where it is signed by more than one: s.54. The parties can agree as to notification of the award but, failing agreement, it shall be by service on the parties of copies without delay: s.55. The tribunal may refuse to deliver an award except on full payment of the arbitrators' fees and expenses. In this case, a party may apply to the court, which may order that the tribunal shall deliver the award on the payment into court by the applicant of the fees and expenses demanded or such lesser amount as the court orders. The amount payable shall be determined by such means and on such terms as the court may direct, and out of the money paid into court there shall be paid such fees and expenses as are properly payable. An application cannot be made where there is an available arbitral process for appeal or review of the fees and expenses: s.56. This section is mandatory.

The parties can agree on the tribunal's powers to correct and award or make an additional award but, otherwise, it may on its own initiative or on a party's application correct an award to remove a clerical mistake or error arising from an accidental slip or omission, or clarify or remove any ambiguity in the award, or make an additional award in respect of any claim which was presented to the tribunal but not dealt with in the award. Application to exercise these powers must be within twenty-eight days of the award or such longer period as the parties agree. A correction shall be made within twenty-eight days of the date the application was received by

the tribunal or, if made at the tribunal's initiative, within twenty-eight days of the award or, in either case, such longer period as the parties agree. Any additional award shall be within fifty-six days of the date of the original award or such longer period as the parties agree: s.57. Unless otherwise agreed by the parties, an award is final and binding, both on the parties and on any person claiming through or under them. This does not affect the right of a person to challenge the award by any available arbitral process of appeal or review or in accordance with this Part of the Act: s.58.

Costs of the arbitration

The costs of the arbitration are the arbitrators' fees and expenses, the fees and expenses of any arbitral institution concerned, and the legal and other costs of the parties, including the costs of or incidental to any proceedings to determine recoverable costs: s.59. Any agreement that a party is to pay the whole or part of the costs in any event is only valid if made after the dispute has arisen: s.60. This mandatory section is inconsistent with the principle of party autonomy but is required by public policy. The tribunal may make an award of costs between the parties, subject to any agreement between them. Unless otherwise agreed, the tribunal shall award costs on the principle that costs should follow the event unless inappropriate: s.61. Unless otherwise agreed, an agreement between the parties as to how costs are to be borne, or under an award allocating the costs, only covers recoverable costs: s.62. The parties can agree what costs are recoverable but, otherwise, the tribunal may determine the award of recoverable costs. If so, it must specify the basis on which it has acted and the items of recoverable costs, and the amount referable to each. If the tribunal does not determine the recoverable costs, a party may, on giving notice to the other parties, apply to the court, which may determine the recoverable costs, or order the means and terms on which they shall be determined. Unless the tribunal or court otherwise decides, the recoverable costs shall be determined on the basis that a reasonable amount should be allowed in respect of all costs reasonably incurred and any doubt as to whether they were reasonably incurred or were reasonable shall be resolved in favour of the paying party: s.63. Unless otherwise agreed, the recoverable costs shall include in respect of the fees and expenses of the arbitrators only such reasonable fees and expenses as are appropriate. Questions relating to what fees and expenses are reasonable and appropriate may be referred to the court, which can determine the matter or order that it be determined by such means and on such terms as specified by the court: s.64. Subject to agreement between the parties, the tribunal may impose a limit on the amount of recoverable costs. Such a direction may be made or varied at any stage but sufficiently in advance of the incurring of costs to which it relates or any steps in the proceedings which may be affected by it: s.65. This is a new concept and could reduce unnecessary expense and protect less wealthy parties from intimidation by rich opponents.

Powers of the court in relation to the award

An award may, by leave of the court, be enforced in the same manner as a judgment or order of the court and, where leave is given, judgment may be entered in terms of the award: s.66(1) & (2). Leave will not be given where the person against whom it is sought shows that the tribunal lacked substantive jurisdiction unless the right to raise the lack of jurisdiction has been lost under s.73 (see below): s.66(3). The section expressly retains the procedures for recognition and enforcement of foreign awards under the 1927 Geneva Convention (s.99 and Part II of the Arbitration Act 1950) and the 1958 New York Convention (ss.100–104 below): s.66(4). The section is mandatory. A party may, on giving notice to the other parties and the tribunal, apply to the court to challenge any award of the tribunal as to its substantive jurisdiction; or for an order declaring an award to be of no effect in whole or in part because of lack of substantive jurisdiction. The tribunal may continue proceedings and make further awards while the application is pending. The court may confirm, vary or set aside the award: s.67. The section is mandatory.

A party may also challenge an award on the ground of serious irregularity affecting the tribunal, the proceedings or the award, subject to s.73 and the restrictions of s.70(2) & (3). A serious irregularity is one or more of the following which the court considered has, or will, cause substantial injustice to the applicant:

(a) failure by the tribunal to comply with its general duty under s.33;
(b) the tribunal exceeded its powers (other than by exceeding its substantive jurisdiction);
(c) failure by the tribunal to conduct proceedings in accordance with the agreed procedure;
(d) failure by the tribunal to deal with all the issues put to it;
(e) any arbitral or other institution or person vested with powers in respect of the proceedings exceeding its powers;
(f) uncertainty or ambiguity as to the effect of the award;
(g) the award being obtained by fraud or it or the way in which it was procured being contrary to public policy;
(h) failure to comply with the requirements as to the form of the award; or
(i) any irregularity in the proceedings or the award admitted by the tribunal or any arbitral or other institution or person vested with powers in relation to the proceedings or the award. In the case of serious irregularity affecting the tribunal, the court may remit the award, in whole or in part, for reconsideration, set the award aside in whole or in part, or declare that the award has no effect, in whole or in part: s.68.

The section is mandatory.

Unless otherwise agreed, a party may appeal to the court on a question of law arising out of an award made. An agreement to dispense with the

reasons for the award is considered as an agreement to exclude the court's jurisdiction. An appeal can only be brought with the agreement of all the parties or with the leave of the court. It is also subject to the restrictions in s.70(2) & (3). Leave to appeal shall only be given if the court is satisfied: (a) that the determination of the question with substantially affect the rights or one or more of the parties; (b) that it is one which the tribunal was asked to determine; (c) that on the basis of the findings of fact in the award the decision is obviously wrong or the question is of general public importance and the decision of the tribunal is open to serious doubt; and (d) that it is just and proper for the court to determine the question. The court may confirm, vary, remit or set aside the award in whole or in part. The leave of the court is required for any further appeal and it will only be given if the court considers that the question is one of general importance, or one which for some other special reason should be considered by the Court of Appeal: s.69. The section is not mandatory. The House of Lords established guidelines in *Pioneer Shipping Ltd* v. *B.T.P. Tioxide Ltd The Nema* [1982] AC 725. Leave to appeal should be granted only sparingly, particularly in cases involving a 'one-off' contract and not a standard form. The court would only allow an appeal if the point is new, capable of serious argument, potentially of great importance and far-reaching in its effect. The court favours finality rather than legality and presumes that the parties agreed to the risk that the arbitrator might make an error of fact or law. An arbitrator can refer a question of EC Law to the ECJ under Article 177 EC Treaty.

Applications challenging or appealing against awards under the three preceding sections may only be brought if the applicant or appellant has first exhausted any available arbitral process of appeal or review and any available recourse under s.57 relating to the correction of the award or the making of an additional award: s.70(2). In addition, any application or appeal must be within twenty-eight days of the date of the award, or the date when the applicant or appellant was notified of the result of any arbitral process of appeal or review: s.70(3). The court may also ask the applicant or appellant to provide security for the costs of the application or appeal: s.70(6). This section is mandatory in relation to ss.67 and 68.

Where the court makes an award under ss.67, 68 or 69, where the award is varied, the variation has effect as part of the tribunal's award. Where the award is remitted in whole or in part, the tribunal shall make a fresh award within three months of the date of remission or for such longer or shorter period as the court directs. Where the award is set aside or declared to be of no effect, the court may also order that any provision that an award is a condition precedent for the bringing of legal proceedings, is of no effect as regards the subject matter of the award or the relevant part of the award: s.71. This section is mandatory. A party who is alleged to be a party to the arbitration but who takes no part in the proceedings may question whether there is a valid arbitration agreement; whether the tribunal is properly constituted, or what matters have been submitted to arbitration in accordance with the agreement by proceed-

ings in court for a declaration, injunction of other appropriate relief. S/he also has the same rights as a party to challenge an award under ss.67 and 68 and s.70(2) does not apply to him/her: s.72. This section is mandatory.

A party can lose the right to challenge the tribunal's substantive jurisdiction, the fact that the proceedings have been improperly conducted, alleging a failure to comply with the arbitration agreement or any other irregularity affecting the tribunal or the proceedings where s/he took part or continued to take part without forthwith or within the time allowed by the agreement making any objection. S/he will be unable to raise that objection later unless s/he shows that, when s/he took part or continued to take part in the proceedings, s/he did not know or could not with reasonable diligence have discovered the grounds for the objection: s.73(1). Where the arbitral tribunal rules that it has substantive jurisdiction and a party has not questioned that ruling by any available process of arbitral appeal or review, or by challenging the award within the time allowed by the agreement or any statutory provision of Part I, s/he may not later object to the tribunal's substantive jurisdiction on any ground which was the subject of that ruling: s.73(2). This section is mandatory.

Other provisions relating to arbitration

Part II of the Act contains provisions relating to specific arbitration situations and to persons who can be arbitrators. The provisions relating to domestic arbitration in ss.85–87 have not been activated following the decision in *Philip Alexander Securities and Futures* v. *Bamberger, The Times*, July 22 1996 that they were contrary to EC law.

Consumer arbitration agreements

The Unfair Terms in Consumer Contract Regulations 1994 are extended to a term which constitutes an arbitration agreement irrespective of whether the consumer is a legal or a natural person: ss.89 & 90. In addition, an arbitration agreement restricting a pecuniary claim to amounts below those specified by order under s.91 is unfair for purposes of the Regulations. The section gives the Secretary of State powers to make an order for England and Wales with the concurrence of the Lord Chancellor.

Small claims arbitration in the county court

There is an entirely separate regime for the arbitration of small claims under s.64 County Courts Act 1984. They are not affected by Part I of the Act.

Appointment of judges as arbitrators

A judge of the Commercial Court or an official referee may, if s/he thinks fit, accept appointment as a sole arbitrator or umpire. But this is subject

to informing the Lord Chief Justice and being informed that s/he can be made available. Fees payable in either case shall be taken in the High Court: s.93. It is doubtful that a commercial judge or official referee would be made available.

Statutory arbitrations

The provisions of Part I of the 1996 Act apply to statutory arbitrations – even those under an enactment passed prior to the date of commencement of the Act, except where they are inconsistent with the enactment or any rules or procedure authorised or recognised by it, or if excluded by any other enactment. The term 'enactment' includes subordinate legislation: s.94. Sections 96 and 97 adapt certain provisions of Part I and exclude the operation of certain provision of Part I from applying to statutory arbitrations.

Recognition and enforcement of certain foreign awards

Under Part III of the Act, provision is made for the continuation of Part II of the Arbitration Act 1950 in relation to foreign awards, within the meaning of that part of the Act, that are not also New York Convention awards: s.99. Only a few states that are parties to the Geneva Convention have not become parties to the New York Convention, so this section and Part II of the 1950 Act will have limited application. The recognition and enforcement of New York Convention awards is contained in ss.100–104. These restate in concise and simple language the provisions of the 1975 Act and raise a presumption in favour of recognition and enforcement of the award which can only be rebutted by the defendant (that is, award debtor) proving one of the cases set out in s.103. As at 30 September 1996 there were 110 states that were parties to the New York Convention.

Under Part IV of the Act, the Lord Chancellor has power to allocate proceedings under the Act between the High Court and the county courts: s.105. The Act is also extended to arbitrations affecting the Crown: s.106.

2.7 Alternative Dispute Resolution (ADR)

Two years after the implementation of reforms to improve the efficiency of civil litigation by streamlining the jurisdiction of the High Court and the county courts, the 1993 Heilbron/Hodge Report referred to unmodernised Victorian buildings, a negligible use of modern technology with virtually all court documents and records compiled by hand and with technical, inflexible court procedures riddled with rules and often incomprehensible to litigants. Companies involved in litigation find it protracted, cumbersome and increasingly expensive. The cost of a two-year commer-

cial dispute ending in a one- or two-month trial can run into millions of pounds. Yet litigation is on the increase, with the Centre for Interfirm Comparison reporting an average 25 per cent growth in litigation in 1992 coming after a 43 per cent average rise in 1991. The report suggests restructuring the High Court; the introduction of new technology; the creation of more specialised courts; and the introduction of simplified procedures, with court documents expressed in plain English. The most radical suggestion, however, involves the recommendation that the government should establish a pilot scheme for Alternative Dispute Resolution (ADR) in one or two civil court centres.

ADR has been used in the Far East for more than thirty years, and in the USA for fifteen years. The Heilbron/Hodge report estimated that 10 per cent of US cases are resolved by ADR. About a third of American states have plans for court-based ADR and there are about 1200 ADR schemes receiving referrals from state courts. Some US schemes indicate a settlement rate as high as 50 per cent and a number of courts have rules requiring lawyers to inform their clients of the available ADR processes.

ADR takes many forms – mediation, conciliation or mini-trial – but common to all forms is the fact that they are non-binding and, if ADR does not work and resolution proves impossible, the parties are still free to litigate. While in the USA the term ADR usually includes binding arbitration, in the UK, ADR normally refers to non-adjudicatory techniques. The Centre for Dispute Resolution (CEDR), created to promote ADR in the UK, offers numerous possibilities and the process can take whatever shape the negotiators want: mediation, executive tribunals, independent expert appraisal, or court-annexed arbitration. Mediation is used in the majority of cases. Company representatives meet around a table with one or more neutrals – independent advisers used in all forms of ADR – who listen to a short presentation of each side's case. The parties are then taken to separate rooms where the positions are discussed and reviewed. Negotiations continue until an agreement is reached with which both sides are happy. Legally binding documents are then drawn up and signed before either party has time to sleep on the decision.

ADR is not appropriate where legal precedents are involved, where relief in the form of an injunction is sought, or where the facts are in dispute. It is also not suitable in cases where it is necessary to start or continue a legal action in order to get the other party to the negotiating table. In most commercial cases, however, the level of the financial claim is the heart of the dispute. In such cases, ADR offers many advantages over litigation, including a wider range of solutions, a better control of risk, and confidentiality. ADR can help to preserve the commercial relationship between the parties because it need not involve allegations of fault. Thus the final outcome can be a creative solution where there is no loser – otherwise known as a win–win. Thus in a dispute involving £120m between Texaco and Borden over breach of contract claims, after years of legal battles, the parties chose to use a mini-trial system where both vice-presidents sat together with a mediator and listened to an abbreviated

version of the evidence. A deal was struck after three weeks with no money involved. The parties renegotiated supply agreements and continued trading together.

English courts provide no incentive for litigants to settle, unlike those in France and Germany, where judges may intervene to encourage such a step. ADR can provide this missing element. Prompted by the recommendations of the 1993 Heilbron/Hodge Report, the commercial court has established a court-annexed ADR scheme. Legal advisers to litigants must ensure that parties are informed of the most cost-effective means of resolving particular issues and disputes. The commercial court clerk keeps a list of ADR services; this includes numerous former commercial judges and ADR bodies such as CEDR and the City Dispute Panel for banking and financial services.

The benefits of ADR are most attractive in respect of costs. Costs at CEDR are based on the amount in dispute and range from several hundred pounds to over £1000 a day. Most mediations, however, settle in one to three days: a recent CEDR-arranged mediation of a dispute involving £27m and set for a 12-week hearing lasted just one day. In England, as in the USA, about 85–90 per cent of cases listed to appear in court are resolved before trial, so there is a great incentive for companies to use ADR. Motorola, the portable phone firm, has reduced its litigation bill by 75 per cent since adopting ADR.

Since its launch in 1990, CEDR has had some 360 cases, worth £1.5bn, referred to it and mediation has had a 85–90 per cent success rate. However, despite this and support from industry and consumer groups such as the National Consumer Council, ADR has not had the impact expected. This is partly attributed to the ‘traditional adversarial mindset and culture of lawyers and clients in litigation’, but for ADR to work in the UK and produce savings for the civil justice system, it needs to be extended beyond commercial disputes to cover all civil litigation, in particular personal injury actions.

Recommended Further Reading

Walker and Walker’s English Legal System, 7th edn (Butterworths, 1994).
The English Legal Process, Terence Ingman, 7th edn (Blackstone Press, 1998).
Alternative Dispute Resolution, Alexander Bevan (Sweet & Maxwell, 1992).
Arbitration: A Practical Guide, Arthur T. Ginnings (Gower, 1984).

Questions

1 In what court could the following legal actions be heard:

(i) a claim of £25 000 damages for breach of contract;
(ii) a claim for £60 000 damages for injuries arising from negligence;
(iii) a claim by a finance company for arrears under a HP agreement;

(iv) a dispute concerning an insurance claim; and
(v) a claim by an employee alleging discrimination under the Race Relations Act?

2 What is a writ of *fieri facias* used for?
3 When would a judgment creditor seek a garnishee order?
4 What is the Mareva injunction and when would it be used?
5 The Anton Piller order is most frequently used in what sort of claim?
6 If a contract containing an arbitration agreement is claimed by one of the parties to be void, will the dispute be referred to arbitration?
7 What is the main form of ADR proceedings?
8 When is ADR not suitable?

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Part II

Introduction to the Law of Obligations

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3 The Law of Contract

Learning Objectives

After reading this chapter you will know about:

1. the essentials of contracts: offer and acceptance, consideration and the intention to create legal relations
2. the vitiating elements which can render a contract void, voidable or unenforceable: mistake, misrepresentation, duress and undue influence, illegality, lack of formality and lack of capacity to contract
3. the classification of the terms of a contract, including express and implied terms and exclusion clauses
4. the ways in which a contract is discharged: performance, agreement, acceptance of breach and frustration

Legal obligations arise from many sources, of which the two main types are *tortious* and *contractual* obligations. A tortious obligation is an obligation not to wrong another by conduct that the law of torts establishes as wrongful. A person breaking such an obligation will face a legal action in respect of the tort. Contractual obligations arise where one person makes a legally enforceable promise to another which puts the promisor under an obligation to perform his/her promise under the sanction of an action against him/her for breach of contract.

An obligation implies the existence of an 'obligor' – the person who is legally under the obligation, and an 'obligee' – for whose benefit the obligation exists. The existence of the obligee who can enforce the obligation for his/her own benefit by a legal action distinguishes the law of obligations from criminal law.

Obligations can also arise under a trust which can be seen as comparable to a contract in the sense that the trustee accepts the obligation to look after someone else's property, rather than having the obligation imposed on him. This textbook does not discuss separately the law of trust directly but since partners, company directors, agents and bank managers can be regarded as being in a quasi-trustee position *vis-à-vis* the partnership property and their partners' interests (see Chapter 7), or the company's property (Chapter 8), or the interests of the principal (Chapter 11) or the account holder (Chapter 15), aspects of the law of trust are important throughout this text. In addition employees owe fiduciary duties to their employers (see Chapter 12).

Trustees and quasi-trustees have an obligation to take care of the property entrusted to them and will be liable for any breach of their fiduciary duties (see Chapter 8), together with any third party who knowingly assists in it. Thus, if a company's directors misappropriate the property of

the company, they will be liable as quasi-trustees to account to the company for the property they have misappropriated, and if they have been aided by bankers or others who knew that what was being done was a misappropriation of assets, they may be liable to the company as constructive trustees: *Selangor United Rubber Estates Ltd* v. *Cradock* (No. 3) [1968] 1 WLR 1555 (see Chapter 8). This obligation not to be the unwitting instrument of another's fraud is rather similar to tortious liability in negligence (see Chapter 4).

3.1 Essentials of a Contract

There are three essentials to be complied with for an obligation by promise to be enforceable: (i) there must be a matching offer and acceptance; (ii) the promise must be by deed or supported by valuable consideration; and (iii) the parties must have intended to create legal relations.

3.2 Matching Offer and Acceptance

There must generally be a matching offer and acceptance between the offeror and the offeree. However, in *G. Percy Trentham Ltd* v. *Archital Luxfer Ltd* [1993] Lloyd's Rep 25, the plaintiffs (building contractors) negotiated with the defendants as subcontractors for the supply and installation of doors and windows. The work was completed and paid for. The plaintiffs later claimed a contribution towards a penalty under their contract and defendants claimed there had never been a contract because there was no matching offer and acceptance. The Court of Appeal held: (i) that the approach to the issue of contract formation is objective and in this case was 'the reasonable expectations of sensible businessmen'; (ii) that, although matching offer and acceptance is the general mechanism for formation of a contract, this is not necessarily so where a contract is alleged to have come into existence as a result of performance; (iii) the fact that a contract is executed (performed) will generally preclude a claim of absence of intention to create legal relations or that the contract is void because of vagueness or uncertainty; and (iv) if a contract comes into existence during and as a result of performance, it will impliedly cover pre-contractual performance. The Court held that a contract had come into existence during performance 'even if it cannot be precisely analysed in terms of offer and acceptance'. This follows the approach of Lord Denning in *Gibson* v. *Manchester City Council* [1978] 1 WLR 520, whose attempt to weaken this requirement was rejected by the House of Lords on appeal ([1979] 1 WLR 294).

Offers, invitations to treat and preliminary statements of price

An offer is an undertaking by the offeror to be contractually bound by the terms of his/her offer; it becomes a binding contract on acceptance if

the other essentials are present. An offer can be made to one person, to a group of persons, or to the world at large in the form of an advertisement: as in *Carlill* v. *Carbolic Smokeball Co*. [1893] 1 QB 256 (see below). An invitation to treat invites another to make an offer which can be accepted or rejected. In *Fisher* v. *Bell* [1961] 1 QB 394 the court held the display of an article for sale is not an offer for sale. Similarly, *Pharmaceutical Society of Gt Britain* v. *Boots Cash Chemists* [1953] 1 QB 401 held that displaying goods for sale on a supermarket shelf was not an offer. In *Partridge* v. *Crittenden* [1968] 2 All ER 421, Partridge was convicted for offering for sale wild birds by an advertisement in a 'classified advertisements' column but the conviction was quashed since the advertisement was only an invitation to treat. In the same way in *Harris* v. *Nickerson* (1873) LR 8 QB 286, a broker failed to recover damages for breach of contract after attending an advertised sale when the lots he was interested in were withdrawn. Advertisements by companies may constitute an offer. In *Carlill* v. *Carbolic Smokeball Co*. (1893), the defendants in a series of advertisements offered to pay £100 to any person who contracted influenza after using their patent 'smoke ball' three times a day for two weeks and stated that they had deposited £1000 in a bank to meet any claims. The plaintiff sued for £100 and the court held that the deposit of the £1000 indicated an intention to pay claims and that the advertisement was an offer. Brochures, pricelists and so on are invitations to treat, as are quotations: *Scancarriers A/S* v. *Aetearoa International Ltd* (1985) 135 NLJ 79.

For contracts for the sale of land, there must be a clear intention to sell. In *Harvey* v. *Facey* [1893] AC 552, in reply to a telegram asking the defendant, 'Will you sell Bumper Hall Pen? Telegraph lowest cash price.' The defendant replied, 'Lowest price … £900.' and the appellants then telegraphed 'We agree to buy Bumper Hall Pen for £900 asked by you. Please send your title-deeds in order that we may get early possession', to which they got no reply. The court held that the defendant's telegram was not an offer but a statement of the minimum price required for the property if it was eventually decided to sell it. In *Clifton* v. *Palumbo* [1944] 2 All ER 497, the statement in a letter by the plaintiff, 'I am prepared to offer you … my … estate for £600 000 …' was held not to be an offer but a preliminary statement of price to enable negotiations to proceed.

Offers may be express or implied from conduct

A bus stopping at a bus stop is an offer and the passenger getting on is the acceptance: *Wilkie* v. *London Passenger Transport Board* [1947] 1 All ER 258 at 259. The process of taking a ticket at a barrier in a car park can also be analysed in terms of offer and acceptance.

Offers must be communicated

A person can only accept an offer of which he is aware, but after that his motive for accepting will not prevent there being a valid contract. In

Williams v. *Carwardine* (1833) 5 Car & P 566 the plaintiff successfully sued for payment of a reward even though her motive in giving the information for which the reward was offered was to clear her conscience when she thought she was dying.

Lapse of offer

Offers lapse: (i) on the death of the offeror, *obiter*, *Dickinson* v. *Dodds* (1876) 2 ChD 463; (ii) on death of the offeree, *obiter* Warrington LJ *Reynolds* v. *Atherton* (1921) 125 LT 690; (iii) on the expiration of the time prescribed for acceptance or a reasonable time, *Ramsgate Victoria Hotel* v. *Montefiore* (1866) LP 1Ex 109; and (iv) where the offer is made on the basis of state of affairs which ceases to exist, *Financings Ltd* v. *Stimson* [1962] 3 All ER 386, where an offer to buy a car on hire-purchase lapsed when the car was vandalised between the offer being made and being accepted.

Revocation of offer

Offers can be revoked at any time before acceptance: *Financings Ltd* v. *Stimson* (1962). The revocation can be communicated by a third party, and is possible even where there has been a promise to keep the offer open for a specified period, unless the offeror has entered into a separate option contract with the offeree. In *Dickinson* v. *Dodds* (1876) 2 ChD 463, the defendant signed an agreement to sell a property to the plaintiff, 'This offer to be left over until Friday …'. The plaintiff decided to buy the property on the Thursday but that afternoon heard from somebody else that the defendant had sold to a third party. That evening he delivered a formal acceptance but his claim for specific performance was refused since there had been an implied revocation of the offer by the sale to the third party.

Revocation is only effective when communicated; the postal rules of communication do not apply: *Byrne* v. *Van Tienhoven* (1880) 5 CPD 344 (see 3.3).

Termination of offer

Offers automatically terminate (i) where the offeree communicates rejection of the offer; and (ii) where the offeree makes a counter offer. A purported acceptance which seeks to introduce new terms is a counter offer. In *Hyde* v. *Wrench* (1840) 3 Beav 334 the defendant offered his property for £1000 to the plaintiff who countered with an offer of £950 before purporting to accept the original offer. The court held that the counter offer had terminated the offer, which could no longer be accepted. In *Neale* v. *Merrett* [1930] WN 189 there was no valid acceptance of an offer to sell a property when the plaintiff introduced terms relating to payment by instalments.

In *Butler Machine Tool Co. Ltd* v. *Ex-Cell-O Corp* (England) Ltd [1979] 1 WLR 401, the parties were contracting, with each using their own 'standard form' (that is, a pre-drafted contract). Butler's offer form included a price variation clause, but the buyer's order was placed on the firm's standard form, which did not include such a clause. The seller acknowledged the order by returning a tear-off slip from the buyer's form and the Court of Appeal held that the buyer had made a counter offer which had been accepted by the sellers and that the contract contained no price variation clause.

Stevenson, Jacques & Co. v. *MacLean* (1880) 5 QBD 346 distinguishes between a counter offer and a request for further information. The plaintiff responded to an offer of goods by telegram to ask if the sellers would spread delivery over two months. Receiving no reply, he accepted the original offer. The court held that a valid contract had been made and awarded damages against the defendants who had sold the goods to a third party.

3.3 Acceptance

Subject to exceptions discussed below, acceptance (i) must be communicated; and (ii) must comply with the terms of the offer.

Silence cannot constitute a valid acceptance

The offeror cannot, unless otherwise provided, presume the existence of a contract in the absence of a rejection communicated by the offeree within a specified period. In *Felthouse* v. *Bindley* (1863) 1 New Rep 401 the plaintiff wrote to his nephew 'If I hear no more about him I shall consider the horse mine at £30.15s.' There was no contract when the nephew failed to reply. This has been further developed in the Unsolicited Goods and Services Act 1971 and 1975 (see Chapter 16). The need for communication is subject to two exceptions: (i) the postal rules of acceptance, and (ii) acceptance by action.

The postal rules of acceptance

Acceptance by post operates from the time of posting even though the letter is delayed or lost, on condition (a) the post is a suitable means of communication; (b) the letter was properly stamped and addressed; and (c) it was properly posted: *Adams* v. *Lindsell* (1818) 1 B & Ald 681. In *Household Fire and Carriage Accident Ins. Co. Ltd* v. *Grant* (1879) 4 Ex D 216, the defendant applied for shares and a letter of allotment was posted but never arrived. The court held that he was a shareholder from the time of the posting. The rules apply to telegrams but not to instantaneous forms of communication such as telephones, telex and fax machines. The cases of *Entores* v. *Miles Far Eastern Corp.* [1955] 2 QB 327 and *Brinkibon*

Ltd v. *Stahag Stahl* [1983] AC 34 show the importance of the rule in determining where the contract was made, and the proper law of the contract in the absence of express provision. In the latter case a contract between a buyer in England and a seller in Austria accepted by a telex from England was subject to Austrian law, since the contract was made on receipt of the telex.

The rule can be excluded expressly or by implication, thus an option to purchase exercisable by notice in writing by implication excluded the postal rules and required actual delivery: *Holwell Securities Ltd* v. *Hughes* [1974] 1 All ER 161, and the rule does not apply to revocation of offers. In *Byrne* v. *Van Tienhoven* (1880), VT in Wales sent a postal offer to B in New York on 1 October but revoked it by post on 8 October. The offer was received by B on 11 October, who telegraphed acceptance confirmed by post on 15 October. The notice of revocation was delivered on 20 October and before the letter of acceptance was delivered on 25 October. The revocation was ineffective, since the offer had already been accepted.

Acceptance by action

For unilateral contracts, the contract comes into existence on the completion of the act or non-act of another in response to it. Reacting to the promise is the acceptance and the consideration: see *Carlill* v. *Carbolic Smokeball Co*. (1893).

Acceptance must comply with the terms of the offer

Where the method of acceptance is specified, the court can regard this as a condition of the offer and any other method will be invalid. In *Compagnie de Commerce et Commission SARL* v. *Parkinson Stove Co. Ltd* [1953] 2 Lloyd's Rep 487, the respondents stipulated that acceptance should be by a specific form and that no other method of acceptance would be valid. The appellants accepted by letter and then purported to cancel the order. The court held that there had been no valid acceptance in the absence of express or implied waiver. Alternatively, the court may treat the stipulation as an indication of the desired speed of response and an alternative method of equal speed is valid: *Tinn* v. *Hoffman & Co*. (1873) 29 LT 271. Requiring acceptance by registered post is not generally a condition and acceptance by ordinary post is valid: *Yates Building Co.* v. *Pulleyn* (1975) 119 SJ 370.

Acceptance 'subject to contract' is no acceptance

There will be no contract until a formal contract is drawn up and agreed: *Winn* v. *Bull* (1877). Common for contracts for the sale of land, once the term is introduced, all stages of the deal will be subject to it even though the words do not appear in subsequent correspondence: *Cohen* v. *Nessdale Ltd* [1982] 2 All ER 97.

3.4 Tenders

A tender can be a form of offer and forms the basis of a contract on acceptance. The invitation to submit a tender is an invitation to treat and the tenderer takes the risk of losing any expenditure incurred in tendering. However, in *Blackpool and Fylde Aero Club Ltd* v. *Blackpool Borough Council* [1993] 3 All ER 25 the Court of Appeal held that a person submitting a tender before the deadline is entitled to having his/her tender considered. Companies may request tenders for the supply of goods over a fixed period, to guarantee stability of prices. If the company accepts a tender, it is not obliged to place orders, but any goods of the nature involved must be from the successful tenderer. The tender is a standing offer and every subsequent order placed is an acceptance, creating a binding contract. The tenderer can, however, revoke the tender at any time but is in breach of contract if s/he fails to deliver pre-revocation orders: *Great Northern Railway Co*. v. *Witham* (1873) LR 9 CP 16.

3.5 Exceptional Cases

Sometimes there is no discernible offer and acceptance. In *Shanklin Pier Ltd* v. *Detel Products Ltd* [1951] 2 KB 854 the plaintiffs entered into a contract for the repair and painting of the pier, specifying that the defendant's paint should be used for the job since the defendants had previously told the plaintiffs that their paint had a life of between seven and ten years. The plaintiffs were able to sue the defendants for damages for breach of warranty of a collateral contract. In *Clarke* v. *Dunraven, The Satanita* [1897] AC 59, two yacht owners entered a race undertaking to be bound by the club rules, one of which provided that an owner was liable for damage arising from breach of the rules. The court held that the owner of a damaged yacht could sue the other owner under an inferred contractual obligation.

3.6 Consideration

Promises can be enforced where they are made with an intention that they should be binding (the civil law approach); or where given in return for some action, forbearance or counter promise by the other party and are thus part of a bargain between the parties. This is the English law approach and gratuitous promises are enforceable only if embodied in a deed. Otherwise promises are only enforceable where the court is satisfied that they have been 'bought' by valuable consideration moving from the other party. Valuable consideration has been an 'essential' of a valid contract since *Eastwood* v. *Kenyon* (1840) 11 Ad & El 438. The best definition of consideration is by Sir Frederick Pollock: '(a) An act or

forbearance of one party, or (b) the promise thereof, is the price for which the promise of the other is bought, and the promise thus given for value is enforceable.' This definition distinguishes between executed (a) and executory (b) consideration.

Executed consideration

The defendant's promise is in return for an act or forbearance of the plaintiff and is enforceable on complete performance of the consideration. The consideration is also the acceptance of the offer; for example, an offer of a reward for finding a lost dog becomes a binding contract when a person who is aware of the offer finds and returns the dog, and can then sue for the reward.

The need for the completion of the consideration before there is acceptance means that the offer can be revoked before complete performance, even once a person had begun to perform the act of consideration. However, in *Daulia Ltd* v. *Four Millbank Nominees Ltd* [1978] Ch 231, in the Court of Appeal, Goff LJ stated *obiter* that, once the offeree had embarked on performance, it was too late for the offeror to revoke his offer. This still does not solve the problem where the payment is for a person *not* to do something.

Executory consideration

The defendant's promise is in return for the plaintiff's counter promise and a contract comes into being immediately, although the performance remains *in futuro.*

Consideration must be sufficient but need not be adequate

There must be something capable of being valuable consideration, but the value of the consideration in relation to the promise is unimportant. A promise to let a house on payment of £1 per annum is enforceable: *Thomas* v. *Thomas* (1842) 2 QB 851; and wrappers from chocolate bars can be consideration: *Chappell & Co. Ltd* v. *Nestlé Co. Ltd* [1960] AC 87. The classic example is a lease of land for a peppercorn rent. There are some important aspects of sufficiency which must be appreciated.

A promise to perform or the performance of a pre-existing obligation imposed by law or under a contract is not valuable consideration

In *Collins* v. *Godefroy* (1831) 1 B & Ad 950, appearing as a witness in a court action was not consideration to support a promise of payment as the offeree was obliged by law to attend. However, if a person promises to perform, or performs more than s/he is legally or contractually obliged to do, the extra effort can constitute consideration. In *Ward* v. *Byham* [1956] 2 All ER 318, where the father of an illegitimate child promised the

mother £1 per week maintenance in return for a promise to care for the child and ensure its happiness, the promise to ensure the child's happiness constituted consideration, since it exceeded the mother's legal obligation for its material welfare.

Stilk v. *Myrick* (1809) 2 Camp 317 and *Hartley* v. *Ponsonby* (1857) 7 E & B 872, both concern a promise to divide the wages of deserting crew members among the remaining crew. In the first case, where only a couple of people had deserted, the court held that the promise of payment was not enforceable because the plaintiff had a contractual obligation to fill in for absentees. In the second case, the number of deserters was so large that the vessel was dangerously undermanned and the court held that the remaining crew members had exceeded their existing contractual obligation. *Stilk* v *Myrick* was reconsidered by the Court of Appeal in *Williams* v. *Roffey Bros & Nicholls (Contractors) Ltd* [1991] 1 QB 1. The defendants were building contractors refurbishing a block of flats. The carpentry work was subcontracted to the plaintiff for £20 000. When it appeared that the plaintiff could not comply with the contract, the defendants agreed to pay a further £10 300 at a rate of £575 per flat completed. Having completed a further eight flats and having only received £1500, the plaintiff ceased working and sued for the extra amount promised. In his leading judgment, Glidewell LJ said that, if a party to a contract promises an additional payment in return for a promise by the other to perform his contractual obligations on time and thereby obtains some benefit or avoids a disbenefit, and the promise is not the result of economic duress or fraud, then the promise will be legally binding.

However 'a promise to perform, or the performance of, a pre-existing contractual obligation to a third party can be valid consideration'. Thus if A has a legal obligation to build a fence for B and he is later promised an extra sum by C for completing the work, A can sue C for payment. In *Shadwell* v. *Shadwell* (1860) 9 CBNS 159, the plaintiff was engaged to marry (at the time an enforceable contract). His uncle then promised to pay him £150 per annum during his life until his income as a barrister should amount to 600 guineas a year. The plaintiff married and his uncle paid him £150 for twelve years before his death eighteen years after the marriage. The plaintiff successfully sued the uncle's executors for the outstanding five years' instalments. The court held that the performance of the pre-existing legal obligation to marry constituted consideration for the promise to pay. This was reaffirmed in *Pao On* v. *Lau Yiu Long* [1980] AC 614, where the plaintiffs contracted with a public company (Fu Chip) to transfer shares in their private company against 4.2 million shares in Fu Chip and promised not to sell 2.5 million of the shares for a year so as not to depress the market. As a guarantee against the fall in the price of the shares, the defendants, the majority shareholders in Fu Chip, in a subsidiary agreement, agreed to buy back 2.5 million shares within that year at $2.50 per share. The plaintiffs, realising that they had made a bad bargain in the event of the share price going up, refused to carry out their promise under the main agreement unless the defendants replaced the

subsidiary agreement with a true guarantee by way of indemnity should the shares fall below the price of £2.50. When the share price collapsed, the defendants refused to honour the indemnity, alleging that there was no valid consideration. The Privy Council found the consideration for the indemnity was the promise to perform or the performance of the Pao's pre-existing obligations to Fu Chip, and stated: 'Their Lordships do not doubt that a promise to perform, or the performance of, a pre-existing contractual obligation to a third party can be valid consideration.'

Past consideration cannot be valuable consideration

In executed consideration, the action or forbearance constituting the consideration must follow the promise. If it precedes the promise it is past consideration and not valid. Thus a promise by the heirs of an estate to pay £500 to the wife of one of them in consideration of improvements which she had already carried out to a property could not be enforced, Re *McArdle* [1951] Ch 669.

In *Lampleigh* v. *Brathwait* (1615) Hob 105, the plaintiff was able to recover money promised to him by the defendant after he had obtained a free pardon on the defendant's behalf from the king because he had acted at the promisor's request. In *Re Casey's Patents, Stewart* v. *Casey* [1892] 1 Ch 104, Casey had worked for two years at the request of the inventors of a pump to exploit their invention commercially. Having succeeded in this he was promised a third share in the patent rights. The court held that Casey was entitled to the patent rights since he had acted at the request of the promisor and there was an implication that his services would be paid for.

These decisions were also reaffirmed in *Pao On* v. *Lau Yiu Long* (1980), where the Privy Council held: 'An act done before the giving of a promise to make a payment or to confer some other benefit can sometimes be consideration for the promise. The act must have been done at the promisor's request, the parties must have understood that the act was to be remunerated ..., and payment ... must have been legally enforceable had it been promised in advance' (per Lord Scarman).

There are statutory exceptions to past consideration. Under the Limitation Act 1980 an action for breach of a simple contract is statute barred after six years from the date of the breach. For contracts by deed and other specialty contracts the period is twelve years. However, a written acknowledgement of the statute barred claim by the party originally liable will revive the right of action for a further period even with no consideration. A further exception is in relation to bills of exchange and cheques (see Chapter 15).

Consideration must move from the promisee

Consideration must be supplied by the person to whom the promise is made, and not by a person who is not a party to the contract, as when A

promises to pay C £50 if B mows A's lawn. This is the basis of the common law Doctrine of Privity of Contract, which states that a contract cannot impose burdens or grant rights to an outsider to the contract. This seems to have become established in *Tweddle* v. *Atkinson* (1861) 4 LTD 468 where, in consideration of the intended marriage between his daughter and the plaintiff, Guy made a contract with the plaintiff's father whereby each promised to pay the plaintiff a sum of money. Guy failed to pay and the plaintiff sued his executors. The action was dismissed, since the plaintiff was a stranger to the contract.

The result is that English law does not recognise third party rights in contract. Thus, if A makes a contract with B and the contract confers a benefit upon C, then C will not be able to enforce the contract. In *Dunlop* v. *Selfridge & Co. Ltd* [1915] AC 847, the defendants obtained supplies of tyres for retail sale from an agent supplied by the plaintiff. Under the contract between the defendants and the agent a term provided that if the retailer sold the tyres at less than the manufacturer's list price, money would be payable to the plaintiff. The plaintiff was unable to enforce the agreement, since only a party to the contract can enforce it. It also means that if A makes a contract with B conferring an advantage on C, then A will not be able to enforce C's rights by way of an action for damages at common law: *Woodar Ind. Dev. Ltd* v. *Wimpey Construction (U.K.) Ltd* [1980] 1 All ER 571. The same thing applies in respect of a contract which imposes a burden on an outsider.

The common law recognises agency as an exception, there are statutory exceptions to this extremely inconvenient doctrine and a number of judicial exceptions have been established. Thus in *Beswick* v. *Beswick* [1968] AC 58, the court recognised that one of the parties to a contract could obtain specific performance for the benefit of the outsider. In this case, a man sold his business to his nephew (the defendant) in consideration of the nephew paying him £6.10s. a week for the rest of his life, and on his death £5 a week to his widow. After the man's death the nephew only made one payment to the widow (the plaintiff). The court held that she was entitled, as administratrix of her deceased husband's estate, to claim specific performance of the contract as his personal representative. And in *Jackson* v. *Horizon Holidays Ltd* [1975] 3 All ER 92, a party to a certain category of domestic contract can sue for damages in respect of a non-party – for example contracting for family holidays, meals in a restaurant or hiring a taxi.

Other exceptions include constructive trusts, quasi-contract and restrictive covenants.

Constructive trusts

In *Gregory & Parker* v. *Williams* (1817) 2 Mer 582, Parker assigned all his property to Williams against a promise that Williams would pay Parker's debts to Gregory. Gregory and Parker were able to enforce this promise in equity, which held that Parker was a trustee for Gregory.

Quasi-contract (unjust enrichment)

In *Shamia* v. *Joory* [1958] 1 QB 448, the defendant owed his agent £1300 and promised to pay £500 of this to the plaintiff, the agent's brother. The defendant later repudiated all liability to the plaintiff. The plaintiff succeeded in his claim. The case established that, where A owes money to B, or holds money on their behalf and promises B to pay the money to C, and confirms this obligation to C, then the law will enforce the payment in quasi-contract on the grounds that otherwise there would be unjust enrichment of A.

Restrictive covenants

In *Tulk* v. *Moxhay* (1848) 2 Ph 774, the plaintiff sold Leicester Square to Elms, who agreed to keep the gardens 'as a pleasure garden and uncovered with buildings'. The land was eventually sold to the defendant, who claimed the right to build. The court granted an injunction preventing building since the defendant acquired the land subject to notice of the restriction (see Chapter 9).

The Law Commission Report (No. 242) Privity of Contract: Contracts for the benefits of Third Parties and a draft bill proposes that the principle of privity of contract should no longer prevent third parties from enforcing contracts made for their benefit.

Promissory estoppel and consideration

The decision in *Central London Property Trust Ltd* v. *High Trees House Ltd* [1947] KB 130 recognised the legal effect of certain promises where there is no consideration. Thus a person who promises to waive or vary his/her legal rights under a pre-existing contract, will not be able to go back on his/her promise and enforce his/her full legal rights if the other party has acted in reliance on that promise. In this case, during the Second World War, the plaintiff promised to accept 50 per cent of the full legal rent owed by the defendant for a block of flats when the defendant had difficulties finding tenants. Under the doctrine the landlord would have been unable to sue to recover money in respect of the non-payment of the rental that he had waived.

3.7 Intention to Create Legal Relations

There must be an intention by the parties that their agreement was to give rise to a legal relationship. Here the courts distinguish two situations: agreements between family and friends; and commercial agreements.

Agreements between family and friends

These are presumed not to give rise to legal relations, and persons seeking to enforce such agreements have the burden of proving that there

is evidence to rebut this presumption. In *Balfour* v. *Balfour* [1919] 2 KB 571 a husband and wife on leave from Ceylon agreed that the husband would pay the wife £30 a month maintenance while she stayed on in England. The court found there was no intention to create legal relations (although Duke LJ seems to base his decision on the wife's lack of consideration). In *Merritt* v. *Merritt* [1970] 2 All ER 760 the fact that an agreement between husband and wife concerning property and maintenance was concluded when they were already separated and was in writing was evidence of legal intention.

Other cases relate to agreements to share winnings from bingo, or agreements to divide prize money: *Simpkins* v. *Pays* [1955] 1 WLR 975, where the court found there was an intention; agreements in respect of lifts to work by a workmate: *Coward* v. *Motor Insurers' Bureau* [1963] 1 QB 259 and *Albert* v. *Motor Insurers' Bureau* [1972] AC 301; and an agreement by a mother to support her daughter during her legal studies: *Jones* v. *Padavatton* [1969] 2 All ER 616, where the court found no intention proved.

Commercial agreements

Here a contract is presumed, and the burden of proving that it is *not* is on the person claiming that there is no contract. Commercial contracts may contain a clause to the effect that the agreement is 'binding in honour only' – called an 'Honourable Pledge Clause'. In respect of football pools, the coupon specifically states that no legal relationship should arise from the transaction, thus ruling out legal actions for money allegedly won: *Jones* v. *Vernon's Pools Ltd* (1938) 2 All ER 626; and *Appleson* v. *Littlewood Ltd* [1939] 1 All ER 454. In *Rose and Frank and Co*. v. *Crompton (JR) & Brothers Ltd* [1925] AC 445 the appellants contracted by tender agreement to buy carbon paper from the respondent manufacturers. The contract stated: 'This arrangement is not entered into … as a formal or legal agreement, and shall not be subject to legal jurisdiction in the Law Courts.' The court held that the appellants could not sue to enforce the agreement, but that orders given and accepted up under it as separate contracts of sale could be enforced by legal action.

The presumption is not easily rebutted: thus the words *ex gratia* with regard to a promise of redundancy payments for an airline pilot were not sufficient to displace the presumption: *Edwards* v. *Skyways Ltd* [1964] 1 WLR 349.

3.8 Collateral Contract/Lock-out Agreements

In *Walford* v. *Miles* [1992] 1 All ER 453 the plaintiffs were negotiating the purchase of the defendant's business. Negotiations reached a point where the plaintiffs agreed to obtain a 'comfort letter' from the bank and not to withdraw from the negotiations. The defendants counterpromised to break off negotiations with a third party, but ultimately sold the business to them. The House of Lords held that an arrangement where the defendant agreed

not to consider further offers was capable of being a binding 'lock-out' agreement. The decision was followed in *Pitt* v. *PHH Asset Management Ltd* [1993] 4 All ER 961. The plaintiff offered £185 000 for a property, which was accepted subject to contract by the defendant. The defendant then received an offer of £195 000 from Miss B and withdrew his acceptance. The plaintiff then offered £200 000, which was again accepted until Miss B offered £210 000, which was accepted. Following threats by the plaintiff to withdraw and to inform Miss B (who would then have been able to lower her offer), the plaintiff and the defendant agreed orally that the defendant would stay with the plaintiff's offer of £200 000. This was confirmed by a letter including the following statement: 'The Vendor will not consider any further offers for the property on the basis that I will exchange contracts within a period of two weeks of the receipt of that contract.' The defendant replied that, if the two-week deadline was not met, they would be free to consider other offers. The defendants later sold the property to Miss B for £210 000 in breach of this agreement, and the plaintiff sued for damages. The Court of Appeal found that the consideration for the defendant's promise was the plaintiff's undertaking to exchange in two weeks of the receipt of a draft contract. This will prevent 'gazumping' where there is a clearly stated period within which the purchaser will exchange contracts. The agreement was also outside the requirements of s.2 of the Law of Property (Miscellaneous Provisions) Act 1989, which requires contracts 'for the sale of an interest in land' to be in writing (see below).

3.9 Vitiating Elements

Even if the essentials of a contract are present, the agreement may not be valid if one or more vitiating elements are present, rendering it void, voidable or unenforceable. The vitiating elements are: (i) absence of true agreement owing to mistake, misrepresentation, duress or undue influence; (ii) the contract may be illegal or impossible; (iii) the contract may be in the incorrect form; (iv) the agreement may be insufficiently clear; and (v) the parties may lack capacity to contract because they are minors, corporations, enemy aliens, mentally unsound or drunk. A void contract is one under which no rights arise: it is void *ab initio* (from the beginning). A voidable contract is initially valid but the injured party has the option of remaining bound by the contract or avoiding – or rescinding – it. An unenforceable contract is one which, although valid, cannot be enforced by action in the courts, usually because it lacks some element of form (see below).

3.10 Operative Mistake at Common Law

A contract is void at common law where the offer and acceptance is affected by mistake, the defence is limited to the defined categories of

operative mistakes of fact: (i) non *est factum*; (ii) unilateral mistake; and (iii) bilateral mistake.

Non est factum (Not my deed)

This relates to written contracts where the party signed the contract believing it to be a completely different document and is restricted by the leading case of *Saunders* v. *Anglian Building Society* [1971] AC 1004 to situations where: (i) the document signed was fundamentally different from the contract intended; and (ii) the party signing had not been negligent. The doctrine applies subject to the same constraints where a person signs a blank document of legal significance leaving it to be completed by somebody else: *UDT Ltd* v. *Western* [1976] QB 513.

In *Lloyds Bank* v. *Waterhouse* [1991] Fam Law 23 an illiterate person escaped liability where he had signed a guarantee without reading it or telling the bank that he could not read. He had relied on the bank's representations as to its nature and was also able to succeed in fraudulent misrepresentation (see 3.12 below).

Unilateral mistake

Here one party is mistaken as to the knowledge – real or constructive – of the other party. There are two aspects: mistake as to identity, or mistake as to terms.

Mistake as to identity

If a party to a contract has obtained the agreement by pretending to be somebody else, the consequences depend on whether it was (i) a face-to-face contract; or (ii) one negotiated at a distance, for example by post.

Face-to-face contracts In *Lewis* v. *Averay* [1972] QB 198, a rogue pretended he was Richard Greene (at the time a well-known film star) and persuaded the plaintiff to let him take away a car which he purchased with a cheque. The cheque bounced and the plaintiff sought to recover the car from the defendant, who had purchased the car from the rogue in good faith before the cheque had bounced. The court, following *Phillips* v. *Brooks* [1919] 2 KB 243 and distinguishing *Ingram* v. *Little* [1961] 1 QB 31, refused to recognise the original contract as being void for mistake and recognised the title of the defendant to the vehicle. In this situation the injured party could rescind the contract on the ground of fraudulent misrepresentation. The advantage is that an innocent third party purchasing the goods from the person obtaining them by fraud obtains a good title to them as long as they were acquired in good faith before the contract was avoided (see Chapter 13).

Contracts at a distance In this case the contract will be void for mistake where the plaintiff shows that the other party's identity was vital and that s/he thought s/he was dealing with a different and real person. In *Cundy* v.

Lindsay (1878) 3 App Cas 459, the plaintiff recovered goods from the defendant which he had purchased from a person supplied by the plaintiff believing him to be well-known, reputable trader. It cannot be used for contracts where one person uses a fictitious alias: *King's Norton Metal Co. Ltd* v. *Edridge, Merrett & Co. Ltd* (1897) 14 TLR 98.

In *Citibank NA* v. *Brown Shipley & Co. Ltd and Midland Bank* v. *Brown Shipley & Co. Ltd* [1991] 2 All ER 690, a bank issued a bankers' draft to another bank in a complicated transaction where the bank had mistakenly dealt with a fraudster instead of the company with which they thought they were dealing. The mistaken identity did not affect the formation of the contract between the two banks. While the fraudster had no title because of the mistaken identity, the court held that he was a mere conduit.

Mistake as to terms

If the two elements of unilateral mistake exist, the contract will be void. In *Webster* v. *Cecil* (1861) 30 Beav 62, the defendant had already rejected an offer for his property of £2000. He then sent a letter to the plaintiff offering to sell it to him for £1250. This was clearly a mistake for £2250, as the plaintiff was aware of it when he accepted. The court held that it was void for mistake. However in *Higgins (W) Ltd* v. N*orthampton Corporation* [1927] 1 CH 128, the court refused to treat as void a contract where the plaintiff had made an error of calculation in submitting a tender for a building contract, since the defendants had no knowledge of this error.

Bilateral mistake

There are two separate categories of bilateral mistake: bilateral mutual mistake, and bilateral common mistake.

Bilateral mutual mistake

Here both parties are mistaken about the subject matter of the contract, as where in a contract of sale of goods one party believes s/he is buying one car and the seller believes s/he is selling another. It is sometimes called non-identical bilateral mistake, and in clear cases the contract is void. In *Raffles* v. *Wichelhaus* (1864) 2 H & C 906 the contract was to purchase goods 'ex "Peerless" Bombay', when two ships of same name were leaving at different times and there was confusion between the parties as to the exact ship. In *Scriven Bros & Co.* v. *Hindley & Co.* [1913] 3 KB 564 the parties' confusion concerned whether the subject matter of the contract was tow or hemp.

In borderline cases the contract will be enforced if it is possible to establish the nature of the agreement objectively. In *Tamplin* v. *James* (1880) 15 ChD 215 the plaintiffs auctioned a public house together with some land and the lot was detailed in plans on view. The defendant purchased the property, mistakenly believing that the lot included a garden at the rear of the inn and refused to complete, claiming the contract was void for mutual mistake, but the court held that, since there was no excuse for

his mistake, the plaintiffs were entitled to specific performance. In *Wood* v. *Scarth* (1855) 2 K & J 33, and (1858) 1 F & F 293 the defendant thought he was leasing premises with payment of a premium, while the plaintiff had been led to believe by the mistake of the defendant's agent that no premium was payable. The defendant refused to complete and the plaintiff was awarded damages (his earlier action for specific performance failed).

Bilateral common mistake

Here both parties share the same mistaken belief, as where the seller and buyer of a ring contract in the mistaken belief that it is solid gold. This is sometimes called identical bilateral mistake and the common law protection is limited to: (i) mistakes as to the existence of the subject matter of the contract – *res extincta* (non-existant thing); and (ii) cases where a party contracts for something that is already his/her – *res sua* (his/her thing). Contracts to acquire something which has ceased to exist before the contract was concluded are void under s.6 Sale of Goods Act 1979. If the goods cease to exist after the contract has been concluded then the contract will be valid.

Where the mistake relates only to the quality of the subject matter, however fundamental, the contract is not void. Thus where parties contracted for a painting which both parties believed to be by Constable, the contract was not void for mistake: *Leaf* v. *International Galleries Ltd* [1950] 2 KB 86. Where parties contracted for a property in the shared belief that there was no preservation order, the contract was valid: *Amalgamated Investment & Property Co. Ltd* v. *John Walker & Sons Ltd* [1976] 3 All ER 509. The leading decision is *Bell* v. *Lever Bros* [1932] AC 161, where the court enforced an agreement whereby the defendants paid compensation to terminate the plaintiff's contract of service. Both parties thought the contract was valid but later discovered that it could have been terminated without compensation. However, in a case where a set of napkins was auctioned as 'with the crest of Charles I and the authentic property of that monarch' the court said the contract was void because the mistake destroyed the object's status as a relic, *Nicholson and Venn* v. *Smith-Marriott* (1947) 177 LTD 189.

3.11 Operative Mistake in Equity

A judge may sidestep the rigidity of common law by exercising his/her equitable discretion, for example by treating a contract valid at common law as voidable. In *Grist* v. *Bailey* [1967] Ch 532, the defendant agreed to sell his house to the plaintiff for a low price, as both mistakenly believed that the property was occupied by a tenant who could not be removed. The defendant refused to complete when he discovered the truth. The court rejected the plaintiff's claim for specific performance but treated the contract as voidable on condition that the defendant should give first

refusal of the house to the plaintiff at the true market value. Equity also allows the rectification of a contract that would be void at common law and then the specific enforcement of the rectified contract. Rectification is available where the written contract does not substantially represent the common intention of the parties, which continued unchanged till the contract was drawn up: *Joscelyne* v. *Nissen* [1970] 2 QB 86. Rectification is possible in respect of unilateral mistake. In *A. Roberts & Co. Ltd* v. *Leicestershire County Council* [1961] Ch 555, the plaintiffs tendered for work to be completed within seventy-eight weeks but the contract as drawn up by the defendants specified thirty months. This alteration benefited the defendants. The plaintiffs signed and the discrepancy was not drawn to their attention. Rectification of the contract was ordered.

3.12 Misrepresentation

A representation is a statement of fact made by one party in the course of negotiations, inducing the other party to enter into a contract. If the other party is induced into the contract by the statement, and the representation is false, the injured party can seek rescission of the contract and/or damages depending upon whether the misrepresentation was fraudulent, negligent or innocent.

It must be a statement of fact

The term 'statement' is not to be taken literally: a gesture, a nod or a wink can constitute statements of fact. In *Horsfall* v. *Thomas* (1862) 1 H & C 90 the plaintiff delivered a defective gun and had concealed the defect. The court held that this would have constituted misrepresentation had the defendant examined the gun before accepting it. Misrepresentation cannot arise from (i) statements of law; (ii) statements of intention; (iii) statement of opinion; and (iv) mere eulogistic commendations or sales puffs.

Statements of law

In *Solle* v. *Butcher* [1950], the statement that a flat was outside the rent restriction legislation was regarded as a statement of fact (coupled with a proposition of law). In *Andre et Cie. S.A.* v. *Ets. Michel Blanc et fils* [1979] 2 Lloyds Rep 427, the court held that a misrepresentation as to foreign law was a misrepresentation of fact.

Statements of intention

These may be statements of fact if it can be shown that the intention never existed in the mind of the representor. In *Edgington* v. *Fitzmaurice* (1885) 29 Ch D 459 the plaintiff claimed the right to rescind an agreement to subscribe for debentures issued by a company where he had been influenced by the prospectus offering the securities by the statement that

the directors intended to use the money raised to expand the business. He was entitled to rescind, since this had never been their intention.

Statements of opinion

These may be statements of fact if the speaker did not hold such an opinion, or that a reasonable person could not honestly have held it on the basis of the information available. Thus an agent's statement that a property was leased to a person 'who is in our opinion a most desirable tenant' was a misrepresentation, since there was no evidence to justify it: *Smith* v. *Land and House Property Corp* (1884) 28 ChD 7. However, in *Bisset* v. *Wilkinson* [1927] AC 177, the plaintiff's statement during negotiations for the sale of land that it would support 2000 sheep was merely a statement of opinion and the contract could not be rescinded.

A 'mere eulogistic commendation' is not a representation of fact

These are statements made in the course of a sale regarded as being of no legal significance. This will not be the case if there are statements of fact. The Estate Agents Act 1979 has restricted the frequency of use of such statements in estate agents' property details.

Silence is not generally a misrepresentation

There is no general duty on the seller of goods to point out their defects. The rule is *caveat emptor* – 'Let the buyer beware'. There is a duty of disclosure and silence or incomplete disclosure will be actionable where: (i) silence distorts a positive representation; (ii) the contract requires utmost good faith (*uberrima fides*); and (iii) the parties are in a fiduciary relationship.

Where silence distorts a positive representation

Statements of fact made prior to the contract must be full and frank and the omission of a material detail is a misrepresentation. In *Curtis* v. *Chemical Cleaning & Dyeing Co*. [1951] 1 KB 805 the client was informed that a form to be signed when leaving clothes for drycleaning only excluded liability for damage to beads and sequins, whereas it was much broader. The exclusion clause could not be relied on because its scope had been misrepresented. A statement made must be corrected on discovering that it is not true or no longer true. In *With* v. *O'Flanagan* [1936] Ch 575 the failure to correct a statement of earnings of business to a prospective purchaser entitled the purchaser to rescind the contract.

Where the contract requires utmost good faith (uberrima fideis)

These are contracts where one party has a duty of full and frank disclosure of all material facts relating to the contract, as where a person completes a proposal form for life assurance.

Where there is a fiduciary relationship between the parties

Certain relationships impose a duty of full and frank disclosure between the parties in all their dealings. Examples include agents–principals; director–company; partners; and solicitor–client. An executive owes a fiduciary duty to his employer. In *Sybron Corp* v. *Rochem Ltd* [1983] 2 All ER 707, failure by an executive to disclose breaches of contracts of employment by his subordinates (which would have revealed his own breach), constituted misrepresentation enabling the employer to recover redundancy payments from the executive (see Chapter 12).

The party must be induced to enter the contract

The misrepresentation is legally harmless if the plaintiff (i) did not know of its existence; (ii) did not allow it to affect his/her judgment; or (iii) was aware of the untruth of the misrepresentation. But a contract may be rescinded even if the misrepresentation was not the only thing inducing the party to enter it. In *Edgington* v. *Fitzmaurice* (1885) 29 ChD 459, the plaintiff was able to rescind even though partly induced through his own mistaken belief that the debenture was secured.

Unaware of misrepresentation

A plaintiff must always be prepared to prove that an alleged misrepresentation influenced his/her decision. In *Re Northumberland & Durham District Banking Co., ex parte Bigge* (1858) 28 LJ Ch 50, a shareholder failed in an action for rescission of a contract to take shares because he was unable to prove that he had read the false reports. In *Horsfall* v. *Thomas* (1862), the buyer of a gun failed since he had not examined the gun for defects hidden by the manufacturer. Lord Denning MR has stated that once a person has made a representation/promise, the burden of proof is on him/her to prove that the other party was not influenced by the representation/promise: *Brikom Investments Ltd* v. *Carr* [1979] QB 467.

Misrepresentation did not affect judgment

In *Smith* v. *Chadwick* (1884) 9 App Cas 187, the plaintiff failed in respect of a false statement in the prospectus for shares that a certain MP was to be a director when he admitted that he had no idea who the MP was. And in *Attwood* v. *Small* (1838) 6 Cl & Fin 232, an action to rescind the contract for the sale of a mine failed since the purchasers had relied on the reports of their own agents.

Aware that misrepresentation was untrue

There is no remedy where there is clear proof that the plaintiff had actual and complete knowledge of the true facts. But a party can still succeed when s/he relies on a misrepresentation even though given access to material that would have proved it false. In *Redgrave* v. *Hurd* (1881) 20 ChD 1,

the plaintiff was able to rescind because of a misrepresentation as to the earnings of a solicitor's practice, even when supplied with a set of accounts that revealed the untruth.

Types of misrepresentation and remedies

Since the Misrepresentation Act 1967, misrepresentations can be (i) fraudulent; (ii) innocent but negligent; or (iii) wholly innocent. The distinction determines the remedies of the injured party.

Fraudulent misrepresentation

This is defined in *Derry* v. *Peek* (1889) 14 App Cas 337 as a false statement 'made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false'. The burden of proof is on the plaintiff to prove fraud. The remedies are (i) rescission of the contract by the injured party and (ii) damages for the tort of deceit.

Negligent misrepresentation

The Misrepresentation Act, s.2(1) provides: 'Where a person has entered into a contract after a misrepresentation has been made to him by another person … and as a result … he has suffered loss, then, if the person making the representation would be liable in damages … had the misrepresentation been made fraudulently, that person shall be so liable … unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true.' There is a presumption that all misrepresentations are made negligently, and the person making it must prove that s/he was not negligent. The remedies are (i) rescission of the contract by the misled party; and (ii) damages under MA 1967 s.2(1).

In *Royscott Trust* v. *Rogerson* [1991] 3 WLR 57 the Court of Appeal decided that the measure of damages recoverable under s.2(1) MA 1967 was tortious rather than contractual, and that a person can recover all losses occurring as a natural consequence of the misrepresentation, including unforeseeable losses, subject to the normal rules on remoteness (see Chapter 5). This removes the advantage of suing for fraudulent misrepresentation, except for the privity of contract restriction, which prevents an action against an agent for the contracting party in respect of the agent's misrepresentations.

Wholly innocent misrepresentation

The burden of proof is on the person making the misrepresentation to establish that s/he had reasonable grounds for making the statement. The remedy is rescission. However, the court may award damages in lieu of rescission under MA 1967 s.2(2) 'if of the opinion that it would be equitable to do so'.

Misrepresentation and exclusion clauses

A term in a contract which excludes or restricts (a) the liability of a party for misrepresentation; or (b) any remedy of a party for misrepresentation, is null and void unless it complies with the requirements of reasonableness under the Unfair Contract Terms Act 1977, Misrepresentation Act 1967 s.3, as substituted by the Unfair Contract Terms Act 1977. This does not affect the principal's right to limit the otherwise ostensible authority of his/her agent. In *Overbrooke Estates Ltd* v. *Glencombe Properties Ltd* [1974] 1 WLR 1335, the plaintiffs instructed auctioneers to sell a property and the catalogue contained a condition limiting the auctioneers' authority to make representations relating to the property. In response to an inquiry, the auctioneers gave information to the defendants about the property, which they bought. The information was inaccurate and they refused to proceed with the purchase. The court held that the plaintiff's claim for specific performance should succeed, since the condition limited the ostensible authority of the auctioneers and their representations were not binding on the plaintiffs.

3.13 Duress, Undue Influence and Unconscionable Bargains

Where contracts result from improper pressure it is possible to claim that there was no real consent. Duress is the common law defence, and rather rigid and precise. Undue influence is the equitable equivalent and enables the court, at its discretion, to set aside contracts in circumstances which fall outside the scope of the common law. A related equitable remedy relates to unconscionable bargains. Contracts affected by either duress or undue influence are voidable.

Duress

Duress is any illegitimate threat which constitutes 'a coercion of the will, which vitiates consent': *Pao On* v. *Lau Yiu Long* [1980] AC 614. Economic duress was recognised in *Universe Tankships Inc of Monrovia* v. *International Transport Workers Federation* [1983] 1 AC 366, where a shipowner was forced into agreeing to a wage agreement when his ship was occupied by the crew, with potentially devastating economic results. Lord Scarman defined duress as having two elements: (i) pressure amounting to compulsion of the will of the victim; and (ii) the illegitimacy of the pressure exerted. In this case the pressure was illegitimate because it was deemed to be secondary picketing. A similar case arose in D*imskal Shipping Co. SA* v. *International Transport Workers Federation (The Evia Luck)* [1992] 2 AC 152 where the ship was boarded by agents of the ITF, who informed the master and the owners that the ship would be blacked and loading would not be continued until the company entered into

certain agreements with the ITF. The company signed the agreements under pressure and then sought a declaration that the agreements were void. The House of Lords held that the fact that the ITF's conduct was legal in Sweden was irrelevant, since English law was the proper law of the contract and that the agreements could be avoided. In *CTN Cash and Carry Ltd* v. *Gallaher Ltd* [1994] 4 All ER 714 the defendants supplied the plaintiff company with cigarettes and arranged credit facilities which they had absolute discretion to withdraw. They delivered a consignment to the wrong warehouse and, before they could transfer it to the proper place, it was stolen. The plaintiffs finally paid for the consignment when the defendant threatened to withdraw credit facilities. The plaintiffs sought to recover the payment, alleging economic duress. The Court of Appeal, dismissing the plaintiffs' appeal, held that, although a threat to perform a lawful act coupled with a demand for payment might amount to economic duress, it would be difficult to maintain such a claim in respect of arms'-length commercial dealings where the party making the threat bona fide believed that its demand was valid. Any extension of 'lawful act duress' would introduce an undesirable element of uncertainty in the commercial bargaining process. Where the innocent party affirms the contract s/he loses his/her right to rescind the contract: *North Ocean Shipping Co.* v. *Hyundai Construction Co.* [1978] 3 All ER 1170.

Undue influence

The plaintiff must show that s/he was subjected to influences that excluded free consent. Thus contracts are voidable if created under threat to prosecute the contracting party, or spouse or close relative: *Kaufman* v. *Gerson* [1904] 1 KB 591, *Williams* v. *Bayley* (1866) LR 1 HL 200. Contracts can be set aside even without proof of undue influence where the parties' relationship is such that one is in a dominant position over the other. In this case there is a presumption of undue influence unless the dominant party can prove that the other party was independently and competently advised before entering the contract. Relationships include: (i) parent and child – *Lancashire Loans Ltd* v. *Black* [1934] 1 KB 380; (ii) solicitor and client – *Wright* v. *Carter* [1903] 1 Ch 27; and (iii) religious leader and disciple – *Allcard* v. *Skinner* (1887) 36 ChD 145. Others include doctor and patient, trustee and beneficiary, and any relationship of trust and confidence.

This developed from *Allcard* v. *Skinner* (1887) 36 ChD 145, where the plaintiff made a generous gift of property to a religious order of which she was a member, on the sole advice of the mother superior (the rules of the Order prevented her from obtaining outside advice without the consent of the mother superior). In spite of finding that no personal pressure had been exerted on the plaintiff and no unfair advantage taken of her position, and that the sole explanation of the gift made to the Order was her own voluntary submission to the vow of poverty, the court held that the gifts were made under a pressure that she could not resist.

Lord Denning's decision in *Lloyds Bank Ltd* v. *Bundy* [1975] QB 326 that a presumption of undue influence arose whenever there was an unequal bargaining position between the parties was rejected by the House of Lords in *National Westminster Bank plc* v. *Morgan* [1985] 1 All ER 821. Morgan was a businessman in financial difficulties; in a scheme to refinance his mortgage on the jointly-owned family home, he persuaded the bank manager to call at the home to assure his wife (erroneously) that the mortgage did not include his business liabilities. Without independent legal advice, the wife executed the mortgage. The Morgans fell into arrears and the bank obtained a possession order. The husband died with no business debts owing, so that the wife did not in fact suffer from the bank manager's misleading advice. Lord Scarman stated that *Allcard* v. *Skinner* only related to gifts, and that for transactions the presumption of undue influence would only arise where the transaction is disadvantageous to the party seeking to set it aside. Here he found the transaction provided 'reasonably equal benefits for both parties'. Lord Scarman found the decision in *Lloyds Bank* v. *Bundy* (1975) justifiable in view of the special relationship between the parties, but did not find such a relationship in this case. For further discussion on undue influence and mortgages see 'Mortgages and Reality of Consent' in Chapter 10.2, Section 10.2.

Unconscionable bargains

A transaction can also be set aside where one of the parties is in need of special protection through poverty or ignorance, or where unfair advantage is taken of him/her. Thus, where a poor man sold his right to a share in an estate for £200 when it was worth £1700, the contract was set aside: *Evans* v. *Llewellin* (1787)1 Cox Eq Cas 333. In *Watkin* v. *Watson-Smith*, *The Times*, 3 July 1986, the defendant, a frail old man of 80, obtained relief after having agreed to sell his bungalow for £2950 when the price should obviously have been £29 500.

3.14 Public Policy and Illegality

Contracts may be void or void and illegal if their terms, purpose or performance are contrary to public policy at common law or under statute. This section concentrates on the common law. Contracts may be (i) illegal (and void) because they involve a degree of moral wrong; or (ii) void because their enforcement would be socially or economically harmful.

Illegal contracts

A contract is illegal at common law if the terms of the contract or the intentions of either party involve the commission of one of the following.

Contracts for the commission of a criminal offence or civil wrong

In *Dann* v. *Curzon* (1911) the plaintiffs agreed to cause a disturbance to promote a play. Contracts to commit a civil wrong include (i) agreements to procure a breach of contract; (ii) agreements between principal debtor and creditor prejudicial to the surety (arising out of a guarantee); and (iii) contracts where an agent takes a bribe.

Immoral contracts

Traditionally the only immoral contracts that are void on the grounds of public policy relate to sexual immorality and immoral publications. This is, however, an area of the law that has changed a lot recently. Whereas in *Benyon* v. *Nettleford* (1850) 3 Mac & G 94, an agreement by a man that a woman should become his mistress was illegal, it is now common for agreements to be made between unmarried persons concerning their rights in relation to shared property. Prostitutes would be unable to enforce contracts for payment, and contracts which are knowingly made to enable the prostitute to solicit for customers have been held to be void. In *Pearce* v. *Brooks* (1866) 1 Exch 213, the plaintiffs could not enforce a contract for the hire of a carriage to the defendant knowing that she was going to use it for the purpose of soliciting. As regards immoral publications, traditionally no enforceable contract can arise out of blasphemous, seditious or indecent publications. However, in *Armhouse Lee Ltd* v. *Chappell* (1996) *The Times*, 7 August the court of appeal allowed the plaintiffs to sue the defendants for the cost of advertisements in a magazine for a telephone sex line and sex dating. The Court of Appeal stated that 'it was undesirable … for individual judges exercising a civil jurisdiction to impose their own moral attitudes'. This suggests that sexually immoral contracts are enforceable unless the immorality amounts to a criminal offence.

Contracts with enemy aliens or nationals living in enemy territory
(see 3.16 on page 90).

Contracts illegal by the law of a friendly foreign country

A partnership agreement to import spirits into the USA contrary to prohibition laws was void: *Foster* v. *Driscoll* [1929] 1 KB 470, as was an agreement contrary to Indian laws against trading with South Africa: *Regazzioni* v. *K. C. Sethia (1944) Ltd* [1958] AC 301.

Contracts prejudicial to the administration of justice

A contract to stifle the prosecution of a person for an act of a public nature is illegal and in *John* v. *Mendoza* [1939] 1 KB 141, a contract tending to defeat bankruptcy laws was illegal. In addition, a person encouraging another to bring a civil action committed the tort of maintenance, and if s/he agreed to take a share in the proceeds of the action s/he

committed the further offence of *champerty*. Both are no longer torts or crimes but the contracts are unenforceable.

Contracts tending to corruption in public life

This includes contracts for the sale of public offices and contracts to procure titles. In *Parkinson* v. *College of Ambulance Ltd and Harrison* [1925] 2 KB 1, Harrison promised the plaintiff to make donations to the College of Ambulance, pretending that the College could use influence to obtain a knighthood for him. On receiving no knighthood the plaintiff unsuccessfully sued to recover his donation.

Contracts to defraud the revenue, both national and local

Napier v. *National Business Agency* [1951] 2 All ER 264; *Alexander* v. *Rayso*n [1936] 1 KB 169.

Effect of the illegality This will depend upon whether: (i) the contract is illegal as formed; or (ii) tainted by the moral intention of one or both of the parties to it. Where the illegality appears on the face of the contract, it will be entirely void, neither party obtains rights under it, and neither party can recover money or property transferred under the contract, subject to three exceptions. First, where the transferor can establish a right or title without relying on the illegal contract.

In *Bowmakers Ltd* v. *Barnet Instruments Ltd* [1945] KB 65 the appellants had acquired tools from the respondent under a hire-purchase contract and had then stolen the tools before they had completed payments, which constituted the tort of conversion. Their defence to an action for damages was based on the fact that the contract under which the respondents had acquired the tools was illegal, and therefore they could not succeed. The court held that they could, since their right of action was wholly independent of the illegal sale.

In *Tinsley* v. *Milligan* [1993] 3 All ER 65, T and M had both contributed towards the purchase of a house which was put into T's name to enable M to make false claims against the DHSS. The parties fell out and M claimed a share of the property. The House of Lords held that M should succeed. Her right to recovery arose from her contribution to the purchase price and did not depend upon reliance on the illegal contract. The court held that it was T who had to raise the issue of the illegal agreement to rebut M's claim.

And in *Skilton* v. *Sullivan* (1994) *The Times*, 25 March the plaintiff contracted to sell carp to the defendant, who paid a deposit. The plaintiff's invoice described the fish as trout, which were zero-rated for VAT. The plaintiff was entitled to sue for the balance: he had committed an illegal act in carrying out the contract, but the contract itself was not illegal and he was not relying on his unlawful act.

Second, where the parties are not equally guilty, the less guilty may recover property or money. In *Hughes* v. *Liverpool Victoria Legal Friendly Society* [1916] 2 KB 482, an agent of the defendants persuaded the plain-

tiff that she was entitled to hold life assurance in respect of certain parties, which was not the case. The policies were therefore illegal and void. However she recovered the payments she had made because she was not in *pari delicto* (equally guilty) with the defendants.

Third, where the party voluntarily repents before performance has been completed. In *Bigos* v. *Boustead* [1951] 1 All ER 92 the plaintiff agreed to supply the defendant's wife and daughter with £150 in Italian currency in Italy, and that he would repay her in English money in England (thus illegally avoiding exchange control regulations). The defendant deposited a share certificate with the plaintiff as security. The plaintiff failed to perform the agreement and the defendant sought to recover his share certificate. The court refused because it felt that he had not truly repented his action.

Collateral contracts between the parties will also be void: *Fisher* v. *Bridges* [1854] 2 E & B 642, as will those with third parties: *Spector* v. *Ageda* [1971] 1 Ch 30. Thus a loan of money is illegal if the lender knows that it is to be used to perform an illegal contract, such as the payment of another illegal loan.

Where the illegality does not appear in the terms of the contract, the party with improper intentions or knowledge on making the contract acquires no rights under the contract and cannot recover property or money transferred in the absence of the first or third exception above. Thus, in *Cowan* v. *Milbourn* (1867) LR 2 Exch 230, the plaintiff hired a hall to deliver blasphemous lectures and was then refused possession of it. His action for possession failed because the purpose of the contract was illegal. In *Ashmore, Benson, Pease & Co. Ltd* v. *A. W. Dawson Ltd* [1973] 2 All ER 856 the defendant haulage company agreed to carry equipment for the plaintiff by road. The defendants overloaded their lorries, watched by the plaintiff's transport manager. One of the lorries overturned and the plaintiff's action for damages was refused on the grounds that it was a contract which was illegal as performed to the knowledge of the plaintiff's servants.

The innocent party can (i) sue for work done or goods supplied under the contract in quasi-contract (*quantum meruit/quantum valebant*); (ii) recover money or property because not in *pari delicto*; or (iii) sue for damages for breach of contract. Thus in *Clay* v. *Yates* (1856) 1 H & N 73 the plaintiff could recover for printing a book for the defendant. He had stopped work when he discovered that the book contained libellous statements. Collateral contracts will not necessarily be affected.

Contracts void for public policy

The most important examples of this type of contract are those to oust the jurisdiction of the court and contracts in restraint of trade.

Contracts to oust the jurisdiction of the courts

A contract taking away the right of action of one or both of the parties to a contract is illegal. This includes agreements between husband and wife

regarding division of matrimonial property prior to a divorce and not subject to the court's approval: *Sutton* v. *Sutton* [1984] 1 All ER 168. (The Law Society published a statement in favour of pre-marriage contracts in May 1991.) A contract may legally contain a clause referring a dispute between the parties to arbitration: *Scott* v. *Avery* (1856) 5 HLC 811 (see Chapter 2).

Contracts in restraint of trade

Contracts restricting a person's liberty to carry on his/her trade, business or profession are binding only where the restriction is reasonable. There are (i) restraints accepted by employees; (ii) restraints accepted by the vendor of a business; and (iii) restraints between manufacturers and traders and distributors (see Chapter 17).

Restraints accepted by employees Contracts of service may limit the freedom of the employee to engage in work or trade once s/he has left his/her employment. A restraint is never acceptable unless the employer has some proprietary interest, such as trade secrets or his business connection (goodwill) to protect. For trade secrets, the employer must prove the employee has acquired a substantial knowledge of some secret process or mode of manufacture. There is no right to protect a special method of organisation adopted by the business, or if only a part of a secret is known to the employee so that he cannot exploit it. The clause must only be wide enough to protect the employer. In *Commercial Plastics Ltd* v. *Vincent* [1965] 1 QB 623, the defendant was employed by the plaintiffs to co-ordinate research and development in connection with adhesive tape production. His contract of service provided that he would not 'seek employment with any of our competitors in the PVC calendering field, for at least one year after leaving our employ'. The restriction was void as it was wider than was reasonably necessary for the protection of the plaintiff's trade secrets, since it was potentially world-wide in its application and applied to the whole field of PVC calendering rather than the production of sheeting for adhesive tape.

An employer may protect himself against an ex-employee enticing away customers, but only against those 'who will acquire, not merely knowledge of customers, but in addition influence over them' (*Herbert Morris Ltd* v. *Saxelby* [1916] 1 AC 688). Restraints have been upheld against: a solicitor's clerk: *Fitch* v. *Dewes* [1921] 2 AC 158; a tailor's cutter–fitter, *Nicoll* v. *Beere* (1885); a milkman: *Home Counties Dairies Ltd* v. *Skilton* [1970] 1 All ER 1227; and an estate agent's clerk: *Scorer* v. *Seymour Jones* [1966] 1 WLR 1419. The clause is not valid if it extends beyond the valid protection of the employer's business connection: *Fitch* v. *Dewes* [1921] 2 AC 158, unless the court is prepared to sever the illegal part of the clause. In *Home Counties Dairies* v. *Skilton* [1970] the restraint clause prevented the defendant from selling milk and dairy produce. The court severed the reference to dairy produce which he had never sold, and enforced the rest of the clause. In *Atwood* v. *Lamont* [1920] 3 KB 571, however, the defendant had been employed by the plaintiff as cutter and head of the tailoring department of

his business in Kidderminster. His contract restrained him from trading within a radius of ten miles as a 'tailor, dressmaker, general draper, milliner, hatter, haberdasher, gentlemen's ladies' or children's outfitter'. The court refused to sever the illegal aspects and enforce the valid restraint, since the provisions formed a single covenant. In either case the clause will only be reasonable where the area and the duration of the restraint are reasonable. The protection extends to indirect restraints. In *Bull* v. *Pitney-Bowes Ltd* [1966] 3 All ER 384 a contributory pension scheme provision for loss of pension rights for employees engaged in any activity or occupation in competition with or detrimental to the interests of the employer was held void.

In *Rock Refrigeration Ltd* v *Jones* [1997] All ER 1, the defendant's restraint of trade clause was to take effect after the termination of the contract of employment 'howsoever arising' or 'howsoever occasioned'. He resigned and accepted work with a competitor of the plaintiff. The Court of Appeal upheld the plaintiff's appeal against the decision that the clause was unreasonable and void because it could apply even after repudiation of the contract by the employer, since, in that event, the employee was released from his obligation and the otherwise valid covenants could not be enforced.

Restraints accepted by vendors of a business If the vendor of a business has received payment in respect of the goodwill of the business it is only reasonable that s/he should accept some sort of a restraint on his/her future business activities. However (i) there must be a genuine sale of a business by the covenantor to the covenantee: *Vancouver Malt & Sake Brewing Co. Ltd* v. *Vancouver Breweries Ltd* [1934] AC 181; and (ii) protection is limited to the actual business sold by the covenantor: *British Concrete Co. Ltd* v. *Schelff* [1921] 2 Ch 563. The restraint must not be wider than necessary for the adequate protection of the proprietary interest acquired by the purchaser, and duration and area of operation are also relevant.

Restrictions may extend to the life of the covenantor: *Elves* v. *Crofts* (1850) and the area may range from the UK, *Leather Cloth Co.* v. *Lorsont* (1869), to the whole world, *Nordenfeldt* v. *Maxim Nordenfeldt Guns & Ammunition Co*. [1894] AC 535. The court is generally more willing to accept restraints between vendor and purchaser of a business since there is greater equality of bargaining power between them and the covenantor is thus able to realise the worth of his business connection. Restraints may be subject to EC competition law (see Chapter 17).

Wagering contracts

A wagering contract is between two parties who have no special interest in the outcome of a future or past event. If one party cannot win or cannot lose, it is not a wagering contract; a bet on the 'tote' is not a wagering contract. They are governed by s.18, Gaming Act 1845 which provides that 'All contracts whether by parol or in writing by way of gaming or wagering shall be null and void.' Neither party can sue on the contract, and money paid or property transferred cannot be recovered.

A new contract to pay money lost by a wager cannot be enforced, whether or not there is fresh consideration, if the intention of the parties in making the contract is to enable the money so lost to be recovered. In *Hill* v. *William Hill (Park Lane) Ltd* [1949] AC 530, the Committee of Tattersalls decided that the appellant should pay off his debts to the respondents by instalments. The court refused the respondent's claim to recover the debt under this agreement, since the payments were of a 'sum of money … alleged to have been won upon any wager' within s.18 of the Gaming Act 1845. An agreement by a father to pay off his son's debts to a bookmaker was also regarded as a device to contravene s.18 of the Gaming Act 1845: *Coral* v. *Kleyman* [1951] 1 All ER 518.

Wagering contracts must be distinguished from gaming contracts, which come within the Betting and Gaming Act 1960 and the Gaming Act 1968. Gaming in contravention of the Act is illegal.

Effect of a void contract

The contract is void only in so far as it conflicts with rules of public policy; money paid or property transferred is recoverable. Under the doctrine of severance the court may enforce the good part of the agreement. In *Goodinson* v. *Goodinson* [1954] 2 QB 118, where a husband and wife entered into an agreement whereby the husband would pay the wife a weekly allowance, one element of the consideration was that the wife would not 'commence or prosecute any matrimonial proceedings against the husband'. The court severed this part of the agreement and enforced the rest.

3.15 Absence of Formalities

Certain contracts must be in a specified form and where these formalities are not complied with the contracts are unenforceable.

Contracts which must be by deed

A lease for more than three years is required to be made by deed. Where a lease is made informally it may be recognised between the parties in equity and, since this equitable lease can be protected by registration, the practical effect of the absence of the deed is not serious for the lessee.

Contracts which must be in writing

The following contracts must be in writing: (i) cheques, bills of exchange and promissory notes; (ii) contracts of marine insurance; (iii) acknowledgements of statute-barred debts; (iv) consumer credit transactions covered by the Consumer Credit Act 1974; and (v) contracts for the sale of land: s.2 Law of Property (Miscellaneous Provisions) Act 1989. An

option to buy land is a sale of land for the purposes of the Law of Property (Miscellaneous Provisions) Act 1989: *Spiro* v. *Glencrown Properties Ltd* [1991] 2 WLR 931.

Contracts which must be evidenced by a memorandum in writing

In this case, writing is essential before the contract can be enforced: Statute of Frauds 1677. The memorandum can be in any form, including an exchange of letters between the parties, and need only exist before the action is brought. Subject to that: (i) the memorandum must contain the names or a sufficient description of the parties; (ii) the subject-matter of the contract must be described so that it can be identified and the material terms of the contract must be stated; (iii) there must be some consideration but the need to set it out was removed by s.3 of the Mercantile Law (Amendment) Act 1856; and (iv) it must contain the signature of the party to be charged, or his agent (this may be printed, typed, a stamp, initial or an identifying mark).

In *Elpis Maritime Co. Ltd* v. M*arti Chartering Co. Inc. (The Maria D)* [1991] 3 All ER 758, the House of Lords found that s.4 prescribed two separate ways in which a contract of guarantee could be made enforceable: (i) by a written agreement signed by the guarantor; or (ii) by a note or memorandum of the agreement, in which case the guarantee may be made verbally. The court held that Clause 24 of the main charterparty contract, which was signed by the defendant on the page containing the clause, was an 'adequate note or memorandum' for the purposes of s.4.

In *Re A Debtor* (No. 517 of 1991) (1991) *The Times*, 25 November, the court held that, notwithstanding s.4 of the Statute of Frauds 1677, an oral agreement varying the mode of performance of a guarantee could be relied on by way of defence, although the absence of a written memorandum would make it impossible to found a cause of action on it. The debtor had guaranteed performance of a monetary debt by an associated company, IHL, but alleged that he had made an oral agreement with a representative of the creditor company that monies advanced by him through another company to IHL should count in reducing or extinguishing his liability under the guarantee.

3.16 Capacity to Contract

There are special rules relating to corporations; minors; the mentally unsound and drunks; and enemy aliens.

Corporations

The contractual capacity of a corporation depends on the way it was incorporated. Chartered corporations are created by royal charter and there are no legal limits to their contractual capacity, although, if they act

beyond their powers given by the charter, they risk losing their charter. The powers of statutory corporations are restricted to those granted by the statute under which they are created, and contracts beyond their powers are *ultra vires* and void. (For registered corporations, see Chapter 8.)

Minors

Minors are persons under 18 years of age (Family Law Reform Act 1969, s.1). This area of the law has been reformed by the Minors' Contracts Act 1987. Minors' contracts are either valid, voidable or unenforceable against the minor.

Valid contracts

There are two categories of valid contract entered into by a minor: executed contracts for necessaries for himself and his family, and beneficial contracts of service.

Executed contracts for necessaries Necessaries are not simply necessities. They exclude goods or services that are pure luxuries, but possibly include luxurious items of utility suitable to the minor's status. Goods are only necessaries if they are suitable (i) to the condition in life of the minor; and (ii) to his/her actual requirements at the time of sale and delivery: Sale of Goods Act 1979, s.3. In *Nash* v. *Inman* [1908] 2 KB 1 the court found that fancy waistcoats could be necessaries but were not, since the minor was already adequately supplied.

Goods and service must be delivered or supplied before the obligation to pay arises and the minor can repudiate the contract before this. Liability under s.3 SOGA 1979 is only to pay a reasonable price for goods and is subject to the contract being fair. Thus a contract to hire a car which provided for liability for damage to the car irrespective of fault was unenforceable: *Fawcett* v. *Smethurst* (1914) 84 LJKB 473.

Beneficial contracts of service This relates to contracts of employment, apprenticeship and training and analogous contracts. The contract must be beneficial for the minor but if generally beneficial it will be enforced despite some non-beneficial clauses. In *Clements* v. *L. & N. W. Ry Co.* [1894] 2 QB 482 a service contract was enforced even though it obliged the minor to renounce statutory rights for compensation for industrial injury in favour of cover by the employer's less advantageous insurance scheme.

Contracts permitting the minor to earn money are equatable with contracts of service and the court has enforced a contract to enable a minor to box professionally, in *Doyle* v. *White City Stadium Ltd* [1935] 1 KB 110; a contract for writing a minor's memoirs, in *Chaplin* v. *Leslie Frewin (Publishers) Ltd* [1966] Ch 71; and a contract where a minor appointed a manager to look after his affairs, in *Denmark Productions Ltd* v. *Boscobel Productions Ltd* [1969] 1 QB 699. Liability arises even though the contract is executory, and a minor was liable for damages for breach of contract for

repudiation of an agreement to a world tour with a professional billiard player: *Roberts* v. *Gray* [1913] 1 KB 520.

Voidable contracts

Contracts to acquire an interest of a permanent nature, such as to buy shares, or to join a partnership or to take a lease are valid unless avoided by the minor during his minority or within a reasonable period after majority. If the contract is repudiated, the minor: (i) will not be liable for future obligations; but (ii) will not be able to recover money paid unless there is a total failure of consideration. In *Steinberg* v. *Scala (Leeds) Ltd* [1923] 2 Ch 452, the plaintiff purchased partly-paid shares in the defendant company and later repudiated the contract. Although not liable for future calls, she could not recover the money paid, since the allotment of the shares by the company constituted the consideration. A minor who paid money under a partnership agreement recovered it when the partnership did not come into existence: *Corpe* v. *Overton* (1833) 10 Bing 252. There are conflicting decisions on leases concerning a minor's liability for rent unpaid for the period before repudiation, but logically there should be no liability.

Unenforceable contracts

Under the Minors' Contracts Act 1987, contracts for loans, the supply of non-necessaries and accounts stated (such as IOUs) are enforceable by the minor but unenforceable against him. The minor, on attaining majority, can ratify a previously unenforceable agreement or make a fresh enforceable agreement on the same terms. The Act abolishes the previous rule under *Coutts & Co.* v. *Browne-Lecky* [1947] KB 104, whereby a guarantee by an adult of a loan to a minor was void: s.2. (see Chapter 10).

The other party can secure return of property acquired by the minor under the contract or 'any property representing it': s.3 MCA 1987. This extends to the recovery of goods or money in his/her possession where s/he has substituted or sold the original goods.

Contracts cannot be enforced indirectly through an action in tort. In *R. Leslie Ltd* v. *Sheill* [1914] 3 KB 607, a minor who had obtained credit by fraudulently representing that he was an adult could not be sued for damages for fraud. Similarly, a minor cannot be sued in tort for a wrong committed within the terms of the contract. In *Jennings* v. *Rundall* (1799) 8 TR 335, a contract to hire a horse specified that the horse should be ridden carefully. The minor was not liable in tort for injuries caused to the horse by riding it too fast. However, in *Burnard* v. *Haggis* (1863) 14 CBNS 45, the minor was liable for the death of the horse when he attempted to jump a fence, since the contract excluded jumping.

Contracts by the mentally unsound and drunks

The mentally unsound or drunks can avoid contracts if they can establish that they were mentally unsound or drunk when the contract was made

and the other party knew this. The issue is discussed in *Hart* v. *O'Connor* [1985] 2 All ER 880. Where necessaries are sold and delivered they must pay a reasonable price for them: s.3 SOGA 1979.

Contracts by enemy aliens

Enemy aliens cannot contract with a British subject during wartime and cannot enforce rights under existing contracts although they may defend the action if sued. British citizens may become enemy aliens by choosing to live in enemy territory. An English registered company may have the nationality of its controlling shareholders: *Daimler Co. Ltd* v. *Continental Tyre and Rubber Co. (Great Britain) Ltd* [1916] 2 AC 307 (see Chapter 6).

3.17 Terms of the Contract

The terms are the undertakings contained in the contract, although there can be a confusion between terms and representations. In *Oscar Chess Ltd* v. *Williams* [1957] 1 All ER 325 the defendant sold the plaintiffs a second-hand car, wrongly describing it as a 1948 model; this was held to be an innocent misrepresentation and not the breach of a condition under s.13 SOGA 1979, then SOGA 1983 (see Chapter 13).

Terms can be express or implied, and then be further subdivided into conditions and warranties. Express terms are specifically incorporated into the contract by the parties, whereas implied terms are incorporated by custom, the court or by statute. Conditions are fundamental terms, the breach of which entitles the injured party to repudiate the contract and sue for damages. A warranty is a term of lesser importance whose breach merely allows the injured party to sue for damages.

3.18 Terms Implied by the Court

Certain categories of contract always contain judicially implied terms, including contracts for renting properties and contracts of service (see Chapter 12). In addition, the court can imply terms into a contract to implement the presumed intention of the parties and to give 'business efficacy' to the contract. This was first seen in *The Moorcock* (1889) 14 PD 64, where there was a contract for mooring a ship alongside a jetty during unloading. Both parties were aware that at low tide the ship would rest on the river bed, but no term in the contract warranted the suitability of the river bed. The ship was damaged and the court found the wharf owners liable for breach of an implied term that the river bed was safe. In *McRae* v. *Commonwealth Disposals Commission* (1950) 84 CLR 377, the plaintiffs contracted for the salvage of a sunken ship but later discovered that there was no wreck at that point. They succeeded in an action for breach of an implied term in the contract that there was a wreck at the specific site.

The term must have been intended to be included by both parties, not just one. Thus in *K. C. Sethia (1944) Ltd* v. *Partabmull Rameshwar* [1950] 1 All ER 51, a contract for the supply of jute was delivered one-third under the contract amount because of a government-imposed export quota. In defence to an action for breach of contract the supplier argued that the words 'subject to quota' should be implied into the contract. The court refused, since the buyer was not to know that the supplier was subject to the quota restrictions. In *Ali* v *Christian Salvesen Food Services Ltd* [1997] 1 All ER 721, the Court of Appeal held that if any topic had been left uncovered by a carefully negotiated collective agreement, the natural inference was not that there had been an omission but that the topic had been omitted on purpose.

3.19 Terms Implied by Statute

Terms are frequently implied into contracts by legislation to ensure a minimum degree of protection for one of the contracting parties, including employees (see Chapter 12) and consumers (see Chapter 13).

3.20 Classification of Terms as Conditions and Warranties

The classification is the role of the court following two alternative approaches: (i) in accordance with the probable intention of the parties at the time of contracting; or (ii) in accordance with the seriousness or otherwise of the breach (an approach used for terms not suitable for strict classification).

In accordance with the probable intention of the parties at the time of contracting

This is the more generally used approach. The court construes the relevant term and defines it once and for all as a condition or warranty. The court is not bound by any definition applied to the term by the contract. In *L. Schuler A.G.* v. *Wickman Machine Tool Sales Ltd* [1974] AC 235, breach of a term in an agency agreement that the defendants would ensure that sales representatives would visit the six major motor manufacturers each week was treated by the court as breach of a warranty, although the term was described as a condition in the contract. In *Bettini* v. *Gye* (1876) 1 QBD 183, the plaintiff contracted to sing and agreed to be in London six days before the commencement of the engagement for rehearsals. Owing to illness he missed the first four days and the defendant repudiated the agreement. The court held that this was not breach of condition and therefore the defendant was liable for wrongful repudiation of

the contract. But in *Poussard* v. *Spiers & Pond* (1876) 1 QBD 410 the plaintiff, an opera singer, missed the final rehearsals and the first four nights of a three-month engagement. When she offered to turn up on the fifth night her services were refused. The court found she had broken a condition which justified repudiation by the defendants. Where several contracts are negotiated in a string, exactly the same meaning must be given to clauses in contracts throughout the chain: *Richco International Ltd* v. *Bunge and Co. Ltd* [1991] 2 Lloyd's Rep 93.

In accordance with the seriousness of the breach

The Court of Appeal in *Hong Kong Fir Shipping Co. Ltd* v. *Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26 stated that there were terms that were too complicated for the traditional approach to classification. The term in question concerned the obligation 'seaworthiness', which Upjohn LJ pointed out concerned a variety of undertakings, some serious and some trivial: 'If a nail is missing from one of the timbers of a wooden vessel, or if proper medical supplies or two anchors are not on board at the time of sailing, the owners are in breach of the seaworthiness stipulation. It is contrary to common sense to suppose that, in such circumstances, the parties contemplated that the charterer should at once be entitled to treat the contract as at an end for such trifling breaches.'

Such terms are called *innominate* or *intermediate terms* and will be classified according to the seriousness of the breach. In *Hong Kong Fir Shipping*, the court found that the charterers of a ship could not repudiate the contract for breach of condition where the ship was unseaworthy for twenty weeks out of a total charter period of two years. This approach has been criticised and the court has generally refused to extend the test to cover breaches of terms relating to the time when ships are to be ready to load, or the period of notice of loading required. Thus in *The Mihalis Angelos* [1971] 1 QB 164 a clause in a charterparty that a vessel was 'expected to be ready to load under this charter about 1 July 1965' was held to be a condition in the strict sense. And in *Bunge Corp., N. York* v. *Tradax Export S. A. Panama* [1981] 1 WLR 711, where the contract required 'at least 15 consecutive days notice of the probable readiness of the vessel', notice given on 17 June for sailing by the end of June as required by the contract was breach of a condition entitling the injured party to repudiate the contract.

Terms relating to time for performance or delivery are usually regarded as conditions, whereas those relating to time for payment are merely warranties. The case of *Union Eagle Ltd* v. *Golden Achievement Ltd* [1997] 2 All ER 215 concerned a contract for the sale of land which specified completion by a specific time, failing which the purchaser's deposit was forfeited as liquidated damages. The documents for the completion were delivered by messenger ten minutes after the five o'clock deadline. The JCPC held that the courts would not intervene to provide an equitable remedy for failure to comply with an essential condition as to time. That,

in this case, time for performance had passed, and performance by the purchaser was no longer possible.

Waiver of breach of condition

A breach of condition can always be treated as a breach of warranty, but waiving the breach on one occasion does not prevent the term from being subsequently and unilaterally reintroduced as a condition on giving reasonable notice. In *Charles Rickards Ltd* v. *Oppenheim* [1950] 1 KB 611, the defendant ordered a car to be built on a Rolls Royce chassis within the specified time. He waived a failure to deliver on a number of occasions but then served notice that, if it was not delivered within four weeks, he would refuse to accept delivery. The court supported his claim. For waiver in contracts for the sale of goods, see Chapter 13.

Conditions precedent and subsequent

A condition within a contract is different from a condition upon which the very existence of the contract depends. Thus a contract subject to a condition precedent will not come into effect until that condition is satisfied: *Aberfoyle Plantations Ltd* v. *Cheng* [1960] AC 115; and, where the contract contains a condition subsequent, it may terminate: *Head* v. *Tattersall* (1871) LR 7 Ex 4.

3.21 Exclusion or Exemption Clauses

Contract frequently contain terms excluding one party either wholly or partially from liability for breaches of contract or tort under the contract. These terms are regulated by common law and the Unfair Contract Terms Act 1977, which virtually outlaws their use against consumers in circumstances that are unfair.

Common law protection against exclusion clauses

The common law attacks exclusion clauses in three stage: (i) denying that it was incorporated into the contract; (ii) limiting its scope by interpretation; and (iii) restricting its scope through the doctrine of privity of contract.

The exclusion clause is not incorporated into the contract

The clause must be contained in a contractual document and not a mere receipt. In *Chapelton* v. *Barry UDC* [1940] 1 KB 532, an exclusion clause was not incorporated into a contract by a term on the reverse of a ticket issued on the hire of deck chairs. If it is in a contractual document, it is then important whether or not the contract was signed. If it is signed it

will generally be impossible for the party signing to deny that the clause is part of the contract in the absence of fraud or misrepresentation: *Curtis* v. *Chemical Cleaning & Dyeing Co.* [1951] 1 KB 805.

If contained in a contract which is unsigned or in the form of a notice, the clause will only be incorporated where the party had actual or constructive notice of the clause before or at the time the contract was made. Constructive notice arises where the party seeking protection displays prominent notices at the place where the contract is entered into. The courts are not very enthusiastic about constructive notice. In *McCutcheon* v. *David MacBrayne Ltd* [1964] 1 WLR 125 the defendants were not protected from liability for loss of a car owned by the plaintiff when the ferry carrying it sank, in spite of an exclusion clause being displayed in their office. Neither were they protected by a reference to the notice on a receipt given when the car was booked in, since this was issued after the contract was entered.

In *Olley* v. *Marlborough Court Ltd* [1949] 1 KB 532 the plaintiff booked into a hotel and property was later stolen from the room. The management claimed to be protected from liability by a notice displayed in the room. The court held that they were not protected, since the contract had been made before the plaintiff went to her room. Similarly, a notice excluding the owners of a car park from liability for injury to users was not part of the contract since it was only visible once drivers had entered into a contract by passing through the automatic barrier: *Thornton* v. *Shoe Lane Parking Ltd* [1971] WLR 585. In *Dillon* v. *Baltic Shipping Co. (The 'Mikhail Lermontov')* [1991] 2 Lloyd's Rep 155, the court held that the plaintiff was not bound by an exclusion clause contained in the tickets for a cruise which limited the liability of the shipping line for personal injury and death, since the issue of the tickets came after a firm contract was already in existence. In spite of defective notice in respect of a particular transaction, a clause can be incorporated through a sufficient course of dealings in the past where there has been consistent use of the exclusion clause. In *J. Spurling Ltd* v. *Bradshaw* [1956] 2 All ER 121, the plaintiff was able to rely on a clause to protect him in respect of loss of goods stored with him since, while the actual notice contained in an invoice was invalid because too late, there had been a long history of dealings between the two companies, always on the basis of an exclusion of liability. A party will not succeed where use of the exclusion clause has not been consistent. In *McCutcheon*, the defendants were unable to rely on past dealings since they had not regularly asked the plaintiff to sign a risk note excluding them from liability. The course of dealing must be more than three or four occasions during the previous five years, as in *Hollier* v. *Rambler Motors (AMC) Ltd* [1972] 2 QB 71.

Limiting scope through interpretation

In cases of ambiguity, the clause will be interpreted against the person seeking to rely on it (*contra proferentem*). This rule is limited to exclusion clauses, and not apply to the interpretation of any other type of term: *GA*

Estates v. *Caviapen Trustees Ltd* (1991) *The Times*, 22 October. In *Thornton* v. *Shoe Lane Parking Ltd* [1971] 2 QB 163, where the exclusion clause in respect of a garage stated 'Cars parked at owners' risk', which could conceivably protect the garage in respect of injury to car drivers as well as damage to cars, the court limited it to damage to vehicles. In *Hollier* v. *Rambler Motors (AMC) Ltd* [1972] 2 QB 71, where the plaintiff's car was damaged by a fire caused by the defendant's negligence, the court held that a clause stating that 'The company is not responsible for damage caused by fire to customers' cars on the premises' was ambiguous in that it did not clearly state that it extended to fires caused by the negligence of the defendant as well as accidental fires.

Restricting the scope of the protection

In *Adler* v. *Dickson* [1954] 3 All ER 396, a clause in a ticket between a passenger and a shipping line protected the company in an action for damages for personal injury but could not protect the employee of the shipping line whose negligent action caused the passenger's injury. In *Scruttons Ltd* v. *Midland Silicones Ltd* [1962] 1 All ER 1, the appellants, who were stevedores employed by a shipowner, sought to claim protection of an exclusion clause contained in the contract (the bill of lading) between the shipper and the respondents, the owners of the cargo, which limited the shipowner's liability to $500. They were not entitled to the protection of the clause since they were not parties to the contract.

Statutory protection: the Unfair Contract Terms Act 1977

The Act applies to different situations where exemption clauses attempt to modify future liability. It does not cover settlements and compromises on events that have already occurred: *Tudor Grange Holdings Ltd* v. *Citibank NA* [1991] 4 All ER 1. See also the discussion on the Unfair Terms in Consumer Contract Regulations 1994 (Chapter 16).

Avoidance of liability for negligence

As regards business liability, exclusion clauses cannot protect against negligence resulting in death or personal injury. For any other loss or damage, a clause is only valid where it 'satisfies the requirement of reasonableness' (see below): s.2(1). This does not prevent the making of an agreement between the owner and hirer of industrial plant for regulating their liability for negligence from use of the plant, thus excluding one from liability at the expense of the other: *Thompson* v. T. *Lohan (Plant Hire) Ltd and Another* [1987] 2 All ER 631, distinguishing *Phillips Products Ltd* v. *Hyland and Another* [1987] 1 WLR 659.

Liability in contract

In contracts where one party 'deals as a consumer', or where there is a standard form contract, exclusion clauses are subject to the 'requirement

of reasonableness': s.3. A person deals as a consumer if (i) s/he does not contract in the course of a business or hold him/herself out as doing so; (ii) the other party does contract in the course of a business; and (iii) (in contracts for goods) the goods are of a type ordinarily supplied for private use or consumption. A person does not deal as a consumer in sales by auction or competitive tender.

There is no protection for contracts between dealers (unless they contract on one party's standard form) and the clause will be binding on the parties subject to common law rules, since there is equality of bargaining position. In *Photo Production Ltd* v. *Securicor Transport Ltd* [1980] AC 827, the House of Lords restated the position it had laid down in the *Suisse Atlantique* case (*Suisse Atlantique Société d'Armement Maritime SA* v. *N.v. Rotterdamsche Kolen Central* [1967] 1 AC 361) where, depending upon their construction, clauses could exclude parties from even a fundamental breach of contract. In the *Photo Production* case, Securicor were excluded from all liability in respect of the destruction of the premises of the plaintiff by a fire started by one of the security guards protecting the site.

The 'requirement of reasonableness'

The exclusion clause shall be judged as satisfying the requirements of reasonableness 'having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made'. The court interprets exclusion clauses strictly. In *Computer and Systems Engineering plc* v. *John Lelliott Ltd* (1991) *The Times*, 21 February, the contract excluded liability for flooding or burst pipes, while the damage was caused by a fractured sprinkler pipe. The court held that the damage was not within the meaning of the clause.

This area of the law is also covered by the Unfair Terms in Consumer Contracts Regulations 1994 (see Chaper 16, Section 16.14)

3.22 Incomplete or Inchoate Agreements

If the terms of a contract are insufficiently clear, it may be unenforceable. In *G. Scammell & Nephew Ltd* v. *Ouston* [1941] AC 151 the defendant agreed to buy a motor van on the understanding that 'the balance of the purchase price can be had on hire purchase terms over a period of two years'. No precise meaning could be given to the term, since hire-purchase contracts varied widely and there was no enforceable contract. The court may sever any meaningless clause if this will not impair the sense of the contract. In *Nicolene Ltd* v. *Simmonds* [1953] 1 QB 543 the court severed from a contract for the sale of goods the phrase 'I assume that we are in agreement that the usual conditions of acceptance apply.' There were, in fact, no such conditions. The court may solve the problem by reference to a trade practice or course of dealing between the parties. In *Hillas & Co. Ltd* v. *Arcos Ltd* [1932] All ER 494, a contract for the

supply of wood during 1930 contained an option for the following year without specifying the kind of timber, the destination or manner of shipment. The court held that these points could be determined by reference to the previous dealings and normal trade practice. The court may also imply a term into the agreement to give it efficacy, or the agreement may itself provide for the clarification of the contract by providing for reference to arbitration. In *Foley* v. *Classique Coaches Ltd* [1934] 2 KB 1, the plaintiff contracted to supply the defendants with petrol 'at a price to be agreed by the parties in writing and from time to time'. It also provided that any dispute should be submitted 'to arbitration in the usual way'. The defendants could not repudiate the contract after three years on the grounds of uncertainty, since the court implied terms whereby the petrol should be of reasonable quality and at a reasonable price and the contract provided an arbitration procedure to fix a price failing agreement.

In *Neilson* v. *Stewart* [1991] SLT, an agreement for the sale of shares included a loan repayment which was to be deferred for one year 'after which time repayment shall be negotiated to our mutual satisfaction'. The purchaser claimed that this phrase rendered the whole agreement unenforceable, but the House of Lords held that the parties did not apparently intend the loan to be fixed as to time and manner of payment, that all loans were repayable on demand and it was not essential that interest should be payable.

All the apparent ambiguities could be resolved.

Where contracts for sale and supply of goods and services make no provision as to price, the obligation to pay a reasonable price is implied by statute (see Chapter 13).

3.23 Discharge of Contracts

A contract is discharged when the rights arising under it are terminated. Contracts can be discharged by performance, by agreement, by acceptance of breach, and by frustration.

3.24 Performance

Problems arise where a party has performed part of his/her contractual obligations and claims payment for what s/he has done. The position varies according to whether the contract is entire or divisible. In the former case, the consideration is whole and performance must be complete; a party can claim nothing for part performance. In *Cutter* v. *Powell* (1795) 6 Term Rep 320, Cutter was to be paid as second mate on a voyage from the West Indies to Liverpool. He died before the ship reached Liverpool and his widow failed in her claim for the work he had done. In

the latter case, the consideration is subdivided into separate parts and payment is claimable for the part performed. A contract of employment for five years with weekly or monthly payment enables claims in respect of each completed unit. Building contracts generally provide for payment on satisfactory completion of each stage, avoiding the problem in *Sumpter* v. *Hedges* [1898] 1 QB 673 (see below).

Exceptions to doctrine of proper performance for entire contracts

Payment for partial performance can be claimed where: (i) failure to complete is the fault of the other party; (ii) it has been accepted; and (iii) there has been substantial performance.

Failure to complete is other party's fault

In *Planché* v. *Colburn* (1831) 8 Bing 14, an author was entitled to part payment in respect of preparation of a manuscript when the editor cancelled the series.

Where partial performance has been accepted

Parties can reject partial performance but, if they accept, they are liable to pay in quasi-contract (see Chapter 5). Part performance can only be accepted where there is a possibility of rejection, so that part performance of a contract to build houses is impossible, even though the buyer obtains the services of another builder to complete the work: *Sumpter* v. *Hedges* [1898] 1 QB 673. In *IBMAC* v. *Marshall (Homes) Ltd* (1968), the plaintiff failed to recover in respect of part completion of a road building scheme.

Where there has been substantial performance

Where the contract is substantially but not exactly performed, the party who has substantially performed his/her contractual obligation is entitled to payment less an amount in respect of the work outstanding. In *Hoenig* v. *Isaacs* [1952] 2 All ER 176, the amount of work outstanding on a contract for interior decoration was valued at around £55 and the court ordered payment to the decorator of the balance outstanding under the contract less the £55. Substantial performance cannot exists where the value of the work outstanding is too great in relation to the total contract price. In *Bolton* v. *Mahadeva* [1975] QB 326, the outstanding work to make a central heating system function was assessed at £174.50 against a total contract price of £560. There was no substantial performance.

3.25 Discharge by Agreement

Parties can release each other from their contractual obligations by simple bilateral agreement if no performance of the obligations has taken place.

Where, however, one party has performed his/her obligations under the contract and promises unilaterally to release the other party from his/her, the promise is only binding if the other party has supplied valuable consideration or the promise is by deed. This is called *accord and satisfaction*, the satisfaction being the consideration required to render enforceable the accord or promise.

Thus, if A owes B £100 under a contract, but B agrees to release A from the obligation to pay or to accept a lesser sum in complete satisfaction, B will be entitled at common law to sue for the unpaid balance in the future. This was established by *Pinnel's Case* (1602) 5 Co. Rep 117a, and followed in *Foakes* v. *Beer* (1884) 9 App Cas 605. The plaintiff had agreed with the defendant to accept payment of a judgment debt by instalments and was subsequently able to sue for the unpaid interest to which she would have been entitled. In *Stour Valley Builders* v. *Stuart* CA Transcript 555, a debtor sent a cheque for less than the total amount owed, subject to a condition that the creditor was only to cash the cheque if he accepted it in full and final satisfaction. The creditor cashed the cheque and was later able to sue for the balance outstanding. In *Re Selectmove Ltd* [1995] 2 All ER 531, the company had offered to pay debts to the Inland Revenue IR) by instalments and the Inspector had agreed to inform the company if this was not acceptable. The company had begun to pay by instalments, when the IR threatened to wind up the company if the arrears were not paid immediately. The company relied on *Williams & Roffey Bros* v. *Nicholls (Contractors) Ltd* [1991] 1 QB 1 that a promise to perform an existing obligation would be good consideration if there were practical benefits to the promissor (see p. 65 above). The argument was rejected as inconsistent with *Foakes* v. *Beer* that an agreement to pay an existing debt by instalments was not enforceable.

Accord and satisfaction and promissory estoppel

A possible partial solution lies in promissory estoppel (see p. 68), since under this doctrine, where a party promises to release the other from a contractual obligation, and the other party acts in reliance on that promise, s/he can use the promise as a defence against an attempt by the promissor to insist upon his/her original legal rights. The doctrine only appears to cover situations where the promise relates to the suspension rather than the termination of contractual rights. In *Central London Property Trust Ltd* v. *High Trees House Ltd* [1947] KB 130, the promise related to agreement by the plaintiff in 1940 to accept payment of 50 per cent of the legal rent for a block of flats while hostilities continued, when it was difficult to find tenants. Denning J held that, had the plaintiff sued for non-paid arrears between 1940 and June 1945, they would have been unable to recover them. The remedy is discretionary and the court will refuse to offer its protection where the party seeking relief has not acted fairly. In *D & C Builders Ltd* v. *Rees* [1966] 2 QB 617, where the court refused to extend protection to the defendant who had forced the plaintiff,

whom she knew to be in desperate need of funds, to accept £300 in complete satisfaction of a debt of £500, the issue of whether promissory estoppel would have covered the termination of contractual rights was not solved, since the decision was based on withholding the discretionary remedy on the grounds of Mrs Rees' dishonourable conduct. But see economic duress (p. 000 above). In *Ferguson* v. *Davies* [1997] 1 All ER 315 the plaintiff sold records to the defendant in return for other records to the value of £600, or a cash payment of £1700. Records worth £143.50 and a payment of £5 were made to the plaintiff. The plaintiff sued for £486.50 and the defendant sent him a cheque for £150 in full payment. The plaintiff cashed the cheque but informed the defendant that he was continuing his action, which he had now increased to £1745.79. The county court judge dismissed the plaintiff's claim, on the grounds that the acceptance of the £150 was a binding accord and satisfaction. The Court of Appeal held that acceptance of a lesser sum than the amount claimed did not constitute accord and satisfaction unless the plaintiff received some additional benefit by way of consideration.

Novation and notice

A contract can be replaced by another by way of novation, usually with different parties. Contracts of employment can only be terminated in accordance with an express provision or the statutory minimum notice provisions under the Employment Protection (Consolidation) Act 1978, subject to the common law notion of reasonable notice (see Chapter 12).

3.26 Discharge by Acceptance of Breach

Where one party breaches a condition of the agreement, the injured party can opt to regard him/herself as continuing to be bound by the contract, or can repudiate it. In either case s/he could sue for damages. A contract can be broken prior to the date for performance by express notice by a party that s/he will not comply with it, or by putting him/herself in a position whereby compliance is impossible. This is called anticipatory breach.

Anticipatory breach

The injured party can regard him/herself as still bound, or treat the contract as repudiated, in which case s/he can sue for breach of contract immediately. In *Hochster* v. *De La Tour* [1843–60] All ER Rep 12, the plaintiff, who was informed on 11 May 1852 that he was no longer to be required as a courier under a contract under which he was to have started work on 1 June 1852, was able to commence his action for breach of contract on 22 May 1852. Failure to accept repudiation can cause problems. In *Avery* v. *Bowden* (1855) 5 E & B 714, the defendant chartered the plaintiff's ship and agreed to load her at Odessa within fourty-five days.

The captain was informed on arriving that the plaintiff did not intend to load the ship, but the captain stayed on, hoping that the plaintiff would change his mind. The outbreak of the Crimean War made performance of the contract illegal and it was discharged by frustration, preventing a claim for damages for breach of contract.

A party refusing to treat the contract as repudiated can continue to treat the contract as valid and perform his/her contractual obligations. In *White & Carter (Councils) Ltd* v. *McGregor* [1961] 3 All ER 1178, the plaintiffs refused to accept repudiation of a contract when no expenses had been incurred, performed their obligations and recovered damages for their subsequently incurred losses. The decision is contrary to the legal requirement to mitigate loss, and later cases have not allowed people to ignore a repudiation: *Attica Sea Carriers Corp.* v. *Ferrostaal Poseidon Bulk Reederei GmbH, The Puerto Buitrago* [1976] 1 Lloyd's Rep 250; *The Odenfield* [1978] 2 Lloyd's Rep 357; *Clea Shipping Corpn* v. *Bulk Oil International Ltd, The Alaskan Trader (No. 2)* [1984] 1 All ER 129. In the latter case the shipowners chartered a ship for twenty-four months from October 1979. In April 1981, the charterers indicated for the second time that they did not require the vessel and refused to give sailing instructions. The shipowners refused to take this as notice of repudiation and kept the ship at anchor with a full crew ready to sail until the charter expired in December 1981. The arbitrator held that the shipowners should have accepted the repudiation by midnight on 8 April 1981 (see Chapter 5).

3.27 Discharge by Subsequent Impossibility: Frustration

A contract is frustrated when performance is impossible because of some unforeseen happening beyond the control of the contracting parties, and neither party will be liable for breach of contract. This exception to the common law principle of absolute contractual duties which refused to release a party from contractual obligations merely because they had become impossible to perform, *Parradine* v. *Jane* [1558–1774] All ER Rep 172, was first recognised in *Taylor* v. *Caldwell* (1862) 32 LJQB 164, where a contract to lease a theatre was frustrated by a fire that destroyed the theatre. Frustration will not apply where the event should have been provided for, or where the contract is merely more difficult or less profitable to perform. In *Davis Contractors Ltd* v. *Fareham UDC* [1956] AC 696, where the plaintiff contracted to build seventy-eight council houses in eight months for a fixed price, but took twenty-two months because of shortage of labour, their claim that the original contract had been frustrated failed. And in *Amalgamated Investment & Property Co. Ltd* v. *Walker & Sons Ltd* [1976] 3 All ER 509, a contract for the purchase of a warehouse for £1.7m, where both parties knew that the intention of the

purchaser was to demolish the building and redevelop, was not frustrated by a preservation order being imposed on the building, which reduced its value to £200 000. Further, in *Tsakiroglou & Co. Ltd* v. *Noblee Thorl GmbH* [1962] AC 93, a contract by the plaintiffs to sell a consignment of groundnuts and deliver them to Hamburg was not frustrated by the closure of the Suez Canal, which forced them to be shipped via the Cape of Good Hope: 'An increase of expense is not a ground of frustration'.

Frustration has been recognised in the following cases:

(i) Impossibility because of changes in the law: *Avery* v. *Bowden* (1855) 5 E&B 714 (outbreak of Crimean War);
(ii) Contracts for personal services discharged by death or permanent incapacity: *Condor* v. *The Barron Knights Ltd* [1966] 1 WLR 87 (contract discharged by insanity);
(iii) Where contract depends upon state of affairs which ceases to exist: *Taylor* v. *Caldwell* (1862) 32 LJQB 164 (destruction of theatre by fire); *Krell* v. *Henry* [1903] 2KB 740; *Chandler* v. *Webster* [1904] 1 KB 904 (contracts to rent accommodation from which to watch the Coronation procession, which was later cancelled). But see *Herne Bay Steamboat Co.* v. *Hutton* [1903] 2 KB 603, where the defendant chartered the plaintiff's ship 'for the purpose of viewing the naval review and for a day's cruise round the fleet': the contract was not frustrated by the cancellation of the royal review, since the fleet was still available for inspection; and
(iv) Where the commercial purpose of the contract is frustrated: in *Jackson* v. *Union Marine Insurance Co. Ltd* (1874) LR 10 CP 125, a ship was chartered to sail from Liverpool to Newport to take on a cargo of iron rails for San Francisco. The ship struck rocks on the way to Newport and was forced to return to Liverpool for repairs, which took eight months to complete. The contract was held to be frustrated and the parties were discharged from the contract.

Frustration does not apply where the frustrating event is self-induced. In *Maritime National Fish Ltd* v. *Ocean Trawlers Ltd* [1935] AC 524, a contract to charter fishing vessels was not frustrated when the charterer was granted fewer fishing licences than he had applied for and he chose to allocate those licences to his own vessels.

The doctrine extends to leases and contracts for land. In *National Carriers Ltd* v. *Panalpina (Northern) Ltd* [1981] AC 675, the appellants leased a warehouse for ten years. After five, the local authority closed the access road for two years. The court, while agreeing in principle that frustration could apply, refused to apply it in this case.

The effect of frustration

The effect of frustration is that the contract is void *ab initio* and the parties can (i) recover money paid; and (ii) claim payment for work performed prior to the frustration: Law Reform (Frustrated Contracts) Act 1943.

Right to recover money paid

Section 1(2) provides: 'All sums paid or payable to any party in pursuance of the contract before the time when the parties were so discharged shall, in the case of sums so paid, be recoverable from him as money received by him for the use of the party by whom the sums were paid, and, in the case of sums so payable, cease to be so payable.' This is qualified by allowing the person to offset expenses incurred in the fulfilment of the contract prior to the frustrating event.

Right to compensation for partial performance

A party who has 'obtained a valuable benefit before the time of discharge' is required to pay 'such sum (if any) … as the court considers just having regard to all the circumstances of the case'. It is not clear whether this covers the facts in *Appleby* v. *Myers* [1867] LR 2 CP 651, where the plaintiffs failed to recover damages when they had contracted to erect machinery on the defendant's premises, which were both destroyed by fire when the work was virtually complete. In *BP Exploration Co. (Libya) Ltd* v. *Hunt* (No. 2) [1983] 2 AVC 352, the court seems to state that the *Appleby* v. *Myers* (1867) LR 2 CP 651 would still not be covered.

Recommended Further Reading

Contract Law, Ewan McKendrick, 2nd edn (Macmillan Professional Masters, 1994).

Cheshire Fifoot and Furmston's Law of Contract, 13th edn (Butterworths, 1996).

Questions

1 A offered a reward for the return of a lost watch by a notice in a shop window. After six months he revoked the offer by a replacement notice in the same window. Six months later, B, who saw the original notice but not the second, returns the watch and claims the reward. Is B likely to succeed?

2 A writes offering to sell you a bike for £250; you accept by post, enclosing a cheque for £50 payable immediately and a further four cheques for £50 post-dated over the next four months, but find that A sold the bike to B before receiving your letter. Can you sue for damages for breach of contract?

3 A contracts to pay B £500 to act as expedition guide through a dangerous jungle. Before the expedition leaves, a local war breaks out in the area and B refuses to go unless A promises to pay him a further £250. On their return, A refuses to pay the extra £250. Can B sue him?

4 In what circumstances is the defence of *non est factum* available?

5 A agrees to build a house for B for £100 000 but later discovers that he had made a mistake in his calculations. Can he now claim for the true cost of the work, on the grounds that the original contract is void?

6. When can a statement of intention be the basis of an action for misrepresentation?
7. What is the difference between duress and undue influence?
8. What is the difference between contracts being ‘void’ ‘voidable’ and ‘unenforceable’?
9. Does the Unfair Contract Terms Act 1977 outlaw the use of exclusion clauses?
10. What is the distinction between an entire and a divisible contract?
11. A owes B £500 in monthly instalments of £50. After paying eight instalments, A tells B he has lost his job and B agrees to forgo the two final instalments. Later B regrets his action and claims the money. Can he succeed in his claim? Would it make a difference if A had lied about losing his job?
12. What is anticipatory breach of a contract?
13. If a contract is frustrated, what rights do the parties have?

4 The Law of Tort

Learning Objectives

After reading this chapter you will know about:

1. the concept of tortious liability and the classification of torts
2. the general defences to tortious liability
3. persons who can sue and be sued in tort
4. the requirements for establishing liability for the tort of negligence, including negligent misstatement
5. the basis of occupiers' liability to visitors and to trespassers
6. the basis of liability for private nuisance
7. the rule in *Rylands* v. *Fletcher*

4.1 Importance of Tortious Liability

Tortious liability is important for businesses, which are liable, among other things, for their negligence and that of their employees (see Chapter 12); for failure to ensure the safety of their premises; and disturbances affecting neighbouring occupiers. Persons are liable in respect of specific actionable wrongs called torts, which are classified according to whether they affect the person, property, economic rights, reputation or general rights. This list covers some of the more common torts relating to business.

Torts affecting the person

Negligence Breach of a duty of care owed to a person causing foreseeable injury to the person (see p. 112).

Torts affecting property

Private nuisance An indirect interference with another's use or enjoyment of land. Owed to the occupier of land (and not generally to an absentee owner unless future occupation is affected – for example, by structural damage). This includes interference through smells, vibrations, penetration by roots and so on (see p. 125).

Trespass to land Direct interference with a person's rights of possession to land. Includes entry on to property and placing things on property. The duty is owed to the possessor even if he is not the owner. The tort is actionable *per se* – that is, actionable without proof of damage. Land can be the subject of trespass not merely at ground level but also below ground and in

the sky. Thus, in *Kelsen* v. *Imperial Tobacco Co. (of Gt Britain and Ireland) Ltd* [1957] 2 All ER 343, the court recognised trespass by a sign which projected in the airspace over the plaintiff's shop; and in *Woolerton and Wilson* v. *Richard Costain (Midlands) Ltd* [1970] 1 All ER 483, a crane travelling over the air space constituted trespass. In *Bernstein* v. *Skyviews & General Ltd* [1977] 3 All ER 902, the court refused to recognise as trespass to land the intrusion of a plane at a height of over 600 ft (s.40 Civil Aviation Act 1949 provides a defence in this case, but the judge did suggest that constant surveillance from the air could be an actionable nuisance).

Trespass to goods A wrongful interference with goods in the possession of another – for example, touching, marking or taking away.

Conversion An act in relation to goods which constitutes an unjustifiable denial of the title of the true owner. The wrong is against the true owner. This includes taking away goods plus a denial that the person from whom they have been taken is the owner. Sale of goods by a non-owner constitutes conversion against true owner.

Negligence Breach of a duty of care in respect of the property of another, causing foreseeable harm (see p. 112).

Rylands v. Fletcher Allowing things stored or collected on land which were not natural to the land to escape and cause damage to property of another. Strict liability: for example, water escaping from reservoirs (see p. 130).

Torts affecting economic rights

Interference with contract Without lawful justification persuading a person to break his/her contract with another, or acting in such a way as to prevent its performance.

Intimidation Making a threat intended to cause another to act or refrain from acting in a certain way to that person's detriment or that of a third party.

Passing off Representing one's goods or services to be those of another, causing loss of trade or damage to business reputation. Trading in a name similar to that of another similar business to the confusion of the public.

Deceit Making a false statement with intent to deceive, intending another to act upon it to his detriment.

Negligent misstatement Breach of duty of care in giving advice to a person to whom one owes a duty of care, causing him/her damage of a foreseeable kind including purely economic loss (see p. 117).

Torts affecting reputation

Defamation 'The publication of a statement which tends to lower a person in the estimation of right thinking members of society generally; or which tends to make them shun or avoid that person.' If the defamation is in permanent form it is a libel, which is actionable *per se* (without proof of damage); if it is in impermanent form, it is a slander, which is generally only actionable on proof of loss. Libel includes defamatory statements in writing or via the media (television, film, records, stage and so on), whereas slander is restricted to verbal statements.

Torts affecting rights generally

Public nuisance Behaviour which materially affects the reasonable comfort and convenience of a class of people who come within the sphere or neighbourhood of its operation; for example, carrying on an offensive trade; obstructing the highway (see p. 125).

Conspiracy A combination of two or more persons planning together to injure a third by unlawful means.

4.2 Establishing Tortious Liability

Plaintiffs must usually establish an actionable interference with their legal rights (*injuria*) resulting in harm or loss suffered by them (*damnum*). Certain infringements of a legal right are actionable without the need to establish loss, but are actionable *per se*. This includes torts such as as trespass to land, or libel. Where persons suffer harm or loss without an actionable interference with their legal rights, there is no right of action.

Malice will not generally turn a legal action into an illegal one, and absence of malice is no defence where an unlawful act has been committed. In *The Mayor of Bradford Corporation* v. *Pickles* [1895] AC 587, the defendant dug trenches on his land with the intention of cutting off the flow of water draining from his land which was collected by the Corporation and to force the council into buying his land for a high price. The Corporation failed to obtain an injunction restraining him, since he had a legal right to drain his land and the malice did not make his action illegal. In *Wilkinson* v. *Downton* [1897] 2 QB 57, the defendant told the plaintiff that her husband had broken his legs, and as a result the wife suffered nervous shock. The defence that it was merely a practical joke failed.

The presence of malice is necessary for some torts, such as malicious falsehood and malicious arrest, and the defences of fair comment and qualified privilege in defamation are lost where malice is established. In the tort of nuisance, malice will turn a legal action into an illegal one (see p. 127).

4.3 General Defences to Tort

Some defences are specific to certain torts: for defamation there are the special defences of justification, fair comment and privilege. Some defences relate to torts in general.

Volenti non fit injuria: consent

It is a defence to prove that the plaintiff consented to the harm. A person can consent to an intentional act which would otherwise be tortious, or it can be consent to run the risk of accidental injury, including participation as a player in sports such as boxing, rugby or football, or even as a spectator. Other important categories relate to employees and persons involved in rescue attempts (see p. 120).

Exclusion of liability

A person can exclude him/herself from tortious liability for negligence or under the Occupiers Liability Act 1957 subject to the operation of the Unfair Contract Terms Act 1977. See also Unfair Terms in Consumer Contract Regulations 1994 (see Chapter 16).

Other defences

Inevitable accident

This arises where the accident could not have been avoided by taking reasonable precautions. In *Stanley* v. *Powell* [1891] 1 QB 86 the plaintiff was hit by a shot fired by the defendant while on an organised pheasant shoot when the shot glanced off a tree before hitting the plaintiff.

Act of God

This is something that occurs in the course of nature and against which one cannot be expected to provide. Thus, in *Nichols* v. *Marsland* [1876] 2 ExD 1 an extraordinary rainfall burst the banks of artificial lakes on the defendant's property and the floodwater destroyed a number of bridges owned by the county council.

Necessity

This is intentional damage to prevent even greater destruction or in defence of the realm. It includes destroying properties in the path of a fire to prevent the spread of the fire.

Mistake

Mistake of fact is a defence where the mistake is reasonable in a case such as wrongful arrest.

Act of state

The state may protect persons from liability for causing damage through carrying out their duties. The defence cannot be raised in respect of injury to a British subject or a friendly alien. In *Nissan* v. *Att. Gen* [1967] 2 All ER 1238, the plaintiff, a British subject who owned a hotel in Cyprus which was occupied by British troops, recovered damages from the government since 'act of state' was no defence against a British subject.

Statutory authority

The extent of the protection available to a public authority depends on whether the authority is absolute or conditional. If absolute, then the authority is not liable provided it has acted reasonably and there is no alternative course of action. Where the authority is conditional, the public authority has the power to act but is under no duty to do so, and it may carry out the relevant act only if there is no interference with the rights of others. In *Vaughan* v. *Taff Vale Railway* (1860) 5 H & N 679, the defendants were not liable for fires caused by sparks from engines since they were obliged to operate a railway and had done so with proper care.

Self-defence

If the tort is committed by a person acting to protect him/herself, members of his/her family or his/her property, or even persons generally, there will be no liability if the action is a reasonable response to the harm threatened.

4.4 Persons Who Can Sue and Be Sued in Tort

The most important special categories are minors, corporations, married couples, trade unions, and executors and administrators.

Minors

A minor can sue and be sued in tort, but must sue, as in contract, through an adult as next friend. The parent may also be liable, as where a parent is also the employer of the minor, where s/he has encouraged the minor to commit the tort and where the tort arises out of his/her negligent supervision. The Congenital Disabilities (Civil Liability) Act 1976 extends protection of the civil law to children who are born disabled as a result of liability of another person, other than the mother; this can be of significance for businesses such as drug companies.

Corporations

Corporation are vicariously liable for torts committed by employees acting within the ordinary course of their employment, and where the

corporation instigated the commission of the tort. Where actual fault must be established, the corporation can be liable under the *alter ego* doctrine (see Chapter 6).

Husband and wife

A married woman is fully liable for her torts (Law Reform (Married Women and Tortfeasors) Act 1935), and additional liability of the husband only arises in exceptional cases, such as where the husband is the wife's employer. Husbands and wives can sue each other but the action may be stayed where no substantial benefit would accrue to either party (Law Reform (Husband and Wife) Act 1962).

Trade unions

Trade unions are unincorporated associations, but under s.2 Trade Union and Labour Relations Act 1974 they are able to make contracts, to sue and be sued in their own names. They enjoy certain immunity in the law of tort under the Trade Union and Labour Relations Act 1974 as amended by the Trade Union Act 1984, s.10 for torts committed during the furtherance of a trade dispute where the union has balloted its members before taking industrial action. Trade unions can otherwise be liable for inducing a person to break his/her contract of employment. Individuals are also exempt from tortious liability for torts in contemplation or furtherance of a trade dispute, s.13, but they are liable for secondary picketing: Employment Act 1980, ss16 and 17.

Executors and administrators

Under the Law Reform (Miscellaneous Provisions) Act 1934 all causes of action in tort, except for defamation, subsisting at the time of a person's death survive against his/her estate. This enables actions to be brought by personal representatives of the deceased against the persons tortiously responsible for his/her death. Damages are claimable under a number of headings including loss of expectation of life. It is also possible to claim in respect of earnings the deceased would have earned during the 'lost years'.

Under the Fatal Accidents Act 1976, the person liable for causing the death of a person may also have additional liability to relatives of the deceased, including husband, wife (not divorced or common law), children (including those unborn), grandchildren, parents, grandparents, brothers, sisters, aunts and uncles and their issue.

4.5 More than One Person Liable as Tortfeasor

There are three different situations where more than one person is liable for the tort: joint tortfeasors, several concurrent tortfeasors and several tortfeasors causing different damage.

Joint tortfeasors

This includes an employer's vicarious liability for the torts of his employee acting within the scope of his employment (see Chapter 12); cases where one person instigates another to commit a tort; cases where there is a breach of duty imposed jointly on two or more persons; and where two or more persons are involved in a 'concerted action to a common end', during the course of which one or more of them commits a tort.

Several (or separate) concurrent tortfeasors

These are tortfeasors whose separate tortious acts combine to produce the same damage. An example is in *Drinkwater* v. *Kimber* [1952] 2 QB 281, where a passenger in a car was injured in a crash between that car and another as a result of the negligence of both drivers.

Several tortfeasors causing different damage

This occurs where two or more persons acting separately cause different damage to the plaintiff, as where a motorist injures a pedestrian through negligent driving and the injured person is subsequently treated negligently by a doctor.

In the case of joint tortfeasors and separate concurrent tortfeasors, each tortfeasor is liable for the whole damage subject to the right to claim contribution from the other tortfeasor(s). Payment by one of the tortfeasors discharges the others. The right of contribution is contained in s.1 of the Civil Liability (Contribution) Act 1978. Where two or more tortfeasors cause different damage, the court will determine the respective liability of each defendant and apportion the liability, and there is no right of contribution between the tortfeasors.

4.6 Cessation of Liability

Liability can be terminated by judgment; waiver; accord; and lapse of time. In the case of defamation, it is also terminated by the death of the plaintiff. The most important is lapse of time.

Lapse of time

Under the Limitation Act 1980 s.2 the general period of limitation for tort is six years from the date the cause of action accrues. Where the action is in respect of personal injuries the period is three years from the date the cause of action accrues, or the date of knowledge (if later) of the person injured: s.11(4)(a) & (b). Thus the date of exposure to asbestos dust through an employer's negligence is when the right of action accrues under (a), but the date when the employee is aware that he has developed lung cancer, which may be years later, is covered by (b). If the

injured person dies before the period in ss.4 expires, the cause of action survives for the benefit of his/her estate for three years from the date of death; or the date of the personal representative's knowledge, whichever is the later: s.11(5). Under the Latent Damage Act 1986, where a person's tortious negligence results in latent damage other than personal injury, the cause of action runs for six years from the date when the damage is discovered.

For torts of a continuing nature such as nuisance, an independent cause of action arises on each day that the tort is committed, so that, even though the wrong was first committed outside the limitation period, the plaintiff can sue in respect of the part committed within the limitation period. For minors or persons suffering from mental disorder, the period does not start to run until their disability ends. The periods of limitation against the estate of a deceased tortfeasor are subject to the normal three-year or six-year rule from the accrual of the cause of action: Proceedings Against Estates Act 1970.

For defamation or malicious falsehood, the right to bring an action expires one year from the date on which the cause of action accrued.

4.7 Negligence

Negligence relates to the protection of persons and property from interference. Where the interference is intentional, the appropriate tort is trespass to the person, goods or property. Where the interference is involuntary but negligent the appropriate action lies in the tort of negligence: *Letang* v. *Cooper* [1964] 2 All ER 929. Negligence is the breach of a legal duty to take care, resulting in unintended harm to the plaintiff. There are three essential ingredients: (i) a legal duty of care owed by the defendant to the plaintiff; (ii) a breach of that legal duty by the defendant; and (iii) injury or damage to property suffered by the plaintiff arising out of the breach of the duty.

The legal duty of care

The plaintiff must establish that a legal duty of care is owed to him by the defendant. The most frequently quoted attempt to rationalise the duty of care is the statement by Lord Atkin in *Donoghue* v. *Stevenson* [1932] AC 562: 'You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour.' Lord Atkin defined neighbours as 'persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question'.

In this case, the manufacturer of a bottle of ginger beer was liable to a consumer who was made seriously ill by the partly decomposed body of a snail in the bottle from which she had been drinking. The consumer was

a friend of the purchaser and freeing liability in negligence from privity of contract established a duty of manufacturers to the ultimate consumer and formed the basis of manufacturers' liability until the Consumer Protection Act 1987 (see Chapter 16).

The court said that the categories of negligence are never closed, meaning that the neighbour principle can be adapted to new situations as they arise. Thus in *Lewis* v. *Carmarthenshire County Council* [1953] 1 WLR 1439 an education authority was held to owe a duty to exercise reasonable supervision of children in its nursery adjoining the road to prevent them from running into the road. And in *Barnes* v. *Hampshire County Council* [1969] 3 All ER 746 the local eduction authority was held liable for allowing children out of school early, before the parents were there to meet them. In *Bermingham* v. *Sher Brothers* 1980 SLT 122 Lord Fraser of Tullybelton commented that a firefighter was no doubt a 'neighbour' of the occupier of premises who owed a duty to warn him of an unexpected danger of which the occupier knew or ought to have known. And in *Ogwo* v. *Taylor* [1988] 1 AC 431 the occupier of a premises was liable to a firefighter for injuries suffered in respect of a blaze at a house which was the result of the occupier's negligence.

The actual victim of the negligence can suffer physical and psychiatric injuries. In *Page* v. *Smith* [1996] 1 AC 155 the plaintiff was injured in a car accident caused by the defendant's negligence. As a result, his myalgic encephalomyelitis (ME), from which he had suffered for twenty years, had become chronic and permanent and he was unlikely to be able to work again. The Court of Appeal allowed an appeal against the award of damages on the grounds that the injury was not reasonably foreseeable. The House of Lords held that once the defendant owed a duty of care to avoid causing personal injury to the plaintiff, it did not matter whether the injury was physical, psychiatric or both. Having determined that the defendant should have foreseen the plaintiff suffering personal injury, it was not necessary to ask whether he should have foreseen the possibility of injury by shock, and irrelevant that the plaintiff did not sustain external physical injury.

Problems arise for persons claiming for psychiatric injury as a result of injury to others. The actual victim is the primary victim and the others are secondary victims. They can be family, friends, rescuers and persons involved in an accident caused by the negligence of their employer. In *Page* v. *Smith* (1996) the House of Lords distinguished the position of the primary and secondary victims, who are subject to control mechanisms that do not apply to primary victims.

Liability to secondary victims was initially decided on the basis of foreseeability. In *Bourhill* v. *Young* [1943] AC 92, a speeding motorcyclist was involved in an accident with a car. Some distance away, in a safe position, a pregnant woman heard the sound of the crash, which frightened her, making her ill and causing her to give birth later to a stillborn child. The court held that she was beyond the area of foreseeable danger and that no duty of care was owed to her. Similarly in *King* v. *Phillips* [1953] 1 QB 429, a

taxi driver carelessly reversed his vehicle and ran over a little boy's tricycle and the little boy screamed. His mother in an upstairs room, heard the scream, rushed to the window and saw the tricycle under the taxi. Thinking her son was injured she suffered from shock. The court held that the driver owed a duty of care to such persons as he could reasonably foresee would be injured by his negligence, and no duty was owed to the mother.

In *Boardman* v. *Sanderson* [1964] 1 WLR 1317, however, the defendant negligently reversed his car over the plaintiff's son's foot and knew the parent was in earshot and likely to run to the scene. The plaintiff recovered damages for nervous shock. In *Dooley* v. *Cammell Laird & Co Ltd* [1951] 1 Lloyd's Rep 271 the plaintiff recovered damages for nervous shock caused by fear for the safety of his workmates when the sling on a crane which he was operating collapsed, sending its load into the hold of a ship where the others were working. And in *McLoughlin* v. *O'Brian* [1983] 1 AC 410 the court awarded damages to a mother who was at home, two miles away, when her husband and three of their children were involved in a serious car accident. One daughter died immediately and later the mother saw the other members of her family in hospital and suffered severe and continuing nervous shock. Lord Scarman stated: 'Space, time, distance, the nature of the injuries sustained and the relationship of the plaintiff to the immediate victim of the accident are factors to be weighed, but not legal limitations, when the test of reasonable foreseeability is to be applied.'

The test of foreseeability was qualified in *Alcock and Others* v. *Chief Constable of South Yorkshire Police* [1991] 3 WLR 1057, where the House of Lords considered damages claims for psychiatric injury arising from the Hillsborough football stadium disaster by relatives and friends of people killed and injured at the match. The House of Lords stated that reasonable foresight of psychiatric injury was not sufficient; proximity was also required between the person claiming the injury and those involved in the disaster. This included all relationships based on love and affection at a comparable level to parents and spouse. For more distant relationships, the burden was on the plaintiff to establish the closeness of the relationship. The House of Lords found that parents who had lost a son and fiancé were within the category, but brothers and brothers-in-law (and by extension sister and sister-in-law) were excluded in the absence of evidence of particularly close ties of love and affection.

In addition, the injury must be caused through sight or hearing of the event or its immediate aftermath, and viewing the scenes on TV did not qualify. Lords Ackner and Oliver agreed with Nolan LJ in the Court of Appeal, however, that simultaneous broadcasts of a disaster could be the equivalent of actual sight or hearing of the event or its immediate aftermath. The immediacy of the aftermath was also stressed. The fact that the earliest identification was eight or nine hours after the disaster excluded it from the definition of 'immediate aftermath', as did subsequent visits to the mortuary for identification purposes. Lord Ackner stressed that the psychiatric injury must be the shock caused by the sudden appreciation by sight or sound of a horrifying event.

In *McFarlane* v. *EE Caledonia Ltd* [1994] 2 All ER 1, the plaintiff was unsuccessful in his claim for psychiatric injury as a bystander on board a support vessel during the Piper Alfa disaster. In the earlier case, Lords Ackner and Oliver had not ruled out the extension of the duty of care to bystanders, but suggested that this would only arise in circumstances of such horror that would be likely to traumatise the most phlegmatic spectator. Lord Keith stated that 'Psychiatric injury to [the bystander] would not ordinarily, in my view, be within the range of reasonable foreseeability, but could not perhaps be entirely excluded from it if the circumstances of a catastrophe occurring very close to him were particularly horrific.' Their Lordships also reiterated that there must be a sufficiently close tie of love and affection between the plaintiff and the primary victim. In *Vernon* v. *Bosley* (No. 1) [1997] 1 All ER 577, the Court of Appeal approved the award of damages for nervous shock to the father of two children drowned when the car in which they were travelling went off the road and the father watched the rescue attempts. In the High Court he had included a claim in respect of the subsequent failure of his business; this was rejected.

The same criteria do not apply to all categories of secondary victim. In *Frost and Others* v. *Chief Constable of South Yorks* [1997] 1 All ER 540 the plaintiffs were police officers claiming damages from their employer for psychiatric injury arising from the Hillsborough disaster. The Court of Appeal found that the plaintiffs' exposure to the horrific events resulted from the admitted negligence of their employer in breach of his duty of care.

The court also referred to an analogous duty of care in respect of rescuers. In *Chadwick* v. *British Transport Commission* [1967] 2 All ER 945, the plaintiff recovered damages for psychiatric injury after he was voluntarily involved in a rescue operation following a train crash caused by the defendant's negligence. The court held that it was foreseeable that persons might come to the rescue and that they were owed a duty of care. The two points came together in *Ward* v. *T. E. Hopkins & Son Ltd* [1959] 3 All ER 225. The defendants were engaged to clean out a well and used a petrol-driven pump. Two employees down the well were overcome by fumes and a doctor called to the rescue was similarly overcome; all three died. The defendants were liable for breach of their legal duty not to expose their employees to unnecessary risks and for negligently causing the doctor's death because an attempted rescue was forseeable.

The Law Commission report 'Liability for Psychiatric Illness' [Report Law Com No. 249 10 March 1998] and the draft Negligence (Psychiatric Illness) Bill propose to remove the restrictions on physical and temporal proximity to the accident and the means by which he or she learned of it. The need for a close tie of love and affection remains.

Restricting extension of the duty of care

The case of *Alcock and Others* v. *Chief Constable of South Yorkshire Police* [1991] is typical of a move towards restricting the duty of care as a matter of public policy. Lord Oliver stated in his judgment that considerations of

policy played a part in the court's perception of what was sufficiently proximate. Throughout the 1980s the scope of the duty of care was widened in a number of decisions. In *Ross* v. *Caunters* [1979] 2 All ER 97 the defendant, a solicitor, was found to owe a duty of care not only to his client but also to third persons. In this case, the defendant gave negligent advice to his client as to the drawing up of a will and failed to warn him of s.15 Wills Act 1837 which made void any bequest to a person who has witnessed the will. Megarry V-C, while accepting that a solicitor owes no general duty to those who are not his clients, said that in a case such as this the solicitor is under a duty, owed both to the third party and to his client, to use proper care in carrying out his instructions. Similarly, in *Yianni* v. *Edwin Evans & Sons* [1981] 3 All ER 592, the court found the defendant surveyors liable in respect of a negligent survey carried out for the building society who were to make a loan to the plaintiff. The plaintiff was advised to obtain a separate survey but went ahead without one. And in *JEB Fasteners Ltd.* v. *Marks, Bloom & Co.* [1983] 1 All ER 583 the defendant auditors were found liable for negligent preparation of accounts for their company client. The accounts were relied on by the plaintiff in acquiring the company. The court held that since the defendants knew that the company was in need of outside financial support and ought to have foreseen that a take-over was a possible means of obtaining finance, a person effecting a take-over might rely on the accounts in making an offer. In *White and Another* v. *Jones and Others* [1995] 1 All ER 691 the House of Lords held that a solicitor was tortiously liable to two beneficiaries who lost an inheritance because of the failure to draw up a will or codicil incorporating a testator's new instructions. Instructions received on 17 July were not passed to the probate department until 16 August by the managing clerk, who went on holiday the following day. On his return, he made an arrangement to see the testator on 17 September, but he the testator died on 14 September.

The refusal to extend the duty of care is based on the 'floodgates argument'. In *Hill* v. *Chief Constable of West Yorkshire* [1989] AC 53, the court held that the police do not owe a duty of care to the general public in relation to the prevention or detection of crime. The action by the mother of the last victim of Peter Sutcliffe (the 'Yorkshire Ripper's) alleged negligence in failing to make an earlier arrest. In *Elguzouli-Daf* v. *Commissioner of Police of the Metropolis*; *McBrearty* v. *Ministry of Defence* [1994] 2 WLR 173 the defendants had been accused respectively, of rape and handling explosives, and detained for twenty-two and eighty-five days before the prosecution abandoned the case for lack of evidence. The Court of Appeal rejected their right to sue the Crown Prosecution Service (CPS) for negligence on the grounds of public policy, although the test of foreseeability was met. This public policy immunity can be seen in *Barrett* v. *Enfield LBC* [1997] All ER 171, where the plaintiff's claim that the local authority was in breach of its duty of care to act as a parent and show the standard of care of a responsible parent was rejected on grounds of public policy. In *Capital and Counties plc* v. *Hants CC* [1997] 2 All ER 865, the

Court of Appeal, deciding three separate appeals, on similar grounds held that the fire brigade does not owe a duty of care to owners or occupiers of property merely by attending and fighting a fire. They could, however, be liable where, by their own actions they had caused increased damage. In the first action, the fire brigade were liable where the fire officer's decision to turn off the sprinkler system resulted in the total destruction of a building. This decision was later applied in *OLL Ltd* v *Secretary of State for Transport* [1997] All ER 897, which held that coastguards were under no enforceable private law duty to respond to an emergency call, nor, if they did respond, would they be liable if their response was negligent unless it amounted to a positive act which directly caused greater injury than would have occurred had they not intervened at all.

Liability for negligent misstatement

In *Hedley Byrne & Co. Ltd* v. *Heller & Partners Ltd* [1964] AC 465 the defendant bankers gave a negligent credit reference to the plaintiff who acted in reliance on it and lost over £17 000 when the client company went into liquidation. The House of Lords recognised that damages could be recovered for economic loss arising from a negligent misstatement where the advice was given by an expert in a relationship of sufficient proximity to the person being advised so that he knows who is going to act in reliance on it and how.

Caparo Industries plc v. *Dickman* [1990] 1 All ER 568 has clarified liability for negligent misstatement. The court held that the company's auditors did not owe a duty of care to shareholders or members of the public who purchased shares in reliance on the audited accounts they had negligently prepared. Although it may be foreseeable that persons use the audited accounts for making decisions about whether to purchase shares, and that these people may suffer financial loss if the accounts are inaccurate, this was insufficient to establish a duty of care. There must be sufficient proximity between the plaintiff and the defendant, and the court must consider it just and equitable to impose a duty of care. The person giving the advice or information must be fully aware of the nature of the transaction in contemplation, and that the plaintiff would rely upon the advice or information. The court found that the purpose of the auditor was to enable the shareholders as a body to use the audited accounts to make corporate decisions, and not for the purpose of individual shareholders making personal decisions as to whether or not to deal in the securities of the company. In *James McNaughton Paper Group Ltd* v. *Hicks Anderson & Co.* [1991] 1 All ER 134, the defendant auditors were not liable to the plaintiffs who had relied on the accounts prepared by them for a group of companies in making a take-over bid for the group. The court held that there was not a sufficient proximity between the parties to establish a duty of care.

Thus liability for economic loss is only recoverable where there is: (i) a negligent mistatement; (ii) expertise; (iii) a duty of care; (iv) a special

relationship; (v) knowledge of reasonable reliance; and (vi) foreseeable loss. In *Galoo Ltd* v. *Bright Grahame Murray and Another* [1995] 1 All ER 16, auditors were liable for damages for negligent preparation of accounts. These were used as the basis of a decision to purchase shares in a company and they company had been made aware that a particular identified bidder would rely on the audited accounts, so owed a duty of care to the identified bidder.

Breach of the duty of care

Whether there has been a breach of duty is a question of fact and based on the objective test of a reasonable man to the situation. The court takes account of the following factors: (i) the likelihood of harm; (ii) the seriousness of the risk and the risk of serious injury; (iii) the usefulness or importance of the defendant's activity when the alleged negligence occurred; and (iv) the relationship between the risk and the measures taken.

The likelihood of harm

The care required increases with the likelihood that the defendant's action will result in harm. If there is only a remote possibility of harm, a person will be acting reasonably even though s/he does not protect against the harm being suffered. In *Bolton* v. *Stone* [1951] AC 850, the plaintiff was standing on the highway when she was injured by a ball from the defendant's cricket club. She failed in an action against the club, since the probability of such an injury was not foreseeable by a reasonable person because balls had only been hit outside the ground on six occasions in twent-eight years.

The seriousness of the risk and the risk of serious injury

Standards may be higher where the defendant is aware of the need for greater care. In *Paris* v. *Stepney Borough Council* [1951] AC 367, the plaintiff was a one-eyed mechanic who was totally blinded while working under the defendant's vehicle by a splinter of metal falling into his good eye. The court held that although it was not normal practice to provide goggles to normally-sighted workers, a higher duty of care was owed to this one-eyed employee, and the plaintiff obtained damages. In *Haley* v. *LEB* [1965] AC 778, the court held that a greater duty of care was owed to a blind pedestrian. The LEB had dug a hole in the pavement which was indicated by warning signs and a flashing light. Haley fell into the hole and was injured and recovered damages from the LEB.

The social importance of the defendant's activity at the relevant time

The court will take into account the value to the community of the defendant's activity at the relevant time. In *Watt* v. *Hertfordshire County Council* [1954] 1 WLR 835, a fireman was injured by a jack falling from a lorry not equipped to carry such heavy equipment. The lorry was the only available

transport to take the jack to the scene of an accident, where a woman was trapped in the wreckage. The local authority was held not liable. Lord Denning MR stated 'one must balance the risk against the end to be achieved' and 'the commercial end to make a profit is very different from the human to save life or limb'.

The relationship between the risk and the measures taken

The measures to avoid the risk of harm must be balanced against the likelihood of the risk. In *Latimer* v. *A.E.C. Ltd* [1953] AC 643, an exceptional storm flooded a factory, leaving the floor covered with a slimy mixture of oil and water. In spite of precautions to make the floor safe, the plaintiff was injured and alleged negligence for failure to close down the plant, but the court held that the risk did not justify such extreme measures.

The burden of proof and res ipsa loquitur The burden of proof is on the plaintiff to establish the breach of the duty of care except where the doctrine of *res ipsa loquitur* (the thing speaks for itself) applies; thus the plaintiff only has to prove the injury suffered, which establishes *prima facie* negligence on the part of the defendant, and which s/he must rebut. For the doctrine to apply, the following must be established: (i) it must be impossible to establish the negligent action or omission that caused the injury; (ii) the injury must be such as would not normally have occurred if proper care had been exercised; and (iii) the defendant must have had control over the events alleged to be the cause of the injury.

Examples of the application of the doctrine are *Scott* v. *London and St. Katherine Docks Co.* (1865) 3 H & C 596, where the plaintiff was struck by six bags of sugar which fell on him as he was passing the defendant's premises; and *Chapronière* v. *Mason* (1905) 21 TLR 633, where the plaintiff broke a tooth on a stone in a bath bun supplied by the defendant.

Cases illustrating point (iii) include *Gee* v. *Metropolitan Railway Co.* (1873) LR 8 QB 161, where the plaintiff was injured when he fell out of an improperly closed door minutes after the train left the station, and the company was liable under the doctrine. But in *Easson* v. *L. & N. E. Ry. Co.* [1944] KB 421, the plaintiff's claim failed because the court held that 'it is impossible to say that the doors of an express train travelling from Edinburgh to London are continuously under the sole control of the railway company'.

In *Pearson* v. *North-Western Gas Board* [1968] 2 All ER 669, the plaintiff's husband was killed and her house destroyed by a gas explosion after the rupture of a gas main caused by a severe frost. The court held that the defendants had rebutted the presumption of negligence since they had a team standing by to deal with any reported gas leaks, but there was no way of predicting or preventing explosions. On the other hand, in *Ward* v. *Tesco Stores* [1976] 1 WLR 810, Ward slipped on some spilt yoghurt while shopping. The yoghurt was probably spilled by another customer but the defendants were liable because they failed to establish that they operated a non-negligent spillages system.

Injury or damage resulting from the negligent action or omission

The damage must be related to the breach of duty and not the result of something else. In *Barnett* v. *Chelsea & Kensington Management Committee* [1969] 1 QB 428, a nightwatchman, taken to hospital complaining of vomiting and negligently refused an examination, died a few hours later from arsenic poisoning. The court held he would have died from the poison in any event and therefore his death was not caused by the negligence. There is no duty owed in respect of economic loss (see p. 000).

4.8 Defences to an Action for Negligence

Exemption clauses

The general law of contract is relevant for determining the validity and scope of the exclusion clause. In addition, under the Unfair Contract Terms Act 1977, s.2(1), a person cannot exempt him/herself from liability resulting in personal injury or death in respect of negligence in a business context.

In *Thompson* v. *T. Lohan (Plant Hire) Ltd and Another* [1987] 2 All ER 631, A hired an excavator plus driver to B. The terms of the contract of hire provided that 'drivers … shall for all purposes … in the working of the plant be regarded as the servants or agents of the hirer … who alone shall be responsible for all claims arising'. One of B's workers was killed because of the negligence of the driver. The court held that A could claim protection of the exemption clause in an action against him by the widow of the person killed. The case establishes that, although s.2(1) prevents parties from excluding themselves from liability, it is possible for them to allocate responsibility between them.

Volenti non fit injuria (consent)

The consent of a person to run the risk of accidental injury may well prevent that person bringing an action for negligence. The doctrine is important in a wide number of instances.

Consent and spectators

Consent is a defence where the organiser of a sporting event has provided reasonable protection against foreseeable risks. In *Hall* v. *Brooklands Auto Racing Club* [1933] 1 KB 205, two cars collided in a race and one crashed through the iron railings set back from the edge of the track, causing injury to the plaintiff. It was the first accident of its kind in twenty-three years and the defendants were held not liable since it was a danger they were not required to have anticipated, and the plaintiff must be taken to have assumed the risk of such an accident. In *Murray* v. *Harringay*

Arena Ltd [1951] 2 All ER 320, the defendants were held not liable where a young spectator was struck in the eye by a hockey puck. The fact that the spectator was a minor was immaterial.

Consent and rescue cases

A person with no legal obligation to become involved in a rescue is exposed to this defence where s/he is injured in the process. The success of the defence will depend on the reasonableness of the rescuer's actions. If s/he acts reasonably there is no consent to risk and greater risk-taking is justified where lives rather than property are threatened. In *Haynes* v. *Harwoods* [1935] 1 KB 146, the defence did not apply where a policemen was injured trying to control some bolting horses and prevent injury to passers-by, whereas in *Cutler* v. *United Dairies (London) Ltd* [1933] 2 KB 297 the plaintiff failed in his action when he suffered injury in helping regain control over a horse which had previously bolted but which was at the time of the injury quietly grazing in a field.

Consent and employees

The plaintiff's knowledge of the danger is not sufficient on its own; s/he must also have consented to the risk, particularly in cases of danger at work. In *Baker* v. *James Bros.* [1921] 2 KB 674, the defendants supplied their employee with a car with defective starting gear. He had complained repeatedly, but continued to use the car. The defence of *volenti* failed; knowledge of the defect did not imply consent to run the risk. It also failed in *Smith* v. *Charles Baker & Sons* [1891] AC 325, where the plaintiff worked in the knowledge that a crane was carrying heavy stones over his head, and both he and his employers were aware of the risk that stones might fall. Things would be different where the employee was receiving extra danger money to run the risk.

Volenti and contributory negligence

In *Dann* v. *Hamilton* [1939] 1 All ER 59, the plaintiff was injured while a voluntary passenger in a car driven by the defendant who was, to her knowledge, the worse for drink. The defence of *volenti* was rejected. The case was distinguished in *Morris* v. *Murray and Another* 1990 3 All ER 801, where the plaintiff, having spent all afternoon drinking with another man, accepted to be a passenger in a private plane piloted by the other man in bad weather conditions. The court distinguished *Dann* v. *Hamilton* where 'the plaintiff was engaged in a quite ordinary social outing with a driver who was not … drunk until quite a late stage when it was not easy for the plaintiff to extricate herself without giving offence'. This situation bore 'little resemblance to the drunken escapade … upon which the plaintiff and the deceased embarked in the present case'. In *Dann* v. *Hamilton* the damages would nowadays be reduced on the grounds of contributory negligence (see Chapter 5).

4.9 Occupiers' Liability

Occupiers' liability is covered by the Occupiers' Liability Act 1957 and 1984. Occupiers' liability is an aspect of the law of negligence relating to the occupier's duty to protect people from dangers inherent in premises. The Act defines premises as 'any fixed or moveable structure, including any vessel, vehicle or aircraft': s.1(3). This includes buildings, land and anything erected on that land including pylons, diving boards and grandstands, and includes cranes and scaffolding.

Definition of occupier

The test of occupation is a degree of control arising from the occupier's presence or activity on the premises. Exclusive occupation is not required. In *Wheat* v. *E. Lacon & Co. Ltd* [1966] AC 552, the defendants, the owners of a public house, were the occupiers of the premises in addition to the manager and his wife, who were in actual occupation. In *Stone* v. *Taffe* [1974] 1 WLR 1575, A owned an hotel, of which B was the manager. Because of the low level of lighting on the stairs of the hotel, C, a guest at the hotel, fell downstairs and was killed. The court held that both the manager and the owner were occupiers. An independent contractor employed to do work on premises may become an occupier. In *Hartwell* v. *Grayson, Rollo and Clover Docks Ltd* [1947] KB 901, a contractor converting a ship into a troopship was an occupier of the ship.

Where an owner dispossesses himself of the premises, s/he ceases to be an occupier, though s/he may still be liable under the Defective Premises Act 1972, which imposes a duty on landlords with regard to the repair of their premises. In this respect the landlord owes the same duty to trespassers as to others.

Persons protected

The law divides persons coming on to property into two groups: authorised visitors and trespassers. Liability for visitors is governed by the 1957 Act and for trespassers the 1984 Act.

The common duty of care owed to visitors

Section 2(1) of the 1957 Act states that, generally, the occupier owes the same duty to all his visitors. This duty is defined in s.2(2) as a duty 'to take such care as in all the circumstances of the case is reasonable to see that the visitor will be reasonably safe in using the premises for the purpose for which he is invited or permitted to be there'. This is the 'common duty of care'. In *Cotton* v. *Derbyshire DC* (1994) *The Times*, 20 June, the defendants were not in breach of their duty of care in not placing a warning sign on a cliff path, since the dangers should have been obvious to walkers exercising reasonable care. A person entering premises for any purpose in the exercise

of a right conferred by law is treated as permitted by the occupier to be there for that purpose, whether they have his permission or not: s.2(6).

Two categories of visitor are subject to special rules: (i) children where there is an increased duty of care, and (ii) people coming on to premises for the purposes of carrying out work where there is a reduced duty of care in respect of dangers relating to the reason why they have been called in.

Children Under s.2(3) 'an occupier must be prepared for children to be less careful than adults'. The duty in respect of children is very severe. S/he is under a duty 'not merely not to dig pitfalls for them, but not to lead them into temptation'. This means that the occupier must not have on his/her land things that may act as an allurement or invitation to a child. Thus in *Glasgow Corporation* v. *Taylor* [1922] 1 AC 44, a boy aged seven died from eating berries growing on a poisonous shrub in a public park. The court held that the berries were tempting in appearance to children and that the corporation knew they were dangerous but had taken no steps to warn children of the dangers of picking them. The concept of an allurement involves the idea of 'concealment and surprise, of an appearance of safety under circumstances cloaking a reality of damage'. This quotation comes from *Latham* v. *Johnson & Nephew Ltd* [1913] 1 KB 398, where a child was injured playing with a heap of stones that was not regarded as an allurement and there was no liability. The same was held in *Perry* v. *Thomas Wrigley Ltd* [1955] 1 WLR 1164, where a child fell into a hole in the ground.

In the case of a very young child, the defendant may escape liability on the grounds that s/he could reasonably have expected the child to be accompanied by a responsible person. This was allowed in *Phipps* v. *Rochester Corporation* [1955] 1 QB 450, where the plaintiff aged five (accompanied by his sister aged seven) fell into a 9 ft deep trench on the defendant's land and broke his leg. In *Coates* v. *Rawtenstall BC* [1937] 3 All ER 602 the court regarded a child of fourteen as a responsible person.

People on the property in a professional capacity Under s.2(3)(b) of the 1957 Act the occupier 'may expect that a person [coming on to the premises] in the exercise of his calling, will appreciate and guard against any special risks ordinarily incident to it, so far as the occupier leaves him free to do so'. In *Roles* v. *Nathan* [1963] 1 WLR 1117, two chimney-sweeps employed by the defendants to block up holes in the flue of a central heating system attempted to do so while the boiler was lit and were killed by the build-up of carbon monoxide gas. One of the reasons for the Court of Appeal deciding in favour of the defendant was that this was a risk incidental to their calling that they should have guarded against.

In determining whether an occupier of premises has discharged his/her duty under the Act regard is taken to all the circumstances, so that:

(i) where the damage is caused by a danger of which s/he had been warned by the occupier, the warning on its own will an absolve the

occupier from inability if, in the circumstances, it was sufficient to enable the outer to be reasonably safe (this was an additional factor in *Roles* v. *Nathan*, where the sweeps were warned of the danger by the occupier's agent); and

(ii) where damage is caused by a danger because of the faulty execution of any work of construction, maintenance or repair by an independent contractor employed by the occupier, the occupier is not answerable if … he had acted reasonably in entrusting the work to an independent contractor having satisfied himself that the contractor was competent and that the work had been properly done. In *Cook* v. *Broderip* (1968) 112 SJ 193, B's cleaner C was injured when she plugged the vacuum cleaner into a new socket installed in the house by D, a qualified electrician, but the socket had been negligently installed. B would not be liable vicariously for the work of D, the independent contractor, as long as he had no reason to believe that D was not skilled in his work. The electrician would be liable in negligence.

The common duty of care does not make an occupier liable for risks willingly accepted by the visitor, and the defence of *volenti non fit injuria* is available. In addition, the occupier is further protected by the Law Reform (Contributory Negligence) Act 1945. Thus, in *Bunker* v. *Charles Brand & Son Ltd* [1969] 2 All ER 59, the plaintiff's employers were subcontractors of the defendants for tunnelling in connection with the construction of the Victoria Line of London's underground train system. The plaintiff carried out modifications to a digging machine while it was in operation. He was injured and sued the defendants for damages. The defendants were occupiers for the purpose of the Act. They failed in their defence of consent, since the court held that knowledge of danger was not assent. Nevertheless the plaintiff's damages were reduced by 50 per cent in respect of his contributory negligence.

Occupiers may restrict, modify or exclude liability by displaying prominently a suitably worded notice at the entrance to the premises: s.2(1). This is restricted by the Unfair Contract Terms Act 1977. Thus where the occupation is for business purposes it is impossible to exclude from liability for personal injury or death resulting from negligence: s.2(1). In the case of other loss or damage, any restriction or exclusion of liability is subject to the test of 'reasonableness': s.2(2). Thus non-business occupiers can continue to exclude for liability for personal injury and death. A change to the Unfair Contract Terms Act 1977 was made by the Occupiers' Liability Act 1984 which provides: 'the liability of an occupier of premises for breach of an obligation or duty towards a person obtaining access to the premises for recreational or educational purposes, being liability for loss or damage suffered by reason of the dangerous state of the premises, is not a business liability of the occupier unless granting that person such access for the purpose falls within the business purposes of the occupier'.

Liability for trespassers

Under the Occupiers' Liability Act 1984 an occupier is required to take reasonable steps to protect reasonably foreseeable trespassers from any risk of their suffering injury through reasonably foreseeable dangers. The dangers are those 'due to the state of the premises or things done or omitted to be done on them': s.1(1). Injury covers 'death or personal injury, including any disease and any impairment of physical or mental condition': s.1(9). The occupier incurs liability where s/he: (a) 'is aware of the danger or has reasonable grounds to believe that it exists'; (b) 'knows or has reasonable grounds to believe that the other is in the vicinity of the danger concerned or … may come into the vicinity of the danger', and (c) 'the risk is one against which, in all the circumstances of the case, he may reasonably be expected to offer the other some protection': s.1(3).

The duty owed is to 'take such care as is reasonable in all the circumstances of the case to see that … [he] does not suffer injury on the premises by reason of the danger concerned': s.1(4). The duty may be discharged by a warning of the danger concerned, or discouraging persons from incurring the risk: s.1(5). It does not extend to risks willingly accepted: s.1(6). There is no liability in respect of loss of or damage to property: s.1(8).

4.10 Nuisance

Nuisance is a strict liability tort, where a person can be liable without the need to show that his/her conduct is intentional or negligent. It is necessary to distinguish between private and public nuisance.

Public and private nuisance distinguished

In private nuisance the plaintiff must prove interference with occupation of his/her property, or his/her enjoyment of rights over the property, things such as the right to light, the right to support, or a private right of way causing physical damage to land or substantially interfering with the use or enjoyment of land or an interest in land, where this interference can be said to be unreasonable. It includes indirect interference caused by smoke, vibrations, heat, noise, fumes and overhanging branches and roots of trees. Claims based on public nuisance are not linked with use of land.

Private nuisance can arise from interference with an individual's rights, whereas public nuisance is an act or omission that materially affects the reasonable comfort and convenience of life of a class of Her Majesty's subjects. Something that only affects one or two people cannot be a public nuisance. Examples of public nuisance are brothel-keeping; obstructing public highways or waterways, allowing a dangerous state of affairs to exist which threatens the public generally; and selling impure foods. It has been suggested that, in order to constitute a public nuisance, the interference

with the public right must have continued for a considerable length of time. However, in *Midwood & Co. Ltd* v. *Mayor of Manchester* [1905] 2 KB 597, a sudden explosion was held to constitute a public nuisance. This can be justified in that the nuisance was not the explosion itself but the 'state of affairs' over a period of time which resulted in the explosion: that is, the build-up of gas.

Public nuisance is a crime, which private nuisance is not.

Public nuisance is only tortious where the plaintiff can show that s/he has suffered damage beyond that suffered by the rest of the community. In *Campbell* v. *Paddington Corporation* [1911] 1 KB 869, the defendants were liable for public nuisance for erecting a stand blocking the highway on the occasion of the funeral of Edward VII. The plaintiff was able to recover damages, since the stand blocked the view from her windows and prevented her from letting out her rooms to spectators. In *Castle* v. *St. Augustine's Links* (1922) 38 TLR 615, C was driving along the road in his car. A golf ball shattered his windscreen and a piece of glass went into his eye. The golf ball had been struck by a player teeing off from a tee running parallel with the main road down which C was driving. The court held that the siting of the tee constituted a public nuisance.

Nuisance and negligence

Nuisance (public and private) and negligence overlap, particularly where the interference complained of concerns the escape of things from premises. Nuisance liability arises from the state of affairs which is foreseeably likely to result in damage to the neighbour. In *Bolton* v. *Stone* [1951] AC 850, where a pedestrian was struck by a cricket ball hit over the wall of a club into the road, in the trial court where public nuisance was established the court stated: 'The gist of such a nuisance … is the causing or permitting of a state of affairs from which damage is likely to result.' The final decision was based on negligence and the club were held not liable (see p. 118 above). In *Miller* v. *Jackson* [1977] QB 966, the plaintiff sued a cricket club for damages arising from cricket balls being hit into the garden and causing damage to the property. The court held that the defendants were liable for negligence, since the risk of injury was both foreseeable and foreseen, and that playing cricket constituted a nuisance (see p. 151).

Types of private nuisance

Private nuisance may cause material damage to the property or a substantial interference with the enjoyment of the property.

Indirect interference causing material damage to property

There must be a physical deterioration, which must be visible to ordinary persons without recourse to scientific evidence and a diminution in the property's value. 'Property' includes not just the land itself but also chattels

stored or kept on the land, and it extends to damage to the value of a business carried out on the land. In *St. Helen's Smelting Co.* v. *Tipping* (1865) 11 HL Cas 642, the plaintiff's shrubs were damaged by fumes from the defendant's copper-smelting plant, resulting in considerable diminution in the value of the property. In *Spicer* v. *Smee* (1946) 175 LT 163 the nuisance was the defective electrical wiring in the defendant's bungalow, which caused it to burn down, destroying the plaintiff's adjacent bungalow.

Interference with enjoyment of property

The interference must be substantial in the sense that it must be 'materially interfering with the ordinary comfort physically of human existence not merely according to elegant or dainty modes and habits of living'. However, the loss of one night's sleep can be 'substantial interference', but it is not necessary for the interference to cause injury to health.

Factors taken into account in establishing nuisance

The court will examine the activity complained of, and weigh the nature and circumstances of the defendant's activity against the nature and extent of the interference caused to the plaintiff. The test is objective and the court takes many factors into consideration, including the purpose or motive of the defendant.

Malice on the part of the defendant

In *Christie* v. *Davey* [1893] 1 Ch 316, the defendant hammered on the party wall, blew whistles, banged trays and shouted during music lessons and performances given by the plaintiff, his neighbour. The fact that his noise was motivated by malice distinguished it from the noise made by the plaintiff and made it a nuisance. In *Hollywood Silver Fox Farm* v. *Emmett* [1936] 2 KB 468, the defendant's malice made the firing of guns on his own land actionable nuisance.

Social value of defendant's activity

The more worthwhile the activity causing the alleged nuisance, the less likely it is to be held to be unreasonable. The court is more generous to power stations and factories than to motorcycle speedway tracks or racecourses. But the mere fact that the activity is worthwhile will not prevent it from being actionable.

The suitability of the locality

In *St Helen's Smelting Co*. v. *Tipping* (1865) 11 HL Cas 642, the House of Lords held that the fact the defendants carried on their business in a fit industrial locality did not allow them to escape from liability. However, in *Pwllbach Colliery Co. Ltd* v. *Woodman* [1915] AC 634, the alleged nuisance was the settling of coal dust on the plaintiff's slaughterhouse and the meat

and sausages inside. The Court of Appeal took the nature of the locality into consideration in rejecting liability. And in *Sturges* v. *Bridgman* (1879) 11 ChD 852, in deciding that the activity of a confectioner, whose noise disturbed a neighbouring physician, was actionable nuisance, the court took notice of the fact that the area was extensively used by the medical profession and stated that what was a nuisance in Belgrave Square would not necessarily be so in Bermondsey.

In *Adams* v. *Ursell* [1913] 1 Ch 269, the court granted an injunction against a fish and chip shop which had opened up next door to the house that the plaintiff had purchased five years before, even though it was a working class area and supplied a public need. In *Dunton* v. *Dover District Council* [1977] 76 LGR 87, the court awarded damages and granted an injunction restricting the opening hours of the playground and the age of the children playing there. In *Bone* v. *Seale* [1975] 1 All ER 787, the Court of Appeal awarded damages to the plaintiff in respect of smells coming from a neighbouring pig farm.

The cost of avoiding the nuisance

The court will consider whether it was practicable for the defendant to prevent the interference or avoid it. If it could be avoided by the expenditure of a reasonable sum, this will show that s/he is acting unreasonably.

The sensitivity of the plaintiff

In *Robinson* v. *Kilvert* (1889) 41 ChD 88, the plaintiff failed in an action for private nuisance when the particularly sensitive paper stored on his premises was damaged by heat from the defendant's cellar which would not have harmed less sensitive goods. And in *Bridlington Relay Ltd* v. *Yorkshire Electricity Board* [1965] 1 All ER 264, the plaintiffs' action failed because they required exceptional freedom from disturbance to operate a television relay service.

Who can sue in respect of private nuisance

A person can only sue where s/he has an interest in the land affected by the nuisance. This restricts the action to the person in possession of the land as owner or lessee rather than a licensee: that is, a person who is on another's land with his/her permission but is not a tenant under a lease. In *Malone* v. *Laskey* [1907] 2 KB 141, the defendants owned a house which they leased to a firm, who sublet it to another firm who employed the plaintiff's husband, who was allowed to live in the house as a perk of his employment. A flush cistern in the lavatory of the house was unsafe, having been loosened by vibrations from the defendant's electricity generator next door. The cistern was negligently repaired by the defendants and the plaintiff was injured when it later fell on her. Her claim for damages in nuisance failed because she was only a licensee. Her claim in negligence was also defeated but this decision was overruled. In two actions,

Hunter v. *Canary Wharf Ltd* and *Hunter* v. *London Docklands Development Corporation* [1997] 2 WLR 684, the House of Lords rejected a right of occupiers of land to sue in nuisance and restated the principle that only a person with an interest in the land could sue. The first action alleged nuisance in respect of interference with the reception of TV broadcasts, and the second deposits of dust caused by the construction of a link road. In respect of the first action, the House of Lords held that an owner was entitled to build on his/her land as s/he wished, subject to planning control, and was not, in the absence of an easement or agreement, liable if his/her building interfered with his neighbour's enjoyment of their land.

It is sometimes possible for a person with a right to possession to sue where his/her interest in the land has been interfered with. A landlord can sue in respect of property leased to a tenant where s/he can establish that there is damage of a permanent nature, as opposed to temporary interference.

There is no authority as to whether damages are obtainable for personal injuries, and cases relating to damage to goods are inconclusive. In *Halsey* v. *Esso Petroleum Co. Ltd* [1961] 1 WLR 683, damages were recoverable in respect of clothes on a clothesline, but in *Cunard* v. *Antifyre Ltd* [1953] 1 KB 551, damages in respect of furniture was refused.

Who can be sued for liability in nuisance

The most obvious party to sue is the occupier of the property from which the nuisance emanates, but a landlord can be jointly liable with the occupier if s/he created the situation causing the nuisance and then leased the property to a tenant, or where s/he authorises, expressly or impliedly, the tenant to create or continue with the nuisance, or where s/he knew or ought to have known about the nuisance before s/he let the premises. Thus, in *Harris* v. *James* (1876) 45 LJQB 545, a landlord was liable for nuisance where he let out his field for the purpose of quarrying lime. However, in *Smith* v. *Scott* [1973] 3 All ER 645, a local authority was held not liable for allowing into a house offensive and undesirable tenants whom it knew were likely to cause a nuisance, since they had not authorised the nuisance.

An employer will be vicariously liable for nuisances created by his/her servant in the course of his/her employment.

An occupier may even be liable for a state of affairs created by a trespasser depending on whether s/he knew of, or ought to have known of, the nuisance; and for nuisance caused by nature or by a previous occupier where s/he is aware of the hazard or the foreseeability of it: for example, for nuisance caused by trees to a neighbouring property, whether the trees were self-sown or planted by a previous owner.

Prescription as a defence to nuisance

A particular defence for nuisance is to claim that the right to commit the nuisance has been acquired because the activity has been carried on

continuously for a period of twenty years. In *Sturges* v. *Bridgman* (1879), where the plaintiff complained of the noise made by his neighbour who was a confectioner, the defence failed because the twenty years ran only from the date the plaintiff had moved his consulting room to the end of his garden adjoining the confectioner, when he first became aware of the noise.

4.11 The Rule in *Rylands* v. *Fletcher*

In *Rylands* v. *Fletcher* (1868) LR 3 HL 330, the defendant, a millowner, employed an independent contractor to build a reservoir on his land. The contractors encountered disused mine-shafts, which connected with mines worked by the plaintiff in adjoining land. The contractors negligently failed to seal them up, and when the reservoir was filled, the mines were flooded. In the judgment of Blackburn J the basis of the defendant's liability was stated in the following terms: 'We think that the true rule of law is, that the person who for his own purposes brings on his lands and collects and keeps there anything likely to do mischief if it escapes, must keep it at his peril, and if he does not do so is *prima facie* answerable for all damage which is the natural consequence of its escape.' The House of Lords qualified this statement by limiting liability to situations where the defendant brought the thing on to his/her land in the course of non-natural use of the land.

There are four ingredients for liability under *Rylands* v. *Fletcher*: (i) the defendant must bring the thing on to his/her land for his/her own purposes; (ii) the thing must be likely to do harm if it escapes; (iii) the use of the land must be non-natural; and (iv) the thing must escape.

Bringing on to his/her land

The defendant does not need to be the owner of the land: liability can arise under a lease or even a licence. In *Charing Cross Electricity Supply Co* v. *Hydraulic Power Co.* [1914] 3 KB 772, the rule covered a company with a statutory right to lay cables under the road.

The thing must be brought on to the land. If it is naturally present on the defendant's land s/he cannot be liable for its escape. Thus there is no liability for the escape of weeds *Giles* v. *Walker* (1890) 24 QBD 656; vermin *Stearn* v. *Prentice Brothers Ltd* [1919] 1 KB 394; rocks *Pontardawe RDC* v. *Moore-Gwyn* [1929]1 Ch 656, and flood-water *Whalley* v. *Lancashire and Yorkshire Ry. Co.* (1884) 13 QBD 131. The escape of naturally occurring objects could constitute private nuisance or even negligence. In *Leakey* v. *National Trust* [1980] 1 All ER 17 the defendants were liable in nuisance for failing to remove naturally occurring earth and debris from their land. And in *Goldman* v. *Hargrave* [1966] 2 All ER 989 the appellant was liable for damage to a neighbouring property by the spread of fire from a tree on his land which had been struck by lightning. He was negligent in not putting the fire out.

The thing must be likely to do harm if it escapes

The rule has been applied to gas, electricity and explosives, but also to leaves. In *Crowhurst* v. *Amersham Burial Board* (1878) 4 ExD 5, the plaintiff was awarded damages when the defendants planted a yew tree whose leaves protruded through the fence and were eaten by the plaintiff's horse, which died. In *Shiffman* v. *Venerable Order of the Hospital of St John of Jerusalem* [1936] 1 All ER 557, the defendants erected a casualty tent in Hyde Park and a flagpole supported by guy ropes. As a result of interference by children, the flagpole fell and injured the plaintiff, who was entitled to damages for negligence; and under *Rylands* v. *Fletcher*. In *Hale* v. *Jennings Bros* [1938] 1 All ER 579, a chair and its occupant broke away from a 'chair-o-plane' run by the defendant and injured the plaintiff, who owned a shooting gallery on adjoining ground.

The escape can be of something connected with the thing brought on to the land. In *Musgrove* v. *Pandelis* [1919] 2 KB 43 the defendant was liable for a fire in an adjoining property caused by a fire in the petrol tank of a car on his property. And in *Att. Gen.* v. *Corke* [1933] Ch 89 the owner of a disused brickworks who allowed people to bring caravans on to the site and live there was liable when the occupants used the neighbouring property as a toilet.

The use of the land must be non-natural

In *Rickards* v. *Lothian* [1913] AC 263 non-natural users was defined as follows: 'it must be some special use bringing with it increased danger to others, and must not merely be the ordinary use of the land or such a use as is proper for the general benefit of the community'. This excludes most domestic and agricultural uses of land, including the working of mines.

Non-natural use includes bulk storage of gas, water or electricity and, in *Smeaton* v. *Ilford Corporation* [1954] 1 All ER 923 sewage, in spite of the reference to the benefit for the community. Benefit to the community has restricted the rule's application. In *Read* v. *J. Lyons* [1946] 2 All ER 471, some of the Law Lords thought that running a munitions factory during wartime was a natural user. In *British Celanese* v. *A. H. Hunt (Capacitors) Ltd* [1969] 2 All ER 1252, the community benefit of the defendant manufacturing electrical components made the use of the land and the storing of strips of metal foil a natural use of the land. However, in *Cambridge Water Co.* v. *Eastern Counties Leather plc* [1994] 1 All ER 53 Lord Goff stated that he did 'not feel able to accept that the creation of employment as such, even in a small industrial complex, is sufficient of itself to establish a particular use as constituting a natural or ordinary use of land'. Cambridge Water Co. sued the defendants, who operated a tannery, concerning the spillage of organochlorines used in the tanning process which, over a number of years, seeped through the tannery floor into the soil below until it polluted a borehole from which the plaintiff extracted water. The defendants' appeal against liability was allowed on the grounds that

they could not in the circumstances reasonably have foreseen that the seepage of the solvent could have cause the pollution of the plaintiff's borehole. The case restricts the scope of the strict liability of the rule to situations where the defendant knew or ought reasonably to have foreseen that those things might, if they escaped, cause damage.

The thing must escape

In *Read* v. *J. Lyons & Co Ltd* [1946], the House of Lords rejected the appellant's claim for damages for personal injury when she was injured by an exploding shell while working in the shell-filling shop of a factory, because the essential element of escape was missing. An escape from property occupied by the defendant on to that occupied by the plaintiff within the same area is sufficient, *Hale* v. *Jennings Brothers* [1938] (above). The escape can be from one room of a house to another. In *Sochacki* v. *Sas* [1947] 1 All ER 344 a fire which started in the plaintiff's room spread to the defendant's room and destroyed his furniture. There was no liability in negligence because it was not known how the fire started and the doctrine of *res ipsa loquitur* was inapplicable. The action in *Rylands* v. *Fletcher* only failed because the fire was a natural use; there was no problem with the issue of escape.

Persons who can sue and the damage for which claims can be made

In *Read* v. *J. Lyons & Co Ltd* [1946] Lord MacMillan stated that the doctrine 'derives from a conception of mutual duties of adjoining or neighbouring landowners' stressing that a necessary requirement should be an escape on to land in which the plaintiff had an interest, and claims could only be brought for damage to land and chattels on that land. In earlier decisions, damages had been awarded for personal injuries, but none subsequent to *Read* v. *J. Lyons & Co. Ltd* [1946].

Defences to *Rylands* v. *Fletcher*

Act of God

This is an event against which no human foresight can provide. It was successful in *Nichols* v. *Marsland* (1876) 2 Ex D 1, where exceptional rainfall caused flooding from artificial lakes on the defendant's land. But doubt is cast on this decision by *Greenock Corporation* v. *Caledonian Ry. Co.* [1917] AC 556, where the appellants built a children's paddling pool in the bed of a stream, obstructing its natural flow. The court held that the defendants were liable when the stream overflowed, damaging the plaintiff's property even though the rainfall 'may be … extraordinary and … unprecedented'.

Act of a stranger

Where the escape is caused by the unforeseeable act of a stranger – as opposed to servants, family, independent contractors, and possibly guests.

In *Rickards* v. *Lothian* [1913], the plaintiff could not recover damages in the absence of proof of negligence when his premises were flooded when a water tap was turned on in the defendant's premises and 'this was the malicious act of some person'.

Contributory negligence

There is no decision on this, but it would undoubtedly be a valid defence.

Statutory authority

The doctrine is excluded if the bringing on to the land and storing is with statutory authority. In *Pearson* v. *North Western Gas Board* [1968] 2 All ER 669 the plaintiff failed in her action relating to personal injury, the loss of her husband and the destruction of her home following an explosion, as the defendants had a statutory duty to supply gas.

Consent of the plaintiff

There are two categories of case where consent is implied. In a landlord and tenant relationship, the tenant is presumed to have consented to the presence of things brought on to the premises at the commencement of the lease. In *Peters* v. *Prince of Wales Theatre Ltd* [1943] KB 73, the tenant of a shop in the defendant's theatre had no cause for complaint when her shop was flooded by the freezing-up of a sprinkler system. The second case is where the plaintiff and the defendant share a building without being in a landlord and tenant relationship and something escapes from part of the building occupied by the defendant into that occupied by the plaintiff. In *Collingwood* v. *Home and Colonial Stores Ltd* [1936] 3 All ER 200 there was no remedy when a fire arising from a fault in the electrical wiring in the defendant's premises spread from the defendant's premises to damage the plaintiff's shop. The argument is based on mutual benefit, but the real reason has often been stated to be that the plaintiff took the premises as they were and must put up with the consequences.

Remoteness of damage

This is clearly a defence following the decision in *Cambridge Water Co. Ltd* v. *Eastern Counties plc* [1994] 1 All ER 53 where the House of Lords established that foreseeability of damage was a prerequisite of liability.

Relationship with other torts

In the *Cambridge Water Co. Ltd* case, Lord Goff approves of Professor Newark's criticism of the legal profession in the late nineteenth century: 'whose conceptions of the boundaries of nuisance were now becoming fogged, failed to see in *Rylands* v. *Fletcher* a simple case of nuisance'. Lord Goff comments on the decision in the case: 'Seen in its context, there is no reason to suppose that Blackburn J intended to create a liability any more strict than that created by the law of nuisance; but even so he must

have intended that, in the circumstances specified by him, there should be liability for damages resulting from an isolated escape.' In spite of the decision in *Hoare & Co.* v. *McAlpine* [1923] Ch 167 it is unlikely that *Rylands* v. *Fletcher* extends to the escape of noise and vibrations. In this case, the defendant was held liable under the rule where a pile driver caused vibrations and damage to the foundations of the plaintiff's hotel. In nuisance there is no automatic liability for the acts of an independent contractor, which is clearly not the case in *Rylands* v. *Fletcher*.

In respect of the tort of negligence, it is clear that a person can be liable under the rule without having been guilty of any negligence. Care, or the lack of it, is an irrelevant factor. On the other hand, it is clear that the court's lack of enthusiasm for the notion of strict liability has allowed defences which lead claims under the rule to merge into claims for negligence, in particular the concept of foreseeability, which is now a condition of strict liability under the Cambridge Water Co. Ltd case.

Recommended Further Reading

Torts, Alastair Mullis and Ken Oliphant (Macmillan Professional Masters, 1993).

Textbook on Torts, Michael A. Jones (Blackstone Press Ltd 6th edn).

Questions

1 What are the three essentials of the tort of negligence which the plaintiff must establish?

2 The 'floodgates argument' attempts to cut back the duty of care. How and why?

3 Generally, purely economic loss cannot be recovered except for negligent misstatement and even then is subject to six points. What are they?

4 In what circumstances does the doctrine of *res ipsa loquitur* apply?

5 How does the defence of *volenti non fit injuria* operate, and how does it relate to contributory negligence?

6 In occupiers' liability there are two categories of 'visitor' to whom special rules apply. Who are they, and how do the rules differ?

7 What are the differences between public and private nuisance?

8 Certain factors are taken into account by the court is establishing nuisance. What are they?

5 Judicial Remedies for Contract and Tort

Learning Objectives

After reading this chapter you will know about:

1. the remedies available for breach of contract and tort: damages, equitable remedies and restitutionary remedies
2. the operation of the doctrine of remoteness of damages for tort and for breach of contract
3. the importance of the plaintiff's need to mitigate his or her loss arising from torts or breach of contract

All legal systems which recognise a law of contract and a law of tort have to solve the problem of the possibility of concurrent claims arising under the two areas of law. The two solutions are (i) to oblige the claimant to claim in contract; or (ii) allow him/her to chose which remedy s/he prefers. In common law countries the law developed in a procedural framework with the law categorised by the forms of action. Only when these were abolished by the Common Law Procedure Act 1852 was the law of obligations reclassified in substantive terms into contract and tort, but the problem of concurrent claims received little consideration until the second half of the twentieth century.

Initially, the courts adopted the first solution, holding that a claim against a solicitor for negligence must be pursued in contract, and in *Groom* v. *Crocker* [1939] 1 KB 194 this was adopted firmly. In *Bagot* v. *Stevens Scanlon & Co. Ltd* [1966] 1 QB 197, Diplock LJ adopted a similar approach in a claim against a firm of architects.

The question is not just one of academic importance. If there is no concurrent liability, a claim based in contract may be statute barred before a person is even aware of it. The consequences of the negligence of professional persons may not be revealed until after the lapse of six years from the date when the breach of contract occurred. The Latent Damages Act 1986, which postpones the accrual of the cause of action until after the plaintiff has the relevant knowledge, is limited to tortious negligence.

The first and most important move towards concurrent remedies in contract and tort came in *Hedley Byrne & Co. Ltd* v. *Heller & Partners Ltd* [1964] AC 465. This provided the opportunity to reconsider the question of concurrent liability. The change of heart came in *Esso Petroleum Co. Ltd* v. *Mardon* [1976] QB 801, which concerned statements made by employees of Esso in precontractual negotiations with Mr Mardon, a potential tenant of a petrol station, concerning the throughput of the

station. He suffered a serious loss when the throughput was less than predicted. The Court of Appeal held that he was entitled to recover damages on the basis of breach of warranty or negligent misrepresentation. Lord Denning dismissed precedents such as *Groom* v. *Crocker* and *Bagot* v. *Stevens Scanlon & Co. Ltd* and held that, in addition to liability in contract, Esso was liable in negligence. The decision was followed in *Batty* v. *Metropolitan Property Realisations Ltd* [1978] QB 554.

In *Midland Bank Trust Co. Ltd* v. *Hett, Stubbs & Kemp* [1979] Ch 384, where the court held that a solicitor could be liable for negligence to his client in tort or in contract, giving the claimant the advantage of a more favourable date of accrual of the cause of action. Oliver J stated: 'There is not and never has been any rule of law that a person having alternative claims must frame his action in one or the other.' The most recent analysis was by the House of Lords, in *Henderson and Others* v. *Merret Syndicates Ltd etc.* [1994] 3 WLR 761. This was one of several cases involving the Lloyd's 'Names'. People who had been placed on syndicates which issued insurance policies making them personally viable without limit should the insured event happen. When they suffered massive losses they sued their agents and sub-agents for damages. Lord Goff dismissed appeals by underwriting agents and held that they owed a duty of care to the Names in tort which was not excluded by the terms of the contract with the Names, and that the Names were free to pursue their action in contract or in tort. They were entitled to claim for purely economic loss, since the relationship between the Names and their agents was a classic example of the type to which the principle in *Hedley Byrne* applies.

Apart from different rules regarding limitation of actions, there are significant differences in the remedies between the two areas of law: specific performance and liquidated damages are limited to breach of contract; different tests apply to remoteness of damage and damages for mental distress; contributory negligence and exemplary damages are only available in tort; and restitutionary damages are more readily available in tort than in contract.

Remedies relieve the plaintiff rather than punish the defendant, with the exception of exemplary damages in tort. Legal remedies are available as of right, whereas equitable remedies – such as specific performance, injunction, rectification and rescission – are discretionary. The remedies available are damages, equitable remedies and restitutionary remedies.

5.1 Damages

Compensatory damages in contract

The aim is to put the plaintiff in the same position as if the contract had been performed. This is called *expectation loss*, and the plaintiff can claim for pecuniary loss, as follows.

Failure to deliver or accept goods or to render a service

Where the goods are readily obtainable elsewhere, damages is the difference between the contract price and the market price when the goods should have been delivered. If the buyer pays above the market price for the substitute goods, the extra amount cannot be claimed. The same applies for a refusal to accept delivery and when the seller sells the goods below market price.

Where there is no available market for goods which have been repudiated, loss of anticipated profit can be claimed. In *Thompson (W. L.) Ltd* v. *Robinson (Gunmakers) Ltd* [1955] Ch 177, the defendants repudiated a contract to buy a new car after one day and the plaintiffs obtained damages for loss of profit on the deal, since there was no demand for the vehicle. In *Charter* v. *Sullivan* [1957] 2 QB 117 in similar circumstances, damages for loss of profit were not awarded, since there were more buyers than cars available. In *Lazenby Garages* v. *Wright* [1976] 2 All ER 770, the court rejected a claim for loss of profits where a buyer repudiated a contract to purchase a second-hand car, which the seller subsequently sold for a higher price. The dealer claimed that, but for the repudiation, he would have sold two cars.

For services, damages is the difference between the contract price and the cost of substituted performance at a date determined by the court.

Supply of defective goods or services

Damages is the difference between what was contracted for and what was delivered, and is based on the cost of cure (putting the defect right) or diminution in value. Generally the cost of cure is granted unless it is shown that the plaintiff has no intention of carrying out the work. In *Tito* v. *Waddell* (No. 2) [1977] Ch 106, the defendant had promised to replant trees on an island after mining operations. Damages based on the difference in value of the island with and without trees were awarded since there was no clear intention of the islanders to replant. In *Radford* v. *De Froberville* [1977] 1 WLR 1262, where the plaintiff sold the defendant land on the basis that the defendant would erect a dividing wall, damages were the cost of building the wall rather than the difference in value (which would have been almost nothing) since the court was satisfied that the plaintiff intended to build the wall. In *Ruxley Electronic* v. *Forsyth* [1995] 3 All ER 268 the plaintiffs built a swimming pool for the defendant which was to be 7′6″ at the deep end for diving. The finished pool was only 6′9″ at the deep end and 6′ at the natural diving point. The trial judge held that this made no difference to the pool's value, that it would cost £21 000 to cure, and it was unlikely and unreasonable that Mr Forsyth would carry out the alterations. He awarded damages of £2500 for loss of amenity. The Court of Appeal reversed the decision and awarded the full cost of the cure. The House of Lords upheld the trial judge. The decision reflects the feeling that damages of £21 000 would overcompensate Mr Forsyth and that it was necessary to find a figure

which, together with a usable pool, would leave him in the same position as he would have been.

Loss of profits

The plaintiff may claim loss of profits if within the reasonable contemplation of the defendant.

Loss of an opportunity

Damages are awarded even though difficult to assess. In *Chaplin* v. *Hicks* [1910] 2 KB 486, the court awarded damages for the loss of the opportunity to be auditioned for a part in a show offered as part of the prize of a competition. Similarly, in *Simpson* v. *London and North Western Rly Co.* (1876) 1 QBD 274, the plaintiff recovered damages for loss of custom when the defendant failed to deliver samples in time for a show, even though no precise assessment of loss was possible.

The award will take into consideration the fact that the plaintiff would have been liable for tax on those benefits: *Beach* v. *Reed Corrugated Cases Ltd* [1956] 2 All ER 652; and *British Transport Commission* v. *Gourley* [1956] AC 185.

As an alternative to expectation losses the plaintiff may claim for losses incurred through acting in reliance on the defendant's promise. In *McRae* v. *Commonwealth Disposals Commission* (1950) 84 CLR 337, the claim was in respect of the expenses of mounting a salvage operation for a non-existing wreck, and in *Anglia Television* v. *Reed* [1972] 1 QB 60, the claim was in respect of expenditure on the pre-production costs of a film when the defendant broke his contract to appear. In all cases it must be shown that the losses were within the reasonable contemplation of the defendant.

Reliance loss is useful when it is difficult to establish a foreseeable expectation of profit. In *CCC Films* v. *Impact Quadrant Films* [1984] 3 All ER 298, the plaintiff's claim was not based on profits lost, but on recovering his initial investment in respect of distribution rights of certain videos. Recovery is not possible where it can be shown that the reliance expenditure would have been lost in any event. Thus a tenant could not recover the cost of improvements to a rented property on a six-month renewable licence: *C & P Haulage* v. *Middleton* [1983] 3 All ER 94.

5.2 Consequential and Incidental Loss

The plaintiff may suffer equally foreseeable but less immediately obvious loss as a result of the breach. Thus defective goods supplied under a contract may damage people or property, and losses following unfair dismissal may extend to pension rights, free health insurance, a company car and so on (see Chapter 12).

In *Jackson* v. *Horizon Holidays Ltd* [1975] 3 All ER 92, the plaintiff recovered damages for his disappointment and that of his wife and

children as a result of a disastrous holiday. In *Jackson* v. *Chrysler* (1978) damages were awarded for 'inconvenience and disappointment' after a holiday was ruined by repeated car breakdowns. There is no award for anguish and vexation for ordinary commercial contracts but only where 'the contract which has been broken was itself a contract to provide peace of mind or freedom from distress'. In *McLeish* v. *Amoo-Gottfried & Co.* (1993) *The Times*, 13 October, the High Court awarded damages for distress and mental anxiety where solicitors for the plaintiff acted negligently in his defence. The court stated that the very essence of the contract had been to ensure his peace of mind by taking all appropriate steps and that it was foreseeable that the plaintiff would suffer mental distress if the solicitors acted negligently. The court was, however, unwilling to give an award for injury to reputation as a separate head of damages.

For contracts of employment, damages are not recoverable for distress in respect of wrongful dismissal: *Addis* v. *Gramophone Co. Ltd* [1909] AC 488 (see Chapter 12).

5.3 Remoteness of Damage in Contract

Even where the loss arises from the breach, the plaintiff's claim may fail if the loss/damage is too remote; the test was established by *Hadley* v. *Baxendale* (1854) 9 Exch 341. The plaintiff ran a mill and when the crankshaft of the mill broke contracted with the defendant carriers to deliver the shaft the following day to a manufacturer as a pattern for making a replacement. Delivery was not made until a week later and the mill was closed for longer than anticipated. The case established liability for (i) losses arising naturally from the breach of contract; or (ii) 'losses such as may reasonably be supposed to have been in the contemplation of the parties at the time the contract was made as a probable result of the breach of it'. The claim for damages because of the extended closure of the mill was neither a natural consequence of the breach nor one within the fair and reasonable contemplation of the parties, since it was conceivable that there was a replacement part.

The test was refined in *Victoria Laundry (Windsor) Ltd* v. *Newman Industries Ltd* [1949] 2 KB 528 to loss being recoverable where it was 'reasonably foreseeable at the time the contract was made as liable to result from the breach'. The defendants were liable for loss of normal profits because the laundry was closed for a longer period than contemplated caused by their delay in replacing boilers, but not for the loss of exceptional dyeing contracts that the plaintiffs were forced to turn down.

A purchaser of goods for resale cannot claim loss of anticipated profit unless the other party was expressly or impliedly notified or could be presumed to have known that they were to be resold. The same applies where the delay or failure to deliver of a carrier results in loss. In *Koufos* v. *C. Czarnikow Ltd, The Heron II* [1969] 1 AC 350, shippers contracted to deliver a consignment of sugar to be sold on reaching Basrah. In breach of

their contract the sugar reached Basrah nine days late, when the price had fallen, and were liable for damages for loss of profit.

5.4 Mitigation of Loss

A person cannot claim for losses which s/he could reasonably have avoided, and a plaintiff has a duty to minimise his/her loss. An employee who is unfairly dismissed must seek alternative employment: *Brace* v. *Calder* [1895] 2 QB 253, although this does not mean accepting re-employment in a position of lower status: *Yetton* v. *Eastwoods Froy Ltd* [1967] 1 WLR 104. A seller of goods faced with a repudiation of the contract must attempt to find a second buyer: *Lazenby Garages* v. *Wright* (1976) (see p. 137). For damages for anticipatory breach: *White & Carter (Councils) Ltd* v. *McGregor* [1961] 3 All ER 1178 (see Chapter 3, p. 101).

5.5 Contributory Negligence

In *Barclays Bank plc* v. *Fairclough Building Ltd and Others* [1995] 1 All ER 289, the plaintiffs appealed against an extension of the defence of contributory negligence to contractual liability. The plaintiffs had engaged the defendants to carry out work including cleaning roofs made of corrugated asbestos sheeting. Because of negligence by a subcontractor, the premises were contaminated with asbestos dust, requiring remedial work of £4m. The defendants claimed contributory negligence, since the work had been supervised by the plaintiffs' own property services division. The Law Reform (Contributory Negligence) Act 1945 s.1(1) provides for reduced damages where the damage is partly the plaintiff's fault and partly the fault of another. 'Fault' is defined in s.4. to include 'negligence, breach of statutory duty, or other act or omission which [gave] rise to a liability in tort or would, apart from this act, give rise to a defence of contributory negligence'. The judge held that the defendant was in breach of an implied contractual duty to take reasonable care which was co-extensive with such a duty in tort, and that the 1945 Act applied. The Court of Appeal held that contributory negligence was not a defence to a claim for damages founded on a strict contractual obligation. Where liability arose from breach of a contractual provision, contributory negligence did not apply, even though the defendant might have a parallel liability in tort for such a failure.

5.6 Non-compensatory Damages

Liquidated and unliquidated damages

Contracts may contain a 'penalty clause' setting out the sum payable by way of damages in the event of breach. The clause will only be contractu-

ally enforceable as liquidated damages without a need to establish actual loss where it is a genuine pre-estimate of the likely loss from the breach of contract. Where the court decides that it is merely a threat held over the other party *in terrorem* it cannot be relied on and the parties will have to prove their loss. The burden of proof for showing that a clause is a penalty and not unliquidated damages lies with the defendant. In reaching a decision, the court follows rules established in *Dunlop Pneumatic Tyre Co. Ltd* v. *New Garage Ltd* [1915] AC 847.

Rules for establishing liquidated damages

(i) Where the amount is extravagant and arbitrary in comparison with the greatest loss that could possibly follow the breach, it will not be valid.
(ii) If the breach for which the damages are payable is a failure to pay a sum of money and the damages are greater, it will not be valid.
(iii) Subject to the above, if the damages arise only in the event of the breach of a specific and identified breach, it is valid: *Law* v. *Redditch Local Board* [1892] 1 QB 127.
(iv) If the damages are payable on the happening of one or more or all of several events, of which some may cause serious damage, while others may cause insignificant damage, there is a presumption that the damages are invalid as a penalty: *Ford Motor Co.* v. *Armstrong* (1915); *Campbell Discount Co. Ltd* v. *Bridge* [1962] AC 600.

If the clause is valid it will be enforced even though the plaintiff has suffered greater loss. In *Cellulose Acetate Silk Co. Ltd* v. *Widnes Foundry Ltd* [1933] AC 20 the plaintiffs' claim of £5850 for actual loss caused by the thirty-week delay in the defendant installing plant was rejected. They were only entitled to £20 per week as per a clause in the contract.

Nominal damages

Where there is an infringement of a contractual right but no quantifiable loss, the court will award nominal damages: see *Lazenby Garages* v. *Wright* [1976] 2 All ER 770 (see p. 137) where the plaintiff received £2 damages. In *Surrey County Council* v. *Bredero Homes Ltd* [1993] 1 WLR 1361, the defendants had been granted two separate planning permissions for a site and covenanted with the plaintiff to develop in accordance with the first, but completed within the terms of the second and built seventy-sevent instead of seventy-two houses. The plaintiffs claimed the profits made by the defendants in breaking the contract but were awarded nominal damages, since they had suffered no loss.

5.7 Compensatory Damages in Tort

Damages are classifiable as (i) general damages; and (ii) special damages. General damages are presumed to have resulted from the tortious act,

whereas special damages will have to be specifically proved by the plaintiff. A person suffering permanent physical or mental injury can be awarded damages under a variety of heads. General damages for personal injuries can be grouped under (i) pain and suffering; (ii) loss of enjoyment of life or amenity; (iii) loss of expectation of life; and (iv) loss of earnings (both actual and prospective).

Credit has to be given for benefits received by the plaintiff as a result of the defendant's wrongdoing, but some collateral benefits are exempt, including money received through benevolence and the proceeds of insurance: see *Parry* v. *Cleaver* [1970] AC 1, where the plaintiff's claim for damages for personal injury was not reduced by the amount of the proceeds of a disability insurance. The reasoning in that case was that he did not have to give credit because he had paid the premiums from his own money. The rule has been criticised as producing double recovery. The rule has now been extended to the law of contract in *Hopkins* v. *Norcros plc* (1994) IRLR 18 (see Chapter 12). In personal injuries claims since 1987, the courts have use structured settlements where the damages are paid in a series of tax-free payments. Such awards are facilitated by the Damages Act 1996.

5.8 Remoteness of Damage in Tort

The old test for remoteness was laid down in *Re Polemis and Furniss Withy & Co.* [1921] 3 KB 560, which made the defendant liable for all the direct consequences of his negligence whether or not they were foreseeable. This was effectively overruled by *Overseas Tankship (UK) Ltd* v. *Morts Dock Engineering Co. Ltd, The Wagon Mound* (No. 1) [1961] 1 All ER 404, where the defendants carelessly discharged oil from their ship in Sydney Harbour. The oil was carried to the plaintiff's wharf about 200 yards away where some welding was being carried out and was continued after assurances that it was safe to continue. A spark set light to some cotton rags floating on the water; this caused the oil to catch fire and the result was that the wharf was seriously damaged. The defendants were not liable because they could not reasonably have foreseen that the plaintiff's wharf would be damaged by fire when they negligently discharged the oil into the harbour: 'It is thus a principle of civil liability … that a man must be considered to be responsible for the probable consequences of his act. To demand more of him is too harsh a rule, to demand less is to ignore that civilised order requires the observance of a minimum standard of behaviour' (Viscount Simonds).

From subsequent decisions the following points emerge. First, as long as the type of physical damage was reasonably foreseeable at the time of the negligent action, the manner in which it occurs and the extent of the damage do not need to have been foreseeable. In *Hughes* v. *Lord Advocate* [1963] 1 All ER 705 a young trespasser was injured by a freak explosion caused when a paraffin lamp fell into an open manhole. The

defendants argued that injury by burning was foreseeable, but not injury through explosion. The court held that 'This accident was caused by a known source of danger but caused in a way which could not have been foreseen and in my judgment that affords no defence.' And in *Vacwell Engineering Co. Ltd* v. *BDH Chemicals Ltd* [1971] 1 QB 88 the defendants were liable in respect of failing to label a chemical which they supplied with a warning that it was liable to explode in water. The fact that damage arising from a minor explosion was foreseeable meant they were liable even when the damage was more extensive than could have been reasonably foreseen. And in *Muirhead* v. *Industrial Tank Specialities Ltd* [1985] 3 WLR 993 the supplier of a defective pump was liable for the loss of the entire stock of the plaintiff's lobsters kept in a fish tank. Goff LJ stated: 'If he had found that damage of that type was reasonably foreseeable, then the fact that, by reason of the full stocking of the relevant tank, the fish died more quickly or in a greater quantity was of no relevance, unless it … constituted the sole or contributory cause of the disaster which took place.'

The stress on the *type* of physical damage can be seen in the following cases. In *Bradford* v. *Robinson Rentals Ltd* [1967] 1 All ER 267, the defendants were liable for their employee suffering frostbite after driving a vehicle where he was exposed to the cold, since this was the same type of harm as those that were reasonably foreseeable, namely colds, pneumonia or chilblains. However, in *Tremain* v. *Pike* [1969] 3 All ER 1303, the plaintiff failed in his action for damages when he contracted the rare Weil's disease from contact with rats' urine since it was completely different from the foreseeable outcome of rat-bite or food poisoning. This conflicts with the general principle that a tortfeasor takes his victim as he finds him so that, if, owing to some peculiar weakness, he suffers injury beyond what is foreseeable, the defendant will be liable for the injury suffered. In *Smith* v. *Leech Brain & Co. Ltd* [1961] 3 All ER 1159, a man particularly susceptible to cancer was struck on the lip by some molten metal at work and contracted cancer and died as a result. The widow recovered damages for his death. In *Robinson* v. *Post Office* [1974] 2 All ER 737, the defendants were liable when the plaintiff suffered a minor injury as a result of his employer's negligence and was given an anti-tetanus injection and, owing to an allergic reaction, developed encephalitis resulting in permanent brain damage and disability.

The doctrine of remoteness will not prevent a person from being liable where s/he injures a person who is very rich or who earns a large salary; nor if the damage is to an object of exceptional value such as an old master engraving rather than a reproduction. In addition, there is only a low degree of foreseeability required to establish tortious liability as compared with the remoteness test in the law of contract: *Koufos* v. *Czarnikow Ltd, The Heron II* [1969] 1 AC 350.

Remoteness of damages was rejected for deceit in *Doyle* v. *Olby (Ironmongers) Ltd* [1969] 2 QB 158, where Lord Denning said: 'The defendant is bound to make reparation for all the actual damages directly

flowing from the fraudulent inducement.' This decision has been upheld by the House of Lords in *Smith New Court Securities Ltd* v. *Citibank N.A.* [1996] 3 WLR 1051. The case concerned fraudulent misrepresentation relating to a contract to purchase shares. Lord Browne-Wilkinson laid down a seven-point rule for assessment of damages where the plaintiff has been induced by fraudulent misrepresentation to buy property: (1) the defendant is bound to make reparation for all the damage directly flowing from the transaction; (2) although such damage need not have been foreseeable, it must have been directly caused by the transaction; (3) in assessing such damage, the plaintiff is entitled to recover … the full price paid by him, but he must give credits for any benefits which he has received as a result; (4) as a general rule, the benefits received by him include the market value of the property acquired as at the date of acquisition; but such general rule is not to be inflexibly applied where to do so would prevent him obtaining full compensation; (5) the general rule … will normally not apply where either (a) the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or (b) the circumstances … are such that the plaintiff is, by reason of the fraud, locked into the property; (6) in addition, the plaintiff is entitled to recover consequential losses caused by the transaction; and (7) the plaintiff must take all reasonable steps to mitigate the loss once he has discovered the fraud. His Lordship expressed no view on the adoption of the Doyle measure of damages under the Misrepresentation Act 1967 in *Royscot Trust Ltd* v. *Rogerson* [1991] 3 WLR 57.

With regard to the date of the transaction rule, Lord Steyn stated that: 'If that method is inapposite, the court is entitled simply to assess the loss flowing directly from the transaction without any reference to the date of the transaction … whenever the overriding compensatory rule requires it.' His Lordship, however, reiterated that the limiting principle of mitigation has no special features in the context of deceit. The same principles may apply for other intentional torts.

5.9 Intervening Cause

Liability is limited where intervening natural events break the chain of causation. Thus, in *Carlogie SS Co. Ltd* v. *The Royal Norwegian Government* [1952] AC 292, the plaintiff's ship was damaged in a collision, repaired and then sailed to the USA and was extensively damaged because of the heavy weather. The House of Lords found the defendants not liable for this damage, since it was not a consequence of the collision. However, features which merely aggravate damage that would have been caused in any case rarely break the chain of causation. Thus a carrier by sea who has provided an excessively slow and defective cargo ship remains liable for the loss of the cargo if the ship, once delayed, is caught up in a later catastrophe such as the outbreak of war: *Monarch SS Co. Ltd* v. *Karlshamns Oljefabriker* [1949] AC 196.

A specialised instance of this involving a human intervening act is *novus actus interveniens* where the defendant can escape liability if able to prove that the plaintiff's injury suffered by the plaintiff was the result of the plaintiff's or another person's subsequent and intervening event which broke the chain of causation linking the injury to his/her tortious act. In *Davies* v. *Liverpool Corporation* [1949] 2 All ER 175, the defendants were vicariously liable for the negligence of a tram conductor who remained upstairs, allowing another passenger the possibility of ringing the bell while the plaintiff was still boarding the tram. The action of the passenger did not break the chain of causation between the wrongful act of the conductor and the injury suffered by the plaintiff. However, in *McKew* v. *Holland and Hannen and Cubitts (Scotland) Ltd* [1969] 3 All ER 1621, the plaintiff had suffered an industrial injury through his employer's negligence, resulting in his leg giving way unexpectedly; he fell when his leg gave way while going down stairs without a handrail, but the court held that his action was unreasonable and broke the chain of causation. As long as the plaintiff's action is not unreasonable, there will be no break in the chain of causation. In *Wieland* v. *Cyril Lord Carpets Ltd* [1969] 3 All ER 1006, the plaintiff recovered damages for injuries after falling downstairs at her home. She had previously been injured at work because of the negligence of the defendant and was obliged to wear a neck support, which interfered with her use of her bifocal spectacles, resulting in the later fall.

5.10 Mitigation

Damages are subject to mitigation, thus damages for defamation may be reduced where the defendant was provoked. Mitigation also applies where the plaintiff increases the loss suffered by his/her own actions. In *Luker* v. *Chapman* (1970) 114 Sol. Jo. 788 the plaintiff lost his right leg as a result of an accident partly caused by the defendant's negligence. He was unable to carry on working as a telephone engineer, refused a desk job for less money and took up teacher training instead. The defendant was not liable for damages for the total loss of earnings during teacher training, since the plaintiff should have accepted the office job. However, in *Moore* v. *D.E.R. Ltd* [1971] 1 WLR 1476, the plaintiff was able to claim for a new car when his three-year-old car had been written off in an accident caused by the negligence of the defendant's employee, and for the cost of hiring a vehicle while waiting delivery of the new car. The court was influenced by the plaintiff's need to have a reliable vehicle for his work. This appears contrary to the law relating to mitigation.

5.11 Contributory Negligence

The Law Reform (Contributory Negligence) Act 1945 provides: 'Where any person suffers damage as a result partly of his own fault and partly of

the fault of any other person or persons … the damages recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage': s.1(1). The court assesses the situation and, provided the defendant caused the situation from which the plaintiff suffered, then s/he is liable, but the amount of compensation is reduced according to the degree to which the plaintiff contributed to his/her own injuries.

Contributory negligence can arise: (i) by the plaintiff contributing to the accident – for example, both the plaintiff and the defendant were driving negligently when the accident occured; and (ii) by the plaintiff making the injury or damage suffered more serious – for example, by failing to wear a seat-belt in a car or a crash helmet on a motorcycle: *O'Connell* v. *Jackson* [1972] 1 QB 270.

The operation of contributory negligence can be seen in *Sayers* v. *Harlow UDC* [1958] 1 WLR 623, where the plaintiff became trapped in a public lavatory and attempted to climb out of the cubicle by placing her foot on the toilet roll holder. The roller turned and she fell and was injured, but her damages were reduced by 25 per cent since she was contributorily negligent in standing on the toilet roll holder. In *Froom* v. *Butcher* [1976] QB 286, the plaintiff's damages were reduced by 20 per cent through failing to wear a seat-belt, and in *Owens* v. *Brimmells* [1976] 3 All ER 765 by 20 per cent because the plaintiff knew that the defendant was driving under the influence of drink.

A person liable for deceit is not entitled to plead as a defence that his victim was guilty of contributory negligence: *Alliance & Leicester Building Society* v. *Edgestop Ltd*; *Same* v. *Dhanoa*; *Same* v. *Samra*; *Mercantile Credit Co. Ltd* v. *Lancaster* [1993] 1 WLR 1462.

5.12 Pure Economic Loss

The plaintiff can recover damages: (i) for physical injury, mental suffering and nervous shock where the damage is not too remote; and (ii) for monetary loss caused by physical harm to his/her property which is the foreseeable result of the defendant's negligence, but not for pure economic loss, except in the case of negligent misstatement.

The distinction between (ii) above and pure economic loss is shown in *Spartan Steel and Alloys Ltd* v. *Martin & Co. Ltd* [1973] QB 27, where the defendant's employees negligently damaged an underground electricity cable, cutting off power to the plaintiff's factory, which caused him to pour away molten metal from a furnace and loss of production time. The plaintiff recovered damages for loss of the metal and loss of profit on it, but failed to recover damages for loss of profit arising from the interruption to production, which was pure economic loss. The refusal to allow claims for pure economic loss is on the grounds of public policy relating to the 'floodgates argument'. Cardozo CJ in *Ultramares Corp* v. *Touche* (1931) 174 NE 441, stated that allowing claims for pure economic loss

would lead to liability 'in an indeterminate amount for an indefinite time to an indeterminate class'.

The courts had been prepared to allow recovery for pure economic loss in tort in two situations: (i) liability for negligent misstatement; and (ii) liability for loss caused by expenditure necessary to prevent imminent danger to life or property. Both exceptions had spawned a series of confusing decisions in the 1980s and it had begun to seem as though the rule relating to pure economic loss had been seriously eroded. The most famous case was *Junior Books Ltd* v. *Veitchi Co. Ltd* [1982] 3 All ER 201, where the defendants were held liable for economic loss arising out of the installation of a defective floor.

The exception in respect of negligent misstatement has been seriously reduced by the House of Lords, which has removed the second based on the House of Lords decision in *Anns* v. *Merton London Borough Council* [1977] 2 All ER 492 and which has been overruled in *Murphy* v. *Brentwood District Council* [1990] 2 All ER 908, where the local authority approved defective building plans with inadequate foundations, resulting in settlement and structural defects. The owner-occupier sold the house at a loss and recovered damages against the local authority at first instance and in the Court of Appeal. The House of Lords held that the cost of replacing or repairing a defective item is a contractual claim, and that only harm caused by a defective item is recoverable in tort. In stressing that economic loss is only recoverable in tort if it arises from negligent misstatement, the House of Lords refused to extend the categories of recovery for economic loss, claiming that this was a legislative responsibility.

5.13 Non-compensatory Damages in Tort

Non-compensatory damages can be nominal, contemptuous, aggravated and exemplary. Nominal damages are awarded in cases where the tort is actionable *per se* without proof of loss – for example, trespass to land, and libel. Contemptuous damages are rarely awarded other than by a jury in a defamation case. They indicate that the plaintiff does not deserve more than a technical acknowledgement of having established an infringement of his/her rights. Aggravated damages are awarded where the court thinks them justified. Thus, in *Bisney* v. *Swanston* [1972] 225 EG 2299, aggravated damages were awarded where the defendant spitefully parked a trailer in the car park of the plaintiff's transport café to cause the greatest possible business interference. Exemplary damages are intended to make an example of the defendant or to punish him. In *Rookes* v. *Barnard* [1964] AC 1129, the House of Lords limited the award to cases where: (i) the plaintiff is the victim of arbitrary and oppressive conduct by a government official: *Arora* v. *Bradford City Council* 1990, [1991] 3 All ER 545; (ii) the defendant calculatedly makes a profit which exceeds the plaintiff's loss; or (iii) damages are awarded by statute. In *Cassell & Co. Ltd* v.

Broome [1972] 1 All ER 808, where the publisher and author of a book knew that the money to be made would probably exceed the damages arising from a libel action, £25 000 exemplary damages were awarded in addition to the £14 000 of compensatory damages.

5.14 Equitable Remedies in Contract

Equitable remedies of rescission, rectification, specific performance and injunction may be ordered in respect of contract. For rectification see Chapter 3.

Rescission

Rescission allows an injured party to the contract as a result of misrepresentation, duress, undue influence or any situation where the contract is voidable as a result of some vitiating element to avoid the contract and be restored to the position s/he was in prior to the contract. The remedy can be lost in the following instances.

The injured party affirms the contract

This is when, with full knowledge of the vitiating element, s/he declares him/herself bound by the contract or acts in some way as to imply affirmation. Lapse of time may be treated as evidence of affirmation.

There is lapse of time

A claim for rescission can be defeated under the maxim 'Delay defeats equities' (the Doctrine of *Laches*). In *Leaf* v. *International Galleries Ltd* [1950] 2 KB 86, a five-year delay was considered too much; and in *Allcard* v. *Skinner* (1887) 36 ChD 145, an eight-year delay was considered too much. The acceptable period may be only weeks.

Restitutio in integrum is impossible

The parties must be able to be restored to their pre-contract positions but, where complete restitution is not possible, the court may order rescission subject to the payment of a balancing compensation.

Third parties rights have arisen

In *Phillips* v. *Brooks* [1919] 2 KB 243, jewellers were unable to recover a ring obtained by a buyer on a fraudulent misrepresentation once the ring had been acquired in good faith by a pawnbroker (see Chapter 13). Where the claim is in respect of a contract to purchase shares induced by misrepresentation, the remedy is lost when the company goes into liquidation: *Oakes* v. *Turquand and Harding* (1867) LR 2 HL 325.

Specific performance

Here the court orders the party in breach to perform the contract. Specific performance will not be ordered in the following instances.

Damages is an adequate remedy

Generally, specific performance will only be available where the subject matter of the contract is unique, as with land, artworks or ships. The category of unique goods has been extended to include goods needed for the buyer in his/her business and not elsewhere available. Thus, in *Sky Petroleum Ltd* v. *VIP Petroleum Ltd* [1974] 1 All ER 954 an oil company was ordered to supply petrol to a garage during a petrol shortage.

For contracts for personal services

No court can compel an employee to work by ordering specific performance of the contract or by restraining the breach of such a contract by injunction.

For contracts where there is no valuable consideration

This also applies to legally binding contracts by deed: *Cannon* v. *Hartley* [1949] Ch 213. The rule is that equity will not aid a volunteer.

Where the performance requires supervision by the court

The court refused to enforce an obligation by a landlord to have a porter constantly in attendance: *Ryan* v. *Mutual Tontine Association* [1893] 1 Ch 116. However, in *Posner* v. *Scott Lewis* [1986] 3 All ER 513, the court specifically enforced a covenant to provide a resident porter. In *Co-operative Insurance Society Ltd* v. *Argyll Stores (Holdings) Ltd* [1997] 3 All ER 297 the House of Lords reversed an order for specific performance of a covenant in a lease to keep a shop open during normal business hours since this would require constant supervision. It could also unjustly allow the plaintiff to enrich him/herself at the defendant's expense if the latter was forced to run a business at a loss. Contracts to build or to deliver goods by instalments will not be specifically enforced.

Where there is no mutuality

The court will not order specific performance against the defendant if it cannot at the same time ensure that the unperformed obligations of the plaintiff will also be specifically performed. Thus, if A promises to convey a house to B if B promises to work for him for ten years, B cannot get specific performance against A, because his own promise to work cannot be specifically enforced.

In addition, the remedy will only be granted where it is 'just and equitable to do so' and may be refused where (a) the contract is unfair; or (b) the plaintiff has behaved unreasonably; or (c) the defendant would

suffer undue hardship; or (d) the defendant made a bona fide and reasonable mistake; or (e) there has been undue delay in seeking the remedy.

The court may order damages in lieu of or in addition to specific performance: Supreme Court Act 1981 s.50.

Injunction

An injunction may be prohibitory and order the person to refrain from doing something, or mandatory and compel him/her to carry out some action – for example to pull down a house built in breach of a restrictive covenant: *Wakeham* v. *Wood* (1982) 43 P&CR 40. An injunction can be granted where a wrong has already been committed to prevent its continuance but equally an injunction can be to prevent an apprehended legal wrong, though none has occurred at present: this is a *quia timet* injunction. An injunction can be interlocutory or perpetual. An interlocutory injunction is granted at an early stage of the proceedings and generally expressed to stay in force until the trial of the action. Similar to this is the interim injunction, which is usually granted in cases of urgency pending the seeking of an interlocutory injunction. The perpetual injunction is granted at the trial or hearing at which the final judgment is given. Injunctions are used to enforce a negative promise in a contract, such as a promise not to build or not to compete. However, even where a contract does not contain an express negative stipulation, there may be an implied negative stipulation.

In cases of exclusive contracts of service the court will only enforce an express negative stipulation where it encourages but does not compel performance of the contract. Thus in *Lumley* v. *Wagner* (1852) 5 De G.M. & G 604, the defendant agreed to sing at the plaintiff's theatre twice weekly for three months, and also promised not to perform at any other theatre during that period. She was restrained by injunction from singing elsewhere. In the later case of *Warner Bros. Pictures Inc.* v. *Nelson* [1937] 1 KB 209, Bette Davis was restrained from breaking her exclusive service contract with the plaintiff by an injunction preventing her from working for another studio. The court held that, since she was a multi-talented woman with many possibilities open to her, the injunction did not compel her to work for the plaintiff. In *Page One Records Ltd* v. *Britton* [1968] 1 WLR 157, the court refused an injunction against the pop group 'The Troggs', restraining them from working for anyone else but the plaintiff. The court held that, since performing as a group was all that the defendants were able to do, they would in fact be compelled to work for the plaintiff. Injunctions are sought to prevent breaches of confidence or of a restraint of trade covenant.

Equitable remedies in tort

Prohibitory injunctions are appropriate to prevent the continuation or repetition of a tort, and are available for any tort. But prohibitory permanent injunctions have generally been sought in relation to nuisance and trespass to land.

In respect of nuisance, the court exercises its power to grant an injunction very carefully. Where temporary noise and disturbance is caused by building operations, such as demolitions, conversions or repairs, no tort will be committed as long as the work is carried out with reasonable care for the neighbours, but in *De Keyser's Royal Hotel Ltd* v. *Spicer Brothers Ltd* (1914) 30 TLR 257 the plaintiff obtained an injunction preventing the defendants operating a pile-driver between 10.00 pm and 6.30 am. And in *Kennaway* v. *Thompson* [1980] 3 All ER 329 the Court of Appeal replaced an award of damages for future interference caused by motor-boat races and water-skiing on the lake near the plaintiff's house, with an injunction restricting the racing activities and the noise level of boats. However, in *Miller* v. *Jackson* [1977] QB 966, the Court of Appeal refused an injunction to stop the playing of cricket on a village green, since the houses to which it constituted a nuisance had been built later where they were clearly vulnerable to interference, and the plaintiff bought the house knowing that cricket was played on the green. The refusal was also out of respect for the interests of the village as a whole.

5.15 Restitutionary Remedies

These reverse unjust enrichment and include an account of profits, an action for money had and received, and restitutionary damages. The essence of restitution is that the defendant has acquired a benefit or has negatively benefited by saving an expense which would otherwise have been incurred where the enrichment derives from the breach of contract or tort.

Restitutionary remedies in contract

These cover recovery of money or recompense in quasi-contract.

Recovery of money

Money paid under a contract may be recovered: (i) where there has been a total failure of consideration; or (ii) where a contract is rescinded; or (iii) under the Law Reform (Frustrated Contracts) Act 1943; or (iv) where the contract was invalid, for example void for mistake.

Recompense in quasi-contract

The right to payment of a reasonable sum for goods or services supplied may arise in the following situations.

(a) Where a contract to supply goods or services does not fix the price, the seller/supplier is entitled to a reasonable price/remuneration: see Sale of Goods Act 1979 s.8(2); Supply of Goods and Services Act 1982 s.15 (see Chapter 13). This is also where the contract is void for uncertainty.

(b) Where the parties have agreed remuneration under a contract which is void: *Craven-Ellis* v. *Canons Ltd* [1936] 2 KB 403.
(c) Where the contract has been frustrated.
(d) Where the court ignores the contract price and orders payment of a reasonable sum, e.g. necessaries have been sold and delivered to a minor, Sale of Goods Act 1979 s.3.
(e) Under the exceptions to complete performance.

Restitution in tort

An action for money had and received

The most obvious application is in the tort of conversion, where the defendant derives a benefit from the plaintiff's property or the proceeds from it. Other cases arise out of the tort of trespass to goods and to land. Thus, in *Oughton* v. *Seppings* (1830) 1 B & Ad 241, the plaintiff recovered the proceeds of sale of a horse which had been wrongfully seized by a sheriff's officer and later sold.

Restitutionary damages

In *Strand Electric Engineering Co. Ltd* v. *Brisford Entertainments Ltd* [1952] 2 QB 246, the plaintiff was awarded damages representing the reasonable hire of property for the period that they had been wrongly retained and used by the defendant. And in *Penarth Dock Engineering Co. Ltd* v. *Pounds* [1963] 1 Lloyd's Rep 359, the plaintiffs won damages assessed on the basis of the benefits derived by the defendant by failing to remove their pontoon from the plaintiff's dock, by which they became trespassers. A similar approach was taken in *Swordheath Properties Ltd* v. *Tabet* [1979] 1 WLR 285, when damages for trespass were calculated on the ordinary letting value of the property.

Account of profits

This equitable remedy is available for infringements of intellectual property rights, patents, copyrights, trademarks, passing off and breach of confidence (see Chapter 9).

Recommended Further Reading

Remedies for Torts and Breach of Contract, A. Burrows, 2nd edn (Butterworths, 1994).

Questions

1 Distinguish between expectation loss and reliance loss in respect of remedies for breach of contract.
2 When can a plaintiff claim damages for 'anguish and vexation' in respect of breach of contract?
3 What are liquidated damages, and what are the rules for establishing them?
4 Compensatory damages for breach of contract and tort are both subject to the doctrine of remoteness of damage. How do they differ, and on what legal decisions are they based?
5 Non-compensatory damages in tort include nominal, contemptuous, aggravated and exemplary damages. What is the difference between them, and when are they awarded?
6 In connection with which remedy does the concept of *restitutio in integrum* arise?
7 How do the equitable remedies of specific performance and injunction overlap in respect of breaches of contract?
8 On what occasions does an action in quasi-contract arise?

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Part III

Business Organisations

6 Business Organisations

Learning Objectives

After reading this chapter you will know about:

1. the different forms of business organisation: the sole trader, the partnership and the registered company
2. the different forms of registered company: unlimited, and limited by guarantee or limited by shares
3. the essential difference between the public and the private company limited by shares
4. the concept of the registered company as a separate legal person and occasions when the veil of incorporation can be judicially or statutorily lifted
5. the essential differences between the partnership and the registered company

6.1 Business Organisations in the UK

The business organisations in England and Wales are the *sole trader*, the *partnership* and the *registered company*. There are advantages and disadvantages associated with these different forms. The most important distinction is that, where persons choose to register a company, the company is a juridic or artificial legal person which, with certain obvious exceptions, has the same rights and liability under the law as a natural person. There is no creation of a separate legal person in the case of the sole trader or the partnership. The main consequence is that the registered company provides the protection of limited liability for its members.

6.2 The Sole Trader

The proprietor may, of course, employ other people, but the responsibility for the success or failure of the enterprise is in the hands of the sole trader, who will usually raise the capital of the business by loans from banks against the security of charges on his/her private property, such as a house, a life insurance policy or shares. The proprietor retains all the profits but is liable for all the losses up to the full extent of his/her private fortune and any legal action in respect of the business will be against the proprietor. The business may trade under a business name, in which case the Business Names Act 1985 must be complied with (see Chapter 7).

The proprietor has great freedom but suffers disadvantages including: (i) limited capital; (ii) limited borrowing; (iii) problems with holidays and

sickness; and (iv) limited scope for expansion, but these would not necessarily be removed by incorporation.

6.3 The Partnership

The partnership allows for an increased capital base, improved borrowing and reduces the problems relating to holidays and sickness. Partnerships are formed and regulated under the Partnership Act 1890 (PA 1890) which defines a partnership as 'the relation which subsists between persons carrying on a business in common with a view of profit': s.1 (1) PA 1890. There must be at least two persons and the term 'business' includes any 'trade, profession or occupation': s.45 PA 1890. The stipulation relating to profit means that the form cannot be used for charitable or non-commercial purposes.

The partnership is not a separate legal person under the law, and partners are jointly liable for the debts and obligations of the partnership without limit: s.9 PA 1890; and jointly and independently for torts committed by partners and employees of the firm: s.12 PA 1890 – even for partners who do not play an active part in the management of the business (so-called 'sleeping partners'). Partnership is not suitable for a person who merely wishes to invest money in a business without incurring any further exposure to risk (see Chapter 7).

6.4 The Registered Company

The Companies Act 1985 (CA 1985) provides that 'any two or more persons, associated for any lawful purpose may, by subscribing their names to a memorandum of association and otherwise complying with the registration requirements of this Act … form an incorporated company, with or without limited liability': s.1(1), CA 1985. However, notwithstanding s.1(1), one person may form a private company limited by shares or by guarantee: s.3A CA 1985. This is under the Companies (Single Member Private Limited Companies) Regulations 1992 implementing the 12th EC Company Law directive. This is not significant for English company law, where the one-person company has been a *de facto* reality since *Salomon* v. *Salomon* (1897) (see below).

Unlimited liability companies

Because their members are fully liable for the debts of the company as in a partnership, they are not subject to the public disclosure required of limited liability companies where there is an obligation to disclose corporate information to the public through the Annual Return to the Registrar of Companies, and the requirement for an annual audit of its

accounts. This is the price paid for the benefit of limited liability unless the limited company remains within statutory size criteria when it can benefit from disclosure and audit exemption (see below). The fact that privacy is now available to small limited liability companies has removed the main reason for forming an unlimited liability company and there are very few in existence.

Limited liability companies

Although the company is always fully liable for its debts, the members of such companies have limited liability for the company's debts and liabilities. There are two forms of limited liability company: the company limited by guarantee, and the company limited by shares, of which only the latter is suitable for trading.

Companies limited by guarantee

The members are required to contribute to the company's assets on liquidation the amount guaranteed when they became members. The form is used for charitable, educational or other worthwhile purposes: for example, the League Against Cruel Sports, the British Ski Federation and London Guildhall University. They can drop the word 'limited' from their name, although their exact status must be disclosed on letterheads and other documents.

Private and public companies limited by shares

The liability of the members is limited 'to the amount, if any, unpaid on the shares respectively held by them': s.1(2)(a) CA 1985. This is the most usual form of all trading companies and is the only company that can exist as a private or a public company. The others can only exist as private companies.

Private companies cannot invite the public to subscribe for shares or debentures (loan stock). Thus private companies are restricted to raising their money through institutional sources or from the sale of shares by private treaty, or to members of the family of shareholders or employees. A public company is one where the Memorandum of Association states that it is a public company, while a private company is defined as a company that is not a public company: s.1(3) CA 1985. Public companies are more closely regulated, since there is a greater need to protect the general public.

Differences between public and private limited companies include:

(i) A private company has the word Limited (Ltd) as the last word of its name, whereas the public company has the words Public Limited Company (plc).
(ii) The private company can commence trading immediately on incorporation, whereas the public company must obtain a certificate to

the effect that it has raised the minimum capital (£50 000) that is required of a public company.

(iii) The private company may only have one director, whereas a public company must have at least two.

(iv) Directors of private companies are not subject to age limits unless the company is a subsidiary of a public company.

(v) The company secretary of a private company does not need formal qualifications, whereas the company secretary of a public company does.

(vi) Private companies are less strictly regulated, including: restrictions on loans to directors, and regulation of raising and maintenance of capital.

(vii) Disclosure requirements in the annual return are less onerous where the private company is classified as either 'small' or 'medium'. There is also exemption for small and medium-sized groups in respect of group accounts (ss.246–9, CA 1985, see p. 170).

(viii) Private companies can enjoy deregulation, which enables them to dispense with formal meetings of their shareholders. This is by way of regulations allowing written and elective resolutions.

(ix) A private company may be exempt from the statutory audit of their accounts (see p. 170).

Most companies are initially incorporated as private companies and will then 'go public' when they have increased sufficiently in size and need greater freedom to raise capital for expansion. Many public companies seek access to the financial markets. There are two markets for company securities, access to which is regulated by the Stock Exchange. Companies seeking to join the London Stock Exchange's Official List must comply with strict requirements of the London Stock Exchange regarding capital size, length of trading record and the percentage of shares in public hands, which must be at least 25 per cent. There is also the Alternative Investment Market (AIM), for which there are no restrictions on capitalisation, length of trading record or minimum percentage of shares in public hands. Companies whose securities have been traded on AIM can apply to join the Official List after two years. The vast majority of limited liability companies are private.

6.5 Changes in Company Form

Companies can change from limited to unlimited liability companies and vice versa, although only one change is allowed. This involves following the procedure set out in ss.49–51, CA 1985. Changes from private to public for companies limited by shares are normal, and some public companies do re-register as private companies: an example was Virgin Records Ltd. Re-registering as a public or private company involves following the procedures set out by the Companies Act 1985. A private

company may re-register as a public company under ss.43–4, CA 1985. A public company may re-register as private under ss.53–5, CA 1985.

6.6 Groups of Companies: Holding and Subsidiary Companies

A 'group' is the term used to describe a number of related companies. A holding company is at the head of a group of companies, all of which are subsidiaries of the holding company. The relationship between holding companies and subsidiaries may be very complex. A classic example is the Maxwell group of companies.

The legal definition of a subsidiary company is in s.736, CA 1985 (as substituted by the Companies Act 1989), which states that a company is a subsidiary of another company if that other company

(a) holds a majority of the voting rights in it;or
(b) is a member of it and has the right to appoint or remove a majority of its board of directors; or
(c) is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in it, or if it is a subsidiary of a company which is itself a subsidiary of that other company.

A company is a 'wholly-owned subsidiary' of another company if it has no members except that other and that other's wholly-owned subsidiaries or persons acting on behalf of that other or its wholly-owned subsidiaries.

A holding company must generally prepare group accounts in which the financial situation of holding and subsidiary company is consolidated as if they were one person: s.227 CA 1985. A subsidiary company may not ordinarily be a member of its holding company: s.23 CA 1985; and cannot give financial assistance to persons wishing to buy shares in the holding company: s.151 CA 1985 (see Chapter 8).

6.7 General Distinctions between Partnerships and Companies

There are many distinctions between the two organisations, and persons thinking of setting up a business must be able to decide on the advantages and disadvantages of the one over the other.

Formalities

There are no formalities for the formation of a partnership, although normally there will be a formally drafted set of Articles or even a Deed of

Partnership. Partnerships can be formed by verbal agreement and can even be recognised by implication from the facts. The incorporation of a registered company involves compliance with the registration requirements under s.1 CA 1985, which involves:

(i) two or more persons subscribing their names to a Memorandum of Association (one person for private company limited by shares or by guarantee;
(ii) filing a set of Articles of Association (where a set of Articles is not filed, those contained in Table A of the Companies (Tables A to F) Regulations 1985 (S.I. 1985 No 805) will apply);
(iii) filing a Statement of First Directors & Secretary & Registered Office;
(iv) a Declaration of Compliance by the solicitor engaged in the company formation; and
(v) payment of the registration fee (£20).

The Registrar issues a Certificate of Incorporation, which is conclusive evidence that the formalities of registration have been complied with and parol evidence cannot be used to dispute the truth of the date on the Certificate of Incorporation: *Jubilee Cotton Mills Ltd* v. *Lewis* [1924] AC 958.

The Memorandum of Association is the primary constitutional document of the company and relates to the external aspects of the company. Thus it will contain a statement of (i) the name of the company; (ii) whether the company is a public company; (iii) the situation of the registered office (which establishes domicile); (iv) the objects of the company; (v) the liability of the members; and (vi) the authorised capital of the company: s.2 CA 1985. The Articles of Association regulate the internal aspects of the company including the rights of shareholders and rules relating to qualification, disqualification, retirement and rotation of directors. The articles delegate the management of the company to the board and may delegate residuary powers over the board to the general meeting of the shareholders.

Separate legal person

A partnership in England and Wales is not a separate legal person, but a company is separate from the shareholders. This was established in the celebrated case of *Salomon* v. *Salomon & Co. Ltd* [1897] AC 22. The plaintiff, a manufacturer of boots and shoes, incorporated the defendant company with a registered capital of £40 000 to take over the business. At that time the law required at least seven people for the formation of a company, and this was achieved by Mr Salomon together with his wife and five children acting as subscribers and taking one share each in the venture. Subsequently, Mr Salomon sold the business, which he valued at over £39 000, to the company, receiving in return £20 000 in fully paid shares, £10 000 in cash (of which £9000 went in discharging debts and

liabilities of the business), and £10 000 in debentures secured on the assets of the company. At the time of the collapse of the company, these debentures were held by a bank from whom Mr Salomon had raised money to keep the company going. In the trial court the judge suggested that the company had a right of indemnity against Mr Salomon. The other signatories of the memorandum were mere nominees of Mr Salomon and the company was Mr Salomon in another form. He used the company as his agent. The view of the company as agent of and trustee for him was also recognised by the Court of Appeal. However, the House of Lords decided that 'The company is at law a different person altogether from the subscribers to the memorandum: and [...] the company is not in law the agent of the subscribers or trustee for them'. Thus Mr Salomon was not liable to indemnify the company's creditors. This has been called a 'calamitous decision' by O. Kahn-Freund (1944) 7 MLR 54, recognising the validity of 'one-man companies'.

A person can be controller, managing director and also an employee of the company under a separate contract: *Lee* v. *Lee's Air Farming Ltd* [1961] AC 12. This principle of the 'veil of incorporation' separates the incorporators of a company from the company itself. The veil of incorporation also operates between the companies in a group, so that each company is regarded as a separate legal entity. Thus in *Lonrho Ltd* v. *Shell Petroleum Co. Ltd* [1980] 1 WLR 627, the plaintiff failed to obtain disclosure of documents in an action against the defendant company of documents which were held by a subsidiary.

Whereas partnership property is jointly owned by all the partners, a company owns its own property and no member of the company has any interest in it. The consequences can be unexpected and disturbing. In *Macaura* v. *Northern Assurance Company* [1925] AC 619, the plaintiff, the owner of a large timber estate in County Tyrone, formed a company in which he was the principal shareholder, the other shares being held by his nominees, and transferred his estate to the company. Subsequently, when the timber was destroyed by fire, he claimed against the defendant company under an insurance policy held in his own name. The court held that, as a shareholder and creditor of the company, he had no insurable interest in the timber, which was exclusively the property of the company. In *Tunstall* v. *Steigman* [1962] 1 QB 593, Mrs S ran a business in one of a pair of shops of which she was the landlord. The other shop was leased to Mrs T. Mrs S sought to terminate Mrs T's lease to expand her own business into the second shop. She had to establish that she needed the premises to carry on a business run by herself. She had earlier transferred her business to a limited company, of which she was the controller, and the court rejected her application on the grounds that the business was owned and operated by the company and not by her.

There are judicial and statutory exceptions when the corporate veil is lifted or pierced. This does not ignore the existence of the company but allows for the separation between shareholders and company, or between parent and subsidiary companies, to be ignored.

Judicial lifting of the veil

The occasions when the court will ignore the separate corporate identity of the company do not conform to any predictable pattern and there are contradictory decisions. The Court of Appeal has tried to rationalise the occasions when the veil will be lifted; in addition there are other, more specialised, occasions when this will be done.

The Adams decision exceptions As recently as 1985, the Court of Appeal declared that: 'In our view the cases … show that the court will use its power to pierce the corporate veil if it is necessary to achieve justice irrespective of the legal efficacy of the corporate structure': *Re A Company* [1985] BCLC 333. The Court of Appeal rejected this approach in *Adams* v. *Cape Industries plc* [1990] Ch 433, which rationalised the occasions when the court will be prepared to intervene. The case concerned an attempt to enforce judgments obtained in the USA against the defendant company and involved establishing that the UK registered company was present in the USA through the agency of a wholly-owned subsidiary. It was therefore necessary to pierce the veil between the subsidiary and the parent. The court considered the occasions when they would lift the veil under three heads: (i) where the companies were a 'single economic unit'; (ii) where one company was a mere 'façade'; and (iii) where one company is an agent for the other.

With regard to (i), the court limited lifting the veil to cases involving the interpretation or construction of a statute, contract or other document. Thus in *The Roberta* (1937) 58 Ll. L.R. 159, a parent company was held to be liable in respect of bills of lading signed by a subsidiary, since the subsidiary was a separate legal person 'in name only and probably for the purposes of taxation'. And in *Holdsworth & Co.* v. *Caddies* [1955] 1 WLR 352, the defendant's claim that, as managing director of the parent company, he could not be ordered to devote his energies solely to the affairs of the subsidiaries since they were separate legal persons was rejected as too technical. And in *Revlon Inc.* v. *Cripp & Lee Ltd* [1980] FSR 85, where the court was prepared to regard the parent company as proprietor of a trademark actually registered in the name of a wholly-owned subsidiary, the court found that the mark 'is an asset of the Revlon group of companies regarded as a whole'. The court further stated: 'This … does not, in my opinion, constitute what is sometimes called a piercing of the corporate veil; it recognises the legal and factual position resulting from the mutual relationship of the various companies.'

With regard to (ii), the court accepted the piercing of the veil where the corporate structure is a mere façade used to enable the corporators to perpetrate a fraud or to avoid the consequences of a valid contractual obligation. In *Gilford Motor Co. Ltd* v. *Horne* [1933] Ch 935, Horne had been employed by the plaintiff company and was bound by a restraint of trade clause which prevented him from soliciting the clients of his employer on leaving their employ. On leaving he attempted to escape the

clause by forming a company through nominees. The court held that the company was a sham and the covenant was enforced against both Horne and the company. Another example of this is *Jones* v. *Lipman* [1962] 1 WLR 832, where Lipman sought to escape specific performance of a contract for the sale of land by transferring the land to a company. In *Re FG (Films) Ltd* [1953] 1 All ER 615, the court rejected the claim that the company had made a film which could then be registered as a British film. The company had a share capital of 100 £1 shares, of which ninety were held by the American company which financed the film. The court found that the English company was an agent of the American company, and that the film was consequently an American film. This could be seen as a façade case.

With regard to (iii), the court held that a subsidiary may act as an agent for a parent company, in which case the parent company will be bound by its actions. It stated, however, that in the absence of an express agreement it will be difficult to establish. This is to prevent a judge from implying an agency relationship merely from the fact that one company controls another, which would result in the lifting of the corporate veil as often as s/he chose to exercise the right, leading to unpredictability in the law. In *Smith, Stone and Knight Ltd* v. *Birmingham Corpn* [1939] 4 All ER 116, the plaintiff company acquired a business which was carried on by a wholly-owned subsidiary on the plaintiff's land held under a yearly lease to the subsidiary. The corporation compulsorily acquired the premises but refused to pay compensation for the loss of the subsidiary's business, since the subsidiary's lease was too short. The court held that the plaintiff was entitled to claim as it was the principal carrying on business through the subsidiary as agent. The decision seems unjustifiable.

In *Cape Industries*, the court refused to lift the veil under any of the grounds. It was not a case concerning the interpretation of a contract, statute or other document for the purposes of (i). The fact that the company, although a wholly-owned subsidiary, was an independent corporate entity with its own management ruled out (ii), and a finding that the subsidiary was not acting as an agent for the parent but carried on business from its own fixed place of business in the USA ruled out (iii).

With regard to exception (i), the court seems to have limited the importance of *D.H.N. Food Distributors Ltd* v. *Tower Hamlets LBC* [1976] 1 WLR 852 by declaring that it is a case which involved the relevant statutory provisions for compensation. In this case D.H.N. had two wholly-owned subsidiaries. The parent operated a cash and carry business; one subsidiary owned the property on which the business was carried on and the other owned the transport. The local authority compulsorily acquired the land on which the business was carried on and paid compensation to the subsidiary but rejected a claim from the parent for loss of the business, since the parent used the land as a mere licensee and not under a lease. Lord Denning MR in the Court of Appeal stated: 'The three companies should, for present purposes, be treated as one and the parent company, D.H.N., is that one'. Goff LJ declared: 'This is a case in which

one is entitled to look at the realities of the situation and to pierce the corporate veil.'

This decision has been criticised in a later case on the grounds that 'it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere façade concealing the true facts': *Woolfson* v. *Strathclyde Regional Council* 1978 SLT 159, a stance also taken in *National Dock Labour Board* v. *Pinn & Wheeler Ltd and Others*, 15 March 1989 (LEXIS).

In *Creasey* v. *Beachwood Motors Ltd [1992]* BCC 639, the plaintiff obtained the substitution of BM Ltd as defendant to a claim for damages for wrongful dismissal against its subsidiary, WLtd under Order 15, rule 7(2) of the Rules of the Supreme Court (RSC). BM Ltd had paid off WLtd's debts (except the plaintiff) and taken over its assets. WLtd had since been dissolved as a defunct company under s.652 CA 1985. Both companies were in the control of the same persons. However, in *Ord and Another* v. *Belhaven Pubs Ltd* (1998) The Times April 7, the Court of Appeal overruled Creasey as a wrong application of piercing the corporate veil and a misuse of the power of substitution in the RSC. The statement of Slade LJ in *Adams* that: 'Neither in this class of case nor in any other class of case is it open to this court to disregard to principle of *Salomon* v. *Salomon & Co. Ltd* [1897] AC 22, merely because it considers it just to do so' has been restated in Y*ukong Line Ltd of Korea* v. *Rendsburg Investments Corpn of Liberia* (No. 2) [1998] 1 WLR 294, where the trial judge refused to pierce the corporate veil and find the controller of a company the undisclosed principal in a charterparty which the company he controlled had repudiated and where he had subsequently frustrated a Mareva injunction by transferring this company's assets to another company within his control.

Other exceptions The court has been prepared to lift the veil of incorporation in time of war to identify the nationality of the company in relation to the nationality of its dominant shareholders. Thus in *Daimler Co. Ltd* v. *Continental Tyre and Rubber Co. (Great Britain) Ltd* [1916] 2 AC 307, the Continental Tyre and Rubber Co. Ltd was regarded as an enemy alien because its shareholders (with one exception) were German nationals resident in Germany. The same approach was taken in *The Polzeath* [1916] 32 TLR 674.

For the purposes of liability for tax, which is based on residence, the court treats a company as residing at the true place of management. Thus in *Unit Construction Co. Ltd* v. *Bullock (Inspector of Taxes)* [1960] AC 351, three companies registered in Kenya were wholly-owned subsidiaries of a UK registered company and, since the parent exercised real control and management of the subsidiaries, they were 'resident in the UK' for the purposes of the Finance Act 1953, s.20(9).

The veil of incorporation is lifted to establish the company's tortious or criminal liability where proof of the company's intention is required to establish liability. Under the 'identification theory', the court attributes

the intention or knowledge of a person identified with the company as the intention or knowledge of the company. The leading case is *Lennard's Carrying Co. Ltd* v. *Asiatic Petroleum Co. Ltd* [1915] AC 705. The appellant shipowners were sued for damages for the loss of a cargo in a fire caused when a ship ran aground when defective boilers made it unnavigable. A defence existed if the company could show that the loss happened without its 'actual fault or privity'. The House of Lords ruled that fault and privity could be established in respect of a company by establishing the existence of fault or privity in the mind of a person who is 'the directing mind and will' of the company. The company was liable because of the failure of the dominant director to rebut the presumption of liability by establishing that was not aware of the unseaworthiness of the ship.

In *H. L. Bolton (Engineering) Ltd* v. *T. J. Graham & Sons Ltd* [1957] 1 QB 159, where a corporate landlord was capable of an intention to occupy premises, Denning LJ stated, 'A company may ... be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with the directions from the centre. Some of the people in the company are ... nothing more than hands to do the work ... Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.'

The identification theory was used for the first time in 1944 to establish criminal liability of companies. In that year, companies were convicted of intent to deceive, *DPP* v. *Kent and Sussex Contractors Ltd* [1944] KB 146; and for conspiracy to defraud, *R* v. *ICR Haulage Ltd* [1944] KB 551. The House of Lords limited liability to acts by the board, the managing director and other superior officers or people to who they have delegated full discretion to act independently of instructions. In *Tesco Supermarkets Ltd* v. *Nattrass* [1971] 2 All ER 127 the branch manager was not the representative of the company for the purpose of liability under the Trade Descriptions Act 1968 for misleading pricing (see p. 484).

Companies cannot be guilty of murder where there is a statutory penalty of life imprisonment but can be guilty of manslaughter *R* v. *HM Coroners for East Kent, ex parte Spooner* (1987) 3 BCC 636, DC. The case arose from the loss of the *Herald of Free Enterprise*, with the death of nearly 200 passengers. The company, along with five senior managers, was charged with manslaughter but the prosecution failed to establish the necessary *mens rea* for any single manager. The court's refusal to aggregate the knowledge and intentions of a number of directors to form a composite intent for the company resulted in the collapse of the case against the company; *R* v. *P & O Ferries (Dover) Ltd* (1990) 93 Cr App Rep 72. The first conviction of a company for manslaughter arose from the deaths of four teenagers sent on a canoeing trip by a company operating an activity centre, where the managing director's *mens rea* was attributed to the company; *R* v. *OLL Ltd* (1994) *The Times*, 9 December. This highlighted the fact that it is easier for a large company to escape liability than a small

company. In *Re British Steel plc* (1994) *The Times*, 31 December, the company was liable for the death of an employee through a breach of the Health and Safety at Work Act 1974. The company's argument that it had satisfied the requirement of s.3 requiring the company to take such care as was reasonably practicable to ensure that an employee was not exposed to a risk by delegating the work to experienced subcontractors and that there was no involvement of the directing mind and will of the company was rejected by the Court of Appeal, who held that the company could not escape liability by setting up safe systems of work in the boardroom.

The Law Commission has proposed the creation of a new offence of corporate killing, in which death would be regarded as having been caused by the conduct of a corporation if it was caused by a failure in the way in which the company's activities were managed or organised. A company would be guilty only if its conduct fell far below what could reasonably be expected. The Commission has proposed that the offence should be formulated in such a way that it is not necessary to identify any individual with the company in order to convict it. This could therefore equalise the position between small and large companies.

Statutory lifting of the veil

The statutory exceptions include s.24 CA 1985. This is of little significance since the existence of single member private companies. It provides that if a company, other than a private company limited by shares or guarantee, carries on business for more than six months with less than two members, any person who (a) was a member of the company during that time, and (b) knew it was carrying on business with less than two members, will be jointly and severally liable for the company's debts during that period. Liability of directors can also arise where directors of a company created as a public company carry on business without first having received a certificate from the Registrar of Companies to the effect that the statutory minimum capital has been raised: s.117 CA 1985. This is also of little real significance. Further examples are s.349(4) CA 1985 (see Chapter 8); and ss212, 213, 214 and 217 of the Insolvency Act 1986 (see pp. 576–579 below).

Limited liability

All partners have unlimited personal liability for the firm's debts: s.9 PA 1890. The only exception is for limited partners in partnerships created under the Limited Partnerships Act 1907, which are extremely rare. Only limited liability companies allow people to invest capital in a company without risk of further loss. Limited liability may be less of a real advantage in very small companies where shareholders will also be directors, since banks and suppliers will only lend or supply such companies where the directors stand as guarantors and/or surety for any credit advanced.

In addition, the Insolvency Act 1986 can make a director of a company personally liable to contribute to company debts beyond the limit of any shares that may be held under s.212 (misfeasance), s.213 (fraudulent trading) and s.214 (wrongful trading) (see Chapter 19). Companies cannot exempt directors from such liability: s.310 CA 1985, but directors will now generally insure themselves against such liability. Under s.310(3) the policy can be taken out and the premiums paid by the company, but this must be disclosed in the Directors' Report.

Change in business

The partners in a partnership can carry on any legal business on which they agree and can change the business of the firm without formality. A company is restricted by the objects clause of the Memorandum of Association. However, under s.3A CA 1985, a company can register as a 'general commercial company' which enables it to carry on any trade or business whatsoever with power to do such things as are incidental or conducive to the carrying on of any trade or business. There is an unrestricted right to alter the objects by special resolution, s.4 CA 1985.

The problem of the *ultra vires* doctrine, which made void contracts outside the company's objects, has been negatived, as has the position of directors contracting on behalf of the company beyond their authority (see Chapter 8).

Perpetual succession

A partnership will be dissolved by the death or bankruptcy of one of the partners or on his giving notice, failing agreement to the contrary: s.32 PA 1890. The retirement of a partner also terminates a partnership: s.26(1) PA 1890. It can also be dissolved by the court on other grounds: s.35 PA 1890. A company continues to exist as a separate legal person despite changes in its membership or even the death of all of them until it is wound up under the Insolvency Act 1986. Changes in the membership of the company will have no effect on the continued existence of the company. This enables control of companies to change by way of mergers or take -overs.

Participation in management

While all partners have a right to take part in the management of the business: s.24(5) PA 1890, the management of a company is delegated to the board of directors: Table A, Art. 70. This allows investors to escape managerial obligations but is a problem where a shareholder wants a right of participation, since directors can be removed by an ordinary resolution of the General Meeting: s.303 CA 1985.

A way round this problem is shown in *Bushell* v. *Faith* [1970] AC 1099, where there were three equal shareholder/directors, each holding 100

shares. An attempt by two of the shareholder/directors to remove the third from the board by a general resolution was frustrated by a provision in the company's constitution that, in the event of a resolution to remove a director from the board, the shares held by that director should, on a poll, have three votes per share as opposed to the normal one vote per share. In the absence of such a stipulation the director of a quasi-partnership company may claim that his/her exclusion from management entitles him/her to petition for the just and equitable winding up of the company under s.122(1)(g) Insolvency Act 1986: *Ebrahimi* v. *Westbourne Galleries Ltd* [1973] AC 360; or to petition under s.459 CA 1985, on the grounds that the exclusion is 'unfairly prejudicial to the interests of the members, and request the court to order that the member's shares be bought by the other members or by the company under s.461(2)(d) CA 1985 at a value to be fixed by the court (see Chapter 8).

Public scrutiny

Partnership affairs are private, whereas each limited liability company is required to file an Annual Return to the Registrar of Companies. This is filed at the Companies Registry, to which the public has access. These rules are considerably relaxed for small private limited companies and groups defined by statutory criteria. Medium-sized private companies and groups also benefit from some relaxation.

There are three criteria in s.248 CA 1985, and companies must comply with two out of three of the criteria every other year in order to qualify for exemption from the Annual Return. The same exemptions apply to groups of private companies.

Criteria	*Small*	*Medium*
Turnover	£2.8m	£11.2m
Assets	£1.4m	£5.6m
Employees	50	250

Another aspect of scrutiny is the need for accounts to be audited: s.235 CA 1985. Under the Audit Exemption Regulations 1994, companies with a turnover of £90 000 or less and a balance sheet total of not more than £1.4m, are entirely exempt from the statutory audit of their annual accounts: s.249A(1) CA 1985. From the same date, companies with a turnover between £90 000 and £350 000 and a balance sheet total of less that £1.4m will also be exempt, provided that the directors ensure an 'independent report' is prepared by a suitably qualified accountant: s.249A(2) CA 1985. Although directors can exempt their companies from a statutory audit, shareholders do have certain safeguards. Any member or group of members holding at least 10 per cent of any class of the issued share capital may require that a company obtains an audit. If those members wish to have an audit the company must be notified in writing one month

before the year end: s.249B(2) CA 1985. Certain companies are not entitled to take advantage of these exemptions, regardless of size. These include public companies, banking and insurance companies (including insurance brokers), anyone authorised under the Financial Services Act 1986 and a parent or a subsidiary undertaking, s.249B(1) CA 1985.

A company is not entitled to the exemption unless the accounts contain a statement by the directors to the effect that the company fulfils the necessary requirements, in particular that the company has kept proper accounting records, that the accounts give a true and fair view, and that no shareholder has requested an audit: s.249B(4) CA 1985; (The Companies Act 1985 (Audit Exemption) Regulations 1994).

Entry of new partners or members

A partner needs the consent of all other partners to transfer his/her partnership share, which means that there is a power of veto by each partner over new entrants, unless the partnership agreement specifies to the contrary. This has the disadvantage that it makes a partner's share of the firm difficult to transfer. One of the stated advantages of a limited liability company is that the capital is divided into freely transferable shares, which carries with it the disadvantage that there is no control over changes in membership. In practice, however, most small private companies restrict transferability of shares by using a form of pre-emption clause in the Articles of Association. This may provide that members require the consent of other members before they can transfer their shares; it may require the member to offer the shares first to existing members before they can be offered elsewhere; and there may even be an obligation on the other members or directors to buy up the shares: *Rayfield* v. *Hands* [1960] Ch 1. A private company's articles will often give directors absolute discretion to refuse to register transfers of shares, in which case the court will not intervene to order registration unless they exercised their power in bad faith: *Re Smith & Fawcett Ltd* [1942] Ch 304. The burden of proving bad faith is on the person seeking to register: *Charles Forte Investments Ltd* v. *Amanda* [1963] 2 All ER 940.

Raising loans

A partnership is restricted to raising loans on the security of fixed charges, whereas a company can create floating charges over the whole undertaking or a part of the undertaking, including circulating assets such as stock and book debts (see Chapter 10).

Limits on size

There is a maximum of twenty partners in a non-professional partnership, but no restriction on the number of shareholders.

Recommended Further Reading

Company Law, J. Dine, 3rd edn (Macmillan Professional Masters, 1998).

Questions

1 What is the purpose of a company limited by guarantee, and what examples of the format can you identify?
2 Identify five differences between a public and private company limited by shares.
3 Why should the decision in *Salomon* v. *Salomon & Co. Ltd* be described as 'calamitous'?
4 On what occasions did the Court of Appeal in *Adams* indicate that they would be prepared to lift the veil of incorporation?
5 When is the *alter ego* doctrine used?
6 Why is limited liability not always a 'real' advantage of the limited liability company?
7 Limited liability companies are generally subject to public scrutiny. What form does this scrutiny take, and are there exceptions?
8 How, in a small private company, can a shareholder/director ensure his or her right to participate in the management of the company?

7 The Law of Partnerships

Learning Objectives

After reading this chapter you will know about:

1. the nature and formation of the partnership
2. the rights and duties of partners
3. the powers of partners to bind the firm contractually
4. the liability of partners for the contracts and other obligations of the firm and for torts committed by the firm or the partners
5. the ways in which a partnership can be dissolved
6. Limited liability partnerships

7.1 The Essentials of Partnership

The definition of a partnership as 'the relation which subsists between persons carrying on a business in common with a view of profit; Partnership Act 1890 s.1(1) establishes the essential criteria required for proving the existence of a partnership. These are: (i) the existence of a business; (ii) carried on in common; (iii) with a view of profit. The definition stresses that partnership is a relationship and not an organisation in its own right with a separate legal personality. This absence of legal personality and the lack of limited liability of the partners is confused by the way in which partnerships are treated. Thus the firm can sue and be sued in its own name under the Rules of the Supreme Court, but any judgment against the partnership is binding on the partners. In addition, the Insolvent Partnerships Order 1994 (SI 1994/2421) allows a partnership to be treated as an entity which can enter arrangements with its creditors in the same way as can a limited company (see Chapter 19). To add to the confusion, partnerships in Scotland do have a separate legal personality, but partners do not enjoy limited liability.

Partnership law is contained in the Partnership Act 1890 (and all statutory reference in this chapter will be to this Act unless otherwise stated), which was largely declaratory with the exception of s.23. It neither codifies nor consolidates the law and must be read in conjunction with the case law. It is possible for all the provisions concerning the rights and duties of the partners to be varied by the consent of the partners, and many other areas of the Act are excluded by contrary intention.

There are no formalities for the creation of the partnership and, while the partners can draw up a formal deed of partnership or written articles, a partnership can be created by oral agreement or by implication. In *Reid* v. *Hollingshead* (1825) 4 B&C 867, the plaintiff, a London merchant, asked a firm of Liverpool brokers to buy 1000 bales of cotton for him and

take a one-third interest in the proceeds of sale instead of commission. In subsequent letters the relationship between the parties was referred to as a 'joint account', a 'joint venture', a 'joint concern', a 'joint purchase', a 'joint speculation' and a 'joint cotton adventure'. The brokers insured and stored the cotton and later charged it to the defendant as security for a loan. The plaintiff sued for conversion but the court held that the defendant had a good title, since the brokers were partners of the plaintiff. In *Walker West Developments* v. *F. J. Emmett* [1978] 252 E.G. 1171, the court identified as a partnership a business relationship between a land owner and a builder in respect of a development contract which provided for sharing the profits from the development. The fact that there was no agreement regarding the division of losses was not important, and that, failing agreement, they would be shared in accordance with the provisions of the Partnership Act 1890.

The existence of a business

Partnerships are limited to a commercial aim – unlike registered companies, which can have non-commercial and charitable aims. Business includes 'every trade, occupation or profession': s.45, although certain professions are prohibited from operating as a partnership, such as the Bar. The essence is that there must be some commercial venture. This excludes relationships whose basis is merely joint ownership of property without any common commercial venture; thus in, s.2(1) 'Joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership … whether the tenants or owners do or do not share any profits made by the use thereof.'

In *Keith Spicer Ltd* v. *Mansell* [1970] 1 All ER 462, the defendant and another person intended to set up a company to take over and run a restaurant owned by the defendant. They opened a bank account in the name of the proposed company but left off the word 'Limited'. The second promoter ordered goods from the plaintiff for the proposed company, which was never formed, and the plaintiff sued the defendant for the price, arguing that the two persons were partners. The Court of Appeal held that the defendant and the other promoter were working to form a company but not 'carrying on a business in common with a view of profit' within the meaning of the Act. Had they actually started trading in anticipation of the company's incorporation the decision would have been different.

Partnership can be formed for the purpose of carrying through one transaction: *Mann* v. *D'Arcy* [1968] 2 All ER 172.

Carried on in common

There must be participation by two or more persons in the business. The distinction that is important here is between being merely connected with the business in some capacity and participating actively within it. In

Britton v. *The Commissioners of Customs & Excise* [1986] VATTR 204, the court rejected the existence of a partnership between a husband and a wife where the wife merely helped in what was the husband's business. This contribution derived from the domestic relationship rather than anything by way of partnership. In *Saywell* v. *Pope* [1979] STC 824, Mr Saywell and Mr Pope were partners and their wives did some work for the firm. The firm expanded in 1973, after which the wives took a more active part in the business. The firm's accountant suggested that the four should draw up a partnership agreement; this was done, but the agreement was not signed until June 1975. Between 1973 and June 1975, the bank mandate still only mandated Mr Saywell and Mr Pope, the creditors and customers were not notified of any change in the constitution of the firm, and the wives contributed no capital. A share of the profits had been credited to them for 1973 and 1974 but they had never drawn on them. In April 1973, the significance of their joining the firm had been explained to them and they had not objected to liability for the debts of the business. The court agreed with the Inland Revenue that the wives only became partners in 1975 since, before the signing of the agreement, the wives had never done anything in the capacity of partners; they had never been integrated into the firm.

With a view of profit

The major criteria for establishing a partnership is sharing the profits from the business. Prior to *Cox* v. *Hickman* (1860) 8 HL Cas 268, the mere receipt of a share of the pofits was sufficient to establish a partnership. In that case, a partnership got into financial difficulties and the creditors allowed the partners to run the business under their supervision as trustees, taking a percentage of the profits each year until their debts were discharged. The court held that the creditors were not partners in the firm. The decision of the House of Lords is now found in s.2(3), which states: 'The receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner in the firm, but receipt of such a share, or of a payment contingent on or varying with with profits of the business, does not of itself make him a partner in the business.'

This was followed in *Britton* v. *The Commissioners of Customs & Excise* (1986), where the profits from the business were paid into a joint bank account which was both a business account and the domestic account from which the wife drew. The court held that: 'The profit was Mr Britton's and Mrs Britton as his wife had access to it.' Sharing profits did not of itself create a partnership. And in *Saywell* v. *Pope* (1979), the fact that the wives did not draw on the share of profits credited to them was regarded as evidence of absence of receipt of those profits, which required something more than a mere entry in the accounts. What is required is a business in common as well as the sharing of profits. While the sharing of the profits may not itself be sufficient to create a partnership, the sharing of the losses may be taken as strong evidence of such a

relationship, but once again not one that is conclusive. Thus it was regarded as significant in *Northern Sales (1963) Ltd* v. *Ministry of National Revenue* (1973) 37 DLR (3d) 612, but not in *Walker* v. *Hirsch* (1884) 27 ChD 460, where the plaintiff and the defendants had entered into a partnership agreement under which the plaintiff was to be paid £180 p.a. plus one-eighth of the net profits and he was also to bear one-eighth of the net losses. He also lent the business £1500. The agreement provided for four months' notice on either side. The defendants gave the plaintiff four months' notice and he sued for the winding up of the firm, claiming that he was a partner. The court held that he was an employee; this was merely a contract of loan repayable when he left the firm's employment.

The Act attempts to clarify the position and identifies five particular situations when a partnership will not arise: s.2(3):

(a) The payment of a debt by instalments out of the profits of a business.
(b) Remuneration of a servant or agent by a share of the profits.
(c) Payment to a widow or child of a deceased partner of a portion of the profits by way of an annuity. [Note that the provision is extended to widowers by s.6(b) Interpretation Act 1978.]
(d) The advance of a loan to a business … under which the lender shall receive:
    - a rate of interest varying with the profits; or
    - a share of the profits, provided that the contract is in writing and signed by the parties thereto.
(e) Payment to a vendor of a business of a portion of the profits by way of an annuity or otherwise in respect of the sale of the goodwill of the business.

It is important to distinguish between partners and creditors, covered by s.2(3)(a) and (d) above. The first presents no problems but, in respect of s.2(3)(d), the court basically looks to the intention of the parties. In *Re Megavand (ex parte Delhasse)* (1878) 7 ChD 511, Delhasse lent £10 000 to a business, which was repayable only on the dissolution of the firm. The agreement stated expressly that he was not a partner but he received a fixed proportion of the profits and had the right to inspect the accounts and dissolve the firm. The court held that he was a partner. The court was influenced by the fact that the 'loan' was the firm's capital basis. In *Pooley* v. *Driver* (1877) 5 ChD 458 the loan agreement contained a promise by the partners and the lender to observe the covenants of the partnership agreement which gave the lender equal rights with the partners in enforcing the agreement, and this and the profit-sharing made him a partner. In *Re Young, ex parte Jones* [1896] 2 QB 484, Jones and Young entered an agreement under which Jones would lend £500 to Young to be repaid at the rate of £3 per week out of the profits. Jones was to help in the office, have control over the money he had advanced and be entitled to draw bills of exchange. He also had a right to enter into a partnership within seven months. He was held not to be a partner.

The stipulation in (d) was construed literally in a dictum in *Re Fort, ex parte Schofield* [1897] 2 QB 495 where Smith LJ said that, 'if the benefit of the section is desired by the lender, then, under the proviso, the contract must be in writing'.

In *Pratt* v. *Strick* (1932) 17 T.C. 459 a medical practitioner assigned his practice on terms that he would live for three months in the house where the practice was carried on and introduce patients, during which time he was entitled to half the profits and liable for half the expenses. There was no partnership; the practice passed to the purchaser from the date of the assignment.

Persons receiving money under (d) and (e) above are deferred creditors of the partnership: s.3; and will not be repaid their debts unless and until all other creditors of the firm have been paid: s.3, *Re Fort, ex parte Schofield* [1897] 2 QB 495.

The sharing of gross returns can never give rise to a partnership: s.2.(2). In *Cox* v. *Coulson* [1916] 2KB 177 the defendant, the lessee of a theatre, made an agreement with the manager of a group of travelling players to present a play in the theatre. The defendant was to provide the theatre and pay for lighting and advertising and receive 60 per cent of the box office receipts. The plaintiff was injured by a shot during a performance. The defendant was not liable.

7.2 The Formation of a Partnership

Persons capable of being partners

A limited liability company can be a partner if authorised by its memorandum of association: *Newstead (Inspector of Taxes)* v. *Frost* [1980] 1 All ER 363. An enemy alien cannot be a partner.

A minor can be a partner but can repudiate the agreement at any time during minority or during a reasonable period thereafter, but will be unable to recover any money paid under the partnership agreement unless there is a total failure of consideration. In *Steinberg* v. *Scala (Leeds) Ltd* [1923] 2 Ch 452, the plaintiff purchased shares in the defendant company, paying money on application and on one further call made by the company. Being unable to meet any further calls, she repudiated the contract while still a minor and claimed recovery of the money already paid. The claim for recovery failed as there had been no total failure of consideration since the plaintiff had received what she had contract for. In *Corpe* v. *Overton* (1833) 10 Bing 252, the plaintiff, while a minor, agreed to enter a partnership and deposited £100 as security for due performance of the contract. He rescinded the contract before the partnership came into being and was able to recover the deposit since there was total failure of consideration. The minor will not be liable for any of the firm's debts during minority but can ratify them on majority: Minors' Contracts Act 1987. Capital invested by a minor can be used to meet the

firm's debts. The minor can be the firm's and the other partners' general agent even though without personal contractual capacity.

A person who is unsound of mind can escape from a partnership agreement if s/he can show that s/he was unsound of mind when s/he entered the agreement and that the other partner(s) knew that s/he could not understand the nature of the agreement. The fact that a partner is unsound of mind is a ground for the other partner(s) to petition for the firm's dissolution.

Salaried partners

In many firms of solicitors there are people who are described as 'salaried partners', whose names are listed on the stationary but who do not receive a share of the profits. The position of these 'partners' is not covered by the Act. In *Stekel* v. *Ellice* [1973] 1 WLR 191, Megarry J discussed the 'salaried partner'. He contrasted people who were employees whose only qualification was being held out as a partner with a situation where there was a partnership deed with all the partners except one sharing the profits, the one being paid a fixed salary. In this case, the person could be a true partner if s/he is entitled to a share of the profits on winding up. He concluded: 'it seems to me that one must in every case look at the terms of the relationship to ascertain whether or not it creates a true partnership'. In *Nationwide Building Society* v. *Lewis* [1997] 1 WLR 1181. Mr Lewis, a solicitor trading as a sole principal, was joined by W as a salaried partner and W's name was added to the letterheading. L handled a matter for the plaintiff but the final report to them was on stationary with both L and W's names. W claimed that he was not a partner and not liable for L's negligent acts. The High Court held that the title of salaried partner did not create a partnership and that W was not liable as a partner for L's actions. The court's decision that as was, however, liable under s.14(1) as having been held out as a partner was overruled on appeal (see p. 184).

Firm and firm name

'Persons who have entered into a partnership … are … called collectively a firm': s.4. The firm has no independent personality. However, it can sue and be sued in its firm name under the Rules of the Supreme Court, but a judgment against the firm will be against all the partners. Partners may trade under any 'firm name' they please but where the name is not a combination of their own names, the name is subject to: (i) compliance with the Business Names Act 1985; and (ii) the common law tort of passing off.

The Business Names Act 1985

Where a firm carries on business under a name which does not consist of the surnames of all the partners (both individual and corporate),

there is a restriction on the use of words giving the impression that the business is linked with central or local government: s.2(1); in addition, certain words require prior permission: for example, bank, building society, trust and so on: s.3. Where a business name is used, the stationery and so on, must carry the names and addresses of the individual partners and a notice must be prominently displayed at the place of business with the same information: s.4(3). For firms with more than twenty partners the provision in respect of stationery and so on is replaced by a statement that the list of partners is available for inspection at the principal place of business. The sanction for non-compliance with the Act is the discretionary power of the court to dismiss legal proceedings on any contract made when the plaintiff was in breach of s.4(1) or (2): s.5.

Passing off

The firm name must not be so like that of an existing business as to cause confusion in the mind of the public. In *Ewing* v. *Buttercup Margarine Co. Ltd* (1917) 2 Ch 1, the plaintiff, who traded in dairy products in the north of England and Scotland as the Buttercup Dairy, successfully obtained an injunction against the defendant company, which was registered in London. Normally the two concerns must also carry on the same business but this is not absolutely necessary. In *Annabel's (Berkeley Square)* v. *G. Schoek (trading as Annabel's Escort Agency)* [1972] RPC 838, the plaintiff was able to obtain an injunction to prevent the defendants from using their name in a way which would damage the goodwill of their nightclub.

A firm name may consist of the proper names of the partners despite the possibility of confusion provided it does not advertise or mark its goods so as to confuse the public. The court will prevent persons trading under their own name where there is an intention to deceive the public: *Croft* v. *Day* (1847) 7 Beav. 84. A person may trade under an acquired or 'pet name': *Jay's Ltd* v. *Jacobi* [1933] All ER 690.

7.3 Illegal Partnerships

Partnership can be illegal because the business is intrinsically illegal, as in *Foster* v. *Driscoll* [1929] 1 KB 470, where the shipping of alcohol into the USA during prohibition was contrary to the laws of a friendly foreign state; or because the business is carried on illegally. In *Dungate* v. *Lee* [1967] 1 All ER 241, the plaintiff and the defendant set up in business as bookmakers. Only the defendant had a bookmaker's permit, but the plaintiff did not deal with clients. The court held that the Betting & Gaming Act 1960 did not require each partner to have a permit and the partnership was legal and valid. A partnership is an illegal association if the number of partners exceeds the legal maximum, which is twenty for

trading partnerships. Solicitors, accountants and stockbrokers are not subject to any limitation: s.716 C.A. 1985; and many professional firms have been exempt by statutory instrument including patent agents, surveyors, auctioneers, valuers, estate agents, land agents, actuaries, consulting engineers, building designers and loss adjusters.

7.4 The Relationships of Partners to Persons Dealing with Them

Powers of partners to bind the firm

Every partner is an agent of the firm and his/her other partners for the purpose of the business of the partnership; and the acts of every partner who does any act for carrying on in the usual way business of the kind carried on by the firm bind the firm and his/her partners, unless the partner has, in fact, no authority for the firm in the particular matter, and the person with whom s/he is dealing either knows that s/he has no authority, or does not know or believe him/her to be a partner: s.5. Thus for the third person to be able to hold the firm liable:

(i) the act must be in relation to the partnership business;
(ii) the act must be for carrying on business in the usual way; and
(iii) the act must be as a partner and not as an individual.

In respect of (i), s.7 provides that where a partner 'pledges the credit of the firm for a purpose apparently not connected with the firm's ordinary course of business, the firm is not bound, unless he is in fact specially authorised by the other partners'. However, the section preserves the individual liability of the partner.

Point (ii) is illustrated by *Goldbergs* v. *Jenkins* (1889) 15 VLR 36, where a partner borrowed a sum of money at 60 per cent per annum interest instead of between 6 and 10 per cent. The firm was not liable. In *United Bank of Kuwait* v. *Hammoud* [1988] 1 WLR 1051, the Court of Appeal decided that it was the usual type of business for a firm of solicitors to give undertakings to a bank on behalf of a client: that is, that the client's money in the firm's account would in the future be transferred to the bank. The court took evidence from an ex-president of the Law Society. Further, if by agreement between the partners, any restriction shall be placed on the power of the partner to bind the firm, no act in contravention of the agreement is binding with respect to persons having notice of the restriction: s.8. In *Watteau* v. *Fenwick* [1893] 1 QB 346, the plaintiff supplied cigars on credit to the manager of a hotel, who was expressly forbidden to buy cigars on credit. Since cigars were articles that would usually be purchased by a hotel and it was within the scope of the usual authority of a manager of a hotel to buy such goods, the defendant was liable.

7.5 The Distinction between Actual and Usual Authority of Partners

The partnership agreement will not usually specify the partner's actual authority, but it is common to find restrictions so that junior partners may be prohibited from contracting for goods or services beyond a certain level. Usual authority is much more important and depends on whether it is a trading or non-trading firm. In *Wheatley* v. *Smithers* [1906] 2 KB 684, Ridley J said, 'trading implies buying or selling' and on that basis held that an auctioneer was not a trader. The distinction was approved in *Higgin* v. *Beauchamp* [1914] 3 KB 1192, where cinema proprietors were held to be a non-trading partnership. The usual authority of partners has been established as follows.

Trading partnerships

In the absence of express prohibitions the partner is authorised to:

(i) sell partnership goods;
(ii) pledge the partnership goods;
(iii) buy goods on the firm's account;
(iv) borrow money on behalf of the firm;
(v) contract debts on behalf of the firm
(vi) pay debts on its account;
(vii) receive and give receipts for debts due to it;
(viii) draw, make, sign, endorse, accept, transfer, negotiate and procure the discounting of negotiable instruments;
(ix) create an equitable mortgage of the firm's land or buildings;
(x) engage and discharge employees;
(xi) retain a solicitor to recover debts due or to defend an action against the firm; and
(xii) employ a solicitor to defend an action against the firm.

In *Mercantile Credit Co. Ltd* v. *Garrod* [1962] 3 All ER 1103, G was the dormant partner in a business concerned in the letting of garages and repairing cars. The agreement prohibited the buying and selling of cars but the active partner, P, sold a car to the credit company to be let on-hire purchase to a customer. P did not own the car and the plaintiffs claimed the £700 paid for it from G. The court held that P had implied authority to sell the car.

Non-trading partnerships

A partner cannot accept, make or issue negotiable instruments other than cheques and cannot borrow or pledge the partnership property.

Acts for which there is no implied authority

Partners, whether in a trading or non-trading partnership, have no implied authority to:

(i) execute a deed unless authorised by deed;
(ii) give a guarantee in the firm name;
(iii) submit a dispute to arbitration;
(iv) accept property in lieu of money in satisfaction of a firm debt;
(v) make his/her partners partners of another firm; or
(vi) authorise a third person to use the firm's name in legal or other proceedings.

7.6 Liability for Debts and Contractual Obligations

Every partner in a firm is jointly liable with the other partners for all debts and obligations of the firm incurred while s/he is a partner; and after his/her death his/her estate is also severally liable for such debts and obligations, so far as they remain unsatisfied, but subject to the prior payment of his/her separate debts: s.9.

Joint liability means liability interdependently with the other partners to the joint creditors of the firm but not independent (or several) liability. This initially meant that there was only one right of action in respect of the firm debt and that, if this right of action had been used against one or some of the partners but not all of them jointly or in the firm name, then an action could not be brought against a partner not included in that action, even though the judgment remained unsatisfied. The Civil Liability (Contribution) Act 1978 s.3 now provides that 'Judgment recovered against any person liable in respect of any debt or damage shall not be a bar to an action … against any other person who is … jointly liable with him in respect of the same debt or damage.' Section 4, however, provides for a 'sanction of cost' to encourage consolidated actions.

It is still normal for persons dealing with a firm to provide that partners shall be jointly and severally liable, however, since this means that, in the event of the bankruptcy of the firm, they would have an equal claim with other separate creditors against the estate of the individual partner, as well as against the joint assets of the firm. This is better than the right postponed to the claims of separate creditors granted by the Act, s.9. Where a partnership bank mandate provides for joint and several liability, the bank will also be able to claim a right of set-off in respect of credit balances on individual partners' accounts held at the same bank, even if not at the same branch.

7.7 Liability for Torts and Other Offences

A firm can be liable for the general torts of partners (s.10), and for the misapplication of money and property of third persons under s.11. It can also be vicariously liable for the torts of its employees under the normal

common law rules (see Chapter 12). Every partner is jointly and severally liable for torts committed while s/he was a partner: s.12.

Vicarious liability

The firm is only liable where the partner was acting (i) in the ordinary course of the business of the firm; or (ii) with the authority of his co-partners; and where (iii) loss or injury is caused to any person not being a partner. In *Hamlyn* v. *John Houston & Co.* [1903] 1 KB 981, a partner of the defendant firm bribed a clerk of a rival firm to disclose confidential information, thus causing the rival firm to suffer loss. The Court of Appeal held the defendants liable for the wrongful act of the partner. It was in the ordinary course of business to obtain information about a trade rival, whether the means employed were legitimate or illegitimate. However, in *Arbuckle* v. *Taylor* (1815) 3 Dow 160, the other partners of a firm were not liable where one partner had instituted criminal proceedings against the plaintiff alleging theft of partnership property, since it was not within the general scope of the firm's activities, even though the case concerned partnership property.

The firm's liability for the criminal acts of fellow partners is not so far-reaching. 'Innocent' partners may be criminally liable for offences committed by fellow partners under the Trade Descriptions Act 1968, as in *Parsons* v. *Barnes* [1973] Crim LR 537, where one partner recklessly makes a false description (see Chapter 16), but partners will only be criminally liable for a partner's fraud in exceptional circumstances. Criminal liability will not extend to an 'innocent' partner where a partner has committed an offence while 'on a frolic on his own', where the offence requires a particular *mens rea*, or where s/he has committed one of the more serious offences.

Innocent partners are jointly and severally liable to make good any losses sustained by a third party where a dishonest partner has misapplied the third party's money or property. This liability arises in two cases:

(i) where one partner acting within the scope of his/her apparent authority receives the money or property of a third person and misapplies it, the firm is liable to make good the loss: s.11(a); and
(ii) where the firm in the course of its business received the money or property, and it was misapplied by one or more of the partners while it was in his/her custody: s.11(b).

In practice there is little difference between the two. In *Rhodes* v. *Moules* [1895] 1 Ch 236, Rhodes mortgaged his property. He was told by a partner in the firm of solicitors that the mortgagees required additional security and handed over to him some share warrants which the partner misappropriated. The firm was liable under s.11(b), since the warrants had been received by the firm in the ordinary course of business. In *British Homes Assurance Corpn Ltd* v. *Patterson* [1902] 2 Ch 404, the plaintiff appointed a solicitor in a partnership to act for it in mortgage transactions. The solicitor later notified them that he had taken the defendant into partnership and the firm name was changed. Subsequently the company sent a cheque

to the solicitors in the old firm name and, when the cheque was misappropriated, sued Patterson under s.11(a). In this case the court held that he was not liable, since the plaintiff had dealt with the solicitor in his personal capacity and not as a partner in the firm. In *Cleather* v. *Twisden* (1884) 28 Ch D 340 trustees deposited bearer bonds to one partner in a firm of solicitors and he misappropriated them. The other partners were held not liable, since it was not part of the business to accept such securities for safe custody. In addition, they did not know of the deposit.

If a partner improperly employs trust property, then the firm is liable to make good the deficiency only if the other partners knew of the breach: s.13.

7.8 Holding Out: The Liability of the Quasi-partner

'Everyone who by words spoken or written or by conduct represents himself, or who knowingly suffers himself to be represented as a partner in a particular firm is liable as a partner to anyone who has on the faith of any such representation given credit to the firm': s.14(1). However, mere carelessness or negligence will not constitute holding out: *Tower Cabinet Co. Ltd* v. *Ingram* [1949] 2 KB 397 (see below). Continued use of the old firm name after the decease of one of the partners will not make that deceased partner liable simply because his firm continues to feature his name as part of the firm name: s.14(2). A retiring partner risks liability if s/he consciously allowed his/her old association to be treated as if continuing.

In *Bass Brewers Ltd* v. *Appleby and Another* [1997] 2 BCLC 700, A practised on his own account in Sunderland as a chartered accountant and licensed insolvency practitioner under the firm name Latham Crossley & Davis, which he had the right to use under a 'group management agreement' with others carrying on business in various parts of the UK. As receiver for the plaintiffs, A sold a property and a cheque for the proceeds payable to the firm was sent to A by the plaintiff's solicitors. Although paid into the client account, it was later transferred to A's overdrawn practice account and never recovered. The plaintiffs obtained a judgement against A and the group management agreement and were given the right to enforce the judgement against the members of the group management agreement. They appealed on the ground that A was not a member of the firm and that the money had been received by A in his personal capacity. Alternatively they claimed that, if the money had been received by the firm, the payment into the practice account was a breach of trust for which they could be liable under s.13 only if they had notice of the breach of trust. The court held that they had allowed themselves to be held out as members of the firm and that the cheque drawn payable to the firm and paid into an account in the name of the firm had been received by the firm. The court also held that the money had then been misapplied by A under s.11 and not s.13.

The basis of liability under s.14(1) established in *Lynch v. Stiff* (1943) 68 CLR 428 was restated by the Court of Appeal in *Nationwide Building Society* v. *Lewis and Another* (1998) *The Times*, 6 March where the court overruled the High Court's finding that a salaried partner of a firm of solicitors whose

name was on a firm of solicitors' letterheading was liable in a respect of a negligent report submitted by his employer on letterheading on which his name appeared as partner. The court held there was no liability if there was no evidence that the client relied on the holding out and that, although reliance could be inferred, the burden of proof was on the claimant.

7.9 Liability of Incoming and Outgoing Partners

A partner who retires does not cease to be liable in respect of debts or obligations incurred before his/her retirement: s.17(1), and an incoming partner is not liable in respect of debts or obligations incurred before s/he became a partner: s.17(2). However, a novation agreement may release the old partner from past liabilities and pass on those liabilities to an incoming partner coming in to replace him/her: s.17(3).

In certain circumstances a retiring partner will continue to be liable in respect of debts and obligations of the firm incurred subsequent to his departure. Liability will depend on compliance with the requirements of the Act with regard to serving actual notice to existing customers of the firm: s.36(1); and constructive notice to potential customers in the future by way of an advertisement in the *London Gazette*: s.36(2).

The importance of s.36(3) is that it restricts the need to give notice under s.36(2) to people who, although not having dealt with the firm in the past, are aware of the firm and of the existence of the retiring partner in the firm. The subsection also excludes the operation of subsections (1) and (2) as regards partners who have died or who have become bankrupt. In *Tower Cabinet Co. Ltd* v. *Ingram* [1949] 2 KB 397, Ingram and Christmas set up a furniture business called 'Merry's' in January 1946. The partnership was dissolved by mutual agreement in April 1947 and Ingram notified the firm's bankers and arranged with Christmas to notify existing clients of his departure. There was no advertisement in the *London Gazette*. Christmas continued to run the business and, in 1948, ordered furniture from the plaintiffs. The order was confirmed on paper bearing Ingram's name. Ingram had no knowledge of this. The plaintiffs, who had obtained a judgment against Merry's now applied for leave to levy execution against Ingram under s.14 and under s.36(2). Ingram was not liable under s.36(2), since the plaintiffs did not know Ingram as a partner before the dissolution.

7.10 The Relationship of Partners to One Another

The terms of any partnership agreement will determine the relationship between the partners in priority over any contradictory provision in the Partnership Act 1890: s.19. However, where the agreement is incomplete, the Act applies.

The terms of the partnership can be changed expressly or by implication: s.19, so that where a firm operates for a number of years in contradiction to the express provisions of the agreement, the agreement will be varied

by the practice. In *Pilling* v. *Pilling* (1865) 3 de G. J. & Sm 162, a father entered into partnership with his two sons. The articles provided *inter alia* that the father's capital, a mill and machinery, should not be brought into the partnership and that he should receive 4 per cent interest per annum on his capital before profits were calculated. During ten years, each partner was credited with interest on capital. The court held that this was evidence of a new agreement and the mill and machinery were partnership property to be shared between the partners on dissolution. Variation by implication can apply even to a formal Deed of Partnership.

7.11 Partnership Property

Partnership property is held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement (s.20) and includes property originally brought in and property acquired on account of the firm or for the purposes and in the course of the partnership business. Where the property includes land, it will be held on a trust for land under the Trusts of Land and Appointment of Trustees Act 1996, which repealed s.22.

Where there is a clear agreement, there is no problem in identifying partnership property, unless the agreement has been varied as previously discussed. Failing agreement, ownership is established by the Act, which provides that there is no presumption that property was brought into the partnership, but all property bought with the firm's money is deemed partnership property, even if conveyed to or taken in the name of one partner only. In *Miles* v. *Clarke* [1953] 1 All ER 779, the plaintiff, a freelance photographer, joined the defendant as a partner in an existing photography business. The agreement merely related to sharing the profits equally and for payment of a salary to the plaintiff. On winding up the business, the plaintiff claimed a share of the assets, including premises leased by the defendant and other equipment he had installed. The court held that the lease and other equipment belonged to Clark, and Miles retained the value of his personal goodwill. The stock-in-trade and other consumable items purchased by the firm constituted the partnership assets. In *Wray* v. *Wray* [1905] 2 Ch 349, a father, his two sons and a third party carried on a business in partnership, and on his death his widow became a partner. A house was purchased out of partnership funds and the conveyance was in the name 'William Wray'. The court held that the house was partnership property and vested in the four partners as joint tenants. See also *Waterer* v. *Waterer* (1873) LR 15 Eq 402.

A writ of execution shall not issue against partnership property except on a judgment against the firm: *Peake* v. *Carter* [1916] 1 KB 652, s.23(1). However, the High Court or a county court may, on the application by summons of any judgment creditor of a partner, make a charging order on the partner's interest in the partnership property for payment of the judgment debt and interest. It may also appoint a receiver of that partner's share of the profits and of any other money coming to him in respect of

the partnership, and give all other orders and directions as if the charge had been made in favour of the judgment creditor by the partner as required: s.23(2). Where such an order is made, the other partner(s) may at any time redeem the interest charged or, where a sale of property is ordered, purchase it: s.23(3).

Where a partner allows his/her share of the partnership property to be charged, the other partners may dissolve the partnership: s.33(2).

7.12 The Rights of Partners *inter se*

Section 24 gives rights to partners subject to agreement to the contrary.

(1) All partners share equally in the capital and profits of the business and must contribute equally to the losses: s.24(1).

This does not mean where one partner only contributed capital while the other(s) contributed 'know-how', that on the dissolution of the partnership, this capital would then be divided among the partners. It does, however, mean that, even where the capital contribution is unequal, the partners will receive an equal share of the profits and be equally liable for any losses, including losses of capital. For example, A, B and C enter a partnership, with A contributing £10 000 towards the capital, B £5000 and C 'know-how'. If on dissolution the surplus assets after payment of debts is only £6000, in which case £9000 capital is lost, A, B and C will each be required to contribute £3000. For the position where one of the partners is insolvent and unable to contribute to lost capital, see the rule in *Garner* v. *Murray* [1904] 1 Ch 57 (below).

In *Popat* v. *Shonchhatra* [1997] 3 All ER 800, the parties were partners in a business in leasehold premises held in joint names. The plaintiff's capital contribution was £4564 (of which £2700 was a loan from the defendant); the defendant's was £23 064. The partnership was determined and the defendant continued on his own. He bought the freehold and later sold the business at a profit. The plaintiff sued for an equal share in the capital and profits. The county court divided the profits *pro rata* the proportionate capital shares, but the Court of Appeal ordered that, in the absence of any agreement, they were entitled to equal shares.

(2) The firm must indemnify partners in respect of payments made and personal liabilities incurred:
- in the ordinary and proper conduct of the business of the firm; or
- in or about anything necessarily done for the preservation of the business or property of the firm: s.24(2)(a) & (b).

(3) A partner making an advance beyond the amount of capital s/he has agreed to subscribe is entitled to interest at the rate of 5 per cent per annum: s.24(3).

(4) A partner is not entitled to interest on the capital subscribed by him/her: s.24(4).

In practice it is normal for partnership agreements to provide for payment of interest on capital which is to be paid prior to a division of the profits, which will then be divided equally irrespective of the ratio of capital contributed.

(5) Every partner may take part in the management of the business: s.24(5).
(6) No partner is entitled to remuneration for acting in the partnership business: s.24 (6).

It is normal for remuneration to be paid to partners who are actively involved in the running of the business, before the net profits are calculated. In this way working partners receive more than those who do not devote their whole time to the business.

(7) No person may be introduced as a partner without the consent of all existing partners: s.24(7).
(8) Differences as to ordinary matters of partnership business may be decided on by a majority of the partners, but no change made in the nature of the partnership business without the consent of all existing partners: s.24(8), *Highley* v. *Walker* (1910) 26 TLR 685.
(9) The partnership books are to be kept at the place of business, and every partner may have access to and inspect and copy any of them: s.24(9).

In *Bevan* v. *Webb* [1901] 2 Ch 59, the court held that this power to inspect the books could be delegated to a valuer and to any person to whom no reasonable objection could be taken where the purpose for which s/he intended to use the inspection was consistent with the main purpose and well-being of the whole of the partnership.

The expulsion of a partner

No majority of the partners can expel any partner unless a power to do so has been conferred by express agreement between the parties: s.25.

Where the partnership deed states that 'if a partner is guilty of misconduct, the others may expel him', this power cannot be exercised by one partner acting alone: *Re A Solicitor's Arbitration* [1962] 1 All ER 772. Where there is a power of expulsion it must be used in good faith, but allows service of notice of expulsion without warning or opportunity to offer an explanation: *Green* v. *Howell* [1910] 1 KB 846.

7.13 Duties of Partners

Rendering true accounts and full information

Partners are in a fiduciary relationship with other partners and contracts between them require full disclosure. This duty is owed to other partners

or their legal representatives: s.28. In *Law* v. *Law* [1905] 1 CH 140, the parties were brothers and partners. The plaintiff sold his share in the partnership but later discovered that certain assets had not been disclosed to him. He succeeded in an action for misrepresentation against the defendant.

Duty to account for secret profits

Every partner must account to the firm for any benefit derived by him/her without the consent of the other partners from any transaction concerning the partnership property, or from any use by him/her of the partnership property name or business connection: s.29(1). In *Bentley* v. *Craven* (1853) 18 Beav 75, the plaintiff was in partnership with the defendants as sugar refiners. Craven, the firm's buyer, bought sugar cheaply and sold it to the firm at the market price. The court held the firm was entitled to the profit made by Craven. The section also applies to transactions undertaken after the partnership has been dissolved by the death of a partner and before the affairs thereof have been wound up: s.29(2). In *Pathirana* v. *Pathirana* [1966] 3 WLR 666, the parties were partners in a petrol station in Ceylon. R gave notice determining the partnership but before the termination date, he obtained a new agreement with the petrol supplier, giving himself the sole agency. He continued to trade on the same premises under his own name. A discovered the new agreements and claimed a share of the profits. The Privy Council held he was able to claim under s.29(1), which provided for the accountability of a partner arising from the use of the partnership property without the consent of the other partner(s). In *Thompson's Trustee in Bankruptcy* v. *Heaton* [1974] 1 All ER 1239, T and H were partners and as such held the lease of a farm. The firm was dissolved by mutual consent and the farm was occupied by H, and later by a limited company controlled by H and his wife. On H's death, T claimed a half-share of the lease, and in the same year, H's executors acquired the freehold reversion and later sold the farm. T's trustee in bankruptcy successfully sought a declaration that the executors held the reversion as trustees for themselves and T.

There is no need to account if the transaction could not possibly affect the partnership business. In *Aas* v. *Benham* [1891] 2 Ch 244, the defendant was a member of a firm of shipbrokers. He assisted in the formation of a shipbuilding company and used experience and information gained as a shipbroker, using the firm's letterheading from time to time. He was paid a fee and became a director of the company. The other partners sought an account for the fee and salary but their claim was rejected on the grounds that using the information gained from the partnership for purposes outside the scope of the business was allowed. This is contrary to the decison in *Boardman* v. *Phipps* [1967] 2 AC 46 where the appellants acted as agents for a trust which held shares in a private company. As a result of information gained as trustees, the agents purchased nearly all the other issued shares in the company without the prior consent of the trustees and, as a result of their management skills, the shares increased

in value to the benefit of the trust and themselves. In an action brought by one of the beneficiaries of the trust, the House of Lords held that the agents were accountable to the trust for the profit made by them, since their opportunity for making a profit arose because of their agency on behalf of the trustees of the trust.

This latter decision is inconsistent with *Aas* v. *Benham* but is consistent with earlier decisons in the field of secret profits made by directors, which must themselves be seen in the light of the decision in *Island Export Finance Ltd* v. *Ummuna* [1986] BCLC 460 (see Chapter 8).

Duty not to compete with the firm

If a partner, without the consent of the other partners, carries on any business of the same nature as and competing with that of the firm, s/he must account for and pay over to the firm all profits made by him/her in that business: s.30. The partnership agreement would usually prohibit the carrying on of such a business and would make breach of this term grounds for expelling the partner or terminating the partnership.

Right of assignee of share in partnership

An assignment by any partner of his share in the partnership, either absolute or by way of mortgage or redeemable charge, does not entitle the assignee to interfere in the management or administration of the business, or to require any accounts or to inspect the books, but entitles him/her only to receive the share of the profits to which the assigning partner would otherwise be entitled, and the assignee must accept the account of profits agreed to by the partners: s.31(1). The assignee cannot object to the bona fide payment of salaries to partners, even though this will considerably reduce his/her share of the profits: *Re Garwood's Trusts, Garwood* v. *Paynter* [1903] 1 Ch 236.

In case of the dissolution of the partnership the assignee is entitled to receive the share of the partnership assets to which the assigning partner is entitled and, for the purpose of acertaining that share, to an account as from the date of the dissolution.

7.14 Dissolution of Partnership

Dissolution without a court order

By expiration or notice

Subject to agreement, a partnership is dissolved under s.32 PA 1890:

(1) if for a fixed term, by the expiration of that term:
(2) if for a single undertaking, by the termination of the undertaking; and

(3) if for an undefined time, by any partner giving notice to the other or others of his intention to dissolve the partnership.

In the case of partnership at will (3), the dissolution is effective from the date in the notice, or, if not dated, from the date of the communication of the notice: *McLeod* v. *Dowling* (1917) 43 TLR 655. Where the partnership can only be terminated 'by mutual arrangement only', one partner alone serving notice will not effect a termination: *Moss* v. *Elphick* [1910] 1 KB 846. Once given, the notice cannot be withdrawn except with the consent of all the partners: *Jones* v. *Lloyd* (1874) LR 18 Eq 265.

By death, bankruptcy or charge

Subject to agreement, every partnership is dissolved by the death or bankruptcy of any partner: s.33 (1) PA 1890. The articles frequently provide that the business may be continued by the surviving partners where one has died. Partners have the right to dissolve the partnership where a partner allows his/her partnership share to be charged: s.33(2).

Dissolution by express provision

Any circumstance may be made a ground for the dissolution of a firm by the insertion of an express clause to that effect, including unsoundness of mind, physical incapacity, incompatibility, dishonesty (both in connection with and outside the scope of the business). In *Carmichael* v. *Evans* [1904] 1 Ch 486, the court held that a partner convicted of travelling on a train without a ticket could be expelled from the partnership where the agreement provided for flagrant breach of partnership duties.

Dissolution by reason of illegality

All partnerships are automatically dissolved by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the members of the firm to carry it out in partnership: s.34. *R* v. *Kupfer* [1915] 2 KB 321 (enemy alien); and *Hudgell, Yeates & Co.* v. *Watson* [1978] QB 451 (where a solicitor's practising certificate lapsed).

Dissolution by order of the court

The court has power under s.35 to order the dissolution of a firm on the application of a partner in the event of the following.

Mental disorder

The power of the court is under Part VII of the Mental Health Act 1983, s.94(2).

Permanent incapacity

Means other than by reason of mental disorder: s.35(b).

Conduct prejudicial to the business

Where a partner is guilty of such conduct as, in the opinion of the court, regard being had to the nature of the business, is calculated prejudicially to affect the carrying on of the business: s.35 (c). In *Essell* v. *Hayward* (1860) 30 Beav. 130, the partnership could be dissolved where a partner was liable to criminal prosecution for fraudulent breach of trust, whereas in *Snow* v. *Milford* (1868) 16 W.R. 654, no dissolution was made because a partner in a banking firm was guilty of adultery, since there was no injury to the firm.

Persistent breach of partnership agreement

'Where a partner … wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable for the other partner or partners to carry on the business with him' (s.35(d)).

Carrying on business at a loss

When the business of the firm can only be carried on at a loss: s.35(e). It must be a practical impossibility for the firm to make a profit: *Handyside* v. *Campbell* (1901) 17 TLR 623.

Just and equitable grounds

Grounds include breakdown of the relationship between the partners and other such situations. Examples from company law dissolution of quasi-partnerships include *Re Yenidje Tobacco Co. Ltd* [1916] 2 Ch 426, where the court ordered the winding up of a company where there had been a complete breakdown in communication between the controlling shareholders arising from one party bringing an action for fraudulent misrepresentation against the other.

Dissolution takes effect from date of court order.

Dissolution by arbitrator

If the articles contain a clause referring disputes to arbitration and the dispute concerns a claim for dissolution, the arbitrator is empowered to dissolve the partnership just as the court might: *Vawdrey* v. *Simpson* [1896] 1 Ch. 166. But the Court has discretion to decide whether the matter shall be tried or referred to arbitration where one partner brings action for dissolution: *Olver* v. *Hillier* [1959] 2 All ER 220; and *Belfield* v. *Bourne* [1894] 1 Ch 521.

7.15 The Consequences of Dissolution

The partners have certain rights and may exercise authority in certain respects for the purposes of winding up the firm. On the dissolution of the

firm or the retirement of one partner, any partner may notify the same, and may require the other partners to concur in all necessary or proper acts to achieve that purpose: s.37. The authority of each partner continues so far as may be necessary to wind up the affairs of the partnership and to complete transactions begun but unfinished at the date of dissolution. In *Welsh* v. *Knarston* (1972) SLT 96, a solicitor's firm contracted to sue a third party on behalf of the plaintiff. The firm failed to perform the contract after it was dissolved, causing the action to become statute-barred. The court found the firm liable for damages for negligence. Partners will not bind the firm in respect of new transactions: (s.38). In *Re Bourne* [1906] 1 Ch 113, Bourne and Grove carried on a partnership business. When Grove died, the firm owed money to its bankers. Bourne continued the business for eighteen months. He deposited title deeds of partnership assets to secure the overdraft in order to wind up the business and later died insolvent. In a dispute between Grove's executors and the bank, the court held that the bank could assume that the dealings were for the purpose of the winding up of the business. Firms are not bound by the acts of a bankrupt partner unless (i) they have represented themselves; or (ii) they have knowingly allowed themselves to be represented, as still being partners of the bankrupt.

Every partner is entitled to have the partnership property applied in payment of the debts and liabilities of the firm, and to have the surplus assets applied in payment of what may be due to the partners, after deducting sums which partners owe the firm. In order to achieve this purpose partners may apply to the court to wind up the business and affairs of the firm: s.39. The section creates a lien as a personal right against co-partners and their representatives.

Where one partner has paid a premium on entering into a partnership for a fixed term and the partnership is dissolved before the expiration of that term, the court may order repayment of the whole or part of the premium as it thinks just. But the court cannot order the return of any part of premium if:

(i) dissolution is wholly or chiefly due to the misconduct of the partner who paid the premium; or
(ii) the partnership has been dissolved by agreement containing no provision for return of any part of the premium; or
(iii) the dissolution is due to the death of a partner: s.40.

7.16 Treatment of Assets on Dissolution

The firm may be sold as a going concern

The sale may be to outsiders or to the other partners. Where the firm is sold, the purchaser may use the firm name and restrain outgoing partners from using it or soliciting their former customers. Partners are not

prevented from carrying on a business in competition with the purchaser, but can be prevented by injunction from soliciting old customers and representing that they are carrying on the actual business sold: *Trego* v. *Hunt* [1896] AC 7.

The assets may be divided among the partners

Here any partner may use the firm name so long as s/he does not involve his/her former partners in liability. In the event of disagreement about division, the court will order the sale of the business.

7.17 Application of Assets on Dissolution

Failing agreement to the contrary, assets are distributed as follows:

(i) paying debts and liabilities of the firm to non-partners;
(ii) repaying partnership loans;
(iii) repaying capital; and
(iv) residue to be divided among the partners in the proportion in which profits were divisible: s.44(b).

If the assets are not sufficient to satisfy the creditors, partners' advances and repayment of capital, the deficiency is to be made up:

(i) out of profits brought forward from previous years;
(ii) out of partners' capital; and
(iii) by the partners individually in the proportion in which they were entitled to share profits.

Where a partner is insolvent and the assets are not sufficient to repay the creditors and partners' loans, this deficiency must be made up by the solvent partners in the ratio in which they were entitled to share profits.

Where the assets are insufficient to repay partners' capital, then each partner must contribute in the proportion in which s/he shares profits, except that where a partner is insolvent, the other partners need only pay in their own share and the insolvent partner's portion of the deficiency falls on the solvent partners in the ratio of their last agreed capitals: *Garner* v. *Murray* [1904] 1 Ch 57. Consider, for example, A, B and C who are partners. Last agreed capital was £6000, £4000 and £700. After repayment of debts there is a balance of £8000: that is, a capital deficiency of £2700. There is therefore a liability of each partner to contribute £900. C is insolvent and cannot pay and he loses his right to £700, but there is still a deficiency of £200. The loss of this £200 is divided between A and B in proportion to their last agreed capital. Therefore A loses £120 and B £80. A receives £4980 and B £3020.

7.18 Profits Made after Dissolution but before Winding Up

Where, after the dissolution of the firm or retirement of one of the partners, the surviving or continuing partners carry on the business of the firm with its capital or assets before any final settlement of accounts, the outgoing partner or his estate is entitled to:

(i) such a share of the profits made since dissolution as the court find to be attributable to the use of his share of the partnership assets: see *Pathirana* v. *Pathirana* [1966] 3 WLR 666 and *Popat* v. *Shonchhatra* [1997] 3 All ER 800; or
(ii) interest at 5 per cent per annum on the amount of his share: s.42(1): *Manley* v. *Sartori* [1927] 1 Ch 157.

7.19 Rescission of Partnership Agreement

Where the agreement is rescinded on the grounds of fraud or misrepresentation of one of the parties, the injured party is entitled:

(i) to a lien on the surplus assets of the firm for any sum of money paid by him/her for the purchase of a share in the partnership and any surplus capital contributed by him/her;
(ii) to be subrogated to the rights of the creditors of the firm for any payment made by him/her in respect of the firm's liabilities; and
(iii) to be indemnified by the guilty person against all the debts and liabilities of the firm: s.43.

7.20 Dissolution of Insolvent Partnership

Section 420(1) Insolvency Act 1986 allows the Lord Chancellor to provide that such provisions of the Act as may be specified in the order shall apply in relation to insolvent partnerships. The resulting order is the Insolvent Partnerships Order 1986 (SI 1986 No.2142). This has now been supplemented by the Insolvent Partnerships Order 1994 (SI. 1994/2421) which enables a partnership to enter agreements with its creditors as an entity. Previously each partner had to make his or her own arrangement and the partnership foundered if one individual arrangement fell down.

The main change is that the partnership is now wound up in the Companies Court as an unregistered company under Part v of the Insolvency Act 1986. Petitions against two or more partners individually are also brought in the Companies Court. The significance of the change is that partners are now liable for disqualification under the Company Directors Disqualification Act 1986 (see Chapter 8).

A situation which s.420 might allow to be dealt with is the apparent lacuna disclosed in *Re Rudd & Son Limited and Foster & Rudd Limited* [1984] Ch 237, namely that there is no logical system of preferential debts in the case of an insolvent partnership, the members of which are limited companies.

7.21 Limited Liability Partnerships in England and Wales

In *ADT Ltd* v. *BDO Binder Hamlyn* (1995) *The Independent*, 7 December, Binder Hamlyn (BH) had audited the accounts of Britannia Securities Group (BSG). ADT was interested in acquiring BSG. A representative of BH met with a director of ADT, confirmed that the audit was a 'true and fair view' of BSG, and ADT purchased BSG. It was subsequently found that the true value of BSG was £40m and not the £105m suggested by the accounts. ADT sued for £65m plus £40m interest. BH's indemnity insurance covered £71m of the award, but the individual liability of the partners was placed at between £150 000 and £250 000. Other claims are in the pipeline, including action against Price Waterhouse arising out of the BCCI collapse (by January 1996 PW had spent £35m in legal fees). Clifford Chance, a leading law firm, are facing a £610m damages claim arising from the Canary Wharf débâcle.

Professional bodies argued that the current partnership with unlimited liability, joint and joint and several liability of partners was no longer suitable for large professional firms. Limited liability partnerships (LLPs) were one solution. The present system under the Limited Partnerships Act 1907 only protects partners not involved in the business of the firm. On 11 December 1995, the States of Jersey, the island's parliament, announced plans to introduce legislation to allow the creation of LLPs. On the same day, two leading accountancy firms, Ernst & Young and Price Waterhouse, who had been involved in drafting the legislation, announced their intention to register as LLPs as soon as the legislation came into force. The legislation, the Limited Liability Partnership (Jersey) Law 1997, was inspired by the widespread adoption of LLPs in the USA following their original introduction in Delaware. Faced with a mass exodus of leading professional firms, Michael Heseltine (then President of the Board of Trade) and the Big Six accountancy firms held talks on the introduction of LLPs in the UK. A consultation paper, *Limited Liability Partnerships – A New Form of Business Association for Professions* was released in March 1997, with a deadline for responses of 16 May. The proposed LLP will have a separate legal personality, with the partners as agents for the firm but not of each other. The business will be carried on by the firm and the firm will be liable for the negligent acts of its members in connection with the business, and not the co-partners. The individual member would continue to be personally liable for his/her negligent act or omission. It remains unclear whether the legisla-

tion will be enacted, but it has been suggested that the Labour government would not oppose the idea of LLPs.

A further approach to the problem was to investigate reform of joint and several liability. A report of the Law Commission, *Feasibility Investigation of Joint and Several Liability* (HMSO, 1996) rejected the idea.

Recommended Further Reading

Partnership Law, Geoffrey Morse, 4th edn, (Blackstone Press, 1998).

Questions

1 The distinction between partners and creditors of a firm can be very fine, and some creditors, even though not partners, will, as a result of the nature of their relationship with the firm, be deferred creditors in the liquidation of the firm. Who are these deferred creditors?

2 What is the rule in *Garner* v. *Murray*, and when and how does it operate?

3 The articles of an accountancy firm impose a limit on a partner's authority to bind the firm to £4000. Partner P contracts in the name of the firm to buy (i) a relevant software package for £7000; and (ii) £1000-worth of golf clubs. Is the firm liable on these contracts?

4 Partners are jointly liable for the debts and obligations of the firm, and jointly and severally liable for the firm's torts. What is the significance of joint, or joint and several liability?

5 In what circumstances is a person liable as a quasi-partner or as an apparent partner, and what is the difference between them?

8 Registered Companies

Learning Objectives

After reading this chapter you will know about:

1 the nature and effect of the Memorandum and Articles of Association
2 the contractual capacity of the company and the liability of directors for *ultra vires* contracts and contracts beyond their authority
3 the nature of share capital of the company and the regulations relating to the raising and maintenance of capital for the protection of the company's creditors
4 the different types of shares which can be issued and the controls on variation of shareholders' rights
5 the appointment, retirement rotation and disqualification of directors and the duties owed by the directors to the company and the enforcement of these duties
6 the common law and statutory rules protecting minority shareholders from the abusive use of majority power

8.1 The Constitution of a Registered Company

This is in the Memorandum and the Articles of Association. The Memorandum covers the external aspects of the company, while the Articles, which are subordinate to the Memorandum, cover internal regulation. The contents of the Memorandum are regulated by s.2 and the form by regulations under s.3 Companies Act 1985; the Companies (Tables A–F) Regulations 1985, Tables B & F. All statutory reference in this chapter will be to this Act unless otherwise stated.

The contents of the Memorandum

The Memorandum of a private company limited by shares must state:

(i) the name of the company;
(ii) whether the registered office of the company is situated in England, Scotland or Wales;
(iii) the objects of the company;
(iv) the liability of the members if limited; and
(v) the share capital with which the company is to be registered and its division into shares of a fixed amount.

It must be signed by the subscribers, who must agree to take the number of shares indicated opposite their respective names – at least one share each: s.2(5). The Memorandum for a public limited liability

company contains an extra clause (ii) stating that it is a public limited company.

The name clause

The last word(s) of the registered name must be either 'limited' or 'public limited company' depending upon its status (or their Welsh equivalents where the registered office is in Wales): s.25. Further, the use of these words is prohibited as part of a business name for anything other than a registered company with limited liability: s.34. Further restrictions on the company name are in the form of prohibitions or words requiring consent. The Act absolutely prohibits the registration of a name:

(i) including 'limited', 'unlimited' or 'public limited company' or their Welsh equivalents other than at the end;
(ii) including any abbreviation of those words other than at the end;
(iii) the same as one in the Registrar's index of registered names;
(iv) the use of which would, in the opinion of the Secretary of State, constitutes a criminal offence; and
(v) which, in the opinion of the Secretary of State, is offensive: s.26(1).

Consent is required for inclusion as part of the company name of:

(i) words giving the impression that the company is connected with Her Majesty's Government or with any local authority; or
(ii) any name or expression specified in the Company and Business Names Regulations 1981: s.26(2).

Directors or shadow directors during the twelve months prior to a company going into insolvent liquidation are prohibited from using a name if it is (i) a name by which the liquidating company was known at any time in that twelve-month period; or (ii) so similar as to suggest an association with that company: s.216 Insolvency Act 1986. The restriction operates for five years from the commencement of the liquidation, except with the leave of the court, and prevents the person from being (i) a director of any other company known by a prohibited name; or (ii) in any way, directly or indirectly, being concerned or taking part in the promotion, formation or management of any such company; or (iii) in any way, directly or indirectly, being concerned or taking part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name. Breach of the provisions leads to personal liability for debts of the company: s.217. The legislation is to stamp out the 'phoenix company', where the controllers place a company in liquidation and immediately form another company with the same or a similar name and recommence business, often with the same assets.

Change of name

A company may change its name voluntarily by special resolution: s.28 (1). In addition, the company may be directed to change its name in the following circumstances:

(i) it is either the same as one appearing on the index at the time of its registration or is too similar to such a name. The change can be ordered only within twelve months of registration: s.28(2)(a) & (b);
(ii) if misleading information has been given for the purpose of the company's registration with a particular name, or that undertakings or assurances given for this purpose have not been complied with, the Secretary of State may, within five years of registration, direct the company to change its name: s.28(3); or
(iii) if the registered name gives so misleading an indication of the nature of its activities as to be likely to cause harm to the public: s.32.

The change is operative from date of the issue of a new Certificate of Incorporation: *Oshkosh B'Gosh Inc.* v. *Dan Marbel Inc. Ltd & Craze* [1989] BCLC 507 (see p. 208 below).

Common law restrictions on choice of name: 'passing off'

If a company name is so similar to the name of an existing company or business, the court may issue an injunction to restrain the carrying on business under that name: *Ewing* v. *Buttercup Margarine Co. Ltd* [1917] 2 Ch 1. But a company having a word in ordinary use as part of its name cannot prevent another company from using the same word: *Aerators Ltd* v. *Tollitt* [1902] 2 Ch 319.

Publication of company names

The company must publish its name outside every place of its business in easily legible letters: s.348(1); on its common seal (if it has one): s.350(1); and on all letters, invoices, and so on: s.349(1). Failing this, the company and any officer may be liable to a fine. More importantly, an officer is liable personally to the holder of a bill of exchange, promissory note, cheque or order for money or goods for the amount of it (unless it is duly paid by the company): s.349(4). Liability arises not simply where the company's name does not appear, but also where it appears incorrectly. In *Hendon* v. *Adelman* (1973) 117 SJ 631, an officer was personally liable for cheques overprinted with 'L & R Agencies Ltd' as opposed to 'L. R. Agencies Ltd'; and in *British Airways Board* v. *Parish* [1979] 2 Lloyd's Rep 386 the defendant was personally liable for cheques drawn where the word 'Limited' was missing. Certain word shortenings are allowable, in *Banque de l'Indochine et de Suez S.A.* v. *Euroseas Group Finance Co. Ltd* [1981] 3 All ER 198 the court accepted the use of Co. and Ltd for Company and Limited and the use of other well established short forms – 'ins' for insurance and so on.

In *Durham Fancy Goods Ltd* v. *Michael Jackson (Fancy Goods) Ltd* [1968] 2 QB 839 the plaintiffs were estopped in their claim against a director of the defendant company since they themselves had drawn up the bill

of exchange which had been accepted on behalf of the defendant company using the wrong name. However, in *Rafsanjan Pistachio Producers Co-operative* v. *Reiss* [1990] BCLC 352, the plaintiffs were not estopped where they had accepted in payment five cheques drawn on a company, two of which had been presented and paid. The defendant was personally liable on the other three.

Oversight is not a defence: *Blum* v. *OCP Repartition SA* [1988] BCLC 170; but an error in spelling may be: *Jenice* v. *Dan* [1993] BCLC 1349. In *Oshkosh* (above), the court held that the Act required the individual affixation of the company name, not merely authorising the signing of orders for goods.

The public company clause

Where the company is a public limited company the Memorandum must state that fact in a separate clause (clause 2) of the Memorandum. Companies can change from public to private (ss53–5) and from private to public (ss43–7) subject to controls laid down by the Act (see Chapter 6).

The registered office clause

This establishes the domicile/nationality of the company. The clause only states that the registered office is situated in England, Scotland or Wales and does not give the address, which is separately supplied at the time of registration. The place where the registered office is situated cannot be altered. The certificate of incorporation states where the registered office is situated, and the information is conclusive evidence: s.13. Where the certificate stated that the registered office was in England, whereas the actual office was in Scotland, the company was registered in England: *Re Baby Moon (UK) Ltd* (1985) 1 BCC 99.

The registered office is the official address at which legal documents, notices and other communications can be formally presented. The following statutory books must be kept there and be available for inspection by members free of charge during business hours for at least two hours a day (creditors may inspect the register of charges free of charge and members of the general public may examine the books, subject to some exceptions, on payment of a prescribed fee):

(i) the register of members;
(ii) the register of charges;
(iii) copies of instruments creating registrable charges;
(iv) the minute books;
(v) the register of directors and secretary;
(vi) the register of directors' interests in shares or debentures of the company;
(vii) the register of debenture holders;

(viii) the register of substantial shareholdings;
(ix) copies of directors' service contracts; and
(x) accounting records.

The objects clause

This was intended to be a brief statement of the company's business, but with the imposition on registered companies of the *ultra vires* doctrine in *Ashbury Railway Carriage & Iron Co.* v. *Riche* (1875) LR 7 HL 653 making contracts beyond the objects void at a time when it was not possible to alter the objects clause, promoters began adopting 'multi-objects' clauses with many business aims, and specifying, as if they were objects, a number of powers that had previously been left to be implied by the court. The court refused to treat the objects in the subclauses as independent objects and granted winding up orders against companies that had abandoned their main object, often identified by the name of the company: *Re German Date Coffee Co.* (1882) 20 Ch 169.

This was defeated by the inclusion of a subclause to the effect that each object in each subclause was an equal and independent object. This was approved in *Cotman* v. *Brougham* [1918] AC 514 and is now generally found combined with a subjective objects clause recognised in *Bell Houses Ltd* v. *City Wall Properties Ltd* [1966] 2 QB 656, where the clause was in the form: 'to carry on any other trade or business whatsoever which can, in the opinion of the board of directors, be advantageously carried on by the company in connection with or as ancillary to any of the above businesses or the general business of the company'.

The objects clause will usually permit gratuitous payments and political and charitable donations which would otherwise be *ultra vires* unless bona fide and directly incidental to the company's business. In *Evans* v. *Brunner, Mond & Co.* [1921] 1 Ch 359, a chemical manufacturer was justified in distributing £100 000 to universities to further scientific education and research only because it was incidental or conducive to the main object of the company. In *Simmonds* v. *Heffer* [1983] BCLC 298 the League against Cruel Sports made two donations to Labour Party funds. The first, to advertise the party's commitment to animal welfare, was within its implied powers, but a second unconditional donation was held to be *ultra vires*. The fact that the objects need not be restricted to the purely commercial was established in *Re Horsley & Weight Ltd* [1982] Ch 442. There is now an implied term authorising *ex gratia* redundancy payments to employees and past employees: s.719.

Companies can be registered 'to carry on a business as a general commercial company', s.3A, in which case (a) the object of the company is to carry on any trade or business whatsoever; and (b) the company has the power to do all such things as are incidental or conducive to the carrying on of any trade or business by it. However, since neither (a) nor (b) would enable a company to dispose of its entire business, a specific power to do that should be included, as should express powers to make gifts, grant

pensions, or guarantee or grant security for debts of other persons, firms or companies.

A company's objects can be altered without restriction by special resolution, s.4, but the holders of not less than 15 per cent of the company's issued share capital can apply to the court within twenty-one days of the resolution for an application that the resolution should be set aside: s.5.

The liability clause

The clause stating that the liability of the members is limited either by shares or by guarantee can be altered only once in the company's lifetime (see Chapter 6).

The capital clause

This clause states the registered or authorised capital of the company and its division into shares of a fixed nominal value but does not indicate the actual capital raised. It establishes the ceiling beyond which the company must pass a resolution to increase its authorised capital; companies can increase, consolidate, subdivide or cancel shares, or convert them to stock, by ordinary resolution: s.121.

Additional clauses in the Memorandum

Where the Memorandum contains clauses which could otherwise be in the Articles, they can be altered by special resolution but the holders of at least 15 per cent of the issued shares have the right to object within twenty-one days: s.17. This does not cover cases where the Memorandum provides for or prohibits such alteration or where the alteration involves the variation or abrogation of class rights. Where class rights are involved the alteration must be in accordance with either s.425 or s.125 CA 1985 or a variation of class rights provision (p. 226).

8.2 The Articles of Association

A company limited by shares may register Articles: s.7. Where no Articles are registered, the Articles in Table A of the Companies (Table A to F) Regulations 1985 apply automatically, and a company may adopt Table A completely, wholly exclude Table A and set its own regulations, or may adopt Table A in a modified form. If its own articles are incomplete in any respect, they will be complemented by Table A: s.8. The articles must be (a) printed; (b) dated; (c) divided into numbered paragraphs; and (d) signed by each subscriber to the Memorandum in the presence of at least one witness: s.7(3); they regulate the rights and duties of the members and the administration of the company and deal with:

- share capital and variation of rights;
- liens and calls on shares;
- transfer and transmission of shares;
- forfeiture of shares;
- conversion of shares into stock;
- reduction of capital;
- general meetings;
- proceedings and voting rights at general meetings;
- power of general meeting over the board;
- appointment, retirement, rotation and disqualification of directors;
- powers of board of directors, and delegation of powers;
- proceedings of directors meetings; and
- the company secretary.

Alteration of the Articles

The articles may be altered by special resolution subject to the provisions of the Companies Act and conditions contained in its Memorandum: s.9(1). In addition, the Articles may be changed by a unanimous informal decision of the members: *Cane* v. *Jones* [1980] 1 WLR 1451, and private companies may alter their Articles by resolution in writing signed by or on behalf of all the members of the company entitled to attend and vote at the meeting: s.381A, subject to control by the auditors: s.381B. Private companies generally provide in their Articles for written resolutions to avoid the controls of s.381B.

The alteration must not (i) conflict with the Companies Act; (ii) be in breach of any restriction in the Memorandum; (iii) be illegal; (iv) extend or modify the Memorandum; (v) deprive members of protection conferred on them by the Companies Act, for example ss125–7 (see p. 226 below); (vi) require a member to take or subscribe for more shares or increase his/her liability to contribute without his/her consent in writing; and (vii) amount to a fraud on the minority.

Alteration must not constitute a fraud on the minority

The court will not permit an alteration that is an abuse of majority power and alteration must be 'bona fide for the benefit of the company as a whole': *Allen* v. *Gold Reefs of West Africa Ltd* [1900] 1 Ch 656. There was a dispute as to whether this should be interpreted objectively or subjectively: in the first case the court would decide whether believes it objectively that the alteration is in the interests of the company, and in the second it would merely require that the shareholders, in voting for the alteration, must honestly believe that they are acting bona fide in the interests of the company.

The subjective interpretation is established as correct, and the court will only intervene to prevent an alteration where bad faith is proved against the majority. In *Shuttleworth* v. *Cox Bros. & Co. (Maidenhead) Ltd* [1927] 2 KB 9, the court approved an alteration, adding that a director

should resign on a written request of all his co-directors stating: 'The only question is whether or not the shareholders … honestly intend to exercise their powers for the benefit of the company.' In *Greenhalgh* v. *Arderne Cinemas Ltd* [1951] Ch 286, the company's Articles contained a pre-emption clause that prevented shares being transferred to a non-member so long as there was a member willing to buy them at a fair value. The majority shareholder wished to sell to a non-member and a resolution was passed allowing a transfer to any person if sanctioned by an ordinary resolution. The court held that the special resolution was valid. Evershed MR stated: 'it is now plain that "bona fide for the benefit of the company as a whole" means … that the shareholder must proceed upon what, in his honest opinion, is for the benefit of the company as a whole [and] the phrase "the company as a whole" … means the corporators as a general body' and 'a special resolution of this kind would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and the minority shareholders, so as to give the former an advantage of which the latter were deprived'. In *Clemens* v. *Clemens Bros. Ltd* [1976] 2 All ER 268, the court found that a scheme by the majority shareholder, with 55 per cent of the shares, to increase the capital with the effect of reducing the stake of the other shareholder from 45 per cent to below 25 per cent was not for the benefit of the company. In such cases the most usual remedy will be to minority petition for unfair prejudice under s.459 (see p. 251 below).

Power to alter Articles cannot be restricted

A company's freedom to alter its Articles cannot be restricted and a company cannot, by contract, deprive its members of their rights to alter the Articles by special resolution, *Punt* v. *Symons & Co. Ltd* [1903] 2 Ch 506. However, where the alteration contravenes an existing contractual obligation the injured party may sue for damages. In *Southern Foundries (1926) Ltd* v. *Shirlaw* [1940] AC 701, Shirlaw was appointed managing director for a term of ten years, with the Articles allowing premature removal of a managing director 'subject to the provisions of any contract between him and the company', and that if he ceased being a director he would automatically cease to be the managing director. Later, new Articles were adopted which allowed for the removal of a director by a written instrument signed by two directors and the secretary. Shirlaw was removed from the board under the new Article and succeeded in an action for damages for breach of an implied term in his contract that he would not be removed as director during the period of his appointment as managing director. The court stressed, however, that the company could not forgo its right to alter its Articles and Shirlaw could not have obtained an injunction. This view has been reaffirmed in *Cumbrian Newspapers Group Ltd* v. *Cumberland & Westmorland Herald Newspaper & Printing Co. Ltd* [1986] BCLC 286, which stated that an agreement by a company not to alter its Articles could not be implied but it did suggest that if a company has contracted not to change its Articles it may be prevented from calling a meeting to do so.

8.3 The Legal Effect of the Memorandum and Articles of Association

The Memorandum and Articles, when registered, bind the company and the members as if they had been signed and sealed by each member, and contained covenants on the part of each member to observe their provisions: s.14 (1). Debts owed to the company by members under the Memorandum and Articles are a specialty debt: s.14(2); however, in *Re Compania de Electricidad de la Provincia de Buenos Aires Ltd* [1978] 3 All ER 668, Slade J drew attention to the fact that s.14(1) does not say that the Memorandum and Articles have been sealed by the company, and debts owed by it to members are simple contract debts.

Normal contract rules do not apply to the articles, thus rectification is not possible: *Scott* v. *Frank F. Scott (London) Ltd* [1940] Ch 794, and mistake and duress are not applicable. In *Bratton Seymour Service Co. Ltd* v. *Oxborough* [1992] BCLC 693, the court held that terms could not be implied into Articles to give effect to intentions of members.

Rights enforceable by the company against a member

In *Hickman* v. *Romney Marsh Sheepbreeders' Association* [1915] 1 Ch 881, where the company's Articles provided for reference to arbitration in respect of disputes between company and members, the court ordered a stay of proceedings where a member brought an action against the company. However in *Beattie* v. *E. & F. Beattie Ltd* [1938] Ch 708, where a director brought an action against the company, an application for a stay of proceedings on the grounds that the Articles provided for reference of disputes to arbitration was rejected, since the reference only applied to disputes between the company and members, whereas this was a dispute in the plaintiff's capacity as director.

Rights enforceable by a member against another member

In *Rayfield* v. *Hands* [1960] Ch 1, the articles of a private company provided that 'every member who intends to transfer shares shall inform the directors who will take the said shares equally between them at a fair value'. The directors denied an obligation to take up the shares; however, the court held that the Articles bound the directors as members to do so and this was a personal obligation which could be enforced by other members directly.

Members' right of enforcement against the company limited

Members can enforce their membership rights including their right to vote: *Pender* v. *Lushington* (1877) 6 Ch.D 70, and their right to be paid a dividend in cash: *Wood* v. *Odessa Waterworks Co.* (1889) 42 Ch.D 636. They can also enforce their constitutional rights to have the company run through the proper organs; in *Re H. R. Harmer Ltd* [1958] 3 All ER 689,

the court recognised that the plaintiffs, who were shareholders and directors, could enforce their rights as members for the company to be run by the board.

Members cannot generally sue to enforce purely outsider rights contained in the Articles. In *Eley* v. *Positive Govt. Sec. Life Assurance Co.* (1876) 1 Ex. D 88, Eley could not enforce an article that he should be solicitor to the company for life, even though he was a shareholder. This artificial limitation has been criticised, but is still generally accepted. Even rights as directors are regarded as outsider rights for this purpose, and directors cannot enforce rights to salary which are contained in the Articles, and the provisions are vulnerable to alteration in the normal course of events, although the alteration cannot be retrospective: *Swabey* v. *Port Darwin Gold Mining Co.* (1889) 1 Meg 385. However, if a director takes office on the basis of a term in the Articles providing for remuneration, the term may be implied into the contract between the director and the company: *Re New British Iron Co.* [1898] 1 Ch 324. And where a person is appointed a managing director under a separate contract, there may be an implied term that s/he will not be removed as director during the period of the contract: *Nelson* v. *James Nelson & Sons Ltd* [1914] 2 KB 770; and *Southern Foundries (1926) Ltd* v. *Shirlaw* [1940] AC 701.

8.4 Company Promoters

A promoter is 'one who undertakes to form a company with reference to a given project, and to set it going, and who takes the necessary steps to accomplish that purpose': *Twycross* v. *Grant* (1877) 2 CPD 469. The definition excludes persons acting in a professional capacity in connection with the formation of a company, such as solicitors, accountants and so on.

Promoters are not entitled to remuneration from the company and are personally liable for the expenses of the promotion. Any pre-incorporation contract for remuneration is void and unratifiable after the company is incorporated. Promoters entering such a contact after incorporation must do so by deed, since the consideration is past. The Articles usually give directors a discretionary power to pay the promoter's expenses, and the promoter will usually be one of the first directors.

Fiduciary duties of promoters

Promoters are in a fiduciary relationship with the company and must not accept bribes or make secret profits. They must keep proper accounts and make full disclosure of interests, either to an independent board of directors or to members through a prospectus or other means. Provided full disclosure is made, any profit made by promoters selling property to the company can be retained. Where promoters breach their fiduciary duties,

the company may claim damages in respect of any loss suffered resulting from the breach. Promoters' failure to disclose a profit made on the sale of property to the company allows the company to set aside the transaction. In *Erlanger* v. *New Sombrero Phosphate Co.* (1878) 3 App Cas 1218, a syndicate headed by E bought a lease of an island and then formed a company to take up the lease. They made a substantial profit on the sale of the lease to the company, but did not make a full disclosure of this. The company was able to rescind the contract. If the company elects not to rescind or has lost the right to do so, the company may recover the profit from the promoter: *Gluckstein* v. *Barnes* [1900] AC 240.

Common law and statutory duties

Promoters are liable where shares or debentures are offered to the public by way of a prospectus for an unlisted public company, or by Listing Particulars in the case of a listed company, where they contain false statements or misrepresentations or where material which is required to be stated is omitted. Liability may arise under the common law or the Financial Services Act 1986.

Pre-incorporation contracts

Where contracts are made on behalf of the company before a certificate of incorporation is issued, the company cannot be liable on the contract and cannot ratify the contract after incorporation. However, a contract which 'purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly': s.36C. The section has been broadly interpreted in *Phonogram Ltd* v. *Lane* [1982] QB 938 to cover any situation where a person acts on behalf of a non-existing company, even where no steps have been taken towards its incorporation.

Attempts to extend the scope of the section to any situation where a person contracts on behalf of a company which is not at the time legally incorporated have failed. In *Oshkosh B'Gosh Inc.* v. *Dan Marbel Inc. Ltd and Craze* [1989] BCLC 507, an unsuccessful attempt was made to render a director personally liable for contracts in a new corporate name before the issue of a Certificate of Incorporation. The Court of Appeal decided on the basis of s.18(1) and (3), which recognise the company's continued existence notwithstanding any change in its name. In *Badgerhill Properties Ltd* v. *Cottrell* [1991] BCLC 805, it refused to entend personal liability to a person signing a contract on behalf of a company, *Badgerhill Properties Ltd*, as *Badgerhill Property Ltd*. And in *Cotronic (UK) Ltd* v. *Dezonie* [1991] BCLC 721 it refused to extend it to a situation where a director contracted in the name of a company which had been dissolved as a defunct company under s.652 (see Chapter 19).

8.5 Provisional Contracts by Public Companies

A public company originally registered as such is not able to commence business until the Registrar issues a certificate that the company has raised the statutory minimum capital (£50 000): s.117. Contracts made earlier are provisional, and the company and any officer in default is liable to a fine. The contract is not void but, if the company fails to comply with its obligations under the section within twenty-one days of being called upon to do so, the directors are liable to compensate the other party for any resulting loss or damage suffered.

8.6 *Ultra vires* Contracts and Outsider Protection

The *ultra vires* doctrine had been practically bypassed by promoters drafting the objects clause so as to give the company virtually unlimited powers, and the problem is further reduced now that it is possible for a company to be formed as a 'general commercial company': s.3A. To ensure that the doctrine should not affect persons dealing with companies, provisions inserted into the 1985 Act by the Companies Act 1989 abolish the external dimension of the doctrine while retaining its internal validity.

The external abolition of *ultra vires*

This is achieved by s.35(1) which provides, 'The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum.' The reference to 'an act' covers charitable and political donations and other gratuitous payments, in addition to transactions, whilst the word 'done' means that any completed act by a company can no longer be impeached. The reference to the lack of capacity 'by reason of anything in the company's memorandum' is potentially wider than the objects of the company. The section means that neither the company nor the outsider dealing with the company can plead the doctrine.

The internal retention of *ultra vires*

The restrictions on the company's contractual capacity and the operation of the *ultra vires* doctrine internally are preserved, since members can apply for an injunction to 'restrain the doing of an act which but for subsection (1) would be beyond the company's capacity' except in 'respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company': s.35(2). The duty of the directors 'to observe any limitations on their powers flowing from the company's memorandum' is also preserved, but the company can ratify any action beyond the objects of the company by special resolution, although relieving the directors from

any liability must be agreed separately by a further special resolution: s.35(3). The significance of ratification is in connection with s.322A (5)(d), see p. 246. An outsider is not bound to enquire as to whether an act is permitted by the company's Memorandum: s.35B; and the doctrine of deemed notice of the company's registered documents which had prevented persons dealing from pleading ignorance of the fact that the activity was *ultra vires* is to be abolished with the implementation of s.711A.

8.7 Unauthorised Contracts and Outsider Protection

The management of the company is delegated to the board of directors (art.70, Table A), which normally allows the board to further delegate its powers to a managing director and to individual directors (art.72, Table A). The Articles may impose limits on the contractual authority of the board, the managing director and individual directors as agents in the form of financial limits beyond which they can only bind the company when they have the approval of the general meeting or the board, respectively. Where there are such limits on their authority, their power to bind the company beyond their authority was governed by the normal rules of agency, and the contracts were voidable unless ratified in general meeting: in *Bamford* v. *Bamford* [1970] Ch 212, an improper allotment of shares was ratified by the general meeting. The company could, however, be liable without ratification under statutory and common law rules. The statutory rules are now of major importance and possibly replace the common law rules.

Statutory protection

The new statutory outsider protection inserted by the Companies Act 1989 provides that, 'In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution': s.35A(1). A person 'deals with' a company if s/he is a party to any transaction or other act to which the company is a party; and shall not be regarded as acting in bad faith by reason only of his/her knowing that an act is beyond the powers of the directors under the company's constitution; and shall be presumed to have acted in good faith unless the contrary is proved: s.35A(2). The references to limitations on the directors' powers under the company's constitution include limitations deriving (a) from a resolution of the company in general meeting or a meeting of any class of shareholders; or (b) from any agreement between the members of the company or of any class of shareholders (s.35A(3)) and are thus wider than mere restrictions contained in the Articles. The rigours of the constitution are preserved internally and an individual member may bring proceedings to restrain the doing of an act beyond the directors' powers except in fulfilment of a legal obligation arising from a previous act:

s.35A(4). The liability of the directors to the company for exceeding their authority is also preserved unless relieved by ordinary resolution: s.35A(5).

It is difficult to see how a company can effectively protect itself from liability by limiting the authority of its board and persons authorised by the board and it is difficult to imagine who will not be regarded as not acting in good faith. This view is strengthened by the fact that 'A party to a transaction with a company is not bound to enquire as to … any limitation on the powers of the board of directors to bind the company or authorise others to do so': s.35B.

To control possible abuse of this system by self-serving directors, the Act makes voidable contracts between the company and the directors, their spouses or companies with which they are associated where the directors have exceeded their constitutional powers: s.322A (see p. 246).

The common law rules relating to unauthorised contracts

The statutory protection for unauthorised contracts probably makes redundant the common law rules that evolved to protect outsiders. They may still be relevant where the person contracts with a company, a director or other agent who has not been authorised by the board of directors, since s.35A may not extend to cover these situations. There are two areas under which a company may be liable in common law for the unauthorised acts of its agents: (i) under the rule in Turquand's Case; and (ii) the doctrine of apparent authority (holding out).

The rule in Turquand's Case

The rule in *Royal British Bank* v. *Turquand* (1856) 6 E&B 327 established that persons dealing with a company can assume that all acts of internal management have been properly carried out. Thus, where directors require prior approval by a resolution of the board or an ordinary resolution of the general meeting to bind the company, the rule will operate to validate transactions when this approval is not obtained. The rule limited the doctrine of constructive notice whereby a person, who had failed to consult the registered documents of the company, was prevented from claiming ignorance of their contents. The removal of the need to consult the registered documents (s.35B) removes the justification for the rule.

The rule originally only protected outsiders who had read the Articles prior to dealing with the company's agents in reliance on a supposed delegation of authority, but this was extended to persons who had not read the Articles prior to the transaction, as long as these documents were consistent with the claim: *Freeman & Lockyer* v. *Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (see below).

The protection is limited to outsiders, although the definition is not always strictly applied: *Hely-Hutchinson* v. *Brayhead Ltd* [1968] 1 QB 549 (see below); and the transaction must be one which is within the usual authority of the agent: *Kreditbank Cassel GmbH* v. *Schenkers Ltd* [1927] 1

KB 826. The outsider loses protection where good faith is missing: *Rolled Steel Products Ltd* v. *British Steel Corporation* [1986] Ch 246. It used to be held that the rule could not operate to bind a company in respect of a forged document: *Ruben* v. *Great Fingall Consolidated* [1906] AC 439. This no longer appears to be the case, and the company may be liable where the forgery is authenticated by an official acting within the scope of his actual or apparent authority.

The rule makes a company liable in respect of contracts negotiated by persons below the level of director, as does new s.35A, where such persons are authorised. It is an aspect of implied authority relating to companies.

The agency rule of apparent authority

Managing directors are agents of the company but not directors, who can only bind companies where they are authorised by the board, or where they have been held out as having authority. Directors who have been held out as managing directors by being allowed to act as such may be regarded as impliedly appointed and bind the company through actual authority. In *Hely-Hutchinson* v. *Brayhead Ltd* [1968] 1 QB 549, the second defendant, Richardson, acting as *de facto* managing director, agreed that the defendand company would indemnify the plaintiff in respect of any liability as guarantor of his company's bank account. The defendants denied liability and the Court of Appeal held that R had actual authority to bind the company.

The company can also be liable by way of implied authority in the same circumstances if the following are established: (i) a representation that the agent had the necessary authority; (ii) the representation was made by the company; (iii) the third party relied on the representation; and (iv) the contract was of a kind the agent could have entered into on behalf of the company, within his usual authority.

In *Freeman & Lockyer* v. *Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, the company's business was run by one of four directors, acting as if he was the managing director, although not in fact appointed as such. He entered into a contract with the plaintiffs, a firm of architects, for a property development, but the scheme collapsed when planning permission was refused and the director left the country. The defendant company denied liability on the grounds that they had not authorised the contracts. The court held they were liable as the director had been held out as their agent. It was not important that the plaintiffs had not previously read the Articles of Association, but merely sufficient that the Articles provided for the delegation of board authority to a managing director.

8.8 The Company's Share Capital

Share capital can be subclassified as follows: *nominal* or *registered capital* is the authorised share capital stated in the capital clause of the

Memorandum; it indicates the maximum amount of capital that the company can raise before needing to increase its authorised capital. Nominal capital which has been allotted is described as *issued capital*; the remainder is called *unissued capital*. Paid-up capital is the aggregate amount paid up in respect of issued capital. Where the shares are issued fully paid, the paid-up capital is the same as the issued capital. Shares can be issued partly paid, although public companies cannot allot shares unless not less than a quarter of the nominal value of the share has been received, together with the whole of the premium: s.101. Where partly-paid shares are issued, the sum unpaid is called *uncalled capital*. The company can call in this capital whenever it wishes, or the Articles or terms of issue may establish a schedule for payment at fixed future dates. Companies can resolve that uncalled capital shall only be called up in the event of the winding up of the company, in which case it is known as *reserve capital*: s.120. This capital fund is capable of being charged as security to a particular creditor.

The doctrine of raising and maintenance of capital

Since a limited liability company only has its capital to back its credit, the capital is the creditors' guarantee fund and 'has ceased to be the name given to the fluctuating net worth of the business and has become a rigid yardstick fixing the minimum value of the net assets which must be raised initially and then retained in the business' (Gower). To this end, company law rules ensure that the company has actually raised the paid-up capital, and that the capital is properly used for the business of the company and not returned to the shareholders.

Shares cannot be issued at a discount

The fundamental rule on raising capital is that shares cannot be issued at a discount and applies to private and public companies: s.100. There is an exception in relation to the payment of underwriting commission, but the amount of the commission is limited to 10 per cent of the issue price or any lesser sum provided by the Articles: s.97. But a more important potential loophole is caused by the fact that a company can issue its shares for a non-cash consideration – a transfer to the company of some asset, either tangible or intangible: s.99 (1). They can only be treated as paid-up to the extent of the value actually received, however, and shares cannot be issued for no consideration or for a past consideration: *Re Eddystone Marine Insurance Co.* [1893] 3 Ch 9.

The issue of shares for a non-cash consideration is more closely regulated for public companies than private companies.

Controls on private companies

There are no statutory controls on the valuation of the consideration and the court will only intervene where it is inadequate on the face of it, or

where there is evidence of fraud: *Re Wragg Ltd* [1897] 1 Ch 796. Shares can be issued in consideration of an undertaking to perform future personal services. There is no limitation on the period during which assets or services have to be transferred or performed, and no minimum payment before shares can be allotted. The only protection is in the filing of a report with the Registrar of Companies to alert potential investors and creditors: s.88.

Controls on public companies

There are four major controls relating to public companies.

(i) A public company may not issue shares in consideration for an an undertaking that the allottee should do work or perform services for the company or any other person: s.99(2).

(ii) If the company allots shares as fully or partly paid-up in consideration of an undertaking to transfer a non-cash asset to it or to a person nominated by it, this must be performed or be performable within five years from the date of the allotment: s.102(1).

(iii) The company cannot allot shares unless the consideration has been independently valued under s.108, and a report as to the valuation made to the company (copy to the allottee) within the six months immediately preceding the allotment: s.103(1). The report and valuation is to be made by an independent person, qualified to act as an auditor of the company. The report must disclose the nominal value of, and premium, if any, paid on those shares; the description of the consideration; the method by which it was valued; the date of the valuation; the extent to which the nominal value of the shares and any premium thereon are to be treated as fully paid-up; and the amount of any cash paid or to be paid for the shares on allotment: s.108. The report must be registered at the same time as the report under s.88.

(iv) It cannot allot shares unless at least a quarter of the nominal value and all the premium (if any) have been paid up: s.101(1).

Similar valuation provisions apply where a company incorporated as a public company enters into an agreement to issue shares for a non-cash consideration during the two years from the date of the issue of the certificate under s.117 to a subscriber to the Memorandum where the consideration represents one-tenth or more of the company's current issued share capital: ss104 & 109. The valuation provisions also apply to a private company seeking to be re-registered as a public company: s.104(3).

In the event of the breach of any of the rules, the allottee must pay cash for the shares and any premium: s.99(3); s.100(2); s.101(4); s.102(6); s.103(6); and s.105(3). Subsequent transferees are jointly and severally liable except for a bona fide purchaser for value: s.112. The company and its officers are also liable to a fine: s.114.

Since the Act provides that any undertaking remains enforceable in spite of a contravention of the Act: s.115, there is the possibility of relief for allottees' liability: s.113.

Shares issued at a premium

A company may issue shares for more than their nominal value where there is a ready market for them. The aggregate amount of the premium must be allocated to a share premium account, both where the shares are issued for cash or a non-cash consideration: s.130(1). Thus the value by which the assets transferred exceed the aggregate nominal value of the shares issued must be paid into the share premium account: *Henry Head & Co. Ltd* v. *Ropner Holdings Ltd* [1952] Ch 124. There is an exception to cover the decision in *Shearer* v. *Bercain Ltd* [1980] 3 All ER 295, which relates to company mergers: s.131.

Once credited to the share premium account, the fund is subject to the capital maintenance rules, s.130(3), subject to exceptions under which the account can be used:

(i) in paying for a bonus issue of shares to members, or
(ii) in writing off:
    (a) the company's preliminary expenses, or
    (b) the expenses of, commission paid or discount allowed on, issues of shares or debentures, or
(iii) in providing for the premium payable on redemption of debentures (s.130(2)).

The share premium account is an anomalous form of capital because (i) no dividend is paid on it; (ii) it is not attributable to any shareholder; (iii) it is not part of the nominal capital; and (iv) the ordinary investor does not regard it as capital. The share premium account is a quasi-capital account. Any percentage dividend is calculated on the basis of the nominal value, which is also the amount shareholders are entitled to on liquidation where assets remain after the payment of debts. The aggregate of the nominal capital is in the share capital account.

Rules relating to maintenance of capital

The fundamental rule is that companies cannot acquire their own shares for value, since the issued capital will be reduced. The rule is in statutory form: 'Subject to the following provisions, a company limited by shares … shall not acquire its own shares (whether by purchase, subscription or otherwise)': s.143(1). There are exceptions where, in some cases, outright prohibition has been replaced by permission subject to stringent controls.

The rule is extended to the acquisition of shares in a company by a nominee of that company. Where shares are issued to a nominee of a company or are acquired by a nominee from a third person as partly paid-up, then the shares shall be treated as held by the nominee and the company shall have no beneficial interest in them. Furthermore, if the nominee fails to pay for the shares within twenty-one days of being called upon to do so then, (i) if s/he is an initial subscriber, the other subscribers; or (ii) if the shares were otherwise acquired, the directors, are jointly and

severally liable with him/her. The Act provides for relief where the subscribers or directors have acted honestly and reasonably, but the burden of proof is on them: s.144. The general rule is subject to exceptions relating to (i) the redemption or purchase of any shares in accordance with Ch VII Part V of the Act; (ii) the acquisition of any shares in a reduction of capital duly made under s.135; (iii) the purchase of any shares in pursuance of an order of the court under s.5, s.54 or Part XVIII ss459–61; and (iv) forfeiture of shares or surrender in lieu under the articles for failure to pay any sum in respect of them (Table A, art.19; s.143(3). Public companies acquiring shares must cancel them and reduce their share capital within either three years or one year, and the voting rights cannot be exercised during that period: s.146.

Power to redeem own shares

Public and private companies may issue redeemable shares of any category as long as the Articles permit (Table A. art.35; s.159), but no redeemable shares may be issued unless there are also non-redeemable shares in issue at the time: s.159(2). Only fully-paid shares may be redeemed: s.159(3), and they can only be redeemed out of 'distributable profits' or from the proceeds of a fresh issue of shares; any premium payable must be paid out of distributable profits: s.160(1)(a)(b). This is subject to s.160(2) – when redeemable shares are issued at a premium, any premium on their redemption may be paid out of the proceeds of a fresh issue of shares up to an amount equal to (a) the aggregate of the premiums received by the company on the shares redeemed, or (b) the current amount of the company's share premium account, whichever is less. Private companies can redeem or purchase their shares from capital: s.171. On redemption the shares are to be treated as cancelled: s.160(4).

Where the redemption is wholly or partly out of distributable profits, companies must transfer the aggregate par value of the shares to a Capital Redemption Reserve. This is a capital account subject to the rules of capital maintenance and may only be used for (i) the allotment of fully paid bonus shares; (ii) the redemption of capital sanctioned by the court; and (iii) a redemption or purchase of shares out of capital: s.170. The Capital Redemption Reserve reflects the need to protect the company's creditors against a reduction in the capital base of the company. It is not required where the shares are redeemed from the proceeds of a fresh share issue, since the new capital replaces the old.

The date on or by which, or dates between which, the shares are to be or may be redeemed must be specified in the Articles or, if the Articles provide, fixed by the directors. In this case the date or dates must be fixed before the shares are issued. Any other circumstances in which the shares are to be or may be redeemed must be specified in the Articles. The amount payable must be specified in, or determined in accordance with, the Articles, and in the latter case the Articles must not provide for the

amount to be determined by reference to any person's discretion or opinion: s.159A.

Companies will normally raise capital by issuing redeemable preference shares, which will not give the shareholders the right to vote, and so not affect the balance of power in the company. The fact of the right or the option to redeem means that, if the shares were initially issued with a larger percentage dividend than is later justified because of a fall in interest rates, the company can redeem the shares and replace them with shares with a lower fixed dividend.

Power to purchase own shares

Public companies may purchase their own shares, whether redeemable or not, as long as the capital maintenance rules are maintained. Private companies can purchase (or redeem) their shares out of distributable profits or out of capital. Where the purchase is wholly or partly out of profits an amount equal to the aggregate nominal value must be transferred to a capital redemption reserve: s.170.

Where the purchase is not out of capital, in addition to the general rules relating to redemption of redeemable shares, there are specialist rules depending on whether the purchases are off-market or on-market.

Off-market purchases

The terms of the proposed contract must be authorised by a special resolution of the company: s.164(2). For public companies, the authority must specify a date not later than eighteen months from the date of the resolution on which the authority is to expire: s.164(4). The power can be varied, revoked or renewed by special resolution, but a special resolution to confer, vary, revoke or renew the power is not effective if the resolution is only carried by virtue of the votes of the member of the company to whom the resolution relates: s.164(5). The resolutions are not effective unless a copy of the contract or a written memorandum of the contract is available at the company's registered office for not less than fifteen days prior to the resolution and at the meeting itself: s.164(6). The same rules relate to contingent purchase contracts, under which a company may acquire the option to purchase its own shares: s.165.

On-market purchases

Since the purchase is regulated by the market, only an ordinary resolution is required: s.166(1). The authority may be general or limited to the purchase of shares of any particular class or description; and may be conditional or unconditional: s.166(2). The authority must state the maximum number of shares to be acquired, determine the maximum and minimum prices, and specify the date on which it is to expire: s.166(3). The authority may be varied, revoked or renewed, but where conferred or renewed it must expire within eighteen months: s.166(4).

Private companies may make a payment out of capital in order to redeem or purchase their own shares: s.171. This is subject to authorisation in the Articles, the shares must be fully paid, and there must remain non-redeemable shares in issue after the purchase or redemption. A company can only pay for or redeem shares out of capital after first having used up the distributable assets, and subject to:

(i) approval by special resolution: s.173(2), subject to the restrictions on voting of those interested in the repayment: s.174(2);
(ii) directors must make a statutory declaration of solvency concerning the company's ability to make the payment and still be able to pay its debts and be viable for the forthcoming year: s.173(3);
(iii) statutory declaration must be supported by a report from the auditors: s.173(5);
(iv) resolution must be passed on or within one week of the statutory declaration and payment must not be sooner than five nor later than seven weeks thereafter: s.174(1);
(v) resolution must be publicised within one week both in the *Gazette* and an appropriate national newspaper: s.175;
(vi) copy of the statutory declaration and the auditors' report must be delivered to the Registrar.

Any creditor and any member who did not vote in favour may apply to the court within five weeks to have the proposed payment set aside: s.176. If the company goes into liquidation within one year of the payment, the vendors of the shares and the directors signing the statutory declaration are liable to contribute to any shortfall of assets to the extent of the original payment.

Reduction of capital

Companies can reduce their capital under ss135–140. The authority must exist in the company's Articles, a special resolution of the company must be passed, and the approval of court must be gained: s.135 (1). The Act lists three circumstances when a company may wish to reduce its capital, thus it may:

(a) extinguish or reduce the liability on any of its shares in respect of share capital not paid up; or
(b) either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital which is lost or unrepresented by available assets; or
(c) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up capital which is in excess of the company's wants (s.135(2)).

Reducing capital under (a) and (c) arises where the company decides either that it does not require the reserves of uncalled capital or that it has paid-up capital surplus to its requirements. In the first case it could

reduce its nominal capital by cancelling the shareholders' liability for further calls and reducing the nominal value of its shares. In the second case, it would reduce the nominal value of the shares and refund to its shareholders amounts paid above the new nominal amount. Reducing capital under (b) above arises where a company has lost capital through trading losses. The company merely writes off the losses by reducing the nominal value of the shares to their real value. There is no cancellation of any obligation to pay a call, nor any return of capital. This type of reduction of capital may be necessary to enable a public company to pay dividends.

Since (a) and (c) directly affect the creditors' guarantee fund, the court will only confirm the reduction once it is satisfied that every creditor of the company has consented to the proposal. The court draws up a list of creditors entitled to object and the company must either obtain their consent or ensure that their claim against the company is settled: s.136. The court may impose conditions on the company before it approves the reduction: s.137(2); the order is only effective once registered: s.138(2). If a public company reduces its capital below the authorised minimum, the reduction will not be registered unless the court directs or the company is first re-registered as a private company: s.139(2). The court may authorise the company to be re-registered as a private company without the passing of the special resolution required by s.53. The liability of shareholders is preserved in respect of the amount by which their shares have been reduced in the case of a creditor who was entitled to object and failed to do so, and where the company cannot pay the amount of his/her debt or claim: s.140.

Where there has been no sanction or an improper sanction by the members, the burden is on the company to prove that the proposed scheme is fair, otherwise the burden is against those seeking to establish that the scheme is unfair: *Re Holders Investment Trust Ltd* [1971] 2 All ER 289.

A company which has more than one class of shares, ordinary and preference, may decide to reduce its capital by buying in the whole of the preference class of shares. This is called a selective reduction. If a selective reduction does not involve a variation of the class rights of the shares to be reduced, there is no need to obtain the sanction of the class being reduced: *Prudential Assurance Co. Ltd* v. *Chatterley-Whitfield Collieries Ltd* [1949] AC 512; *Scottish Insurance Corp. Ltd* v. *Wilsons & Clyde Coal Co. Ltd* [1949] AC 462; *Re Saltdean Estate Co. Ltd* [1968] 1 WLR 1844; and *House of Fraser plc* v. *ACGE Investments Ltd* [1987] AC 387 (see p. 225).

8.9 The Payment of Dividends

Companies cannot make a distribution except out of profits available for the purpose: s.263(1). These are defined as 'accumulated, realised profits, so far as not previously utilised by distribution or capitalization, less its accumulated, realised losses, so far as not previously written off in a

reduction or reorganisation of capital duly made': s.263(3). Public companies are further restricted in that they cannot make distributions which would reduce the net assets below the aggregate of the called-up capital and undistributable reserves. The 'net assets' are defined as the aggregate of the company's assets less the aggregate of its liabilities; and the undistributable reserves are:

(i) the share premium account;
(ii) the capital redemption reserve;
(iii) the amount by which the company's accumulated, unrealised profits, so far as not previously utilised by capitalization of a description to which this paragraph applies, exceed its accumulated, unrealised losses (so far as not previously written off in a reduction or reorganisation of capital duly made); and
(iv) any other reserve which the company is prohibited from distributing by any enactment or by its Memorandum or Articles.

The restrictions on public companies is to ensure capital maintenance, and the significance of the share premium account and the capital redemption reserve can be appreciated. The principle behind treating the revaluation reserve as an undistributable asset is to prevent the company from distributing unrealised profits.

Shareholders are liable to repay any distribution received where they knew or had reasonable grounds for believing that the distribution is in breach of the Act: s.277. In *Precision Dippings Ltd* v. *Precision Dippings Marketing Ltd* [1985] 3 WLR 812, it was held to be *ultra vires* for a company to pay dividends except out of profits available for the purpose.

8.10 Financial Assistance for the Acquisition of Own Shares

Public and private companies are prohibited from giving financial assistance to persons to enable them to acquire shares in the company or in its holding company: s.151. Financial assistance is not defined, but includes gifts, guarantees, securities or indemnities and financial assistance by way of a loan: s.152. The prohibition relates to direct and indirect, and contemporaneous and subsequent financial assistance. Thus it is prohibited to give a loan and so on for the purposes of enabling somebody to purchase shares: s.151(1), and where they have already acquired those shares, to reduce or discharge any liability they have incurred in the acquisition: s.151(2). There is no prohibition against financial assistance from a parent in respect of a subsidiary, and a foreign subsidiary is not prohibited from giving financial assistance in respect of the purchase of shares of its English parent: *Arab Bank plc* v. *Mercantile Holdings Ltd and Another* [1994] 1 BCLC 330.

Companies breaching the law on financial assistance are liable to a fine, and every officer in default is liable to imprisonment or a fine, or

both: s.151(3). The share purchase transaction itself is valid, but any contract breaking the law and any securities issued in contravention of the law are void, *Heald* v. *O'Connor* [1971] 1 WLR 497, but the courts may sever the illegal aspect of the transaction and anything not affected by the illegality is valid and enforceable: *Carney* v. *Herbert* [1985] AC 301.

Exceptions to the general rule

The principal purpose exception

The main emphasis is now on the predominant purpose for which the assistance is given and the good faith of those giving it. Thus, the giving of contemporaneous financial assistance is not prohibited if the principal purpose is not for the purpose of an acquisition of shares, or, if it is, it is an incidental part of some larger purpose of the company, and given in good faith and in the interests of the company: s.151(1). The giving of subsequent financial assistance is not prohibited if the principal purpose is not to reduce or discharge any liability incurred by a person for the purpose of the acquisition or, if it is, it is an incidental part of some larger purpose of the company and in good faith and in the best interests of the company: s.153(2). The exception was introduced following *Belmont Finance Corpn Ltd* v. *Williams Furniture Ltd* (No. 2) [1980] All ER 393, to validate bona fide transactions by a company with an incidental aim of providing financial assistance – for example, the bona fide purchase of assets by a company where the purchase enables the vendor to purchase shares in the company. The exception has been severely limited by the House of Lords' decision in *Brady* v. *Brady* [1988] BCLC 20, which stressed that there must be an identifiable principal and subsidiary purpose at the same time for the exception to operate. The court rejected the approach of the High Court and the Court of Appeal that the exception validated financial assistance as part of a company reconstruction or to avoid management deadlock. The case concerned the division of a group into two separate business between the two brothers who controlled it and who had fallen out.

Technical exceptions include the distribution of a dividend lawfully made, the allotment of bonus shares and reductions of capital under s.137, and redemption and purchase of shares: s.153(3). Another exception relates to loans made by a company in the ordinary business of the company: s.153(4)(a). It is limited to companies where lending is a principal object, and the loan must not be restricted solely for the purpose of the purchase of shares: *Steen* v. *Law* [1963] AC 287; it is not enough that there is a mere power to lend money in the company's objects. A further exception is provision by a company in good faith in the interests of the company, of financial assistance for the purpose of an employees' share scheme or facilitating share transactions involving employees, former employees or their wives, husbands, widows, widowers, children or

stepchildren aged under 18: s.153(b) & (bb). The making by a company of loans to persons (other than directors) employed in good faith by the company with a view to enabling them to acquire fully paid shares in the company or its holding company to be held by them as beneficial owners: s.153(4)(c). For public companies, the giving of financial assistance under s.153(4) only applies where the net assets are not reduced or the assistance is out of distributable profits: s.154.

Exemption for private companies

Private companies may give financial assistance for the acquisition of shares subject to the rules in ss155–58. The directors must make a statutory declaration as to the state of the company immediately following the financial assistance and for the future (both as a going concern and in the event of its going into liquidation): s.156. The assistance must be approved by the members of the company by a special resolution and there is the right for the dissenting minority to apply to the court for a cancellation of the resolution: s.157. In addition, the payment of the assistance cannot be earlier than four weeks from the date of the special resolution, nor more than eight weeks from the date of the statutory declaration. Where there is an application for cancellation, the payment cannot be made until the final determination of the application unless the court orders otherwise.

Civil liability arising from financial assistance

Companies cannot sue to recover money paid under a contract since it is illegal. However, directors will be liable to account to the company in respect of their breach of trust. In addition, persons who have knowingly been an accessory to the wrongful misapplication of corporate property by the directors are liable to account to the company as constructive trustees. Liability as an accessory to a breach of trust requires dishonesty on the part of the accessory, whether or not the directors themselves are also acting dishonestly. Thus if the directors misapply corporate assets believing they are acting honestly in reliance on the advice of a dishonest third party, the third party will be liable to account even though there is no such liability on the directors: *Royal Brunei Airlines Sdn Bhd* v. *Tan Kok Ming* [1995] 2 AC 378. Furthermore, third parties who have knowingly received misapplied corporate funds or property are also liable to account to the company as constructive trustees. There has been uncertainty about the knowledge level to establish liability as a constructive trustee. In *Baden Delvaux & Lecuit* v. *Société Générale pour favoriser le développement du commerce et de l'industrie en France SA* [1983] BCLC 325, Peter Gibson J identified five kinds of mental state: (i) actual knowledge; (ii) wilfully shutting one's eyes to the obvious; (iii) wilfully and recklessly failing to make such enquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an

honest and reasonable man; and (v) knowledge of circumstances which would have put an honest and reasonable man on enquiry. Liability as a constructive trustee in either respect requires knowledge within the first three categories – there must be a degree of intentional wrongdoing. A claim based on constructive knowledge or notice (categories (iv) and (v)) will fail. In addition, the company can sue the directors for damages for conspiracy: *Belmont Finance Corpn Ltd* v. *Williams Furniture Ltd* [1979] Ch 250. A minority shareholder can initiate a derivative action under the common law exceptions to *Foss* v. *Harbottle*, or petition under s.459 in respect of an illegal transaction.

8.11 Companies Taking Charges over Their Shares

Public companies cannot take a charge over their own shares: s.150. This is subject to exceptions, principally where the ordinary business of the company includes the lending of money or the provision of credit or bailment of goods under hire-purchase.

8.12 Shares and Shareholders

A share is the expression of a proprietary relationship. Shareholders are owners of the company but do not own the company's assets, which belong to the company as a separate and independent legal entity: *Macaura* v. *Northern Assurance Co.* [1925] AC 619. Being a shareholder gives the right to receive a proportion of the profits of the company by way of a dividend while the company operates and a proportion of its assets in the winding up, and all other benefits of membership. A share has been defined as 'the interest of the shareholder in the company measured by a sum of money, consisting of a series of mutual covenants entered into by all the shareholders *inter se* and made up of various rights contained in the contract in the articles': *Borland's Trustee* v. *Steel Bros & Co. Ltd* [1907] 1 Ch 279. A share is a unit of account for measuring a member's interest in the company. Each share is required to have a sum of money assigned to it as its nominal – or par – value.

The rights and liabilities of the shareholder

A share is a bundle of several rights and liabilities. The principal duty is to pay the nominal value of the share and any premium. The principal rights are (i) the right to a dividend if while the company is a going concern a dividend is duly declared; (ii) the right to vote at the meetings of members; and (iii) the right, in the winding up of the company, after the payment of the debts, to receive a proportionate part of the capital or otherwise to participate in the distribution of the assets of the company.

Registered and bearer shares

The CREST registration and transfer system allows listed securities to be held in electronic files. Private investors can have certificates or be a sponsored member of CREST through their broker, remaining the registered holder and transfering their securities through their sponsor. Shares can also be held for them by a nominee company of a CREST member, e.g. a bank. It is difficult to mortgage shares without share certificates. The material concerning certificates is, therefore, of limited relevance.

Shares will normally be registered and a company must have a power in its Articles to enable it to issue bearer shares: s.188. The title in respect of registered shares depends on the entry of the holder's name in the Register of Members and transfer of title involves the substitution of the name of the transferee for that of the transferor. The share certificate is prima facie evidence of title: s.186. For bearer shares, the holder is issued with a share warrant which may include coupons for the payment of dividends. This is a document of title and the shares are transferable by delivery of the warrant, which is a negotiable instrument. A transferee for value, in good faith and without notice of the defective title of the transferor obtains a good title as holder in due course. A person holding bearer shares is not automatically a member of the company: this will depend upon the Articles.

Mortgages of shares

Shares can be mortgaged as a security for a loan (see Chapter 10).

Classes of share

Prima facie, all shares enjoy equal rights, and where a company divides its shares into different classes, the presumption of equality must be specifically displaced. Where a company has divided its capital into shares of different classes, for which it must have authority in its Articles, it is at liberty to attach to them such descriptions as appear appropriate, and the rights will vary from company to company. All shares may now be issued as redeemable shares. The most usually encountered classes are *ordinary shares*, *preference shares* and *deferred shares*.

Ordinary shares

Ordinary shares have no express rights or privileges conferred above those implied by the law. Unless otherwise indicated, all shares issued by a company are presumed to be ordinary shares. The rights of an ordinary shareholder implied by law are (i) to be paid on unlimited, non-cumulative dividend where the company makes a profit and a dividend is declared – and payment will be after payment of any preference dividends; (ii) to receive notice of and attend and vote at general meetings of the company; and (iii) to the return of capital and share in any surplus capital in the event of winding up.

Preference shares

Preference shareholders always have priority over ordinary shareholders to payment of a fixed dividend. In addition there may be a preferential right to a return of capital on winding up. There is a presumption that the right to a dividend is cumulative: *Webb* v. *Earle* (1875) LR 20 Eq. 556. Although presumed cumulative, the right to a dividend only arises when the dividend is declared, and arrears of undeclared cumulative dividend are not provable in a winding up. Where provision is made for payment of non-declared dividend, they are paid out of surplus assets after payment of the company's debts.

Where shares are given preferential rights, they are an exhaustive statement of those rights. A preferential right to a fixed dividend means there is no right to participate in further dividend distributions to ordinary shareholders: *Will* v. *United Lankat Plantations Ltd* [1914] AC 11. Similarly, the right to a preferential return of capital on winding up excludes a claim against surplus assets of the company on winding up: *Scottish Insurance Corporation Ltd* v. *Wilsons & Clyde Coal Co. Ltd* [1949] AC 462. In this case, the House of Lords stated: 'Whether a man lends money to a company at 7% or subscribes for its shares carrying a cumulative preferential dividend at that rate, I do not think that he can complain of unfairness if the company … proposes to pay him off.'

On a reduction of capital, shares with a preferential right to return of capital on a winding up must be repaid first: *Re Chatterley-Whitfield Collieries Ltd* [1948] 2 All ER 593, and *Prudential Assurance Co. Ltd* v. *Chatterley-Whitfield Collieries Ltd* [1949] AC 512. This exposes preference shareholders to a selective reduction of capital and, as long as the shareholders are given the same rights on a reduction as they are entitled to on a winding up, there is no variation of their class rights and they have no right to object. The risk of prior repayment is 'part of the bargain between the shareholders and forms an integral part of the definition or limitation of the bundle of rights which make up a preferred share': *Re Saltdean Estate Co. Ltd* [1968] 1 WLR 1844; *House of Fraser plc* v. *ACGE Inv. Ltd* [1987] AC 387, affirmed by the House of Lords *Re House of Fraser plc* [1987] BCLC 293. However, in *Re Northern Engineering Industries plc* [1994] 2 BCLC 704 the Articles provided that the rights attached to any shares shall be deemed to be varied by 'the reduction of the capital paid up on those shares'. The company proposed to reduce its capital by paying off the preference shares and cancelling them. The Court of Appeal confirmed the decision of the High Court in refusing to confirm the reduction on the grounds that it constituted a variation of class rights and that the shareholders had not consented.

Deferred shares

Also known as management or 'founders' shares, they usually carry multiple voting rights with the right to an unlimited dividend deferred until a fixed minimum percentage is paid to the ordinary shareholders. Capital

repayment is usually deferred, in which case the deferred shareholders have exclusive rights to surplus assets. The prospectus is required to give details of any deferred shares. They are rarely issued and most have been converted into ordinary shares.

Variation of shareholders' rights

The power to vary the shareholders' rights depends on whether there is one class, or two or more classes of share. In the first case the shareholders have membership rights and in the second they have class rights. Where there is only one class of share, the company's power to alter the rights depends on whether they are contained in the Memorandum or the Articles. If in the Memorandum they can be varied under s.17, unless there is a prohibition on alteration; and, if in the Articles, under s.9.

Variation of class rights

The rules relating to variation of class rights depend on whether the rights are contained in the Memorandum or elsewhere than the Memorandum and are governed by ss125–7. Where the rights are contained in the Articles or the terms of issue, there will generally be provision for variation of class rights, usually by reference to approval by extraordinary resolution at a class meeting; and, if so, the procedure must be followed. Failing this, there is a statutory procedure for variation, either with the written consent of three-quarters of the shareholders of that class, or the sanction of an extraordinary resolution passed at a separate class meeting: s.125(2).

Where the rights are in the Memorandum, there are three possibilities. If the Memorandum prohibits variation, then the rights are unalterable except by way of a reconstruction under s.425. If the Articles set out a procedure included at the time of original incorporation, rights can only be varied in accordance with that procedure. If there is no procedure stipulated in either the Memorandum or the Articles, variation of rights requires the unanimous consent of all the members of the company: s.125(5).

Whether the rights are contained in the Memorandum or the Articles, in either case, where the variation is concerned with the directors' authority to issue shares under s.80 or with a reduction of capital under s.135, then, in spite of any procedure stipulated in the Memorandum or Articles, the holders of three-quarters of the issued shares of that class must give written consent to the variation, or it must be sanctioned by an extraordinary resolution passed at a class meeting. In all cases requiring resolutions, private companies can proceed by unanimous written resolution under s.381A. The alternative right to proceed by way of a s.425 reconstruction is contained in s.126.

Where class rights are varied either by procedures established under the Memorandum or Articles, or the rights are varied under s.125(2), the holders of no less than 15 per cent of the issued shares of the class in question (having not consented to the variation) may apply to the court

within twenty-one days for the variation to be cancelled, in which case it will not have effect unless and until confirmed by the court.

The definition of a variation of class rights

The courts distinguish between a direct variation of the rights and indirect variation by changing the environment in which those rights exist. The latter is not considered a variation of class rights. In *White* v. *Bristol Aeroplane Co.* [1953] Ch 65, an increase in capitalization which diluted the control of the existing class of preference shareholders was not a variation of their class rights; neither was a proposed bonus issue of ordinary shares to defeat the voting control of preference shareholders: *Re John Smith's Tadcaster Brewery* [1953] Ch 308. Further, a resolution by a company with two classes of share, 10p and 50p, with both carrying a right to vote, splitting its 50p shares into five 10p shares and destroying the previous control over special resolutions held by the plaintiff in respect of his 10p shares, was not a variation of class rights: *Greenhalgh* v. *Arderne Cinemas Ltd* [1946] 1 All ER 512. Similarly, a rateable reduction of capital which affected the dividend rights of the preference shareholders was not a variation of class rights: *Re Mackenzie & Co. Ltd* [1916] 2 Ch 450. It is now worth considering whether these decisions would not be grounds for a petition under s.459.

In *Cumbrian Newspapers Group Ltd* v. *Cumberland & Westmorland Herald Newspaper & Printing Co. Ltd* [1986] BCLC 286, the plaintiff company acquired over 10 per cent of the shares of the defendant company and the defendant's Articles were altered so that the plaintiff could prevent the defendant from being taken over without its consent by conferring special rights on the plaintiff. The court defined these as rights conferred on the plaintiff as a member of the company but not attached to any particular class of shares, but held that where specific rights were conferred on members in their capacity as members, the shares for the time being held by those members constituted a 'class of shares' and the rights should be categorised as class rights for the purposes of s.125. In *Harman and Another* v. *BML Group Ltd* [1994] 1 WLR 893, a company had 190 000 B shares held by B and 310 000 A shares, 260 000 of which were held by H and M. Under a shareholders' agreement the two classes of shares ranked equally except for certain specified pre-emption rights, and a shareholders' meeting could not have a quorum unless a B shareholder or proxy was present. In an appeal against a decision under s.371 that a quorum constituted any two members of the company, the Court of Appeal held that B's right to be present in a quorum was a class right not to be overridden by s.371.

8.13 Becoming a Member of a Company

A person can become a member of the company by (i) allotment; (ii) transfer; (iii) transmission (Table A, arts 29–31); (iv) subscribing to

the Memorandum; and (v) estoppel (holding out). Except in the case of subscription, there are two conditions of membership: agreement to become a member, and entry on the register of members. Transmission is where the shares are passed to another on the death of a former shareholder, and estoppel arises where a person allows his/her name to appear in the register of members without requesting a correction of the register.

8.14 Ceasing to be a Member

A person ceases to be a member of the company by: (i) transfer; (ii) forfeiture or surrender (Table A, arts 18–22); (iii) sale by the company under its power of lien (Table A, arts 8–11); (iv) transmission (Table A, arts 29–31); and (v) redemption of redeemable shares.

8.15 Transfer of Shares

Unless the company's Articles provide otherwise, every shareholder has a right to transfer his/her shares freely: s.182. The company cannot register the transfer unless a proper instrument of transfer is delivered to it: s.183 (1), and until this is done and the transferee's name is entered on the register of members, s/he acquires an equitable title only. A share certificate is prima facie evidence of title: s.186, and the certification by a company of any instrument of transfer of any shares in the company is to be taken as a representation to any person acting on the faith of the certification that there have been produced to the company documents which show a prima facie title to the shares named in the instrument. The certification does not, however, constitute a representation that the transferor has any title to the shares: s.184(1). Where a person acts on the faith of a false certification made negligently, the company is under the same liability to him/her as if the certification had been made fraudulently. The regulations for transfer are contained in Table A, arts 23–8. The company has a duty to have ready for delivery a certificate of all shares within two months of allotment or of the date of the lodging of a transfer: s.185(1). The company and every officer in default is liable to a fine in default of s.185(1): s.185(5).

Restrictions on transfers

The Articles of private companies may allow the directors to refuse to register transfers of shares. Where the refusal is not on specified grounds, the directors are not required to give a reason for their refusal, which cannot be questioned unless there is evidence that they had not acted bona fide or had not considered the question at all: *Re Coalport China Co.* [1895] 2 Ch 404. Where the directors have an absolute discretion to refuse to register a transfer without giving reasons, the power is subject

only to the duty of the directors to act bona fide in what they consider to be the best interests of the company: *Re Smith & Fawcett Ltd* [1942] Ch 304. The burden of proving that they have not acted bona fide is on the person seeking to establish *mala fides*: *Charles Forte Investments Ltd* v. *Amanda* [1963] 2 All ER 940.

Public companies can have restrictions on free transferability except if their shares are dealt with on the Stock Exchange or the Alternative Investment Market (AIM). The most frequent restriction is the pre-emption clause which provides that shares cannot be transferred to a non-member as long as there is an existing member prepared to purchase them at a fair price. Where articles provide that shares must first be offered to existing members before they can be transferred to an outsider, a transfer to an outsider without the members' knowledge is invalid: *Tett* v. *Phoenix Property & Inv. Co. Ltd* [1986] BCLC 149.

Articles may provide that other members are bound to buy the shares of a member wishing to transfer them, *Rayfield* v. *Hands* [1960] Ch. 1, and a company enforcing a power of sale under a lien must comply with the clause: *Champagne Perrier–Jonet SA* v. *H. H. Finch Ltd* [1982] 3 All ER 713.

8.16 Estoppel by Share Certificate

Share certificates contain two statements of fact: the name of the registered holder, and the extent to which the shares are paid up. If a company issues certificates which are incorrect and the statements are relied on by a third party, the company is estopped from denying the truth of the statement. This may result from the submission to the company of a forged transfer document. In *Re Bahia and San Francisco Rly Co.* (1868) LR 3 QB 584, T, the registered holder of five shares, left the share certificate with her broker. Later a forged transfer purporting to be executed by T in favour of S and G was sent to the company for registration and a certificate issued to S and G. They later sold the shares to B. The company was ordered to restore T's name to the register and B was awarded damages against the company on the ground that the company was estopped from denying that S and G were the legal holders.

There must be an act in reliance on the false statement; thus the company is not generally liable to the person to whom the share certificate is issued. However, in *Balkis Consolidated Co.* v. *Tomkinson* [1893] AC 396, Tomkinson, acting in reliance on his supposed title to the shares, entered into a contract to sell them. When the company refused to register the transfer, he purchased more shares to honour his contract and successfully claimed damages against the company. The company can claim an indemnity from the person sending in the forged transfer, even though the person is totally innocent: *Sheffield Corporation* v. *Barclay* [1905] AC 392; and *Yeung Kei Yung* v. *Hong Kong & Shanghai Banking Corpn* [1981] AC 787. In *Bloomenthal* v. *Ford* [1897] AC 156 the appellant

lent money to a company on the security of 10 000 £1 fully paid shares in the company. He was ordered to be removed from the list of contributories in respect of the shares on which nothing had been paid up on the grounds of estoppel. In *Ruben* v. *Great Fingall Consolidated* [1906] AC 439, it was held that a company could not be estopped by a forged share certificate issued by the company secretary, but the position now appears to be that a company is bound where a share certificate is authenticated by a company officer acting within the scope of his authority.

In *Longman* v. *Bath Electric Tramways Ltd* [1905] 1 Ch 646, B became the registered holder of shares but two certificates made out in his name were not sent to him since, on the same day, B presented to the secretary for certification a transfer of the shares to H and M. Subsequently the secretary, by mistake, returned the original certificates to B, who lodged them with L as security for a loan. In an action by L to be registered as holder, the court held that the company owed a duty of care only to the transferee in respect of a share certificate lodged for certification, and that the proximate cause of the loss was the improper use by B of the certificates.

8.17 The Register of Members

Every company must keep a register of members, the contents of which are specified in s.352. The register must be kept at the registered office or at the place where it is made up, when the Registrar of Companies must be informed where it is kept: s.353. The register must be available for inspection and members may obtain a copy of the register or part of it on the payment of the appropriate charge. The company can close the register to members for not more than thirty days each year on giving notice by advertisement: s.358. The court can rectify the register: s.359. No notice of any trusts shall be entered on the register or be receivable by the Registrar, s.360, and the register is prima facie evidence of matters entered in it: s.361.

8.18 The Register of Substantial Shareholdings

There are provisions for disclosure of substantial shareholdings carrying unrestricted voting rights. If a person obtains an interest in at least 3 per cent of the nominal value of that share capital or disposes of the same, s/he has an obligation within two days of notifying the company in writing of that fact. The company must make the necessary entry within three days in a special register: ss198–219.

8.19 The Directors

A director includes ‘any person occupying the position of a director, by whatever name called’: s.741. This includes legally appointed – *de jure* –

directors and persons who are not appointed as such but who function as directors – *de facto* directors. In addition there is the 'shadow director', defined as a person 'in accordance with whose directions or instructions the directors of the company are accustomed to act' s.741(2) – but excludes persons giving advice in a professional capacity and parent companies in respect of their subsidiaries. The Company Directors Disqualification Act 1986 s.22 also contains a similar definition of a director (ss4) and shadow director (ss5) as does the Insolvency Act 1986 (s.251). However, in these cases, the definition of shadow director does not exclude parent companies in respect of subsidiaries.

There was no distinction made between a *de facto* and shadow director in *Re Tasbian Ltd* (No. 3) [1991] BCLC 792 where Balcombe LJ referred to the appellant, a 'company doctor' as a shadow or *de facto* director in connection with disqualification proceedings. However, in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, Millett J saw them as alternatives and 'in most and perhaps all cases … mutually exclusive'. A *de facto* director is held out as a director by the company, and claims and purports to be a director although never actually or validly appointed as such. It is necessary to prove that s/he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that s/he was concerned in the management of the company's affairs or undertook tasks which can be performed by a manager. A shadow director, by contrast, claims not to be a director and is not held out as a director by the company. It is necessary to prove (i) who are the directors of the company – *de facto* or *de jure*; (ii) that the defendant directed those directors how to act or was one of the persons who did; (iii) that those directors acted in accordance with such directions; and (iv) that they were accustomed so to act. The case concerned a claim that the holding company (and possibly also its directors) could be a shadow director of a subsidiary.

There have been unsuccessful attempts to establish banks as shadow directors: *Re A Company* [1989] BCLC 13; and *Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd* [1991] 1 AC 187, where the bank was not a shadow director as it only nominated two directors out of a board of five. A company can be a director: s.289 (1)(b).

The appointment of directors

Those named in the statement of first directors and secretary are deemed appointed: s.10(2). Subsequent appointments are governed by the Articles, which usually provide for appointment in general meeting by ordinary resolution (Table A: 73–80), the board generally has a power to fill casual vacancies (Table A: 79).

No person other than a director retiring by rotation shall be appointed a director at an AGM unless: (i) s/he is recommended by the directors; or (ii) not less than fourteen nor more than thirty-five days before the date appointed for the meeting, notice by a member qualified to vote has been given of the intention to propose that person stating the particulars

required for register of directors, s.289, together with notice by the person of willingness to be appointed (Table A: 76). Not less than seven nor more than twenty-eight days' notice must be given to all entitled to receive notice of the meeting of a person recommended by the directors or of whom notice has been given under Table A: 76 (Table A: 77). Notice must give particulars of the person required for the register of directors.

Directors of a public company must be voted on individually unless the meeting has unanimously agreed to waive the rule, otherwise the appointment is invalid: s.292. Directors can appoint a person to act for them as an alternate director: Table A: 65–9.

The number of directors

For a private company there must be a minimum of one director, and for a public company the minimum number is two: s.282. A sole director may not be the secretary of the company: s.283(2); and this restriction cannot be avoided by the device of corporate personality: s.283(4). The number of directors may be increased by ordinary resolution (Table A: 64).

The retirement of directors

At the first AGM all directors retire and at every subsequent AGM one-third or the number nearest must retire, being those who have been longest in office since appointment or reappointment (Table A: 73). Where persons are appointed on the same day, those to retire are decided by lot (Table A: 74). If the vacancy is not filled at the AGM, the director shall be deemed reappointed unless it is resolved not to fill the vacancy, or unless a resolution for reappointment has been put and lost (Table A: 75). A director retiring at an AGM retains office until the meeting appoints a replacement, or until the end of the meeting (Table A: 80).

Age restrictions on directors

Directors of a private company which is not a subsidiary of a public company are not subject to an age limit, but for public companies, a person cannot be appointed if aged 70 or over and must vacate office at the end of the AGM following his/her seventieth birthday: s.293, subject to the power of companies to exclude this measure by their Articles or where they adopt a special procedure for the appointment of directors beyond the age limit: s.293(7) and (5). The control is generally ineffective.

Disqualification of directors

Directors can be disqualified from acting as such either by statute or under the terms of the Articles of Association. Statutory disqualification is the more important area of the law in this respect and the number of directors suffering disqualification has increased greatly in recent times, although

there is still criticism that many who should be disqualified are still escaping as a result of the lack of vigilance of the Department of Trade and Industry.

Statutory disqualification

Under the Company Directors Disqualification Act (CDDA) 1986 the court may (and under s.6 *must*) disqualify persons. Disqualified persons cannot, without leave, be a director, liquidator or administrator of a company, or be a receiver or manager of a company's property or in any way, directly or indirectly, be concerned or take part in promotion, formation or management for a specified period: s.1 CDDA 1986.

The Act does allow a certain discretion, which has led to the court making partial disqualification orders against directors, under which they may be disqualified in respect of one or more companies but be allowed to continue to operate as a director of another, subject to controls: *Re Mathews Ltd* (1988) 4 BCC 513; *Re Majestic Recording Studios Ltd* [1989] BCLC 1; *Re Lo-Line Electric Motors Ltd* [1988] BCLC 698; and *Re Chartmore Ltd* [1990] BCLC 673 (see Chapter 19).

Conviction of an indictable offence A director may be disqualified when convicted on an indictment or summarily, of an offence in connection with the promotion, formation, management or liquidation of a company, or receivership or management of the property of the company. The maximum period of disqualification is five years (summary) or fifteen years (on indictment): s.2 CDDA 1986. In *R* v. *Goodman* [1994] 1 BCLC 349 the Court of Appeal held that insider dealing constituted an offence 'in connection with the … management … of a company' for the purposes of s.2(1) CDDA 1986.

Persistent breaches of companies legislation Directors can be disqualified for breaches relating to any return, account or other document to be filed with, delivered or sent, or notice of any matter to be given, to the Registrar of Companies: s.3 CDDA 1986. Three or more defaults in five years constitutes a persistent breach: s.3 (3). The maximum period of disqualification is five years.

Fraud and so on in winding-up The court may make a disqualification order if a person:

(a) has been guilty of an offence (whether convicted or not) under s.458 (fraudulent trading); or
(b) has been guilty of fraud in relation to the company or breach of his/her duty (this includes shadow directors). The maximum period of disqualification is fifteen years: s.4 CDDA 1986.

Disqualification on summary conviction In connection with filing a return, account or other document the court may make a disqualification order: s.5 CDDA 1986. The maximum period of disqualification is five years.

Duty to disqualify unfit directors of insolvent companies The court must impose a minimum disqualification of two years if a person is or has been director of a company which has become insolvent and where his conduct as a director (including conduct as director of another company) makes him unfit: s.6 CDDA 1986. Unfitness is defined in Schedule I Part II as responsibility for the company becoming insolvent or for transactions which are voidable preferences: s.9. Other factors are taken into consideration by the court, such as continuing to operate the company with a number of debts outstanding: *Re Dawson Print Group* [1987] BCLC 596; *Re Stanford Services* [1987] BCLC 607; *Re Churchill Hotel (Plymouth) Ltd and Others* [1988] BCLC 341; *Re Lo-line Electric Motors Ltd* [1988] BCLC 698; and *Re Sevenoaks Stationers (Retail) Ltd* [1990] 3 WLR 1165; general breaches of standard of care as a director for which an objective test is applied: *Re Bath Glass* [1988] BCLC 329; *AB Trucking and BAW Commercials* (unreported, 3 June 1987); *Re DKG Contractors Ltd* [1990] BCC 903; *Re Civicia Investments Ltd* [1983] BCLC 456; and *Re Crestjoy Products Ltd*, 18 October 1989 (Lexis). The court also takes mitigating factors into consideration: *Re Rolus Properties Ltd & Another* (1988) 4BCC 446 (reliance on professional advice); and Re Chartmore [1990] BCLC 673 (youth).

Application is by the Secretary of State only, but s/he can direct the Official Receiver to apply where a company is being wound up by the court. Except with leave, application cannot be made after two years from the company becoming insolvent. Where leave is sought for an extension, the court must consider (i) the length of the delay; (ii) the reasons for the delay; (iii) the strength of the case against the director; and (iv) the degree of prejudice caused to the director by the delay, but before considering these points, the application should be refused if the applicant's case is so weak that it could not lead to a disqualification: *Re Polly Peck International plc* (No. 2) [1994] 1 BCLC 574. The liquidator, administrator or administrative receiver have a statutory duty to report to the Secretary of State if aware of evidence of a director's unfitness: s7(3). 'Director' includes shadow directors. The maximum period of disqualification is fifteen years.

In *Re Sevenoaks Stationers (Retail) Ltd* [1990] 3 WLR 1165, the Court of Appeal divided a fifteen-year period into three: ten or more years reserved for particularly serious cases; two to five years where the case is relatively not very serious; and six to ten years for serious cases not meriting the top bracket. In *Re Seagull Manufacturing Co. Ltd* (No 2) [1994] 1 BCLC 273, the court held that, although as a general principle legislation only applied to British subjects or to foreigners present in England, in the light of the fact that a company in s.6(1) included a foreign company, and that companies could be controlled across frontiers, Parliament must have intended that s.6 would extend both to foreigners who were out of the jurisdiction and to conduct which occurred out of the jurisdiction.

Disqualification after investigation of company Persons may be disqualified from acting as directors following investigation by DTI inspectors under s.432, or where information from documents obtained under

ss447 and 448 satisfies the court of unfittedness under Schedule I, Part I: s.8 CDDA 1986. This includes misfeasance, breach of fiduciary or other duty; misapplication or retention or any other conduct giving rise to obligation to account for money or other property; and failure to comply with statutory regulations concerning registration. Application is restricted to the Secretary of State. In *Re Looe Fish Ltd* [1993] BCLC 1160, the allotment of shares by a director to maintain control of the company constituted evidence of unfitness for the purposes of s.8.

In *Re Blackspur Group plc* [1998] 1 WLR 422 the Secretary of State sought the disqualification of the applicant (among others) under ss6 and 8 CDDA 1986; the applicant accepted that there was a prima facie case and that, if the allegations were proved, he was likely to be disqualified for ten years. He applied for the proceedings to be stayed against an undertaking never again to be a director or in any way involved in the management of a company. The Secretary of State objected and the Court of Appeal affirmed the decision of the court that an undertaking did not have the same effect as a CDDA order, and that it was wrong in principle for the court to stop proceedings.

Participation in wrongful trading Directors who are liable to contribute under s.213 or s.214 Insolvency Act 1986 can be disqualified for a maximum of fifteen years: s.10. There is no requirement to make an application for disqualification.

Undischarged bankrupts Cannot act as a director of, or directly or indirectly to take part in or be concerned in the promotion, formation or management of, a company except with the leave of the court: s.11. This is a strict liability offence. In *R* v. *Brockley* [1994] 1 BCLC 606, the defendant was liable when he acted as a company director, believing that he had been discharged from his bankruptcy and having been so advised by a para-legal employed by his then solicitors. The same applies for failure to pay under a county court administration order: s.429 Appropriation Act 1986, s.12.

Consequences of contravention

Breach of a disqualification order (or an offence under ss11 & 12) incurs criminal penalties: s.13. Where the offence is committed by a body corporate with the connivance, consent or attributable to the neglect of any officer, that person can be prosecuted: s.14. A person acting in breach of the provisions is jointly and severally liable for the debts of the company: s.15. The Secretary of State maintains a register of disqualification orders, which can be inspected on the payment of a fee: s.18.

Disqualification under the terms of the articles

Articles usually require directors to vacate office on becoming unsound of mind, or if they are absent from meetings for a specified length of time (Table A; 81). The director may be required to hold qualification shares,

in which case s/he must acquire the requisite shareholding within two months of appointment and if s/he fails to do so, or subsequently disposes of them, s/he will automatically cease to be a director of the company: s.291. Where a director is automatically disqualified or where his/her appointment is defective, any acts carried out will be valid notwithstanding the defective appointment or lack of qualification: s.285.

Resignation and removal of directors

Resignation is effective when notified and cannot be withdrawn without consent of the persons entitled to appoint new directors. Oral resignation at the GM is effective even where articles require resignation in writing.

A director can be removed by an ordinary resolution of the shareholders with special notice: s.303. A copy of the resolution must be sent to the director, who can have written representations of a reasonable length sent to members and speak at the meeting: s.304. The company gives notice of the resolution with notice of the meeting (or by newspaper advertisement or other ways allowed by Articles) at least twenty-one days before the resolution: s.379(2). A 'life' or 'permanent' director is removable under s.303: *Pedley* v. *Inland Waterways Assoc. Ltd* [1977] 1 All ER 209; and *Bushell* v. *Faith* [1970] AC 1099.

Publicity concerning directors

Companies must keep a register of directors and secretaries at their registered office. Information is specified by s.289 (directors) and s.290 (secretaries): s.288. The register must be updated within fourteen days and remain open during business hours for no less than two hours for any member to inspect at no charge; and other persons on the payment of a nominal sum.

8.20 Directors' Duties

Directors have statutory duties to the company but they also, as a body, have an equitable duty to act in good faith for the benefit of the company. In addition, as individuals, they are also in a fiduciary position in relation to the company. Traditionally, the fiduciary duties were only owed to the company and not to shareholders, either individually or collectively. However, this is subject to certain exceptions. The duties may also be owed to creditors in certain circumstances.

No fiduciary duty to individual shareholders

In *Percival* v. *Wright* [1902] 2 Ch 421, where the plaintiffs offered to sell shares to the directors at a specific price, after the sale they discovered that the directors has been negotiating for the sale of the company at that time, and that they had placed a higher value on the shares than had been

received by Percival. The court rejected the claim to set aside the contract, on the grounds that no duty was owed to individual shareholders but to the company alone. There is an exception where directors hold themselves out as agents of the shareholders: *Allen* v. *Hyatt* (1914) 30 TLR 444. In *Heron International Ltd* v. *Lord Grade* [1983] BCLC 244, the Court of Appeal found that the directors of a company which was the target of two rival take-over bids may owe duties to their shareholders, but the orthodox view was restated by Dillon LJ in *Multinational Gas and Petrochemical Co.* v. *Multinational Gas and Petrochemical Services Ltd* [1983] 2 All ER 563; and in *Dawsons International plc* v. *Coats Patons plc* (1988) 4 BCC 305, and *Stein* v. *Blake* [1998] 1 All ER 724.

Possible fiduciary duty to creditors

In *Winkworth* v. *Edward Baron Development Co. Ltd* [1987] 1 All ER 114, Lord Templeman stated, 'A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.' The issue of the creditors' interests was also addressed by Nourse LJ in *Brady* v. *Brady* [1988] BCLC 20, where he stated, 'in a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much. Conversely, where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone'. Where there is an identifiable breach of duty to creditors, this may then be the subject of misfeasance proceedings under s.212, Insolvency Act 1986. In *Re Purpoint Ltd* [1991] BCLC 491, the court made an order against the director in respect of money used to purchase a car on hire-purchase when the company was insolvent, and where the evidence suggested that the car was nothing to do with the company's business but was bought for the new business venture of the director. The fact of a director owing a duty to creditors was disputed in *Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd* [1991] 1 AC 187, which makes developments in this area uncertain to predict.

Fiduciary duty to employees

Directors are statutorily bound to have regard to the employees' interests: s.309(1). The duty is not owed to the employees and is enforceable in the same way as any other fiduciary duty: s.309(2).

The fiduciary duty

The fiduciary duty arises from the directors' quasi-trustee position with regard to the company's assets. This duty is owed by all directors, even non-executive directors.

The nature of the fiduciary duties of directors

The general fiduciary duty can be broken down under a number of headings:

(i) to act bona fide in the interests of the company as a whole;
(ii) to exercise the powers of the directors for the purposes for which they were conferred;
(iii) not to allow their duty to the company and their personal interests to conflict;
(iv) not to make secret profits from their position;
(v) not to misuse confidential information;
(vi) not to fetter their discretion;
(vii) duty of care, skill and diligence.

Duty to act bona fide in the interests of the company as a whole

Directors have a duty to act in the interests of the company as a whole and not in the interests of any one person or group of persons. In *Re W & M Roith Ltd* [1967] 1 All ER 427, the managing director altered the Articles to enable pensions to be paid to directors, employees and their widows and, when no longer in good health, entered into a service agreement guaranteeing his widow a pension in the event of his dying in office. The court found in favour of the liquidator, who contested the right of the widow of the deceased managing director to prove as a creditor in respect of the value of the pension since the service agreement was not made for the benefit of the company but that of Mrs R. The test is subjective in that it is what the directors consider to be in the interests of the company, not the court: *Re Smith & Fawcett Ltd* [1942] Ch 304.

Duty not to misuse powers

Directors must exercise the powers they are given by the Articles for the proper purpose. The power to allot shares must not be used to create or destroy majorities or for perpetuating the directors' power. In *Piercy* v. *S. Mills & Co. Ltd* [1920] 1 Ch 77, the directors allotted unissued shares to defeat the plaintiff's attempt to become a director; in *Hogg* v. *Cramphorn Ltd* [1967] Ch 254, and *Bamford* v. *Bamford* [1970] Ch 212, the same powers were used to frustrate take-over bids which the directors thought were not in the best interests of the company. In these cases the court allowed the company to ratify this exercise of the power. In *Howard Smith Ltd* v. *Ampol Petroleum Ltd* [1974] 1 All ER 1126, directors issued shares to the plaintiff, preferring the company to be taken over by the plaintiff rather than by the defendant company and an associate company which controlled the company and sought to make it a wholly owned subsidiary. This area of abuse is severely curtailed since the board's power to allot shares is restricted by s.80, and pre-emption rights for existing shareholders over new issues exist in s.89; however, private companies can exclude these provisions and public companies can qualify them.

Duty to avoid conflict of interests

The old equitable rule as defined in *Aberdeen Rly Co.* v. *Blaikie Bros* (1854) 2 Eq Rep 1281 has been severely weakened. In that case the court held that the fiduciary duty was so strong that 'no one … shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect'; and a contract between the company and a partnership for benches when the company chairman was a partner in the firm was voidable, even though there was no evidence of conflict of interests. The Articles usually allow directors to enter contracts with the company, either directly or indirectly, and to retain profits and commission arising: Table A. art.85. The only restraining influence is the statutory need to declare the interest to the board when the issue of the contract first arises: s.317, and the need to comply with the articles regarding the right to vote on the resolution. Thus Table A, art.94 provides that a director cannot vote on a matter where s/he has a direct or indirect interest, and art.95 provides that, where s/he has no right to vote, a director shall not be counted for the purposes of a quorum at the meeting. It is possible for there to be no voting restriction.

Where a company has entered a contract in which a director has an interest, the contract is ratifiable and the interested director can vote as a shareholder: *North-West Transportation Co. Ltd* v. *Beatty* (1887) 12 App Cas 589. Failure to make the statutory disclosure also makes a contract voidable, *Hely-Hutchinson* v. *Brayhead Ltd* [1968] 1 QB 549; disclosure must be to the whole board and not merely a committee of the board: *Guinness plc* v. *Saunders* [1990] 1 All ER 652. Disclosure of an interest is required even in a company with a single-member board: *Neptune (Vehicle Washing Equipment) Ltd* v. *Fitzgerald* [1995] 1 BCLC 352.

Duty not to make secret profits

A director must not profit personally from opportunities acquired through his/her position without the consent of the company in general meeting. Secret profit must be accounted for unless disclosed to the general meeting and approved by ordinary resolution.

Until recently the standards imposed by English law were very high, but a more flexible approach seems to be emerging. The leading case is *Regal (Hastings) Ltd* v. *Gulliver* [1942] 1 All ER 378, where Lord Russell of Killowen stressed that the defence of bona fides, the absence of fraud or whether or not the profit would or should go to the company was irrelevant as regards the duty to account: 'The liability arises from the mere fact of a profit having … been made. The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account.' This strict doctrine can be seen in *Industrial Development Consultants Ltd* v. *Cooley* [1972] 2 All ER 162, where the defendant was obliged to account to the company, of which he had been the managing director, for the whole of the benefits derived by him under a contract entered in

breach of his duties in spite of the fact that the company itself could never have competed successfully for the contract.

This raises the issue of directors taking personal advantage of corporate opportunities. This can be fraudulent when the directors will normally have to account for any benefit derived or will be deemed to hold the contracts on trust for the company. In *Cook* v. *Deeks* [1916] 1 AC 554, three directors negotiated a contract on behalf of their company and then signed the contract in their own names and used their power as controlling shareholders to pass a resolution that the company had no interest in the contract. They held the contract for the benefit of the company, and the purported ratification was a fraud on the minority.

In *Canadian Aero Service Ltd* v. *O'Malley* (1973) 40 DLR (3d) 371, the president and executive vice-president were liable where, having obtained a contract on behalf of the company, they resigned and acquired the contract for the benefit of their new company. Important indicators for future development are in the following factors which led to the decision: (i) the contract diverted to themselves was a 'maturing business opportunity' of the company; (ii) they had negotiated the contract on the company's behalf; (iii) their resignation was motivated by the desire to take over the benefit of the contract; and (iv) their securing of the contract for themselves was not a result of a fresh initiative but because of their position within the company.

Where the corporate opportunity has been bona fide rejected by the company, a director is free to take up the opportunity personally. In *Peso Silver Mines Ltd* v. *Cropper* [1966] SCR 673 the defendant took up an offer of mining claims rejected by the plaintiff company. The court held that he was not liable to account to the company (now under different control). The court was influenced by the fact that the director was not abusing any confidential information and by a dictum of Greene MR in respect of a hypothetical case in *Regal (Hastings) Ltd* v. *Gulliver* in the Court of Appeal.

A more flexible approach to the corporate opportunities doctrine emerged in *Island Export Finance Ltd* v. *Umunna and Another* [1986] BCLC 460. Umunna, as managing director of the plaintiff company, had secured a contract in 1976 from the Cameroon postal authorities for the supply of post boxes. In 1977 he resigned because of general dissatisfaction and subsequently set up in business on his own and obtained orders from the Cameroon postal authorities for his own company. IEF Ltd claimed that he was liable to account for breach of fiduciary duties and breach of confidentiality. On the breach of fiduciary duties, the court recognised that directors continue to owe a fiduciary duty to their company even after they have left. They were influenced, however, by the fact that, while Umunna may have contemplated the Cameroon postal authorities as a potential future source of business, this was neither a primary nor an important motive for his resignation. In addition, both at the time of resigning and when Umunna secured his orders with them, the possibility of IEF Ltd obtaining further orders could not realistically

be seen to be a maturing business opportunity. The court also found that obtaining the contract was a result of Umunna's fresh initiative. As a result Umunna was not held liable to account.

In *Balston Ltd* v. *Headline Filters Ltd* [1990] FSR 385, Mr Head terminated his employment and resigned his directorship from the plaintiff company after seventeen years, to set up in business on his own. He stated that he had no clear idea at the time of the nature of his future business. He was contacted shortly afterwards by a customer of the plaintiff who informed him that the plaintiff company had indicated to him that they were discontinuing the production of filter tubes which he was in the habit of buying from them. At this point, Head began a business making the filter tubes in question and began supplying them to the previous customer of the plaintiff. The court held that he had not diverted to himself a maturing business opportunity and there was nothing wrong in an ex-director setting up in competition with his ex-company. It is interesting to consider whether the stress on the 'maturing business opportunity' would have resulted in a different decision in *Industrial Development Consultants Ltd* v. *Cooley*.

Directors who are shareholders can use their votes as shareholders to ratify the transaction out of which they have derived secret profits, where the secret profit was not made in bad faith; otherwise the purported ratification will be a fraud on the minority giving rise to a minority action. Thus in *Regal (Hastings)* the court stated *obiter* that, had the profit been disclosed and ratified by the company in general meeting, there would have been no liability to account, whereas in *Cook* v. *Deeks*, the attempted ratification was regarded as ineffective. The distinction between the two cases seems to be the presence or absence of good faith.

Duty of confidentiality

It had previously been accepted that there was no legal objection to directors holding directorships in competing companies. While this still must be the case for non-executive directors, it is doubtful that it is true for executive directors after the decision in *Hivac Ltd* v. *Park Royal Scientific Instruments Ltd* [1946] Ch 169. Thus the old decisions in *London and Mashonaland Exploration Co. Ltd* v. *New Mashonaland Exploration Co. Ltd* [1891] WN 165, and *Bell* v. *Lever Bros* [1932] AC 161 have now been doubted: *Abbey Glen Property Corpn* v. *Stumborg* [1976] 2 WWR 1.

There clearly is a problem where confidential information learned in one company is conveyed to another. *Island Export Finance Lt*d v. *Umunna and Another* [1986] BCLC 460 established that information acquired by a director in the course of his directorship is subject to the same classification as that of an employee as in *Faccenda Chicken Ltd* v. *Fowler* [1987] Ch 117 (see Chapter 12). It stressed that the nature of the continuing fiduciary duty could not be so wide as to categorise as a breach of duty any use by a former director of business knowledge and skill acquired in the course of his/her work which would constitute a restraint of trade.

Duty not to fetter discretion

Directors must not fetter their discretion or act as mere puppets on the instructions of another. In *Selangor United Rubber Estates Ltd* v. *Cradock* (No. 3) [1968] 1 WLR 1555, the directors of a company who, as nominees of the controlling shareholder, acted in accordance with his instructions were given constructive knowledge of his fraudulent intentions and were liable to account for money which they withdrew from the company's bank account in a transaction that constituted an illegal financial assistance. However, in *Fulham Football Club Ltd and Others* v. *Cabra Estates plc* [1994] BCLC 363, undertakings by directors of the football club to the defendant to use their powers as director and shareholders to act in support of the defendant's planned development of the football ground were not in breach of their fiduciary duty not to fetter their discretion.

Duty of care, skill and diligence

There are two problems with regard to the duty of care. First, since the duty was developed by the courts of Chancery, the standard of care expected of directors is analogous to that of the trustee. The standard is therefore that of the honest layman rather than that of a 'reasonable' business man or woman, although there are signs of a move towards this approach in recent decisions. Second, directors who have acted negligently may escape liability through the company ratifying their actions. The duty of care is set out in *Re City Equitable Fire Assurance Co. Ltd* [1925] Ch 407 which establishes the following: (i) a director is expected to show no greater care and skill than can be expected from a person of his/her knowledge and experience; (ii) a director is not required to give his/her full time and attention to the affairs of the company; and (iii) where the management of the company is properly delegated to others, a director is justified, in the absence of grounds for suspicion, in trusting the official to perform such duties honestly.

The subjective nature of the duty results in different standards for different directors. Persons who have professional qualifications relevant to the business will be judged by the relevant professional standard. The statement that a person is not required to give full time and attention to the affairs of the company is only applicable in the case of non-executive directors. Executive directors will be employees of the company under a contract of service and will be full-time appointments. Non-executive directors are judged by the same standards as executive directors: *Dorchester Finance Co. Ltd* v. *Stebbing* [1989] BCLC 498.

Directors who have acted negligently may still escape liability through ratification of their negligent act by an ordinary resolution in general meeting even where the majority of the shares are held by the directors. Doubts on this were expressed in *Re Horsley & Weight Ltd* [1982] Ch 442 1045, where two out of five directors purchased a retirement pension policy for a retiring director. The company went into liquidation a year

later and the court held that it was clearly outside the powers of the two directors to purchase the policy, and that their decision could only be effective if ratified. The two directors were also the sole shareholders and the court held that, since they both assented to the transaction, the transaction was binding and unassailable by the liquidator. The case seemed to draw a distinction between lack of authority and misfeasance so that Templeman LJ stated: 'If there had been … a finding of misfeasance … I am not satisfied that the directors could excuse themselves because two of them held all the issued shares in the company and as shareholders ratified their own gross negligence as directors.' These doubts were rejected by dicta in *Multinational Gas & Petrochemical Co. Ltd* v. *Multinational Gas & Petrochemical Services Ltd* [1983] 2 All ER 563, which decided that these reservations were without foundation, although they did seem to indicate that there is a distinction between negligence and misfeasance which is more than mere negligence. The case decided that, where the directors are carrying out the instructions of the shareholders, they cannot be negligent, since the shareholders owe no duty of care to the company. In *Re D'Jan of London Ltd* [1994] 1 BCLC 561, Mr D'Jan was being sued by the liquidator of his company for having negligently signed an insurance proposal form that enabled the insurers to repudiate liability when a fire destroyed stock owned by the company. Hoffman LJ stated that the *Multinational* principle requires that the shareholders have, formally or informally, mandated or ratified the act. It was not sufficient that they probably would have ratified it if they had known or thought about it before the liquidation. He held that Mr D'Jan's 99% holding of shares was not sufficient for the defence.

The duty of care and wrongful trading

The offence of wrongful trading in s.214 Insolvency Act 1986 establishes an objective duty of care alongside the subjective duty as regards a director of a company (a) which has gone into insolvent liquidation; and (b) where at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation: s.214(2). Directors owe a statutory duty of care to creditors and can be made liable to contribute towards the assets of the company in liquidation (see Chapter 19).

A development from s.214 into the normal law of negligence of directors appears to be under way. In *Norman* v. *Theodore Goddard (A Firm)* [1991] BCLC 1028, Hoffman J stated that he was willing to assume that the test of the director's duty of care should be on the knowledge, skill and experience that he actually had in addition to that which a person carrying out his functions should be expected to have. This was restated as a proposition of the law in *Re D'Jan of London Ltd* [1994] 1 BCLC 561. This approach may overtake the test in *Re City and Equitable*.

8.21 Statutory Enforcement of Directors' Duties

There are a number of specific statutory controls over directors arising from the erosion of the equitable rule preventing directors from contracting directly or indirectly with the company.

Prohibition on tax-free payments to directors

It is not lawful to pay a director remuneration, whether as director or otherwise, free of income tax: s.311.

Payment of compensation for loss of office

It is unlawful to pay a director compensation for loss of office or in consideration of retirement, without approval of the general meeting: s.312. It is also unlawful unless approved when payment is in connection with a transfer of the whole or part of an undertaking: s.313. Any unlawful payment is held on trust for the company: s.313(2).

In a take-over bid, directors must take all reasonable steps to ensure that particulars of proposed payments are sent to members with the notice of the share offer: s.314, and there is liability to a fine on default: s.314(3). Any money paid in default of s.314 is held on trust for persons selling shares as a result of the offer: s.315(1), and expenses of distribution of the money to them is borne by the director: s.315(1).

Where, however, the compensation arises out of the director's contract of service, it escapes control under the above sections: *Taupo Totara Timber Co. Ltd* v. *Rowe* [1977] 3 All ER 123.

Directors to disclose interest in contracts

This is discussed above.

Directors' service contracts open for inspection

Companies must keep copies of directors' contracts of service at an appropriate place, which includes the registered office or principal place of business. The Registrar must be notified of the place and any change, and they must be available for not less than two hours per day during business hours: s.318.

Restriction on duration of directors' service contracts

Where the term of employment continues or may continue for more than five years and (a) cannot be terminated by the company by notice; or (b) can be terminated only in specified circumstances, this must be approved by resolution of the company in general meeting. Terms in contravention are void: s.319.

Substantial property transactions involving directors

Companies are prohibited from arrangements where directors or connected persons acquire assets from the company, or vice versa, where the value of the assets is of the requisite value unless approved by the general meeting. The section excludes transactions up to £2000 but regulates those in excess of £100 000 or 10 per cent of company's asset value and is to prevent sales by the company to its directors at an undervalue and purchases by the company from its directors at an inflated value. There are exceptions: s.321. Transactions in breach of s.320 are voidable under s.322 unless certain conditions exist: s.322(2). The director or person connected with him/her and any director authorising the transaction is liable to account to the company for any gain and to indemnify the company for any loss or damage: s.322(3), subject to relief under s.322(5) and (6). In *Re A Company* [1995] BCC 89, D plc purchased a freehold property from O Ltd which was owned by a director of D plc and his wife. The transaction was approved by the board of D plc but not by the general meeting and was held to be in breach of s.320. In *Re Duckwari plc* [1997] 2 WLR 48, the court was required to determine the damages suffered by D plc in an action under s.322(3)(b). The land had been purchased when the development property market was buoyant but the market subsequently collapsed. D plc claimed compensation for the loss in value, the costs of the purchase, interest on bank loans to enable the purchase to be made, loss of investment interest and other incidental expenses as a result of holding the property. The court held that the primary remedy for contravention of s.320 is avoidance of the contract. Where the company cannot avoid, or elects not to avoid, the contract, the recoverable loss will include the difference between the market value at the date of the transaction and the price paid or received, as the case may be. There was no right to claim compensation for subsequent loss of value. Since the price paid had not been excessive at the date of the transaction, no damage was suffered by D plc as a result of the transaction, and any loss arose from the decision to retain the property. In the same way, if a company sold property to a director at a fair price and the property subsequently increased in value, the company could not claim an account of the increase in value. In *BRDC Ltd* v. *Hextall Erskine & Co* [1997] 1 BCLC 182 the plaintiffs successfully claimed damages for their solicitors' negligent advice in relation to a joint venture between B Ltd and the second plaintiff S Ltd when they failed advise that prior approval of the general meeting was required under s.320. It was impossible to rescind the transaction and the company sued for the subsequent loss. The court held that the defendants had deprived the company of the protection of the approval of the general meeting. The negligence of the directors in making a bad investment could not be attributed to the company for the purposes of contributory negligence as this was inconsistent with the scheme and purpose of s.320.

Share dealings by directors and their families

Dealing in share options is prohibited and punishable by imprisonment and/or a fine: s.323. Directors must give written notice to the company of shares or debentures held in the company, subsidiary or holding company and of any sale or acquisition within five days (Schedule 13, Part II): s.324. Any breach results in criminal liability. Companies must keep a register of directors' interests: s.325, see Schedule 13, Part IV. This is extended to spouses and children by ss327–8. Listed companies must notify the Stock Exchange: s.329. The provisions also cover shadow directors.

Invalidity of certain transactions involving directors

Where a company enters a transaction where the parties include (a) a director of the company or its holding company; or (b) a person connected with such a director or a company with whom s/he is associated, and the board exceeds the limitations under the company's constitution, the transaction is voidable by the company. Whether it is avoided or not, any party and any director authorising it is liable (a) to account for any direct or indirect gain; and (b) to indemnify the company for any resultant loss or damage: s.322A. The equivalent section for single member companies is contained in s.322B.

Restrictions on loans to directors: ss.330–46

Private companies cannot make loans to directors of the company or their holding company or stand as guarantor/surety for a third-party loan. Loans to directors of subsidiary companies are not affected, nor are loans to persons subsequently becoming directors. The restriction also applies to shadow directors.

Relevant companies (plcs or private companies in a group containing a plc) are prohibited from making loans, quasi-loans or credit transactions, or standing as guarantor/surety for loans and so on, from third party to a director or a connected person, which includes (i) spouse, child or stepchild; (ii) a company with which a director is associated (director and connected persons are interested in at least one-fifth of equity share capital or exercise or control more than one-fifth of votes at GM); or (iii) a trustee of any trust, if the beneficiaries include the director or (i) or (ii) above, or if the terms confer a power on trustee exercisable in favour of the director or (i) or (ii) above, or (iv) a partner of the director or any of (i),(ii) or (iii) above: s.346(2).

Loans and Quasi-loans

There is special exemption for (i) small loans not exceeding £5000; (ii) intra-group transactions (applies to relevant companies only) so that a company can make a loan to a member of a group even though a director

of one member is associated with another: s.333; a company may also make loans to its holding company: s.336; and (iii) money-lending companies making loans in the ordinary course of business and no greater than nor on more favourable terms than is reasonable; relevant companies' loans are limited to £100 000, except for banks (no limit). In addition, a money-lending company may make loans for the purchase or improvement of a director's main dwelling-house, including substitution for loans from a third party. These can be on more favourable terms and for more than would normally be offered if made in the ordinary course of business and ordinarily made on similar terms to employees. There is a maximum limit of £1m.

Quasi-loans are defined in s.331(3) and include the operation by the company of credit cards for the director and connected persons. There are exemptions for (i) small amounts with a maximum limit of £5000 to directors (not connected persons) if repayment is to be within two months; (ii) intra-group transactions – a company may make a quasi-loan to another member of the same group including a holding company; and (iii) money-lending companies who may make quasi-loans if in the ordinary course of business and for amounts no greater and on terms no more favourable than ordinarily offered. There is a limit of £100 000, except for recognised banks, where there is no limit.

Credit transactions

These are defined in s.331(7) and relate to the purchase of assets for the directors subject to the agreement of the director to repay the company by instalments. The statute makes exemption for (i) small amounts not exceeding £5000; (ii) intra-group transactions – a company may enter into a credit transaction as a creditor for its holding company; and (iii) credit transactions in the ordinary course of business.

Funding directors' expenditure on duty to company

Such advances must be approved in general meeting prior to being made or at the next following AGM, failing which they must be repaid or discharged within six months of meeting. For relevant companies there is a £10 000 limit for each director: s.337.

Liability for breach

Transactions in breach of s.330 are voidable by the company: s.341. Directors are liable to indemnify the company for loss, and there is a duty to account for gains whether the contract is avoided or not and without prejudice to liability at common law: s.341(2). For relevant companies, breach constitutes a criminal offence for which the company is liable: s.342(2), as well as any directors who knowingly authorised the transaction: s.342(1), as is a person who knowingly procures the entering into a prohibited transaction.

Insider dealing

A person who has information as an insider commits the offence of insider dealing if s/he deals in securities that are price-affected in relation to that information and does so on a regulated market or acts as or in reliance on a professional intermediary: s.52(1) & (3) Criminal Justice Act 1993. The offence can also be committed by (a) encouraging another person to so deal (whether or not that person is aware of the situation); or (b) by improperly disclosing insider information.

8.22 Relief from Liability

A company cannot exempt an officer from negligence, default, breach of duty or breach of trust to the company: s.310. The company may purchase and maintain insurance against liability; s.310(3), but this must be disclosed in the Directors' Report, Companies Act 1985 Schedule 7, para. 5A.

The court may relieve an officer wholly or partly from liability for negligence, default, breach of duty or trust if s/he acted honestly or reasonably: s.727 (*Commissioners of Customs & Excise* v. *Hedon Alpha Ltd* [1981] QB 818). There is doubt as to the extension of this protection to liability under s.214 Insolvency Act 1986. The court held that it was not applicable in *Re Produce Marketing Consortium Ltd* [1989] BCLC 513, but its application was not excluded in later decisions: *Re DKG Contractors Ltd* [1990] BCC 903; *Re Home Treat Ltd* [1991] BCC 165; and *Re Welfab Engineers Ltd* [1990] BCLC 833.

8.23 The Company Secretary

Every company must have a company secretary: s.283. The first secretary is the person named in the statement of first directors and secretary filed with the Registrar before incorporation; subsequent appointments are made by the directors. The secretary may be an individual or a corporation, but a corporation cannot be the secretary if its sole director is also the sole director of the company: s.283(4). A sole director cannot also be secretary: s.283(2).

The secretary of a private company is not required to have any professional qualifications but, for a public company, the directors must take reasonable steps to secure that the secretary is a person who appears to them to have the requisite knowledge and experience and either was a secretary of a public company before s.79 CA 1980 came into force or who by virtue of his/her professional qualifications (as a chartered secretary, an accountant or a lawyer, or standing) appears to the directors to be capable of discharging the functions of a secretary: s.286.

The secretary is the chief administrative officer of the company and his/her duties include attending and minuting board and general meetings, authenticating certain documents, recording transfers of shares, keeping

the company's books and registers, and making necessary returns. The decision of *Panorama Developments (Guildford) Ltd* v. *Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711 recognised that the secretary had ostensible authority to enter into contracts connected with the administrative side of the company's affairs 'such as employing staff, ordering cars and so forth'. Authority does not extend to commercial or trading contracts, and the company would not be liable for money borrowed in its name.

The secretary owes fiduciary duties to the company similar to those of a director and is liable to specific criminal penalties if s/he defaults in his/her statutory duties.

8.24 The Enforcement of Directors' Duties

The rule in *Foss* v. *Harbottle* (1843) 2 Hare 461 provides for majority rule. If there is a wrong against a company or an alleged irregularity in its internal management that is capable of confirmation by a simple majority of the members, the court will not interfere at the suit of a minority, which must accept the decision of the majority. The minority can attempt to bring about a change in the majority by the normal democratic process of persuasion and, if a minority shareholder does not agree with the majority, s/he can always sell his/her shares.

This rule has been restated in modern terms by Jenkins LJ in *Edwards* v. *Halliwell* [1950] 2 All ER 1064. The rule has two aspects; (i) the proper plaintiff in an action in respect of a wrong alleged to be done to a company is prima facie the company; and (ii) where the alleged wrong is a transaction which may be made binding on the company and all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter. In *Stein* v. *Blake* [1998] 1 All ER 724, the Court of Appeal, applying *Prudential Assurance Co. Ltd* v. *Newman Industries Ltd* (No. 2) [1982] 1 All ER 354, ruled that a shareholder was not entitled to sue in respect of an alleged misappropriation of companies' assets by the other shareholder and that it was only the companies, or their liquidators, that could bring the actions.

Exceptions to the general rule

The rule is subject to a number of common law and statutory exceptions and it is interesting to speculate whether the common law exceptions to the rules have not now been overtaken by the statutory exceptions.

Common law exceptions to the rule in *Foss* v. *Harbottle*

Illegal acts

The majority have never been able to affirm an act which is *ultra vires* the company: *Ashbury Railway Carriage & Iron Co. Ltd* v. *Riche* (1875) LR 7

HL 653. This previous common law exception is now replaced by s.35(2). However, the exception relates to other illegal acts such as financial assistance under s.151.

Decisions requiring qualified majority

A majority cannot confirm a resolution by simple majority where the constitution of the company requires a qualified majority: in *Edwards* v. *Halliwell* [1950] 2 All ER 1064, a trade union's rules provided that members' subscriptions could only be increased by a special resoluton of the delegates. The court allowed a minority action where the union purported to increase subscriptions by an ordinary resolution.

Personal rights of a shareholder

The minority shareholder can always enforce his/her personal rights as a shareholder: *Pender* v. *Lushington* (1877) 6 Ch. D 70 (see p. 206 above).

Where there is a fraud on the minority

The concept of fraud on the minority involves an abuse of its power by the majority. This abuse can be directed at the minority shareholders where there is an attempt by the majority to compulsorily acquire the shares of the minority; alternatively, the abuse can be directed against the company itself, as where the majority attempts to expropriate a corporate opportunity for itself. In both cases the minority can sue (i) to block an abusive use of majority power: *Clemens* v. *Clemens Bros Ltd* [1976] 2 All ER 268 (see p. 205 above), or (ii) to recover the company's expropriated property: *Cook* v. *Deeks* [1916] 1 AC 554 (see p. 240).

The form of the minority action

Depending on the nature of the exception, the minority action may take a different form. The following actions exist: a personal action; a representative action; and a derivative action. The personal action is for infringements of the shareholder's personal rights as a member. The representative action is where the member sues for the benefit of an affected class of shareholders (including him/herself); it is a direct representative action (or class action). A derivative action is brought in respect of wrongs against the company. The shareholder sues in place of the company. The minority shareholder must establish as a preliminary issue the following points: (i) that there has been a wrong in the nature of a 'fraud' committed against the company; and (ii) that the wrongdoers are in control of the company.

Fraud against the company

The term 'fraud' includes abuses of power both in the capacity of director and shareholder. In *Estmanco (Kilner House) Ltd* v. *GLC* [1982] 1 All ER 437, the GLC built a block with sixty separate flats. The flats were to be

sold and each purchaser would then take one share in the management company. The Articles provided that, until all the flats were sold, the GLC should exercise the voting rights in respect of all the shares. When twelve flats had been sold, the GLC changed its policy with regard to the block and decided to transfer council tenants into it. A tenant of one of the flats brought this action in the name of the company. The GLC then called a meeting of the company, at which they voted to discontinue the action. The court held in favour of one of the tenants who sought to take over the action as a derivative action, that this constituted a sufficient abuse of majority power.

The term does not, however, include 'mere negligence', *Pavlides* v. *Jensen* [1956] 2 All ER 518, but does include negligence resulting in profit to those wrongdoers responsible for the negligence: *Daniels* v. *Daniels* [1978] Ch 406. This seems to qualify as misfeasance rather than negligence.

The wrongdoers are in control

'Control' means actual voting control of the company. It is not sufficient to show *de facto* control merely through combined dominance of shareholding and management position: *Prudential Assurance Co. Ltd* v. *Newman Industries Ltd* (No. 2) [1982] 1 All ER 354, but the court does take into consideration control through nominees.

The court may order the company to indemnify the minority shareholder where it was reasonable and prudent for him/her to bring the action and if it was brought in good faith: *Wallersteiner* v. *Moir* (No. 2) [1975] 1 QB 373. The court refused to make such an order in *Smith* v. *Croft* (No. 2 & No. 3) [1987] BCLC 206 and [1987] BCLC 355, where the minority shareholder brought an action claiming that the directors were paying themselves excessive remuneration in spite of an independent report which dismissed the allegation as being without foundation and against the express wishes of the independent majority shareholder, which seems to impose yet another condition on the minority shareholder.

Statutory exceptions to *Foss* v. *Harbottle*

The most important statutory exception is the right to petition against unfair prejudice: s.459. Its virtual replacement of the common law is reinforced by *Re A Company* [1986] 1 WLR 281, where Hoffman J rejected a claim that a s.459 petition was not possible since the petitioner could have brought a derivative action. This was approved by Millett J in *Re Charnley Davies Ltd* (No. 2) [1990] BCC 605, an action under s.27 Insolvency Act 1986, which is modelled on s.459. He stressed that the same facts may found either a derivative action or a s.459 petition, but the suitability of the one or the other depended on the relief sought. If the person seeks restitution of property, a derivative action is appropriate, whereas if the petitioner seeks to be bought out, s.459 is more suitable.

Petition against unfair prejudice

Section 459 provides: 'Any member of a company may apply to the court by petition for an order under this section on the ground that the affairs of the company are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial': s.459(1).

The court can make any order on the petition, but s.461(2) gives some examples. These include (i) regulating the conduct of the company's affairs in the future; (ii) requiring the company to refrain from doing or continuing an act complained of or conversely ensuring the action of a company where the petitioner complains of a failure to act; (iii) authorisation of civil proceedings in the name and on behalf of the company; and (iv) the purchase of a member's shares by other members or by the company itself.

Where purchase of shares is sought, their valuation can be either as a proportionate part of the company without discount for the fact of being a minority holding, or at the discounted market value. The Court of Appeal favoured the first solution: *Re Bird Precision Bellows Ltd* [1986] 2 WLR 158. Vinelott J chose the time of the presentation of the petition as the moment to value the shares in *Re Cumana Ltd* [1986] BCLC 430, and on appeal the Court of Appeal held that 'the date for valuation … is a matter for the … trial judge's discretion'. It also rejected the inclusion in the order of an 'escape clause' to cover a situation in which the party was unable to find the necessary money to purchase the shares. It is important to identify what is meant by unfair prejudicial conduct and the nature of the interests of the members capable of unfair prejudice.

Unfairly prejudicial conduct The phrase 'unfairly prejudicial' is wider than the word 'oppression' from the Companies Act 1948 s.210, which it supersedes. This required the petitioner to prove a course of conduct which was 'harsh, burdensome and wrongful'. In addition, the remedy was an alternative to a just and equitable winding up, and the petitioner had to establish that there were grounds for winding up the company. It has been suggested that the basic test will be whether the value of the member's shareholding has been seriously impaired: *Re A Company* [1983] 2 All ER 36. In *Re Bovey Hotel Ventures Ltd* (1981) (unreported), Slade J added that the test of unfairness is objective and not subjective. It is not necessary for the petitioner to show that the persons complained of acted in the conscious knowledge that what they were doing was unfair. The test is whether a reasonable bystander would regard the actions as unfairly prejudicial to the petitioner.

In *Re Elgindata Ltd* [1991] BCLC 959, the court rejected a petition alleging mismanagement. Warner J cited Peter Gibson J in *Re Sam Weller & Sons Ltd* [1990] Ch 682, where he said: 'the court would ordinarily be

very reluctant to accept that managerial decisions could amount to unfairly prejudicial conduct'. Warner J continued: 'a shareholder acquires shares in a company knowing their value will depend in some measure on the competence of the management … Short of a breach by a director of his duty of skill and care … there is prima facie no unfairness to a shareholder in the quality of the management turning out to be poor.' This was reinforced by the decision in *Re Charnley Davies Ltd* (No. 2) [1990] BCC 605 under s.27 Insolvency Act 1986, where the court held that negligent disposal of assets by an administrator could not be the basis of a petition. However, in *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354, the court stated that where the mismanagement was sufficiently significant so as to cause loss to the company then it could constitute the basis for finding unfair prejudice.

The remedy is not equitable, and the petitioner's own behaviour is not an automatic bar to relief but may be important. Thus in *Re R. A. Noble & Sons (Clothing) Ltd* [1983] BCLC 273, the petitioner's exclusion from management was justified by his own neglect of his responsibilities and his petition was rejected, but in *Re London School of Electronics Ltd* [1986] Ch 211 the petitioner's conduct did not disqualify him from petitioning since it was in reaction against the unfairly prejudicial conduct on which the petition was based.

The nature of the members' interests The first reported decision on s.459, *Re A Company* [1983] 2 All ER 36, followed s.210 Companies Act 1948 and limited the right to petition to cases where the unfair prejudice affected a person as a shareholder. This would have continued to bar petitions based on exclusion from management as in *Ebrahimi* v. *Westbourne Galleries Ltd* [1973] AC 360 (see p. 254). However, in *Re A Company* [1983] 2 All ER 854, Vinelot J stated *obiter*, 'It seems to me unlikely that the legislature could have intended to exclude from the scope of s.459 a shareholder in the position of Mr Ebrahimi in the Westbourne Galleries case'. And in *Re A Company* [1986] BCLC 376, Hoffman J said: 'In the case of a small private company in which two or three members have ventured their capital … on the footing that each will earn his living by working for the company as a director … [the] member's interests … may include a legitimate expectation that he will continue to be employed as a director and his dismissal from that office and exclusion from the management of the company may therefore be unfairly prejudicial to his interests as a member.' Relief has been obtained where the petitioner complained of removal from office among other things (*Re Bird Precision Bellows Ltd* [1986]; *Re Cumana Ltd* [1986] and *Re London School of Electronics Ltd* [1986] Ch 211).

In *Re A Company* [1986] BCLC 376, the judge refused to strike out a petition on the grounds that it only related to the petitioners' interests as vendors and employees. Hoffman J stated 'the interests of a member are not necessarily limited to his strict legal rights under the constitution of the company'. And in *Re Sam Weller & Sons Ltd* [1990] Ch 682 the fact

that a company had followed the same dividend policy for thirty seven years was unfairly prejudicial to members of the company who relied on the dividend for their income, as opposed to those who received remuneration as directors. The court held that the interests of shareholders is wider than the term 'rights', and that shareholders of the same class can have different interests. Peter Gibson J, in respect of the petitioners, stated: 'As their only income from the company is by way of dividend, their interests may be not only prejudiced by the policy of low dividend payments, but unfairly prejudiced.'

Successful actions have been brought in respect of breaches of fiduciary duties including conflict of interests, *Re Bovey Hotel Ventures Ltd*, 31 July 1981 (unreported), excessive remuneration and a rights issue regarded as an attempt to dilute the interest of a shareholder: *Re A Company* (No. 002612 of 1984) [1985] BCLC 80; and *Re Cumana Ltd* [1986] BCLC 430.

Just and equitable winding up

The court has a wide discretionary power to wind up a company on a petition presented by a member under s.122(1)(g) of the Insolvency Act 1986. The categories of complaint are unclear, and Lord Wilberforce in the leading case of *Ebrahimi* v. *Westbourne Galleries Ltd* [1973] AC 360 stressed that in his view the general words should not be reduced to the sum of particular instances, and most of the old cases could be subsumed by the criteria established in *Ebrahimi*. In this case, the plaintiff had been in a partnership with N and they later formed a company to take over the business and became the only directors and shareholders, each holding 500 shares. When N's son joined the business, E and N transferred 100 shares to him and he became a director. Ebrahimi was removed from the board and petitioned for the just and equitable winding up. The House of Lords held that the exercise of legal rights was subject to equitable considerations which might make it unjust or inequitable for a person to insist on exercising his/her strict legal rights; that Ebrahimi and N had formed the company to perpetuate their previous partnership, and that E's exclusion was unjust.

Lord Wilberforce suggested that the remedy applied to a small private company where one or more of the following factors was present: (i) it should be an association formed or continued on the basis of a personal relationship, involving mutual confidence; (ii) there should be an agreement that all or some of the shareholders shall participate in the management of the business; and (iii) there should be restrictions on the transfer of the members' shares.

The decision has been applied in a number of cases. In *Re A & BC Chewing Gum Ltd* [1975] 1 All ER 1017, the minority shareholder was entitled under the Articles and by virtue of a separate agreement to appoint one director. When the majority refused to give effect to the appointment, the court held that the company should be wound up. In *Re*

North End Motels (Huntly) Ltd [1976] 1 NZLR 446, the court ordered the company to be wound up where a minority shareholder/director was consistently outvoted at board meetings. It was influenced by the fact that the petitioner had had no independent advice before joining the company and had very little business experience, and the majority shareholder had the final word as to share valuation.

The equitable principles of Ebrahimi have been applied outside the framework of a winding-up petition. Thus in *Clemens* v. *Clemens Bros. Ltd* [1976] 2 All ER 268, the court set aside an issue of additional shares aimed at diluting the plaintiff's holding. However, in *Bentley-Stevens* v. *Jones* [1974] 2 All ER 653, the court held that a director could not claim reinstatement under Ebrahimi.

Unfair prejudice and just and equitable winding up

The link between these petitions is clear from *Re R. A. Noble & Sons (Clothing) Ltd* [1983] BCLC 273, where the petitioner was refused relief under s.459 since his exclusion from management was prejudicial but not unfair, but obtained a winding-up order under s.122(1)(g), under the *Ebrahimi* criteria. Similarly, in *Jesner Ltd* v. *Jarrad Properties Ltd* [1993] BCLC 1032, the petitioner obtained a just and equitable winding up, having failed to establish unfair prejudice. A petition for unfair prejudice is to be preferred, but the right to petition for just and equitable winding up seems wider.

A petition under s.459 is not restricted to small companies, but its application to large companies has not been very successful. In *Re Tottenham Hotspur plc* [1994] 1 BCLC 655, the court rejected a claim to reinstate V pursuant to an agreement that S would be chairman and V a director and chief executive. The just and equitable petition is restricted to small companies.

Department of Trade investigations

The Department of Trade and Industry (DTI) may appoint inspectors on the application of 200 members or members holding not less than one-tenth of the issued shares: s.431; or where there are circumstances suggesting fraud, illegality, unfair prejudice to members, misfeasance or other misconduct of the company's officers, or the wrongful withholding of information from members: s.432(2). This is more useful since there is no minimum of members required. The Secretary of State must also appoint inspectors where the court so orders: s.432(1).

Inspectors may question directors and other officers and requisition documents, whereas it is frequently difficult for a minority shareholder to establish his/her allegations against the controllers. Where the inspection produces sufficient evidence, the Secretary of State can proceed to petition for the winding up of the company or petition against unfair prejudice in the same way as a member under s.460. The report furnished by

the inspectorate may also lead to the disqualification of directors. Investigations tend to be used for corporate insolvency investigations, and minority shareholders are unlikely to obtain relief.

Recommended Further Reading

Company Law, J. Dine, 3rd edn (Macmillan Professional Masters, 1998).
Farrar's Company Law, 5th edn (Butterworths, 1998).

Questions

1. What are 'phoenix companies' and how does the law attempt to control them?
2. The Memorandum and Articles of Association, when registered, constitute a contract between the company and its members. In what way are the rights and remedies of the parties more restricted than for normal contracts?
3. The reforms of 1990 achieve the external abolition and the internal retention of the ultra vires doctrine. How?
4. For the purposes of outsider protection in respect of unauthorised contracts the law protects a person dealing with the company in good faith. What constitutes 'dealing' and 'good faith' in this context?
5. Why is the capital of a company more important than that of a sole trader or a partnership, and how does the law seek to protect this creditors' guarantee fund?
6. The share premium account and the capital redemption reserve are quasi-capital accounts. When do they arise, and for what can they be used?
7. What rights qualify as class rights for the purpose of s.125?
8. How can directors escape liability for negligence?
9. How has the concept of the 'maturing business opportunity' modified the previous approach to accountability of directors for secret profits?
10. What must be established before a person can bring a derivative action in respect of a wrong done to a company?
11. How does the right to petition under s.459 differ from and overlap with the right to petition for the just and equitable winding up of the company?
12. What are the criteria for just and equitable winding up as set out in the *Ebrahimi* case?

Part IV

Business Assets, Borrowing and Securities

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9 Business Property

Learning Objectives

After reading this chapter you will know about:

1. the classification of property in England and Wales
2. the nature and classification of real property, including the difference between unregistered and registered land
3. the nature of intangible property or choses in action, including the difference between assignable and negotiable choses
4. the different forms of intellectual property: trade marks and brand names, patents, copyright and registered designs

9.1 The Nature and Classification of Business Property

Business property takes many forms, both tangible and intangible, and is important for a firm in safeguarding its business and increasing its borrowing capacity. Tangible (or corporeal) property includes land (see Section 9.2. below) and goods which are capable of physical possession (called 'choses (or things) in possession') (see Sectrion 9.7) and, in the case of goods, physical transfer (see Chapter 13); whereas intangible (or incorporeal) property rights are enjoyed through the enforcement of the rights of the owner. Intangible property ('choses (or things) in action'), can be assignable or negotiable (see Section 9.8. Shares are choses in action and the shareholder derives no benefit from the share certificate itself, but rather from the rights it represents (see Chapter 8).

Other examples are insurance policies, debts and all types of intellectual property: copyrights, patents and trade marks (see Section 9.9), which confer exclusive rights to commercial exploitation of intellectual property for a determined period of time. A company which develops a new product involving an inventive step protects that invention by registering a patent, and in respect of books, music, artistic works and designs, the company can protect these by the laws protecting copyright and product design. A particularly valuable asset in relation to products and services is the identifying characteristics by which the consumers identify the product or service and select it in preference to another. These are protected through the law of trade marks. The classification of property in England and Wales is shown in the Figure 9.1.

9.2 Introduction to the English Law of Real Property

Absolute ownership of land is vested in the Crown. Below that level, the law distinguishes between 'freeholders' and 'leaseholders'. Freehold

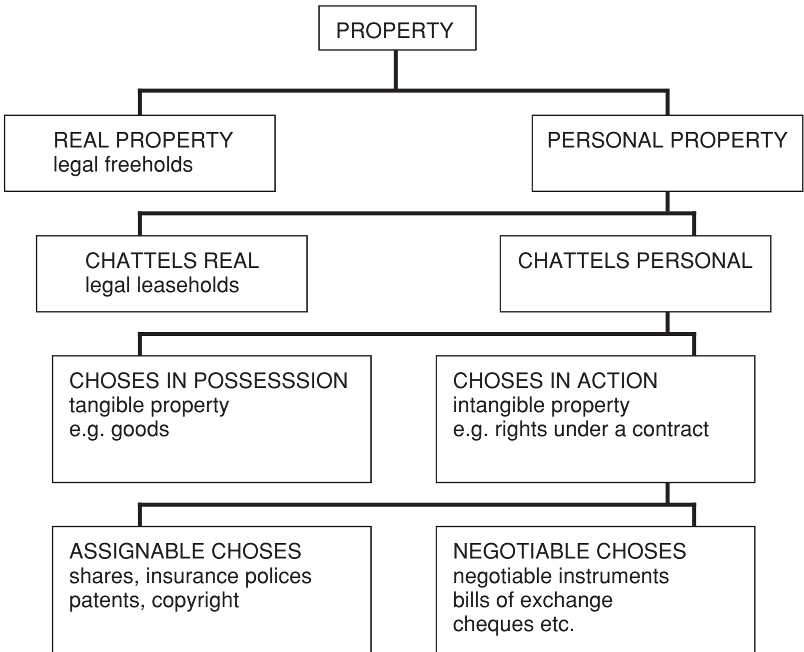

Figure 9.1 Classification of property in England and Wales.

owners own an estate in the land from the Crown, and are the nearest that persons get under English law to 'ownership' of land. Leaseholders hold an estate under a contract called a lease. The word 'estate' describes the nature and duration of the rights owned by freeholder or leaseholder. The estate will vary according to whether it is freehold or leasehold, legal or equitable.

Freehold estates

The principal freehold estate is the fee simple estate. The word 'fee' means that the estate is heritable, and 'simple' that the rights of inheritance are unrestricted. Estates can be absolute or conditional. The effect of a condition depends on whether it is a condition precedent or subsequent. In the former case, compliance with the condition is necessary before the estate can exist. For example: 'To AB in fee simple when or if he attains the age of 21 years.' In the latter case, the estate can be terminated by the happening of the conditional event, for example 'To AB in fee simple provided he never sells out of the family.' The fee absolute estate is subject to no condition.

Estates can be 'in expectancy' or 'in possession'. The former is where a right to possession only arises on the termination of an earlier estate in a

succession of estates called a settlement. Where land is settled 'To AB for life and thereafter to CD in Fee Simple', AB has an estate in possession and CD, during the life of AB, has an estate in expectancy. Future estates are 'remainders' or 'reversions'. CD's estate is a remainder because, on the termination of AB's life estate, the estate remains away from the grantor. If there was no gift over to CD, the estate would revert back to the grantor or his/her heirs, who have a reversionary interest.

The most perfect and most normal form of the fee simple estate is the fee simple absolute in possession. Other freehold estates of minor importance are the 'fee tail' estate where inheritance is restricted to the descendants of the original tenant in tail and the estate would terminate if the line of descendants came to an end. There also is the 'life estate' which generally terminates on the death of the person to whom the estate is granted.

Leasehold estates

The 'term of years' is the most important leasehold estate and is one for a fixed determinable period of time, calculated in years or months. It includes the renewable yearly lease. The term of years can also be conditional or absolute and in possession or in expectancy. Other leasehold estates of little importance are the 'estate at will', which is a tenancy determinable at the will of either party. The 'estate by sufferance' arises when a person with an estate for a term of years continues in possession after the term.

Equitable estates

Equitable estates can arise under a trust and where some non-compliance with the legal formalities of the common law prevents the transfer or creation of a legal estate.

Equitable estates arising under a trust

Under a trust, the owner of an estate would convey the land to a person for the 'use' of another. The transferee's moral obligation was only enforced in equity, the common law treating him/her as the full and unfettered owner. Initially the obligation was only enforceable against the trustee and not against a purchaser from the trustee. Ultimately, however, the beneficiaries' rights became enforceable against a purchaser except for a bona fide purchaser of the legal estate for value without notice, actual or constructive, or the trust.

Equitable estates arising other than under a trust

These arise where non-compliance with the legal formalities prevents the transfer of a legal estate: for example, an attempt to transfer a freehold estate without the use of a formal deed, or the creation of a mortgage

without a deed. In both cases the court can, at its discretion, order specific performance of the agreement but will recognise the transferee or the mortgagee as holding an equitable title.

Legal and equitable estates compared

Legal estates bind subsequent purchasers of the land, even those without notice of their existence, whereas equitable estates are overreached. This means that the beneficial interest switches from the land to the proceeds of sale where there has been a sale of the legal estate to a bona fide purchaser for value without notice of the trust.

9.3 Rights Over the Property of Another

A person may have legal or equitable rights over property owned by another person. These interests may enable him/her (i) to enjoy the benefits from the land of another in the form of easements or profits *à prendre*; or (ii) to restrict the other owner's rights to use his/her property through a restrictive covenant.

Easements and profits

Easements include rights of way, rights to light, rights to abstract water and rights to the support of buildings (terraced houses). Profits include rights in connection with shooting, fishing, grazing, cutting turf and taking wood. The Law of Property Act 1925 reduced the number of legal interests to five.

Restrictive covenants

A restrictive covenant in a contract to transfer title restricts the transferee's right on the use of the land for the benefit of the transferor. Legally binding between the contracting parties it had no legal force against a subsequent transferee because of privity of contract. It was, however, enforceable in equity against a transferee of the land with notice of the covenant: *Tulk* v. *Moxhay* (1848) 2 Ph 774.

9.4 The Reforms of 1925

The Law of Property Act 1925 took the essential difference between legal and equitable estates as the basis of reform and reduced the legal estates to two: the fee simple absolute in possession, and the term of years absolute. Subsequently, other estates could only exist as equitable estates under a trust. The number of legal interests was reduced to five. The Settled Land Act 1925 simplified the creation of trusts, separating the transfer of the trust property from the terms of the trust through the use of

two deeds, and provided that, on sale of trust property, the rights of the beneficiaries are transferred to the money realised by the sale. This is called 'overreaching'. The Land Charges Act 1925 replaced the equitable notion of 'notice' by registration in the Land Charges Register to preserve rights over the estates of another with failure to register making their rights void against a subsequent purchaser. The Administration of Estates Act 1925 made intestate succession to real property the same as personal property in establishing the 'statutory next of kin'. The Land Registration Act 1925 introduced a completely new system of registered land with registered title and a simplified transfer system based upon the share transfer system. The Settled Land Act 1925 has now been replaced by the Trusts of Land and Appointment of Trustees Act 1996, which replaces the dual system of strict settlements and trusts for sale with a single system – the 'trust of land', and abolishes the doctrine of conversion whereby land held under a trust for sale was converted to personal property. The new Act will apply to all future trusts and nearly all existing trusts except for existing strict settlements which will continue to be governed by the Settled Land Act. The registered land system under the 1925 Act (amended by the Land Registration Act 1997) will replace unregistered land because of the compulsory registration of the following dispositions of unregistered land: (a) any qualifying conveyance of the freehold estate; (b) any qualifying grant of a lease for more than twenty-one years; (c) any qualifying assignment of a lease with more than twenty-one years to run from the date of the assignment; and (d) any disposition effected by an assent or by a vesting deed of the freehold estate or a lease with more than twenty-one years to run: s.123(1). A conveyance, grant or assignment is 'qualifying' for the purposes of the Act if it is made (i) for valuable or other consideration; (ii) by way of a gift; or (iii) in pursuance of a court order: s.123(6)(a). Compulsory registration also applies to a legal mortgage of an unregistered freeholds or leaseholds with more than twenty-one years to run where the mortgage is protected by the deposit of title deeds and ranks in priority to all other mortgages affecting the land (see Chapter 10).

9.5 Registered and Unregistered Conveyancing

On a sale of land, the contract between the vendor and the purchaser must be in writing and incorporate all express terms in one document: s.2 Law of Property (Miscellaneous Provisions) Act 1989. The contract becomes binding on the exchange of contracts. Before any transfer of ownership, the vendor's title must be established. The procedure depends on whether the land is unregistered or registered. The sale of leasehold property is by assignment of the remaining term of years under the lease. Before the Landlord and Tenant (Covenants) Act 1995, which applies to new tenancies created after 1 January 1996, a tenant's original liability under the lease in respect of the rent and so on is terminated when s/he assigns his/her lease. Previously, the original tenant remained liable under

the doctrine of privity of contract for the failure of subsequent assignees to pay the rent to the landlord.

Unregistered conveyancing

The title is proved through the 'title deeds', which must establish a chain of at least fifteen years to a 'good root of title'. The purchaser searches the title in the Land Charges Registry which classifies encumbrances under different classes: restrictive covenants (Class D(iii)); legal mortgages unprotected by deposit of title deeds (puisne (that is, lesser) mortgages)(Class C(i)); equitable mortgages (Class C(iii)); estate contracts including options (Class C(iv)); or spouse's rights of occupation under the Matrimonial Homes Act 1983 (Class F). The final transfer of the land is by a deed of conveyance drawn up by the purchaser's solicitor.

Registered conveyancing

Each area has a District Registry and each registered title is allocated a title number. Each registered interest comprises three separate registers: (i) the Property Register, which describes the property, usually by reference to a map; (ii) the Proprietorship Register, which gives the name of the registered proprietor and a description of his/her title – normally title absolute for both freeholds and leaseholds, but leasehold titles where the freehold title is unregistered will be 'good leasehold title'; and (iii) the Charges Register, which details charges and other claims registered against the property. Once a search of the register has been made with the permission of the registered proprietor, a standard form of legal transfer is executed in the form of a deed, and the registers are updated. In either case, the purchaser also conducts a local authority search for existing or future development proposals. Where the land is owned by a company, any interests in respect of the property can be discovered by a search on the company's file at the Companies Registry.

9.6 The Classification of Estates and Interest in Land: Unregistered and Registered

Unregistered land

The classification is based on the old distinctions between legal and equitable estates and interests and comprises (i) legal estates; (ii) legal interests; (iii) equitable estates under a trust; (iv) equitable interests; and (vi) equitable interests subject to the equitable doctrine of notice.

Registered land

The following interests in land exist: (i) registrable interests; (ii) registered charges; (iii) overriding interests; and (iv) minor interests.

Registered charges

These are registered legal mortgages. The Land Certificate is replaced by a Charge Certificate issued to the mortgagee (see Chapter 10).

Overriding interests

Registered land works on the 'mirror principle' and the register accurately reflects the exact picture of the title to the property. Overriding interests contradict this principle and cannot be registered independently or appear on the register in any way, but they are binding on a subsequent purchaser. The most import category relates to rights of occupation. In *Williams and Glyn's Bank Ltd* v. *Boland* [1981] AC 487, a husband and wife bought a house from their joint earnings but the house was registered in the name of the husband alone. The husband later mortgaged the house to the bank without telling the wife, and the bank made no enquires about the wife. The husband defaulted on the mortgage and the bank claimed possession of the house prior to sale. The House of Lords upheld the decision of the Court of Appeal that the wife had an overriding interest and refused the bank's claim. The basis of the claim was the wife's contribution to the purchase of the property. Thus in *Bristol & West Building Society* v. *Henning and Another* (1985), *The Times*, 3 April, the wife was not regarded as having an overriding interest in the property since she had not contributed to the purchase price, even though she had contributed to the decorating and refurbishment.

Minor interests

These are either overreachable even though protected by a register entry or non-overreachable as long as they are protected by a register entry. The overreachable interests are the old equitable and legal estates under a trust protected by a restriction on the Proprietorship Register. They are overreached if the purchaser complies with the restrictions – for example, by paying the purchase price to the person(s) named as trustees. The most important non-overreachable interests are equitable mortgages. These are protected by (a) cautions against dealing placed by the mortgagee, which operate by notifying him/her of any attempt to register a dealing in the land (the mortgagee has fourteen days in which to contest the registration, failing which the caution is removed and the registration will proceed); and (b) Protection by Notice of Deposit of Land Certificate/Charge Certificate which operates in the same way as a caution (see Chapter 10).

9.7 Choses in Possession

The term covers all tangible (or corporeal) property capable of physical possession by the owner: that is, goods. Goods are transferable by sale under the Sale of Goods Act 1979. Other forms of transfer including hire are covered by the Supply of Goods and Services Act 1982, and the supply

of goods on hire-purchase and conditional sale agreement are covered by the Supply of Goods (Implied) Terms Act 1973. Goods supplied under a credit sale agreement are under the Sale of Goods Act 1979 (see Chapters 13 and 14).

9.8 Choses in Action

The term relates to intangible property which is enjoyed by the enforcement of rights of ownership. Choses in action can be assignable or negotiable.

Assignable choses in action

Intangible property rights can be assigned and the assignment may be legal or equitable (formal or informal). The legal assignment of certain choses in action is governed by separate Acts of Parliament – for example, shares and insurance polices) but the general law relating to the legal assignment of choses in action is s.136 Law of Property Act 1925 (LPA 1925). To be legal, the assignment must comply with the specific rules relating to the particular chose or the Law of Property Act provision. Under s.136 LPA 1925, in order for an assignment to be legal and effective the assignment must be:

(i) absolute (that is, an assigment of the whole debt); and
(ii) in writing signed by the assignor; and
(iii) expressly notified in writing by the assignee to the debtor.

Thus, if A owes £500 to B, B can assign his/her right to payment to C. A is the debtor, B the assignor and C the assignee. The legal assignee can enforce his/her rights by action against the debtor who can, however, raise against him/her any defence that s/he could have raised against the assignor, such as the right to set off. The assignment is thus subject to the doctrine of *nemo dat quod non habet* (no one can give what s/he does not have) in that s/he gets no better title than the assignor. If the assignment is informal the equitable assignee cannot enforce his/her rights in his/her own name but must join the assignor as co-plaintiff in any action. An equitable assignment also requires notice to the debtor and is subject to the doctrine of *nemo dat*.

Negotiable choses

Assignment of choses in action at common law was only legally possible after the passing of the Judicature Act 1873; previous to this, all assignments were equitable. Merchants had, however, developed the practice of transferring among themselves documents representing rights to payment under a ‘bill of exchange’ free from the requirement of giving notice to the person ultimately obliged to pay, who was required to pay to

the holder when payment was due. To inspire confidence in this practice, the custom developed that, if a bill was taken in certain conditions, then the transferee would take the bill free from defects in title of the transferor.

These conditions were that the assignee took the bill: (i) for value; (ii) in good faith; and (iii) without notice of any defect in title of the transferor. Such a person was the 'holder in due course' of the bill, whose transfer was not subject to the doctrine of *nemo dat*. (For bills of exchange, cheques and promissory notes, now covered by the Bills of Exchange Act 1882, three further conditions are added (see Chapter 15).

Negotiable instruments

Choses capable of negotiation are classified as negotiable instruments and include: (i) bills of exchange, promissory notes and cheques; (ii) treasury bills; (iii) share warrants and debentures issued or payable to bearer; (iv) bankers' drafts; (v) circular notes; and (vi) dividend warrants. Postal orders and bills of lading are not negotiable instruments. A negotiable instrument is not legal tender (but bank notes are negotiable instruments) and a creditor can refuse to accept a negotiable instrument in discharge of a debt. However, discharge of a monetary obligation by negotiable instrument is not 'the giving of something different' and the transaction is covered by the rule that a debt is not discharged by the payment of a smaller sum: *D & C Builders Ltd* v. *Rees* [1966] 2 QB 617 (see Chapter 3). Payment by negotiable instrument is conditional upon it being honoured; failing that, the original liability revives and the creditor may sue on the original debt or on the negotiable instrument. The advantage of the latter is that there is no defence available (see Chapter 15).

In certain cases the negotiability of a document can be removed without affecting its assignability, but making an instrument non-assignable also removes its negotiability: a cheque payable to 'John Brown or Order' and crossed 'not negotiable' is transferable but not negotiable, but a cheque payable 'To John Brown only' is neither negotiable nor transferable. By the Cheques Act 1992, s.81A of the Bills of Exchange Act 1882 provides that a cheque crossed 'account payee (only)' or 'a/c payee (only) is only valid as between the parties and is non-transferable (see Chapter 15).

Characteristics of negotiable instruments

Negotiable instruments have the following features:

(i) they are transferable by mere delivery (or by indorsement plus delivery in the case of a bill of exchange drawn payable to order);
(ii) there is no need for notice of transfer and payment is to the holder for the time being;
(iii) legal title passes on negotiation and the holder can sue to enforce payment in his/her own name;
(iv) the title passes free from equities of which the transferee has no notice; and

(v) a holder in due course has a title free from the defects that affected the transferor.

9.9 Intellectual Property Rights

Trade marks and brand names

A brand is a name that customers know and react to. The brand manipulates a buyer's perception of the thing's worth and adds value. The value of the brand is the impression of extra worth that it engenders in customers, whose loyalty is thus that bit more secure. Brand loyalty leads to increased profit: BMW cars and IBM computers may not be significantly better than their rivals, but customers will pay significantly more for them. Branding emerged only in the last 100 years, and by 1890 most countries had trade mark legislation establishing a name as a legally protectable asset. It was late in the nineteenth century that makers of products could take advantage of new mass-manufacturing techniques, distribution networks and advertising to win customers on a national or international scale. To distinguish their products, manufacturers gave them distinctive names to differentiate them from 'own label' products of local retailers. George Eastman called his camera 'Kodak' because it was 'short, vigorous, incapable of being mis-spelt … and meant nothing'. The commercial significance of brands has led to a number of brand-driven take-over deals, with bidders prepared to pay in excess of the asset value of the target company to acquire valuable brand names on the basis that it is almost impossible to create a megabrand from scratch. Thus Nestlé paid £2.55 billion – more than five times the book value – for Rowntree Macintosh to acquire the rights to Kit-Kat, After Eight, Smarties and Polo.

Unregistered trade marks are protected by the common law tort of passing off, but registered trade marks are protected by statute.

Registered trademarks

The law is contained in the Trade Marks Act 1994 and all references in this section will be to that Act unless otherwise stated. It was passed to implement EC Council Directive (89/104/EEC), which sought to approximate the laws of the member states relating to trade marks and to make provision in connection with Council Regulation (EC) No. 40/94 on the Community trade mark. The Act also gives effect to the Madrid Protocol Relating to International Registration of Marks of 27 June 1989. The Act has no effect on the law of passing off: s.2(2).

A trade mark is 'any sign capable of being represented graphically which is capable of distinguishing goods or services of one undertaking from those of other undertakings'; it may 'consist of words (including personal names), designs, letters, numerals or the shape of goods or their packaging': s.1(1).

It can include the colour of a product or a motorbike messenger's uniform, the appearance of a firm's delivery van or the pattern on a take-away hamburger box, or any packaging including distinctive bottle shapes and smells. Symbols include the Bass red triangle, the first UK registered trade mark. Michelin succeeded in registering 'X' for radial tyres and distinctive combinations of letters can be registered, as with ICI, ICL, GEC, BP and SDP. Problems relating to registration number combinations led the Intel Corporation to give a newly designed 'chip' the name 'Pentium' rather than follow its earlier practice of using numbers.

The Act extends to collective marks distinguishing the goods or services of members of the association which is the proprietor of the mark from those of other undertakings: for example, ABTA, FIMBRA: s.49 and Schedule 1. It also covers certification marks which indicate that the goods or services are certified by the mark's proprietor in respect of origin, material, mode of manufacture of goods or performance of services, quality, accuracy or other characteristics: s.50 and Schedule 2.

Signs which do not satisfy s.1(1) are excluded, including marks with no distinctive character, or solely designating the kind, quality, intended purpose, value, geographical origin, the time of production of goods or of rendering of services, or other characteristics of goods or services, and marks which have become customary: s.3(1). A shape cannot be registered if it results from the nature of the goods themselves, or is necessary to obtain a technical result or to give substantial value to them: s.3(2). Registration is also refused for marks contrary to public policy or accepted principles of morality or likely to deceive the public as to the nature, quality or geographical origin of the goods or services: s.3(3).

Marks cannot be registered if identical with an earlier trade mark covering identical goods or services, or where similarity of mark and goods or services is likely to cause confusion to the public. This extends to unregistered marks protected by any rule of law (that is, passing off), or protected in any other form (that is, copyright, design right or registered designs): s.5.

The rights of the registered proprietor

The proprietor has exclusive rights in the registered trade mark which are infringed by use of the trade mark in the UK without his/her consent: s.9(1). Infringing acts include the use by a person of a registered trade mark in the course of a trade that is:

(i) identical with the trade mark in relation to identical goods or services for which it is registered: s.10(1);
(ii) identical with the trade mark and used in relation to similar goods or services to those for which the trade mark is registered; or the sign is similar and is used in relation to identical or similar goods or services for which the mark is registered and there is the likelihood of confusion on the part of the public: s.10(2); or
(iii) identical with or similar to the trade mark, and used in relation to non-similar goods or services for which the trade mark is registered

where the trade mark has a reputation in the UK and the use takes unfair advantage of or is detrimental to the distinctive character or the repute of the mark: s.10(3).

A person uses a sign if s/he (a) affixes it to goods or the packaging thereof; (b) offers or exposes goods for sale, puts them on the market or stocks them for those purposes under the sign, or offers or supplies services under the sign; (c) imports or exports goods under the sign; or (d) uses the sign on business papers or in advertising: s.10(4). A person who applies a mark to material to be used for labelling or packaging goods, as a business paper, or for advertising goods or services, is a party to any use of the material which infringes the mark if s/he knew or had reason to believe that the application was not duly authorised by the proprietor or licensee of the mark: s.10(5).

A registered trade mark is not infringed by the use of another registered trade mark in relation to goods or services for which the latter is registered (s.11(1)) but subject to the fact that the registration of a trade mark may be declared invalid as being in breach of s.3; in which case it is deemed never to have been registered: s.47(6). There is also no infringement by:

(a) the use by a person of his/her own name or address;
(b) the use of indications concerning the kind, quality, quantity, intended purpose, value, geographical origin, the time of production of goods or of rendering of services, or other characteristics of goods or services; or
(c) the use of the trade mark where it is necessary to indicate the intended purpose of a product or service (in particular as accessories or spare parts), provided the use accords with honest industrial or commercial practices: s.11(2).

A registered trade mark is not infringed by the use in the course of trade in a particular locality of an earlier right which applies only in that locality (s.11(3)), nor by use in relation to goods put on the market in the European Economic Area under that trade mark by the proprietor or with his/her consent (s.12(1)), except where there are legitimate reasons for the proprietor to oppose further dealings in the goods, in particular where their condition has been changed or impaired: s.12(2).

Applicants for registration or the proprietor may disclaim right to the exclusive use of any element of the mark, or agree that the rights shall be subject to a specified territorial or other limitation, which will be published and entered in the register: s.13.

Remedies for infringement

Infringement is actionable by the proprietor and all such relief by way of damages, injunctions, accounts or otherwise is available to him as in respect of the infringement of any other property right: s.14. There are two specific remedies.

Order for erasure of offending sign The court may order a person who has infringed a trade mark to cause the offending sign to be erased, removed or obliterated from any infringing goods, material or articles in his/her possession, custody or control, or to secure the destruction of the infringing goods, material or articles in question: s.15(1).

Order for delivery up of infringing goods, materials or articles Infringing goods, material and articles are defined in s.17. However, an application for an order under s.16 may not be made after the end of the period of six years from:

(a) in the case of infringing goods, the date on which the trade mark was applied to the goods or their packaging;
(b) in the case of infringing material, the date on which the trade mark was applied to the material; or
(c) in the case of infringing articles, the date on which they were made.

The six-year limit is extended where the proprietor of the registered trade mark was under a disability or prevented by fraud or concealment from discovering the facts entitling him/her to apply for an order: s.18(2).

Where infringing goods, material or articles have been delivered up under s.16, an application may be made that they be destroyed or forfeited to such persons as the court thinks fit: s.199(1). If no order is made, the person in whose possession, custody or control they were before being delivered up is entitled to their return: s.19(5). A person threatened with proceedings for groundless infringement proceedings can claim relief, including a declaration that the threats are unjustifiable, an injunction against continuance of the threats, and damages in respect of any loss sustained. S/he is entitled to relief if s/he can show that registration is invalid or liable to be revoked in a relevant respect: s.21(3). Unauthorised use of a trade mark in relation to goods is a criminal offence unless the person shows that s/he had reasonable grounds to believe that the use of the sign was not an infringement. The person is liable on summary conviction to imprisonment for a term not exceeding six months, or a fine not exceeding the statutory maximum, or both, and on conviction on indictment to a fine or imprisonment for a term not exceeding ten years, or both: s.92.

Application for registration

Application is to the Registrar and must contain (i) a request for registration; (ii) the name and address of the applicant; (iii) a statement of the goods or services for which registration is sought; and (iv) a representation of the mark. The application must state that the mark is being used by or with the consent of the applicant in relation to those goods or services, or that s/he has a bona fide intention that it should be so used; and be accompanied by an application fee and the appropriate class fees: s.32. Goods and services are classified according to a prescribed system, and questions concerning the class of goods or services is determined by the

Registrar: s.34. Trade marks are registered in respect of particular goods or classes of goods and most countries follow the International Classification of Goods Convention: for example, sports equipment is Class 28, clothing Class 25.

A person has priority for registering the trade mark for some or all of the same goods or services for six months from filing the first application: s.35(1). If application is made within that period, the relevant date for establishing precedence is the date of filing the first application, and the registrability is not affected by any use of the mark in the UK in the period between that date and the date of the application: s.35(2). Equivalent filing in a Convention country gives rise to the same priority right: s.35(3).

The Registrar carries out a search of earlier trade marks. The applicant must be informed if the requirements for registration are not met, and have the opportunity to make representations or to amend the application. The Registrar can accept or reject the applications: s.37. If the registration is accepted, the application is published to give persons the opportunity to oppose the registration within a prescribed time: s.38. The applicant may withdraw his/her application or restrict the goods or services covered by the application. If the application has been published, notification of withdrawal must also be published. Otherwise, an application can only be amended in relation to the name and address of the applicant, errors of wording or of copying, or obvious mistakes, and then only where the correction does not substantially affect the identity of the mark or extend the goods or services covered by the application: s.39.

Registered marks are valid for ten years and renewable for further periods of ten years under s.42. If registration is not renewed, the Registrar shall remove the trade marks from the register: s.43. A registered trade mark cannot be altered during the period of registration or on renewal, except in respect of alteration of the proprietor's name and address where the mark includes this: s.44. The registered mark is subject to surrender, revocation and invalidity.

Surrender It may be surrendered in respect of some or all of the goods or services for which it is registered: s.45.

Revocation The mark may be revoked on the grounds:

(a) that within the five years following registration it has not been put to genuine use in the UK by the proprietor or with his/her consent and there are no proper reasons for the non-use;
(b) that such use has been suspended for an uninterrupted period of five years without proper reasons;
(c) that, in consequence of acts or inactivity of the proprietor, it has become the common name in the trade for a product or service for which it is registered; and
(d) that, in consequence of the use made of it by the proprietor or with his/her consent, it is liable to mislead the public, particularly as to

the nature, quality or geographical origin of the goods or services for which it is registered: s.46(1).

Of particular importance here is (c), which occurs once a trade mark ceases to distinguish the goods or service of the proprietor. The easiest way for a trade mark to lose validity is where it becomes a generic name. Thus words such as linoleum, gramophone, aspirin, hovercraft and nylon are all marks that have lost their distinctive link with the products of a particular manufacturer. 'Vaseline' needed to be re-established as a distinctive mark. The proprietor will specify stringent regulations for the use of the mark. Trade marks should always be used as an adjective and not a noun and should always be used as registered and not altered. Wherever possible, they should be used in conjunction with the generic description – for example, 'Jif – Cream Cleanser' – and they should either be capitalised completely or used with an initial capital. Any licensee must be obliged to follow a registered user agreement.

Articles marketed under a registered trade mark should be marked 'Reg Trade Mark' on the object or on the packaging. The practice of using an R in a circle next to the mark has no legal significance, but is likely to be judicially recognised and it acts as a warning to traders that a monopoly is being claimed. A similar effect is caused by the use of the TM symbol. Another alternative is to mark the protected sign with an asterisk followed by a statement that the symbol indicated is a registered trade mark. It is an offence to say that a mark is registered when it is not: s.95. Common law marks are identified by the words: '"…" is a Trade Mark'.

Invalidity The registration can be invalidated on application to the Registrar or the court and, where it is declared invalid, the registration shall be deemed never to have been made.

Ownership, assignment and licensing

When a trade mark is granted to two or more persons, each is entitled to an equal undivided share in the mark, subject to any agreement to the contrary: s.23. A registered trade mark is transmissible by assignment, testamentary disposition or operation of law in the same way as other personal property, and in connection with the goodwill of a business or independently: s.24(1). An assignment or transmission may be partial in that it is for only some of the goods or services for which it is registered, or for use in a particular manner or a particular locality: s.24(2). The assignment must be in writing, signed by or on behalf of the assignor or a personal representative or, in the case of a company, by the affixing of a corporate seal: s.24(3). A registered trade mark can be charged as security for a loan: s.24(5).

The Act provides for the registration of transactions affecting registered trade marks. Registrable transactions include: (i) assignment of a mark or any right in it; (ii) the grant of any licence under a registered

trade mark; (iii) the granting of any security interest (whether fixed or floating) over a registered trade mark or any right in or under it; (iv) the making by personal representatives of an assent in relation to a registered trade mark or any right in or under it; and (v) an order of the court or other competent authority transferring a registered trade mark or any right in or under it: s.25(2).

Transactions are ineffective against a person acquiring a conflicting interest in or under it until application for registration has been made; and a person claiming as a licensee does not enjoy the protection of ss30 or 31 (s.25(3)). Application must be within six months or, where the court is satisfied that this was not practicable, as soon as practicable thereafter. Assignees or licensees are not entitled to damages or an account of profits occurring between any date of the transfer and the registration of the prescribed particulars: s.25(4). No notice of any trust shall be entered on the register, and the Registrar shall not be affected by any such notice: s.26(1).

A licence to use a registered trade mark may be general or limited, and the limited licence may relate to some but not all of the goods or services for which the mark is registered, or in relation to the use of the mark in a particular manner or a particular locality: s.28(1). The licence must be in writing, signed by or on behalf of the grantor, or by the affixing of a corporate seal in the case of a company: s.28(2). The Act allows for a sub-licence granted by a licensee, and the provisions of the Act apply to both: s.28(4). An exclusive licence means a licence, whether general or limited, authorising the licensee to the exclusion of all other persons, including the grantor, to use a registered mark in the manner authorised: s.29(1).

Where the licensee's rights are infringed, s/he can bring proceedings in his/her own name: s.30(1). Subject to his/her licence providing otherwise, a licensee can call on the proprietor of the trade mark to take infringement proceedings in respect of any matter that affects his/her interest: s.30(2), and if the proprietor refuses or fails to do so within two months, the licensee may bring proceedings in his/her own name as if s/he were proprietor: s.30(3). Where infringement proceedings are brought by a licensee, the licensee cannot proceed with the action without the leave of the court unless the proprietor is joined as a plaintiff or added as a defendant. This does not affect the granting of interlocutory relief on an application by the licensee alone: s.30(4).

An exclusive licence may provide that the licensee shall have the same rights and remedies in respect of matters occurring after the grant as if the licence had been an assignment: s.31(1). Where such provision is made, the licensee may bring infringement proceedings against any person other than the proprietor in his/her own name: s.31(1). Any rights and remedies of an exclusive licensee are concurrent with those of the proprietor and, where the infringement proceedings relate wholly or partly to an infringement in respect of which they have concurrent rights, the proprietor or the exclusive licensee may not without leave proceed with the action unless the other is joined as plaintiff or added as defendant: s.31(4).

Character licensing, granting rights to use imagery in association with products or services, is a major source of income for owners of characters from all major media sources. Thus, from television: Tom & Jerry, Thunderbirds, Mutant Hero Turtles; from publishing, including comics: Dennis the Menace; from the movies: the Flintstones, Jurassic Park. Licensing allows manufacturers to use the character on shirts, pillows, pencil cases and so on. The Mutant Hero Turtles earned some £60m in licensing rights. The Registrar is, however, unwilling to clutter the register with short-term marks, as can be seen in refusals relating to 'Rawhide' in 1962 (*Rawhide* [1962] RPC 133) and 'Pussy Galore' in 1967, and registration could still be refused in similar situations.

Patents

A patent gives the patentee the exclusive right to exploit an invention for a stated period of time. Patents last for twenty years from the date of application to the Patent Office provided renewal fees are paid every year from the fifth year onwards. The rights granted by the patent are set out in the Patents Act 1977 and all statutory references in this section will be to that Act unless otherwise stated.

Application is to the Patent Office, accompanied by a specification consisting of a detailed description of the invention and a set of claims. The claims define the scope of the invention for which the patentee seeks a monopoly. It is the invention as defined in the claims that is tested for patentability and against which alleged infringements are considered. The Patent Office carries out a search in the relevant technical literature ('prior art') to test for 'novelty' and 'inventive step'. The examination is in two stages: a preliminary and a substantive examination, with separate fees. The applicant is sent the result of the search usually within about twelve to fifteen months.

Depending on the results of the search, the applicant may decide to abandon or modify his/her application or request an examination. The request for examination must be made within six months from the date the application is published by the office. The publication must be within eighteen months of filing the application. At the examination stage, the application is examined by a technically qualified Patent Office Examiner to see whether it complies with the requirements. An applicant is given one opportunity voluntarily to amend his/her specification during the examination, but s/he may amend it a number of times in accordance with the examiner's requirements. Once the procedure of examination is completed and any objections of the examiner have been met, a patent will be granted and a notice of the grant published in the Official Journal and a Certificate of Patent issued. A patent can be revoked after grant.

Where two or more applications are made independently for the same or overlapping inventions, priority is given to the first to file. Under the Paris Convention (1833) most countries have agreed that the date of first filing a patent application in the 'home' country establishes the priority

date for applications to other Convention countries provided the application is made within twelve months.

International application procedures

An application made at the British Patent Office will result in the grant of a British patent only. A UK patent is effective in England, Wales, Scotland, North Ireland and the Isle of Man. It does not extend to the Channel Islands, though a UK patent may be registered there. An applicant wishing to obtain patent protection in several countries can register nationally or use two international systems: the Patents Co-operation Treaty and the European Patent Convention.

Patents Co-operation Treaty (PCT) This provides for the filing of a single application, designating the countries for which the applicant seeks protection. A single search is carried out and the application is sent to each of the designated countries for separate examination as a national application under their own laws. The system is operated by the World Intellectual Property Organisation (WIPO) and came into operation in 1978. Some thirty-one countries are members, including the UK, the USA and most European states. The applicant applies in his/her National Patent Office (which is a PCT Receiving Office). There are two steps in a PCT application: the international phase and the national phase.

European Patent Convention This provides for filing at the European Patent Office in Munich and the member states in which protection is requested are specified. Only one application is required to achieve a patent in up to eleven countries. The application is searched and examined at the European Patent Office and if it satisfies the requirements of the Convention, separate national patents are granted for the specified countries. Apart from the first nine months after grant, when the European patent can be challenged at the European Patent Office, validity and infringement can only be contested before the separate national courts. All EC member states (except Greece) and some other Western European countries belong. A Europatent takes effect once the European Patent Bulletin publishes the fact of its grant. The term of the patent is twenty years and renewal fees are payable at the rates prescribed in each state. Most applications are made directly to Munich and not to the British Patent Office.

Patentability

The invention must (i) be novel; (ii) involve an inventive step; (iii) be capable of industrial exploitation; and (iv) not be excluded from being patented.

Novelty The invention must be new, which means it must not form part of the state of the art at the priority date. The state of the art comprises

all matter which has, at any time before that date, been made available to the public anywhere in the world by written or oral description. Available to the public means disclosure to one person who is free in law and equity to use the information as s/he pleases. Certain types of prior disclosure will not invalidate a patent: for example, disclosure in breach of confidence or at an international exhibition. An example is Dunlop, who patented the pneumatic tyre in 1888. Shortly afterwards competitors produced an 1845 patent by a person called Thompson. Dunlop's patent was then invalid. Another example concerns Mr Biro, who was unable to register a patent in respect of the ballpoint pen since he had previously had some made up and distributed to friends and others.

Inventive step There is an inventive step if it is not obvious to a person skilled in the technical field of the invention.

Capable of industrial application Methods of treating humans and animals, whether by surgery, therapy or diagnosis are unpatentable.

Patentable The Patents Act 1977 gives a non-exhaustive list of non-patentable inventions. These include:

(a) discoveries, scientific theories or mathematical methods;
(b) literary, dramatic, musical or artistic works or any other aesthetic creations;
(c) schemes, rules or methods for performing a mental act, playing a game, doing business, or a programme for a computer; and
(d) the presentation of information.

A patent cannot be granted for any variety of plant or animal nor for an essentially biological process for their production. A patent may be granted for a microbiological process.

Infringement

A person infringes a patent in the UK by doing one of the following without the proprietor's consent: (i) where the invention is a product, s/he makes, disposes of, uses or imports or keeps it for disposal or otherwise; (ii) where the invention is a process, s/he uses it or offers it for use when s/he knows, or it is obvious, that its use would be an infringement; or s/he disposes of, offers to dispose of, uses or imports any product obtained directly by means of that process or keeps any such product whether for disposal or otherwise. It is also an infringement to supply, or offer to supply, 'means essential for putting an invention into effect' to a person not entitled to work the patent, when s/he knows, or it is obvious to a reasonable person in the circumstances, that those means are suitable for putting and are intended to put the invention into effect in the UK.

There are certain limited exceptions, including acts done for private non-commercial purposes, acts done for experimental purposes, acts done

on ships or aircraft temporarily or accidentally within territorial waters or airspace. A person who has him/herself used the invention before the priority date of the patent may do so again or continue to do the acts s/he did before that date.

Patent maintenance

The Patent Office keeps a register of patents open to the public. All goods that are the subject of a patent should bear the words 'Patented' followed by the patent number. If this is not practicable, the packaging should be marked. If there is no marking, then, in the event of proceedings for infringement, damages can only date back to the time when the infringer was made aware that s/he had infringed it, provided s/he can prove that at the date of the infringement s/he was not aware and had no reasonable grounds for supposing a patent existed. It is an offence punishable with a fine to hold out that goods are Patented or that a patent is applied for when this is not true. Once a patent runs out, a reasonable period of time is given for phasing out stocks of the product bearing any patent marks. Following the grant of the patent, renewal fees have to be paid on an annual basis from the fifth year. The renewal fees rise steeply towards the end of the twenty year period. A patent will lapse on non-payment of renewal fees. Failure by an employee to make the payment means that after that year the patent cannot be restored to the register: *Re Textron Inc.* [1988] 1 FTLR 210. A patent owner can surrender his/her patent.

Remedies for infringement

The patent holder is entitled to an injunction, delivery-up of infringing articles and damages or an account of profits. Damages are assessed on loss of profits or a royalty basis.

Ownership, assignment and licensing

A patent may be owned by the inventor or by his/her employer or by two or more co-inventors. Any invention made in the normal course of duties of an employee belongs to the employer, but otherwise to the employee. There is compensation to employees: (i) if the invention belongs to the employer who obtains a patent, the employee is entitled to compensation if the patent is of outstanding benefit to the employer; and (ii) an employee may own the invention but assign the patent to the employer and there is a procedure for assessing the compensation if the parties cannot reach agreement. The matter can be decided by the Patent Office or the court.

An assignment must be in writing and signed by or on behalf of both parties to the transaction, otherwise it is void. A licence may be granted orally and may be non-exclusive or exclusive. All transactions must be registered at the Patent Office. Penalties for non-registration include loss of priority over subsequent transactions and restrictions on the right to recover damages.

Under the Act, a patent owner is required to grant a licence under his/her patent, and persons can apply for a compulsory licence where:

(i) three years have expired since date of the patent;
(ii) the invention, though capable of being worked in the UK, is not being either worked or worked to the full extent possible;
(iii) demand in the UK is not being met on reasonable terms or to the fullest extent possible; or
(iv) importation has the effect of preventing the invention being worked in the UK.

If the Comptroller is satisfied on any of the above grounds, s/he may order the patent to be continued under a 'compulsory licence' and the patent owner must grant a licence. If s/he fails to offer reasonable terms, then this will be settled for him/her.

Assignments and so on may infringe national or Community competition laws (see Chapter 17).

Protection of form and appearance: copyright and design

Copyright exists in every original literary, dramatic, musical or artistic work, and every sound recording or cinematograph film, television or sound broadcast provided that it is not contrary to public policy. The copyright work is protected for a definite time, depending on its nature. The protection is automatic and arises when the work is created; there is no registration procedure or any formalities except with regard to registered design. Copyright covers a wide range of subject-matter and is of great commercial significance, the most obvious commercially valuable examples being copyrights in films, videos, records, tapes and CDs. The UK law of copyright is found in the Copyright, Designs and Patents Act 1988 (CDPA, 1988) as amended by the Duration of Copyright and Rights in Performances Regulations 1995 (SI 1995 No. 3297). Copyright protection is important on an international scale and many countries will offer similar protection to that offered in the UK. Where they are signatories of the Universal Copyright Convention 1952, they will offer identical protection as they do to their own nationals.

The protection of form and appearance covered by copyright, design right, design registration and semiconductor chip designs requires the work to be original. Originality does not require the work to have been inventive, and two people could claim copyright for similar works.

Copyright

Works within the scope of the UK copyright law include (i) literary works; (ii) dramatic works; (iii) musical works; (iv) artistic works; (v) the typographical arrangement of published editions; (vi) sound recordings; (vii) films; and (viii) broadcasts and cable programmes: s.1. CDPA 1988.

Literary works

These are defined in s.3 as 'any work, other than a dramatic or musical work, which is written, spoken or sung', and accordingly includes: (a) a table or compilation; and (b) a computer program. The literary work is protected even though it is only spoken or sung and includes speeches, interviews, poetry recitals or the live performance of a monologue. However, it only qualifies for protection once recorded in writing or otherwise: s.1(2). Writing includes any form of notation by hand or otherwise and regardless of the method by which, or medium in or on which, it is recorded: s.179. Any means of recording is sufficient, including databases, tape, disk and so on. Literary merit is not required and listings of TV programmes, football fixture lists and street directories classify as literary works. The work must be of sufficient length, however, and there is no copyright in respect of a name: *Exxon Corporation* v. *Exxon Insurance Consultants International Ltd* [1982] Ch 119 – ('Exxon'); *Tavener Rutledge Ltd* v. *Trexapalm Ltd* [1977] RPC 275 – ('Kojak'); or for book titles or advertising slogans, or song-titles: *Francis, Day & Hunter Ltd* v. *Twentieth Century Fox Corporation Ltd* [1940] AC 112.

Dramatic works

These are not defined except that s.3(1) specifically includes within the category works of dance or mime. They are not restricted to a play or screenplay and would cover instructions for action or presentation of some kind of performance, including choreography and stage directions. They can be recorded in any form, including a televised performance by ice dancers and possibly figure-skating.

Musical works

There is no statutory definition, but the Act provides that 'music is to be distinguished from any accompanying words to be sung spoken or performed or actions intended to be performed with the music': s.3(1). Music is not protected until recorded in some way.

Artistic works

Artistic works include graphic works, photographs, sculptures or collages, architecture in the form of buildings or models, and works of artistic craftsmanship: s.4. Artistic quality is not required. This resulted in extending copyright protection to design drawings; these are no longer included but there is transitional protection until 1 August 1999 for designs already protected (see below: Copyright in designs).

Typographical arrangements of published editions of literary, dramatic and musical works

Protection is given to the layout, arrangement and appearance of printed pages of such works under s.8, independent of the printed work itself.

Sound recordings

A sound recording is either ‘a recording of sounds, from which sounds may be reproduced’, or ‘a recording of the whole or any part of a literary, dramatic or musical work, from which sound reproducing the work or part may be produced’. In either case the recording qualifies for protection regardless of the medium on which the recording is made or the method by which the sounds are reproduced or produced. The sound track of a film is now a sound recording for the purposes of the Act; previously it was treated as part of the film.

Film

Film is defined as ‘a recording on any medium from which a moving image may by any means be produced’ and covers photographic film, videotape and video discs. There is no need for the recording to be of visual images, and it would seem to cover the recording of signals enabling the generation of abstract pictures on a screen.

Broadcasts and cable programmes

A broadcast is a programme composed of images and sounds seen and heard on television screens, or heard on the radio and broadcast by wireless telegraphy. A cable programme service is defined as a service which consists wholly or mainly in sending by means of a telecommunications system otherwise than by wireless telegraphy of visual images, sounds or other information: s.7. The difference is merely in the transmission. The broadcast is protected irrespective of whether the material broadcast is protected or merely a live news broadcast or transmission of a sporting event. The independent protection of the broadcast prevents others rediffusing the broadcast and profiting from the broadcaster’s investment and effort.

A cable programme service must be intended to present programmes to the public, or be receivable in more than one place. It includes any type of computer network such as a database or information service, but excludes private (domestic or business) cable systems not connected to any other telecommunications system and not used in providing a service to others: s.7(2). It includes a database linking a manufacturer and a dealer network, but not an inter-branch network of the same organisation. The position of interactive databases such as Viewdata or Prestel is not clear: the Secretary of State does have powers to add or remove exceptions but not to amend existing exceptions: s.7(3).

Protection of live performances

The unauthorised recording or filming of performances is protected in criminal law but specific civil rights are introduced for the performers and anyone who enjoys exclusive rights to record or film the performer. A ‘performance’ means a live performance given by one or more individuals

including a dramatic performance, a musical performance, a reading or recitation of a literary work, a performance of a variety act or a similar presentation. The performance must be live, need not be before an audience and includes pirating a studio 'live' performance which is being filmed or otherwise recorded.

Copyright infringement

The copyright owner has basic rights whose infringement is an act of primary infringement; other rights exist whose infringement will be a secondary or even a tertiary infringement. Secondary and tertiary infringements are usually subject to the precondition that the infringer must have had knowledge or a reasonable belief that what was done was an infringement. This is not necessary for primary infringement. The marking of products may be sufficient to establish knowledge or reasonable belief, as can be a warning letter from the rights owner. The law also recognises moral rights, which restrict what can be done with the copyright work. The moral rights exist independently of copyright in the work.

Primary infringement

Copyright protects the holder against (i) the copying of the protected work; (ii) the right of initial public circulation; (iii) performing, showing or playing a work in public; (iv) broadcasting or including the work in a cable programme; (v) renting films, sound recordings and computer programs to the public; and (vi) adapting the work and enjoying the above rights in relation to the adaptation.

Copying the work Infringement can arise even if only a substantial part of the work is copied; it does not have to be exact and exists if there is sufficient objective similarity. For a high quality work requiring great skill and effort, copying even a small part might be an infringement. It includes making a transient copy of the work, or making a copy as an incidental part of some other use of the work: s.17(6); or using a computer program where all or part of the program is copied into the computer's memory. Where the copyright relates to material in electronic form, copying would be constituted by displaying the information on a screen.

There is a special right for works supplied in electronic form such as computer programs, where the work is 'copy-protected' to make copying difficult or impossible without special equipment: s.296. The right extends to CDs and tapes which are designed not to be copied. The right is given to the person who issues the copy-protected work to the public, who can only exercise it against someone who supplies a device designed or adapted to circumvent the copy protection, persons who make, import, sell, hire or offer or expose for sale or hire any such device, and anyone who publishes information intended to enable or assist people to circumvent the copy-protection method used. A similar right exists for persons

charging for the reception of broadcasts or cable programmes, or who make encrypted transmissions: s.298.

Initial circulation Once the copies are in circulation, anyone can buy and sell the copies and deal with them in any way except for importation and rental. Sound recordings, films and computer programs can only be rented with the copyright owner's consent, even though copies are in circulation.

Performance in public The copyright owner has the exclusive right to perform or permit others to perform a copyright work in public: s.19(1). There is a corresponding right for sound recordings, film, broadcast or cable programmes to play or show the work in public: s.19(3).

Broadcasting and inclusion in cable programmes This exclusive right of the owner of certain copyright works extends to giving other persons permission to broadcast or include the material in a cable programme: s.20.

Adaptations of copyright works The copyright owner has the exclusive right to make and permit others to make adaptations of literary, dramatic and musical works (s.21(1)), and to control what is done to an adaptation of a copyright work. The right of control over the adaptation covers all the basic copyrights. Adaptations include (i) the translation of a literary or dramatic work; (ii) making a dramatic work into a non-dramatic work and vice versa: s.21(3)(a); and (iii) an arrangement or transcription of a musical work: s.21(3)(b). For a computer program the term 'translation' includes a version of the program converted into or out of one computer language or code into another: s.21(4).

Secondary infringement

Liability requires the person infringing copyright to have some knowledge or reasonable belief that an infringement is likely to be committed. Infringements include: (i) importing into the UK infringing copies of a work other than for private and domestic use: s.22; (ii) possessing and commercially dealing in infringing copies of a copyright work: s.23; (iii) making or importing or possessing in business anything designed or adapted for making copies of a copyright work: s.24. – this extends to selling or hiring or offering such a thing for sale or for hire; and (iv) transmitting a copyright work on a telecommunications system: s.24.

Tertiary infringement

This only arises once there has been a primary infringement by a person using apparatus for playing sound recordings, showing films or for receiving broadcasts or cable programmes and so on; others can then be liable for tertiary infringement, including suppliers of the apparatus, persons allowing it to be used on their premises, or the supplier of the copy of the

work used. But they must have known or had reason to believe that there was a likelihood of infringement: s.26.

Permissible acts in relation to copyright works

The Act makes specific provision excluding copying and other acts for activities including educational purposes, libraries and archives and things done in connection with public administration: that is, copying in connection with judicial proceedings. There are also exceptions in connection with 'fair dealing' in relation to literary, dramatic, musical and artistic works in connection with research and private study, criticism and review, and news reporting: s.29. For the purposes of criticism or review the Act requires sufficient acknowledgement of the author: s.30. What is sufficient is laid down in s.178. The Act excludes incidental inclusion in films, broadcasts and so on of an artistic work, a sound recording, film, broadcast or cable programme: s.31. This will not extend to copyright works that are included deliberately, such as music as part of the soundtrack. Also excluded is the recording of television programmes, whether broadcast or cable, for private and domestic use: s.70.

Moral rights

This is the right of the authors of literary, dramatic, musical and artistic works, and the directors of films, to be identified as such and to object to any derogatory treatment of the work. It prevents anyone else claiming authorship of the work. Derogatory treatment includes any addition to or deletion from the work: s.80(2). It does not include translating a literary or dramatic work or arranging or transcribing a musical work which involves only a change of key or register. The right to be identified as the author of the work must be asserted; this can be done in the document assigning the copyright, or by serving notice in writing: s.78. There is also a right to privacy for photographs or films made for private and domestic purposes and which can prevent their publication, exhibition to the public, and broadcast or inclusion in a cable programme. The moral rights are personal to the author or director and cannot be transferred. They can only be exercised by that person or by their personal representatives. An author or director can exercise the rights even after the copyright has been transferred or licensed.

Ownership of copyrights

The author will be the first person who is the copyright owner; it is therefore important to identify the author. This will depend upon the nature of the work.

Literary, musical, dramatic and artistic works

The author is the creator of the work (s.9), and the author of the work is the owner of copyright in it: s.11. For photographs, the position has

changed under the 1988 Act, and the author is the creator, who in most cases will be the person who takes the photograph. An exception to ownership of copyright in respect of literary, musical, dramatic and artistic works relates to works created by employees in the course of their employment, when the copyright belongs to the employer subject to agreement to the contrary.

Typographical arrangements of published editions

The creator of the typographical arrangement of a published edition is the publisher: s.9.

Sound recording and films

The author is the person by whom the arrangements necessary for the making of the recording or film were made: s.9(2), and the author is the owner of copyright: s.11.

Broadcasts and cable programmes

The creator of a broadcast is the person making the broadcast: s.9. The creator of a cable programme is the person providing the cable service: s.9. The creator is the author who is copyright owner: s.11.

Performances

Each performer is treated as the author or creator of the particular part in the overall performance. The rights in a performance are personal to the performer and cannot be bought or sold (s.192), which means that the performer is the first and only owner of rights in the performance. On the death of the performer, the rights and their control can pass by will and, in the absence of a will, are exercisable by the deceased's personal representatives.

The recording rights in the performance belong to the person with an exclusive recording contract with the performer, or a person who has bought the benefit of the exclusive recording contract, subject in both cases to the person satisfying the nationality requirements of the Act. A licensee from the person with the benefit of the exclusive recording contract may own the recording right if the licence allows for the making of recordings covered by the exclusive recording contract with a view to their commercial exploitation, provided that the licensee meets the nationality requirements of the Act.

Joint ownership

The work is joint if the contributions are not distinct: s.10. Thus a book is a work of joint authorship if it is impossible to identify the individual contribution of the authors. Joint owners can only exercise their rights jointly and cannot grant licences in the copyright work individually or sue individually. However, the moral rights of the authors are exercisable individually: s.88.

The prospective owner of the copyright work can contract to transfer the rights in the work to a person before the work comes into existence, as where a work is commissioned and where the agreement is in writing and signed by or on behalf of the prospective owner, the purchaser will be the copyright owner when the work is created: s.91.

Period of copyright protection

The periods of copyright protection in the 1988 Act were amended by the Duration of Copyright and Rights in Performance Regulations 1995, which implement Directive No. 93/98/EEC. Since the periods were in some cases extended (from fifty to seventy years after the author's death), the Regulations make provision for revived copyright.

Protection in a literary, dramatic, musical or artistic work expires at the end of the period of seventy years from the end of the calendar year in which the author dies: s.12(2). However, if the work is of unknown authorship, copyright expires (a) at the end of the period of seventy years from the end of the calendar year in which the work was made; or (b) at the end of the period of seventy years from the end of the calendar year in which the work was first made available to the public: s.12(3). If the identitity of the author is discovered before the end of the periods in (a) and (b), then s.12(2) applies. For a literary, dramatic or musical work, being made available to the public includes performance in public, or being broadcast or included in a cable programme service; for an artistic work it includes exhibition in public; for a film, including the work being shown in public or being included in a broadcast or cable programme service, but no account shall be taken of any unauthorised act: s.12(5). Where the country of origin of the work is not a European Economic Area (EEA) state and the author is not a national of an EEA state, the duration of the Copyright is according to the country of origin provided that it does not exceed the period under subsections (2) to (5). If the work is computer-generated, however, the copyright expires at the end of the period of fifty years from the end of the calendar year in which the work was made. For works of joint authorship, the date is calculated from the date of death of the last author or, where only one or more of the joint authors is known, the date of death of the last of them to die.

For sound recordings, copyright expires (a) at the end of the period of fifty years from the end of the calendar year in which it is made, or (b) fifty years from the end of the calendar year in which it is released: s.13A(2)s. For films, copyright expires at the end of the period of seventy years from the end of the calendar year in which the death occurs of the last to die, of: (a) the principal director; (b) the author of the screenplay; (c) the author of the dialogue; or (d) the composer of music specially created for and used in the film: s.13B(2) This is subject to the fact that if the identity of one or more of those persons is unknown, the period shall run from the date of the death of the last person whose identity is known: s.13B(3). If the identities of all the persons is unknown, copyright expires at the end of

the period of seventy years from the end of the calendar year in which the film was made, or the end of the year in which it was first made available to the public. Where the country of origin is a non-EEA state and the author of the film a national of a non-EEA state, the duration of copyright in the work is according to the law of the non-EEA state as long as it does not exceed the provisions under s.13B(2) to (6): s.13B(7).

The duration of copyright in respect of broadcasts and cable programmes expires at the end of the period of fifty years from the end of the calendar year in which the programme was made or included in a cable programme service: s.14.

The duration of rights in performances expire at the end of the period of fifty years from the end of the calendar year in which the performance took place, or from the end of the calendar year in which it was released, s.191.

The moral rights of authors and directors continue as long as the copyright in the work but the right to object to being falsely represented as the author of a work lasts until twenty years after the death of the person concerned: s.86. An example of enforcement of this right is in *Clark* v. *Associated Newspapers Ltd* [1998] 1 All ER 959, where Sir Alan Clark obtained damages under the law of passing off, and s.84, concerning a spoof series in the *Evening Standard* under the title 'Alan Clark's Secret Political Diary'.

General licensing schemes

Private organisations run licensing schemes for various categories of author who are members of these organisations, to allow persons to deal with a copyright work which would otherwise be an infringement. The Performing Rights Society regulates the performing of music in public places, including playing recordings of copyright music on the radio and so on. Phonographic Performance Ltd regulates the rights to perform recordings in public; and the Copyright Licensing Authority regulates rights which include photocopying published literary works. A statutory body called the Copyright Tribunal, created under the 1988 Act, reviews the operation of general licensing schemes.

Criminal liability

Several criminal offences arise from infringement of copyright. The penalties include fines and imprisonment for up to two years, and the court can order the offender to give up any infringing copies to the copyright holder or to have them forfeited or destroyed.

9.10 Product Design Protection

The law relating to design protection is in the Registered Designs Act 1949 (RDA 1949) (as amended 1988) and the Design Right (Semiconductor

Topographies) Regulations 1989. The product design is treated separately from the means used to record it, which can be a design drawing, blueprint and a technical specification or a model or prototype. The former is a 'design document' and the latter is defined as something 'embodying a design': ss51 and 263(1). Designs can be protected by (i) copyright; (ii) design right; or (iii) right in registered designs.

Copyright protection

The 1988 Act excludes infringement of a product design from a design document from copyright infringement: s.51. However, copyright protection applies to (i) the two-dimensional aspects of design; (ii) situations where the design is for something which is itself an artistic work; and (iii) designs for typefaces. Thus designs for wallpaper, fabric and carpet patterns, motifs, engraving and decorative embossing are within copyright protection, as is the design for a three-dimensional artistic work or work of artistic craftsmanship such as wrought ironwork, jewellery or engravings. The design drawings would qualify as an artistic work.

Design right protection for products

For the purposes of design right protection, a design is defined as: 'the design of any aspect of the shape or configuration (whether internal or external) of the whole or part of an article'. The definition specifically excludes surface decoration: s.213(3). The design must be recorded in an article or a design document: s.213(6); but a design document includes databases and so on: s.263(1). Excluded from protection are features of shape or configuration which enable an article to fit with another article so that either article can perform its function: s.213(3). Similarly, where one article is intended to form an integral part of another article, the design right will not protect features of shape or configuration which are dependent upon the shape of the other article. These limitations allow the manufacture of competing spare parts, subject to the transitional protection for designs protected by copyright. The methods or principles of construction are also excluded from the design right protection: s.213(3); this will render unprotectable features of a design that are merely dictated by the material used and the method of construction.

Design right does not cover computer programs and recipes and materials. There is nothing to prevent anyone copying the ingredients in a processed food product unless the product is protected by patent, as in the case, for example, of Wall's 'Viennetta' ice-cream. The new law will cover circuit diagrams.

Registered design protection for products

Registered design protection is for designs which are attractive and the design must be registered at the Designs Registry under the Registered

Designs Act 1949 as amended by the 1988 Act. Registered design relates to features of shape, configuration, pattern or ornament applied to an article by any industrial process being features which in the finished article appeal to and are judged by the eye: s.1(1) RDA 1949 as amended. The design is registered in relation to a specified article or articles and needs to be extended to cover any kind of article to which it could be applied, as in the case of a product range. Features of designs of spare parts are registrable in their own right, since 'article' includes any part of an article if the part is made and sold separately: s.44. Two- and three-dimensional design aspects are included, but the Registered Designs Rules 1989 specify that copyright protection must be relied on for wall plaques, medals and medallions, and printed matter primarily of a literary or artistic character, including book jackets, calendars, certificates, coupons, dress-making patterns, greetings cards, labels, leaflets, maps, plans, playing cards, postcards, stamps, trade advertisements, trade forms and cards, transfers and similar articles.

Designs are not registrable if the appearance is not material. Purposes, principles or methods of construction do not qualify for registered design protection, and the integral features exception from design right also applies to registered design. There is, however, no functional combination exception; and features dictated solely by function are not protectable: s. 1(1)(b)(i) as amended.

Rights in respect of product designs

Copyright in designs

From 1 August 1989 copyright only applies to the design of things that will be artistic works when made to the design, or attractive two-dimensional designs like wallpaper, fabric, logos and so on. For designs for three-dimensional products made before that date, there is a ten-year protection under the law of copyright.

For product designs made before 1 August 1989, the protection continues for up to ten years from that date. For designs that are still protected under copyright, once copies of the work (including a typeface) are made by an industrial process, protection is limited to twenty-five years with the period running from the end of the calendar year in which the copied articles are first marketed. Under the Copyright (Industrial Process and Excluded Articles) (No. 2) Order 1989, an article is treated as being made by an industrial process if at least fifty are made and the article is a copy of an artistic work but not part of a set of articles for registered design purposes. The order also specifies types of things of a literary or artistic character, which will still be covered by the ordinary copyright rules.

Design right

The owner of the design has the exclusive right to reproduce the design for commercial purposes: s.226. This means making articles to the design,

or recording the design in a design document for the purpose of making articles to the design. There is no protection for functional features, integral features, methods or principles of construction, surface decoration or commonplace features.

For there to be an infringement, the reproduction must be for 'commercial purposes', which includes anything done with a view to selling or hiring the article in the course of a business: s.263(3). Primary infringement covers making or authorising anyone to make articles to the design, or recording the design in a design document without consent. Secondary infringement covers importing, possessing and dealing in infringing articles for commercial purposes: s.227. This requires knowledge or a reasonable belief that the articles concerned are infringing articles.

Registered rights

The registered proprietor has the exclusive right to make and to import articles to which the design has been applied (RDA 1949, s.7). This is limited to the purposes of selling, hiring or using for the purposes of any trade or business. This means that there is no infringement if the goods are made or imported for private and domestic purposes or for any other purpose that is not for the purposes of a trade or business. The proprietor also has the exclusive right to deal in articles to which the design has been applied. Dealing means to sell, hire, offer or expose for sale or hire. Registered designs can be infringed without copying, so that if anyone produces an article which is substantially similar to the registered design this will be an infringement. A registered design is also infringed by the making of anything for use in the manufacture of infringing articles: s.7(3).

Protection does not extend to functional features, integral features, methods or principles of construction and where the appearance is not material to the decision to buy. Absence of knowledge or of a reasonable belief that the design is registered may enable the person infringing the design to avoid the payment of damages: s.9. There are no criminal offences in relation to registered design rights. There are no criminal offences in relation to infringement of design rights.

Ownership in product designs

For copyright, this is governed by the ordinary copyright rules previously stated. In respect of design right protection, the designer is the person who creates a design: s.214(1). Where the design is computer-generated, the designer is the person by whom the arrangements necessary for the creation of the design are made: s.214(2). The first/prospective owner of design right is the designer unless the design is commissioned, or produced in the course of the designer's employment: s.215(1). If it is commissioned, the owner is the person commissioning the design: s.215(2). If the design is created in the course of employment and neither the employer nor the employee have been commissioned by a third party, the

owner is the designer's employer: s.215(3). If the only way a design can qualify for design-right protection is by satisfying the first marketing requirement, then the owner of design right is the person who first markets articles made to the design: s.215(4). Thus where the manufactured articles are not first marketed by the design-right owner, then the exclusive licensee or the exclusive distributor can become entitled to the design right. Where a prospective owner of the design agrees to transfer the design right before the design is created, the transferee will become the owner of the design right automatically on creation of the design: s.223(1). Such an agreement must be in writing signed by or on behalf of the prospective owner. No one can be the owner of a registered design unless an application for registration has been made and registration granted. The author of a registrable design is the person who creates it: s.2(3) (RDA 1949), or, where the design is computer-generated, the author is the person making the arrangements necessary for the design. The author will be the original proprietor of the design, and the person entitled to apply to register the design: s.2(1).

Where the design is commissioned, the person commissioning is the proprietor entitled to register the design: s.2(1A); and where the design is created by an employee in the course of employment, the employer is the proprietor unless the design was commissioned: s.2(1B). It is possible to transfer the rights to a design or grant a licence in respect of it before registration and the Act allows a person who obtains an interest in a design in such a way to apply for registration: s.2(1) and (2).

9.11 Semiconductor Chip Design Protection

Semiconductor chip designs have their own system of protection, now contained in the Design Rights (Semiconductor Topographies) Regulations 1989. The regulations protect the design of the topography of the chip but do not prevent anyone from making a chip with similar functions which is protected in patent law. The regulations specify the aspects of design that are protected.

The owner has the same exclusive rights as the owner of design rights. It is not a primary infringement, however, to reproduce the design for private, non-commercial aims, for analysing or evaluating the design, or for analysing or evaluating the concepts, processes, systems or techniques embodied in it, or for the purposes of teaching the same. This leaves the door open to reverse engineering. The secondary infringement aspects of design right apply to semiconductor chip designs with slight variations. There are no criminal offences created in respect of infringement of semiconductor topography design rights. The protection also excludes functional features, integral features, methods and principles of construction, surface decoration and commonplace features.

The authorship rules for semiconductor chip designs is the same as for design right, including provisions relating to first marketing (s.215(4)) and

including provisions relating to designs created by employees or designs that are commissioned. Designs can be transferred by prospective owners and the purchaser becomes the owner of the design right automatically: s.223(1).

Recommended Further Reading

A Practical Approach to Land Law, Judith-Anne Mackenzie and Mary Phillips, 7th edn (L. Alison, Blackstone Press, 1997).
An Introduction to Intellectual Property Law, Phillips and Firth, 3rd edn (Butterworths, 1995).
Sourcebook on Intellectual Property Law, Peter Groves (Cavendish 1997).
Readings in Intellectual Property, Ed. Alison Firth, Shelley Lane, Yvone Smyth (Sweet and Maxwell 1998).
Elements of Land Law, Kevin Gray, 2nd edn (Butterworths, 1993).
Land Law, Kate Green, 2nd edn (Macmillan Professional Masters, 1993).

Questions

1 What are the most usual freehold and leasehold estates in land?
2 People sometimes have rights over land owned by others. How are these rights described, and can you name five examples of such rights?
3 Give examples of intangible personal property, and the technical term used to describe them.
4 Most property is subject to the doctrine of *nemo dat quod non habet*. What does this mean, and what type of property is an exception to the doctrine?
5 What are the different types of intellectual property?
6 How can a trade mark lose its validity, and how can the registered proprietor guard against such an eventuality?
7 In order for an invention to be patented it must comply with four criteria. What are they?
8 How is a patent protected, and for how long does the protection last?
9 Copyright exists in respect of a literary work. How is literature defined for this purpose?
10 What are the primary rights enjoyed by the copyright owner?
11 What is the principal difference between the moral rights of the author and the other rights arising from copyright ownership?
12 Rights to designs can be protected in three ways. What are they, and how are they different?

10 Securities for Loans

Learning Objectives

After reading this chapter you will know about:

1. the way land, goods, securities and life insurance policies can be mortgaged, legally or equitably, to provide security for a loan
2. the remedies and protection of the mortgagee and the protection of the mortgagor
3. the charges which can be created over their property by registered companies, and the distinction between fixed and floating charges
4. guarantees and indemnities as a security, including the contractual considerations, special categories of guarantor, the rights of the guarantor and the termination of guarantees
5. the use of a retention of title clause as security for the supplier of goods against the eventuality of the purchaser becoming bankrupt or going into liquidation when the goods are still not paid for
6. the value of the lien as a form of security

10.1 The Nature of a Security

When a person lends money to another or supplies goods on credit, the lender/supplier will generally require some form of collateral security depending on the transaction, and the property owned by the borrower or a third party prepared to stand as surety. In addition, some forms of security arise automatically. If the borrower fails to pay for the goods or repay the loan, the lender reimburses him/herself by enforcing his/her rights against the property charged or the surety. Forms of security discussed in this chapter include:

(i) mortgages of real and personal property, tangible and intangible;
(ii) fixed and floating charges created by companies;
(iii) guarantees/indemnities by a third party;
(iv) retention of title clauses; and
(v) liens over personal property.

10.2 Mortgages of Land

The essence of a mortgage is to use the mortgagor's (the borrower's) property as security for a loan by the mortgagee (the lender). If the mortgagor defaults, the mortgagee can recover the loan plus outstanding interest by realising the mortgaged property. Mortgages can be legal or equitable (formal or informal).

Legal mortgages

For most property, the mortgagor will effect a legal mortgage by transferring the property to the mortgagee subject to the mortgagee's obligation to retransfer it on repayment of the loan plus interest. In respect of land, this has not been possible since the Law of Property Act 1925. There are two systems for creating a legal mortgage while allowing the mortgagor to retain title: the *mortgage by demise* and the *legal charge.*

Mortgage by demise

The mortgagor creates a lease over the property to the mortgagee by deed subject to cesser (termination) on redemption: that is, terminable on repayment of the loan plus interest. The loan agreement will provide for repayment by the legal date of redemption, but is subject to the mortgagor's equity of redemption which allows him/her to redeem the property at any time (subject to reasonable restrictions) by repayment of the loan plus interest.

Where the land is freehold, the lease is generally for 3000 years. The mortgagor may create second and subsequent mortgages over the same property. A second and subsequent mortgage will be created by a lease at least one day longer than that held by the first or prior mortgagee. In the case of leasehold property, the mortgagor creates a sublease to the mortgagee by deed, the length of the lease being at least one day shorter than the unexpired term on the mortgagor's lease. Second and subsequent mortgagees will have subleases of at least one day longer than that of the prior mortgagee. This form of mortgage is only possible over leasehold property where the lease allows for subletting.

Legal charge

The charge by deed expressed to be by way of legal mortgage is useful for mortgaging leasehold property where the mortgagor has no right to sublet. The system operates to create a legal interest in favour of the mortgagee and gives the mortgagee identical protection. The mortgagor can create second and subsequent legal charges.

Equitable mortgages

Equitable mortgages can be either first or second and subsequent mortgages. There are three ways of creating an equitable mortgage.

Memorandum plus deposit of title deeds/land certificate

The Law of Property (Miscellaneous Provisions) Act 1989, s.2 prevents reliance on an equitable mortgage or charge of real property where there was no written contract signed by or on behalf of each party. The memorandum can be in writing or by deed, which will affect the mortgagee's

remedies, and will generally contain an undertaking to create a legal mortgage enabling the mortgagee to convert the mortgage into a legal mortgage. It is not possible to create an equitable mortgage of land by mere deposit: *United Bank of Kuwait plc* v. *Sahib* [1995] 2 WLR 94.

Memorandum unsupported by deposit of title deeds/land certificate

The memorandum must satisfy s.2. Law of Property (Miscellaneous Provisions) Act 1989, but can be in writing or by deed, which will affect the mortgagee's remedies.

Agreement to create a legal mortgage

Where there is a legally enforceable agreement to create a legal mortgage conforming to s.2, Law of Property (Miscellaneous Provisions) Act 1989, the agreement creates an immediately binding equitable mortgage. The court may order specific performance of the agreement and convert it to a legal mortgage.

Mortgages and reality of consent

A mortgage may be set aside where it has been obtained by misrepresentation or undue influence (see Chapter 4). In *Barclays Bank plc* v. *O'Brien* [1994] 1 AC 180, a mortgage was set aside as against a wife induced to stand as surety for her husband's debts by a misrepresentation of which the mortgagee had notice. And in *TSB Bank plc* v. *Camfield* [1995] 1 All ER 951, the wife had been induced by her husband's innocent misrepresentation that their maximum liability for the business loan was limited to £15 000. The wife claimed the right to have the charge set aside, whereas the bank claimed that it was a valid security for £15 000. The Court of Appeal set the transaction aside. In *Barclays Bank plc* v. *Boulter* [1997] 2 All ER 1002, the Court of Appeal held that the burden was on the bank to prove that it did not have constructive notice of the misrepresentation, and not on the wife to prove that it did.

In *CIBC Mortgages plc* v. *Pitt* [1993] 4 All ER 433, the bank, on the security of the matrimonial home, advanced money ostensibly for the purchase of a holiday home. It was, in fact, to pay the husband's debts. The wife sought to set the charge aside on the ground of her husband's undue influence. The House of Lords held that she had to show that the bank had actual or constructive notice of the undue influence and that, as far as the bank was aware, this was a normal advance for the parties' joint benefit. In *Banco Exterior Internacional SA* v. *Mann* [1995] 1 All ER 936, the husband wished to charge the matrimonial home as security for his company. The bank sent documents to the company's solicitor, including a declaration relating to the effect of the charge to be signed by the wife in the solicitor's presence. The solicitor explained the declaration to the wife who said she had little choice but to sign and the solicitor certified that the effect of the charge had been explained. The Court of Appeal held that the bank had

taken such steps as were reasonable to avoid being fixed with constructive notice. The decision was followed in *Bank of Baroda* v. *Rayarel* [1995] 2 FLR 376, where a wife, her husband and son charged their home to secure the debts of the husband's and son's company. The wife signed a certificate stating that she had received legal advice before signing and the Court of Appeal held that the charge was valid. In *Royal Bank of Scotland plc* v. *Etridge* [1997] 3 All ER 628, the wife claimed that the solicitor appointed by the bank had not explained the charge to her alone, and that she had viewed him as being employed by her husband. The Court of Appeal discharged a possession order on the grounds the bank was responsible for the solicitor discharging his duty and would be fixed with constructive notice of undue influence if he did not, even though the solicitor had endorsed the charge with a statement that he had discharged his duties. However, in *Barclays Bank plc* v. *Thomson* [1997] 4 All ER 816, the Court of Appeal held that the bank was entitled to rely on an assurance by the solicitor that he had discharged his professional duty towards the wife even though the solicitor also acted for the husband's business. And in *Dunbar Bank plc* v. *Nadeem* [1997] 2 All ER 253, the High Court held that the wife could only succeed in setting aside a charge on the grounds of undue influence where she accounted to the lender for the benefit she had received for the use of the money. Not all cases related to spouses. In *Banco Exterior Internacional SA* v. *Thomas* [1997] 1 All ER 46, Mrs D charged her house to the bank and signed a guarantee in respect of the liability of M, a close personal friend. Her former solicitor advised her against entering the transaction. He informed the bank of his views by phone and also wrote to them that Mrs D had agreed to proceed against his strong advice. The bank sought to enforce the security and Mrs D (and subsequently her executors) claimed undue influence by M to the knowledge of this by the bank. The Court of Appeal allowed the bank's appeal and held that it was not the bank's business to ask why Mrs D wished to stand surety but merely to ensure that she knew what she was doing, which she did having received independent legal advice from her ex-solicitor. And in *Credit Lyonnais Bank Nederland NV* v. *Burch* [1997] 1 All ER 144, the Court of Appeal set aside a mortgage over the defendant's flat and an all monies guarantee executed in favour of her employer. The court held that the transaction was so obviously disadvantageous to her for a company where she was only a junior employee to raise a presumption of undue influence. It was not sufficient for the bank's solicitor to advise her to seek independent legal advice before signing; the bank was required to ensure that she obtained this advice. The fact that the defendant did not seek independent legal advice should have indicated to the bank that she was acting under the undue influence of her employer.

10.3 Priority and Protection of Mortgagees

Where there is more than one mortgage over the same property, it is necessary to prioritise the mortgagees' claims. The system operates to ensure

that subsequent mortgagees discover the existence of earlier mortgagees prior to the finalisation of the charge, and depends upon whether property is unregistered or registered.

Mortgage protection in unregistered conveyancing

There are two forms of protection in unregistered conveyancing: retention of the title deeds by the mortgagee, or registration under the Land Charges Act (LCA) 1925/1972. A legal mortgagee is required to take the title deeds of the property, and the mortgage is more accurately described as a legal mortgage plus deposit of title deeds. The first legal mortgagee is protected against any subsequent mortgagee since the fact that the title deeds are no longer available for deposit is notice of the prior charge. Legal and equitable mortgagees with deposit of title deeds need do no more to protect themselves.

A mortgagee who does not hold the title deeds must register his/her mortgage in the Land Charges Registry. The register entry depends upon the type of mortgage. Legal mortgages without deposit of title deeds are registered as a class C.i charge; equitable mortgages by memorandum as a general equitable charge under Class C.iii; and an agreement to create a legal mortgage as an estate contract under Class C.iv charge. Failure to register renders the mortgage void against a subsequent purchaser for value of the legal estate irrespective of notice, although, in the case of a Class C.iv charge, the purchaser must be for money or money's worth: s.4 LCA 1972. A purchaser is defined as 'any person (including a mortgagee or lessee) who, for valuable consideration, takes any interest in land or in a charge on the land': s.17 LCA 1925.

A mortgagee may use a priority notice: s.10 LCA 1972. This is an application to the Land Charges Register by a prospective mortgagee intending to register a mortgage, at least fifteen days before that registration is to take place. If the registration takes place within thirty days of the priority notice, registration takes effect as if it had been made at the time the charge was created.

Where the mortgaged land is owned by a company, the charge must be registered under the Companies Act 1985, s.395 within twenty-one days of the date of the creation of the charge and compliance with this legislation is paramount (see p. 314 below).

Mortgage protection in registered land

Registered conveyancing always requires some entry on the register of charges. The protection will depend on the nature of the register entry, which in turn depends on the nature of the charge.

Legal mortgages will generally be converted to registered charges effected by sending to the Registrar the legal charge (in duplicate), the land certificate, and the registration fee. The charge will be entered in the charges register, the land certificate will be retained and the registry will

issue to the mortgagee a charge certificate showing the register entry of the mortgage and with the mortgage deed bound into the charge certificate. Subsequent legal mortgages are protected in the same way, but the mortgagee will be subject to the earlier registered charge and is issued with a second charge certificate listing the earlier charge followed by the later charge held by the mortgagee.

For equitable mortgages with deposit of the land certificate, protection is by notice of deposit of land certificate, which gives the mortgagee notice of any attempt to register any subsequent charge or dealing in the property. The mortgagee then protects his/her interest within the period allowed, failing which the mortgage will be 'warned off'. This is also sometimes used by legal mortgagees since it is cheaper than registration. Other equitable mortgages obtain identical protection by means of a caution against dealings.

Where the land is owned by a company, there must be registration of both legal or equitable mortgages with the Registrar of Companies within twenty-one days of the creation of the charge, followed by registration with the Land Registry.

10.4 Protection of the Mortgagor

The mortgagor is protected in four ways.

The equity of redemption

The mortgagor's main protection is the right to redeem his/her property at any time on payment of the principal, interest and costs, irrespective of any contractual date for repayment laid down in the mortgage. It is a proprietary right vested in the mortgagor and it can be conveyed, demised and so on, and passes with the mortgagor's estate on his/her death.

The right is protected by the doctrine that no 'clogs or fetters' should be imposed on the right to remove or seriously restrict the mortgagor's exercise of it. Thus a term purporting to exclude the right is not be allowed: *Sammuel* v. *Jarrah Timber and Wood Paving Corp. Ltd* [1904] AC 323. More usually there will be an attempt to restrict the right to redeem during a certain period, but if the postponement renders the mortgage irredeemable for all practical purposes it is void: *Fairclough* v. *Swan Brewery Co. Ltd* [1912] AC 566. The courts are prepared to recognise a reasonable restriction where there is no evidence of oppression: restrictions of twenty years and even fourty years have been held to be reasonable.

The equity of redemption can be terminated (i) by waiver by the mortgagor; (ii) by the mortgagee being in possession for twelve years: Limitation Act 1939, s.12; (iii) by the sale of property by the mortgagee under his/her statutory power of sale; or (iv) where the mortgagee obtains a decree of foreclosure (see p. 303 below).

Protection against mortgagee obtaining collateral advantage

The mortgagee may attempt to obtain some collateral advantage over the mortgagor. The most important examples relate to 'solus agreements' whereby a mortgagor may be 'tied' by the terms of the mortgage to obtaining supplies of goods and services from the mortgagee. Petrol companies and breweries acting as mortgagees over commercial premises will often seek this kind of tie. The court treats these as contracts in restraint of trade which are void unless reasonable. In *Esso Petroleum Co. Ltd* v. *Harper's Garage (Stourport) Ltd* [1968] AC 269, the court held that a restraint over five years was reasonable, but not one over twenty-one years. Under Community law, solus agreements are automatically void under art. 85, EC Treaty unless exempted individually or under a block exemption (see Chapter 17).

Oppressive and unconscionable terms

The court can set aside such terms in a mortgage transaction, which can include the rate of interest. The protection is more important where the mortgagee is an individual, a credit company or some foreign financial institution. In *Cityland and Property (Holdings) Ltd* v. *Dabrah* [1968] Ch 166, the mortgagor was a tenant buying the freehold of his house from his landlord and was 'obviously of limited means'; he undertook to pay a premium or bonus which represented either no less than 57 per cent of the amount of the loan or interest at 19 per cent. The terms of the mortgage were rewritten.

The court is influenced by the relative bargaining position of the parties. In *Multiservice Bookbinding Ltd* v. *Marden* [1979] Ch 84, the court stressed that the mortgagor must show that the bargain was unfair and not merely unreasonable, which involves one party imposing objectionable terms in a morally reprehensible manner. The court considered the legality of index-linked interest rates in a mortgage to a small company, the effect of which meant that the capital repayment after ten years had become £87 588 as against £36 000 borrowed. The average interest was 16.01 per cent. The court found the bargain hard but not unfair.

Extortionate credit bargains

The court has power to reopen extortionate credit bargains under s.137, Consumer Credit Act 1974. The Act does not extend to loans above £15 000 or to mortgage transactions entered into with a local authority or building society as creditor, and therefore does not apply to the majority of mortgages of residential property. It does apply, however, to transactions by credit companies and non-institutional lenders, where the borrower is greatly in need of protection.

The court can set aside, in whole or in part, any obligation imposed by that bargain upon the debtor, or otherwise alter the terms of the credit

bargains where the bargain is extortionate: s.139. The meaning of 'extortionate' is laid down in s.138 and the court is particularly directed to the equality of bargaining position between the parties.

In *A. Ketley Ltd* v. *Scott* [1981] ICR 241, the court failed to grant relief where the mortgage interest was equivalent to 48 per cent. It was influenced by the extraordinary nature and urgency of the loan, the high risk accepted by the lender, and the absence of pressure exerted on the defendant. The court was also influenced by the deceit of one of the defendants in failing to disclose that the property charged to the plaintiff was already subject to a prior charge.

Where a company is in insolvent liquidation, the liquidator has power to set aside extortionate credit bargains under the Insolvency Act 1986 (see Chapter 19).

10.5 Remedies of the Mortgagee

The mortgagee's remedies depend upon whether the mortgage is legal or equitable.

Legal mortgages

There are five remedies for the mortgagee.

Possession

A mortgagee rarely exercises this right except where there is an income to be derived from the property, and the stringent controls imposed by equity make the appointment of a receiver more effective. In *White* v. *City of London Brewery Co.* (1889) 42 ChD 237, the mortgagee who took possession and leased licensed premises to a tenant subject to an obligation to buy his beer from the company was liable to account for the additional rent they would have received by letting the premises as a 'free' house. The right is generally used in conjunction with the mortgagee's statutory power of sale.

The mortgagee's right to possession can have drastic consequences and there is relief for the mortgagor. In 1969 the Report of the Committee on the Enforcement of Judgment Debts recommended that a court should be entitled to adjourn a request for possession, and the statutory power giving this effect was introduced in s.36 of the Administration of Justice Act 1970. This failed to have the desired effect and was amended by s.8 of the Administration of Justice Act 1973. The court has the power to grant an adjournment of possession proceedings if there is a likelihood that the mortgagor will, during the period of the adjournment, find not only the arrears of mortgage instalments but any instalment which might have become due during the period. In *Bank of Scotland* v. *Grimes* (1985) NLJ, Vol. 135, this right was extended to the case of a loan by a bank repayable

at the end of twenty-five years where interest was repayable in monthly instalments.

The court can only grant relief where the mortgagor can produce evidence of an ability to pay up within a reasonable time. The suspension of possession proceedings must be for a definite period: *Royal Trust Co. of Canada* v. *Markham and Another* [1975] 1 WLR 1416, and a period of six months has been indicated as reasonable for the purposes of the Act, but it could be longer or shorter depending on individual circumstances.

The mortgagor's spouse has a statutory right to tender mortgage payments, and is therefore in a position to resist possession proceedings. This right was flawed until the passing of the Matrimonial Homes and Property Act 1981, since there was no obligation on the part of the mortgagee to inform the mortgagor's spouse of the default; neither was there an obligation to serve notice of the possession proceedings. This is now contained in the Matrimonial Homes Act 1983, which obliges the mortgagee to serve notice of proceedings on everybody protected by registration.

The power of sale

The mortgagee has a statutory power of sale where the mortgage is effected by deed: s.101, Law of Property Act 1925. The power of sale arises when the legal date of redemption has passed; therefore, if there is no legal date of redemption, the power can never come into existence: *Twentieth Century Banking Corpn Ltd* v. *Wilkinson* [1977] Ch 99. The power of sale only becomes exercisable, however, where the following conditions are satisfied: (i) default in repayment of mortgage money for three months; (ii) arrears of interest for two months; or (iii) breach of some other provision contained in the mortgage: s.103.

If the power of sale is exercised after it has arisen but before it has become exercisable, a bona fide purchaser of the property without notice is protected (s.104), but the mortgagee will be liable in an action for damages brought by the mortgagor. In mortgages to banks, the mortgage will generally remove the conditions of s.103 and allow the bank to exercise the power of sale earlier (but see Chapter 16).

The sale by the mortgagee passes a good title to the purchaser free from subsequent encumbrances – that is, free from subsequent mortgages; and claims of second and subsequent mortgagees will be transferred to the surplus proceeds of the sale, if any. Where the power of sale is exercised by a second or subsequent mortgagee, the sale can either be subject to or free from the prior charge. Where the sale is free from prior encumbrances, prior mortgagees have priority over the proceeds of sale. The proceeds of sale are to be applied (i) in payments of all costs, charges and expenses properly incurred in connection with the sale; (ii) in discharge of the mortgage money and interest due; and (iii) in payment of the residue to the mortgagor (or subsequent mortgagees).

In *Cuckmere Brick Co. Ltd* v. *Mutual Finance Ltd* [1971] 2 All ER 633, the Court of Appeal held that the mortgagee had a duty 'to take reasonable

care to obtain the true market value of the mortgaged property'. In this case, the plaintiffs charged land which they owned and in respect of which they had obtained planning permission to build houses, to the defendants. The defendants took possession and appointed auctioneers to sell the land. The advertisements failed to mention the planning permission. The plaintiffs drew this to the defendant's attention and sought a delay in the sale; however, the auctioneers, acting on the defendant's instructions, went ahead with the sale and the land was sold at an undervalue. The Court of Appeal held that a mortgagee, in exercising his power of sale, owes a duty to take reasonable care to obtain the best price possible. In *Standard Chartered Bank Ltd* v. *Walker* [1982] 1 WLR 1410, the Court of Appeal held that a receiver appointed by a bank owed a duty both to the borrower and to a guarantor of the debt to take reasonable care to obtain the best price possible, and in choosing the time of sale and the bank was liable even though the receiver was the agent of the company in question, since it had interfered in the receivership. In this case the sale of the assets was on a cold day in February and the goods realised less than half of the auctioneer's estimate. In *American Express Banking Corp.* v. *Hurley* [1985] 3 All ER, the court held that, while the receiver was the mortgagor's agent, the mortgagee was not responsible for the conduct of the receiver unless the mortgagee directed or interfered with the receiver's activities. In spite of the fact that the court found no such interference, it nevertheless held that a mortgagee or receiver owed a duty to the guarantor of the mortgagor's debt to take reasonable care to obtain the true market value of the secured assets. However, if there is a conflict between the interests of the mortgagor and the mortgagee, any duty of care owed to the mortgagor is subordinated to the mortgagee's right to act in the protection of his/her own interests. The *Cuckmere Brick* case and the other decisions must now be read in the light of the Privy Council decision in *Downsview Nominees Ltd* v. *First City Corpn Ltd* [1993] AC 295, where the court stated: 'If the mortgagee exercises his power of sale in good faith for the purpose of protecting his security, he is not liable to the mortgagor even though he might have obtained a higher price and even though the terms might be regarded as disadvantageous to the mortgagor. *Cuckmere Brick* is […] Court of Appeal authority for the proposition that, if the mortgagee decides to sell, he must take reasonable care to obtain a proper price but is no authority for any wider proposition.' Where the mortgagee is a building society, the society has a statutory duty to ensure that the sale price is the best which may reasonably be obtained: s.36, Building Societies Act 1962.

In *AIB Finance Ltd* v. *Debtors* [1997] 4 All ER 677, the High Court held that, where a mortgagee exercises his power of sale over property on which a business is carried out, he had a duty to maximise the value of the asset and therefore had a duty to continue the business so that it could be sold as a going concern. In this case, the mortgaged business premises were sold for £43 500 whereas the debtors claimed that as a going concern it would have realised around £180 000.

In respect of registered land, the mortgagee's statutory power of sale is restricted to registered charges, namely legal charges which have been registered and where the Registrar has issued the mortgagee with a charge certificate.

Foreclosure

The remedy requires application to the court and the right to foreclosure only arises where repayment falls due. The court initially makes an order for foreclosure *nisi* (conditional) and the order only becomes absolute (final) where the mortgagor has made no repayment. In practice, on a foreclosure application the court will generally order a power of sale under s.91 Law of Property Act (LPA) 1925. The foreclosure order absolute vests the property in the mortgagee and terminates the mortgagor's equity of redemption, but has largely been replaced by the statutory power of sale.

Appointment of a receiver

A mortgagee has a statutory power to appoint a receiver in the same circumstances and subject to the same conditions as the statutory power of sale: s.101(1)(iii) LPA 1925. The receiver must be appointed in writing (s.109(1)) and will be the agent of the mortgagor unless the mortgage deed provides otherwise: s.109(2). This means that even though the mortgagor has no say in his/her appointment, s/he will be liable for any acts or defaults of the receiver, which makes the appointment of a receiver more attractive to the mortgagee than entering into possession personally.

The duty of the receiver is to receive all the income from the mortgaged property and then to apply the income (i) in discharge of rents, rates, taxes and other outgoings; (ii) in payment of his/her own commission and of fire, life or other insurance premiums payable under the mortgage; (iii) in payment of the interest on the mortgage; and (iv) any surplus to be set towards the discharge of the principal (if so instructed by the mortgagee). (For receivers of companies, see Chapter 19.)

Sue on the mortgagor's personal covenant to repay

This is a normal action to enforce repayment of the debt. Since the mortgage is by deed, the limitation period for actions is twelve years.

Equitable mortgages

A similar category of remedies can be discussed as for the legal mortgage.

Entry into possession

It is doubtful whether an equitable mortgagee has any right to possession of the mortgaged property.

Power of sale

If the mortgage is by deed, the statutory power of sale exists as described above. Where the land is registered, the mortgagee will first of all have to convert his/her mortgage into a registered charge, otherwise the equitable mortgagee will be able to effect a conveyance of the legal estate even though having no legal title him/herself: *Re White Rose Cottage* [1965] Ch 940. Where the mortgage is not by deed, the mortgagee can apply to the court for a power of sale under s.91 LPA 1925.

Foreclosure

The court has power to order foreclosure on behalf of an equitable mortgagee but will in practice order a sale in lieu of foreclosure.

Appointment of a receiver

The statutory power applies to equitable mortgages by deed, but in other cases the mortgagee may apply to the court for the appointment of a receiver.

10.6 Mortgages of Registered Stocks and Shares

The mortgagee will generally only be prepared to take a charge over the securities of a public company whose shares are either on the Stock Exchange Official List or on the Alternative Investment Market (AIM). Some public companies do not have their securities listed on any market: stockbrokers carry out transactions by way of matched bargains and it may not be possible to find an immediate buyer. Securities in private companies will generally not be acceptable because of the problems in valuing and realising them. The form of the mortgage depends upon whether the security is registered or bearer. A company may issue bearer securities for stock and fully-paid shares if expressly authorised by its Articles. The company issues a share warrant which is a negotiable instrument and transferable by mere delivery. Possession of the warrant is the basis of title; it will include dividend coupons which are presented to the company when a dividend is declared. They are very rare but there are no formalities for mortgaging them. A mortgage is created by depositing the warrants subject to an agreement to return them on repayment of the loan plus interest. The mortgagee can transfer them to a third party on default.

Most securities are registered, with the registered holder's name and address in the register of members or debentureholders. Under the CREST registration and transfer system for listed securities, private investors can opt to have paper certificates which will facilitate the mortgaging of those securities. The certificate is *prima facie* evidence of title to the securities: s.186 Companies Act 1985. Title ultimately depends upon entry in the appropriate register, and transfers involve the replacement of

the transferor's name with that of the transferee. The registered holder for the time being is the person to whom dividend or interest payments are made. Mortgages can be legal or equitable.

Legal mortgages of registered securities

A formal legal mortgage involves a transfer from the name of the registered holder to that of the mortgagee or his/her nominee, subject to an undertaking to retransfer on repayment of the loan plus interest. The instrument used is the stock transfer form introduced by the Stock Transfer Act 1963; this form is used for transfer of stocks and shares in companies and also for most government stocks. The form must be signed by the transferor but does not need to be signed by the transferee. This mortgagee or his/her nominee will become the registered holder, with the right to transfer the securities in the event of default by the mortgagor.

Equitable mortgages of registered securities

These will generally be created by the mortgagor depositing the share certificate or debenture stock certificate with the mortgagee. There is no need for any transfer or memorandum to be signed but, where the mortgagee is a bank, it will generally insist upon a memorandum to establish that the securities are being held as a security, rather than just for safety.

An equitable mortgage is disadvantageous for the mortgagee in that, where there are existing equitable claims against the securities (as where the registered holder held them as trustee for beneficiaries), the mortgagee would rank after earlier equitable claims even those of which he had no notice. The mortgagor could also obtain a replacement certificate and transfer the securities to a new registered holder and over ride the mortgagee's equitable claim. Other problems arise where the company makes a bonus issue that will reduce the market value of the shares. The bonus shares will be sent to the registered holder. There are also problems with rights issues, where the offer is sent to the registered holder. A rights issue could well affect the value of the issued shares.

The equitable mortgagee has some legal protection. S/he can send the company a notice of deposit informing it that s/he holds the securities as mortgagee. This will not have any great effect, since the company cannot enter on its register notice of any trust, expressed, implied or constructive: s.360 Companies Act 1985. There is an advantage, however, since once the company has been notified of the charge, the company will not be able to claim a lien on the shares in respect of advances subsequent to receipt of the notice of deposit. In *Bradford Banking Co. Ltd* v. *Henry Briggs, Sons & Co. Ltd* (1886) 12 App Cas 29, the court held that the notice of deposit was not a notice of trust for the purposes of s.360. Liens are not exercisable against fully-paid quoted shares, but a company issuing a new share or stock certificate after the service of a notice of deposit would certainly be negligent and liable to the mortgagee.

A more formal possibility is to serve a stop notice on the company as amended by the Rules of the Supreme Court in 1965. The procedure involves serving a notice on the company in accordance with the procedure in the RSC 0.50, r.11. Where a stop notice is served, the company must serve fourteen days' warning to the mortgagee before registering any transfer of the shares. The mortgagee can in that period obtain a restraining order or an injunction in a suit against the mortgagor. The procedure is seldom used but is useful where there is no possibility of a legal mortgage (where the shares are qualification shares for holding office as director) and there are doubts as to the integrity of the mortgagor. The mortgagee cannot transfer the shares without the signature of the mortgagor on a share transfer form and will normally require the mortgagor's signature on a form when the mortgage is taken.

10.7 Miscellaneous Securities

Mortgages can be taken over other miscellaneous securities, including the following.

British government stocks

A person holding government stock is registered as the holder in the books held by the Bank of England where the stock was purchased through a broker and s/he will be issued with a certificate. Where the stock was purchased through the National Savings Department, the holder's name is entered on the National Savings Stock Register. Both legal and equitable mortgages are possible; a legal mortgage involves the transfer of the stock into the mortgagee's name, whereas an equitable mortgage is created by the deposit of the stock certificate plus a memorandum. In the case of the stockholder being registered on the National Savings Register, the mortgagee can take a blank, signed application form for the transfer of the stock.

National Savings income bonds

These securities are on the National Savings Stock Register and an equitable mortgage can be taken by deposit of the certificate plus, normally, a memorandum of deposit. The mortgagor can be asked to sign an encashment notice. Legal mortgages are not possible.

National Savings deposit bonds

An equitable mortgage can be created by deposit of the certificate and it is usual to get the mortgagor to sign an encashment notice. Legal mortgages are not possible.

National Savings certificates

An equitable mortgage is created by deposit of the certificate, usually with a signed repayment form. They are not a good form of security, since the holder can always easily obtain replacement certificates and cash them, and there is no notice system to protect the mortgagee. A legal mortgage is not possible.

Premium savings bonds

An equitable mortgage is possible by deposit plus a signed repayment form but it is not a good form of security, since the bondholder can obtain fresh certificates and cash them. Legal mortgages are not possible.

Unit trusts

Only equitable mortgages of units are possible. The mortgage can be created in two ways: transfer of the units to the mortgagee; or deposit of the certificate and notice to the unit managers which is recorded and acknowledged because the unit trust is not covered by s.360, Companies Act 1985. The mortgagee will ask the mortgagor to sign the renunciation form when the mortgage is taken to enable him/her to realise the units.

10.8 Mortgages of Life Insurance Policies

Mortgages can be created over life insurance policies, and they are regarded as one of the most satisfactory forms of security compared to mortgages of company securities and land. Thus the value of the policy is easily established and this value will not be subject to unpredictable variation as is the case of company securities, and even of land. The value of the policy can only increase as long as the premium is paid. In addition, the realisation of the security is easily effected by surrender of the policy to the insurance company.

The value of the policy lies in its surrender value, which is the sum the insurance company will pay out against the cancellation of the policy. The policy will acquire a surrender value after premiums have been paid over two or three years, and the surrender value will increase during the life of the policy as long as premiums are paid. The surrender value will frequently be set out on the policy document itself and, where this is not the case, the insurance company will supply the information. Since the value can only increase, there is no need for the bank to allow a margin of depreciation, as in the case of stocks and shares.

Risk of vitiation of the policy

The major risk in a mortgage over a life policy is that the assured will cease to pay the premiums on the policy. To obviate this risk, where the policy has been charged to a bank, the bank may well undertake the obligation to pay the premiums and simply debit the mortgagor's bank account. There are three vitiating factors to consider.

Failure to disclose all material facts

A contract of assurance is a *uberrima fidei* contract, which requires full disclosure of all material factors known to the person seeking assurance cover that will be likely to affect the insurance company in agreeing to accept the risk and fixing the premium. This will include information concerning health, and dangerous occupations and habits. In effect, the liability of the assured is usually limited to the questions to be answered on the proposal form.

Where the assured has failed to disclose all material facts, the policy may be vitiated by the insurance company. There are no steps a mortgagee can take to protect against such an eventuality, but this is something that rarely happens in practice. The most common failing in this respect is for people taking life cover to mislead the insurance company about their age when taking out the policy. Since the age of the assured is one of the factors that will affect the amount of premium payable, this could mean that the surrender value of the policy will be lower than it would be had the real age been disclosed to the company. Many insurance companies fail to require proof of age when the policy is taken out, but will insist upon proof of age before paying out against the policy and the mortgagee should ensure that the assured satisfies this by sending in a birth certificate.

There is a risk of the vitiation of the policy where it restricts the activities of the assured, as where it excludes liability for death from certain occupations such as aviation, mining and so on, or where it restricts sporting and leisure activities. Most life policies will not usually contain stringent conditions of this nature.

Death by suicide

There is also a remote possibility that the mortgagor's death will be outside the scope of the policy of assurance. Some policies will contain a clause to cover the assured's death by suicide, and there is no problem with these types of policy as long as the terms of the clause are respected. Other policies may not cover suicide and the deliberate death of the assured by his/her own hand will avoid the insurance. There is an important distinction between sane and insane suicide and the latter will not avoid a policy, even where there is no suicide clause, since the act of the assured is not deliberate. In practice, there is no problem for sane or insane suicide, since most reputable insurance companies will honour the

policy up to its surrender value, which will satisfy the claims of the mortgagee, if not the family of the assured.

Lack of insurable interest

Where the policy does not relate to the life of the assured or a spouse, there is a slight risk that the policy will be illegal and void since the assured had no insurable interest in the life assured; in other words, no financial interest in their life. This is a very slight risk, since most reputable insurance companies would never issue such a policy and would in that case waive the issue of illegality to the extent of its surrender value.

Legal and equitable mortgages of life policies

The mortgage can be legal or equitable depending on the formality of the mortgage.

Legal mortgages

These are created by legal assignment subject to the obligation to retransfer on repayment of loan plus interest. Legal assignment is governed by the Policies of Assurance Act 1867. The assignment must be in writing, either by endorsement on the policy or by separate instrument in the words or to the effect set out in the Schedule to the Act: s.5. The form of assignment in the Schedule is in the following form: 'I, A.B. of … in consideration of … do hereby assign unto C.D. of …, his Executors, Administrators and Assigns, the within Policy of Assurance granted … In witness, …'. Where the mortgagee is a bank, the bank will use its own form.

The form will contain an assignment clause coupled with a statement that the mortgage secures the payment of all sums due to the bank, including interest and bank charges. There will also be a proviso that the bank will reassign the policy to the customer at his/her own expense on payment of all money due. The form will also contain a statement that it is a continuing mortgage which will cover the borrowing of the customer for the future up to the limit allowed. The customer will also agree to pay the premiums punctually and produce receipts of payment to the bank, and there will be agreement that, should the customer fail to pay the premiums, they can be paid by the bank and the sums debited from the customer's bank account. The agreement will enable the bank, without the customer's consent, to sell and surrender the policy to the insurance company or any other person and will exclude the restrictions on the mortgagee's powers under s.103 LPA 1925 (see above). The agreement will also exclude the operation of s.93, LPA 1925 and will allow for consolidation.

In addition to the written assignment, there must be notice served on the Life Office, the company issuing the policy: s.3. Where there is a legal assignment of the policy, the assignee can sue to enforce the rights under the policy in his/her own name and is able to give a legal discharge of the policy.

Equitable mortgages of life policies

There are no formalities for the creation of a mortgage of a chose in action, and an equitable mortgage can be created by an oral agreement between the parties or, more usually, deposit of the life policy accompanied by a written memorandum of the terms of the mortgage. The mortgage will be valid against the trustee in bankruptcy or the executor or administrator of the mortgagor, but the insurance company will require a discharge from the assured (or, if s/he is dead, from his/her personal representatives) as well as from the mortgagee before they will pay out any money on the policy.

The mortgagee will usually give notice of the mortgage to the insurance company although there is no legal requirement to do so. By giving notice, the mortgagee will acquire priority over any previous mortgagees who have not served notice and of which s/he has no actual or constructive notice. In the absence of notice, the priority of equitable mortgagees is determined by the date order of their charges.

10.9 Goods as a Security

Charges are possible over goods, and this is frequently used in connection with the finance of foreign trade. Charges can be created in three ways.

Mortgage

A mortgage of goods leaves the possession of the goods with the borrower but transfers the title to the lender. Mortgages of goods are not encountered frequently, since they are regulated by the Bills of Sale Acts 1878–82, which require registration of the charge in the Central Office of the Supreme Court within seven days of its creation. Since the register is public, and since registration of bills of sale will be published in various trade journals, there is a lot of harmful publicity associated with this form of security. The bill of sale must also comply exactly with the form prescribed by the Bills of Sale Act 1882, s.9, otherwise it will be void.

Pledge

Pledges leave the title to the goods with the borrower but give possession to the lender. A pledge arises when goods (or documents of title to goods) are delivered to the pledgee (lender) by the pledgor (borrower) as security for a debt, subject to an obligation to return them once the debt is discharged. If the agreement stipulates a fixed date for repayment, the pledgee (lender) has an implied power of sale if the pledgor (borrower) defaults. In cases where there is no fixed date, the pledgee must demand repayment and then exercise his/her power of sale if there is subsequent failure to pay and after the serving of notice on the pledgor of his/her

intention to sell the goods. This is the most frequent form of charge over goods.

Hypothecation

Hypothecation charges goods without title or possession passing to the lender, and generally only arises where the borrower was not in actual or constructive possession of the goods, when a pledge would be more usual.

10.10 Securities Created by Registered Companies

Companies borrowing on a long-term basis will generally do so against the issue of a debenture acknowledging the debt and specifying the terms under which the loan is made. Most debentures will also create charges over the assets of the company. All statutory references in this section relate to the Companies Act 1985 unless otherwise indicated. The term 'debenture' is not precisely defined. It is not limited to loans secured on the assets of the company, except for quoted securities, where otherwise the term 'unsecured loan stock' is always used. A debenture can be defined as: a written acknowledgement of indebtedness, usually by deed and usually secured by a charge on the assets of the company. It can exist in the form of a single debenture or one of a series ranking *pari passu* (on equal footing). It includes debenture stock.

Most debentures in a series and debenture stock are created by trust deed to trustees for the debenture holders who, in the case of debenture stock, will be issued with a debenture stock certificate. The trust deed enables the company to create legal charges over its property and allows for variation of the assets charged and greater protection to the debenture holders, whose interests will be protected and enforced by the trustee, usually a trust corporation or an insurance company.

Debentures can be registered or bearer and can be redeemable or irredeemable. They can be perpetual, which distinguishes them from mortgages: s.193. Thus in *Knightsbridge Estates Trust Ltd* v. *Byrne* [1940] AC 613, the House of Lords held that a mortgage of a freehold property by the appellants to B, with a covenant to repay the money by eighty half-yearly instalments was a debenture and not a mortgage, and the postponement of the right to redeem for fourty years was not void as a clog on the equity of redemption. Debentures can also be convertible into shares, in which case they cannot be issued at a discount. Otherwise there is no restriction on the issue of debentures at a discount.

10.11 Charges over Company Assets

Charges can be either fixed or floating and it is common for a debenture to be secured by a combination of the two.

Fixed charges

These can be either legal or equitable (formal or informal) and are a charge over specific assets which the company cannot subsequently deal with or dispose of without the chargee's consent, since the chargee's rights against the property accrue on the creation of the charge. The chargeholder ranks above all other creditors of the company – including the receivership, administration or liquidation expenses, and the preferential creditors in the event of liquidation, administration or receivership (see Chapter 19).

Floating charges

A floating charge is equitable and was first recognised in *Re Panama, New Zealand and Australian Royal Mail Co.* (1870) 5 Ch App 318; it is defined by its characteristics in *Re Yorkshire Woolcombers Assoc. Ltd* [1903] 2 Ch 284:

(i) it is a charge on a class of assets of the company present and future;
(ii) these assets change from time to time in the ordinary course of the business of the company; and
(iii) until the chargeholder takes some step to enforce the security, the company may carry on its business in the ordinary way as far as concerns the particular class of assets.

The floating charge 'hovers' over the assets to which it relates but never becomes specifically attached to an asset or group of assets until crystallisation. A floating charge over stock leaves the company free to deal in and dispose of the property covered by the charge, including the right to create further charges ranking in priority above the floating charge, and this only ceases on crystallisation, when the rights of the chargee will vest in the stock then owned by the company and the company no longer has the right of free disposal of the property charged. Floating charges are created over the whole undertaking or a group of assets – stock in trade, book debts and so on.

Crystallisation of floating charges

On crystallisation, a floating charge fixes on the assets charged, which are owned by the company at the moment of crystallisation, and it becomes a fixed equitable charge over those assets. This does not, however, affect its priority in the liquidation or administration of the company, since a floating charge is defined in the Insolvency Act (IA) 1986 as a charge 'which, as created, was a floating charge': s.251 IA 1986. This, together with s.175 IA 1986, which establishes the preferential creditors' priority over floating charges, prevents situations as in *Re Brightlife Ltd* [1987] Ch 200, where the floating charge, convertible to a fixed charge by service of notice by the chargeholder, obtained priority over preferential claims for VAT since the notice was served before the commencement of winding up. The equivalent to s.175 for company receivership is s.40 IA 1986.

Point (iii) of the criteria from *Re Yorkshire Woolcombers' Assoc. Ltd* refers to crystallisation, but there are several events that can trigger this rather than the one identified, and crystallisation occurs:

(i) when a receiver (or administrative receiver) or administrator is appointed by the chargeholder under the terms of the debenture, or by the court;
(ii) on the commencement of winding up;
(iii) where a company ceases to be a going concern: *Re Woodroffes (Musical Instruments) Ltd* [1985] 3 WLR 543; and
(iv) under the terms of an automatic crystallisation clause.

The validity of automatic crystallisation clauses where the charge crystallises on the happening of a crystallising event was settled in *Re Brightlife Ltd* [1987] Ch 200. Their advantages are now limited by s.251, s.175 and s.40 IA 1986 but they are still important in relation to unsecured creditors who cannot execute judgments against charged property once a charge has crystallised, since the effect of the crystallisation is to complete the assignment of the property to the chargee and they cease to be 'the goods of the company': In *Re ELS Ltd* [1994] 3 WLR 616.

Fixed or Floating?

Fixed charges are generally created over freehold and leasehold property, both present and future, fixed plant and machinery and goodwill when a restriction on the chargor's power to deal with or dispose of the property presents no problems. There have, however, been many attempts to create fixed charges over book debts and chattels. However, the court has the right to determine the nature of the charge created, irrespective of how it is described: *Re Armagh Shoes Ltd* [1982] NI 59. The court considers the nature of the charge and if the criteria in *Yorkshire Woolcombers* are identified, the charge will be defined as a floating charge. In *Siebe Gorman & Co. Ltd* v. *Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142, a company created a debenture in favour of the bank, secured (among other things) by a fixed first charge over 'all book debts and other debts now and from time to time due or owing to the Company'. The debenture provided that all monies received in respect of these debts should be paid into the company's account. The money could not be assigned or charged by the company without the prior consent of the bank in writing, and the company could be called upon to execute a legal assignment of the money to the bank. The court held that a fixed charge had been created. In another case involving a bank as chargee, the monies were to be paid into a designated account held by the bank with a right of withdrawal only if counter-signed by an officer of the bank: *Re Keenan Bros Ltd* [1986] BCLC 242. It is not so easy for lenders other than banks. In *Re Brightlife Ltd* [1987] Ch 200, a 'first specific charge' over book debts and other debts was held to be a floating charge, since there was no restriction on the company dealing and disposing of the monies once received.

This need for restriction on the freedom of disposal is crucial, but it need not be total. In *Re Cimex Tissues Ltd* [1994] BCC 626, a charge over plant and machinery identified by a valuation report was held to be a fixed charge even though the company had restricted rights to replace the machinery 'for the purpose of carrying on its trading business' as certain of the items wore out. In *Re G E Tunbridge Ltd* [1994] BCC 563, however, a charge expressed to be a fixed charge over business chattels including office furniture, typewriters, electronic equipment and so on was held to be a floating charge according to the *Yorkshire Woolcomber* criteria. There was no detailed schedule of the chattels (the judge noted that the decision might otherwise have been different), nor was there any specification of the freedoms allowed to the company in respect of the chattels.

A sophisticated solution is seen in *Re New Bullas Trading Ltd* [1994] 1 BCLC 485, the Court of Appeal recognised the validity of a debenture creating a fixed charge over uncollected book debts and a floating charge over the proceeds of the debts once they were paid into a specified bank account if the chargee failed to give instructions as to how the money was to be dealt with. The court held that, legal impossibility apart, nothing prevented the parties from making whatever contract they chose.

10.12 The Registration of Charges

Part XII of the Companies Act (CA) 1985 contains provisions relating to the registration of charges which were due to be replaced by Part IV of the Companies Act 1989. In 1994, the Department of Trade and Industry issued a Consultative Document seeking views on three possible options: These are (i) to retain the legislation in Part XII CA 1985; (ii) to retain the main core of Part XII but to incorporate improvements in Part IV CA 1989 together with a system of provisional registration; or (iii) to replace the present system where charges are registered only after creation with a notice filing system allowing for registration before or after the creation of the charge. Reform will come in two or three years.

Charges requiring registration and effect of non-registration

Under s.395(1), charges created by a company registered in England and Wales as defined in s.396 are void against the liquidator or administrator and any creditor of the company unless the prescribed particulars of the charge together with the instrument (if any) by which it was created or evidenced are delivered to the Registrar of Companies within twenty-one days after the charge's creation. Failure to comply with s.395(1) renders the money secured by the charge immediately repayable: s.395(2). The charge is not, however, void against the company, and in *Mercantile Bank of India Ltd* v. *Central Bank of India* [1938] AC 287, the chargee of an unregistered floating charge was able to convert the charge into a fixed charge and seize the assets covered before the commencement of

liquidation. Where a company acquires property subject to a charge that would be registrable under s.395 if created by the company, the charge must be registered within twenty-one days of the completion of the acquisition by the company of the property: s.400. Where the property is abroad, the twenty-one days runs from the date of the receipt of a copy of the instrument by the company in Great Britain. The effect of failure to register under s.400(1) is not to make the charge void, but the officers of the company in default are liable to a fine: s.400(4). The charges required to be registered are specified in s.396(1):

(a) a charge for the purpose of securing any issue of debentures;
(b) a charge on uncalled capital;
(c) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale;
(d) a charge on land or any interest in it;
(e) a charge on book debts of the company;
(f) a floating charge on the company's undertaking or property;
(g) a charge on calls made but not paid;
(h) a charge on a ship or aircraft, or any share in a ship; and
(j) a charge on goodwill, or on any intellectual property.

Category (a) would seem to refer to the issue of a series of debentures rather than operating to catch any form of charge not specifically mentioned. The reference to a charge on land in (d) covers legal and equitable mortgages of land even if the land is overseas. Thus an equitable charge created by memorandum and deposit of title deeds is registrable, and, if not, the charge is void and the chargee cannot claim a lien over the deeds and documents: *Re Molton Finance Ltd* [1968] Ch 325. In addition, an agreement to create a mortgage or charge over land is registrable as an equitable mortgage, and any mortgage or charge created subsequently is also registrable. Where an equitable charge is registered and is later converted to a legal charge under a term of the mortgage, the legal charge does not require registration: *Re William Hall (Contractors) Ltd* [1967] 2 All ER 1150. Book debts (e) are debts connected with and arising in the course of trade of any business, due to the proprietor of the business and entered in books. Charges over the company's bank account are not book debts: *Re Brightlife Ltd*. The DTI suggests replacing the charge on 'book debts' with a charge on 'receivables', which would be defined as: 'any amounts due or to become due to a company in respect of goods supplied or to be supplied or services rendered or to be rendered by a person … in the course of that person's business'. Rights of escrow in respect of a bank account are not a registrable charge: *Lovell Construction Ltd* v. *Independent Estates plc & Others* 1994 1 BCLC 31.

Conclusive nature of Registrar's certificate

The Registrar of Companies is required to keep a register of charges with respect to each company and the particulars of the charge required by the

law must be entered in the register: s.401(1). The Registrar must issue a certificate of the registration of any charge (s.401(2)) and the certificate is conclusive evidence that the requirements of the Act have been satisfied: s.402(2)(b).

The effect is that inaccuracy in the registered particulars and in the Registrar's certificate does not affect the validity of the charge, even where the date of the charge and of the particulars was inaccurate and the Registrar has accepted for registration documents which were out of time. In *Re Eric Holmes Ltd* [1965] Ch 1053, a charge created on 5 June which was dated as having been created on 23 June and registered within twenty-one days of that date was not void for non-registration under s.395(1). In *Re C L Nye Ltd* [1971] Ch 442, a charge created on 28 February 1964, dated 18 June 1964 and registered on 3 July 1964 was valid. The charge is also valid even if the particulars are defective, but the terms are as stated in the instrument itself, not in the register. In *Re Mechanisations (Eaglescliffe) Ltd* [1966] Ch 20, the company created two legal charges over freehold land to secure sums amounting to £18 000 plus any further sums owing in respect of goods supplied and interest. The certificate issued on the basis of incorrect particulars supplied showed a limit of £18 000 and did not refer to further sums for goods supplied. In the liquidation, the mortgagees claimed to be secured creditors for a total of £23 000. The court held that the charges were valid for the whole amount and that the registered particulars and the certificate did not avoid the security in respect of the excess over the amount of £18 000 mentioned.

The company must endorse a copy of the certificate on every debenture or certificate of debenture stock issued by the company: s.402. Specific charges on unregistered land must be registered under the Land Charges Act 1972 as well as at the Companies Registry and those on registered land must also be registered at the Land Registry. Floating charges over unregistered land only need to be registered at the Companies Registry, but floating charges over registered land can be protected by a notice or by a caution. When the debenture creates both a fixed and a floating charge over registered land, it will normally be registered as a charge in respect of the fixed charge, whereas the floating charge will be protected by a notice (see Chapter 9).

Rectification of the register

On the application of the company or a person interested, a High Court judge may on such terms and conditions as seem to be just and expedient, order that the time for registration shall be extended, or that the omission or mis-statement of any registered particular shall be rectified: s.404(2). The judge must be satisfied that the failure to register or the omission, or mis-statement of any particular was 'accidental or due to inadvertence or to some other sufficient cause, or is not of a nature to prejudice the position of creditors or shareholders of the company, or that on other grounds

it is just and equitable to grant relief'. Where none of the five grounds is established, late registration is refused: *Re Telomatic* [1994] 1 BCLC 90.

The court will generally add to the order allowing out-of-time registration the formula: 'That the time for registering the charge be extended until the ( ) day of ( ) 19 ; and this order is to be without prejudice to the rights of the parties acquired during the period between the date of the creation of the said charge and the date of its actual registration.' This indicates that the failure to register within twenty-one days causes the charge to become void *ab initio* until registered under an order made under s.404, when it becomes valid from the date of registration. The wording was introduced after the decision in *Watson* v. *Duff Morgan and Vermont (Holdings) Ltd* [1974] 1 All ER 794. Where a subsequent charge is created subject to a prior charge which is unregistered, the second charge will normally be postponed to the first when the register is rectified. The formula does not protect unsecured creditors.

An order to allow late registration of a charge after the company has gone into liquidation is only made in exceptional circumstances. Charges can be registered out of time after the making of a petition for an administration order under s.10(1)(c) Insolvency Act 1986 and after the appointment of an administrator under s.11(3)(d) (see Chapter 19).

Priority of charges

An unregistered charge which is void under s.395 loses it priority. Registration of a charge under s.395 gives rise to deemed notice of the existence of the charge. Thus, in respect of fixed charges, the priority of the charges will depend on the order of registration, irrespective of the nature of the charge, legal or equitable, since the registration of the equitable charge constitutes notice of its existence to the subsequent legal chargee.

In the case of floating charges, charges will rank in the order in which they are registered, except that a floating charge over the whole undertaking may be postponed to a floating charge over a part where the first floating charge enables subsequent floating charges over a part to be created, ranking in priority: *Re Automatic Bottlemakers Ltd* [1926] Ch 412.

Where there is a combination of fixed and floating charges, the floating charge will always be postponed to fixed charges even though created subsequently. It is, however, common for floating charges to contain a clause restricting the company from creating subsequent charges ranking in priority above it. The mere fact of the restriction being contained in the floating charge will, however, have no validity against the holder of a subsequent fixed charge, since there is no constructive notice of the contents of the charge. If the restrictive clause is endorsed on the registered particulars, some degree of inferred knowledge could be argued but, generally, a subsequent chargee, aware of the existence of a floating charge, will request a copy of the charge and have knowledge of the restriction. Where the subsequent chargee has knowledge, s/he will not rank in priority over the floating charge.

A registered charge has priority over an earlier unregistered charge, even though the holder of the registered charge has notice of the unregistered security: *Re Monolithic Building Co.* [1915] 1 Ch 643.

Satisfaction and release

The Registrar, on receipt of a statutory declaration in the prescribed form verifying that the debt has been repaid or satisfied in whole or in part, or that part of the property or undertaking has been released or ceased to form part of the company's property or undertaking, may enter on the register a memorandum to that effect and, where there is a memorandum of satisfaction in whole, the Registrar shall, if required, send a copy to the company: s.403.

The remedies of the debenture holders

The remedies available to the secured creditors of the company are:

(i) to sue for the principal and interest;
(ii) to petition for the winding up of the company;
(iii) to appoint a receiver or administrative receiver under the terms of the debenture; and
(iv) to exercise any power of sale over charged property contained in the debenture.

The holders of debenture stock are not strictly creditors of the company and the trust deed will generally restrict the right of any action to the trustee (for discussion of (ii) and (iii) see Chapter 19).

Main defects of current registration system

The main defect is that a valid charge may remain off the register for a period of twenty-one days from its creation, plus the time between delivery of particulars and the appearance of the charge on the register. Because of this, the lender may defer handing over funds to the company until s/he has carried out a search more than twenty-one days after the registration of his/her own charge, to be satisfied that no prior charge has been registered over the same assets. The responsibility of the Registrar to check the particulars against the charge is arguably the responsibility of the person presenting the particulars for registration and, if the register does not validly reflect the terms of the charge, the charge is still valid, to the disadvantage of the person relying on the register.

10.13 The Disadvantages of Floating Charges

Floating charges are subject to a number of disdvantages and are only beneficial to the company creating them, since they allow it to use as

security a fluctuating group of assets that are not capable of being secured by a fixed charge. The decision in *Re Croftbell Ltd* [1990] BCLC 844 indicates a major advantage for the charge holder in that, where the floating charge is over the whole, or substantially the whole, of the assets of the company and allows the charge holder to appoint an administrative receiver on default. This enables the charge holder to block the appointment of an administrator (see Chapter 19). The disadvantages can be discussed under the following five headings.

Priority disadvantage

On liquidation or receivership, a fixed-charge holder has a prior claim over all creditors in respect of the assets charged whereas a floating-charge holder has a prior claim over all creditors in respect of the assets charged, except for preferential creditors and the expenses of the liquidation: s.175 and s.40 IA 1986 (see Chapter 19).

Until crystallisation, the floating charge is postponed to subsequent specific charges, which rank in priority over earlier floating charges, subject to any negative pledge restriction. It is also postponed to the claims of (i) a landlord who has distrained for rent; (ii) a creditor who has obtained a garnishee order absolute; (iii) an execution creditor who has seized and sold goods under a distress warrant; and (iv) the creditor under a hire-purchase contract.

Charge holder's rights subject to set off, liens and retention of title

The charge holder has the same rights over the property charged as the company. Thus, where a charge exists over book debts, creditors of the company can claim set-offs and liens against the charge holder in the same way as they would be able to claim against the company: *Rother Iron Works Ltd* v. *Canterbury Precision Engineers Ltd* [1974] QB 1; and *George Barker (Transport) Ltd* v. *Eynon* [1974] 1 WLR 462 (see Chapter 19). (For retention of title, see p. 328 below.)

Company's power to dispose of assets charged

By the time the charge holder takes action to enforce his/her charge, there may be insufficient assets remaining to provide adequate security. To guard against this, the charge holder should require periodical certificates as to liquid assets and liabilities. The disposal of assets may be total where the company transfers its assets in exchange for shares in another company: *Re Borax Co.* [1901] 1 Ch 326.

Increased vulnerability to avoidance

In addition to the risk of being avoided as a voidable preference under s.239 IA 1986, a floating charge is further vulnerable to total or partial

avoidance under s.245 IA 1986. This affects floating charges made to unconnected persons within one year before the commencement of winding up or the making of an administration order, or connected persons within two years (see Chapter 19).

Increased vulnerability to administrator

The administrator of a company can dispose of any property subject to a charge: s.15 IA 1986. For floating charges, this is without reference to the court, but where the charge or security is of any other type, such as fixed charge, hire-purchase, conditional sale agreement, chattel-leasing agreements or retention of title agreements, the administrator must first obtain the authorisation of the court: s.15(2). The secured creditor is protected, since the net proceeds of such disposal must be handed over to the person whose security has been overreached (s.15(4)) but there is greater protection for holders of fixed charges who are entitled to recover the assessed value of the asset charged even where it is more than has been realised by the sale: s.15(5).

10.14 Duty of Charge Holder with Regard to Authority of Company and Officers

Persons taking a charge from a company may wish to reassure themselves that it has been executed in accordance with the company's constitution and within its objects and the directors' authority, although there are no longer required to check the constitutional documents of the company because of the reforms to the *ultra vires* doctrine and unauthorised contracts (see Chapter 8). The chargee must, however, ensure that it is not void as financial assistance under s.151 CA 1985, and that the directors' authority is not compromised by conflict of interest (see pp. 220 and 323).

10.15 Guarantees and Indemnities

A contract of guarantee must be distinguished from a contract of indemnity, of which the most obvious difference is that the contract of guarantee is required to be evidenced by a memorandum in writing under the Statute of Frauds 1677, s.4. (see Chapter 3). In a guarantee, the guarantor or surety promises to pay the present or future debts of another person, called the principal debtor, to the person to whom the principal debtor is or is about to become indebted. A guarantee involves two contracts and three parties. The guarantor is saying to the person about to advance money to the principal debtor: 'Lend A.B. the money, and if s/he does not repay you, I will.' The guarantor is only secondarily liable for the debt and his/her liability to pay only arises on the principal debtor's default. In

a contract of indemnity, there is only one contract between the indemnor and the person lending money, or supplying credit. Under a contract of indemnity, the indemnor is saying: 'Lend the money to A.B. I will see that you are paid.' The indemnor is primarily liable.

In the case of a guarantee, if the contract between the creditor and the principal debtor is void, the guarantor is also released. This used to be important where the principal debtor was a minor or a limited liability company. The situations have been resolved by the Minors' Contracts Act 1987, s.2, which abolished the rule in *Coutts & Co.* v. *Browne-Lecky* [1947] KB 104 (see Chapter 3), and the *ultra vires* reforms in s.35(1) CA 1985 (see Chapter 8). Bank guarantees contain a clause making the contract both a guarantee and an indemnity.

Contractual considerations of guarantees

There are three contractual considerations to examine.

Consideration

Unless a guarantee is by deed, there must be consideration for it, although the Mercantile Law Amendment Act 1856 provides that it is unnecessary to set out the consideration in the written instrument constituting the guarantee. In practice, however, the consideration will usually be set out.

The consideration cannot be in the form of a past debt and, in the case of a bank guarantee, there would be a potential problem if the consideration was stated in the form of a specific sum, since it is likely that the guarantee would have no effect unless the bank lent precisely this sum: *Burton* v. *Gray* (1873) 8 Ch App 932. A bank guarantee will most usually be in the form of a continuing security which will cover advances made by the bank to the principal debtor and terminable on three months' written notice by the guarantor to the bank, or, in the event of the death of the guarantor, until three months after notice of death.

The normal consideration for a bank guarantee will be: 'In consideration of the bank making or continuing advances or otherwise giving credit or affording banking facilities for as long as the bank may think fit or granting time to … (hereinafter called "the Principal").'

Disclosure

Contracts of guarantee are not *uberrima fideis* contracts requiring one or both parties to disclose all material facts. This was established in *Cooper* v. *National Provincial Bank Ltd* [1945] 2 All ER 641, where the plaintiff sought to have set aside two bank guarantees on the grounds that the bank had failed to disclose that the husband of the principal debtor was an undischarged bankrupt who had authority to draw on the account, and that the account had been operated in an improper and irregular way. A bank guarantee will normally be signed at a tripartite meeting between

the bank, the principal debtor and the guarantor, with the principal debtor's presence giving implied authority to the bank to disclose information as a result of any direct questions put by the guarantor.

Mistake, misrepresentation and undue influence

Contracts of guarantee were vulnerable in the past to the defence of *non est factum*, and could be void even though the person signing had been negligent: *Carlisle and Cumberland Banking Co.* v. *Bragg* [1911] 1 KB 489. *Saunders* v. *Anglian Building Society* [1971] AC 1004 means that the defence is unavailable to a person who was negligent in signing the document. Cases can still arise, however, as in *Lloyd's Bank* v. *Waterhouse* [1991] Fam Law 23 (see Chapter 3). A guarantee form should never be allowed to be signed in the absence of the creditor. In *Associated Japanese Bank (International) Ltd* v. *Crédit du Nord* [1988] 3 All ER 902, the plaintiff bank entered into a scheme proposed by a fraudster to buy machines from him for over £1m and to lease them back to him. The defendant bank stood guarantor of his liability to the plaintiff. The fraudster disappeared without making payments and it was discovered that the machines had never existed. The plaintiff sought to enforce its rights against the defendants under the guarantee. The action failed because the court found that there was an express of implied condition in the guarantee that the machines existed. In the alternative, Steyn J was prepared to hold the guarantee void for common mistake, since both parties to the guarantee believed that the machines existed and would not otherwise have entered into the transaction.

The guarantee may be avoided where the guarantor has been induced to sign by a misrepresentation, even if made innocently: *MacKenzie* v. *Royal Bank of Canada* [1934] AC 468. There is also authority for saying that silence can amount to a misrepresentation where 'a guarantor put a question or made an observation in the presence and hearing of the bank-agent, which necessarily and inevitably would lead anyone to the conclusion that the intending guarantor was labouring under a misapprehension with regard to the state of the customer's indebtedness': *Royal Bank of Scotland* v. *Greenshields* 1914 SC 259 at p. 268.

As regards undue influence, there is no general fiduciary duty between a banker and a customer: *National Westminster Bank plc* v. *Morgan* [1985] 1 All ER 821 (see Chapter 3). Where the proposed guarantor is, however, the wife of the principal debtor, even though there is no presumption of undue influence regarding the relationship, the very nature of the relationship makes it easier to establish undue influence: *MacKenzie* v. *Royal Bank of Canada* [1934] AC 468. The creditor should always ensure that the wife is advised to obtain independent legal advice before signing the guarantee. In *Bank of Montreal* v. *Stuart* [1911] AC 120, Mrs Stuart stood as a guarantor in respect of a loan to a company in which her husband was interested. This was signed at the office of, and in the presence of, a solicitor who acted for the bank and for her husband, and who was also an officer and shareholder of the company. She later substituted the initial guarantee for a larger one and finally entered into a series of transactions

under which she surrendered all her estate to the bank and was left without independent means. In all this she never once received independent legal advice. In spite of stating in evidence that she had acted of her own free will to help her husband, the court found that Mrs Stuart, who was an invalid, had acted in passive obedience of her husband, and the transactions were set aside.

Special categories of guarantor

The are four special categories of guarantor.

Minors

Guarantees by minors cannot be enforced during their minority but they can ratify the contract on majority or make a fresh enforceable agreement in the same terms: Minors' Contracts Act 1987.

Partnerships

A partner has no implied authority to bind the firm: *Brettel* v. *Williams* (1849) 4 Exch 623. Therefore, unless it clearly appears in the articles of the partnership that the giving of a guarantee is within the ordinary course of the firm's business, a guarantee must be signed by all the partners. Guarantees will always provide for the joint and several liability of the partners: see 'Guarantees by two or more persons' below. The guarantee will not survive a change in the constitution of the firm.

Limited companies

The doctrine of *ultra vires* is important, as is the authority of the board, but problems are now resolved by the latest reforms, although in practice banks will still insist on checking constitutional documents.

Problems arise where the guarantee is void because it constitutes financial assistance contrary to s.151 Companies Act 1985: *Heald* v. *O'Connor* [1971] 1 WLR 497. The guarantee would also be voidable where the directors executing the guarantee are personally interested in the guarantee; this can occur where one company guarantees the account of another company, and a director of the company voting on the resolution is also a director or shareholder of the company for whose benefit the guarantee is being given. This can also relate to any form of direct security issued by the company in place of an earlier guarantee by the directors. In *Victors Ltd* v. *Lingard* [1927] 1 Ch 323, the five directors of a company guaranteed the company's account at the Midland Bank. Some months later, the directors resolved that the company should issue a debenture to the bank as additional security. The articles were in the form of Table A and excluded interested directors from voting on and being reckoned for the purposes of establishing a quorum of the board. The court found that there was a personal interest to the directors since the debenture relieved their liability. In this case the company was estopped from alleging the

invalidity of the debentures, but in other circumstances this would have been the case. Where this situation is likely to arise, the creditor should ensure that the resolution relating to the guarantee (or other issue of securities) is either passed by the votes of disinterested directors or, where this is not possible, the decision must be taken by the company in general meeting. Even where the Articles allow directors to vote on contracts in which they have an interest, s.317 Companies Act 1985 imposes an obligation to declare that interest at a meeting of the board of directors at which it first arises. Where the creditor is aware that this requirement has been breached the guarantee will be voidable by the company: *Rolled Steel Products Ltd* v. *British Steel Corporation* [1986] Ch 246.

Guarantees by two or more persons

These give rise to particular problems, notably the nature of the liability of the guarantors, which can be joint, or joint and several. Prior to the Law Reform (Miscellaneous) Provisions Act 1934, the liability for existing and future debts of a guarantor with joint liability came to an end on his/her death under the doctrine of survivorship. It has been argued that this has been changed by the 1934 Act, but the position remains unclear. In the case of joint and several liability, the liability of the guarantor for existing debts is preserved on his/her death and the creditor can claim against the estate.

To make the co-guarantors jointly and severally liable, the words 'we hereby jointly and severally guarantee' should be used. This will usually be accompanied in the case of a bank guarantee by a clause allowing the bank to release or discharge one or more of the guarantors from liability under the guarantee without prejudice to its rights and remedies against the remaining guarantor/s, removing the rule whereby discharge of one or more of several co-guarantors releases the others from liability: *Barclays Bank Ltd* v. *Trevanion The Banker*, Vol. XXVII (1933) p. 98.

The co-guarantors do not need to sign the guarantee in each other's presence, but the failure of all parties to sign discharges those who have already signed. In *National Provincial Bank of England* v. *Brackenbury* (1906) 22 TLR 797, a joint and several guarantee was intended to be signed by four guarantors, but only three out of the four signed and the court held that they were not liable. In *James Graham & Co. (Timber) Ltd* v. *Southgate-Sands* [1985] 2 All ER 344, the plaintiff issued a writ against three guarantors. Before the trial one of the guarantors was made bankrupt and it was discovered that the other signatures were forgeries. The Court of Appeal held there was no liability of one guarantor where the signatures of the co-guarantors were forged. Where one of the guarantors varies the terms of the guarantee without the consent of the others, all of the co-guarantors will be discharged. In *Ellesmere Brewery Company* v. *Cooper* [1896] 1 QB 75, four persons executed a joint and several guarantee which limited the liability of two to £50 each and the other two to £25 each. After the three others had executed the bond, the fourth guarantor executed the bond but marked against his signature '£25 only'. This material alteration discharged the others from liability and, since the others

were discharged, the person making the material alteration was also not bound.

See below for the special rules relating to termination of joint and several guarantees.

Rights of the guarantor

The guarantor has rights against (i) the creditor; (ii) the principal debtor; and (iii) co-sureties, but a bank guarantee form will remove virtually all the rights of the guarantor where they conflict with the interests of the bank.

Rights against the creditor

The guarantor can at any time ask the creditor how much s/he is currently liable for under the guarantee. For bank guarantees, because of the duty of confidentiality to the customer, the guarantor will only be told that s/he is liable to the full amount of his/her guarantee or, the actual amount of the debt.

Once the debt has become due, the guarantor may pay off the creditor and sue the principal debtor provided s/he obtains an assignment of the guaranteed debt. The guarantor can claim the benefit of any right of set-off of the principal debtor against the creditor. If the guarantor pays off the debt or the part of the whole debt which s/he has guaranteed, s/he is subrogated to all the rights of the creditor in respect of the debt, including any securities given by the principal debtor and by co-sureties to the creditor. In bank guarantees, the competing rights of the guarantor will be removed by the inclusion of a whole debt clause: 'This guarantee shall be applicable to the ultimate balance that may become due to the bank from the Principal and until repayment of such balance, I will not take any steps to enforce any right or claims against the Principal in respect of any moneys paid by me to the Bank hereunder.'

Where a person has given a guarantee or indemnity to a creditor of a company or an individual now in liquidation or bankrupt, the guarantor cannot prove in the liquidation or the bankruptcy unless s/he has discharged the principal debtor's total obligation to the creditor, even where s/he has only agreed to be liable up to a maximum amount because only one proof can be admitted for the same obligation. If the guarantee is only for part of the principal debtor's debt, the surety may prove once s/he has paid that part in full and the creditor may prove for the remainder. This applies to a guarantee expressed to be for the repayment of 25 per cent of a loan plus interest thereon, or the first £100 000 of the principal debtor's indebtedness to the creditor.

Rights against the principal debtor

Where the creditor has a right to immediate payment against the guarantor, the guarantor can call upon the principal debtor to pay the debt, even though the creditor has not demanded payment from the principal debtor.

In *Thomas* v. *Nottingham Incorporated Football Club Ltd* [1972] Ch 596, the court held that, as soon as the guarantor gave notice to the creditor terminating the guarantee, he was entitled to call upon the principal debtor to pay, even though the guarantor was only liable to pay on demand and no demand had been made.

As soon as the guarantor pays any money under his/her guarantee, s/he has an immediate right of action against the principal debtor and, where the principal debtor is bankrupt or, in the case of a company, in liquidation, has a right to prove for the debt. This is generally restricted by the use in a bank guarantee of a whole debt clause (see above).

Rights against co-sureties

Where there are co-sureties, a person who pays the debt, or more than his/her proportion of the whole debt, is entitled to contribution from his/her co-sureties, whether there is joint or joint and several liability, and whether they are co-sureties under one instrument or more than one. Where the principal debtor is solvent, the guarantor must join the co-defendant in any action against co-sureties: *Hays* v. *Carter* [1935] 1 Ch 397. Any action for contribution must take into account the benefit of securities taken from the creditor and any payments from the principal debtor.

Termination of the guarantee

Termination is only a problem for a continuing guarantee under which the creditor continues to advance credit or supply goods in reliance on the guarantee until it is terminated. In this case, although the guarantor is released in respect of further advances or deliveries, his/her existing liability is preserved. The creditor's problem is to ensure that his/her claim against the guarantor is preserved and will not be discharged through the operation of the rule in *Clayton's Case* (1816) 1 Mer 572, which means that credits will reduce or extinguish the liability of the guarantor, while payments out of the account (or fresh advances on credit) will create new advances, for which the guarantor will not be liable. A bank will normally rule off the principal debtor's account and open a new account for future transactions.

In *Westminster Bank Ltd* v. *Cond* (1940) 46 Comm Cas 60, the bank had inserted a clause into a guarantee allowing the bank to continue the account with the principal and preserving the guarantor's liability as at the date when the guarantee was determined, notwithstanding any subsequent payment into or out of the account. The court held that the guarantor's liability remained even though the bank had continued to operate the account without a break for almost six years after the notice of termination. The clause was drafted to cover notice of termination and death of the guarantor, but it could be extended to cover insanity and bankruptcy.

Termination can arise through the following circumstances.

Payment by the guarantor or the principal debtor

Payment by the guarantor terminates his/her liability under the guarantee, as will payment by the principal debtor. In the latter case, however, the guarantee will generally be drafted to exclude termination by payments that are later established as voidable preferences, which can then be reclaimed from the creditor by the trustee in bankruptcy or the liquidator or administrator of a company.

Notice by the guarantor

In the case of a continuing guarantee, the guarantee will normally provide for the termination of the guarantee by three months' notice by the guarantor. In such a case, the creditor could continue to make advances in reliance on the guarantee, and the guarantor will be liable for the balance outstanding at the end of the period. The same would apply in the event of termination by notice of the guarantor's death, where the guarantee provides that it shall continue for three months after notice of death.

Notice of guarantor's death, insanity, bankruptcy or liquidation

If the guarantee has been acted upon before the death of the guarantor, it will continue until the creditor receives notice of the death. The same position will operate in the event of the insanity of the guarantor. Whereas bank guarantee forms usually provide for continuance beyond the notice of death, no such provision is made for insanity, and the guarantee cannot be relied upon once notice is received. If the guarantor is made bankrupt or placed in liquidation, the creditor should no longer rely on the guarantee once notice has been received.

Death of the principal debtor

The guarantee is terminated to the extent that the total liability of the principal debtor is established. There is only a practical problem concerning the operation of bank guarantees. The bank guarantee will normally extend to cover cheques presented after the death of the principal debtor but before the bank has had notice of the death. Once there is notice, the bank will return the cheques unpaid, marked 'drawer deceased'.

Variation of the terms of the principal contract

A material variation of the principal contract will discharge the guarantor from liability. In this context, the most important variation will be where the creditor gives the principal debtor more time to pay. The rule has been criticised but is strictly applied. However, most guarantees will be drafted to exclude this rule.

Change of parties

Where there is a change in the constitution of the parties to or for whom the guarantee is given, in the absence of agreement to the contrary, the

guarantee is revoked as regards future transactions. This rule is embodied in the Partnership Act 1890, s.18, but the same thing applies to registered companies and the merger of two or more companies revokes a guarantee given to one of the companies as to future transactions.

Release of the principal debtor by the creditor

A guarantor is discharged if the creditor releases the principal debtor from his/her liability: *Perry* v. *National Provincial Bank of England* [1910] 1 Ch 464. This does not apply to compositions under the Insolvency Act 1986 (see Chapter 18), but most guarantees will be drafted to exclude this rule.

Special rules relating to joint and several guarantees

The notice of the death of one joint and several creditor does not, even when notified to the creditor, prevent the remaining guarantor or guarantors from remaining liable for further advances. In the case of a continuing guarantee, although the termination of the guarantee will usually result in the ruling-off of the principal debtor's account and the opening of a new account, this may not be necessary where the guarantee contains a clause, as in *Westminster Bank Ltd* v. *Cond* (1940) (above); further, if the guarantee contains a clause to the effect that the notice of the termination or death of one of the co-guarantors does not terminate the guarantee (which can only be terminated by the notice of all the co-guarantors), the guarantee will continue to cover future advances, even against the deceased guarantor: *Egbert* v. *National Crown Bank* [1918] AC 903. The notice of the insanity of one of the co-guarantors will presumably have the same effect on the other guarantor or guarantors, but the liability of the insane guarantor will terminate in respect of further advances. If one joint and several guarantor is made bankrupt the position is the same as for death and an agreement could make an express provision relating to the continuing liability of the co-guarantors. Once again, the bank would have to rule-off the principal debtor's account and channel new transactions through a new account if it wished to prove in the estate of the bankrupt guarantor unless there is a *Westminster Bank Ltd* v. *Cond* (1940) clause.

10.16 Property Covered by a Retention of Title Clause

A retention of title clause is frequently incorporated into a contract for the sale of goods to protect the seller of the goods in the event of the non-payment of the buyer. The basis is the Sale of Goods Act 1979, under which the property in specific goods in a deliverable state passes to the buyer, which may be at the time of the contract but always on or before delivery (s.18), unless the parties have expressed a different intention (s.17), culminating in 'reservation of disposal', where title does not even pass on delivery: s.19.

Properly drafted clauses maintain the contract's status as a sale contract, so the purchaser must be able to use and resell the goods, but gives him/her bailment of them and leaves legal title with the seller until certain conditions are met. The contract will prevent goods passing to the trustee in bankruptcy, liquidator or receiver, and allow unsold and unused goods to be repossessed by the seller. Thus in *Romalpa* (see below) the sellers reclaimed the unused aluminium; in *Re Peachdart* [1983] 3 All ER 204, unused leather; and in *Clough Mill Ltd* v. *Martin* [1984] 3 All ER 982, unused yarn.

The original British decision was *Aluminium Industrie Vaassen* v. *Romalpa Aluminium Ltd* [1976] 2 All ER 552, in which aluminium foil was supplied to the defendant for processing, on condition that ownership should not pass until payment of the full price, and that products made from the foil should be kept by the buyers as bailees separately from the other stock as surety for the outstanding price; but that the buyers should have the power of sale of the manufactured articles as the sellers' agents. The court held that the supplier had the right to the unused stocks of foil, a charging order over the goods into which the foil had gone, and the proceeds of sale of the finished goods. The relevant part of Clause 13 in the contract reads: 'The ownership of the material to be delivered … will be transferred to the purchaser when he has met all that is owing … Until the date of payment, purchaser … is required to store material in such a way that it is clearly the property [of the sellers].' But there are three variations on the basic clause, as follows.

Protection against onward sales

If the purchaser resells the product in its original state the purchaser will get a title under s.25(1) Sale of Goods Act 1979, since the original purchaser is a 'buyer in possession', which will defeat the claims of the title retention holder: *Four Point Garages Ltd* v. *Carter* [1985] 3 All ER 12. The supplier can require the buyer to notify the purchaser of the title of the original seller through a variation on the basic clause, 'If the purchaser shall resell the goods whilst they are still the property of the seller, he shall notify the purchaser that the goods remain the property of the original seller, until such time as the seller under this contract has received payment for the goods', and prevent the operation of s.25(1). This will still not prevent failure of the clause by the second buyer destroying the identity of the goods.

Where goods sold subject to retention of title are sold and delivered to a sub-buyer also subject to retention of title, unless the sub-purchaser pays for the goods, the original seller can claim title to goods remaining in his/her hands, *Re Highway Foods Int. Ltd* [1995] 1 BCLC 209.

The 'all monies' clause

This seeks to retain title until all debts are settled and has been considered in Scottish law in *Armour* v. *Thyssen Edelstahl Werke AG* (1990) FT,

26 October, where Lord Keith saw no difference in principle between a clause which passed property on payment of the price and one passing property on the payment of all debts. But it could be contrary to the doctrine of privity of contract and the definition of a sale contract in s.2(1) Sale of Goods Act 1979 and constitute a charge over book debts requiring registration in the case of a company.

Tracing into the proceeds of sale and/or manufactured goods

The major extension of the basic title retention clause attempts to trace the goods into the proceeds of sale and/or into a manufactured product incorporating the goods. In *Romalpa* the clause effectively provided for rights over manufactured products into which the aluminium could be traced, and the proceeds of onward sale into the bank account of the company. The cases on tracing in equity establish that, where a trustee of property translates that property from its original form into another by sale, or sale and repurchase, the beneficiary is entitled to those proceeds of sale or the repurchased item. Tracing depends on the relationship of trust being set up.

In relation to tracing into the proceeds of sale, the clause must create a constructive trust of the goods and there must be a fiduciary relationship. *Compaq Computers Ltd* v. *Abercorn Group Ltd* [1991] BCC 484 establishes that the court will not imply a right to trace; there must be a specific clause. This must retain equitable as well as legal title and describe the purchaser as both 'bailee' and 'fiduciary', and even specifically as 'trustee', although the term 'agent' can also be used. Thus the purchaser resells the goods as agent/fiduciary for the supplier. The clause should then claim the proceeds of sale, requiring records of sales specifically to be kept and the proceeds 'to be held in a separate fund for the use of the seller'. In *Hendy Lennox (Industrial Engines) Ltd* v. *Grahame Puttick Ltd* [1984] 1 WLR 185, there was an insufficient creation of a fiduciary position. In *Re Weldtech Equipment Ltd* [1991] BCC 16, defective drafting created a charge on book debts. In *Re Peachdart* and *Re Andrabell Ltd: Airborne Accessories* v. *Goodman* [1984] 3 All ER 407, the clause failed because there was no requirement for separate funds. In relation to tracing into manufactured goods, the court takes the view that the title to the goods has passed to the purchaser once the manufacturing process has inextricably mixed the product with others. In *Re Bond Worth* [1979] 3 All ER 919, an attempt to trace fibres into carpets was held to create a floating charge over the finished product, which was void for want of registration under s.396(1) CA 1985. The same thing is seen in *Ian Chisholm Textiles Ltd* v. *Griffiths and Others* [1994] 2 BCLC 291 in respect of an attempt to trace into dresses made up from fabric. In *Stroud Architectural Systems Ltd* v. *John Laing Construction Ltd* [1994] 2 BCLC 276, an attempt to create retention of title over glazing units was held to create a floating charge, which was void for want of registration. Any use of words such as 'charge' or 'security' are likely to lead the court to find a registrable charge: *Pfeiffer*

Weinkellerei-Weinenkauf GmbH v. *Arbuthnot Factors Ltd* [1988] 1 WLR 150; *Compaq Computers Ltd* v. *Abercorn Group* Ltd [1991] BCC 484; and *Re Interview Ltd* [1975] IR 382.

In other cases the courts have similarly restricted the right to trace on the grounds of loss of identity. In *Borden (UK) Ltd* v. *Scottish Timber Products Ltd* [1979] 3 All ER 961, resin was used in the manufacture of chipboard, and in *Peachdart*, leather in the manufacture of handbags. In both cases, once manufacture was undertaken, the product subject to the title retention lost its inherent identity and the right to recover the product was lost. In *Hendy Lennox (Industrial Engines) Ltd* v. *Grahame Puttick Ltd* [1984] 1 WLR 185, the product was a diesel engine inserted into a generator by four bolts. Although it became part of a larger finished product it was possible to disassemble it and recover the engine in specie; the product did not lose its identity and could be recovered. Attempts to draft a clause seeking to trace a right in the goods into which the product has been manufactured are a waste of time, and where goods become attached to land as a fixture they may also have lost their identity.

10.17 Liens

There are three types of lien: *possessory*, *equitable* and *maritime*.

Possessory liens

A lien gives a person in possession of goods, papers and so on the right to retain possession of them until the person is paid outstanding charges in respect of those goods. The right to the lien is lost once possession is lost. The holder of the lien does not generally have a right to sell the goods held. The lien can arise through the common law or by statute and can be particular or general.

Particular liens are more common than general liens and give the right to retain an item until all the liabilities are settled in respect of those goods. Thus an agent has a right of lien in respect of goods until settlement of his/her commission or remuneration and any expenses in respect of those goods. Accountants have a particular lien over books, files and papers of the client: *Woodworth* v. *Conroy* (1976), carriers in respect of charges incurred, innkeepers in respect of goods deposited or left in respect of money owed for board and lodging (Innkeepers Act 1878), and repairers in respect of work carried out. The seller of goods who is in possession of them has a lien and right of stoppage in transit of goods until payment of the purchase price (see Chapter 13).

General liens give the person in possession of goods and so on the right to retain possession of them until the settlement of all claims outstanding with the owner of the goods. A general lien may arise by agreement, by a course of dealing, or be recognised by custom. Solicitors have a general lien over clients' papers. Bankers have a lien in respect of

cheques collected on behalf of a client for value, and over the credit balances in clients' accounts in respect of debit balances in other accounts at the same bank (see Chapter 15). Other persons with a general lien include stockbrokers and factors.

The lien is enforced by retaining the goods that are the subject of the lien. The holder does not generally have the right of sale, but this arises in the case of repairers under the Torts (Interference with Goods) Act 1977, and unpaid sellers of goods: s.48(3) Sale of Goods Act 1979 (see Chapter 13). The right to the lien is lost through waiver where possession is lost, even though it might be recovered subsequently: *Westminster Bank Ltd* v. *Zang* [1966] AC 182 (see Chapter 15). It is also lost on payment or tender of the amount owed and where the holder takes a security in substitution for the lien.

Equitable liens

This type of lien exists independently of possession of property. It is an equitable charge on property which exists until claims have been discharged. Thus an unpaid vendor in a contract for the sale of land has an equitable lien over the property from the moment of exchange of contracts until payment of the purchase price. Equitable liens arise over the property of a dissolved partnership in respect of the ex-partners. The equitable lien binds persons acquiring the property except a bona fide purchaser for value without notice of the lien. The lien is enforced by sale.

Maritime liens

This lien arises in a respect of a ship for payment of claims in maritime law. The persons who claim a right of lien include seaman in respect of their wages, and claimants in respect of damage caused by collision. The lien is not based on possession and is effected by arresting the ship.

Recommended Further Reading

The Law and Practice of Banking, Vol. 2: Securities for Bankers' Advances, James Milnes, 8th edn (Holden, Pitman Publishing, 1993).

The Law Relating to Banking Services, David Palfreyman, 4th edn (M & E Handbooks, Pitman Publishing, 1993).

Questions

1. How can a legal mortgage of freehold or leasehold land be created?
2. With regard to mortgages of registered land, how does the mortgagee protect his/her right to priority over later mortgagees?
3. The mortgagor of real property is protected by the equity of redemption. Explain the operation of this right and how it can be restricted or terminated.

4. What are the risks for the equitable mortgagee of registered shares, and what protection is there for the mortgagee?
5. What is the value of an insurance policy when used as security for a loan?
6. What are the risks of vitiation of the policy?
7. What is the definition of a floating charge, and in what circumstances does the charge crystallise?
8. Name the five disadvantages and the one advantage to a lender secured by a floating charge over a company's assets.
9. What is the essential difference between a guarantee and an indemnity?
10. What do you understand by the term *uberrima fidei* and does it apply to a contract of guarantee?
11. What is the significance of the 'whole debt clause' in a guarantee?
12. What problem arises where a supplier of goods attempts to claim a right to trace those goods into objects manufactured by the purchaser?
13. In respect of a possessory lien, distinguish between a particular and a general lien.

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Part V

Business Contracts

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11 The Law of Agency

Learning Objectives

After reading this chapter you will know about:

1. the nature of agency and the source of the agent's authority to bind the principal
2. the rights and duties of the agent
3. the liability of the agent to third parties
4. the termination of the agency
5. the Commercial Agents Regulations 1993

11.1 Definition of Agency

An agent has authority to act on behalf of another (the principal) to affect the legal position of the principal and a third party, and does not need contractual capacity. Agents can be employees of the principal or independent contractors supplying specialist skills; companies may appoint other companies as their agent with responsibility for a particular market.

There is a difference between the legal and the commercial use of the term, and many cases where the term 'agent' or 'agency' is used are not true agency. Thus car dealers may be described as being a manufacturer's agent, but they sell cars as principals, and a buyer has no rights against the manufacturer arising simply out of the purchase contract. Similarly, the granting of a 'sole agency' for products is not a strictly an agency agreement since it prevents the manufacturer from selling the goods personally, which is not true in a genuine agency agreement: *Lamb (W.T.) & Sons* v. *Goring Brick Co. Ltd* [1932] 1 KB 710. Estate agents are not normally agents in the legal sense, since they have no authority to contract regarding properties which they are instructed to sell.

11.2 Types of Agent

There are four types of agent. Special agents have authority on specific occasions or for a specific purpose, such as signing cheques. The principal is only bound where the agent has actual authority. General agents have authority to act within certain limits. The best example is a general partner in a firm who is a general agent and can bind the firm and the other partners in contracts in the ordinary course of the business. The principal can be bound by acts within the usual authority of the agent. Universal agents have unlimited authority to act for the principal. *Del credere* agents, in

return for a higher commission, are primarily responsible for payment in respect of contracts negotiated on behalf of the principal. The best example is an advertising agency.

11.3 The Authority of the Agent

The agent must have authority, which can arise in the following ways: (i) prior consent of the principal; (ii) subsequent consent of the principal – ratification; (iii) operation of law – agency of necessity; or (iv) the doctrine of apparent authority.

By consent of the principal

Normally, the principal will authorise the agent to act on his/her behalf in advance of any exercise of the agent's authority. Authority can be verbal, in writing or by deed, where the agent is required to contract on behalf of the principal by deed, when the agent will be the donee of a power of attorney and subject to the Powers of Attorney Act 1971. Generally, there is no distinction between verbal and written authority except for specific occasions when written authority is required by the law.

The agent can bind the principal in contracts within his/her actual authority. If s/he acts beyond his/her actual authority or without authority then the principal cannot be bound unless s/he adopts or ratifies the transaction. If s/he refuses to ratify the transaction the agent will be liable for damages for breach of warranty of authority to the third party. Even where the agent has specific authority to bind his/her principal, s/he may also have apparent authority and may be able to bind his/her principal beyond his/her actual authority.

Ratification

Where an agent acts without authority or beyond his/her authority, the principal may choose to adopt the contract by ratification. Ratification is only possible subject to certain conditions; if these are not complied with then the ratification will be ineffective. The conditions are as follows:

(i) The principal must have been in existence when the contract was negotiated on his/her behalf. Registered companies cannot ratify contracts negotiated on their behalf before their incorporation (see Chapter 8).

(ii) The agent must contract as such and name or identify the principal. In *Keighley, Maxtead* v. *Durant* [1901] AC 240 the agent purchased wheat at a higher price than authorised but without revealing that he was acting as an agent. The principal purported to ratify the contract but later refused to accept delivery. The House of Lords held that he could not be liable for damages for breach of contract.

(iii) The principal cannot ratify a void contract or a forgery.
(iv) The principal must have capacity to contract both at the time the contract was negotiated and at ratification.
(v) The principal must be aware of all material facts relating to the contract. This is the general rule, but a principal may ratify the acts of his/her agent without knowing of them: *Fitzmaurice* v. *Bayley* (1856) 6 E&B 868.
(vi) Ratification must be of the whole contract.
(vii) Ratification must be subsequent, within a reasonable time and before the time fixed for performance of the contract.

Ratification is retrospective, excluding contracts of insurance, except for marine insurance, and where it would cause excessive hardship to third parties. Ratification can be express or by implication and there are no strict formal requirements except that, where the agent has contracted by deed, the ratification must also be by deed. Ratification will in many cases arise from conduct of the principal and it is sometimes difficult to identify whether an act of ratification has taken place. Thus in *Forman & Co. Proprietary Ltd* v. *The Ship Liddesdale* [1900] AC 190, a shipowner's agent ordered extra repairs to be done to a ship beyond the scope of his authority. The shipowner later took the ship back and sold it. It was argued that the act of taking back the ship constituted ratification but the court rejected this argument, saying that the shipowner had little option but to take the ship back and that ratification required some positive unequivocal act. However, in other cases the court has accepted that, where an agent acted beyond his/her authority in buying goods and where the principal objected but later sold some of the goods, this amounted to ratification: *Cornwal* v. *Wilson* (1750) 1 Ves Sen 509. See also *Buron* v. *Denman* [1848] 2 Exch 167.

Where an agent accepts an offer on behalf of his/her principal 'subject to ratification', the acceptance is a legal nullity until ratification and if the offer is revoked before ratification there is no contract: *Watson* v. *Swann* (1862) 11 C.B.N.S 756.

Authority by operation of the law: agency of necessity

Agency of necessity arises where the court recognises a person as having the authority of an agent to bind another person. This is subject to the following conditions:

(i) A person must have responsibility for the property of another under a pre-existing contract.
(ii) There must be some emergency which arises in connection with the property of that person.
(iii) The person charged with responsibility for the property must be unable to get instructions from the owner of the property.
(iv) The person charged with responsibility must act in good faith in respect of the property in the interests of the owner.

In *Prager* v. *Blatspiel, Stamp and Heacock Ltd* [1924] 1 KB 556, the defendants, London fur dealers, sold dressed skins to the plaintiff for delivery to Bucharest. Delivery was impossible because of the German occupation of Romania. After two years the defendants sold the skins. After the war the plaintiff sued for damages; the defendants claimed that they were agents of necessity, but they failed, since the court held that there had been failure to show inability to communicate, the existence of a commercial necessity and that the action had been undertaken in good faith in the best interests of both parties. A claim by the Greater Western Railway concerning the sale of a consignment of tomatoes failed because there had been no inability to contact the owner of the goods by the carrier: *Springer* v. *Gt Western Railway Co.* [1921] 1 KB 257. In *Gt Northern Railway* v. *Swaffield* (1874) LR 9 Exch 132, a horse was sent by train and, there being nobody to meet it at its final destination and the railway being unable to contact the owner, they booked the horse into a livery stable shortly before the arrival of the servant sent to meet the horse. The railway company was found to have acted under its authority as an agent of necessity.

There are external and internal aspects of agency of necessity. The former involves third parties seeking to enforce contracts against the principal entered by an agent of necessity and strict compliance with the common law rules is required. For the latter, the agent seeks reimbursement from the principal, or a defence against an action for wrongful interference; strict compliance with the rules of agency of necessity is not required. In *The Winson* [1982] AC 939, a ship was chartered to carry wheat from the USA to Bombay and during the voyage the ship became stranded on a reef. The salvors unloaded some of the wheat, which was shipped to Manila, and warehoused it, even though there was then no immediate necessity. The House of Lords found the cargo owners liable to reimburse the salvors' expenses.

Agency of necessity will not arise where the person has voluntarily assumed responsibility for another's property. In *Binstead* v. *Buck* [1777] 2 WB1 1117, a person took in a lost dog and then unsuccessfully claimed the right to retain it pending payment of his expenses.

The doctrine of apparent authority

There are two major aspects of the doctrine relating to usual and estoppel authority.

Usual or ostensible authority

An agent may have usual authority arising from his/her status, which may be wider than the actual authority s/he has been given by the principal. In this case s/he can bind the principal to contracts entered within the scope of his/her apparent authority unless the third party has been notified of his/her actual authority. The courts have established the usual authority of certain types of agent. Under the Partnership Act 1890, all partners are

the general agents of the firm and their partners and have implied authority to bind the firm in any contract within the scope of the usual business of the firm. The court also distinguishes between trading and non-trading partnerships, and partners in trading partnerships have a wider implied authority which extends to borrowing on behalf of the firm.

An example of usual or ostensible authority is in *Watteau* v. *Fenwick* [1893] 1 QB 346, where the manager of a hotel under an express prohibition from the hotel's owner not to purchase cigars on behalf of the hotel purchased cigars from a supplier, who relied on the fact that this was normally within the authority of a hotel manager. The court held the hotel proprietor was liable on the contract. In the field of company law, in *Panorama Developments (Guildford) Ltd* v. *Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711, a company secretary was recognised as having implied authority to bind his company in contracts of an administrative nature. The company was liable for contracts by the company secretary for cars hired ostensibly for the company's business but in reality for his private use.

Acts within an agent's usual or ostensible authority will bind the principal even where they are fraudulent. Thus, in *Lloyd* v. *Grace, Smith & Co.* [1912] AC 716, the defendant firm of solicitors was liable for the fraudulent conveyancing work of the managing clerk, since he had acted in the course of his employment.

The position of mercantile agents who are defined as 'having in the customary course of [their] business … authority either to sell goods, or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods' is governed by the Factors Act 1889, s.2. This provides that any dealing by the agent with goods or the documents of title to goods which they hold with the consent of the owner by sale, pledge or disposition, in their ordinary course of business, will be binding on the owner even if unauthorised as long as the person taking under the disposition acted in good faith and without notice of the agent's lack of authority.

Estoppel authority or 'holding out'

Where a person holds out another as having authority as an agent, and a third party acts in reliance on that holding out, the person holding the other out as agent will be estopped or prevented from denying the truth of his/her earlier representation and will be bound by any contract negotiated within the terms of the holding out. Thus, in *Spiro* v. *Lintern* [1973] 1 WLR 1002, Mr Lintern had knowingly allowed his wife to act as if she had authority to negotiate the sale of his house. Mr Spiro acted in reliance on the authority of the wife, regarded himself as the purchaser of the property and commenced work on it. Mr Lintern then purported to sell the property to a third party at a higher price, alleging his wife's lack of authority. Mr Spiro successfully applied for specific performance of the contract. In *Freeman and Lockyer* v. *Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, a director of the defendant company entered a

contract with the plaintiffs on behalf of the company without authority. The contract was for the development of a property and, when planning permission was refused, the director left the country and the plaintiffs sought to recover their fees from the company, which maintained that it was not liable since the director was unauthorised. The court held that the company was liable, since the board had allowed the director to give the impression that he was the managing director of the company, that the plaintiffs had acted in reliance on this representation, and that the contract that had been negotiated would be within the usual authority of a managing director. In *Hely-Hutchinson* v. *Brayhead Ltd* [1968] 1 QB 549, fact of the board allowing a director to act as a managing director was treated as an implied appointment to that position giving him actual authority to bind the company (see Chapter 9).

An agent whose agency has been terminated by his/her principal will still have estoppel authority to bind his/her ex-principal in respect of post-termination contracts with persons with whom s/he was accustomed to deal in the past. It is important for a principal to notify all such persons that the relationship has been terminated. This is important for partners retiring from a firm who remain apparent partners under s.36 P.A.1890 unless the firm gives individual notice to all persons who dealt with the partner prior to his/her retirement and publishes a notice of retirement in the *London Gazette*, where the principal place of business is in England or Wales.

11.4 The Rights and Duties of the Agent

The agent owes the following duties to his/her principal: (i) obedience; (ii) care and skill; (iii) personal performance; (iv) duty to account; and (v) duty of good faith.

Obedience

The agent must obey his/her principal and cannot operate beyond his/her instructions unless given a power of discretion, even where s/he acts in what s/he believes ae his/her principal's best interests. If s/he fails to obey his/her instructions s/he will be liable to the principal. Thus, in *Bertram, Armstrong & Co.* v. *Godfrey* (1830) 1 Knapp 381, the plaintiff instructed his stockbroker to sell certain stocks when they reached a certain price, but the broker failed to sell the stocks and they were later sold at a lower price. The court held that by holding on to the stock the broker had purchased them himself, and now owed the plaintiff the difference in price plus interest. Where the instructions are ambiguous, the court looks to see whether the agent has acted reasonably, even though incorrectly: *Weigall* v. *Runciman & Co.* (1916) 85 LJKB 1187.

Only contractual agents can be liable for failing to perform their duties, but where the agent has a discretion to act s/he will not be liable for

failure to act if s/he exercised the discretion reasonably: *Boden* v. *French* (1852) 10 CB 886.

Duty of care and skill

An agent, whether contractual or gratuitous, is required to exercise the same degree of care and skill which a reasonable wo/man would exercise in respect of his/her own affairs. Thus in *Chaudhry* v. *Prabhakar* [1989] 1 WLR 29, a person was liable for giving negligent advice to a friend in choosing a second-hand car. A professional person must display the degree of skill appropriate to the profession. This is implied into all agency contracts by s.13 Supply of Goods and Services Act 1982 (see Chapter 13).

Duty of personal performance: *Delegatus non potest delegare*

An agent must generally carry out personally any task delegated to him/her by the principal. Delegation can be expressly permitted or arise by implication and, in each case, the relationship between the principal and the sub-agent needs to be identified.

The occasions when there is an implied right to delegate were set out by the Court of Appeal in *De Bussche* v. *Alt* (1978) 8 ChD 286, which also commented on the relationship between the principal and the sub-agent. The court found that authority to delegate should be implied: 'where, from the conduct of the parties to the original contract of agency, the usage of trade, or the nature of the particular business … it may reasonably be presumed that the parties to the contract of agency originally intended that such authority should exist; or where in the course of employment unforeseen emergencies arise which impose upon the agent the necessity of employing a substitute; and that when such authority exists, and is duly exercised, privity of contract arises between the principal and the substitute, and the latter becomes as responsible to the former for the due discharge of the duties … as if he had been appointed agent by the principal himself'. However, in *Calico Printers' Association Ltd* v. *Barclays Bank* (1931) 145 LT 51, Wright J stated: 'But I do not think the English law has admitted any such general principle, but has in general applied the rule that even where the sub-agent is properly employed, there is still no privity between him and the principal; the latter is entitled to hold the agent liable for breach of the mandate which he has accepted, and cannot, in general, claim against the sub-agent for negligence or breach of duty … To create privity it must be established not only that the principal contemplated that a sub-agent would perform part of the contract, but also that the principal authorised the agent to create privity of contract between the principal and the sub-agent, which is a very different matter requiring precise proof.' In this case the agent was held liable for the negligence of the sub-agent.

Thus the agent can only delegate his/her authority (i) if s/he has express or implied authority; (ii) in cases of necessity; and (iii) in respect of the

delegation of purely ministerial tasks. Where there is such a delegation, the sub-agent is the agent of the agent and accountable to the agent who will, in turn, be accountable to the principal. The principal cannot sue the sub-agent in contract and will sue the agent. With regard to tortious liability, recent decisions have held that, where agents have bailed goods to person, the bailees owe a duty of care not only to the bailor but also to the bailor's principal: *Lee Cooper Ltd* v. *C. H. Jeakins & Sons Ltd* [1967] 2 QB 1. But the position is far from clear, since in *Balsamo* v. *Medici* [1984] 2 All ER 304 the court refused to allow an action in tort by a principal against a sub-agent in respect of money received by the sub-agent.

In *Allam* v. *Europa Poster Service*s [1968] 1 All ER 286, the court held that it was possible to delegate authority to serve notice terminating existing licences for advertising sites to the defendant's solicitor since this was a purely ministerial act involving no delegation of confidence or discretion. In *John McCann & Co.* v. *Pow* [1975] 1 All ER 129, the court refused to recognise that an estate agent had an implied authority to delegate the finding of a buyer for a client's property to another firm of estate agents, and that the appointed agents could not claim commission in respect of the sale of the property through the efforts of the other agency.

Duty to account

The agent must account for money and property received by him/her in connection with his/her role as agent. In respect of money, s/he has a duty to keep separate accounts and where the accounts are mixed, there is a presumption that everything in the account belongs to the principal.

The duty of good faith

Agents are in a fiduciary relationship to their principal, which imposes on the agent the following duties.

Conflicts of interest

The agent must not place him/herself in a position where there is a conflict between his/her personal interests and his duties as agent. Thus, in *Reiger* v. *Campbell-Stuart* [1939] 3 All ER 235, the plaintiff instructed the defendant to try to find properties suitable for conversion into flats. The defendant found a suitable property offered at £2000 and arranged for his brother-in-law to purchase it. He then purported to buy the property from the brother-in-law at £4500, before selling it to the plaintiff for £5000. The plaintiff successfully sued for an account to her of the secret profit the agent had derived. Other examples of conflict of interests are the agent selling his/her own property to the principal or buying property from the principal or acting as an agent for both parties to a transaction. In *Kelly* v. *Cooper* [1993] AC 205 (PC), where the plaintiff claimed conflict of interest and failure to disclose information against estate agents whom

he had appointed to find a buyer for his property, the agents sold the property without disclosing that the purchaser had also bought the neighbouring property through them when this knowledge was a material factor in negotiating the sale price. The court held that agents carrying on a general agency business where there was bound to be a conflict of interests between the principals are in a different position from other agents. The contract between the principal and the agent did not impliedly include (a) a term requiring the defendants to disclose confidential information which they might receive from other vendors; (b) a term precluding them from acting for rival vendors; or (c) a term precluding them from earning commission on the sale of a property owned by a rival vendor.

Duty of full and frank disclosure

The agent has a duty to make full and frank disclosure of all information relating to his/her agency. Thus in respect of selling goods on behalf of the principal s/he must reveal to the principal all offers s/he has received, and has a duty to obtain the best possible price. In *Keppel* v. *Wheeler* [1927] 1 KB 577, estate agents were employed to sell a house and obtained an offer of £6150, which was accepted 'subject to contract' by the owner. They subsequently received a further offer of £6750. After the completion of the sale at the lower price, the owner of the property successfully sued for damages for breach of duty, which was the difference between the two offers. The agents were, however, entitled to their commission.

Duty not to make secret profits

The agent must not use or disclose confidential information acquired as agent for his/her own benefit, nor in any way derive a secret profit from his/her position as agent. Where the agent does make a secret profit from his/her position s/he is obliged to account to the principal for the profits. Thus, in *Reading* v. *A. G.* [1951] 1 All ER 617, a sergeant with the British Army in Eygpt was held liable to account to the Crown for money he had been paid for accompanying lorries carrying illicit spirits. Where the secret profit is derived honestly, the agent will still be entitled to claim commission or remuneration: *Hippisley* v. *Knee Bros* [1905] 1 KB 1. The agent will still be liable to account for secret profits even though his/her action has benefited the principal. In *Boardman* v. *Phipps* [1967] 2 AC 46, B, a solicitor, and P, acting together as agents for the trustees of an estate, attended the AGM of a company in which the trust held a large shareholding. They believed that the company could be more profitable and used their own money to acquire a controlling interest in the company. This was done openly but without the consent of the trustees. They made large profits for themselves and for the estate from capital distributions on their shareholdings. The House of Lords held them liable to account for the profit which they had made, since the profit had been made by reason of their fiduciary position as agents. and the opportunity and the

knowledge that had come to them in that capacity. If the secret profit is in the form of a bribe, the principal can take steps against the agent and the person giving the bribe. The agent will not be entitled to any remuneration or commission and must account for any already received: *Andrews* v. *Ramsay & Co.* [1903] 2 KB 635. The principal can recover the bribe from the agent if paid and can otherwise recover it from the briber unless s/he impliedly or expressly assents to the payment: *Anangel Atlas Naviera SA* v. *Ishikawajima-Harima Heavy Industries Co. Ltd* [1990] 1 Lloyd's Rep 167. The principal's right to recover the bribe from the agent is proprietary and s/he can claim properties purchased by the agent with money received as bribes: *A. G. for Hong Kong* v. *Reid* [1994] 1 All ER 1. The principal may also sue the agent and third party for any loss suffered under the tort of deceit. In *Salford Corporation* v. *Lever* [1891] 1 QB 168, involving bribes paid to the manager of the corporation gas works in respect of coal supplies, the Court of Appeal held that the principal could sue for damages for fraud from the briber (where the amount of the bribe was the measure of damages), even though they had in an earlier action sued the manager for recovery of the bribe 'without allowing any deduction in respect of what he has recovered from the agent'. In *Mahesan* v. *Malaysian Government Officers Co-op.* [1979] AC 374, the Privy Council stated that the principal could not recover both against the agent and the briber but must elect between these alternative remedies before judgment. The agent can be summarily dismissed (*Boston Deep Sea Fishing and Ice Co.* v. *Ansell* [1888] 39 ChD 339) and the principal can avoid all contracts negotiated by the agent even though they are not tainted: *Shipway* v. *Broadwood* [1899] 1 QB 369.

Agents accepting bribes will be guilty of conspiracy at common law, and both the agent and the briber are guilty of an offence under the Prevention of Corruption Act 1906, s.1 if they acted corruptly. A corrupt motive will be presumed in certain cases under the Prevention of Corruption Act 1916, s.2. The agent is subject to the duty of good faith even after the termination of the agency: *Island Export Finance Ltd* v. *Umunna* [1986] BCLC 460. (For partners, see Chapter 7; for directors, Chapter 9.)

11.5 The Rights of the Agent Against the Principal

The agent has the three following rights against the principal.

The right to indemnity

The agent must be indemnified for any liability or expenses incurred as agent except in respect of (i) unauthorised acts; (ii) losses resulting from the fault of the agent; and (iii) losses in respect of illegal acts or wagering contracts. The right is lost if the agent is in breach of his/her duties unless s/he has acted in good faith.

The right to remuneration

The right to remuneration depends upon the contract and it may be express or implied. The contract is an entire contract and the agent will only be able to claim remuneration where s/he has exactly and completely complied with his/her instructions. Where the agent is to be remunerated but the amount of the remuneration is unspecified, s/he is entitled to be paid a reasonable amount: s.15 Supply of Goods and Services Act 1982. However, in *Kofi Sunkersette Obu* v. *Strauss & Co. Ltd* [1951] AC 243, where the agent's contract provided that the commission, if any, was to be fixed by the principal, and where the principal made no decision on the matter, the Privy Council refused to enforce the agent's claim for commission.

Where a fixed commission is to be paid on the completion of a task or tasks, the agent may not be entitled to commission even where the transaction from which the commission arises is achieved, unless the agent can show that s/he was instrumental in bringing it about. Thus, in *Coles* v. *Enoch* [1939] 3 All ER 327, Coles had sought to purchase a property from the defendant but, unable to raise the money, agreed to act as an agent in finding a purchaser. His attempt to interest a prospective purchaser in Manchester was overheard and, after he had left, the bystander approached the other person and discovered the whereabouts of the property. He then travelled to London and, through his own efforts, traced the property and bought it. The court refused the plaintiff's claim to commission on the sale on the grounds that he had not been instrumental in concluding the sale. However, in *Rolfe & Co*. v. *George* (1968) 113 SJ 244, where a person seeking to sell a property had already found a buyer but engaged the plaintiff as agent in the negotiation of a price, the court held the agent was entitled to commission.

Conversely, if the contract provides for commission to be earned as an earlier stage, the agent may be entitled to commission even where the deal is not completed. Thus estate agents may earn commission on the 'introduction of a purchaser ready and willing to buy', when the right to remuneration vests as soon as this is done, even where the buyer later backs out of the deal: *Christie, Owen & Davies Ltd* v. *Stockton* [1953] 2 All ER 1149; *Christie, Owen and Davie*s v. *Rapacioli* [1974] 2 All ER 311; *Drewery and Drewery* v. *Ware Lane* [1960] 3 All ER 529; *Peter Long and Partners* v. *Burns* [1956] 3 All ER 207; and *Scheggia* v. *Gradwell* [1963] 3 All ER 114. Such terms were inserted following *Luxor (Eastbourne) Ltd* v. *Cooper* [1941] AC 108, which held that there was not an implied term in a contract preventing the principal from depriving the agent of his commission by deciding not to go ahead with the sale even though a buyer had been found.

The right to a lien in respect of remuneration/commission and indemnities

Agents have a right to retain possession of goods belonging to the principal until indemnities and remuneration in respect of those goods have

been paid. This is called a particular lien. In other cases the agent may be able to retain possession of goods owned by the principal in respect of any outstanding payments even though they do not arise from transactions relating to the goods actually retained. This is a general lien. The right to a lien is lost when goods pass out of the agent's possession (see Chapter 11).

11.6 Agents' Liability to the Third Party

Agents may incur personal liability to the third party in the following circumstances.

Liability in respect of bills of exchange and cheques

Where an agent has signed a bill of exchange or cheque in a representative capacity but has failed to make it clear that s/he has only signed in such a capacity s/he may be personally liable on the bill or cheque under s.26 Bills of Exchange Act 1882 (see Chapter 15). A separate liability may arise under s.349(4) Companies Act 1985, where officers of a company sign a bill of exchange or cheque in respect of a company where the company's name does not appear or appears incorrectly (see Chapter 8).

Contracts by deed

Unless the agent is appointed by deed, s/he will be personally liable on a deed executed by him/her as agent.

Where the agent contracts for a non-existing principal

See p. 338 above and Chapter 8.

Where the agent contracts on behalf of an undisclosed principal

Where the agent enters into a contract on the principal's behalf but fails to reveal to the third party that s/he is acting as an agent, the third party will deal with the agent as if s/he were the principal. The third party can elect to sue the agent or the principal. However, once s/he has elected who to sue, s/he cannot change his/her mind. Commencing a legal action against the agent is presumed to be election, but this presumption can be rebutted if the third party can show that s/he was not aware of the principal's existence when s/he started the action and s/he can then substitute the principal as defendant. Once a judgment has been obtained, it is then impossible for the third party to sue the principal, even if the judgment remains unsatisfied. In *Sika Contracts Ltd* v. *Gill & Closeglen Properties Ltd* (1978) 9 BLR 11 the plaintiff was able to enforce against Gill, a

chartered engineer, a contract that Gill had signed as an agent for the second defendants. He had not indicated that he was signing in a representative capacity and the court refused to imply this from the fact that his professional qualifications followed his name. In *Yukong Line Ltd of Korea* v. *Rendsburg Investments Corpn of Liberia* (No. 2) [1998] 1 WLR 294, the court refused to lift the corporate veil of a company and declare that the controller and director of the company was an undisclosed principal for the company at the moment of signing a charterparty or retrospectively because he transferred funds from the company to avoid a Mareva injunction.

The agent can sue or be sued but must defer to the principal if the principal intervenes to claim the benefit of the contract. The principal can intervene to claim the benefit of the contract only where the agent has acted within his/her actual authority except where s/he has denied the existence of the principal. The undisclosed principal cannot intervene where this is expressly or impliedly excluded in the agreement between the agent and the third party, or where the identity of the contracting party is crucial and where the principal's right to claim the benefit of the contract would force the third party into a contract to which s/he would otherwise not have agreed. In *Said* v. *Butt* [1920] 3 KB 497, the plaintiff wanted a ticket for a first night but, knowing the theatre owners would not sell him one personally, arranged for a friend to buy the ticket; he was refused entrance and sued. The court held that the mere device of using the name and services of his friend could not make the plaintiff a contractor of the theatre against their will. However, in *Dyster* v. *Randall & Sons* [1926] Ch 932, the defendants could not resist performance of a contract of sale of land where the plaintiff had asked a friend to purchase it for him knowing that the vendors would not sell to him; and in *Siu Yin Kwan* v. *Eastern Insurance Co. Ltd* [1994] 1 All ER 213, an undisclosed principal was able to sue on a contract of insurance made by his agent acting within his actual authority, since this was not a personal contract.

Liability for breach of warranty of authority

If the agent acts without or beyond his/her actual authority and the principal does not adopt the contract, the third party can sue the agent for breach of warranty of authority and recover damages. Liability of the agent is strict and it is no defence that s/he was unaware that s/he was acting without authority or beyond his/her authority: *Yonge* v. *Toynbee* [1910] 1 KB 215.

The Powers of Attorney Act 1971 provides that, where the donee of a power of attorney acts after the power has been revoked, s/he will not be liable to the donor or any other party if at the time s/he was unaware that the power of attorney had been revoked. The Act further provides that the third party can enforce any post-termination contract against the donor as long as s/he was unaware of the revocation of the power of the donee.

11.7 Termination of Agency

The agency relationship can be terminated by (i) mutual agreement; (ii) revocation of the agent's authority; (iii) custom; (iv) complete performance of the contract; (v) expiration of time; (vi) frustration; (vii) death or insanity of either party; (viii) bankruptcy of the principal; and (ix) revocation of the agent's authority.

Mutual agreement and revocation of authority

Either party to the contract may terminate the contract at will and without any notice except where the agency contract can be equated with a contract of employment, in which case reasonable notice must be given: *Parker* v. *Ibbetson* (1858) 4 CBNS 346. Where the agent has been engaged for a fixed period, then earlier revocation by the principal may constitute a breach of contract, entitling the agent to claim damages. The contract nevertheless remains terminated and specific performance is not available since the contract is one for personal services. Agents instructed to sell a house and so on for a fixed commission cannot prevent the principal deciding not to sell: *Luxor (Eastbourne) Ltd* v. *Cooper* (see p. 347 above).

The principal cannot revoke the authority once the agent has carried out, or is in the process of carrying, out his/her instructions. The principal cannot revoke if the authority of the agent is combined with an interest, as where the authority is given as a security for a debt from the principal to the agent. Such an agency is not terminated by bankruptcy, death or insanity of the principal. There are also restrictions in the case of an irrevocable power of attorney under the Powers of Attorney Act 1971, s.4, which is not terminated by bankruptcy, death or insanity of the donor. Also, under the Enduring Powers of Attorney Act 1985, s.1(1)(a), an enduring power of attorney is not revoked by the supervening mental incapacity of the donor.

Problems arise where the principal effectively terminates the relationship by closing down or merging the business where this occurs before the termination of a fixed term agreement entitling the agent to commission, remuneration or some other benefit. Generally, the agent will only be able to sue for damages for breach of contract under the terms of an express or implied term in the contract. In *Rhodes* v. *Forwood* [1874–80] All ER Rep 476, the agent was authorised to arrange for the sale of all coal dispatched by a colliery owner in Liverpool for seven years on a commission basis. The colliery business was sold before the end of the period and the agent failed in an action for damages for breach of contract. The court held that there should have been express provision if it had been absolutely intended for the contract to run for seven years. However, in *Turner* v. *Goldsmith* [1891] 1 QB 544, the plaintiff had a five-year contract as a salesman on commission which specified that he would sell 'any shirts or other goods manufactured or sold by' the defendant. The contract was not terminated when the defendant's factory was destroyed by fire, since it

extended beyond goods manufactured by the defendant and he was entitled to damages for lost commission.

In *Comet Group plc* v. *British Sky Broadcasting* [1991] TLR 211, Comet contracted with British Satellite Broadcasting to promote BSB's equipment until February 1991. This operated until BSB's merger with Sky Television in 1990, when it instructed Comet to suspend all further sales. Against Comet's claim for damages for repudiation, BSB claimed that the contract was a form of agency and the contract could not be held to imply that the principal would continue in business until its expiry. The court held that the contract differed from agency in a number of respects and awarded damages for breach of contract to the plaintiffs. See section 11.8 below.

Termination on death or insanity of the principal

Post-termination contracts are void and the agent is liable to the third party for damages for breach of warranty of authority. In *Yonge* v. *Toynbee* [1910] 1 KB 215, solicitors instructed to defend an action continued in ignorance of their client's insanity, and were liable to indemnify the other party for post-termination costs. Although the agent's actual authority may be terminated by the principal's insanity, his/her apparent authority may continue. In *Drew* v. *Nunn* (1879) 4 QBD 661, the apparent authority of a wife to pledge her husband's credit for necessaries continued during his temporary insanity, making him liable to the suppliers.

Termination of agency on the bankruptcy of the principal

The agent's authority is not terminated by his/her own bankruptcy, except where it disqualifies him/her from continuing, as in the case of company directors and licensed insolvency practitioners.

11.8 Commercial Agents

The Commercial Agents (Council Directive) Regulations 1993 (S.I. 1993/3053, as amended by S.I. 1993/3173), effective from 1 January 1994, have strengthened the position of a commercial agent, defined as 'a self-employed intermediary who has continuing authority to negotiate the sale or purchase of goods on behalf of another person (the principal), or to negotiate and conclude the sale or purchase of goods on behalf of and in the name of that principal': r.2(1). 'Self-employed' includes companies as well as individuals, while 'continuing authority' excludes agents appointed for a specified number of transactions. The Regulations do not apply to unpaid commercial agents: r.2(2)(a); commercial agents when they operate on commodity exchanges or in the commodity market: r.2(2)(b); and commercial agents whose activities as such are considered secondary according to criteria set out in the Schedule to the Regulations: r.2(3).

Certain agents known as 'canvassing' or 'introducing' agents and generally lacking the power to bind their principals could be within the regulations, but the DTI considers that the extra features of a *del credere* agency cause it to fall outside them.

A commercial agent must look after his/her principal's interests and act dutifully and in good faith: r.3(1); must make proper effects to negotiate and, where appropriate, conclude the transactions s/he is instructed to take care of; communicate to his/her principal all the necessary information available to him/her; and comply with his/her principal's reasonable instructions: r.3(2). The principal must act dutifully and in good faith: r.4(1); and (i) provide the agent with the necessary documentation relating to the goods; (ii) obtain the information necessary for the performance of the agency contract; and (iii) notify the agent within a reasonable period if s/he anticipates that the volume of transactions will be significantly lower than s/he could have expected: r.4.2(a) & (b). Ther principal must inform the agent within a reasonable period of his/her acceptance or refusal of, and any non-execution by him/her of, a commercial transaction which the agent has procured for him/her.

Failing agreement on remuneration, a commercial agent is entitled to that usually allowed to commercial agents for the goods where s/he carries on his/her activities and, if there is no customary practice, is entitled to reasonable remuneration: r.6(1). Regulations 7–12 apply only to cases where a commercial agent is remunerated (wholly or in part) by commission. S/h is entitled to commission on transactions concluded during the period covered by the contracts, which arises whenever the principal and the third party have entered into a contract and extends to sales by the principal in an area where the agent has exclusive right, or to persons within a group in respect of which the agent has exclusive rights: r.7. The agent may be entitled to commission on post-termination sales within a reasonable period resulting from his efforts; and on orders placed pre-termination but concluded afterwards: r.8. Regulation 9 apportions commission between a departing and an incoming agent. Commission should be paid as soon as one or more of the following occurs: (i) when the principal has accepted or delivered the goods; (ii) when the principal should have accepted or delivered the goods; (iii) when the third party accepts or delivers the goods; or (iv) when the third party pays for the goods: r.10 (1); and at the latest when the third party has executed his/her part of the transaction or should have done so if the principal had executed his/her part, as s/he should have done (r.10(2)), and not later than on the last day of the month following the quarter in which it became due: r.10(3).

Agreements derogating from (2) and (3) to the agent's detriment are void: r.10(4). The right to commission can be forfeited should any contract not be executed through no fault of the principal, and commission paid is recoverable: r.11. The principal must provide a commission statement with the main components in its calculation and, on request, allow access to information to check the commission due: r.12.

The agent and the principal are entitled to receive from the other on request a signed written document setting out the terms of the agency contract, including subsequently agreed terms: r.13(1). Where the contract is for an indeterminate period, either party may terminate it by notice: r.15(1). The minimum periods of notice are (a) one month for the first year; (b) two months for the second year commenced; and (c) three months for the third year commenced and for subsequent years, and may not agree to a shorter period: r.13(2). If longer periods are agreed, the period cannot be shorter for the principal than for the agent: r.13(3); and, unless otherwise agreed, the end of the period of notice must coincide with the end of the calendar month: r.13(4). Where a fixed period agency contract continues to be performed after that period, it is deemed converted to an indeterminate period contract: r.14; and the periods of notice under r.15(2) apply.

Rules allowing immediate termination because of the failure of one party to carry out all or part of his/her contractual obligations and where exceptional circumstances arise (frustration) are preserved: r.16. Otherwise, the agent is entitled to indemnity/compensation on termination; the parties can opt for indemnity or compensation but the agent is entitled to compensation in default of an election: r.17. The agent is entitled to an indemnity if and to the extent that (a) s/he has brought the principal new customers or has significantly increased the volume of business from existing customers and from which the principal continues to derive substantial benefits; and (b) the indemnity is equitable having regard to all the circumstances and, in particular, the commission lost by the commercial agent: r.17(3). Indemnity will not exceed one year's commission based on average annual remuneration over the preceding five years, or the average over a shorter period: r.17(4). The indemnity does not prevent the agent from seeking damages: r.17(5).

The agent is compensated for damage arising which shall be deemed to occur particularly when the termination: (a) deprives the agent of the commission which proper performance of the contract would have procured while providing his/her principal with substantial benefits linked to the agent's activities; and/or (b) has not enabled him/her to amortise costs and expenses incurred on the advice of his/her principal: r.17(7). Entitlement to indemnity or compensation arises where termination is by the death of the agent: r.17(8); but is lost where the principal is not notified within one year of the termination: r.17(9).

A restraint of trade clause in agents' contracts is valid for not more than two years after termination of the contract and only if (a) in writing; and (b) relating to the geographical area or the group of customers and the geographical area of the agent and the goods covered by his/her agency: r.20.

In *Page* v. *Combined Shipping and Trading Co. Ltd* [1997] 3 All ER 656, the plaintiff entered a contract in January 1995 to buy and sell commodities on the defendant's behalf in return for half the net profit, for a minimum period of four years. In June 1995, the defendant informed the

plaintiff that its South African parent had decided to cease trading. The plaintiff treated this as a repudiatory breach, terminated the contract, sued for loss of commission under r.17(6) and sought a Mareva injunction to restrain the defendant from removing assets to South Africa. The application was dismissed, on the grounds that since the defendant could have so operated the contract for the remaining period of time in such a way that the plaintiff would have made no money, the plaintiff had lost nothing by the premature termination and did not have an arguable case under r.17 to recover any significant compensation. The Court of Appeal allowed the plaintiff's appeal and granted the restraint injunction. The court stated that, as the 1993 regulations were enacted to protect and improve the position of commercial agents, it was arguable that the compensation payable to the agent under r.17 was based on the commission that he would have earned if the contract had continued to be performed in the proper manner and not the commission that he would have earned if the defendant had reduced the trading over the period to nil, thereby reducing his liability to the plaintiff.

Recommended Further Reading

An Outline of the Law of Agency, B. S. Markesinis and R. J. C. Munday, 3rd edn (Butterworths, 1992).

Fridman's Law of Agency, 7th edn (Butterworths, 1996).

Questions

1 A principal can only ratify acts by agents acting without or beyond their authority, subject to what conditions?

2 What are the conditions necessary to establish authority as an agent of necessity?

3 Distinguish between usual and estoppel authority.

4 What are the rights and duties of an agent in respect of the principal?

5 When an agent acts for an undisclosed principal, when can the principal intervene to claim the benefit of the agent's contract?

6 If an agent contracts for a principal after the cessation of his/her authority, what liability does s/he incur?

12 Contracts of Employment

Learning Objectives

After reading this chapter you will know about:

1. the ways in which the law distinguishes between employees and independent contractors, and the importance of the distinction
2. the terms implied into a contract of employment by the common law and by statute, including the right to equal pay and protection against discrimination on the grounds of race and sex
3. the law relating to unfair dismissal, including statutory and common law remedies
4. the protection of employees on the transfer of undertakings
5. the nature of fixed term and performance contracts

12.1 The Contract for Service and the Contract for Services

A contract for service gives rise to the relationship of employer and employee, whereas the contract for services is between an employer and a self-employed person, an independent contractor. The difference is crucial, since many rights and duties hinge on the distinction, both in common law and under statute.

The distinguishing criteria

The nineteenth-century test based on the control over the worker by the employer was replaced by one focusing on the control of work environment. Thus, in *Cassidy* v. *Ministry of Health* [1951] 2 KB 343, the defendants were liable for the negligence of medical staff despite the absence of control over the work. However, actual control is important where a machine and operator are hired or where a contractor's employees work in a factory occupied by another. Thus, in *Mersey Docks and Harbour Board* v. *Coggins and Griffiths (Liverpool) Ltd and McFarlane* [1947] AC 1, the defendants hired from the Harbour Board a crane and operator, who injured McFarlane. Although the hirers could direct the crane driver, he remained in the control of the Harbour Board, who were therefore vicariously liable. And in *Garrard* v. *Southey (A. E.) and Co. and STC Ltd* [1952] 2 EB 174, two employees of electrical contractors working in a factory were paid by the contractors who alone could dismiss them, but were supplied with materials, tools and plant by the factory's occupiers and supervised by their foreman. The factory occupiers owed a duty of care to them as employer and employee.

A more complex series of tests has evolved for distinguishing between employees and independent contractors. In *Market Investigations* v. *Minister of Social Security* [1969] 2 QB 173, the court identified significant factors including (i) the degree of control of the employer; (ii) the prospect of profit or risk of loss by the employee; (iii) whether the employee is regarded as part of the organisation; (iv) the source of materials and equipment used for the work; (v) the tax situation and the position with regard to national insurance contributions; (vi) the parties' own view of the relationship; and (vii) the traditional structure of the occupation.

In *Ready Mixed Concrete* v. *Minister of Pensions and National Insurance* [1968] 2 QB 497, which involved a dispute as to whether the company was liable for national insurance contributions for the team of 'owner-drivers' who the company claimed were self-employed, the drivers owned and maintained their own lorries, which were bought on hire-purchase from a Ready Mixed subsidiary, were painted in the company colours and could only be used for company work. The drivers could delegate the driving, but the company could insist on personal performance. The drivers had no fixed hours and fixed their own routes, but they had to be available when required and obey reasonable orders 'as if … an employee', and received a guaranteed wage and performance-related payments. The judge held this was not inconsistent with their being independent contractors. In *Ferguson* v. *John Dawson & Partners (Contractors)* [1976] 1 WLR 1213, the plaintiff was injured falling from a roof which was not protected by a guard rail. He was working 'on the lump', under which workers were paid a lump sum without deductions for tax and national insurance as if they were self-employed. In effect the plaintiff, an unskilled worker, was under the control of the site agent, tools were provided by the company and he was paid hourly. The Court of Appeal held that he was an employee, a main factor being that the plaintiff had no choice in respect of his status.

Where there is a choice and the worker decides to change status, the court will recognise it even though there is no change in the substance of the contract. In *Massey* v. *Crown Life Insurance Co.* [1978] 1 WLR 676, a branch manager requested a change of status to independent contractor because it was economically beneficial for him, but later, unsuccessfully, sought to establish his employee status for the purpose of a claim for unfair dismissal. However, in *Catamaran Cruisers Ltd* v. *Williams* (1994) IRLR 501, Williams, an employee, was asked by his employer to provide his services through a limited company which received a fee for them. The Employment Appeals Tribunal (EAT) upheld the tribunal's decision that Williams had remained an employee.

The position of casual workers

The situation is more complex for casual or quasi-casual workers, including home, seasonal and catering workers. In *Airfix Footwear* v. *Cope* [1978]

ICR 121, a homeworker worked for seven years assembling parts of shoes; equipment was provided by the company, she was paid on a piece-work basis and was responsible for her own tax and national insurance stamps. She claimed unfair dismissal and the company argued that no employer–employee relationship existed because there was no mutuality of obligation – an obligation to offer work and an obligation to accept it. This was regarded as a relevant factor by the EAT, although, here, the regularity of the relationship over the seven-year period established this mutual obligation.

This was crucial in *O'Kelly and Others* v. *Trusthouse Forte plc* [1983] IRLR 369. The company had a fluctuating need for banqueting staff and relied on casual workers, some of whom had priority status as 'regular casuals', and there was sufficient work to ensure full-time employment for the regulars. The plaintiffs were dismissed for trying to organise a union. The following factors indicated employee status: (i) the plaintiffs had no personal investment in the business; (ii) they were under the company's direct control; (iii) they were part and parcel of THF; (iv) they were furthering the business of THF; (v) their uniforms and equipment were supplied by THF; (vi) their work roster was fixed, and permission was required to take time off; (vii) they were governed by a disciplinary and grievance procedure; and (viii) they could benefit from a holiday pay or incentive bonus scheme based on past services. Against this, four factors indicated self-employed status: (i) they were not entitled to notice; (ii) they could refuse to work on a particular roster; (iii) THF had no obligation to provide work or pay them; and (iv) both sides believed they were independent contractors. The tribunal found they were independent contractors, the key factor being the lack of mutual obligation. The decision was upheld by the Court of Appeal.

The position of temporary workers

Under the Employment Agencies Act 1973, agencies are required to give temporary workers written statements of the terms and conditions of employment, to deduct tax and national insurance contributions from their pay, and to state whether they are employed by the agency or are self-employed. However, in *Wickens* v. *Champion Employment* [1984] ICR 365, the court held that temporary workers were not employees of the agency despite their contract being described as a contract of service, based on lack of control and of mutual obligation, the fact that each engagement was a separate contract, and that the workers were responsible for their own safety. In *Ironmonger* v. *Movefield Ltd t/a Deerings Appointments* [1988] IRLR 461 the Employment Appeal Tribunal held that the tribunal was in error in stating that, since an agency worker was not self-employed, s/he must be an employee. It is more than likely that the workers will not be employees and will not enjoy employment protection rights as such.

12.2 Vicarious Liability

While the person who actually commits a tortious act is always liable, in certain circumstances another person may also be liable even though s/he has not in fact been involved in the tortious act. In this case, the parties are liable as joint tortfeasors. An employer is vicariously liable for the tortious acts of employees within the scope of their employment, whereas s/he is only liable in exceptional circumstances for the torts of an independent contractor. Under the Employers' Liability (Compulsory Insurance) Act 1969, an employer must have insure cover against such vicarious liability.

The doctrine contradicts two major principles of liability in tort:namely that (i) a person should only be liable for loss or damage caused by his/her own acts or omissions; and that (ii) a person should only be liable when s/he was at fault. The doctrine is sometimes justified for employers, on the grounds that they appoint and control the employee.

The employer's liability is limited to the employee's acts within the scope of his employment. In *Limpus* v. *London General Omnibus Co.* (1862) 1 H&C 526, the employers were liable when their employee raced his bus against others contrary to their instructions, since it was in the course of his employment as a bus driver. In *Beard* v. *London General Omnibus Co*. [1900] 2 QB 530, they were not liable when the conductor drove the bus, since this was outside his employment. In *Twine* v. *Bean's Express Ltd* (1946) 175 LT 131, a driver employed by the defendants gave a lift to a third person who was killed because of the employee's negligent driving. The court held that the defendants were not liable, since the driver had gone beyond the scope of his employment. This decision was followed in *Conway* v. *Geo. Wimpey & Co.* [1951] 1 All ER 363. However, in *Rose* v. *Plenty and Another* [1976] 1 All ER 97, the employer was held vicariously liable for injuries caused to a young boy helping on a milk round in spite of the fact that there was a notice in the depot saying, 'Children must not in any circumstances be employed by you in the performance of your duties'. Lord Denning MR and Scarman LJ distinguished the previous cases on the grounds that the boy was on the float in connection with the delivery of the milk, which was within the scope of the driver's employment.

In *Warren* v. *Henleys* [1948] 2 All ER 935, the employer was not liable where a pump attendant at a petrol station punched a client, but in *Lloyd* v. *Grace, Smith & Co*. [1912] AC 176, a firm of solicitors were liable for their managing clerk's fraud, since he had acted in the course of his employment. Further, in *Williams* v. *Curzon Syndicate Ltd* (1919) 35 TLR 475, the employers of a night porter with a criminal record who stole the plaintiff's jewellery from a safe in the manager's office were liable for not exercising due care in engaging the porter. And in *Pettersson* v. *Royal Oak Hotel Ltd* [1948] NZLR 136, the employers of a barman were liable when, after a beer glass had been thrown at him by a drunken customer, he threw a piece of the broken glass back, injuring another customer in the process.

The test for employer's liability is 'whether a reasonable man would say either that the employee's act was part and parcel of his employment even though it was unauthorised and prohibited by the employer, in which case the employer was liable, or that it was so divergent from his employment as to be plainly alien to his employment, and wholly distinguishable from it, in which case the employer was not liable': *Harrison* v. *Michelin Tyre Co. Ltd* [1985] 1 All ER 918. The decision establishes liability where employees are larking about; in this case, the employers were liable when the plaintiff was injured when a duckboard on which he was standing was tilted by a handtruck pushed by another employee. In *Hudson* v. *Ridge Manufacturing Co. Ltd* [1957] 2 All ER 229, the employers were vicariously liable for injury caused by an employee tripping up another as a practical joke, since the man in question had a known reputation as a practical joker and the company had not dismissed him. In *Century Insurance Co. Ltd* v. *Northern Ireland Road Transport Board* [1942] 1 All ER 491, the employers of a driver of a petrol tanker were vicariously liable for the damage caused when the driver lit a cigarette and threw away the match while discharging petrol into the garage reservoir. See also *Jones* v. *Tower Boot Co. Ltd* [1997] 2 All ER 406 (see p. 375).

12.3 Continuity of Employment

The common law provisions relating to employees apply to all employees, but statutory employment protection regarding redundancy and unfair dismissal is restricted to employees who can establish a qualifying period of continuous employment. This was originally defined according to a number of qualifying weeks with the weeks counting only where a minimum of sixteen hours were worked. In *R* v. *Secretary of State for Employment ex parte Equal Opportunities Commission (EOC)* and *Mrs P. Day* [1994] IRLR 176 the House of Lords held that the insistence on a minimum of sixteen hours per week was contrary to EC law and discriminatory as regards part-time workers working less than sixteen hours per week (who were more likely to be women). The Employment Protection (Part-Time Employees) Regulations 1995 made entitlement to redundancy payment and/or compensation for unfair dismissal subject to continuous employment for a minimum of two years the only requirement. Retrospective claims may be brought from as far back as 8 April 1976, when the European Court of Justice ruled that Article 119 of the EC Treaty created enforceable individual rights.

In *Seymour-Smith and Perez* v. *Secretary of State for Employment* [1996] All ER 1, two women were unable to bring a complaint of unfair dismissal to an industrial tribunal because they had not been employed continuously for two years as required by a 1985 Order, which had increased the period from twelve months. They sought judicial review to quash the order, on the grounds that it discriminated against women. The Court of Appeal held that they could rely on the directive to challenge the validity

of the order, that the order was discriminatory, that it would be inappropriate to quash the order, but that they were entitled to declaratory relief. The House of Lords discharged the declaration for technical reasons but the validity of the 1985 order is not resolved; *R* v. *Secretary of State for Employment, ex parte Seymour-Smith and Another* [1997] 2 All ER 273.

The law relating to employees' rights is now largely contained in the Employment Rights Act 1996 and all statutory reference in this chapter will be to this Act unless otherwise stated.

12.4 Formation of the Contract of Employment

The contract of employment is not required to be in a particular form and it may be written, oral, implied from conduct or a combination of those forms. However, the employer must – with some exceptions – provide a written statement of particulars of employment within two months of the commencement of employment: s.1(1) & (2). The statement must contain particulars of: (a) the names of the employer and employee; (b) the date when the employment began; and (c) the date on which the employee's period of continuous employment began: s.1(3). The statement shall also contain particulars, as at a specified date not more than seven days before the statement is given, of: (a) the scale or rate of remuneration, or the method of calculating remuneration; (b) the intervals at which remuneration is paid (weekly, monthly, etc.); (c) any terms or conditions relating to hours of work, including normal working hours; (d) any terms and conditions relating to any of the following: (i) entitlement to holidays, including public holidays, and holiday pay; (ii) incapacity for work because of sickness or injury, including any provision for sick pay; and (iii) pensions and pension schemes; (e) the length of notice which the employee is required to give and entitled to receive to terminate his/her contract of employment; (f) the title of the job or a brief description of the work for which s/he is employed; (g) where the employment is not intended to be permanent, the period for which it is expected to continue or, if it is for a fixed term, the date when it is to end; (h) either the place of work or, where the employee is required or permitted to work at various places, an indication of that and of the address of the employer; (j) any collective agreements which directly affect the terms and conditions of the employment, including, where the employer is not a party, the persons by whom they were made; and (k) where the employee is required to work outside the UK for a period of more than one month – (i) the period for which s/he is to work; (ii) the currency in which remuneration is to be paid; (iii) any additional remuneration payable, and any benefits to be provided; and (iv) any terms and conditions relating to his/her return to the UK: s.1(4).

The statement must also include a note (a) specifying any disciplinary rules applicable to the employee or referring him/her to the provisions of a document specifying such rules which is reasonably accessible to the employee; (b) specifying (i) a person to whom s/he can apply if dissatisfied

with any disciplinary decision relating to him/her; and (ii) a person to whom the employee can apply for the purpose of seeking redress of any grievance relating to his/her employment, and the manner in which the application should be made; and (c) where there are further steps consequent on any such application, explaining those steps or referring to the provisions of a reasonably accessible document explaining them: s.3(1). This section does not apply to rules, disciplinary decisions or procedures relating to health and safety at work: s.3(2). The rules are relaxed if, on the date of the commencement of the employment, the relevant number of employees was less than twenty. If there is a change to any of the matters required to be included or referred to in the statement, the employer shall give the employee a written statement containing particulars of the change: s.4(1). The statement is to be given at the earliest possible opportunity and not later than (a) one month after the change in question; or (b) where the change results in the employee being required to work outside the UK for a period of more than one month, the time when s/he leaves the UK, if that is earlier: s.4(3).

Payment of wages

At or before the time of payment of wages or salary to him/her, an employee has the right to be given a written, itemised pay statement containing a statement of the gross wages, the amounts of any variable and fixed (subject to s.9) deductions and their purpose, the net amount of wages, and, where different parts of net amount are paid in different ways, the amount and method of each part-payment: s.8. Wages are defined broadly as any sums payable to the worker in connection with his/her employment, including any fee, bonus, commission, holiday pay or other emolument referable to his/her employment, whether payable under his/her contract or otherwise. The definition includes entitlement to statutory sick pay, maternity pay and so on.

Part II of the Act is concerned with the protection of wages. An employer is prohibited from making unauthorised deductions from wages: s.13. There is a right of employees not to have to make payments to the employer. There are restrictions on the extent to which employers in the retail trade can make deductions from wages in respect of cash shortages or stock deficiencies (s.18), determine wages by reference to shortages or deficiencies (s.19), and limit payments from the employee in respect of shortages and deficiencies (ss.20 & 21). The National Minimum Wage Act 1998 has introduced, with some exceptions, a standard national minimum wage.

Terms implied into a contract of employment by the common law

Duty to maintain mutual trust and confidence

Neither employer nor employee should act in a way to damage the mutual trust and confidence which ought to exist between them. This duty is

particularly important in connection with constructive dismissal, where the employee argues that s/he has been effectively dismissed because of a fundamental breach of a contractual term in the contract of employment by the employer (see p. 383). The duty owed by the employer to the employee is relatively recent, but increasingly important in its effect. It has been expressed as an obligation that the employer shall not 'without reasonable and proper cause, conduct itself in a manner calculated and likely to destroy or seriously damage the relationship of confidence and trust between employer and employee': (per *Browne-Wilkinson Woods* v. *WM Car Services (Peterborough) Ltd* [1981] ICR 666 at p. 670. Lord Slynn of Hadley recently noted in *Spring* v. *Guardian Assurance plc* [1994] 3 All ER 129 at p. 161 'the changes which have taken place in the employer/employee relationship, with far greater duties imposed on the employer than in the past … to care for the physical, financial and even psychological welfare of the employee.' This has culminated in *Malik* v. *Bank of Credit and Commerce International SA* [1997] 3 All ER 1, where two long-serving employees of the collapsed bank succeeded in obtaining 'stigma compensation' arising from the fact that they had been put at a disadvantage in the employment market. The House of Lords held that an employer was under an implied obligation not to conduct his/her business in a manner likely to destroy or seriously damage the relationship of confidence and trust between employer and employee. If it was reasonably foreseeable that this conduct would prejudicially effect the employee's future employment prospects and loss of that type was sustained, damages would be recoverable. The trust-destroying conduct did not need to be directed at the employee, nor did the employee have to be aware of the trust-destroying conduct while s/he was an employee.

Employees' duty to obey reasonable and lawful orders

The employee must obey the employer's reasonable and lawful orders. An order relating to tasks outside the employee's normal job description may depend on the status of the work, whether it is a temporary or permanent requirement, the company's financial position, and even the job market. An extension of this is a duty to co-operate with the employer. This can be seen particularly in cases of employees operating a work-to-rule as part of a dispute. In *Secretary of State* v. *ASLEF* (No. 2) [1972] 2 QB 455, the Court of Appeal found this a breach of an implied term of the employment contract, variously described as a duty not to wilfully obstruct the employer's business or not to obey instructions in a wholly unreasonable way, or a duty to promote the commercial interests of the employer. In a case involving a teacher, the court stressed the professional nature of the employment and that this sort of duty could be limited to such employees, *Sim* v. *Rotherham BC* [1987] Ch 216.

Fiduciary duties of employees

The general fiduciary duties arising under the contract of employment can be broken down to a number of more specific duties.

Duty not to compete In *Hivac Ltd* v. *Park Royal Scientific Instruments Ltd* [1946] Ch 169, a skilled employee was restricted from working, even in a spare-time capacity, for an employer's rival, (for company directors, see Chapter 8).

Duty of confidentiality An employee cannot use for his/her own benefit or communicate to others any confidential information that came to his/her knowledge during his/her employment. In *Faccenda Chicken Ltd* v. *Fowler* [1987] Ch 117, the court identified three categories of information acquired during the course of employment. The first category was so readily available that it was never confidential and could be freely communicated even during employment. A second category was confidential during employment but employees were entitled to use the information after leaving employment. The third category consisted of information of such a highly confidential nature that the employee could be restrained from using or communicating it even after his/her employment was terminated. In the case in question, the court held that information concerning clients of the past employer was within the second category and that the information could be used by an ex-employee unless protected by a valid restraint of trade clause. The defendant was dismissed for allegedly stealing chickens and, together with other ex-employees of the plaintiff, set up a rival operation using sales information – client list and requirements, delivery routes, times and pricing. In *A. G.* v. *Blake* [1998] 1 All ER 833, the Crown claimed breach of fiduciary duties when a previous member of the Secret Intelligence Service (SIS) published a book without Crown permission. The Court of Appeal held that the fiduciary duty and the duty of confidentiality only lasted as long as the relationship lasted, the information remained confidential, and that submitting the manuscript for publication without obtaining clearance was not in breach of fiduciary duty as the material was no longer secret or confidential. The court, however, granted an injunction restraining Blake from receiving further royalties.

An important exception relates to 'whistle-blowers' who reveal information in the public interest. In *Initial Services* v. *Putterill* [1968] 1 QB 396, a employee was not in breach of confidentiality in revealing that his employer was involved in an illegal price-fixing scheme; and in *Lion Laboratories* v. *Evans* [1985] QB 526 employers were refused an injunction when an ex-employee revealed that a breathalyser was inaccurate. This is now to be regulated by the Public Interest Disclosure Act 1998.

Duty not to make secret profits An employee is not allowed to make a secret profit from his/her employment by using the employer's name or equipment for his/her own purposes, or deriving a personal benefit from confidential information gained as an employee. Where the secret profit is innocent, the employer will be able to recover the profit from the employee but not dismiss him/her or refuse to pay remuneration.

However, where the secret profit is not innocent, as where the employee takes bribes from suppliers, the employer will be able to dismiss the employee (see Chapters 11 and 8).

Duty to disclose misconduct In *Sybron Corp.* v. *Rochem* [1985] Ch 299, it was established that a senior executive has a duty to report misconduct of other employees to the employer. In this case the employee was the European operations manager of an American company who was given a generous payment by the company on taking early retirement. It was later discovered that the employee, in conspiracy with other employees, had been defrauding the company for years by diverting business to a rival company set up for the purpose. The court held that his breach of duty to disclose the misconduct of the employees (which would have revealed his own complicity) entitled the employer to set aside the compensation payments (see Chapter 4).

Duty of care At common law the employer has a duty to: (i) take reasonable care for the safety of the employee; (ii) provide safe tools and equipment; (iii) provide a safe place of work and a safe system of work; and (iv) ensure that the employee has properly skilled co-employees. Employers are liable for injuries to employees caused by defective equipment, even where the defect is attributable wholly or partly to a third party; that is, the manufacturer of the equipment: Employers' Liability (Defective Equipment) Act 1969. The employer's failure to insure the employee does not give the employee a civil action against the employer for breach of statutory duty: *Richardson* v. *Pitt-Stanley and Others* [1995] 2 WLR 26. The employer's duty is now contained in the Health and Safety at Work Act 1974. This imposes a statutory obligation on the employer in respect not only of his/her employees but also of sub-contractors' employees: *R* v. *Swan Hunter Shipbuilders Ltd and Another* [1982] 1 All ER 204. The duty of employers is generally defined in s.2(1), and particular duties are spelt out in s.2(2), including the provision and maintenance of plant and systems of work that are safe and without risks to health; arrangements for ensuring safety and absence of risks in health in connection with the use, handling, storage and transport or articles and substances; the provision of such information, instruction, training and supervision as is necessary to ensure the health and safety at work of his/her employees; the maintenance of any place of work in a condition that is safe and without risks to health; and the provision and maintenance of a working environment that is without risks to health and adequate as regards facilities and arrangements for employees' welfare at work. In *R* v. *Gateway Foodmarkets Ltd* [1997] 3 All ER 78, the Court of Appeal held that s.2(1) imposed strict liability on an employer and that, in the case of a corporate employer, the company was liable unless all reasonable precautions had been taken by its servants and agents. The provisons of the Act are enforced by an inspectorate.

Terms implied into contracts of employment by statute

The right to equal pay

The right to equal pay in the Equal Pay Act 1970 came into force at the same time as the Sex Discrimination Act 1975 to avoid any negative effect on women's job prospects. The need for legislation arose from Britain's entry into the European Community, since art. 119 of the EC Treaty requires that 'men and women should receive equal pay for equal work'. The article has been subsequently amplified by the Equal Pay Directive 1975 and the Equal Treatment Directive 1976. The article was held to be directly effective in *Defrenne* v. *Sabena* (No. 2) [1978] 3 CMLR 312; thus individuals in the UK can claim rights under it, and any conflict between national law and Community law is resolved in favour of the latter. The Equal Treatment Directive was held to be directly applicable with 'vertical' effect in *Marshall* v. *Southampton & South West Hampshire Area Health Authority* [1986] QB 401, restricting enforcement against the state or an organ of the state, and not an individual or company.

The Equal Pay Act was drafted to apply to all terms of the contract of employment and not just pay, but excluded death or retirement benefits, which are also excluded from the Sex Discrimination Act 1975, on the basis that this was permitted under EC law. The European Court of Justice (ECJ), however, extended the equality protection through its interpretation of the word 'pay' in art. 119, reinforced by the definition of pay in the Equal Pay Directive as including 'all aspects and conditions of remuneration'. This has enabled it to be extended to travel concessions for retired employees: *Garland* v. *British Rail Engineering* [1983] 2 AC 751; access to occupational pension schemes: *Vroege* v. *NCIV Institut voor Volkshuisvesting BV* [1995] ICR 635; age of retirement: *Marshall* v. *Southampton & South West Hampshire Area Health Authority* [1986] QB 401; pension age, and pension benefits and statutory or contractual severance payments: *Barber* v. *Guardian Royal Exchange Assurance Group* [1991] 2 WLR 72. In the *Barber* case, the ECJ ruled that the direct effect of art.119 on entitlement to pensions may not be relied upon for entitlement arising prior to 17 May 1990 (the date of the decision) unless legal proceedings had already been initiated. This resolved the problem of retrospective claims which could otherwise have gone back to 1976 and the *Defrenne* decision, making art.119 directly effective. The latter has led to equal treatment for men and women under occupational pension schemes under the Pensions Act 1995. The change to a common retirement age of 65 is to be phased in between 2010 and 2020.

For occupational pension schemes, the problem of discrimination arises in respect of excluding access to part-time workers, since the greater percentage of part-time workers are women. The *Vroege* decision held that the *Barber* time limits did not apply, which means that part-timers have the potential right to make claims back to 1976. In the UK, there are a large number of such claims. The main issues relate to time-limit restrictions

under the Equal Pay Act 1970 (EPA) that (i) actions must be brought within the six-month limit of s.2(4) EPA 1970; and (ii) that claims cannot be brought for a period of employment more than two years before the claim: s.2(5). In a group of test cases for the public and private sector, the Industrial Tribunal, the EAT and the Court of Appeal have upheld the limits. In *Preston* v. *Wolverhampton Healthcare NHS Trust* [1998] 1 All ER 528, the House of Lords has referred questions to the European Court of Justice (ECJ) for a preliminary ruling on whether national limits on claims for discrimination in respect of occupational pension schemes as part-timers are themselves incompatible with Community Law. The issue of limiting claims to two years has already been found incompatible with Community Law in a case concerning an equivalent Northern Ireland provision: *Magorrian* v. *Eastern Health and Social Services Board* [1998] All ER (EC) 38.

A further area of indirect discrimination involving part-timers is the calculation of redundancy severance pay. In *Barry* v. *Midland Bank plc* [1998] 1 All ER 805, severance pay depended on the number of completed years of service, whether full-time or part-time, and the pay at the date of termination. The plaintiff was a part-timer when made redundant, but claimed that the award failed to reflect that eleven of her thirteen years of service had been as a full-time employee. The Court of Appeal held that the scheme was appropriate and reasonably necessary, that any indirect discrimination was objectively justified and due to a genuine material factor other than the difference of sex.

The House of Lords has sought a preliminary ruling on whether an award of compensation for unfair dismissal constitutes 'pay' within the meaning of art. 119: *R* v. *Secretary of State for Employment, ex parte Seymour-Smith and Another* [1997] 2 All ER 273.

The Equal Pay Act allows men and women to claim equal terms with an employee of the opposite sex employed by the same or an associated employer in respect of (i) like work; (ii) work rated as equivalent; and (iii) work of equal value. Where an equal pay claim succeeds, the woman's contract is deemed to include an equality clause which has the effect that any term of the contract that is less favourable is modified to become as favourable as the man's: s.1, EPA 1970.

'Like work' A woman is doing like work if it is 'of the same or a broadly similar nature' to that of a man. In *Capper Pass* v. *Lawton* [1977] QB 852, a woman cook in the directors' dining room preparing lunches for 10–20 people per day successfully claimed the same rate of pay as two male chefs working in the staff canteen preparing 350 meals a day in six sittings. In *Eaton* v. *Nuttall* [1977] 3 All ER 1131, the court considered that the greater responsibilities of a male production scheduler over a woman in the same job but dealing with items of less value justified a higher rate of pay.

'Equivalent work' This enables comparisons between totally different jobs, to overcome the problem that certain jobs will always be predom-

inantly 'male' or 'female'. Thus, if the jobs of the man and the woman have been rated as of equivalent value under a job evaluation study, then the woman is entitled to equal pay with the man: s.1(5), EPA 1970. This requires an analytical job evaluation study.

'Work of equal value' This was introduced under the Equal Pay (Amendment) Regulations 1983 as a result of an action by the EC Commission against the UK for non-implementation of the Equal Pay Directive 1975 because there was no means whereby a female employee could initiate a claim on the basis that her work, although dissimilar, was as valuable as a man's. In *Pickstone* v. *Freemans plc* [1989] 3 WLR 265, female warehouse operatives, who were paid the same as a man on the same job, claimed that their work was of equal value to that of a male warehouse checker. The employer argued that, since a man was employed on the same work at the same rate of pay, this was a covered by the 'like work' provision of the legislation and that, although the Equal Pay Act, s.1(2)(c) provided for equal pay for work of equal value, claims could not be brought under this section in respect of 'like work' or 'work rated equivalent'. This, if accepted, would have opened the doors to tokenism, where the presence of a single man employed with the women would rule out any claim under the equal value heading.

A claim in respect of work of equal value involves the appointment by the employment tribunal of an independent expert to investigate the claim. The women may only claim equal pay with a man in the 'same employment', which means employed by the same or any associated employee at the same establishment or at a different establishment which shares common terms and conditions for relevant categories of staff. The woman can choose whoever she wishes as comparator, and may even choose several. The Act seems to restrict claims to cases where men and women are employed at the same time, but the ECJ in *Macarthys Ltd* v. *Smith* [1980] 2 CMLR 205 has held that the principle of equal pay should not be limited by the requirement of contemporaneity, where a woman employed as a stockroom manager discovered that she was being paid less than her male predecessor.

Defences The employer has a defence where s/he can show that the difference is caused by a material factor other than sex – including length of service, merit, qualifications and so on. Other material factors have been claimed with partial success and the court has accepted arguments related to market forces, where differences are justified by the different routes of entry of employees, grading structures and collective bargaining, where the employees belonged to different unions. A further possibility relates to 'red-circling' where a (usually male) employee is moved to a lower-rated job because of ill-health or because the job has been regraded but is still paid at the higher rate. This defence will not apply when the higher pay is based on past discrimination. Other factors are geographical differences, with the justification of the 'London weighting': *NAAFI* v. *Varley* [1977] 1 WLR 149.

Until recently the fact that a claimant was a part-time worker justified worse terms. The Equal Opportunities Commission (EOC) has established in the House of Lords that the rule under which part-timers working between eight and sixteen hours a week must have worked more than five years before qualifying for employment rights such as unfair dismissal, redundancy and maternity leave – as opposed to two years for full-time workers – is discriminatory: *R* v. *Secretary of State for Employment, ex parte EOC* [1994] 2 WLR 409.

Arguments have been successful on the basis of the total package. In *Leverton* v. *Clwyd County Council* [1987] 1 WLR 65, the House of Lords held that there was a genuine material difference between the case of a nursery nurse and clerical staff since, although nursery nurse's salary was less than that of the clinical workers, she worked four and a half hours less per week and had fifty days extra holiday per year. This is difficult to reconcile with *Hayward* v. *Cammell Laird Shipbuilders* (No. 2) [1988] AC 894, where a canteen cook successfully claimed that her work was of equal value with that of three men employed by Cammell Laird: a painter, a thermal insulation engineer and a joiner, where, on the basis of the total package, the employer sought to argue that there was a genuine material difference between their jobs and hers, and that the plaintiff was £11 better off rather than £25 worse off, as claimed. The claim that the overall job package should be looked at as a whole was rejected by the House of Lords, which held that each separate part of the package was to be looked at individually and brought up to the best possible standard. This term-by-term approach has been endorsed by the ECJ in *Barber* v. *Guardian Royal Exchange Assurance Group* [1991] 2 WLR 72.

Statutory employment protection rights

These are in the Employment Rights Act 1996. They do not imply terms into the contract of employment, but exist parallel to and override any inconsistent contractual provisions. They are generally subject to a minimum qualifying period of employment. The Employment Rights (Disputes Resolution) Act 1998 aims to facilitate easier resolution of employment disputes. Industrial tribunals through which such rights were enforced are now renamed employment tribunals under the Act.

Maternity rights Women have (i) a right not to be dismissed on the grounds of pregnancy: s.99; (ii) a right to time off with pay for ante-natal care: ss.55–57; and (iii) a right to maternity leave and maternity pay and a right to return to work: ss.71–85. The right not to be dismissed on grounds of pregnancy is contained in the Pregnant Workers Directive (92/85/EC) adopted in October 1992. An employee shall be regarded as unfairly dismissed if (a) the reason – or principal reason – for the dismissal is that she is pregnant, or any other reason connected with her pregnancy; (b) her maternity leave period is ended by the dismissal, and the reason – or principal reason – is that she has given birth to a child or any other reason

connected with her having given birth; (c) her contract is terminated after the end of her maternity leave and the reason – or principal reason – is that she took … maternity leave; (d) the reason – or principal reason – for the dismissal is a relevant requirement or relevant recommendation under s.66 requiring her to be suspended from work under the terms of an enactment or provision or a code of practice under s.16 Health & Safety at Work Act 1974 on the ground that she is pregnant, has recently given birth or is breastfeeding; or (e) her maternity leave period is ended by dismissal, the reason – or principal reason – being that she is redundant and that s.77 has not been complied with (see redundancy below). There is no qualifying period, and women dismissed for pregnancy after a short period of service no longer have to bring their cases under the Sex Discrimination Act (SDA). This is still necessary where a woman's job application is rejected because she is pregnant. Bringing claims under the SDA necessarily involved a comparison between the positions of a woman and a man. The problem was resolved by the ECJ's decision in *Webb* v. *EMO Air Cargo* [1994] 3 WLR 941, which ruled there is no exception or derogation from the prohibition on the dismissal of pregnant women from the beginning of the pregnancy to the end of maternity leave, that there is no question of comparing the situation with that of a man, and that pregnancy is not in any way comparable to a pathological condition. Selection for redundancy on the grounds of pregnancy is also unfair: *Stockton-on-Tees BC* v. *Brown* [1988] 2 WLR 935.

There is no qualifying period for time off for ante-natal care under ss.55–57. The right relates to an employee who is pregnant, and who has, on the advice of a registered medical practitioner, midwife or health visitor, made an appointment to attend at any place for the purpose of receiving ante-natal care. This right is subject to the production on request of a certificate confirming the pregnancy and an appointment card, except for the first appointment: s.55. The employee is entitled to paid remuneration for the period of absence at the appropriate hourly rate: s.56. An employee may complain to an employment tribunal that her employer has unreasonably refused her time off, or has failed to pay the whole or any part of any amount to which the employee is entitled. The complaint must be made within the period of three months beginning with the date of the appointment, or such further period as the tribunal considers reasonable: s.57.

Under the Pregnant Workers Directive all women have the right to maternity leave. The Directive has been transposed into UK legislation in sections 71–78. This entitles the employee to the benefit of the terms and conditions of employment which would have been applicable to her if she had not been absent (and not been pregnant or given birth to a child): s.71(1). This includes pension scheme membership, use of a company car and the accrual of holiday entitlement, but no entitlement to remuneration: s.71(2). Instead, for so long as the woman has been in employment for twenty-six weeks, she receives statutory maternity pay (SMP) at the rate of 90 per cent of her normal earnings for six weeks and then maternity allowance, the equivalent of statutory sick pay, for the remaining period.

Employees whose service is too short to qualify for SMP receive a maternity allowance for the whole period. The commencement of the maternity leave is the earlier of (a) the date notified to the employer by the employee; or (b) the first day after the beginning of the sixth week before the expected week of childbirth on which she is absent wholly or partly because of the pregnancy: s.72(1). Failing that, her maternity leave commences with the date of birth: s.72(2). The period of maternity leave continues for a period of fourteen weeks from its commencement or until the birth of the child, if later: s.73(1).

At the end of the fourteen-week period, there is also the statutory right to return to work. For women who, at the beginning of the eleventh week before the expected week of childbirth have been employed continuously for not less than two years, the period of leave is extended by twenty-nine weeks after the beginning of the week in which childbirth occurs, giving them a right to up to fourty weeks maternity leave: s.79(1). The previous requirement of five years for part-time workers is discriminatory since the ruling in *R* v. *Secretary of State for Employment ex parte EOC* [1994] 2 WLR 409 and *Webb* v. *EMO Air Cargo* [1994] 3 WLR 941. Most of this extra period is unpaid, however, unless the employer enhances the statutory rights. The woman receives basic SMP, the equivalent of statutory sick pay and pension rights, for an extra four weeks, making eighteen weeks in total. Employers' maternity schemes may be more favourable and the employee may take advantage of whichever right is, in any particular respect, the more favourable: s.78. Some employers agree to pay more than the statutory amount subject to an agreement to return to work for a certain period after the birth.

An employee does not have the right to maternity leave under s.71 unless, at least twenty-one days before her maternity leave period commences, or as soon as is reasonably practicable, she informs her employer in writing of (a) her pregnancy, and (b) the expected date of childbirth, or, if childbirth has occurred, the date on which it occurred. The employee must, of requested by her employer, produce a certificate stating the expected week of childbirth: s.75. An employee who intends to return to work earlier than the end of her maternity leave must give at least seven days' notice of the date on which she intends to return. If she fails to give such notice, the employer can postpone her date of return to ensure that s/he has the requisite seven days' notice. An employer is not, however, entitled to postpone the return to work to a date after the end of the statutory maternity leave: s.76.

The right is to return to work with her employer, or her employer's successor, before the end of her maternity leave period in the job in which she was previously employed (a) on terms and conditions not less favourable than those which would have been applicable had she not been absent at any time since the commencement of her maternity leave period, (b) with her seniority, pension rights and similar rights as they would have been; and (c) otherwise on terms and conditions not less favourable than those which would have been applicable: s.79.

An employee does not have the right to return to work unless she has included with the information required under s.75, the information that she intends to exercise her right. The employer can, not earlier than twenty-one days before the end of the maternity leave, request that the employee should give him/her written confirmation that she intends to exercise her right, and the employee is not entitled to exercise that right unless she gives the confirmation within fourty days of receiving the request, or as soon as is reasonably practicable. Any request for confirmation must be in writing and accompanied by a statement of the effect of the section: s.80.

An employee shall exercise the right of return by giving written notice to the employer at least twenty-one days before the notified day of return. An employer may postpone the return by not more than four weeks if s/he notifies the employee before that day that for specified reasons s/he is postponing the employee's return until that date, and she will be entitled to work with the employer on that date. If an employee gives her employer, before the notified date of return (or the end of the period of twenty-nine weeks), a certificate from a doctor stating that because of disease or bodily or mental disablement she will be incapable of work on the notified day of return, the employee may (a) postpone her return to work for up to four weeks after the notified date of return (even if it falls beyond twenty-nine weeks from the date of childbirth); and, (b) where no date of return has been notified to the employer, extend the time so that she returns to work not more than four weeks after the end of the period of twenty-nine weeks: s.82.

Where the right of return is not practicable because of redundancy, the employee is entitled to be offered alternative employment, if any, under a new contract, which must be suitable and appropriate for the employee, and where the provisions in respect of the capacity and place in which she is to be employed and other terms and conditions of her employment, are not substantially less favourable to her that if she had returned to work under her right to return: s.81. If an employee with a right to return to work under s.79 has either her maternity leave period ended by dismissal, or she is dismissed after the end of her maternity leave period, in accordance with her contract rights, the rights under s.79 are exercisable only on the employee repaying any compensation for unfair dismissal or redundancy payment if the employer so requests: s.84. Where an employee has a right to return to work under s.79 and another right to return to work under a contract of employment or otherwise, she may not exercise the two rights separately, but may take advantage of whichever right is, in any particular respect, the more favourable: s.85.

A woman who gives notice of her intention to return but does not do so cannot be penalised. If the employee asks to return in a part time capacity, it would dangerous to dismiss her, since refusal to allow employees to work part-time could be indirect discrimination, because more women than men are part-time workers. There may be more changes in this area, since a case has been referred to the ECJ asking whether the anti-discrimination

laws give women the right to be paid during maternity leave, and the court will consider whether women on maternity leave have the right to be paid at the same rate as employees on sick leave. The signing-up by the Labour government to the EU Social Chapter paves the way for right to leave of absence for paternity.

Guarantee payments Where employees are laid off through no fault of their own, ss.28–34 provide that they are to receive a guaranteed minimum payment for the workless day(s). The qualifying period is one month, s.29(1), except that for an employee under a fixed-term contract of three months or less, or a contract made in contemplation of the performance of a specific task which is not expected to last for more than three months, the right only arises if s/he has been continuously employed for a period of more than three months: s.29(2). The right arises where the employee is laid off because of (a) a diminution in the employer's business for work of the kind which the employee is employed to do; or (b) any other occurrence affecting the normal working of the employer's business in relation to the kind of work which the employee is employed to do: s.28(1). An employee is not entitled to a guarantee payment in respect of a workless day if the failure to provide him/her with work occurs in consequence of a strike, lock out or other industrial action involving any employee of his/her employer or of an associated employer (another company within the group): s.29(3). The employee is not entitled to payment if his/her employer has offered to provide suitable alternative employment, and the employee has unreasonably refused the offer: s.19(4).

The guarantee payment is calculated in accordance with s.30. The guaranteed hourly rate is the amount of one week's pay divided by the number of normal working hours in a week. The amount is limited to a maximum of £14.50 per day, and the employee is restricted to claiming for no more than five days in a three-month period: s.31.

Right to remuneration where suspension is on medical grounds If a business is closed down under health and safety regulations, employees are still entitled to remuneration unless the employer has a contractual right to suspend them. The qualifying period is one month, but an employee has no rights to payment if s/he was unfit to work during the period of suspension. In addition, the employer has a defence where the employee unreasonably refuses alternative employment: Part VII, ss.64–65. The Act also provides for suspension of women on maternity grounds: namely, that she is pregnant, has recently given birth or is breastfeeding: ss.66–68. Calculation of the remuneration is in accordance with s.69 and there is a provision for complaint to an industrial tribunal where there has been a failure to make the payments: s.70.

Right to time off These rights in Part VI relate to (i) public duties: ss.50–51; (ii) redundant workers to seek new employment or make arrangements for training: ss.52–54; (iii) ante-natal care: ss.55–57 (see above); (iv) trustees of occupational pension schemes: ss.58–60; and (v) for employee representatives: ss.61–63.

Public Duties An employer must allow an employee who is a JP to take time off for the purpose of performing the duties of his/her office: s.50(1). The employer must also allow members of a local authority, a statutory tribunal, a police authority, a board of prison visitors or prison visiting committee, a relevant health body, a relevant education body or the Environment Agency time off for the purpose of attending meetings of the body or its committees and so on. There is no right to time off with pay, and the time must be reasonable.

Looking for work and arranging training An employee who has been given redundancy notice is entitled to be permitted to take reasonable time off for these purposes only if s/he has been employed continuously for two years or more: s.52. The employee has a right to remuneration at the appropriate hourly rate calculated in accordance with s.53. The fact that most employers no longer require redundant employees to work out their notice makes this right rather meaningless.

Occupational pension scheme trustees The right to time off relates to performing his/her duties as a trustee or undergoing training in connection with them. The time off must be reasonable and attracts the right to remuneration: s.59.

Employee representatives This relates to employee representatives for the purposes of Chapter II of Part IV of the Trade Union and Labour Relations (Consolidation) Act (TULRCA) 1992 (Redundancies) or Regulations 10 and 11 of the Transfer of Undertakings (Protection of Employment) Regulations 1981, or a candidate in an election to become an employee representative. The right is to reasonable time off to perform his/her functions and the time off is remunarated at the appropriate hourly rate.

In addition to these rights to time off, there is also a right regarding trade union duties and activities. There is no minimum service requirement but the right is restricted to officials and members of recognised trade unions. The time off can be with or without pay and the period is not specified but must be reasonable. The rights are now contained in TULRCA. Trade union officials are entitled to time off with pay to carry out their union duties and to receive training. But the duties and the training must be concerned with negotiations with the employer, related to issues which can be the subject of a trade dispute and related to matters in respect of which the employer recognises the union. Time off for training is similarly restricted: ss.168, 169, TULRCA.

Members of a trade union are entitled to unpaid time off for trade union activities, which covers activities such as acting as a union representative and being a member of the national executive or a representative at branch, area or regional meetings, or at the TUC annual conference: s.170, TULRCA. Time off to take part in industrial action is not covered.

Under the Health and Safety at Work Act 1974 (HSWA 1974), employees may have their own safety representatives, who can consult employers. However, under an amendment to the Act in 1975, only recognised trade unions have the right to appoint safety representatives.

Safety representatives are entitled to the necessary time off with pay to carry out their function or to receive training. This restriction to union representatives is of doubtful legality in view of the decision of the ECJ that the UK had failed to implement the 1975 Directive on Collective Dismissals and the 1977 Acquired Rights Directive by limiting the duty of employers in those cases to consult representatives of recognised trade unions rather than representatives of the workforce: *Commission of the EC* v. *UK* (1994) IRLR 392; and *Commission of the EC* v. *UK* (1994) IRLR 412.

Discrimination on the grounds of race or sex

Under the Sex Discrimination Act (SDA) 1975 and the Race Relations Act (RRA) 1976, it is unlawful to discriminate directly or indirectly on the grounds of sex or race. The Sex Discrimination Act also covers discrimination against married people on the grounds of their married status (SDA, s.1(3)), while the RRA prohibits discrimination on the grounds of 'colour, race, nationality and ethnic or national origin'. The terms 'race' and 'ethnic origin' are not immediately clear, and the latter has been the subject of litigation. The definition of ethnic origin approved by Lord Fraser provides: 'a group is identifiable in terms of its ethnic origins if it is a segment of the population distinguished from others by a sufficient combination of shared customs, beliefs, traditions and characteristics derived from a common or presumed common past, even if not drawn from what in biological terms is a common racial stock'. The definition encompasses Jews, Sikhs, English-speaking Welsh, and the Irish. Rastafarians have not been defined as forming such a group.

There are three types of discrimination which are unlawful under the Acts: direct, indirect and discrimination by way of victimisation. Unlawful discrimination can be committed at the point of hiring, during the course of employment, or at its termination. Complaints may be brought before an industrial tribunal which may award compensation and make recommendations to the employer to obviate the impact of the discriminatory act. The Equal Opportunities Commission (EOC) and the Commission for Racial Equality (CRE) have broad powers under the Acts.

Direct discrimination This involves treating a person less favourably than another on sexual or racial grounds. In *James* v. *Eastleigh Borough Council* [1980] 2 AC 751, the council was found guilty under the SDA where Mr James was not allowed free admission to the municipal swimming pool at the age of 61, whereas they allowed such access to his wife of the same age. The free admission was allowed on the basis of pensionable age and there was no intention to discriminate on the grounds of sex. The fact that this was found to be direct discrimination meant that damages were awardable even though the discrimination was not intentional, and ruled out the defence of justification, available for indirect discrimination. Discriminatory behaviour cannot be justified by compensation by the

employer. Thus, in *Ministry of Defence* v. *Jeremiah* [1980] QB 87, where an employer required only male employees to carry out particularly obnoxious work and paid them extra for doing so, it was still discriminatory, as was an agreement where women were permitted to leave a factory five minutes before men: *Peake* v. *Automotive Products* [1978] QB 233.

The Race Relations Act, s.1(2) also prohibits segregation on racial grounds, and an employer risks trouble where departments or shifts within the factory are divided on racial grounds, even though this is at the request of the employees.

Sexual or racial harassment are not mentioned in the legislation, but *Porcelli* v. *Strathclyde Regional Council* [1986] ICR 564 decided that sexual harassment was contrary to s.1(1) and 6(2)(b) of the SDA 1975. Sexual harassment includes unwelcome sexual attention; suggestions that sexual may further an employee's career (or that refusal might hinder it); insults or ridicule of a sexual nature; lewd, suggestive or over-familiar behaviour; and display or circulation of sexually suggestive material. A decision where an Irish employee was constantly exposed to Irish jokes and other taunts was based on harassment. An employer is vicariously liable for the discriminatory acts of his/her employees 'in the course of employment' under both Acts (s.41, SDA; s.32, RRA). The employer's defence would be to prove that s/he has taken all reasonable steps to prevent the discriminatory acts, in which case only the employee would be liable. In *Jones* v. *Tower Boot Co. Ltd* [1997] 2 All ER 406, Jones, a person of mixed race, resigned as a machine operator with the defendants because of extreme racial harassment from the other employees, including being called a 'baboon' and branded by a hot screwdriver. The EAT held that the acts were outside the term 'in the course of employment'. The Court of Appeal reversed the decision, holding that the words 'in the course of his employment' were to be given their natural everyday meaning and not construed restrictively by reference to principles of employer's vicarious liability.

For direct discrimination, the element of comparison with somebody of the opposite sex or from a different racial group is crucial. The problems in respect of sex discrimination and pregnancy have been discussed above (see p. 369).

Indirect discrimination Indirect discrimination is the uniform application of a condition or requirement where that requirement puts one sex or racial group at a disadvantage, and where the requirements cannot be justified on non-sexual or non-racial grounds. Thus (i) there must be a requirement or condition applied to all applicants or employees; (ii) the requirement or condition must be so that the proportion of women, married women or members of minority racial groups capable of complying with it is smaller than the comparator group; (iii) the condition must not be justifiable; and (iv) it must be detrimental to the complainant who is unable to comply with it.

In *Price* v. *Civil Service Commission* (No. 2) [1978] IRLR 3, a requirement that applicants for the post of executive officer should be between

the ages of seventeen and twenty-eight was discriminatory against women, since these were the ages between which many women were likely to be bringing up children. A requirement that a person should have an 'O' level in English Language has also been held to be discriminatory. A 'requirement or condition' does not cover recruitment criteria that are not an absolute bar to appointment. In *Meer* v. *Tower Hamlets LBC* [1988] IRLR 399, the expressed preference for a candidate who had previous experience working for a local authority was not indirect discrimination.

Problems arise in connection with establishing a comparator group, and the fact that the notion of what is a 'considerably smaller' proportion is not defined. In addition, even where a condition tending to rule out women or minorities is established, there is always the defence that it is justifiable, but the employer would have to show 'objectively justified' grounds to make out the defence, according to the ECJ in *Bilka-Kaufhaus* v. *Weber van Hartz* [1986] 2 CMLR 701.

Discrimination by victimisation The Act also protects people against victimisation by their employer for having made complaints of discrimination.

Exceptions There are certain exceptional situations whereby insistence on a particular sex or membership of a minority group can be justified as being a genuine occupational qualification. Under s.7, SDA, gender is an occupational qualification where physiological authenticity requires a man; to preserve decency and privacy; where the work is in a private home and requires close physical or social contact with the employer; where the job requires living in and there are facilities only for one sex; where the job is at an all-male institution; where the job involves provision of personal services to individuals promoting their welfare or education and the services can be best provided by a man; where the law prohibits the employment of a woman; where the job is in another country whose laws or customs preclude it being done by a woman; or where the job is one of two to be held by a married couple. In addition, the SDA makes provision for a number of occupations: police, prison officers, ministers of religion, midwives and mineworkers.

The equivalent provision in the Race Relations Act is s.5, which includes physical authenticity (actors), restaurants, and where personal services promoting welfare or education are being provided to members of a particular racial group and can most effectively be provided by someone of that same racial group. The RRA allows discrimination against seamen recruited outside the UK.

In *Harrods Ltd* v. *Remick* [1998] 1 All ER 52, H Ltd licensed particular departments where the licensee's goods were be sold. The licensee provided the sales force subject to H Ltd's approval and adherence to H Ltd's dress code. Two claimants had been dismissed, one for non-specified failure to adhere to the dress code and the other, an Asian, for wearing a nose ring. A third claimant failed to obtain a job with a licensee after H Ltd failed to approve of her. The Court of Appeal found H Ltd guilty under s.7,

RRA 1976. This relates to work done for a person (the principal) which is available for doing by individuals who are employed by another person, who supplies them under a contract made with the principal.

Remedies If discrimination is proved, the tribunal has power (a) to make an order declaring the rights of the parties; (b) to require the employer to pay compensation; and (c) to recommend the employer to take action within a specified period to obviate or reduce the adverse effect of the discrimination. Although levels of compensation have generally been low in the past, more realistic levels are now being awarded since the decision in *Marshall* v. *Southampton & SW Hants AHA* (No. 2) [1991] ICR 136. Recent awards where the armed forces required women to leave or to have abortions if they became pregnant have been very high.

If a contract is illegal, the courts will not generally enforce it or allow any statutory rights in respect of it. An exception is made for sex discrimination claims. In *Leighton* v. *Michael* [1995] *The Times*, 26 October, Leighton worked in a fish and chip shop where PAYE and national insurance were deducted from her wages. The shop was taken over by Michael, who stopped deducting tax in spite of Leighton's protests. Her claim for sexual harassment was dismissed on the grounds of the illegality of her contract. The EAT, however, said that neither statute nor public policy disqualified a person from the right not to be discriminated against sexually because their contract was illegal. This will also apply to race discrimination.

Discrimination in respect of sexual orientation

In *Smith* v. *Gardner Merchant Ltd* [1996] IRLR 342, the EAT held that the SDA 1975 did not protect homosexuals against discrimination on the grounds of their sexual orientation following the Court of Appeal decision in *R* v. *Ministry of Defence, ex parte Smith* [1996] 1 RLR 100. However, in another case involving dismissal from the navy on the grounds of sexual orientation, *R* v. *Secretary of State for Defence, ex parte Perkins* [1997] 3 CMLR 310, the court agreed to refere a question to the ECJ on whether Article 2(1) of the Equal Treatment Directive applied to homosexuals. In *P* v. *S and Cornwall CC (C-13/94)* [1996] 2 CMLR 247, the ECJ held that a transsexual dismissed after a sex change had been discriminated against. However, in *Grant* v. *South-West Trains Ltd* [1998] All ER (EC) 193, where the plaintiff had been refused travel concessions for a same-sex partner, the ECJ ruled that the company's regulations applied equally to male and female workers and were not discriminatory under art.119. The court also stated that stable relationships between two persons of the same sex were not regarded as equivalent to marriage or a stable relationship between two persons of the opposite sex.

Discrimination on the grounds of disability

The Disability Discrimination Act (DDA) 1995 protects 'a person who has a disability' (s.1(2)), or a person who has had such a disability (s.2).

A disability is a physical or a mental impairment, that has a substantial and long-term adverse effect on a person's ability to carry out normal day-to-day activities (s.1(1)).

There must be: (i) a 'physical or mental impairment'; and (ii) the impairment must adversely affect the ability to carry out normal day-to-day activities; and (iii) the adverse effect must be 'substantial'; and (iv) 'long-term'.

Impairment The term 'physical impairment' is not elaborated on, but 'mental impairment' is qualified in Schedule 1, para. 1(1). A person has a mental impairment if the illness is 'clinically well-recognised'. Schedule 1, para. 1(2) allows the Secretary of State power to include or exclude conditions covered by the term 'impairment', and 'psychopathic or anti-social disorders and addictions' such as 'kleptomania, pyromania, paedophilia and personality disorders' will be excluded. Whether drug and alcohol addictions will be excluded remains to be seen. In the first year, asthma falls within the Act and a health visitor, sacked after being off work with chronic fatigue syndrome (ME), won £16 000 in an out-of-court settlement.

Normal day-to-day activities There is a prescribed list in Schedule 1, para. 4: mobility, manual desterity, physical co-ordination; continence; ability to lift, carry or otherwise move everyday objects; speech, hearing or eyesight; memory or ability to learn or understand; the ability to concentrate; and the perception of risk or physical danger. The list is exhaustive, but its scope is extended because, if an impairment causes stress, fatigue or pain these effects will be taken into account in determining whether or not it produces a substantial effect on a person's ability to perform day-to-day activities.

Substantial The effect should be 'more than minor' and exclude 'trivial matters'. An HGV driver with rheumatoid arthritis who was sacked was told that his disability was not substantial enough.

Long-term effect The effect must have lasted for at least twelve months, or be expected to last either twelve months or for the rest of the individual's life (for terminally ill people with a reduced life-expectancy): Schedule 1, para. 2.

The Schedule extends protection to people with fluctuating conditions such as epilepsy (Schedule 1, para. 2(2). People with severe disfigurements are deemed to satisfy the condition regarding substantial adverse effect on day-to-day activities (Schedule 1, para. 3) provided the disfigurement is long-term or one that is likely to recur, for example, eczema. A person suffering from a progressive condition who, as a result, has (or has had) an impairment which has (or has had) an adverse effect on his/her ability to carry out a normal day-to-day activity, this effect will be deemed to be substantial, provided that the condition is likely to lead to such an impairment: Schedule 1, para. 8(1). This will cover people

suffering, for example, from multiple sclerosis, who may enjoy periods of remission.

The Act relates to discrimination in respect employment (Part II); in relation to goods, facilities and services (Part III); education (Part IV); and public transport (Part V); and establishes the National Disability Council (Part VI) to oversee its implementation and enforcement.

Discrimination in Employment (Part II)

Section 4 of the Act provides:

(1) It is unlawful for an employer to discriminate against a disabled person
  (a) in the arrangements s/he makes for the purpose of determining to whom s/he should offer employment;
  (b) in the terms on which s/he offers that person employment; or
  (c) by refusing to offer, or deliberately not offering a disabled person employment.

(2) It is unlawful for an employer to discriminate against a disabled person whom s/he employs
  (a) in the terms of employment which s/he affords the disabled person;
  (b) in the opportunities which s/he affords him/her for promotion, a transfer, training or receiving any other benefit;
  (c) by refusing to afford him/her, or deliberately not affording him/her, any such opportunity; or
  (d) by dismissing him/her, or subjecting him/her to any other detriment.

An employer discriminates against a disabled person if

(a) for a reason which relates to the disabled person's disability, the employer treats him/her less favourably than s/he treats or would treat others to whom that reason does not or would not apply; and
(b) the employer cannot show that the treatment in question is justified: (s.5(1)).

The employer also discriminates if:

(a) s/he fails to comply with a s.6 duty imposed on him/her in relation to the disabled person; and
(b) cannot show that his/her failure to comply with that duty is justified (s.5(2)).

A s.6 duty is to provide reasonable adjustments to the working environment as are required by the Act. An example is the case of a machinist with a club foot who was sacked after seventeen years when it became difficult for her to stand at her machine all day. She was awardede £2000 and ordered to be reinstated. The employers made adjustments and she was given a job allowing her to sit down.

Positive discrimination in favour of a disabled person is possible, and employers can lawfully advertise posts restricted to disabled people. It is only lawful to discriminate between one disabled person and another in the case of a charity whose specific goals are to benefit a particular disability: s.10. Once a complainant has shown that the reason for less favourable treatment is related to his or her disability, the employer can justify this by showing the reason for the treatment was both material to the circumstances of the particular case and substantial: s.5(3).

Health and safety grounds are a major justification against employing the disabled. The Health and Safety at Work Act 1974 imposes a duty on employers to provide safe fellow employees and a duty to third parties not to expose them to risk. Where there is a conflict between the DDA 1995 and other statutory provisions, the other provisions take precedence (s.59). The employer would have to show that, regardless of reasonable adjustments to the working environment, the disabled applicant would represent a risk.

The Act may apply to self-employed people as well as employees. Employees of the Crown are covered: ss.64 and 66. The Act also prohibits principals from discriminating in relation to contract work: s.12. A 'principal' is a person who contracts with another employer to provide him/her with contract workers.

Employers are legally responsible for any acts of discrimination carried out by their employees, whether or not this was done with their knowledge or approval (s.58) unless the employer has taken 'such steps as were reasonably practicable' to prevent such acts: s.58(5). Although not expressly covered by the Act, harassment can constitute less favourable treatment by analogy with the SDA 1975.

Exclusions

Employers with fewer than twenty employees are excluded: s.7, as is work performed wholly or mainly outside Britain: ss.4(6) and 68(2), and work on board a ship, aircraft or hovercraft: s.68(3). The provisions do not cover partnerships, which could affect professional disabled people and members of the police forces (including British Transport Police), armed services, prison officers and firefighters, are similarly excluded.

A government Code of Practice will contain practical guidance to eliminate discrimination and encouraging good practice.

The DDA also covers the issue of discriminatory employment advertisements: s.11. It is illegal to victimise a person who has sought to take proceedings under the Act – this applies to both non-disabled and disabled people. Persons who knowingly aid another in an action made unlawful by the Act are treated as if they had committed the discriminatory act: s.57. The Act also makes unlawful any discrimination against disabled people by 'trade organisations': s.13. This would include trade unions and organisations of employers and professional bodies such as the Bar Council, the Law Society and the British Medical Association.

Enforcement

A claim must be brought in an industrial tribunal within three months of the alleged discriminatory act: s.8, and Schedule 3, para. 3(1). The tribunal may hear a case outside the time limit if it is 'just and equitable to do so': Schedule 3, para. 3(2). Complainants must satisfy the tribunal that they have been unlawfully discriminated against. Employers wishing to justify unequal treatment must prove that their reason falls within s.5.

The tribunal may make such orders as it considers just and equitable: s.8. The orders will be similar to those available in cases of sex or race discrimination. Legal aid is not available at the time of writing. An unsuccessful claimant will not bear the legal expenses of the successful party unless s/he knew there was no substance and no chance of success. Appeals are to the EAT and the Court of Appeal. Legal aid may be available for the appeals. Around 100 cases a month are being filed with tribunals.

Unfair dismissal

The employer must prove that the dismissal was fair under one of the grounds in s.98, ERA 1996. These relate to (i) capability or qualifications of the employee; (ii) conduct; (iii) redundancy; (iv) that continued employment would be in breach of a statutory duty of the employee or the employer; and (v) some other substantial reason justifying dismissal.

The Act lists grounds that are automatically unfair: (i) pregnancy or any reason connected with pregnancy, including failure to offer an alternative employment: s.99; (ii) in connection with the carrying out of duties as a health and safety representative, or bringing to the employer's attention circumstances that the employee reasonably believed were harmful or potentially harmful to heath and safety: s.100; (iii) protected shopworkers and betting workers who refuse Sunday work: s.101; (iii) because of being trustee of an occupational pension scheme: s.102; (iv) because of being an employee representative: s.103; (v) because of assertion of relevant statutory rights: s.104; and (vi) redundancy where the circumstances apply equally to other employees who have not been made redundant: s.105.

In addition, the Trade Union and Labour Relations (Consolidation) Act 1992 (TULRCA) provides that dismissal is unfair (i) if the reason was that the employee (a) was, or proposed to become a member of an independent trade union, (b) had taken part, or proposed to take part in the activities of an independent trade union at an appropriate time, or (c) was not a member of any trade union, or of a particular trade union, or one of a number of particular trade unions, or has refused, or proposed to refuse, to become or remain a member: s.152; or (ii) if selection for redundancy related to union membership or activities. The provisions relating to qualifying period and upper age limit do not apply to the dismissal of an employee was union membership or activities: s.154.

Dismissal is also unfair in breach of the SDA, the RRA and the DDA.

An employee may challenge dismissal before an industrial tribunal. Dismissal includes (i) termination of a contract of employment by the employer with or without notice; (ii) refusal to renew a fixed-term contract; and (iii) termination of his/her contract by the employee because of the employer's conduct – 'constructive dismissal': s.95(1). An employee is also dismissed where the employer gives notice of dismissal and the employee, during the period of notice, gives notice terminating the contract at an earlier date for the reason for which the employer's notice was given: s.95(2). The effective date of the termination is according to rules laid down in s.97. An employee has right to a written statement of the reasons for dismissal: s.92.

Termination with or without notice There are cases where there is ambiguity as to whether an employee has been dismissed, and the essential test seems to be what the employer intended by the words used, and what a reasonable employee would have understood. If a person resigns in anger or because s/he is threatened with disciplinary proceedings, or fears that otherwise s/he will be dismissed, s/he may later try to establish that s/he has been dismissed. Employees may volunteer to be made redundant and then claim to have been dismissed.

It can be difficult to know whether a person has been dismissed or whether the contract has been terminated by some other mechanism not giving rise to a claim for unfair dismissal. Contracts may contain automatic termination clauses to cover situations where an employee seeks an extended period of leave abroad, where failure to return at the appointed time would be deemed to be resignation or termination. In *Igbo* v. *Johnson Matthey Chemicals* [1986] ICR 505, the Court of Appeal held that if the contract was terminated it would constitute a dismissal.

Contracts can be terminated by frustration which is not dismissal: see *Poussard* v. *Spiers & Pond* (1876) 1 QBD 410. Incapacity through illness is the main source of claims. The criteria for determining when the incapacity frustrates a contract were laid down in *Egg Stores (Stamford Hill)* v. *Leibovici* [1977] ICR 260, and include (i) the length of the employment; (ii) the expected duration of the employment; (iii) the nature of the job; (iv) the nature, length and effect of the disabling event; (v) the need for a replacement; (vi) whether wages have continued to be paid; (vii) the acts and statements of the employer; and (viii) whether, in all circumstances, a reasonable employer could be expected to wait any longer before permanently replacing the employee. The Court of Appeal endorsed this approach in *Notcutt* v. *Universal Equipment Co. (London)* [1986] ICR 414.

Frustration may arise from the employee's imprisonment, although the employer may claim it as a self-induced breach of contract leading to a claim of unfair dismissal. In *Hare* v. *Murphy Brothers* [1974] 3 All ER 940, a foreman was sentenced to twelve months' imprisonment for assault, and the prison sentence was held to have frustrated his contract. In *Shepherd (FC) & Co. Ltd* v. *Jerrom* [1985] IRLR 275, a prison sentence of between six months and two years frustrated an apprenticeship contract of four years.

Where an employer dies, goes into voluntary or compulsory liquidation or, in the case of a partnership, is dissolved, an employee is treated as having been dismissed and is entitled to redundancy payments if the business is not continued under a new owner or his/her contract is not continued. For the position with regard to the appointment of an administrator of a company or a partnership or an administrative receiver for a company, see Chapter 19.

Refusal to renew a fixed-term contract A fixed-term contract must have a defined beginning and end, with the date known at the outset. Where no termination date is specified, it may be a contract for a particular purpose and not protected. A fixed-term contract may include a term providing for termination by either party giving notice: *Dixon* v. *BBC* [1979] QB 546 (see p. 392).

Constructive dismissal Claims often arise from the employer exercising a power to vary the contract. In *White* v. *Reflecting Roadstuds Ltd* (1991) IRLR 323, White's contract provided that 'the company reserves the rights … to transfer employees to alternative work, and it is a condition of the contract that they are willing to do so when requested'. White's attendance suffered since he found his current employment too physically demanding. After a warning, he was transferred, and claimed this was constructive dismissal. The EAT found the transfer was in accordance with the flexibility clause, which permitted transfer to work at lower rates of pay. The use of the clause did not have to be reasonable but could only be used on grounds of operational efficiency.

If the variation term is vague or ambiguous, the court or tribunal can assess the reasonableness of the employer's action and, initially, were initially prepared to treat a failure to follow good employment practices as constituting constructive dismissal. The Court of Appeal rejected this approach in *Western Excavating (EEC)* v. *Sharp* [1978] QB 761, and indicated that unreasonable conduct which did not constitute a breach of the contract would not justify a claim of constructive dismissal. This made it virtually impossible to base a constructive dismissal claim on the employer's unreasonable use of a contractual power. Thus in *Rank Xerox Ltd* v. *Churchill* (1988) IRLR 280, the EAT held that the employer was not in breach by requiring a clerical worker to relocate from central London to Marlow, however unreasonable that might be, since the contract provided that 'the company may require you to transfer to another location'. A sign of a change was seen in *United Bank Ltd* v. *Akhtar* (1989) IRLR 505, where a mobility clause gave the bank power to transfer Akhtar, temporarily or permanently, elsewhere in the UK. On Monday 2 June he was informed that on the following Monday he would no longer be based in Leeds but in Birmingham, and was notified of this in writing on 5 June. He requested twenty-four days to sort out his affairs but received no reply, and his pay was stopped from 5 June. The EAT held the employer was in breach of contract despite the clear mobility provision.

The EAT had taken into consideration the implied term of mutual trust and confidence. This mutual duty is virtually impossible to describe, and cases serve only to illustrate when the term has been broken. In *UB (Ross) Youngs Ltd* v. *Elsworthy* (1993) IDS Brief 498, the contract contained a term that shift-working employees could be transferred to other shifts after consultation and two weeks' notice. Shifts were reorganised and a husband and wife, who had been on the same shift, were placed on different shifts. Mrs Elsworthy complained but, as no solution was found, she then resigned. The court held that this was constructive dismissal. The management had not considered her domestic situation and failed to convince the court that their needs could not have been met without putting the Elsworthys on separate shifts. There was breach of mutual trust and confidence. In *Greenaway Harrison Ltd* v. *Wiles* (1994) IRLR 380, the employer wished to change the hours of telephonists, and women with children, who claimed that they would find the new shifts difficult, were told that they would be dismissed if they failed to agree to the new terms. The court held that, in the absence of real consultation, although the employer had a legal right to terminate the contract without notice, the threat amounted to constructive dismissal and was unfair.

Failure to allow a woman to return to work at the end of maternity leave will constitute dismissal from the date on which she should have been allowed to return and she will be considered to have been employed up to that date: s.96.

Remedies for unfair dismissal A complaint may be presented to an industrial tribunal against an employer by any person claiming that s/he was unfairly dismissed: s.111. If an employee has been found to have been unfairly dismissed, the tribunal has a first duty to explain the remedies of reinstatement and re-engagement under s.113. And, if the complainant expresses such a wish, the tribunal may make an order under the section. In respect of reinstatement, employees return to the employer in their old job as if they had never been dismissed: s.114. Re-engagement means that they will be taken back by the employer in a new job, or in the old job but at a different location, or even by a different company within the group. Employees should enjoy the same advantages as if there had been no interruption in service: s.115. Employers can be ordered to take back an employee, but in practice this remedy is only awarded in about 1 per cent of all cases. If an order is made under s.113, but the terms of the order are not fully complied with, the tribunal can award compensation to the employee as it thinks fit, subject to the the limit in s.124. If the order is made but the employee is not reinstated or re-engaged, the tribul must make an award of compensation calculated in accordance with ss.118–127, and an additional award of compensation of the appropriate amount. This additional award is to be not less than twenty-six nor more than fifty-two weeks' pay where the dismissal is illegal discrimination under the SDA or the RRA, and in any other case not less than thirteen nor more than twenty-six weeks' pay.

The alternative and more usual remedy is compensation. The compensation will be made up of (i) a basic award calculated following an arithmetical formula according to the number of years' service in much the same way as redundancy payment; and (ii) a compensatory award of such an amount as the tribunal considers just and equitable having regard to the loss suffered by the employee, and calculated in accordance with s.123, but subject to a limit of £11 300. There is also the possibility of a special award. This is one week's pay multiplied by 104, or £13 775, whichever is the greater, but subject to a limit of £27 500 except where the award is made under s.117 when, unless the employer can satisfy the tribunal that it was not practicable to comply with the reinstatement or re-engagement order, the award shall be increased to one week's pay multiplied by 156, or £20 600, whichever is the greater. Although there is a potential of high awards for unfair dismissal, most awards made are low, which causes dissatisfaction with the remedy.

Statutory claim Employees must establish that they have been employed continuously for a period of two years (see previous discussion on whether this period is discriminatory), and an action must be brought to the tribunal within three months of the effective date of the termination. The legislation, however, excludes claims in respect of (i) employees past normal retiring age: s.109; (ii) persons on strike; and (iii) spouse(s) of the owner(s) of the business.

Common law action for wrongful dismissal Employees can always bring an action for wrongful dismissal at common law and claim damages. The problem here is that, since contracts of employment – apart from fixed-term contracts – always allow the employer to terminate the employment by giving the employee adequate notice, the courts have limited damages to the net wages during the notice period.

Breach of employment contract jurisdiction was given to industrial tribunals by the Industrial Tribunals Extension of Jurisdiction (England and Wales) Regulations 1994. This Order now has to be read in conjunction with the Industrial Tribunals Act (ITA) 1996. Jurisdiction is concurrent with the county court. The tribunal can hear claims for a breach of the employment contract or any other contract connected with employment; claims for sums due under such a contract, or claims for recovery of such sums in pursuance of any enactment relating to the terms of performance of such a contract: s.3(2) ITA 1996. As well as claims for damages for personal injuries, other claims excluded from the tribunal jurisdiction are those for breach of a term: (i) requiring the employer to provide living accommodation for the employee, or imposing an obligation on the employer or employee in connection with the provision of accommodation; (ii) relating to intellectual property; (iii) imposing an obligation of confidence; and (iv) which is a covenant in restraint of trade.

There are three requirements before the claim can be heard by the tribunal: (i) the contract must have terminated; (ii) the claim must be made

within three months of termination, or within three months of the last day of employment, subject to extension; and (iii) the claim must either arise out of the termination or still be outstanding at termination and must not have been settled by the time of application.

Employers cannot initiate claims but may bring any counterclaim or set-off once a claim has been initiated by the employee. Counterclaims must be brought within six weeks of the employer receiving a copy of the originating application, subject to extension. The limit for damages is fixed at the time of writing at £25 000. There is no qualification period in relation to claims, nor any minimum hours of service, and claims can be brought by any ex-employee.

Claims are likely to be brought in respect of failure to pay wages in lieu of notice, especially by employees with less than two years' service. There are also likely to be claims for failure to follow a contractual procedure relating to redundancy, dismissal and other procedures that are frequently incorporated into the contract of employment. This will allow employees with less than two years' continuity of employment to claim for unfair dismissal for failure to comply with the contractual procedure, whereas they would not qualify for a statutory claim. It would be possible for employees with two years' continuity of employment to bring statutory and common claims which, adding both claims together, will enable a maximum compensation of £36 000.

Damages for breach of a contract of employment Contract damages are intended to put a person in the position s/he would have been in had the contract been properly performed, and employees will be entitled to the loss that they have suffered through the contract being wrongly terminated – usually the value of their remuneration package for the time it would have taken to terminate the contract properly (see 'Notice' below).

Compensation is limited to contractual entitlement. In *Powell* v. *Braun* [1954] 1 All ER 484, Powell was given an increased annual bonus instead of a wage increase. The court held that, although previously discretionary, by being given in place of a wage increase it had become contractual. It is also important to distinguish between general and individual discretionary benefits. General discretionary benefits (such as the provision of a canteen providing free or subsidised food) are compensatable; in contrast, individual discretionary benefits which the employee has not taken up (such as cheap loans) can be withdrawn. Contractual rights to bonuses, commission and profit-sharing are often based on being in employment on a particular date, and the employee will be entitled to compensation for their loss. There is no claim for discretionary bonuses and expected wage increase. Loss of share option rights in the contract of employment will also be compensatable: *Chapman and Elkins* v. *CPS Computer Group* (1987) IRLIB 336. If share option right is contained in a separate contract, it may exclude the right to claim on termination of the employment contract.

Apart from wages, damages are likely to include profit share, lost commission, pension, cars, medical and other insurance, any cheap loan or mortgage subsidy or educational benefit taken up by the employee, and free or reduced cost goods and services and expenses which do not have to be accounted for and so need not be incurred. Payments by third parties are also included, such as tips to a waiter: *Manubens* v. *Leon* [1919] 2 KB 128.

The refusal of damages for (i) injured feelings; or (ii) because the dismissal makes finding new employment more difficult is based on *Addis* v. *Gramophone Co. Ltd* [1909] AC 488. As regards injured feelings, it was thought that the decision in *Cox* v. *Philips Industries Ltd* [1976] 3 All ER 161, where damages were awarded for the plaintiff's emotional distress when he was demoted, would lead to a change in the law, but in *Bliss* v. *South East Thames Regional Health Authority* [1987] ICR 700 the court followed the earlier case in rejecting a claim in respect of illness said to have been the result of the dismissal. In respect of 'stigma compensation', the House of Lords has recognised that damages may be awarded where the actions of the employer reduce the employment prospects of the employee and that in appropriate cases damages could be awarded for loss of reputation caused by breach of contract, and that financial loss in respect of damage to reputation caused by a breach of a contract of employment could be recovered: *Malik* v. *Band of Credit and Commerce International SA* [1997] 3 All ER 1 (see above, p. 362). Damages are not reduced for contribution as in unfair dismissal but the employer can counterclaim or set-off money due against the damages awarded. The employee is under a duty to mitigate his/her loss by seeking new employment. However, employees can first of all look for a better job before lowering their sights to a job with inferior pay. Thus, in *Yetton* v. *Eastwoods Froy Ltd* [1967] 1 WLR 104, a managing director did not breach his duty to mitigate his loss by refusing a contract as an assistant managing director.

Employees must also bring into account any monies or benefits received as a result of their unemployment, but this does not include any benefits from any insurance to which they have contributed for income and mortgage protection. In *Hopkins* v. *Norcross plc* (1994) IRLR 18, the court treated a right to an immediate pension as analogous to insurance even if non-contributory, since the employee had 'earned' the right to the pension by his work, and damages were not reduced by receipt of an occupational pension.

Unemployment benefit is deducted, as is supplementary benefit, although the position here is unclear. Thus, in *Hilton International Hotels (UK) Ltd* v. *Faraji* (1994) IRLR 264, Faraji began to suffer depression after being unfairly dismissed and being unemployed. During this period he received invalidity benefit. Hilton International claimed that he should not receive compensation for that period, since he was not available for work and was not losing income. The EAT said it was necessary to look at the cause of unemployment and see if the depression followed from that, and the tribunal was entitled to conclude that it did. If the dismissal is for

redundancy, the redundancy pay will only be deducted where the employee has taken the redundancy pay as part of the compensation for loss of employment. In *Baldwin* v. *British Coal* (1994) IRLB 501, Baldwin accepted shorter notice to take advantage of a redundancy offer and it was held that he could not claim compensation for reduced notice and, even if he could, the court would have taken the redundancy payment into account.

National insurance contributions which the employee will not pay while unemployed are deducted. Tax is not due on the first £30 000 of damages but, to prevent the employee being in a better position than would otherwise be the case, the £30 000 is assessed net of tax. The main beneficiaries of this type of claim are employees under long-term fixed term contracts which make no provision for termination by notice. Thus, in *Shove* v. *Downs Surgical plc* [1984] 1 All ER 7, the plaintiff was dismissed as chairman and managing director of the company when he had thirty months still to run on his contract. He calculated his losses, including loss of salary, loss of company car and loss of company health and pension scheme, at £60 729, but the court awarded him £83 477, to take into consideration that he would have to pay tax on the damages award above £30 000. This was to ensure that he eventually received the amount he had claimed after paying the tax. However, the court refused to consider damages for the plaintiff's distress.

Redundancy

The provisions relating to statutory redundancy payments is in Part XI, ERA 1996. An employer shall pay a redundancy payment to an employee who is (a) dismissed by reason of redundancy; or (b) is eligibile by reason of being laid off or kept on short time: s.135 (1). Dismissal has the same meaning as in relation to unfair dismissal. An employee is eligible by reason of lay-off or short-time if this continued for four or more consecutive weeks, or for a series of six or more weeks (of which not more than three were consecutive) within a period of thirteen weeks. An employee must have been in continuous employment for two years prior to the redundancy: s.155. There is no right to redundancy payment for an employee who has reached the normal retiring age in the business or the age of sixty-five: s.156. The payments must be of at least the statutory minimum. These are:

(i) for each year of employment at age 41 or over but under 65, one-and-a-half weeks' pay;
(ii) for every year of employment at age 22 or over but under 41, one week's pay; and
(iii) for each year of employment at age 18 or over but under 22, half a week's pay.

There is a maximum sum per week, which changes regularly, and a maximum number of years of service which count, twenty years at the time of writing: s.162.

The EC Collective Dismissals Directive (EC/75/129) made it an obligation for employers to consult trade unions over proposed mass redundancies. The law is now contained in Trade Union and Labour Relations (Consolidation) Act 1992 (TULRCA). Where an employer is proposing to dismiss as redundant twenty or more employees at one establishment within a period of ninety days or less, the employer shall consult about the dismissals all the persons who are appropriate representatives of any of the employees who may be so dismissed: s.188(1), TULRCA 1992. Where the exployer is proposing to dismiss 100 or more employees, the consultation must commence at least ninety days before the first dismissals take effect; in other cases the requirement is at least thirty days: s.188(1A). For the purposes of this action, the appropriate representatives are (a) employee representatives elected by them; or (b) if an independent trade union is recognised by the employer, representatives of the trade union: s.188(1B). Failure to consult entitles a complaint to be taken to an industrial tribunal: s.189. There is also an obligation for the employer to notify the Secretary of State at the same time as the consultations commence: s.193.

Transfers of undertakings

The sale of a business has redundancy implications where the purchaser requires fewer employees. However, even where the employees are retained, their existing contracts will be terminated and replaced by a new one, and cessation of employment falls within the definition of redundancy.

The position of such employees was specially covered by the EPCA, s.94 and Schedule 13, para. 17, but is now covered by the Transfer of Undertakings (Protection of Employment) Regulations 1981, which implement the Acquired Rights Directive (EC/77/187) passed to protect the position of the employees of a business that has been transferred. The regulations do not cover a take-over effected by a transfer of shares, since the identity of the employer remains the same because the company is a separate legal person from the shareholders. Since this is the most usual type of transfer in the UK, the value of the regulations is thereby weakened.

Under the Transfer of Undertakings Regulations (TUR), contracts of employment are transferred to the new employer. TUR was amended by Trade Union Reform and Employment Rights Act 1993 (TURER) after threats by the Commission of infringement proceedings. The definition of 'undertaking' has been extended to cover non-commercial ventures, in accordance with *Dr Sophie Redmond Stichting* v. *Bartol* [1992] IRLR 366. The definition in reg. 3 of transfer of an undertaking, or part of one, now (a) may be effected by a series of two or more transactions; and (b) may take place whether or not any property is transferred to the transferee by the transferor. In the *Sophie Redmond* case, the directive applied even though there was no actual transfer of property – the foundation's grant was withdrawn and given to another organisation which

took over its premises, clients and work and offered employment to some of its employees.

Regulation 5 originally provided for the automatic transfer of contracts of employment to the new employer without the employee's consent, contrary to *Nokes* v. *Doncaster Amalgamated Collieries* [1940] AC 1014. This was rectified by subpara. 4A, 4B and 5. Under 4A, automatic transfer does not occur where the employee 'informs the transferor or the transferee that he objects to becoming employed by the transferee', however, subpara. 4B removes the possibility of action against the transferor. The employee is only entitled to claim redundancy pay from the transferor under subpara. 5 where a substantial change is made in his/her working conditions to his/her detriment.

Regulation 5(2) provides for the transfer of the transferor's 'rights, powers, duties and liabilities under or in connection with any such contract'. This will cover breach of contract claims, statutory duties such as breach of the Wages Act 1986, maternity rights, equal pay, unfair dismissal and redundancy discrimination claims, and perhaps even protective awards. It will also cover claims for injuries at work. In *Secretary of State for Employment* v. *Spence* [1986] ICR 651, Balcombe LJ said that 'in connection with' covered not only statutory but also tortious liability. This has been acted upon by a county court, which held that the same wording in the National Heath Service and Community Care Act 1990 meant that, if an employee sustained injuries caused by negligence while employed by the transferring employer, liability effectively transferred to the acquiring employer: *Wilson and Others* v. *West Cumbria Health Care NHS Trust* (1994) IRLR 506.

TUR only applies to a person 'employed immediately before the transfer'. To prevent the transferor making the employees redundant in collusion with the transferee just before the transfer, there is a provision that the employee shall be treated as being unfairly dismissed if the transfer or a reason connected with it is the reason, or the principal reason, for his/her dismissal (reg. 8.(1)), except with regard to an 'economic, technical or organisational reason entailing changes in the workforce'. In *Litster* v. *Forth Dry Dock and Engineering Co. Ltd* [1989] IRLR 161, FDDE was in receivership and its business was to be taken over by a company set up for the purpose. The transferee did not want to take over the workforce of FDDE and, by an agreement between the transferor and the transferee, the employees were made redundant an hour before the transfer. In this case, the dismissal was clearly linked to the transfer and there was collusion between the transferor and transferee. In *Secretary of State for Employment* v. *Spence* [1986] ICR 651, however, the dismissals of employees at 11 a.m. before the successful completion of the sale of the undertaking and their re-employment by the transferee at 2 p.m. on the same day were not unfair under reg. 8(1) and the employees were not able to claim the benefit of TUR.

In *Betts* v. *Brintel Helicopters Ltd* [1997] 2 All ER 840, BH Ltd had contracts with an oil company transporting men and goods between the

land and North Sea oil rigs. When the contracts expired, the contract was awarded to KLM. KLM did not take on staff or equipment from BH Ltd and moved the base of operations to another airport. Some of BH Ltd's staff were redeployed but the plaintiffs were dismissed. They claimed that they had become employees of KLM under the 1981 regulations. The Court of Appeal held that an undertaking comprised a stable economic entity and in determining whether there had been a transfer of such an undertaking, the decisive criterion was whether that entity retained its identity. Where one fixed-term contract for services was replaced by another, no such transfer occurred if there was no transfer of significant tangible or intangible assets or taking over of a major part of the workforce. Here there had been no transfer to KLM because of the transfer to KLM of the right to land on the oil rigs in place of BH Ltd.

TUR also provides for consultation between the employer and the trade union representatives of a recognised trade union of any affected employees.

The ECJ has held that the directive applied to privatisation of public services where the service transferred had a sufficiently discrete identity: *Rask* v. *ISS Kantineservice A/S* [1993] IRLR 133. In *Dines* v. *Pall Mall* (1994) IDS Brief 518, the contracting-out of the cleaning service of Orsett Hospital was covered by TUR. In *Schmidt* v. *Spar-und Leihkasdse der fruheren Amter Bordesholm, Keil und Cronhagen* (1994) IDS Brief 516, the court held that the regulations applied even where only one employee transferred. The decision of the EAT in *Milligan* v. *Securicor Cleaning Ltd* [1995] ICR 867, that an employee dismissed because of a transfer can claim unfair dismissal with less than two years' prior service was overruled by the Court of Appeal in *MRS Environmental Services Ltd* v. *Marsh and Another* [1997] 1 All ER 92. Both cases concerned the privatisation of cleaning services by local authorities.

Notice

Employees are entitled to notice unless they have agreed to waive it. This will be the notice period in the contract, or the minimum period of notice in s.86, whichever is the greater. If the contract is for an indeterminate period, there must be a term relating to notice, and if there is no express term, one will be implied by the courts. This will be a 'reasonable' period of notice and in the case of very senior managers could be expected to be six months: *Adams* v. *Union Cinemas* [1939] 3 All ER 136: with other managers being due three months: *Mullholland* v. *Bexwell Estates* (1950) Sol Jo 671; and senior clerical worker could expect one month: *Philips* v. *M. J. Alkam* (1969, unreported). This period will only be replaced by the statutory period if the latter is longer. In the case of a fixed-term contract there is no need to give notice of expiry, and if there is no express notice provision one will not be implied. The time taken to terminate the contract is the outstanding period for the calculation of damages. If the fixed-

term contract contains a notice clause but actual notice is not given and the contract is terminated immediately, compensation is for the outstanding period: *Laverack* v. *Woods of Colchester* [1966] All ER 683. Similar rules apply for contracts expressed to terminate automatically when a task is completed or when money runs out. As already stated, the period may be even longer where the contract includes a redundancy or disciplinary procedure, when the amount of time necessary to go through every step of the procedure including all appeals must be added to the notice. Thus, in *Dietman* v. *London Borough of Brent* (1988) IRLR 228, Dietman was entitled to compensation for three months' notice and the three months of the dismissal procedure.

The minimum period of notice After one month or more of continuous employment the minimum period of notice is one week; this rises to two weeks after two years of continuous employment and thereafter increases by one week for each additional year up to a maximum of twelve weeks: s.86(1). The common law right to a reasonable period of notice takes priority over the statutory minimum.

Sick pay

Since April 1983 employers have been obliged to provide statutory sick pay. The rates of pay are established by statute. The right arose under the Social Security and Housing Benefit Act 1982.

12.5 Restraint of Trade Clauses

The topic of terms in employees' contracts restricting their freedom to work after termination of their employment is discussed in Chapter 3.

12.6 Fixed-Term and Performance Contracts

Although associated with contracts for the employment of company directors, these can relate to an employee at any level employed for a defined period, as with 'This contract will terminate on 31 March 1996' or 'This contract will run for three years from 1 April 1995'. A variant is the performance or task contract, where the parties agree that the contract will terminate on completion of a task or on the occurrence of specific circumstances even though the termination date cannot be fixed in advance: 'The contract will terminate on the date on which the project completion certificate is signed' or 'The contract is for the duration of the programme and will end automatically when the budgeted funds for the programme are exhausted'. In both cases, wrongful termination during the period of the contract incurs liability for damages for breach of contract.

The reasons for using a fixed-term or performance contract are to (i) retain an employee for a known and required period; (ii) prevent key employees leaving at an inconvenient time; (iii) create an opportunity to terminate employees' employment without incurring legal liabilities; (iv) motivate employees to produce results within a defined period; and (v) attract employees wanting a secure but not indefinite period of employment.

The statutory provisions relating to unfair dismissal and redundancy apply to fixed term contracts but not performance contracts. Unfair dismissal rights can be excluded where the contract is for a fixed term of one year or more and the dismissal consists of non-renewal and the employee has agreed to the exclusion of these rights in writing before the expiry of the contract. In the case of redundancy rights, the contract period is two years or more. Thus the contract may state: 'The employee agrees to waive any unfair dismissal and redundancy rights which may otherwise arise on the expiry and non-renewal of this contract'. This is not necessary in performance contracts, where unfair dismissal and redundancy rights do not arise on their expiry.

It should be noted that (i) the renewal of a series of short fixed-term contracts can give rise to redundancy and unfair dismissal where in total they amount to the relevant length of continuous employment; (ii) waivers operate only for the last of a series of contracts and a final short-term contract may reactivate previously excluded rights; and (iii) a short extension of a contract containing a waiver can negative the waiver. A renewal is different from an extension, and a renewal varying the original written contract by changing the expiry date will not negative the waiver. Employees on a fixed-term contract for one month or less which is extended by renewal for three months or more are entitled to the same statutory notice as employees on indefinite contracts of employment. Employees on fixed-term contracts of three months or less are not entitled to guarantee payments, statutory sick pay or medical suspension pay unless they actually work for longer than three months.

Generally, a fixed-term contract should entitle the employer to terminate the contract without notice before expiry in certain circumstances. Typically, the contract will provide for termination if the employee (i) commits gross misconduct or is in serious neglect of duty; (ii) wilfully fails to abide by the organisation's policies and procedures; (iii) breaches the duty of fidelity and confidentiality; (iv) brings the organisation into disrepute; or (v) is unable through illness or accident to perform the contractual duties either permanently or for more than six months. Some fixed-term contracts contain a provision for termination by notice by either side. This is more frequent in a typical three-year rolling contract which is automatically renewed on a set date each year. This will contain a clause allowing either party to give notice that they do not wish this renewal to occur. The advantage of the rolling contract is that the employee has the benefit of a potentially high level of damages should the contract be terminated wrongfully or prematurely.

Recommended Further Reading

Employment Law, Deborah J. Lockton, 2nd edn (Macmillan Law Masters, 1996).

Questions

1 Name some of the tests which the court applies in distinguishing between employees and independent contractors.
2 To what extent is an employer liable for his/her employees' acts even though they are expressly prohibited by the employer?
3 What are the terms implied into a contract of employment by the common law?
4 In respect of what work does the Equal Pay Act allow men and women to claim equal terms?
5 What is the difference between direct and indirect discrimination in respect of the Sex Discrimination Act?
6 There are three types of unfair dismissal. What are they, and what remedies are available for the unfairly dismissed employee?
7 Damages for breach of a contract of employment relate to contractual entitlement. What are examples of contractual entitlements in respect of which compensation is claimable?
8 What is the difference for a company's employees between the transfer of the business and a transfer of the business assets?

13 Contracts for the Sale and Supply of Goods

Learning Objectives

After reading this chapter you will know about:

1. the nature of the contract of sale
2. the terms implied by statute into contracts for the sale of goods and the possibility of their exclusion
3. the rules concerning the passing of property from the seller to the buyer and the passing of the risk
4. the principle of *nemo dat quod non habet* and the statutory exceptions to it
5. the remedies of the seller and the buyer
6. the implied terms in respect of contracts for the supply and hire of goods and for the provision of services

13.1 Contracts for the Sale of Goods

The law relating to contracts for the sale of goods is found in the Sale of Goods Act 1979 as amended by the Sale and Supply of Goods Act 1994, and the Sale of Goods (Amendment) Acts of 1994 and 1995. Statutory references in this part of the chapter are to the Sale of Goods Act 1979 except where otherwise indicated.

Contracts for the sale of goods are contracts 'whereby the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price': s.2(1). The word 'property' refers to ownership. The definition takes into account agreements where the ownership in the goods will not transfer immediately but at some later date. This type of contract is 'an agreement to sell'. The use of the word 'property' excludes from the Act any type of contract relating to goods where ownership does not pass. Thus it excludes contracts relating to hire of goods or contracts of bailment where possession but not ownership passes.

'Goods' are defined as including all personal chattels other than things in action and money, and in particular 'includes emblements, industrial growing crops and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale and includes an undivided share in goods': s.61(1). Thus crops comes within the definition of goods. Other things which are 'attached to or form part of the land' are 'goods' if they are identifiably distinct from the land. 'Goods' includes all 'chattels personal'; that is, all tangible moveable

things. The goods must be transferred for a 'money consideration, called the price'. This excludes contracts of barter. However, contracts under which goods are transferred by a combination of money plus other goods are included.

If the main purpose of the contract is not the transfer of property to the buyer, even though there is an element of transfer, such a contract is a contract for labour and materials. In *Robinson* v. *Graves* [1935] 1 KB 597, the Court of Appeal held that a contract by an artist to paint a client's portrait was not a contract for the sale of goods, since the main element in the contract was the skill of the artist. The same applies where a garage fits new parts to a car while carrying out a service or other repair, or a builder supplies bricks under a contract to build a wall or tiles when building a house: *Young & Marten* v. *McManus Childs* [1969] 1 AC 454.

13.2 The Form of the Contract

There are no particular formalities for a contract for the sale of goods and 'a contract of sale may be made in writing (either with or without seal), or by word of mouth, or partly in writing and partly by word of mouth, or may be implied from the conduct of the parties': s.4. In addition, capacity to contract 'is regulated by the general law concerning capacity to contract and to transfer and acquire property': s.3(1). However, where necessaries are sold and delivered to a minor or to a person who by reason of mental incapacity or drunkenness is incompetent to contract, s/he must pay a reasonable price for them: s.3(2).

13.3 The Implied Terms in a Contract for the Sale of Goods

The law has been changed by the Sale and Supply of Goods Act 1994. Under the Act, as amended, there are implied terms relating to the right to title; compliance with description; satisfactory quality; fitness for purpose; and conformity between sample and bulk. These will be considered below, in this order. The Unfair Terms in Consumer Contracts Regulations 1994 could also apply (see Chapter 16).

Right to title

There is an implied condition that the vendor has the right to sell. This is contained in s.12(1) which provides: 'In a contract of sale, other than one to which subsection (3) … applies, there is an implied term on the part of the seller that in the case of a sale he has a right to sell the goods, and in the case of agreement to sell he will have such a right at the time when the property is to pass.' As regards England and Wales and Northern Ireland, the term implied by subsection (1) is a condition: s.12 (5A).

The implied term is broken where the seller sells goods to which s/he has no title. Thus, in *Rowland* v. *Divall* [1923] 2 KB 500, the plaintiff bought a car from the defendant but after four months discovered that the car belonged to a third party, and returned it. He was entitled to treat the contract as discharged for total failure of consideration. If the seller subsequently acquires the title to the goods, this will mean that the title to the goods will be conferred on the buyer at a later date than it should have been. Once this title has been conferred, the buyer will not be able to repudiate the goods under s.12(1). However, s/he can repudiate the contract prior to the moment at which title is conferred. Thus, in *Butterworth* v. *Kingsway Motors* [1954] 1 WLR 1286, the buyer of a car from a seller who had not yet acquired title because she had not completed payments to the hire-purchase company was able to repudiate the car after eleven months when he discovered the situation, even though the seller completed her payments the following week. (This situation would now be covered by the Hire Purchase Act 1964, Part III.)

The position is the same where the seller has title to the goods but where s/he does not have right to sell them. In *Niblett Ltd* v. *Confectioners' Materials Co.* [1921] 3 KB 387, the contract of sale related to tins of condensed milk labelled 'Nissly Brand' which infringed the Nestlé trade mark. Nestlé obliged the buyers to remove the offending labels before they resold the tins. It was held that the sellers had breached the term that they had the right to sell the goods. They had also breached s.12(2)(b), which relates to an implied term that the buyer will enjoy quiet possession of the goods. In *Microbeads* v. *Vinhurst Road Markings* [1975] 1 WLR 218, following the sale of some road-marking machines, the patent for the machines was acquired by a third company, with the result that they could enforce their patent rights against the buyers. The buyers sued the seller, claiming breach of a condition as to title and breach of the warranty of quiet possession. The court held that there was no breach of s.12(1), but there was a breach of s.12(2)(b) which relates to quiet possession in the future and the sellers were liable in damages. The term is a warranty for England, Wales and Northern Ireland: s.12 (5A)

Section 12(3) deals with the situation where the contract intended that the seller should only transfer a limited title to the buyer. In such contracts there is an implied term that all charges or encumbrances known to the seller and not known to the buyer have been disclosed before the contract is made: s.12(4); and that the buyer's quiet possession of the goods will not be disturbed by (a) the seller; (b) where the parties intend that the seller should transfer only such title as a third person may have, that person; and (c) anyone claiming through or under the seller or that third person otherwise than under a charge or encumbrance disclosed or known to the buyer before the contract is made: s.12(5). In respect of England, Wales and Northern Ireland these terms are warranties: s.12(5A).

Compliance with description

The relevant section here is s.13, which provides:

> (1) Where there is a contract for the sale of goods by description, there is an implied term that the goods will correspond with the description.
> (2) If the sale is by sample as well as by description it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.
> (1A) As regards England and Wales and Northern Ireland, the term implied by subsection (1) above is a condition.

Breach of this condition enables the buyer to repudiate the contract even where the goods are of suitable quality and fit for the purpose of the purchaser. Thus a contract to supply canned fruit in cases of thirty tins was able to be repudiated when it was discovered that one half of the consignment was packed twenty-four tins to a case: *Re Moore & Co. Ltd and Landauer & Co.* [1921] 2 KB 519. In *Arcos* v. *Ronaasen (E.A.) & Son* [1933] AC 470, the contract was for staves for manufacturing barrels described as being ‘half an inch thick’. Those supplied varied between half an inch and nine-sixteenths of an inch, and the buyer was able to repudiate the contract, even though the goods were fit for the purpose. This shows the importance of the seller specifying margins within which the goods may vary without failing to comply with the contractual description.

The section also extends to cover sales by sample as well as by description. Thus s.13(2) provides that ‘If the sale is by sample as well as by description it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.’ In *Nichol* v. *Godts* (1854) 10 Exch. 191, the sale of oil by way of a sample plus the description ‘refined rape oil’ fell within the subsection where the bulk corresponded with the sample but not with the description.

Sale by description

This covers situations where the buyer has not seen the goods and relies on the description applied to them. In *Varley* v. *Whipp* [1900] 1 QB 513, the plaintiff bought a piece of farming equipment described as having only been used for one season. On delivery it was seen to be old and had been repaired. The buyer was entitled to repudiate the contract.

The scope of the term was extended by Lord Wright in *Grant* v. *Australian Knitting Mills* [1936] AC 85, where he stated: ‘there is a sale by description even though the buyer is buying something displayed before him on a counter….’ In this case, woollen underwear sold over the counter was held to be a sale by description. This position is now covered by s.13(3), which provides that: ‘A sale of goods is not prevented from being a sale by description by reason only that, being exposed for sale or hire, they are selected by the buyer.’ This clearly extends to goods displayed in a supermarket where there is a description contained in the

packaging or labelling of the goods, but not to goods which were exposed without any notice or labelling.

Satisfactory quality

The normal doctrine in relation to the supply of goods is the doctrine of *caveat emptor* (let the buyer beware). This is in s.14(1), which provides: 'Except as provided by this section, and section 15 … and subject to any other enactment, there is no implied term about the quality or fitness for any particular purpose of goods supplied under a contract of sale.' This is the position for contracts where the seller is a private individual, and where there is no warranty unless one is specifically incorporated. The position is different where the goods are sold in the course of a business. Thus:

> (2) Where the seller sells goods in the course of a business, there is an implied term that the goods supplied under the contract are of satisfactory quality.
> (2A) For the purposes of this Act, goods are of satisfactory quality if they meet the standard that a reasonable person would regard as satisfactory, taking account of any description of the goods, the price (if relevant) and all other relevant circumstances.
> (2B) For the purposes of this Act, the quality of goods includes their state and condition and the following (among others) are in appropriate case aspects of the quality of goods – (a) fitness for all the purposes for which goods of the kind in question are commonly supplied, (b) appearance and finish, (c) freedom from minor defects, (d) safety, and (e) durability.
> (2C) The term implied by subsection (2) above does not extend to any matter making the quality of goods unsatisfactory – (a) which is specifically drawn to the buyer's attention before the contract is made, (b) where the buyer examines the goods before the contract is made, which that examination ought to reveal, or (c) in the case of a contract for sale by sample, which would have been apparent on a reasonable examination of the sample.

The Act provides that the word 'term' used in subsection (2) above shall as regards England, Wales and Northern Ireland be a condition: s.14(6).

With regard to s.14(2C)(b), if the buyer makes an inspection which does not reveal defects simply because the inspection is negligent, the buyer will be precluded from making a claim in respect of defects which a more thorough examination would have revealed. In *Thornett & Fehr* v. *Beers* [1919] 1 KB 486, the buyers of barrels of glue were prevented from claiming in respect of defects in the glue when their examination had only extended to an examination of the barrels themselves.

However, under the old law, where the buyer examined the goods and discovered a defect but decided to proceed with the purchase on the basis that the defect is easily remedied, s/he was protected when the defect

turned out to be more difficult to remedy. In *R & B Customs Brokers Co. Ltd* v. *United Dominions Trust Ltd* [1988] 1 WLR 321, a person purchased a car knowing that it had a leak, but only later discovered that the leak was major and incurable. Neill LJ stated: 'I am not at present persuaded … that the condition in s.14(2) is excluded if at the time the contract is made the buyer is reasonably of the opinion that the defect can be, and will be, rectified at no cost to himself.' The issue was not resolved by the Court of Appeal, who decided that the buyer could rely on s.14(3) (below) that the car was not reasonably fit for the particular purpose for which the buyer had informed the seller that he wanted it.

The reference to 'fitness for all the purposes for which goods of the kind in question are commonly supplied': s.14(2B)(a), was a major issue under the previous law relating to merchantable quality. In *Aswan Engineering Establishment* v. *Lupdine* [1987] 1 WLR 1, the issue was the merchantable quality of heavy duty plastic buckets which, although suitable for most normal purposes, collapsed when left by the buyer stacked in a container in the sun where the heat in the containers reached 70 degrees Centigrade. The court held that, for the buckets to be of merchantable quality, it was not necessary for the buckets to be suitable for all purposes. Whether the decision would be the same under the new law is difficult to say.

The points in s.14(2B) (b) and (c) appear in line with previous decisions such as that in *Rogers and Another* v. *Parish (Scarborough) Ltd and Another* [1987] QB 933, where the Court of Appeal held that a series of small defects in a new Range Rover, which did not make it undrivable or unroadworthy, did make it unmerchantable. The court held that the statutory definition extended in the case of motor vehicles to include a pride in the external and internal appearance relative to the market at which the car was aimed. The judge's suggestion that the merest cosmetic blemish on a Rolls Royce might make it unmerchantable would also appear to be in line with the new law in s.14(2A).

On the question of durability, s.14(2B)(e) reflects the old law that required goods to be of merchantable quality for a reasonable time after delivery, so long as they remained in the same apparent state as that in which they were delivered, apart from normal wear and tear: *Lambert* v. *Lewis* [1982] AC 225. This is of importance, particularly with regard to the sale of second-hand goods. In *Bartlett* v. *Sydney Marcus* [1965] 1 WLR 1013, the buyer of a second-hand car, who was warned that the car had a defective clutch which had been taken into account in its pricing, was unable to claim under the old law of merchantable quality when the clutch failed about one month later. However, in *Crowther* v. *Shannon* [1975] 1WLR 30, the court held that an eight-year-old Jaguar with 82 000 miles on the clock was not reasonably fit for the purpose when the engine seized after three weeks' driving; see below: s.14(3). In *Bernstein* v. *Pamsons Motors (Golders Green) Ltd* [1987] 2 All ER 22, the buyer of a new car took the car on two or three short journeys in the first two weeks. After just 140 miles and still within three weeks of delivery, the car engine

seized. The court held that the car was not of merchantable quality but the buyer was only entitled to damages and had lost the right to repudiate the contract because of lapse of time.

The previous law covered all goods supplied under the contract, so that there was liability from the supply of Coalite containing a detonator: *Wilson* v. *Rickett, Cockerell & Co. Ltd* [1954] 1 QB 598. It also extended to packaging: in *Geddling* v. *Marsh* [1920] All ER 631, the sellers of bottled mineral water were liable where a buyer was injured when a defective bottle exploded. The new law will presumably have the same effect.

Fitness for purpose

Fitness for purpose overlaps with satisfactory quality. The requirement is contained in s.14(3), which provides:

> Where the seller sells goods in the course of a business and the buyer, expressly or by implication, makes known to the seller … any particular purpose for which the goods are being bought, there is an implied term that the goods supplied under the contract are reasonably fit for that purpose, whether or not it is a purpose for which such goods are commonly supplied, except where the circumstances show that the buyer does not rely, or that it is unreasonable for him to rely, on the skill or judgment of the seller.

As regards England, Wales and Northern Ireland, the word ‘term’ is a condition: s.14(6). A case illustrating the relationship between s.14(2) and s.14(3) is *Kendall (Henry) & Sons* v. *William Lillico & Sons Ltd* [1968] 2 All ER 444. This case concerned groundnuts which were supplied to a game farm where pheasants were reared. The groundnuts contained tiny quantities of highly poisonous mould, which caused many of the pheasants to die. The court held that the goods were unfit for the purpose of feeding pheasants, which was an ordinary and reasonable use for them. As regards liability under s.14(2), the goods were of merchantable (satisfactory) quality since they were fit for some purposes for which they were ordinarily and reasonably used – feeding cattle – and were commercially saleable as such. Presumably this will not be changed by s.14(2B(a).

The buyer makes known any particular purpose for which the goods are being bought

Where the contract relates to goods which have only one normal use, the mere fact of the purchase itself indicates the purpose of the buyer. This was applied in relation to the sale of a faulty hot-water bottle in *Priest* v. *Last* [1903] 2 KB 148. Where the goods are required to fulfil a particular purpose the buyer will only be protected where the seller is expressly informed. The purchaser of a coat who contracted dermatitis because of an abnormally sensitive skin which had not been drawn to the attention of

the seller failed under s.14(3): *Griffiths* v. *Peter Conway Ltd* [1939] 1 All ER 685.

The buyer relies on the skill or judgment of the seller

The degree of reliance on the seller's skill does not have to extend to every aspect of the contract. In *Ashington Piggeries Ltd* v. *Christopher Hill Ltd (Nordsildmel Third Parties)* [1971] 1 All ER 847, the appellants invented a new compound feed for mink and supplied the formula to the respondents to be made up. The formula contained herring meal and the herring meal supplied by the third parties contained a substance toxic to all animals, but to which mink were particularly sensitive. Although they had supplied the formula, the buyers had relied on the suppliers to select ingredients of a suitable quality. The respondents were in breach of both s.14(2) and (3).

A similar situation arose in *Cammell Laird Ltd* v. *Manganese Bronze and Brass Ltd* [1934] AC 402, where the appellants ordered two ship's propellers, supplying a detailed blueprint and set of specifications, but leaving the thickness of the propeller blades to the respondents, and one of the propellers was unsuitable because the blades were not thick enough. The court, holding the respondents liable under s.14(3), stated that there is no need for the buyer to rely on the seller's skill and judgment in every detail; it is enough if s/he relies on it to a substantial extent.

Where the purchaser asks for goods by reference to a trade or brand name, this will generally exclude any implied term relating to suitability for any purpose. However, in *Baldry* v. *Marshall* [1925] 1 KB 260, the plaintiff asked the defendant car dealers for a car 'suitable for touring purposes'. The defendants recommended a Bugatti, which the plaintiff then ordered. The car was unsuitable and the plaintiff was entitled to reject the car and recover the purchase price.

Goods must be 'reasonably fit'

The question of whether the goods are of satisfactory quality must take into account the price at which they were sold, whether they were second-hand, and other factors. However, the seller will not escape from liability if the goods are not reasonably fit for the purpose by producing evidence that s/he had taken all reasonable precautions to ensure fitness. In *Frost* v. *Aylesbury Dairy* [1905] 1 KB 1, the defendants were liable for supplying milk containing typhoid germs in spite of taking all reasonable hygiene precautions.

It is clear that the goods must not only be fit for the purpose when delivered but 'that the goods will continue to be fit for that purpose for a reasonable time after delivery, so long as they remain in the same apparent state and condition as that in which they were delivered, apart from normal wear and tear'. This statement is from *Lambert* v. *Lewis* [1982] AC 225, where the buyer was unable to claim in respect of a failed tow-bar

coupling once it became clear that the locking mechanism was broken, terminating the seller's obligation.

Contracts for sale by sample

A contract for sale by sample is where there is an express or implied term to that effect in the contract: s.15(1), when there is an implied term (a) that the bulk will correspond with the sample in quality; (b) that the buyer will have a reasonable opportunity for comparing bulk with the sample; and (c) that the goods will be free from any defect, making their quality unsatisfactory, which would not be apparent on reasonable examination of the sample: s.15(2).

As regards England, Wales and Northern Ireland, the term implied by subsection (2) is a condition: s.15(3). But this is subject to s.15A, which provides:

> (1) Where in the case of a contract of sale –
> (a) the buyer would, apart from this subsection, have the right to reject the goods by reason of a breach on the part of the seller of a term implied by section 13, 14 or 15 …, but
> (b) the breach is so slight that it would be unreasonable for him to reject them, then if the buyer does not deal as a consumer, the breach is not to be treated as a breach of condition but may be treated as a breach of warranty.

The section applies unless a contrary intention appears in, or is to be implied from, the contract: s.15A(2); and it is for the seller to show that a breach fell within subsection (1)(b).

Bulk will correspond to sample in quality

In *E & S Ruben Ltd* v. *Faire Bros & Co. Ltd* [1949] 1 All ER 215, the court held that the condition is broken even though only a simple process is required to make the bulk correspond with the sample. The contract related to a quantity of 'Linatex' (a type of vulcanised rubber). The sample supplied was flat and soft, whereas the bulk was crinkly and folded, though these defects could be cured if the material was warmed. There was a breach of s.15 and the contract could be repudiated. This may now fall within s.15A.

Reasonable opportunity of comparing bulk with sample

In *Polenghi Brothers* v. *Dried Milk Co. Lt*d (1904) 92 LT 64, the contract was for a quantity of dried milk powder under a contract by sample. The contract specified that payment was to be made in cash 'on the arrival of the powders against shipping or railway documents'. The buyer refused to pay on delivery of shipping documents, contending they had a right to compare the bulk with sample. The court held that they were entitled to this opportunity.

Free from defect not apparent on reasonable examination of the sample

In *Godley* v. *Perry (Burton & Sons (Bermondsey) Ltd (Third Party), Graham, (Fourth Party))* [1960] 1 All ER 36, a retailer had purchased a supply of catapults from a wholesaler under a contract of sale by sample. The retailer was liable to a small boy who was injured when one of the catapults broke and injured his eye. The retailer claimed indemnity from the wholesaler. The wholesaler contested that a reasonable examination of the sample would have revealed its defects, and that the retailer's test – merely pulling back the elastic – was unreasonable. The court held this was all that could have been expected of a potential purchaser.

13.4 Waiver of Breach of Condition

A party to a contract can always waive a breach of condition and treat it as a breach of warranty. Where a person has waived the breach on one occasion this does not prevent him/her from subsequently and unilaterally reintroducing the term as a condition on giving reasonable notice. In *Charles Rickards Ltd* v. *Oppenheim* (1950), the defendant ordered a car to be built on a Rolls Royce chassis. The work was not completed within the specified time, but some months later when the car had still not been delivered Rickards said that if it was not delivered within four weeks he would refuse to accept it. The court held that he could refuse to accept delivery.

Under s.11(4), where a contract is not severable: that is, it is not a contract providing for the supply of goods by separate instalments, and the buyer has accepted the goods or part of them, the breach of a condition by the seller can only be treated as a breach of warranty unless there is an express or implied term to that effect. This is now subject to s.35A, which provides: '(1) If the buyer – (a) has the right to reject the goods by reason of a breach on the part of the seller that affects some or all of them, but (b) accepts some of the goods, including, where there are any goods unaffected by the breach, all such goods, – he does not by accepting them lose his right to reject the rest.'

A buyer is not deemed to have accepted goods until s/he has had a reasonable opportunity of examining them and, in the case of a contract for sale by sample, of comparing the bulk with the sample: s.34. S/he accepts the goods when s/he intimates to the seller that s/he has accepted them, or when s/he does any act in relation to them which is inconsistent with the ownership of the seller, or when s/he retains the goods after the lapse of a reasonable time: s.35. This last point is a serious limitation on the protection of the Act against defects of quality in goods supplied, since in effect it means that after a few weeks at the most the right to repudiate the contract and demand replacement goods is lost. Thus, in *Bernstein* v. *Pamsons Motors (Golders Green)* [1987] 2 All ER 22 (above), the right to repudiate a new car was lost within three weeks of delivery.

13.5 Exclusion of Terms Implied by the Sale of Goods Act 1979

Where one of the parties deals as a consumer

For contracts for the sale of goods where one of the parties 'deals as a consumer', the implied terms relating to title, description, satisfactory quality, fitness for purpose and so on can never be excluded. A person deals as a consumer if (i) s/he does not contract in the course of a business or hold him/herself out as doing so; (ii) the other party does contract in the course of a business; and (iii) the goods are of a type ordinarily supplied for private use or consumption. A person does not deal as a consumer in sales by auction or competitive tender.

Contracts between dealers

Where the contracts are between dealers, however, the implied terms can be excluded subject to the 'requirement of reasonableness', except for the implied term as to title, which can never be excluded. The requirement of reasonableness takes into account: (i) the relative strength of bargaining positions of the parties; (ii) whether the buyer received an inducement to agree to the term, or could have bought elsewhere without the term; (iii) whether the buyer knew or ought to have known of the existence and extent of the term; and (iv) whether goods were manufactured, processed or adapted to the buyer's special order.

In *George Mitchell (Chesterhall) Ltd* v. *Finney Lock Seeds Ltd* [1983] 1 All ER 108, the court also took account of the fact that the seller could have insured against liability without significantly affecting prices. The case concerned the purchase of cabbage seeds by the plaintiff. Because of the negligence of the suppliers, the seeds were not those of cabbages, and the farmer lost anticipated profits of £60 000. The defendants claimed protection under an exclusion clause which limited their liability to the cost of the seeds. The court, applying the criteria above, held that they were not protected. An additional factor cited by the court was that the suppliers could easily have insured against the risk. In *St Albans City and District Council* v. *International Computers Ltd* (1996) *The Times*, 14 August, the council suffered a loss of £1.3m as a result of an error in computer software supplied under a contract which limited the defendant's liability to £100 000. The court took into consideration (a) the fact that the parties were of unequal bargaining power; (b) the firm had not justified the figure of £100 000, which was small in relation to the potential loss; (c) the firm was insured worldwide for a sum of £50m; and (d) the practical consequences counted in favour of the authority. Accordingly, the firm had failed to discharge its burden to establish that the exclusion clause was a fair and reasonable one. The decision was affirmed by the Court of Appeal.

13.6 Similar Protection for Other Contracts under which Goods Pass

Other statutes under which goods pass otherwise than by sale contain equivalent provisions. These Acts are the Supply of Goods (Implied Terms) Act 1973, which covers goods supplied under hire-purchase contracts and conditional sale agreements (ss.8–11) (see Chapter 14); the Supply of Goods and Services Act 1982, which covers other contracts under which goods pass, such as barter or 'free' gifts (for example, offers of 'gifts' for the purchase of goods such as motor oil) and so on (ss.2–5); and contracts of hire (ss.7–10). The Unfair Terms in Consumer Contracts Regulations 1994 could also apply (see Chapter 16). Exclusion of these implied terms is also restricted. These provisions are discussed separately below (see p. 429).

13.7 The Passing of the Property and the Passing of the Risk

The transfer of property is the transfer of the title from the seller to the buyer. It is important to be able to identify precisely when this transfer takes place, since the transfer of property is also the moment when the risk of accidental damage to the property also passes. Section 20 provides: 'Unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer's risk whether delivery has been made of not.'

There is an important proviso: 'where delivery has been delayed through the fault of either buyer or seller the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault'. An example of this can be seen in *Demby Hamilton & Co. Ltd* v. *Barden (Endeavour Wines Ltd Third Party)* [1949] 1 All ER 435, where the sellers agreed to supply thirty tons of apple juice, delivered in weekly truckloads, delivery to be completed by February 1946. In December 1945 the buyer asked them to hold up deliveries. Further deliveries were made in January and April 1946, after which the buyer refused to accept more juice. By November 1946 the remaining juice held by the seller had gone bad. Loss fell on the buyer, since delivery had been delayed through his fault.

The passing of property or ownership is independent of the transfer of physical possession of the goods. Thus the seller may retain possession but the ownership may have passed to the buyer, and the buyer may obtain possession while the seller retains ownership. To fix the moment at which the title passes, the Sale of Goods Act contains specific rules in Part II, ss.16–19; these vary according to whether the goods are specific or unascertained.

Specific and unascertained goods

Specific goods are defined as 'goods identified and agreed upon at the time a contract of sale is made and includes an undivided share, specified as a faction or percentage, of goods identified and agreed on as aforesaid': s.61. An example is the case of a contract for the sale of a specific painting or of a second-hand car. Most contracts in supermarkets and other self-service stores will relate to specific goods. The definition was amended to include an undivided share of goods by the Sale of Goods (Amendment) Act 1985. There are two types of unascertained goods: (i) contracts for a quantity of goods out of a bulk, such as in a contract to buy five cases of a specified wine from the wine merchant's stock of cases, (the goods are unascertained since any five cases will comply with the contract); and (b) contracts for generic goods, such as five loaves of bread, or 500 tons of coal.

The goods that are the subject matter of the contract may be 'either existing goods, owned and possessed by the seller, or goods to be manufactured or acquired by him after the making of the contract of sale': s.5(1). The latter are 'future goods', which can be specific or unascertained. Thus, if the contract relates to goods to be manufactured or prepared to a specification of the buyer, they will be unascertained goods. If the contract relates to a specific object which the seller will acquire, then the contract will relate to specific goods. In *Varley* v. *Whipp* [1900] 1 QB 513, a contract for the sale of a second-hand agricultural machine which was not owned by the seller at the time of contract was a contract for the sale of specific goods.

Rules relating to passing of property of specific goods

The basic rule for the passing of the property in specific goods is contained in s.17, which provides:

> (1) Where there is a contract for the sale of specific or ascertained goods the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred.
> (2) For the purpose of ascertaining the intention of the parties regard shall be had to the terms of the contract, the conduct of the parties, and the circumstances of the case.

There are no problems when the contract expressly provides for the passing of the property, but this is rarely the case and the court is then involved in examining all the circumstances to discover the intentions of the parties. Where there is no clearly expressed or discernible intention, the property passes in accordance with Rules 1–4 set out in s.18.

Rule 1

'Where there is an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when the

contract is made, and it is immaterial whether the time of payment or the time of delivery, or both, be postponed.' The reference to an 'unconditional' contract merely requires a contract which does not rule out the operation of the rule, and 'deliverable state' is defined as goods 'in such a state that the buyer would under the contract be bound to take delivery of them'.

Problems can arise between the operation of the rule and the intentions of the parties. In *Dennant* v. *Skinner and Collom* [1948] 2 KB 164, the buyer successfully bid for a van at an auction, paid by cheque and signed a form to the effect that the property would not pass to him until the cheque was cleared. The cheque was dishonoured and the buyer had in the meantime sold the car to another person. The auctioneer sued to recover the van from the second buyer. The court held that, when the buyer signed the statement concerning the transfer of title, it had already passed to him 'on the fall of the hammer' under Rule 1.

The final phrase of Rule 1 is confusing in respect of determining the intention of the parties, since it provides that the passing of property is independent of either or both the postponement of payment and delivery. In effect, these will often be the major circumstances to determine the intentions of the parties. However, in *Ward* v. *Bignall* [1967] 1 QB 534, Diplock LJ said: 'in modern times very little is needed to give rise to the inference that property in specific goods is to pass only on delivery or payment'.

A case showing the operation of several aspects of this is *Underwood* v. *Burgh Castle Brick & Cement Syndicate* [1922] 1KB 343, where there was a contract for the sale of a condensing machine weighing thirty tons and bolted to the floor. The sellers had to unbolt the machine and load it on to a train for delivery and it was damaged while being loaded. On the issue of whether the property had passed to the buyer when the accident occurred, the court held that the machine was not in a deliverable state and that the agreement between the parties relating to a delivery of the machine free on rail (f.o.r.) indicated an intention that property would only pass when the machine was loaded.

Rule 2

'Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods, for the purpose of putting them into a deliverable state, the property does not pass until the thing is done, and the buyer has notice that it has been done.' The reference to 'notice to the buyer' is actual, not constructive, notice.

Rule 3

'Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing … for the purpose of ascertaining the price, the property does not pass until the act or thing is done and the buyer has notice that it has

been done.' The rule only operates where the requirement is on the seller; a requirement imposed on the buyer to weigh and so on does not trigger the operation of the rule.

Rule 4

'When goods are delivered to the buyer on approval or on sale or return or other similar terms the property in the goods passes to the buyer: (a) when he signifies his approval or acceptance to the seller or does any other act adopting the transaction; (b) if he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, then if a time has been fixed for the return of the goods, on expiration of that time and, if no time has been fixed, the expiration of a reasonable time.'

The reference in (a) to an act adopting the transaction covers the situation where the buyer has sold the goods or pawned them. In *Kirkham* v. *Attenborough* [1895–9] All ER Rep 450, Kirkham, a manufacturing jeweller, delivered jewellery to Winter 'on sale or return'. Winter pledged the goods with Attenborough, a pawnbroker, and the price remained unpaid. Kirkham sought recovery of the goods from Attenborough. The court held that the pledge had adopted the transaction, passing the property to Winter, who thus passed good title to Attenborough. This can be contrasted with *Re Ferrier* [1944] Ch 295, where the failure to return the goods was no fault of the buyer and beyond his control. The rule is excluded where the contract provides that the property in goods sold on approval shall not pass until the seller is paid: *Weiner* v. *Gill* [1906] 2 KB 574.

In *Poole* v. *Smith's Car Sales (Balham) Ltd* [1962] 2 All ER 482, Poole, a car dealer, sold a second-hand car to the defendant company 'on sale or return' in August 1960. The car had not been returned by October 1960, so Poole wrote stating that, if it was not returned by 10 November, the car would be deemed to have been sold to them. The car was finally returned at the end of November. The court held that the property had passed to the buyers under Rule 4(b), since a reasonable time had expired without its being returned.

In *Atari Corporation (UK) Ltd* v. *Electronics Boutique Store (UK) Ltd* [1998] 2 WLR 66 The defendants bought computer games under an agreement which provided for 'Payment 30 November 1995. Full sale or return until 31 January 1996'. On 19 January 1996, when the goods had not been paid for, the defendants wrote that they had decided to cease stocking certain items which would be placed in their central warehouse for the preparation of a detailed list. The defendants appealed to the Court of Appeal against a decision that they had failed to give notice of rejection in time under s.18. The court held that there was a valid notice of rejection; that where goods were delivered on sale or return, a notice rejecting unsold goods did not have to be in writing or to identify the goods to which it related; and that the goods need not be physically capable of collection when the notice was issued but within a reasonable time.

The passing of property in an undivided share in goods forming part of a bulk

Where there is a contract for the sale of a specified quantity of unascertained goods where (i) the goods or some of them form part of a bulk; and the buyer has paid for some or all of the goods forming part of the bulk, then, unless the parties otherwise agree, (i) property in an undivided share in the bulk is transferred to the buyer; and (ii) s/he becomes an owner in common of the bulk: s.20A(1) and (2). The undivided share of the bulk is calculated according to the quantity of goods paid for in relation to the bulk at that time: s.20A(3), subject to the fact that if the aggregate of the undivided shares should at any time exceed the aggregate of the bulk, the undivided share shall be proportionately reduced so that the aggregate is equal to the bulk: s.20A(4). Where a buyer has paid for part of the goods only, delivery to him/her out of the bulk shall be ascribed in the first place to the goods for which s/he has paid: s.20A(5). A person who has become an owner in common is deemed to have consented to (a) deliveries to other owners in common out of the bulk; and (b) any dealing with or removal, delivery or disposal of goods in the bulk by any other owner in common in so far as the goods fall within that co-owner's undivided share in the bulk at the time: s.20B(1)(a) and (b). No cause of action shall accrue against a person by reason of his/her acting in accordance with paragraphs (a) or (b) or subsection 1: s.20B(2). Nothing in this section or s.20A shall (i) impose an obligation on a buyer of goods out of the bulk to compensate any other buyer out of that bulk for any shortfall; (ii) affect any contractual arrangement between buyers for adjustments between themselves; or (iii) affect the rights of any buyer under his/her contract: s.20B(3). The term 'bulk' means 'a mass or collection of goods of the same kind which (a) is contained in a defined space or area; and (b) is such that any goods in the bulk are interchangeable': s.61(1). A new definition of 'delivery' in relation to sections 20A and B includes 'such appropriation of goods to the contract as results in property in the goods being transferred to the buyer': s.61(1).

The passing of property in unascertained goods

The basic rule is contained in s.16, which provides: 'Subject to section 20A below, where there is a contract for the sale of unascertained goods no property is transferred to the buyer unless and until the goods are ascertained.' Once the goods are ascertained, they will then pass under s.17 and under Rule 5 of s.18, failing any discernible intention of the parties.

Rule 5: '(1) Where there is a contract for the sale of unascertained or future goods by description, and the goods of the description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer, or by the buyer with the assent of the seller, the property in the goods then passes to the buyer; and the assent may be express or implied, and may be given either before or after

the appropriation is made.' The essential aspects of Rule 5 are unconditional appropriation plus assent.

Unconditional appropriation

What constitutes unconditional appropriation was considered by Pearson J in *Carlos Federspiel & Co.* v. *Charles Twigg & Co.* [1957] 1 Lloyd's Rep 240: 'A mere setting apart or selection by the seller of the goods which he expects to use in performance of the contract is not enough. If that is all, he can change his mind and use those goods in performance of some other contract and use some other goods in performance of this contract. To constitute an appropriation of goods to the contract, the parties must have had, or be reasonably supposed to have had, an intention to attach the contract irrevocably to those goods.'

The case involved contracts to sell cycles and tricycles 'f.o.b. UK port'. The goods were packed and marked with the port of destination but were never sent to Liverpool for shipping. The seller went into liquidation and the buyers claimed the goods from the liquidator on the ground that the goods had passed under Rule 5 because they had been unconditionally appropriated. The action failed on the grounds that the court discerned an intention of the parties that ownership should pass on shipment, and that the appropriating act is usually the last act to be performed by the seller, and the last two acts, the sending of the goods to Liverpool and having them shipped, were not performed. In contrast, in *Pignataro* v. *Gilroy & Son* (1919) 120 LT 480, the court held there was appropriation where the sellers sold 140 bags of rice to the buyer and gave him a delivery order on 28 February 1918 to obtain delivery of 125 bags at Chambers Wharf, and that the remaining fifteen were available for collection at the sellers' warehouse. The buyer did nothing until 25 March, when he sent someone to collect the fifteen bags at the warehouse and discovered that they had been stolen shortly before. The court held that the risk had passed to the buyer, and the seller was not liable for non-delivery. In *Re Stapylton Fletcher Ltd and Re Ellis Son & Vidler Ltd* [1995] 1 All ER 192, the court held that where cases or bottles of identical wines were held segregated from the trading stock, in store for a group of customers, they would be sufficiently ascertained for the purposes of s.16.

Under Rule 5 (2), delivery of the goods to a carrier for delivery to the buyer will usually constitute unconditional appropriation: 'Where, in pursuance of the contract, the seller delivers the goods to the buyer or to a carrier or other bailee or custodier (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right to disposal, he is taken to have unconditionally appropriated the goods to the contract.' This is not so where the consignment is one of several and the goods are not clearly appropriated on delivery to the carrier. In *Healy* v. *Howlett & Sons* [1917] 1KB 337, the seller contracted to sell twenty boxes of fish to a buyer and dispatched by train 190 boxes to various customers, all the boxes being unmarked. The goods went bad

during the journey from Ireland to London and the court held that the property only passed when the railway company allotted the boxes to specific customers during the journey.

Rule 5(2) specifically excludes from appropriation situations where the seller delivers goods to a carrier for delivery to the buyer but reserves a right of disposal of the goods. In such a case, the property in the goods will not pass until the condition is complied with. Thus the seller may deliver the goods to the carrier, with instructions that the goods are not to be handed over to the buyer until the buyer has paid for them. This reservation of right of disposal is contained in s.19(1).

The operation of the rule is important with regard to the moment when the property in the goods passes to the buyer and a prosecution for theft. In *Edwards* v. *Ddin* [1976] 1 WLR 942, a motorist drove into a garage forecourt, had his car filled with petrol and then drove away without paying. It was held that the garage owner did not reserve the right to dispose of the petrol once it was in the tank and therefore the property in it had passed to the motorist in accordance with s.18, rule 5. Since the Act clearly envisages that appropriation can be by the buyer or the seller, the position in relation to supermarkets is important. This was established in *Lacis* v. *Cashmarts* [1969] 2 QB 400 in a statement by Parker LCJ: 'the intention of the parties quite clearly as it seems to me is that the property shall not pass until the price is paid'. The same is true whether in respect of goods picked up by the customer or of goods that are weighed and bagged by an employee. In *Martin* v. *Puttick* [1968] 2 QB 82, Winn J stated: 'the limit of the authority of the meat counter assistant is clearly merely to wrap up and hand over the meat and not to deal in any way with any transfer of property from the owner of the shop to the customer'. This statement was cited with approval in *Davies* v. *Leighton* [1978] Crim LR 575.

The appropriation must be assented to by the other party. This is generally not a problem, since the section specifically allows this to be implied and to be given in advance.

Appropriation of unascertained goods which are part of a bulk

Where unascertained goods destined for several customers are transported in bulk for delivery to various destinations. Once the last but one delivery has been made, the goods remaining are appropriated and the risk passes to the final buyer, *Karlshamns Oliefabriker* v. *Eastport Navigation Corporation* [1982] *The Elafi*, 1 All ER 208.

This decision is now embodied in s.18 Rule 5(3) (added by the Sale of Goods (Amendment) Act 1995) which provides : 'Where there is a contract for the sale of a specified quantity of unascertained goods in a deliverable state forming part of a bulk which is identified either in the contract or by subsequent agreement … and the bulk is reduced to (or to less than) that quantity, then, if the buyer … is the only buyer to whom goods are then due out of the bulk – (a) the remaining goods are to be taken as appropriated to that contract at the time when the bulk is so reduced; (b) the property in

those goods passes to that buyer. The same rule operates where there is a reduction of the bulk to (or to less) than the aggregate of the quantities due to a single buyer under separate contracts; Rule 5(4).

Retention of title

A very important consequence arising from s.19(1) is the retention of title clause which provides that the property in the goods will not pass to the buyer until the buyer has paid for the goods, even though delivery has been made to the buyer, who has the right to sell and/or use the goods delivered. This is as a form of security to the supplier and, in the event of the winding-up of the buyer, the supplier can recover the remaining unsold stocks in the buyer's possession (see Chapter 10, p. 328).

13.8 Sale by a Non-owner

Where there has been a sale of goods by a non-owner, the law's role is to adjudicate between the competing claims of the rightful owner and the innocent purchaser. The general solution is that the law recognises the rightful owner's rights through the principle of *nemo dat quod non habet*, and protects the innocent purchaser only in certain circumstances.

The general principle of *nemo dat quod non habet*

The general principle of *nemo dat quod non habet* is stated in s.21(1), which provides: 'Subject to this Act, where goods are sold by a person who is not their owner, and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had, unless the owner of the goods is by his conduct precluded from denying the seller's authority to sell.' This subsection provides for exceptions: namely, sale by an agent and estoppel.

Section 21(2) provides further exceptions in so far as 'nothing in this Act shall affect – (a) the provisions of the Factors Acts, or any enactment enabling the apparent owner of goods to dispose of them as if he were the true owner thereof; or (b) the validity of any contract of sale under any special common law or statutory power of sale or under the order of a court of competent jurisdiction'.

These and other exceptions in the Act and other legislative provisions will now be discussed.

Exceptions to *nemo dat*

Estoppel authority

An estoppel, when successfully raised, prevents the true owner from claiming that the sale of goods was unauthorised. An estoppel arises when the true owner leads the innocent purchaser to believe that the unauthorised

seller has the right to sell the goods. In order to be successful, the following points must be established:

(i) the true owner represents – intentionally or negligently – that the seller is entitled to sell the goods;
(ii) the innocent buyer acts in reliance on the representation; and
(iii) the innocent buyer buys the goods.

In *Eastern Distributors* v. *Goldring* [1957] 2 QB 600, the owner of a van wished to raise a loan against it and, together with a motor trader, deceived a finance company by filling in forms as if the van belonged to the trader and the rightful owner wanted to buy it on hire-purchase. The finance company acquired the van for cash from the motor trader and transferred it on hire-purchase to the true owner. The latter failed to make any instalment payments and later sold the van to an innocent purchaser. In a dispute concerning the rightful ownership of the van, the court upheld the claim of the finance company that, by representing that the van belonged to the motor trader rather than to himself, he was estopped from asserting his ownership. The representation by the true owner must be either intentional or negligent in order for an estoppel to arise. This can be contrasted with the decision in *Mercantile Credit Co.* v. *Hamblin* [1965] 2 QB 242, where Hamblin contacted a motor trader about raising a loan on the security of her car and completed hire-purchase proposal forms, thinking that this was a mere application for a loan. The court held that she had not intended to deceive the finance company into believing the car was the property of the motor trader, and that, since she knew nothing about financial matters and had trusted in the motor trader, neither was she negligent.

The level of negligence necessary has been discussed in a number of cases. In *Heap* v. *Motorists Advisory Agency Ltd* [1922] All ER Rep 251, Heap was induced by North to allow him to drive away a car ostensibly to show it to a third party. North used the car for a few weeks and then sold it to the defendants. Heap claimed its return under s.21(1). The court held that Heap was not precluded from denying North's authority to sell. Negligence must be more than mere carelessness and amount to a disregard of the owner's obligations towards a person setting up the defence.

The defence is not available where the innocent purchaser has merely agreed to buy goods. Thus, in *Shaw* v. *Commissioner of Police for the Metropolis* [1987] 1 WLR 1332, the purchaser from a non-owner agreed to buy a car with the property passing on payment. Since he had not paid, he was unable to claim a good title against the true owner of the vehicle.

Mercantile agents

The second major exception relates to the position of a mercantile agent or factor and the operation of the Factors Act 1889. A mercantile agent is defined by the Act as 'a mercantile agent having in the customary course of his business … authority either to sell goods or to consign goods for the

purpose of sale, or to buy goods, or to raise money on the security of goods': Factors Act s.1(1). In order to qualify as a mercantile agent, the agent must also be independent from the principal, s/he must be acting as an agent in a way of business and authorised to deal with goods in his/her own name. In *Lowther* v. *Harris* [1926] All ER Rep 352, the plaintiff left some tapestries with a man called Prior, who owned a shop. Although Prior had no authority to sell them, he sold them to the defendant. The plaintiff sued the defendant in conversion. The issue was whether Prior, who had no general business as an agent, and who had only one principal, could be a mercantile agent. The court held that he was. A person can be a mercantile agent even though s/he acts for one principal and only acts on one occasion, provided s/he acts in a business capacity.

The basis of the statutory exemption from the *nemo dat* doctrine is s.2(1) of the Factors Act, which provides:

> Where a mercantile agent is, with the consent of the owner, in possession of goods or the documents of title to goods, any sale, pledge or other disposition of the goods, made by him when acting in the ordinary course of business of a mercantile agent, shall, subject to the provisions of this Act, be as valid as if he were expressly authorised by the owner of the goods to make the same; provided that the person taking under the disposition takes in good faith, and has not at the time of the disposition notice that the person making the disposition has no authority to make the same.

In order to pass a good title the following must be established:

(i) The mercantile agent must be in possession of the goods or documents of title to goods as a mercantile agent. A bill of lading is a document of title but not the registration documents for a motor vehicle: *Beverley Acceptance* v. *Oakley* [1982] RTR 417. As regards having possession as a mercantile agent, a car left at a garage for repair does not qualify and the section will not apply.

(ii) The possession must be with the consent of the owner. Consent is presumed in the absence of evidence to the contrary, and if the owner withdraws consent this will have no effect unless and until it is drawn to the attention of the person taking the goods: Factors Act s.2(3)(4).

The fact of the consent being obtained by a trick will not be relevant as long as the consent is given to the agent in his/her capacity as a mercantile agent. Thus in *Pearson* v. *Rose and Young* [1951] 1 KB 275, the plaintiff left his car with a man called Hunt to see what offers he could obtain on the car. He did not ask or authorise Hunt to sell it, and had no intention of giving the property in the car to him. Hunt sold the car to the defendants. The court held that the plaintiff could not recover the car since Hunt was a mercantile agent in possession of the car with the consent of the owner, even if he had obtained consent and possession by a trick.

In *Du Jardin* v. *Beadman Brothers* [1952] 2 All ER 160, a car dealer obtained possession of a second-hand car from the plaintiff, pretending that he would be able to sell it. He left his own car as security, together with a cheque which was later dishonoured. He secretly took back his own car and then sold the plaintiff's car to a third party acting in good faith. The court held that the third party acquired a good title. In *Folkes* v. *King* [1923] 1 KB 282, the plaintiff delivered his car to a mercantile agent with instructions not to sell it below a certain price. The agent sold it for a lower figure to the defendant who purchased it in good faith. The court held that the plaintiff could not recover his car since the agent passed a good title under s.2(1). However, in *Stadium Finance Co.* v. *Robbins* [1962] 2 QB 664, the car dealer was left a car by the defendant with a tentative arrangement that he would try to find a buyer. The defendant took away the ignition key, but left the registration document in a locked compartment in the car. The agent obtained access to the registration book and sold the car to the plaintiffs, having supplied a substitute key. The plaintiffs let it out on hire-purchase to a person who fell in arrears with his payments and the finance company tried to repossess the car but found that the defendant had retaken the car. The plaintiffs sued, claiming that the property in the car had passed to them on the grounds that it had been sold in the ordinary course of business by a mercantile agent, but were unsuccessful.

(iii) The sale must be in the ordinary course of the mercantile agent's business.

(iv) The person taking the goods must have no notice of the agent's lack of authority. The burden of proof is on the purchaser.

Sale under a voidable title

The basis of this exception is s.23, which provides: 'Where the seller of goods has a voidable title to them, but his title has not been avoided at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith and without notice of the seller's defect of title.' The most common way in which a person acquires a voidable title to goods is by acquiring goods under a contract effected by misrepresentation. However, it can also arise where the contract is induced by undue influence. Where a contract is affected by an operative mistake the contract will be void. However, where the mistake relates to the identity of the purchaser in a face-to-face situation, the contract will not be void for mistake but voidable for misrepresentation, see *Lewis* v. *Averay* [1972] 1 QB 198 (see Chapter 4).

Sale by a seller in possession

This exception derives from the fact that it is difficult to establish ownership in respect of goods, and therefore possession of goods is to be taken

as *prima facie* evidence of ownership. This statutory exception arises under s.24, which provides: 'If a person who has sold goods continues or is in possession of the goods or of the documents of title to them, any sale or pledge by him to a buyer or pledgee who takes the goods in good faith without notice of the previous sale will give a good title to the buyer or pledgee.' There is an almost identical provision in the Factors Act 1889, s.8. Thus, if S sells goods to B and the property passes to B but possession remains with S, if S then sells and delivers them to C, who buys them in good faith, C has a good title to the goods and B can sue S for breach of contract.

Sale by a buyer in possession

The statutory basis of this exception is s.25, which provides:

> Where a person having bought or agreed to buy goods obtains, with the consent of the seller, possession of the goods or the documents of title to the goods, the delivery or transfer by that person, or by a mercantile agent acting for him, of the goods or documents of title, under any sale, pledge or other disposition thereof, to any person receiving the same in good faith and without notice of any lien or other right of the original seller in respect of the goods, shall have the same effect as if the person making the delivery or transfer were a mercantile agent in possession of the goods or documents of title with the consent of the owner.

An identical provision is in the Factors Act 1889, s.9. Thus, if S sells goods to B and possession passes to B but the property remains with S, if B sells and delivers them or documents of title to them to C, who buys in good faith, C obtains title and S can sue B for payment.

The section does not confer title to a buyer who purchases from a seller with no title. In *National Mutual General Insurance Association Ltd* v. *Jones* [1988] 2 WLR 952, thieves stole a car which was then sold to A, who sold it to C (a car dealer), who sold it to D (another dealer), who sold it to Jones. Rejecting Jones's claim that he had acquired a good title to the car against the rightful owner, the court held that the section could only defeat the title of an owner who had entrusted possession of his goods (or documents of title to goods) to a buyer. It could not remove title from an owner from whom the goods had been stolen.

A key element in respect of s.25 is the importance of the words 'having bought or agreed to buy'. A person has not 'bought or agreed to buy' goods where s/he has taken goods on a 'sale or return' basis. Sale by such a person will, however, be able to pass a good title, since the act of the sale or the pledge will operate to pass the title to the seller: see s.18, Rule 4, above. A more important exclusion from protection relates to persons who hold the goods under a contract of hire. This is of particular importance in relation to sale by a person to whom goods have been bailed under a contract of hire-purchase. As long ago as the decision in *Helby* v.

Matthews [1895] AC 471, the court held that such a person had not bought nor agreed to buy goods, and thus could not pass a good title to an innocent purchaser. The effect of this was to ensure the popularity of the hire-purchase contract with traders and finance companies, since they could always recover the goods from the innocent purchaser.

A person who has bought goods under a conditional sale agreement was formerly held to be someone who has 'bought or agreed to buy' for the purpose of s.25 (*Lee* v. *Butler* [1893] 2 QB 318), but this has been amended by the Consumer Credit Act 1974 and buyers under a conditional sale agreement within the scope of the Act are not persons who have 'bought or agreed to buy' for the purposes of s.25 and s.9 Factors Act 1889.

This protection of the owner of goods subject to a hire-purchase or conditional sale agreement is now restricted by the operation of the exception in relation to motor vehicles under the Hire Purchase Act 1964, Part III.

In respect of motor vehicles, under the Hire Purchase Act 1964, Part III, the law now protects the innocent purchaser of a motor vehicle in the following conditions:

(i) the seller must be someone who is hiring the vehicle under a hire-purchase agreement or buying it under a conditional sale agreement; and
(ii) the purchaser must be a 'private purchaser'.

The sale must be to a private purchaser, who must not be a dealer (or a finance house) carrying on business in the motor trade. This is so even where the dealer acquires the car for his/her own private purposes (*Stevenson* v. *Beverley Bentinck* [1976] 1 WLR 1593); however, the Act will protect the first private purchaser from the dealer.

Sale under a common law or statutory power

Some people are given common law or statutory powers to sell property belonging to others. Thus a pawnbroker is able to sell the goods pledged to him/her when the loan is not repaid by the pledgor. An innkeeper can sell the property of a guest if the guest's bill is not paid. Under the Torts (Interference with Goods) Act 1977, a person such as a repairer, improver, valuer or storer of goods has a right to sell uncollected goods after first serving notice on the bailor and waiting for the expiry of the notice. The purchaser will acquire a good title under s.21(2)(a) Sale of Goods Act 1979, but the sale will still not grant a good title to a purchaser if the bailor had no title.

Sale under a court order

The High Court has the power in certain circumstances to order the sale of goods. The purchaser will acquire a good title under s.21(2)(b) Sale of Goods Act 1979.

13.9 Performance of the Contract

It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them in accordance with the terms of the contract of sale: s.27. Unless otherwise agreed, delivery and payment are concurrent conditions: s.28.

Delivery

The meaning of the word 'delivery' must be understood in the light of the Act. Thus, whether the buyer has to take possession of the goods or the seller has to send them to the buyer is a question depending on the contract between the parties: s.29(1). Where there are no contractual terms relating to delivery, the rules as to delivery are contained in the Act. Thus, unless there is a contrary provision, the place of delivery is at the seller's place of business, if s/he has one, and, if not, his/her residence. However, if the contract is for the sale of specific goods which are to the knowledge of the parties in some other place, then that place is the place of delivery: s.29(1). Where the seller is bound to send the goods to the buyer but no time for sending them is fixed, the seller is bound to send them within a reasonable time: s.29(2). Demand or tender of delivery may be treated as ineffectual unless made at a reasonable hour: s.29(3). Where the goods are in the possession of a third person, there is no delivery unless and until that person acknowledges to the buyer that s/he holds the goods on his/her behalf: s.29(4).

Where the seller is authorised or required to send the goods to the buyer, delivery of goods to a carrier, whether named by the buyer or not, for the purpose of transmission to the buyer is *prima facie* deemed to be delivery to the buyer: s.32(1). However, the seller must enter into a reasonable contract with the carrier relative to the nature of the goods, failing which, if the goods are lost or damaged in transit, the buyer may refuse to treat delivery to the carrier as delivery to him/herself, or may claim damages against the seller: s.32(2). Where the goods are to be sent to the buyer by sea, and when it would be usual for the goods to be insured, the seller must give sufficient notice to the buyer to insure them, failing which the goods will be at the buyer's risk during the sea transit: s.32(3).

Where the seller agrees to deliver goods at his/her own risk at a place other than where they were when sold, the buyer must, unless otherwise agreed, take any risk of deterioration arising from the course of transit: s.33.

Instalment delivery

Unless otherwise agreed, the buyer is not bound to accept delivery by instalments: s.31(1). Where there is a contract for the sale of goods to be delivered by stated instalments, which are to be paid for separately, and

the seller makes defective deliveries in respect of one or more of the instalments, or the buyer neglects or refuses to take delivery of or pay for one or more instalments, it depends upon the terms of the contract and the circumstances of the case whether the breach of contract is a repudiation of the whole contract or whether it is a severable breach giving rise to a claim for compensation but not to a right to treat the whole contract as repudiated: s.30(2).

In *Robert A. Munro & Co. Ltd* v. *Meyer* [1930] 2 KB 312, the plaintiffs agreed to sell to the defendants 1500 tons of meat and bonemeal of a specified quality, with delivery by instalments. The plaintiffs delivered some 611 tons of meal that was not of the specified quality. The defendants repudiated the contract. The plaintiffs sued for money due under the agreement and the defendants counterclaimed for damages. The court held that the size of the breach of the contract, and the likelihood of its being repeated, entitled the defendants to repudiate the contract and claim for damages in respect of the inferior meal delivered. As a contrast, in *Maple Flock Co. Ltd* v. *Universal Furniture Products (Wembley) Ltd* [1933] All ER 15, the sellers agreed to supply the buyers with 100 tons of flock by instalments. The first 15 deliveries of 1½ tons each were satisfactory, but when a sample of the sixteenth delivery was analysed it was found to contain more chlorine than the contract allowed. The buyers sought to repudiate the contract, but the court held that defective delivery of one instalment did not amount to repudiation by the sellers of the whole contract. Hewart LCJ stated the test as follows: 'the main tests to be considered are, first, the ratio quantitatively which the breach bears to the contract as a whole, and secondly, the degree of probability or improbability that such a breach will be repeated'.

A case showing the relationship between ss.30 and 31 is *Regent OHG Aisenstadt und Barig* v. *Francesco of Jermyn Street Ltd* [1981] 3 All ER 327. The plaintiff contracted to sell 62 suits to the defendant, with delivery by instalments over an agreed period, the number and size of each delivery being at the discretion of the seller. The buyer informed the seller that he wished to cancel the order, but the seller insisted on making deliveries. Five attempted deliveries were rejected by the buyer and, in defence to a claim for damages for non-acceptance, the buyer claimed that, as the deliveries had been one suit short of the contract quantity, he was entitled to reject the whole consignment under s.30(1). The court held that s.30(1) was inconsistent with, and had to yield to, s.31 in the case of a severable contract. Under this section, the short delivery was not sufficient to justify a repudiation of the whole contract.

Acceptance

Where goods that s/he has not previously examined are delivered to a buyer, s/he is not deemed to have accepted them unless and until s/he has had a reasonable opportunity of examining them to see whether they

conform to the contract: s.34(1). And the seller is bound to give the buyer a reasonable opportunity of examining the goods to see whether they conform to the contract: s.34(2).

The buyer is deemed to have accepted the goods when (i) s/he intimates to the seller that s/he has accepted them; or (ii) does any act to the goods which is inconsistent with the ownership of the seller; or (iii) retains the goods, after the lapse of a reasonable time, without intimating to the seller that s/he has rejected them. The way in which this can limit the remedies available to the buyer has already been discussed (see p. 000 above).

Where the seller delivers a smaller quantity than s/he had contracted, the buyer may reject them, but if s/he accepts them s/he must pay at the contract rate: s.30(1). Similarly, where the seller delivers a larger quantity of goods, the buyer may accept the amount contracted for and reject the rest, or reject the whole. Where s/he accepts the whole, s/he must pay for them at the contract rate: s.30(2). Where the seller delivers goods that are mixed with goods of a different description, the buyer may accept those that are in accordance with the contract and reject the rest, or reject the whole: s.30(3). Where goods are delivered to the buyer that s/he refuses to accept, having a right to do so, s/he is not bound to return them and it is enough to indicate that s/he refuses to accept them: s.36.

When the seller is ready and willing to deliver the goods, and requests the buyer to take delivery, and the latter fails within a reasonable time to take delivery, s/he is liable to the seller for any loss and for a reasonable charge for the care and custody of the goods, provided that nothing in this section shall affect the rights of the seller where the refusal of the buyer to take delivery amounts to a repudiation of the contract: s.37.

13.10 Rights of the Unpaid Seller Against the Goods

Under the Act, the unpaid seller of goods has rights over the goods even though the property in the goods has passed to the buyer. These are in addition to the rights of action against the buyer for non-payment or failure to take delivery (see below). A seller of goods is deemed to be an unpaid seller when (a) the whole of the price has not been paid or tendered; or (b) when a bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise: s.38(1).

The unpaid seller's rights are (i) a lien on the goods or right to retain them for the price while s/he is in possession of them; (ii) where the buyer is insolvent, a right of stopping the goods *in transitu* (in transit) after s/he has parted with possession of them; and (iii) a right of resale as limited by the Act.

The seller's lien

The unpaid seller of goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases:

(i) where the goods have been sold without any stipulation as to credit;
(ii) where the goods have been sold on credit, but the term of credit has expired; and
(iii) where the buyer becomes insolvent: s.41(1).

The seller may exercise his/her right of lien even though s/he is in possession of the goods as agent or bailee of the buyer: s.41(2).

Where an unpaid seller has made a part delivery of the goods, s/he may exercise his/her right of lien on the remainder unless the right to the lien has been waived: s.42. Termination of the right to the lien occurs:

(i) when he delivers the goods to a carrier or other bailee or custodier for the purpose of transmission to the buyer without reserving the right of disposal of the goods;
(ii) when the buyer or his agent lawfully obtains possession of the goods; and
(iii) by waiver of the lien or right of retention: s.43.

Right of stoppage in transit

When the buyer of goods becomes insolvent, the unpaid seller who has parted with possession of the goods has the right of stopping them in transit, thus s/he may resume possession of the goods and retain them until payment or tender of the price: s.44.

Duration of transit

Goods are in the course of transit from the time when they are delivered to a carrier for the purpose of transmission to the buyer until the buyer, or his/her agent, takes delivery of them: s.45(1). This is so even if the buyer or his/her agent obtains delivery before their arrival at the appointed destination: s.45(2).

If, after the arrival of the goods at the appointed destination, the carrier acknowledges to the buyer or his/her agent that the carrier holds the goods on the buyer's behalf, the transit is at an end, and it is immaterial that the buyer indicates a further destination for the goods: s.45(3). Where the goods are rejected by the buyer, the transit is not at an end, even if the seller refuses to take them back: s.45(4). When goods are delivered to a ship chartered by the buyer, it depends upon the circumstances of each case whether they are in possession of the master as carrier or as agent of the buyer: s.45(5). When the carrier wrongfully refuses to deliver the goods to the buyer or his/her agent, the transit is at an end: s.45(6). When a part delivery of goods has been made to the

buyer, the remainder may be stopped in transit unless the part delivery shows an agreement to give up possession of the whole of the goods: s.45(7).

Exercise of stoppage in transit

The unpaid seller may exercise his/her right by taking actual possession of the goods or by giving notice of his/her claim to the carrier. The notice may be to the person actually in possession of the goods or to his/her principal. In order to be effective, the notice must be given at such time and in such circumstances that the principal, by acting with reasonable diligence, may communicate it to his/her servant or agent in time to prevent delivery to the buyer: s.46(1). When notice of stoppage in transit is given, the carrier must redeliver his/her goods to or according to the order of the seller. The expenses of the re-delivery are borne by the seller: s.46(2).

Position of unpaid seller where property has not passed to the buyer

Where the property in the goods has not passed to the buyer, the unpaid seller has, in addition to his/her other remedies, a right of withholding delivery similar to and co-extensive with his/her rights of lien and stoppage in transit where the property has passed to the buyer: s.39(2).

Effect of sub-sale or pledge by buyer on seller's right to lien or stoppage in transit

The right to lien or stoppage in transit is not affected by any sale or other disposition of the goods by the buyer, except:

(i) where the seller has assented to it: s.47(1); or
(ii) where a document of title to goods has been lawfully transferred to the buyer, and s/he transfers the document to a person by way of sale who takes it in good faith and for value. Where the transfer is by way of pledge, the right of lien and stoppage can only be exercised subject to the rights of the transferee: s.47 (proviso).

The right of resale

The contract of sale between the seller and the buyer is not rescinded by the exercise of the unpaid seller's right of lien or stoppage in transit: s.48(1); but where the unpaid seller then resells the goods, the buyer acquires a good title to them over the original buyer: s.48(2). The right to exercise the right of resale arises automatically where the goods are of a perishable nature, but otherwise, where the unpaid seller has given notice to the buyer of his/her intention to resell, and the buyer does not within a reasonable time pay or tender the price, the unpaid seller may recover from the original buyer damages for any loss by his/her breach of contract:

s.48(3). Where the seller reserves a right of resale on the default of the buyer and, following such a default, resells the goods, the original contract of sale is rescinded but without prejudice to the seller's claim for damages: s.48(4).

13.11 Actions for Breach of the Contract

The Act provides for remedies for the seller and the buyer.

Remedies of the seller

In addition to the rights against the goods previously described the seller has the following rights against the buyer: (i) action for the price; and (ii) damages for non-acceptance of the goods.

Action for the price

Where the property has passed to the buyer and the buyer wrongfully refuses to pay for the goods, the seller can sue for the price of the goods: s.49(1). The right to sue for the price may even arise when the property has not passed to the buyer, and the goods have not been appropriated, where the contract provides for payment on a certain day, irrespective of delivery: s.49(2).

Damages for non-acceptance

Where the buyer refuses to accept and pay for the goods (s.50(1)), the damages are the estimated loss directly and naturally resulting in the ordinary course of events from the buyer's breach of contract: s.50(2). Where there is an available market for the goods, the measure of damages is *prima facie* ascertained by the difference between the market price and the contract price at the time when the goods ought to have been accepted or, where no time is fixed, when delivery was refused: s.50(3) (see Chapter 5).

Remedies of the buyer

The buyer has the following three remedies against the seller.

Damages for non-delivery

If the seller wrongfully refuses to deliver the goods, the buyer may sue for damages for non-delivery. The measure of damages is the estimated loss directly and naturally resulting from the seller's breach of contract. Where there is an available market in the goods, the measure of damages is *prima facie* the difference between the contract price and the market or current price at the time when they ought to have been delivered or at the time of refusal of delivery: s.51.

Specific performance

In an action for breach of contract to deliver specific or ascertained goods, the court may, if it thinks fit, on the application of the plaintiff, make an order for the specific performance of the contract: s.52 (see Chapter 5).

Damages for breach of warranty

Where there is a breach of warranty by the seller, or where the buyer elects or is compelled to treat a breach of condition as a breach of warranty, the buyer cannot reject the goods but may (a) set up the breach of warranty in diminution or extinction of the price; or (b) maintain an action against the seller for breach of warranty. The measure of damages is the estimated loss directly and naturally arising from the breach of warranty. In the case of a breach of warranty of quality the loss is *prima facie* the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had complied with the warranty: s.53(3). The fact of setting up the breach of warranty in diminution or extinction of the price does not prevent the buyer from bringing an action for damages for breach of warranty if s/he has suffered further damage. In *Bence Graphics International Ltd* v. *Fasson UK Ltd* [1997] 1 All ER 979, the defendant supplied vinyl film to the plaintiff to manufacture decals to identify bulk containers. It was a term of the contract that the film would remain legible for at least five years. The film degraded prematurely, the plaintiffs received extensive complaints from customers and were forced to retain £22 000 worth of defective material. The Court of Appeal held that the plaintiff's liability to the ultimate user was contemplated as the measure of damages and that the *prima facie* measure of damages under s.53(3) was displaced.

13.12 Contracts for the Supply of Goods

The Supply of Goods and Services Act 1982 was passed to clarify the law in this area. The Act deals with three areas of the law: (i) contracts for the transfer of property in goods; (ii) contracts for hire of goods; and (iii) contracts for services. In each case there are implied terms closely modelled on those in the Sale of Goods Act 1979 as amended by the Sale and Supply of Goods Act 1994 and controls limiting the extent to which parties can contract out of these terms.

Contracts for the transfer of property in goods

These are contracts where there is a transfer of property in goods which are not contracts for the sale of goods or contracts of hire-purchase. The Sale of Goods and Services Act 1982 protects the transferee under these contracts in respect of title, description, satisfactory quality, fitness for

purpose and compliance of bulk with sample through the insertion of implied terms into such contracts through ss.2–5 of the Act identical with those in ss.12–15 of the Sale of Goods Act 1979.

The Act only deals with the implied terms; all other aspects of the law relating to the passing of property and so on are covered by common law, but there is not much case law on the topic. The contracts principally covered by this part of the Act are (i) collateral contracts relating to the supply of goods; (ii) contracts of exchange or barter; and (iii) contracts where, although there is a supply of goods, the essence of the contract is the provision of services. This covers contracts relating to repair where goods may be supplied as part of the repair work.

Collateral contracts

These are contracts where, in return for the purchase of one product, the purchaser will be entitled to another. Thus, for example, a petrol station may offer 'free gifts' to purchasers of cans of motor oil. The contract for the motor oil is covered by the Sale of Goods Act 1979, but the 'free gift' falls under ss.2–5 of the Supply of Goods Act 1982. In *Esso Petroleum Ltd* v. *Commissioners of Customs and Excise* [1976] 1 All ER 117, the House of Lords rejected a claim by the Commissioners that Esso were liable for purchase tax on World Cup coins that the company was giving away as a sales promotion to every purchaser of four gallons of petrol, on the grounds that they were not being 'produced in quantity for sale'.

Contracts of barter or exchange

Such contracts clearly do not include contracts where there is an element of part-exchange plus the payment of cash, since these will be contracts of sale, even though the cash element may be very small. The essence of such contracts is that the goods that are being given in part-exchange for the item supplied will be attributed a cash value which is then deducted from the value of the replacement item. The attribution of financial value negatives the notion of this as a contract of barter or exchange and seems to cover any contract where a value is placed on the objects exchanged.

A clear case of barter or exchange occurs where goods are obtained against tokens to which no money value is attributed. Thus, for example, where a chocolate manufacturer offers a record against ten wrappers from a chocolate bar with no money element in the deal, claims concerning the quality of the record are under the Supply of Goods and Services Act 1982, ss.2–5.

Contracts for work and materials

These cover contracts to repair cars, involving the fitting of spare parts; rewiring houses, with the provision of wiring, plugs and switches; and contracts for building houses and so on under which title to the bricks will pass. Where claims arise under such contracts it is important to identify

whether the cause of the complaint relates to the failure of any new component supplied or to negligent installation. In the former, the claim will arise under ss. 2–5, whereas negligent workmanship is covered by s.13. The Supply of Goods and Services Act 1982 only relates to goods supplied under the contract, with the result that property in the goods passes.

The exclusion of the implied terms is restricted in the same way as for the implied terms of the Sale of Goods Act 1979. This protection is contained in the Unfair Contract Terms Act 1977, s.7 (as amended by the Supply of Goods and Services Act 1982). The protection makes the same distinction between persons dealing as a consumer and dealers, and the same reasonableness tests apply. The Unfair Terms in Consumer Contracts Regulations 1994 may also apply (see Chapter 16).

Contracts for hire of goods

This is a contract under which the hirer obtains the possession but not the property in the goods hired; the person hiring the goods is the bailee of the goods and the hirer is the bailor. The 1982 Act defines the contracts covered by this part of the Act and contracts of hire-purchase are excluded: s.6(2)(a), but a contract is a contract for the hire of goods whether or not services are also provided under the contract, and irrespective of the nature of the consideration for the hire: s.6(3).

The implied terms are contained in ss.7–10 of the 1982 Act. The terms relating to description, satisfactory quality, fitness for purpose, and sample are identical in effect with the equivalent sections in the Sale of Goods Act 1979. The main difference relates, obviously enough, to the implied term relating to title. Thus, in s.7 there is an implied condition on the part of the bailor that s/he has a right to transfer possession of the goods by way of hire for the period of the bailment, or that in the case of an agreement to bail s/he will have such a right at the time of bailment: s.7(1).

There is also an implied warranty that the bailor will enjoy quiet possession of the goods for the period of the bailment, except for the case of disturbance by the owner or a person entitled to the benefit of any charge or encumbrance disclosed or known to the bailee before the contract is made: s.7(2). These provisions do not affect the right of the bailor to repossess goods under an express or implied term of the contract: s.7(3).

The Unfair Contract Terms Act 1977 applies to contracts of hire and makes the same distinction between persons dealing as a consumer and non-consumer deals. Implied terms relating to description, satisfactory quality, fitness for purpose, and sample cannot be excluded, in the former case, whereas in the latter they may be excluded subject to the test of reasonableness. The one difference in protection here, however, relates to the implied term as to title and quiet possession, which can be excluded in either case but only subject to the test of reasonableness. The Unfair Terms in Consumer Contract Regulations 1994 could also apply (see Chapter 16).

Contracts for the supply of services

This is a contract under which a person ('the supplier') agrees to carry out a service. The 1982 Act specifically excludes contracts of service and apprenticeship. It is a contract for the supply of a service whether or not goods are also transferred, or to be transferred or bailed, or to be bailed by way of hire, and irrespective of the nature of the consideration: s.12(1),(2) and (3).

The Secretary of State has power by Order to provide that one or more of the sections of this part of the Act relating to the provision of service shall not apply to a specified service, and such an order can provide for different statutory provisions: s.12(4) and (5). The one order made so far excludes the implication that the supplier of a service will carry out the service with reasonable care and skill in accordance with s.13 from applying to (i) the services of an advocate in court or before any tribunal, inquiry or arbitrator and in carrying on the preliminary work directly affecting the conduct of the hearing; and (ii) the services rendered to a company by a director or a company in his/her capacity as such.

The first part preserves the protection of advocates (principally solicitors): *Rondel* v. *Worsley* [1969] 1 AC 191. The second protects non-executive directors who would otherwise have been unfairly singled out by the Act, since it would not apply to executive directors under a contract of service.

The terms implied

There are three implied terms implied.

Reasonable care and skill This is implied by s.13, which provides: 'In a contract for the supply of a service where the supplier is acting in the course of a business, there is an implied term that the supplier will carry out the service with reasonable care and skill.'

Time for performance This is implied by s.14, which provides: (1) 'Where, under a contract for the supply of a service by a supplier acting in the course of a business, the time for the service to be carried out is not fixed by the contract, left to be fixed in manner agreed between the parties or determined by the course of dealing between the parties, there is an implied term that the supplier will carry out the service within a reasonable time. (2) What is a reasonable time is a question of fact.'

Consideration for the service This is implied by s.15, which provides: '(1) Where, under a contract for the supply of a service, the consideration for the service is not determined by the contract, left to be determined in a manner agreed by the contract or determined by the course of dealing between the parties, there is an implied term that the party contracting with the supplier will pay a reasonable charge. (2) What is a reasonable charge is a question of fact.'

Exclusion of implied terms

A clause purporting to exclude or limit the liability of the supplier will be subject to the requirement of reasonableness where the person to whom the service is being supplied was dealing as a consumer, or where the supply was on the basis of the standard form contract of the supplier: s.3, Unfair Contract Terms Act (UCTA) 1977.

With regard to the implied term of reasonable care and skill, the breach of such a contractual term falls within the definition of negligence: s.1(a) UCTA 1977. As a result, this implied term is also subject to the restriction of exclusion clauses against negligence liability, and any clause which attempts to remove or limit the liability of the supplier under s.13. will not extend to death or personal injury: s.2 UCTA 1977. The Unfair Terms in Consumer Contracts Regulations 1994 could also apply (see Chapter 16).

13.13 Goods Supplied under Hire-purchase and Conditional Sale Agreements

Contracts for goods supplied under hire-purchase and conditional sale agreements contain similar clauses relating to implied terms as for the Sale of Goods Act 1979 and the Supply of Goods and Services Act 1982. These terms are contained in ss.8–11 of the Supply of Goods (Implied Terms) Act 1973. There are identical controls relating to the exclusion of the implied terms as for the other Acts.

13.14 Discrimination in Respect of Services, Goods and Facilities

The Race Relations Act 1976 prohibits discrimination in respect of the provision of goods, facilities or services: (a) by refusing or deliberately omitting to provide him/her with any of them; or (b) by refusing or deliberately omitting to provide him/her with goods, facilities or services of the like quality, in the like manner and on the like terms as are normal in the first-mentioned person's case in relation to other members of the public or … to other members of a section of the public; s.20(1). Examples of facilities and services are (a) access to and use of any place which members of the public are permitted to enter; (b) accommodation in a hotel, boarding house and so on; (c) facilities by way of banking or insurance or for grants, loans, credit or finance; (d) facilities for education; (e) facilities for entertainment, recreation or refreshment; (f) facilities for transport or travel; and (g) the services of any profession or trade, or any local or other public authority: s.20(2).

Part III of the Disability Discrimination Act (DDA) 1995 prohibits discrimination in the provision of services, goods or facilities in similar terms: s.19(1). It is irrelevant whether or not there is a charge for the

service: s.19(2)(c). Examples of services are similar to the RRA 1976, but include access to and use of means of communication and information services but exclude education and merely talk of facilities provided by employment agencies or training: s.19(3). Transport is also excluded: s.19(5). Discrimination can be justified if the provider reasonably believes that: (a) it is necessary in order not to endanger the health or safety of any person (including the disabled person); (b) the disabled person is incapable of entering into an enforceable agreement, or of giving an informed consent; (c) where it is necessary because the provider would otherwise be unable to provide the service to the public (for example, a coach refusing to train a disabled athlete); (d) where less favourable treatment in terms of standard, manner or terms is necessary in order to provide the service either to the disabled person or to other members of the public (for example, obliging a disabled person attending a concert/theatre to take a particular seat); and (e) where the difference in terms reflects the greater cost incurred by the provider: s.19(4).

Service providers must make adjustments to ‘a practice, policy or procedure which makes it impossible or unreasonably difficult for disabled persons to make use of a service’: s.21(1). Where this involves a physical feature, the provider must take all reasonable steps to (a) remove the feature; (b) alter it; (c) provide a reasonable means of avoidance; or (d) provide a reasonable alternative method a making the service available: s.21(2).

It is unlawful for a person with a power to dispose of any premises to discriminate against a disabled person in the terms on which s/he offers to dispose of those premises; by refusing to dispose of those premises; or in his/her treatment of the disabled person in relation to any list of persons in need of premises of that description: s.22(1).

An unlawful discrimination claim is by civil proceedings for tort within six months in the county court.

Recommended Further Reading

The Sale of Goods, P. S. Atiyah, 9th edn (Pitman, 1995).
Sale and Supply of Goods, Michael Furmston (Cavendish Publishing, 2nd edn 1995).

Questions

1 What is the importance of the terms implied into contracts for the sale of goods being conditions?

2 Section 13, Sale of Goods Act 1979 refers to a ‘sale of goods by description’. What does this mean?

3 What does the doctrine of *caveat emptor* mean, and when does it apply?

4 If you had asked a firm to provide food for a party suitable for vegetarians, under what section of the Sale of Goods Act 1979 would you

have an action if the food supplied was perfectly edible but not suitable for vegetarians?

5 With regard to contracts between dealers, implied terms can be excluded subject to the 'requirement of reasonableness'. What criteria does the statute set out for establishing the requirement of reasonableness?

6 Why is it important to fix the exact moment when property in goods passes from the seller to the buyer, and when does this occur in the case of a contract for specific goods in a deliverable state?

7 You have bought goods on sale or return; when does property in the goods pass to you?

8 Distinguish between unconditional appropriation and appropriation by exhaustion in respect of unascertained goods.

9 The Sale of Goods Act 1979 contains a number of exceptions to the rule of *nemo dat quod non habet*. What is the meaning of this rule, and what exceptions are there to it?

10 In addition to being able to sue the buyer for the price, the unpaid seller of goods has remedies against the goods themselves in certain circumstances. What are those remedies, when do they arise, and when are they lost?

11 What terms are implied into contracts for the supply of services where the supplier is acting in the course of a business?

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Part VI

Payment Methods

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14 Consumer Credit Agreements

Learning Objectives

After reading this chapter you will know about:

1. the scope of the Consumer Credit Act 1974 with regard to regulated agreements
2. the difference between the hire-purchase contract, the conditional sale agreement and the credit sale agreement
3. the form and contents of regulated agreements and the consequences of non-compliance
4. the protection of the debtor in the form of the right to cancellation and restrictions on the creditor's right to repossess
5. the consequences of termination of the agreement by the debtor or the creditor

The Consumer Credit Act 1974 was passed as a result of the report in 1971 of the Crowther Committee on Consumer Credit and was a fundamental reform of the law which aimed to bring under the one Act all forms of consumer credit. Credit is defined as a 'cash loan or any other form of financial accommodation': s.9. The Act generally extended the law relating to hire-purchase contracts to all other forms of consumer credit. As well as hire-purchase contracts, the legislation applies to:

- loans by finance companies and banks;
- bank overdrafts;
- credit card agreements;
- credit sale agreements;
- conditional sale agreements;
- check trading agreements; and
- certain rental agreements, such as for television sets.

The primary objective of the Act is 'truth in lending', in respect of which it creates a standard measure of the cost of borrowing in the form of the annual percentage rate of charge (APR). The APR is calculated by taking the total cost of the credit, including interest and other charges. This is then expressed as an annual percentage rate in accordance with regulations under s.20. The rate can be found by reference to the Consumer Credit Tables published by Her Majesty's Stationery Office (HMSO). Consumer credit agreements may now be greatly affected by the Unfair Terms in Consumer Contracts Regulations 1994 (see Chapter 16).

14.1 Agreements Within the Act

Fully regulated agreements

The Act applies to regulated consumer credit agreements, which are agreements complying with two conditions: (i) the debtor is not a company or a body corporate; and (ii) the credit advanced must be between £50 and £15 000. The limit applies to the credit and not to any deposit or charges, and therefore the agreement may be regulated even though the total purchase price exceeds £15 000. The person supplying the finance is the creditor, and the customer or borrower is called the debtor. Regulated agreements are classifiable as (i) consumer credit agreements; and (ii) consumer hire agreements.

Consumer credit agreements

These are agreements whereby the creditor provides an individual with credit not exceeding the specified figure. All the agreements listed above, except for rental agreements, fall into this category. There are two types of credit provision. Credit sale, conditional sale and hire-purchase agreements are *fixed sum credit agreements*, since the agreement provides for a specific amount of credit. On the other hand, bank overdrafts and credit card agreements are *running account credit*, sometimes called 'revolving credit', where the debtor can receive cash, goods and services from time to time up to the level of his/her credit allowance for the time.

These agreements can be further classified under the following headings: (i) restricted use credit agreements; and (ii) unrestricted use credit agreements. A restricted use credit is one where the credit is tied to a particular transaction, so that hire-purchase agreements, conditional sale and credit sale agreements are examples of restricted use agreements, as are shop budget accounts, check trading and the use of credit cards for the purpose of obtaining goods and services. On the other hand, a bank loan is a case of unrestricted use credit since there is no restriction on the use of the credit provided by the creditor. The Act also distinguishes between: (i) debtor–creditor–supplier agreements (DCSA): s.12; and (ii) debtor–creditor agreements (DCA): s.13. DCSA agreements arise where there is connection between the creditor and the transaction. This may be because the creditor and the supplier are one and the same, or where there is an existing arrangement between the supplier and the creditor with regard to the provision of credit. They include: (i) restricted-use credit agreements where the creditor/supplier are the same person; (ii) restricted-use credit agreements by the creditor under a pre-existing arrangement between him/herself and the supplier, as with a credit card; and (iii) unrestricted-use credit agreements by the creditor under pre-existing arrangements with the supplier to finance transactions between the debtor and the supplier.

If there is no connection between the supplier and the creditor, then the agreement will be a DCA. An example includes the provision by a bank of an overdraft to be spent where and how the debtor wishes.

Consumer hire agreements

These are agreements for the hire of goods and they must be capable of lasting more than three months and not require the hirer to make payments exceeding the specified figure: s.15.

Partially regulated agreements

Two types of agreement are only partially regulated by the Act. These are (i) small agreements; and (ii) non-commercial agreements. The small agreement is either a regulated consumer credit agreement (excluding hire-purchase or a conditional sale agreement) where the total credit does not exceed £50, or a regulated consumer hire agreement where the hirer is not required to pay more than £50: s.17. A non-commercial agreement is one made by a creditor not in the course of a business carried on by him/her: s.189(1).

Exempt agreements

Certain consumer credit and consumer hire agreements are not regulated by the Act: s.16. In respect of the exempt agreements it should be noted that they can be reopened by the court where they are extortionate: s.16(7). In addition, the regulations governing advertisements and quotations apply to all organisations involved in house mortgage lending since September 1985. The exempt agreements include the following.

Mortgage lending

Loans secured on land and made by building societies, local authorities and other bodies to finance the purchase of land or the construction of a dwelling on land already owned are exempt: s.16(2). This will also extend to cover loans for mortgage protection insurance premiums. Consumer credit agreements, whereby a person pays for improvements to existing properties in the form of double glazing and so on where there is a mortgage created over the property, are regulated agreements.

Low cost credit

These agreements are DCAs where the APR does not exceed the highest of the London and Scottish clearing banks' base rates plus 1 per cent, or 13 per cent, whichever is the higher.

Finance of foreign trade

Credit agreements in connection with the import or export of goods and services do not fall within the scope of the Act.

Normal trade credit

This exemption covers credit where the final bill is to be paid in one instalment, and DCSAs for fixed sum credit where repayment does not exceed four instalments, or running account credit repayable in one amount, as with Amercian Express and Diners' Club.

Consumer hire agreements for telephones and gas and electricity meters

14.2 Licensing and Seeking Business

Part III of the Act establishes a comprehensive system of licensing for those who conduct business dealing with regulated and non-regulated agreements in the consumer credit and hire business. These licensing regulations apply to (i) consumer credit businesses and consumer hire business; and (ii) ancillary businesses.

Consumer credit and consumer hire businesses

This includes someone who carries on a business which provides under a regulated agreement either credit or goods on hire. Thus finance companies must be licensed, and so must the ordinary retailer who enters into a credit sale, conditional sale or hire-purchase agreement with any of his/her customers.

Ancillary businesses

This includes the business of credit brokerage, debt adjusting, debt counselling, debt collecting, and operating a credit reference agency. Thus the retailer who arranges finance for his/her customers under the familiar triangular transaction of hire-purchase agreement (see below) must be licensed as a credit broker.

The Director General of Fair Trading is responsible for administering the licensing system, with powers to vary, suspend, renew and withdraw licences. It is an offence to carry on a business requiring a licence without having one: s.39. A regulated agreement will generally be unenforceable against the customer where made by an unlicensed business: s.40, or after an introduction by an unlicensed credit-broker: s.149; this will also apply to agreements for unlicensed ancillary services: s.148.

There are also rules relating to advertising and canvassing. Thus an advertiser commits an offence if his/her advertisement:

(i) infringes regulations made under s.44;
(ii) advertises the supply of goods or services on credit when those goods or services are not also available for cash: s.45; and
(iii) is false or misleading in a material respect: s.46.

It is also an offence:

(i) to send to someone under 18 a document inviting him/her to seek information about credit or to obtain credit: s.50;
(ii) to issue an unsolicited credit token (such as a credit card): s.51;
(iii) to infringe regulations as to the contents and form of a quotation of credit terms: s.52; and
(iv) to fail to comply with regulations on the information to be displayed at the premises of a credit business: s.53.

Canvassing debtor–creditor agreements off trade premises is an offence: s.49; but the canvassing of debtor–creditor–supplier agreements is permitted, provided the canvassing is licensed: s.23. Canvassing off trade premises for the provision of services as a credit broker, debt adjuster or debt counseller is an offence: s.154.

14.3 Form and Contents of the Agreement

Regulated agreements must comply with the requirements of the Act as regards (i) legibility; (ii) information; (iii) state when signed; and (iv) copies to the debtor. If not complied with, the creditor may not be able to enforce the agreement, although the court may dispense with these requirements where it is just and fair to do so, depending on the degree to which the customer has been prejudiced by the breach and the degree of culpability of the creditor or owner. The formalities are as follows:

(i) All the terms must be embodied in the written agreement, or in a document referred to in the written agreement: s.61(1)(b), and must be readily legible: s.61(1)(c). Details of any right of cancellation enjoyed by the debtor must be included: s.64(1)(a); and the document must comply with the regulations made under s.60 regarding form and contents, such as names and addresses of the parties, the amounts and dates of payment and the true cost of the credit.
(ii) The agreement must be signed by the debtor or hirer in person, and by or on behalf of the creditor or owner: s.61(1)(a).
(iii) The creditor must receive one copy of the agreement when s/he is given or sent the agreement to sign: s.62(1) and s.63(1); and, if the agreement is not made when s/he signs it, s/he must be given a second copy within seven days of the making of the agreement: s.63(2). For cancellable agreements, the second copy must be sent by post: s.63(3); for credit token agreements (credit card or check trading agreements) the second copy must be given before or at the time the credit token is given to the customer: s.63(4); and a copy of the agreement must be given each time a new credit token is given: s.85.
(iv) For prospective regulated agreements that are to be secured by a mortgage of land, the prospective borrower must receive a copy of

the agreement at least seven clear days before s/he is sent the actual agreement to sign: s.61(2); and during that time and for a further period of seven days, the prospective creditor must stay away from the customer so as to allow him/her a consideration period free from sales pressure unless the customer specifically requests the prospective creditor to contact him.

14.4 Cancellation

Debtors can cancel regulated agreements within a few days after they have been entered, where (i) the antecedent negotiations included oral representations by the creditor or owner or the dealer made in the customer's presence; and (ii) the customer signed the agreement elsewhere than at certain trade premises, including the trade premises of the creditor or the owner or, for DCSAs, the trade premises of the dealer: s.67. Agreements are therefore cancellable if signed at the debtor's home or at his/her own business premises. This cooling-off period begins with the customer's signature and lasts until the end of five clear days from receiving the second copy of the agreement. The effect of cancellation varies according to the agreement; in the case of a hire-purchase, conditional sale and credit sale agreement, the customer can recover payments made: s.70; s/he must return the goods, although s/he is not obliged to deliver them and can wait until they are collected from him/her following a written request: s.72. S/he has a lien on them for the return of his/her payments: s.70(2). S/he has to take reasonable care of the goods for twenty-one days after serving notice of cancellation. Where the goods are perishable there is no duty to return them, and where goods are supplied to meet an emergency or have been consumed or incorporated into something else, there is no obligation to return them, but they must be paid for: s.69(2).

In the case of an ordinary loan the customer must repay any credit s/he had already received together with interest except that there is no interest on credit repaid within one month of the cancellation: s.71.

14.5 Dealer as Creditor's Agent

A person involved in negotiating a regulated agreement between a creditor and debtor is the agent of the creditor: s.56. This includes the dealer in a hire-purchase transaction involving a finance company, or the retailer dealing with a customer paying by credit card. The result of this is that the creditor is liable for any misrepresentations made by the dealer or retailer; any money paid to the dealer or retailer is regarded as having been received by the creditor; and notice to the dealer or retailer is notice to the creditor in respect of withdrawing an offer to enter a regulated agreement: s.57; cancellation of the regulated agreement: s.69; or rescission of the regulated agreement: s.102.

In *Forthright Finance Ltd* v. *Ingate (Carlyle Finance Ltd third party)* [1997] 4 All ER 99, I agreed to buy a Austin Metro car under a conditional sale agreement with F Ltd. A year later, she negotiated with a dealer to trade in the Metro against a Fiat Panda. The dealers were licensed credit brokers who agreed to buy her Metro, valued at £2000, and discharge the £1992 owed to F Ltd. I paid a £1000 deposit and entered a conditional sale agreement with C Ltd, a finance company, which recorded the cash price of £2995 the deposit of £1000 and the balance of £1995 on credit. The dealers went into liquidation without having paid the £1995 to F Ltd. F Ltd obtained a judgment against I, who claimed indemnity against C Ltd under s.56. The district judge ordered C Ltd to indemnify I, but this was reversed on appeal because the antecedent negotiations concerning the Metro did not relate to the goods sold under the agreement, that is, the Panda. The Court of Appeal held that the negotiations were part of a package relating to the Panda even though the value of the Metro cancelled out the debt due under the agreement. C Ltd was liable under s.56(2) to discharge the defendant's debt to F Ltd.

14.6 Creditors' Liability for Suppliers' Defaults

In respect of debtor–creditor–supplier agreements other than those where the creditor him/herself contracts to supply the goods to the customer (for example, hire-purchase, conditional sale and credit sale agreements – where the supplier is liable under the Supply of Goods Implied Terms Act 1973 or the Sale of Goods Act 1979) the creditor is liable for the default of the supplier under s.75. In such cases, when the debtor has a claim against the supplier, s/he has a similar claim against the creditor, who is jointly and severally liable with him to the debtor. Thus a person acquiring goods or services using a credit card can bring a claim against the credit card company. This excludes items with a cash price below £100 and above £30 000.

14.7 Misusing Credit Facilities

The debtor under a regulated agreement is not liable for any use of credit facilities by another person who is not his/her agent or acting by his/her authority: s.83. There is an exception with regard to the misuse of a cheque or other negotiable instrument, and further, in the case of credit tokens, the holder may be liable up to a maximum of £50 on losing the token. S/he is not liable for any misuse after the creditor has received notice of the loss of the card: s.84. The debtor cannot be liable for misuse of his/her credit card where it is lost in the post before reaching him/her (see Chapter 15).

14.8 Early and Late Payment by the Debtor

If the debtor gives written notice to the creditor s/he can complete his/her payments ahead of time: s.94. S/he may then qualify for a rebate of his/her interest charges under regulations made under s.95. Where s/he is late in making payments s/he may have to pay extra interest to take into account the delay, but s/he cannot be obliged to pay interest at a higher rate than that payable under the agreement as a whole: s.93.

14.9 Default and Non-default Notices

Where the creditor wishes to sue for payments due, s/he has an unrestricted right to commence proceedings in the county court which has exclusive jurisdiction in this area. However, where the creditor, owing to the default of the debtor, wishes

(i) to terminate the agreement; or
(ii) to demand earlier payment of any sum; or
(iii) to recover possession of any goods or land; or
(iv) to treat any right conferred on the debtor by the agreement as terminated, restricted or deferred; or
(v) to enforce any security;

s/he must serve notice on the debtor. The notice must give the debtor at least seven days' notice before the creditor can pursue one of the above provisions. The notice must make clear what can be done by the debtor to rectify the breach: s.87; and if s/he then does that the breach is regarded as never having occurred: s.89.

Where the creditor in respect of a specified duration agreement (such as hire-purchase agreement) wishes to do one of the above for a reason other than the default of the debtor s/he must serve a notice of his intention. If the debtor has been served with a default or non-default notice, or if any action is brought by the creditor to enforce a regulated agreement, the debtor can ask the court for a time order: s.129. This will allow the debtor extra time to rectify any breach of the agreement and can allow extra time to make payments that are overdue. In the case of hire-purchase and conditional sale agreements the court can in fact alter the pattern of future payments or allow extra time for them to be made.

14.10 Extortionate Credit Bargains

The debtor can at any time ask the court to reopen the agreement as being extortionate: ss.137–40. An agreement is extortionate if it requires payments that are grossly extortionate or if it grossly contravenes ordinary principles of fair dealing: s.138. The court has wide powers to alter

the terms of the agreement and can even require repayment of sums already paid (see Chapters 18 and 19).

14.11 Death of Debtor

If the debtor dies, termination of the agreement by the creditor is impossible where the agreement is for a specified duration and fully secured. Even if it is not fully secured, the creditor can only terminate the agreement where power to do so is granted by the agreement and where on application to the court s/he is able to show that the obligations of the debtor are unlikely to be carried out. This allows the deceased debtor's relatives to continue the hire-purchase and other credit and hire agreements of specified duration if they wish. It does not apply to credit cards and other agreements of unspecified duration.

14.12 Hire-Purchase and Other Instalment Sales

A hire-purchase contract is a contract of hire together with an option to purchase. The debtor is not a person who has bought or agreed to buy for the purposes of s.25 SGA 1979, and thus cannot pass a good title to a purchaser while the goods are still subject to the agreement, except for sale of motor vehicles to private purchasers (see below). A credit sale is a contract under which there is a legal obligation to buy, and the property in the goods is transferred to the buyer at the moment of the contract under s.18, Rule 1, SGA 1979 (see Chapter 13). A conditional sale is a contract under which there is a legal obligation to buy, but the property in the goods does not pass to the buyer until payment of the instalments is complete. At common law, such agreements fall within the scope of s.25 SGA 1979 and thus a good title can be passed to a bona fide purchaser while the goods are still subject to the agreement. This is not true for regulated agreements, which are the same as hire-purchase. In *Forthright Finance Ltd* v. *Carlyle Finance Ltd* [1997] 4 All ER 90 the plaintiff finance company, the owner of a Ford car, delivered the car to a dealer under an agreement described as a hire-purchase agreement. The dealer was given an option to purchase the car, which was deemed exercised when all the instalments had been paid at which point the property passed to him unless he elected not to take title. The dealer delivered the car to a customer under a conditional sale agreement financed by the defendant. The trial judge held that the agreement between the plaintiff and the dealer was a hire-purchase agreement, and the defendant was liable for damages to the plaintiff for conversion. The Court of Appeal upheld the defendant's appeal and found that the agreement was in substance and in form a conditional sale agreement where the dealer had 'agreed to buy' the car and could pass good title under s.25(1) SGA 1979.

The discussion which follows relates to hire-purchase; the points of variance with the other agreements are indicated at the end.

Involvement of a finance company

The dealer may not be able to finance the credit and require the services of a finance company; the dealer enters into a contract of sale with the finance company, and the finance company enters into a hire-purchase contract with the customer/debtor. There is no contract between the dealer and the customer/debtor.

Normally in such a case there will be an agreement between the creditor and the dealer under which the dealer agrees to be liable to the finance company in the event of default by the debtor. This is called a recourse agreement and is usually in the form of an indemnity agreement, but it can be a guarantee. The significance of the difference between the two can be seen in *Goulston Discount Co. Ltd* v. *Clark* [1967] 2 QB 493. In this case, the finance company sued a dealer for £157 damages under a recourse agreement. If the agreement had been in the form of a guarantee, they would be limited to the amount claimable from the debtor (in this case £74 in respect of arrears prior to termination). Since the agreement was an indemnity, the dealer was liable for the whole of the loss suffered by the finance company (see Chapter 10). An alternative is the repurchase agreement, under which the dealer will repurchase the goods from the creditor on the default of the customer/debtor.

Liabilities of the parties

The parties are the dealer and the finance company.

The dealer

Normally the dealer has no liability to the debtor where the goods are not fit. The debtor has rights against the finance company/creditor. However, where the dealer gives the debtor an express warranty of the fitness of the goods, a collateral contract of warranty exists between the two. The debtor can thus sue him/her for breach of this contract. In *Shanklin Pier Ltd* v. *Detel Products Ltd* [1951] 2 KB 854, the plaintiffs contracted with a company for the repair of their pier and specified that the defendant's paint should be used because the defendant had warrantied that it had a life of seven to ten years. In fact, it had a very short life and the plaintiffs were entitled to claim damages against them. There will also be a contract where the dealer agrees to carry out a service, such as installation. Under this heading, the dealer could be liable under ss.13–15 Supply of Goods & Services Act 1982 (see Chapter 13).

The finance company

The finance company will be liable to the debtor under the Supply of Goods (Implied Terms) Act 1973, ss.8–11 relating to the same implied terms as found in the Sale of Goods Act 1979, ss.12–15. Exclusion clauses would be subject to the Unfair Contract Terms Act 1977, which prevents

their use in cases involving a debtor dealing as a consumer (see Chapter 13). The Unfair Terms in Consumer Contracts Regulations 1994 could also apply (see Chapter 16).

At common law, the dealer is not generally regarded as the agent of the creditor but s/he is for regulated agreements. Thus, where the dealer fills in figures different from those agreed to by the debtor, the debtor is not bound in the case of a regulated agreement. This contrasts with the common law position as seen in *UDT Ltd* v. *Western* [1976] QB 513, where the defendant agreed to buy a car for £550 on hire-purchase, paid a deposit of £34 and signed the plaintiff's standard form in blank, leaving the dealers to fill in the figures. The form sent to the plaintiffs was for a loan agreement and the figures inserted were £730 for the purchase price and £185 for the deposit. When the defendant received a copy of the agreement, he realised that it was not correct but did nothing and paid no instalments. The court held that the defendant was liable.

Form of the agreement and right to cancel

See discussion on pp. 439–440 above.

Termination of the agreement

An agreement can be terminated in accordance with the terms of the agreement, or it may be broken. Termination occurs where the debtor exercises his/her option to return the goods to the creditor, and the agreement is broken where there is default by the debtor. This would normally provide the creditor with the right to terminate the agreement by notice to the hirer. S/he may even have a right of termination in some other event, such as death, or bankruptcy or imprisonment of the debtor. In respect of regulated agreements there are restrictions on the right of termination (see discussion above concerning notice of default and the death of the debtor).

Where the debtor is in arrears with his/her payments, there are three ways in which s/he can escape termination by the creditor:

(i) paying off the arrears before expiry date of default notice;
(ii) applying to the court for extra time (see above, s.129); or
(iii) s/he may be protected by the Protected Goods Provisions, s.129.

Thus, in respect of (iii), where at least one-third of the total hire-purchase price has been paid, the creditor must obtain a court order to recover possession: s.90. Where the creditor acts in breach of the rules, the agreement is terminated and the debtor is released from all liability under the agreement. S/he can recover all sums already paid. In *Capital Finance Co. Ltd* v. *Bray* [1964] 1 WLR 323, the finance company repossessed a car in respect of which the debtor had repaid more than one-third of the total price but later, realising they had made a mistake, left the vehicle outside the debtor's home. When they sued for outstanding

instalments and the recovery of the vehicle the court held that the agreement had been terminated, that the debtor was released from his liability and that he could recover money paid under the agreement. This is subject to two exceptions: (i) where the repossession is with the consent of the debtor at the time of the repossession; and (ii) where the debtor has disposed of the goods or has permanently abandoned them. Thus in *Bentinck Ltd* v. *Cromwell Engineering Co.* [1971] 1 QB 324, the debtor left his car which had been damaged in a crash at a garage, leaving no instructions for repair. He paid no further instalments and disappeared nine months later. The car was repossessed from the garage by the finance company and the court held that they were not in breach of the law even though more than one-third of the total purchase price had been paid since the car had been abandoned.

The minimum payment clause

The agreement will ususally contain a minimum payment clause under which the purchaser undertakes to pay a calculable amount in the event of the agreement being terminated or broken. Where this sum is excessive the question is whether the contractual rules relating to penalties apply. Two situations can be identified: (i) where the agreement is terminated as a result of breach by the debtor; and (ii) where the agreement is terminated by exercise of an option in accordance with the terms of the contract.

In the case of breach by the debtor, the distinction between liquidated damages and penalties will apply; thus if the stipulated minimum payment is inserted *in terrorem* it will not be recoverable. In *Bridge* v. *Campbell Discount Co. Ltd* [1962] AC 600, B acquired a van from the finance company on hire-purchase for a total hire-purchase price of £482, the deposit of £105 was made up of part-exchange of a car and the payment of £10 in cash. The instalments payable monthly were £10. The agreement provided for the termination of the contract by the debtor at any time, in which case a minimum payment clause should operate under which the debtor was to pay the arrears of the hire rent and, as 'agreed compensation for depreciation', two-thirds of the hire-purchase price. After eight weeks, the debtor indicated that he would be unable to continue the payments and returned the vehicle. He was sued for £206, which was two-thirds of the purchase price less the instalments paid. The court held that the letter concerning his unwillingness to pay further instalments did not constitute the exercise of his option to terminate the contract but a notification of his intention to break the agreement, and that, since the agreement was terminated by breach, the rules relating to penalties applied. The minimum payment clause was a penalty which was unenforceable and the case was remitted to the county court to fix the damages suffered by the finance company.

In the case of termination by the exercise of an option the position is less clear, and older authorities suggest that the debtor would be bound

by the clause even where the sum was excessive: *Associated Distributors Ltd* v. *Hall* [1938] 2 KB 83. The case was discussed in *Bridge's Case*, where there was disagreement about the current state of the law. In any event, a debtor is not taken to exercise his/her option to terminate unless knowing of its consequences: *UDT (Commercial) Ltd* v. *Ennis* [1968] 1 QB 54.

In the case of a regulated agreement, the debtor has a statutory right to terminate the agreement at any time before the final payment falls due: s.99. In this case, as well as returning the goods, the Consumer Credit Act 1974 stipulates the amount payable when the option is exercised: s.100. The debtor must pay:

(i) all arrears of instalments before termination; and
(ii) damages for loss caused by failure to take reasonable care; and
(iii) the smallest of the three following:
  (a) minimum payment; or
  (b) amount necessary to bring payments up to one half of the total hire-purchase price; or
  (c) the loss sustained by the creditor as a result of termination.

The right to terminate can only be exercised 'before the final payment falls due', which means that, if the agreement contains an accelerated payments clause under which failure to pay two or more instalments gives the creditor right to serve notice, making the outstanding balance payable, the debtor cannot serve notice of termination after the outstanding balance became due after the notice served by the creditor: *Wadham Stringer Ltd* v. *Meaney* [1981] 1 WLR 39.

The creditor's claim for damages

Where the agreement is terminated by breach on the part of the debtor or by notice of the creditor, after the debtor has committed a breach and the creditor cannot rely on the minimum payment clause, the question arises as to the measure of damages to which s/he is entitled. In assessing damages, a distinction is made according to whether (i) there is a breach of contract by the debtor which is accepted by the creditor; or (ii) termination by the creditor because the debtor is in arrears.

Where repudiation is accepted by the creditor, damages are the loss which the creditor has suffered as a result of the debtor's failure to carry out the contract. This would arise where the debtor fails to pay several instalments and it is clear that s/he does not intend to be bound by the contract, or where hs/e writes saying that s/he cannot or will not make further payments.

When a creditor terminates the contract because of the debtor being in arrears, the measure of damages in this case is only the amount of instalments that are unpaid at the date of the termination. In *Financings Ltd* v. *Baldock* [1963] 2 QB 104, B obtained a truck on hire-purchase from the plaintiffs. He failed to pay the first two instalments and the finance company terminated the agreement and repossessed the truck, which they

later sold. They claimed £538 in respect of their loss suffered. The court held that the contract was terminated by the creditor and they were only able to claim the outstanding arrears of £56.

The powers of the court with regard to regulated agreements

Any action will be in the county court and any guarantor will be made a party to the action. The creditor's claim will usually be for possession, and minimum payment or damages. The court has three options: (i) a time order, giving the debtor extra time to pay: s.129; (ii) an immediate return order, together with minimum payment or damages: s.133; and (iii) a transfer order, applicable where the goods are divisible and the debtor has paid enough of the total price to cover both the cost of part of them and at least a quarter of the rest of the total price.

14.13 Protection of the Private Purchaser of a Motor Vehicle

Under the Hire Purchase Act 1964, s.27(2) as amended by CCA 1974, a private purchaser of a motor vehicle in good faith and without notice that it is still subject to a hire-purchase agreement obtains a good title to the vehicle (see Chapter 13).

14.14 Conditional Sale and Credit Sale Agreements

For conditional sale agreements, there is full application of the Act as for hire-purchase contracts. Credit sale agreements are subject to most of the provisions of the Act including formality and cancellation. There is no statutory right of termination and the creditor has no right to recover possession of the goods on default. Rights relating to the goods not being of satisfactory quality would be under the Sale of Goods Act 1979.

Recommended Further Reading

Sale of Goods and Consumer Credit, A. P. Dobson, 4th edn (Sweet & Maxwell, 1989, reprinted 1993).

Questions

1 In order to be a regulated consumer credit agreement, the agreement must comply with two conditions. What are they?

2 Regulated agreements can be classified as (i) restricted use credit agreements; and (ii) unrestricted use credit agreements. Give examples of each type.

3 In what circumstances does a debtor have the right to cancel a regulated agreement?
4 Distinguish between a hire-purchase agreement, a conditional sale agreement and a credit sale agreement.
5 What do you understand by the Protected Goods Provisions under s.129, Consumer Credit Act 1974?
6 What is the advantage of using a credit card to contract for goods or services where the supplier or provider defaults?

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15 Bills of Exchange, Cheques, Credit and Debit Cards

Learning Objectives

After reading this chapter you will know about:

1. the essential requirements of a valid bill of exchange and the distinctions between a bill of exchange and a cheque
2. the ways in which bills of exchange and cheques can be negotiated and the advantages of the holder in due course
3. the relationship between the banker and the customer, and their rights and duties
4. the statutory protection of the paying and the collecting banker
5. the significance of electronic funds transfer (EFT)

15.1 Bills of Exchange and Cheques in Settlement of Debts

The importance of bills of exchange in effecting payment for goods or services is limited to international trade. Cheques are a widely used form of bill of exchange and, except where otherwise stated, the law applicable to bills applies to cheques. All references in this chapter are to the Bills of Exchange Act 1882, unless otherwise indicated.

15.2 Bills of Exchange and Cheques Contrasted

A bill of exchange is defined in s.3(1) of the Bills of Exchange Act 1882 as 'an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to bearer.' If we apply this to a transaction, the parties to the bill and the cheque will become clearer. Thus if X sells £500 pounds' worth of goods to Y, X will draw a bill of exchange addressed to Y payable to himself or order for the contractual amount. The bill can order Y to pay the sum on demand or at a fixed or determinable time after the date on which the bill is drawn. X is the drawer of the bill (and also the payee in this example) while Y, the person to whom the bill is addressed and who must pay the fixed sum on demand or when the bill matures, is the drawee. The wording of the bill could be: 'Pay X or order £500 90 days after date'. In

this case the bill matures and payment will be due ninety days after the date on the bill. The addition of the words 'or order' means that X can negotiate this bill to another supplier. Thus the bill gives a period of credit to Y, and allows X to use the bill to obtain supplies immediately. Alternatively, the bill can be 'discounted' by negotiating it to a bank, which will pay less than the sum for which the bill is drawn and hold it until maturity.

A cheque is a bill of exchange drawn on a banker and payable on demand. If a cheque is used in the above situation, Y will draw the cheque on his bank, and the bank will pay it when presented by the payee, X. The bank is the drawee and is paying from the debt to the drawer arising from the credit balance in the drawer's account.

15.3 The Essentials of a Bill of Exchange

An instrument which does not comply with the definition in s.3(1) is not a bill of exchange (it may, however, act as an equitable assignment of funds): s.3(2). The section further provides that a bill is not invalid by reason (i) that it is not dated; (ii) that it does not specify the value given; (iii) that any value has been given therefor; or (iv) that it does not specify the place where drawn or where payable.

The bill must be an order

The bill must order payment and not merely request or authorise it. A document reading 'We hereby authorise you to pay on our account to the order of G. £6000' was held not to be a bill of exchange.

The order must be unconditional

The Act states that 'an order to pay out of a particular fund is not unconditional (i.e. is conditional) within the meaning of this section', but then goes on to state that 'an unqualified order to pay coupled with (a) an indication of a particular fund out of which the drawee is to reimburse himself or a particular account to be debited with the amount, or (b) a statement of the transaction which gives rise to the bill, is unconditional': s.3(3).

This needs clarification:

(i) 'Pay X £500 out of the monies to be received by you from Y' is conditional, because payment depends on the receipt of the money from Y and is not a bill of exchange.

(ii) 'Pay X £500 and charge it to the monies to be received by you from Y' is an unconditional order coupled with an indication of the fund from which the drawee is to reimburse him/herself.

(iii) 'Pay X £500 and debit the bill or cheque to my No. 2 account' is also an unconditional order and is a valid bill of exchange, but one

drawn 'Pay X from my No. 2 account' is not unconditional, since payment depends upon the account being in credit.

The validity of a requirement in the bill that the payee should give a receipt for payment depends on whether the direction is addressed to the drawee, or to the payee. If addressed to the drawee it is a condition upon which the drawee's obligation to pay is dependent. If addressed to the payee, the order will be unconditional. Thus 'Pay X, provided the receipt form at the foot hereof is duly signed, stamped and dated' invalidates the instrument as a bill. A cheque requiring a receipt by words at the foot or on the reverse are addressed to the payee and the cheque is valid.

The instrument must be in writing and signed by the drawer

The signature can be added at any time, but before being signed the bill is inchoate and ineffective. The signature may be a rubber stamp or the corporate seal of a registered company; a signature in pencil is sufficient. A bill or cheque with an unauthorised signature is wholly inoperative but capable of ratification. Where the signature is a forgery it is wholly inoperative and cannot be ratified (see p. 454 below).

The order must be addressed by one person to another

Although there are always three parties to a bill – the drawer, drawee and payee – they do not necessarily represent three separate persons, and a bill can be drawn payable to the drawer or to the drawee (or their order): s.5(1). On the other hand, there could be more than three persons involved, since there can be more than one drawee and more than one payee: s.6(2); s.7(2). Where there are two or more drawees, the bill cannot be drawn in the alternative or in succession: s.6.(2); but it can be drawn payable to two or more payees in the alternative: s.7(2).

The order must be for a sum certain in money

A sum is still certain although required to be paid with interest, by stated instalments or by stated instalments with a provision for payment of the whole sum upon default of one instalment or by reference to an indicated rate of exchange. Where there is a discrepancy between the amount in figures and the amount in words, the amount in words is the sum payable. A bill cannot be drawn payable in cash or goods.

The instrument must provide for a certain or determinable time of payment, or it must be payable on demand

A bill is payable on demand where it is expressed to be payable on demand, or at sight, or on presentation, or where no time for payment is expressed: s.10. A bill payable at a determinable future time is one

expressed to be payable 'At a fixed period after date or sight' or 'On or at a fixed period after the occurrence of a specified event which is certain to happen, though the time of the happening may be uncertain': s.11. The event must be certain to happen at the time of the drawing of the bill. Thus a bill drawn payable '90 days after the death of X' is valid but not one drawn payable '90 days after the marriage of X', since the marriage is not certain to take place. A bill drawn payable on a contingency will not be validated by the happening of the event. A bill drawn payable 'on or before …' is also not valid: *Williamson* v. *Rider* [1963] 1 QB 89.

The instrument must specify an identifiable payee (unless drawn payable to bearer)

The payee must be named 'or otherwise indicated … with reasonable certainty': s.7(1). A bill or cheque may be drawn payable to the holder of an office for the time being. A cheque drawn payable 'to cash or order' is not a cheque but a document intended to enable a person to obtain payment from a banker within the meaning of s.4(2)(b) Cheques Act 1957, so that the banker dealing with it without negligence may claim the statutory protection given to bankers in respect of cheques (see below): *Gader* v. *Flower* (1979) 129 NLJ 1266.

A further important provision relates to bills and cheques drawn payable to non-existing or fictitious payees: s.7(3). A non-existing payee is one who does not exist for the drawer. In *Clutton* v. *Attenborough & Son* [1897] AC 90, an employee persuaded the plaintiff, his employer, to draw cheques in favour of B for work done; the employer had not heard of B. The employee forged an endorsement and negotiated the cheque to the defendants, who were paid by the plaintiff's bank. The plaintiff failed in an action to recover the money. Since the payee was a non-existent person, the bill was one drawn to bearer and negotiable without endorsement, and therefore the forged endorsement that would otherwise have prevented the defendants from claiming as a holder in due course was nullified.

Where the payee exists and is a client of the company, whether s/he is fictitious or not will depend on the state of mind or the intention of the drawer of the instrument. Where the drawer did not intend the person named as payee to benefit, s/he will be fictitious, even though such a person in fact exists. In *Bank of England* v. *Vagliano Brothers* [1891] AC 107, Vagliano's clerk drew up bills of exchange on V in favour of Petridi & Co., who were customers of V, and obtained V's signature as acceptor before forging the payee's signature and discounting the bill to the Bank of England. V sought reimbursement from the bank, but the court upheld their right to debit V's account as the bill was payable to bearer under s.7(3). The case was distinguished in *Vinden* v. *Hughes* [1905] 1 KB 795, where the employer drew a cheque intending to benefit the payees, who he had been led to believe by a fraudulent clerk, were entitled to receive the money. The payees were not fictitious and the cheque was not one payable to bearer.

15.4 Capacity and Authority of the Parties

The capacity of a party to incur liability under a bill or cheque is co-extensive with capacity to contract: s.22. The section specifically relates to minors, who cannot be made liable on a bill or cheque, although it is enforceable against any other party: *Re Soltykoff* [1891] 1 QB 413. Where the minor used the money for the payment of necessaries, the supplier can sue on the contract.

No party can be liable on a bill or cheque unless s/he has signed it: s.23. A person can be a signatory as the drawer, the endorser and, in the case of a bill of exchange, as an acceptor of the bill. Acceptance is where the drawee agrees to be bound by the bill, making it more easily discountable or negotiable. A person is liable where s/he has signed the bill or cheque in some capacity in a business name or an assumed name, and a signature in the form of the name of a partnership will bind all partners of the firm: *Central Motors (Birmingham)* v. *P.A. & S. N. P. Wadsworth* [1983] CLY 79. There are no defences regarding the state of mind of the person signing a bill in any capacity.

A forged signature is wholly inoperative whether as drawer, endorser or acceptor (s.24), and a person can only be liable on a forged signature through estoppel: *Greenwood* v. *Martins Bank Ltd* (1933) AC 51 (see p. 464 below). A forged endorsement on a bill or cheque means that parties subsequent to the forged endorsement cannot claim as holders in due course. The section also relates to unauthorised signatures, including the unauthorised use of an authorised signature, but these can be ratified.

A signature 'per pro' (pp) serves as notice that the agent signing has only a limited authority and the principal is only bound where the agent is acting within the actual limits of his authority: s.25. Where a person signs in a representative capacity the person for whom s/he signs will be liable, but not the signer, as long as s/he has clearly indicated his/her representative capacity, since 'the mere addition to his signature of words describing him as an agent or as filling a representative capacity does not exempt him from personal liability': s.26(1). However, in *Bondina Ltd* v. *Rollaway Shower Blinds Ltd and Others* [1986] BCLC 177, the Court of Appeal held that, where a director signed the modern form of cheque overprinted with the company's name, this was solely the company's cheque and the director was not personally liable.

In doubtful cases, the court can look to the realities of the situation: s.26(2). In *Elliott* v. *Bax-Ironside* [1925] 2 KB 301, a bill was drawn on the company and accepted by it. The drawer demanded the personal endorsement of two of the directors so that it was accepted 'payable at the W. Bank, H. O. Bax-Ironside, Ronald A. Mason, directors Fashions Fair Exhibition Ltd' and endorsed 'Fashions Fair Exhibition Ltd, H. O. Bax-Ironside, Ronald A. Mason'. The court found the directors personally liable as endorsers, since the company was already liable as acceptor. In *Rolfe Lubell & Co.* v. *Keith and Another* [1979] 1 All ER 860, the court

held that extrinsic evidence was admissible to resolve any ambiguity as to the capacity in which the endorser had endorsed the bill.

15.5 Acceptance of a Bill of Exchange

Certain formalities only apply to bills of exchange, including acceptance when the drawee accepts the obligation to pay the sum specified under the bill and becomes the acceptor. Most bills are presented for acceptance to be more easily negotiable and discountable, but only a limited category of them must be presented for acceptance: (i) where a bill is payable after sight, presentment for acceptance is necessary in order to fix the maturity of the instrument; and (ii) where a bill expressly stipulates that it shall be presented for acceptance, or where a bill is drawn payable at a place other than the residence or place of business of the drawee: s.39. The rules relating to the time for presentment and the presentment are set out in ss.40 and 41. Bills not accepted within the customary time must be treated as having been dishonoured and the holder must serve notice on the drawer and indorsers: ss.42 and 43; failure to serve notice results in their being discharged from liability under the bill. The acceptance signifies the assent of drawee to the drawer's order to pay: s.17(1), and must comply with the requirements of s.17(2).

General and qualified acceptance

An acceptance can be general or qualified: s.19. A general acceptance assents without qualification to the order of the drawer, whereas the qualified acceptance imposes a qualification which varies the effect of the bill as drawn. A qualified acceptance can be:

(a) *conditional*: payable on delivery of bills of lading;
(b) *partial*: bill drawn for £500, accepted payable for £250;
(c) *local*: accepted payable at W. Bank, Moorgate 'only', or 'and at no other place';
(d) *time*: drawn payable in 90 days, accepted payable 180 days;
(e) *not all drawees*: bill addressed to AB and CD, accepted by AB only.

A qualified acceptance allows the holder to treat the bill as dishonoured or to accept it as valid. In this case, any drawer or endorser is discharged unless s/he has expressly or impliedly authorised the holder to take the qualified acceptance, or subsequently gives his/her consent to it: s.44(2). The holder serves notice on the prior parties and, if they do not express dissent within a reasonable time, they will be deemed to have assented: s.44(3).

For partial acceptance the holder merely serves notice and does not need to obtain the assent of the prior parties, who are immediately liable for the amount for which the bill has been dishonoured, and remain liable for the balance if not paid on maturity.

15.6 Payment of a Bill of Exchange

A bill must be presented for payment and, where the bill is not payable on demand, this must happen on the day it matures. If payable on demand, it must be presented within a reasonable time: s.45(1)(2). The Banking and Financial Dealings Act 1971 abolished the 'days of grace' which used to be added in calculating maturity; these are in s.18.

If the bill is not presented at the due date or within a reasonable time, the drawer and indorsers of the bill are discharged: s.45. There are excuses for delay in presentment or for non-presentment when the delay or failure will not discharge the drawer or endorsers: s.46 (*Yeoman Credit* v. *Gregory* [1963] 1 WLR 343; and *Hamilton Finance Co. Ltd* v. *Coverley Westray etc.* [1969] 1 Lloyd's Rep 53).

Non-payment constitutes dishonour, and the holder must immediately serve notice on the drawer and endorsers to preserve their liability: ss.48–9. Delay or failure is excused in certain circumstances: s.50. A notice of dishonour duly addressed and posted is deemed notice should there be a failure in the postal service: s.49. In *Eaglehill Ltd* v. *J. Needham Builders Ltd* [1973] AC 992, a bill matured for payment on 31 December but, through error, the notice of dishonour was posted on 30 December and delivered on 31 December. Lord Cross considered that notice was received when opened, which would have been done at the same time that the clerk of the bank decided that the bill was dishonoured. Lord Cross continued: 'If two acts have been done, one of which ought to have been done after the other if it was to be valid and the evidence which could reasonably be expected to be available does not show which was done first they will be presumed to have been done in the proper order.' The notice was therefore effective.

A foreign bill which is dishonoured by non-acceptance or non-payment is required to be noted and protested: s.51. This is optional in the case of inland bills. Protesting a bill involves obtaining a certificate from a notary public attesting the dishonour of the bill. Noting is simply the minute that the notary makes on the bill at the time of the dishonour: it is an incipient protest. The form of the protest is contained in the First Schedule of the Act. Where the services of a notary cannot be obtained, any householder or substantial resident in the presence of two witnesses will suffice: s.94.

15.7 Inchoate Instruments

A bill of exchange can be initiated by a signature on a blank piece of paper, which is delivered by the signer to be converted into a bill of exchange: s.20. The signature can be as drawer, acceptor or endorser and is authority to complete the instrument as a bill within a reasonable time in accordance with the authority given. If it is completed beyond the authority, it is unenforceable against the party issuing it. However, where

it passes to a holder in due course after completion, it is enforceable as if completed in accordance with the authority. There is a conflict concerning the issue and delivery of a bill. The Act provides that 'Every contract on a bill … is incomplete and revocable until delivery of the instrument in order to give effect thereto'; subject to the fact that 'if the bill is in the hands of a holder in due course a valid delivery of the bill by all parties prior to him … is conclusively presumed': s.21.

However, where the bill has never been issued as such, even the holder in due course is unprotected. In *Smith* v. *Prosser* [1907] 2 KB 735, the defendant left signed but unstamped promissory notes with his agent in safe custody. The agent stamped and filled in the forms and negotiated them. The defendant was not liable. Similarly, in *Baxendale* v. *Bennett* (1878) 3 QBD 525, blank acceptances were stolen from a drawer, completed and negotiated, but the signer was not liable since they had not been issued.

15.8 Negotiation of a Bill of Exchange or Cheque

A bearer bill or cheque is negotiated by delivery, whereas a bill or cheque payable to order is negotiated by 'the indorsement of the holder completed by delivery'. In the case of a bearer bill or cheque, the person negotiating it is a 'transferor by delivery' and is not liable to the transferee because of the lack of a signature. However, in the case of a transferee for value s/he warrants that (a) s/he has a right to transfer it; (b) the bill is what it purports to be; and (c) that, at the time of the transfer, s/he was not aware of any fact making the bill valueless: s.58.

Indorsement of a bill or cheque

A valid indorsement must be written on the bill or cheque itself, usually on the back, except an indorsement written on an allonge (an attached slip) or on a copy of the bill issued or negotiated in a country where copies are recognised: s.32(1). It must be signed by the indorser (s.32(1)), but a rubber stamp is sufficient: *Bird & Co. (London) Ltd* v. *Thomas Cook & Son Ltd and Thomas Cook & Son (Bankers) Ltd* [1937] 2 All ER 227. An indorsement purporting to transfer a part only of the amount payable, or to transfer the bill or cheque to two or more indorsees severally is not a negotiation of the bill: s.32(2). Where a bill is made payable to two or more payees or indorsees, they must all indorse the bill or cheque unless they are partners or the indorser is an agent for the others: s.32(3). If the payee or indorsee's name is misspelt or s/he is wrongly described, the bill or cheque can be indorsed in the same way but the proper signature can be added also: s.32(4). Where there are two or more indorsements on the bill, they are treated as having been made in the order in which they appear until the contrary is proved: s.32(5). Indorsements can be 'in blank' or 'special' and may also be 'restrictive': s.32(6).

Blank and special indorsement

A bill is indorsed in blank where the holder merely signs his/her name on the reverse of the bill. This transforms the bill or cheque into one payable to bearer and it can be negotiated by mere delivery: s.34(1). In a special indorsement the indorsement is to a specific indorsee or to his/her order: 'Pay AB' or 'Pay AB or order': s.34(2). This preserves the order status of the bill or cheque. A blank indorsement can be converted to a special indorsement by any holder making it payable to or to the order of him/herself or some other person above the indorser's signature: s.34(4).

15.9 The Consideration for a Bill

No action can be brought on a bill or cheque in respect of which no consideration has been given. Consideration is defined in s.27(1) as anything capable of supporting a simple contract, except that past consideration is valuable consideration for a bill or cheque. But an 'antecedent debt or liability' means a debt or liability due from the maker or negotiator of the instrument, not that of a third party. In *Oliver* v. *Davis & Woodcock* [1949] 2 KB 727, the plaintiff lent £350 to Davis, who gave him a post-dated cheque for £400. Davis could not honour the cheque and persuaded Miss Woodcock to let the plaintiff have her cheque for £400 in its place. She stopped the cheque and successfully pleaded absence of consideration. Doubts were expressed following *Diamond* v. *Graham* [1968] 2 All ER 909, where the plaintiff gave a cheque for £1650 to a third party on the condition that s/he arranged for the defendant to give the plaintiff a cheque for the same amount. Both cheques were dishonoured. The defendant argued that no consideration had passed from the plaintiff to him but the Court of Appeal held that the plaintiff's cheque to the third party was adequate consideration. One of the judges also based his argument on s.27(2) that, where consideration has been given at any time for a bill or cheque, a holder of it is deemed to be a holder for value as regards all parties to it who were parties prior to the time when the consideration was provided. Thus if X draws a cheque payable to Y as a gift, and Y then endorses it to Z in payment of a car, if the cheque were later dishonoured, Z could sue both X and Y. If, however, Z endorsed the cheque to N as a gift and the cheque was later dishonoured, N could sue X and Y.

15.10 The Holders of a Bill

There are three categories of holder of a bill or cheque: *the holder*, *the holder for value* and *the holder in due course*.

The holder

A holder is 'the payee or indorsee of a bill who is in possession of it', or the bearer thereof (in respect of a bearer bill or cheque): s.2. An indorsee holding a bill under a forged indorsement is not the holder, since the indorsement is a nullity. A person must be a holder before s/he can be a holder for value or a holder in due course. A person holding a bill or cheque subsequent to a forged indorsement has no claim against any party prior to the forged indorsement. The holder of a bill or cheque in respect of which no consideration has been given cannot sue to enforce payment.

The holder for value

Where value has at any time been given on the bill or cheque, the holder will be a holder for value who can sue to enforce payment but takes the bill or cheque subject to any defect of title of the transferor. There are three types of holder for value. First is the payee for value. Where a bill or cheque is payable to a person who has supplied consideration, s/he is a holder for value. The payee can never be a holder in due course, which can only arise from negotiation: *Jones (R.E.) Ltd* v. *Waring and Gillow Ltd* [1926] All ER 36. Second is the holder of a bill or cheque on which value has been given at any time, even though the holder has not him/herself supplied consideration, s.27(2). Third is the holder of a bill who has him/herself given value. This person will be a holder for value but can be a holder in due course if s/he complies with the rest of s.29(1).

The holder in due course

The holder in due course must satisfy all the conditions of s.29(1).

The bill or cheque must be complete and regular on the face of it

A bill is complete without an acceptance. But a cheque or bill is not complete if the name of the payee or drawer is absent, and is not regular if mutilated so that it appears to have been cancelled. They are regular in spite of being post-dated, but incomplete if not dated at all. A person cannot be a holder in due course of cheques crossed 'not negotiable', and cheques crossed 'Account payee (only)' are non-transferable.

An irregularity of indorsement will also make the bill or cheque irregular. In *Arab Bank Ltd* v. *Ross* [1952] 1 All ER 709, promissory notes were made out by R, each payable to 'Fathi and Faysal Nabulsy Co.', and had been endorsed by one of the partners of the firm 'Fathi and Faysal Nabulsy' (omitting the 'Co.'). The Court of Appeal found the indorsement irregular, which ruled out the possibility of negotiation to a holder in due course.

Before the bill or cheque is overdue

When a bill or cheque is overdue for payment it can only be negotiated subject to defects of title affecting it at its maturity. In the case of a bill payable on demand, it must be negotiated within a reasonable time; for cheques the cut-off is generally six months from the date of issue.

There must be no notice of previous dishonour

Notice means 'either knowledge of the facts, or a suspicion of something wrong, combined with a wilful disregard of the means of knowledge'.

The bill must be taken in good faith

Good faith is something 'done honestly, whether it is done negligently or not': s.90. The proviso concerning negligence is important for bankers' protection (see below).

For value

This has already been discussed (see p. 458).

Without notice of any defect in the title of the person who negotiated it

The title of the transferor of a bill or cheque is defective when s/he 'obtained the bill, or the acceptance thereof (bills only) by fraud, duress … or any other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to fraud'.

There is a presumption that every holder is a holder in due course until the bill or cheque is shown to be tainted by fraud or illegality: s.30(2). Where the holder acquires title through a holder in due course, whether for value or not, s/he will have the rights of holder in due course even though s/he had notice of any fraud or illegality affecting the instrument, as long as s/he him/herself is not a party to such fraud or illegality. In *Jade International Steel Stahl Und Eisen GmbH & Co. KG* v. *Robert Nicholas (Steels) Ltd* [1978] QB 917, the defendants had dishonoured a bill drawn by the plaintiffs alleging delivery of faulty goods. They had discounted the bill to their bank, which took the bill as holder in due course, and later received the bill back from them. The court gave judgment on the bill in the plaintiff's favour and refused the defendant's application for leave to defend, on the grounds that the plaintiffs were now the holders in due course of the bill.

15.11 The Cash Equivalence of the Bill of Exchange or Cheque

The principle of the cash equivalence of the bill of exchange is revealed in a statement by Sir Eric Sachs in *Cebora S.N.C.* v. *S.I.P. (Industrial*

Products) Ltd [1976] 1 Lloyd's Rep 271: 'For some generations one of [the] certainties [of the application by our courts of the law … relating to bills of exchange] has been that the bona fide holder for value of a bill of exchange is entitled, save in truly exceptional circumstances, on its maturity to have it treated as cash, so that in an action upon it the Court will refuse to regard either as a defence or as grounds for a stay of execution any set off, legal or equitable, or any counterclaim, whether arising on the particular transaction upon which the bill of exchange came into existence, or, *a fortiori*, arising in any other way. The rule of practice is thus, in effect, pay up on the bill of exchange first and pursue claims later.' This stresses the importance of this principle in connection with the use of bills of exchange in international trade, but the principle applies equally to domestic transactions and equally to cheques and promissory notes and means that payment cannot be delayed on account of any counterclaim. The bill, cheque or promissory note is a contract in itself independent of the transaction that underlies it. The defences against payment relate to the defects in the bill itself – the fraud, duress or illegality referred to in s.30(2). Other defences have been misrepresentation: *Clovertogs Ltd* v. *Jean Scenes Ltd* [1982] Com.L.R. 88. Total failure of consideration between immediate parties is also a defence.

Apart from these defences, the court has a discretion to stay the order of execution in an action on bills of exchange, but this is only exercised in truly exceptional circumstances, as reinforced in this statement by Lord Wilberforce in *Nova (Jersey) Knit Ltd* v. *Karngarn Spinnery GmbH* [1977] 2 All ER 463: 'When one person buys goods from another … he may demand payment in cash; but if the buyer cannot provide this at once, he may agree to take bills of exchange payable at future dates … Unless they are to be treated as unconditionally payable instruments … which the seller can negotiate for cash, the seller might just as well give credit. And it is for this reason that English law … does not allow cross-claims, or defences, except such limited defences as those based on fraud, invalidity, or failure of consideration, to be made.'

15.12 Discharge of a Bill of Exchange or Cheque

The discharge of the bill is not the same as the discharge of the parties to the bill. A bill is discharged in one of the ways set out in the Act, of which two are of particular importance.

By payment in due course

The bill or cheque is discharged by payment by the drawee or acceptor to the holder of the bill at or on its maturity 'in good faith without notice that his title is defective': s.59(1). Payment by the drawer or an endorser does not discharge the bill: s.59(2), except in the case of an accommodation bill paid in due course by the person accommodated, either the

drawer or the endorser. Where the bill is paid by the drawer or endorser, the rights of the paying party are set out in s.59(2)(a) and (b): *Callow* v. *Lawrence* (1814).

The payment must be to the holder, which excludes payment to a person holding under a forged endorsement for bills of exchange. For a cheque, however, the banker can be discharged under s.60 (see p. 470 below), but this will not affect the rights of the person to whom payment has been made.

The party who has paid in error under a forged indorsement may sue the person who has presented it for payment and recover the money as money paid under a mistake of fact: *Jones (R. E.) Ltd* v. *Waring and Gillow Ltd* [1926] All ER 36. In *Barclays Bank Ltd* v. *W. J. Simms & Son & Cooke (Southern) Ltd and Another* [1980] QB 677, the defendant company had carried out some work for a building association and the association sent them a cheque in payment. On the following day, a receiver was appointed in respect of the company and the association stopped the payment. The bank programmed their computer with a stop instruction, but the receiver had the cheque specially cleared, the stop instruction was overlooked and the cheque paid. The court held that the bank could recover the payment.

By material alteration

Where a bill is materially altered without the assent of all parties liable on the bill or cheque, it is discharged except as against (i) the party who has him/herself made or authorised the alteration; and (ii) subsequent endorsers: s.64(1). This is subject to the proviso that where the materially altered bill or cheque is in the hands of a holder in due course and the material alteration is not apparent, in addition to remedies against the person making the material alteration and subsequent endorsers, the holder in due course can treat the bill or cheque as if it had not been altered and enforce it as originally drawn against the prior parties and the acceptor (bills only).

A material alteration is (i) any alteration of the date, the sum payable, the time of payment or the place of payment; and (ii) the addition of a place of payment without the acceptor's assent, where the bill has been accepted generally. An important difference between bills of exchange and cheques with regard to material alteration relates to the duty of care. In *Scholfield* v. *Earl of Londesborough* [1896] AC 514, Sanders drew a bill of exchange on the defendant for £500, and the defendant accepted the bill, on which gaps had been deliberately left by Sanders. In these gaps Sanders inserted the figure '3' and the words 'three thousand' so that the bill was one for £3500. The bill was endorsed to the plaintiff who took it in good faith and for value. He sued the defendant for £3500. The defendant paid £500 into the court and denied liability. The court held that the acceptor of a bill of exchange owes no duty of care to the holder to guard against any alteration after acceptance. However, in *London Joint Stock Bank* v.

Macmillan and Arthur [1918] AC 777, a clerk employed by the respondent firm drew a cheque payable to bearer for the sum of £2 with only the space for the figures filled in. The partner signed it, believing it was for petty cash. The clerk then altered the cheque to read as one drawn for £120 and cashed it. The firm sued the bank, alleging that the money had been wrongly debited to their account and the bank alleged negligence in drawing up the cheque. The court held that there was a special duty owed by a bank customer to take care in drawing a cheque. As a consequence of the negligence the bank was entitled to debit the firm's account for £120.

A bill is discharged by negotiation to the acceptor: s.61 (bills only); by express waiver or renunciation: s.62; and by cancellation: s.63.

15.13 The Banker–Customer Relationship

The relationship between the bank and the customer is essentially that of debtor–creditor, except that the bank is not liable to pay the customer money lent unless and until the customer demands payment: *Foley* v. *Hill* (1848) 2 HL Cas 28; and *Joachimson* v. *Swiss Bank Corporation* [1921] 3 KB 110 . The relationship gives rise to duties between the parties.

15.14 The Duties Owed by the Bank to the Customer

Obligation to honour cheques

Where the customer's account is in credit, there is an obligation on the part of the bank to honour all the customer's correctly drawn cheques. Where the amount credited is not sufficient to cover the amount of the cheque, the banker can refuse to pay the cheque. Where the customer has an overdraft facility, s/he can draw cheques up to the limit of the agreed overdraft and the bank must honour them. The position is the same regarding standing orders: the mandate need only be honoured when, on the date of payment, there are adequate funds in the account; the bank has no obligation to monitor the situation and honour the mandate later when there are sufficient funds (*Whitehead* v. *National Westminster Bank Ltd* (1982) *The Times*, 9 June). Where the cheque is covered by a cheque guarantee card the bank will usually honour the cheque up to the limit. Where a customer frequently draws cheques when there are no funds to cover them, the bank may ask for the return of the card. Drawing cheques when there are no funds to cover them may also be a criminal offence.

Where the bank wrongfully dishonours a cheque drawn by a customer this gives rise to a right of action for breach of contract and the customer can claim damages for any loss suffered. Private customers can only recover substantial damages where special loss is proved, failing which only nominal damages are awarded, while traders can recover substantial damages without pleading and proving the wrongful damage. In *Gibbons*

v. *Westminster Bank Ltd* [1939] 2 KB 882, the plaintiff, a customer of the defendant bank, drew a cheque which was wrongfully dishonoured, since the bank had credited a sum of money paid into the wrong account; the manager offered her £1.10p in full satisfaction, which she refused. The court awarded her nominal damages of £2.

There is an alternative action in defamation. In *Davidson* v. *Barclays Bank* (1940) 56 TLR 343, the plaintiff drew a cheque when there were insufficient funds to meet it because the bank had wrongly honoured a countermanded cheque. The cheque was returned marked 'Not sufficient'. The bank's defence of privilege was rejected. For many years bankers could claim that the favourite formula on dishonoured cheques, 'Refer to drawer', had no defamatory meaning, but since *Jayson* v. *Midland Bank Ltd* [1968] 1 Lloyd's Rep 409, the words are potentially libellous and many alternatives have been found to be potentially defamatory, including 'Exceeds arrangement' and 'Accounts closed', and it is doubtful whether any formula will avoid a libel action. In *Baker* v. *Australia and New Zealand Bank Ltd* [1958] NZLR 907, the plaintiff was awarded nominal damages for breach of contract but £100 for libel.

Duty not to pay cheques without authority

A bank is liable to the customer where it pays a cheque without authority in the following three cases.

If it has been validly countermanded

This must be communicated to the bank in unambiguous terms by the customer. There is no provision for constructive notice of countermand. In *Curtice* v. *London, City and Midland Bank Ltd* [1908] 1 KB 293, the plaintiff drew a cheque for £63 but then sent a telegram to the bank stopping payment, which was posted in the bank's letter box at 6.15 p.m., but was missed when the mail was collected the next morning. The cheque was paid. The court held there was no valid countermand of payment, in spite of the bank's negligence, and doubted whether a telegram was sufficient authority.

If it is void for material alteration

Where the cheque is void for material alteration, the bank may be able to debit the customer's account where the cheque was drawn negligently, to make alteration easy (see p. 462).

If the customer's signature is forged

Customers may be estopped from asserting the forgery and the bank can then debit the account. In *Greenwood* v. *Martins Bank Ltd* [1933] AC 51, the plaintiff held an account at the bank but his wife kept the cheque book and gave him cheques as he required them. He discovered that she

had forged his signature on cheques over a period but he did not inform the bank. Later, after his wife had committed suicide, he sought repayment of the sums debited in respect of the forgeries but was estopped through breach of his duty to notify the bank on discovering the forgery. In *Brown* v. *Westminster Bank Ltd* [1964] 2 Lloyd's Rep 187, the bank had on numerous occasions drawn the plaintiff's attention to the number of cheques drawn on her account in favour of her servant but she did not deny drawing the cheques. The plaintiff's son, who held her power of attorney. finally sued in respect of 329 cheques and the court held that the plaintiff was estopped.

The decision in *Kepitigalla Rubber Estates Ltd* v. *National Bank of India Ltd* [1909] 2 KB 1010, saw the bank lose its defence of estoppel by negligence in respect of forgeries over two months where it was shown that the directors had not examined the pass book or the company's cash book. The court held that customers did not have a duty to organise their business in such a way as not to facilitate forgery. This was followed in *Wealden Woodlands (Kent) Ltd* v. *National Westminster Bank Ltd* (1983) 133 New LJ 719; and by the Privy Council in *Tai Hing Cotton Mill Ltd* v. *Liu Chong Hing Bank Ltd* [1985] 2 All ER 947.

Liability where bank has paid without authority

Where the bank has wrongly paid out on a cheque, the money can be recovered as money paid under a mistake of fact. However, the payee has a defence (a) if the payer was not influenced by the mistake; (b) if there was good consideration for the payment; or (c) if the payee has changed his/her position in good faith on the strength of the payment: *Barclays Bank Ltd* v. *W. J. Simms Son and Cooke (Southern) Ltd and Another* [1980] QB 677. The fact that the bank has paid out on a forged signature does not estop the bank from recovering the payment, since there is no obligation to recognise the customer's signature and payment is not a representation that it is genuine: *National Westminster Bank Ltd* v. *Barclays Bank International and Another* [1975] QB 654.

Where the bank has wrongly credited money to a customer's account, the error can be corrected within a reasonable time unless the customer, being unaware of the error, alters his/her position to his/her detriment in reliance on the truth of the amount credited. It is not clear whether the mere fact of spending the money constitutes reliance. This was answered positively in *Lloyds Bank Ltd* v. *Brooks* (1950) 72 JIB 114, where Larner J held that the bank owed a duty not to over-credit the account, inducing the customer to spend more than she had. In *United Overseas Bank* v. *Jiwani* [1976] 1 WLR 864, the defendant opened an account with the plaintiff bank in Geneva to build up assets outside Uganda. In October there was a credit balance of $10 000 and the bank received a telex from Zurich that $11 000 had been paid into the account. The subsequent written confirmation of the telex was mistaken by the bank for a further credit and they advised the defendant accordingly. The defendant was

buying a hotel in Geneva. He withdrew £20 000 dollars after the first credit and, when advised of the second, issued another cheque for $11 000. The bank discovered their error and tried to recover the sum overdrawn. The court set out three conditions to be satisfied by the defendant: (i) that the state of his account had been misrepresented by the bank; (ii) that he had been misled by the misrepresentations; and (iii) that, as a result, 'he changed his position making it inequitable to require him to repay the money'. The third condition was the most crucial, since he would have obviously continued with the purchase of the hotel.

Revocation of the banker's authority and duty to honour cheques

The Act specifies two events that determine the bank's duty and authority to pay a customer's cheque: (i) valid countermand (see above); and (ii) notice of customer's death: s.75. This is not an exhaustive list, however, and the following should also be considered:

(a) notice of customer's insanity;
(b) receipt of any court order affecting the account, such as garnishee order absolute or Mareva injunction (see Chapter 2);
(c) where a bankruptcy order or winding-up order has been made against a customer;
(d) notice of presentation of petition for a winding-up order or a bankruptcy order of a customer;
(e) knowledge of any defect of title of the presenter of a cheque for payment;
(f) where the bank knows or ought to know that the cheque is a misapplication of funds; and
(g) in the case of a trust account, any payment inconsistent with the trust.

In respect of (f), the main risk is where the bank is involved in transactions which constitute illegal financial assistance for the purchase of a company's shares under s.151 Companies Act 1985 (see p. 220). If it can be shown that the bank had knowledge that payments processed through the company's or other accounts were illegal financial assistance, the bank would be liable as a constructive trustee to repay the money to the company. The bank can only be liable, however, where it had (i) actual knowledge; or (ii) wilfully shut its eyes to the obvious; or (iii) wilfully and recklessly failed to make such enquiries as an honest and reasonable person would make; *Baden Delvaux et Lecuit* v. *Société Générale* pour favoriser le développement du commerce et de l'industrie en France SA [1983] BCLC 325.

As regards (g), it is not clear when an account is a trust account. In *Rowlandson and Others* v. *National Westminster Bank Ltd* [1978] 1 WLR 798, a woman opened an account at a branch of the defendant bank and paid money into the account for the benefit of her grandchildren. The children's fathers were authorised to draw on the account and one used the money to pay his debts. The bank was ordered to recredit the account with the money.

Duty on joint accounts

In the case of a joint account requiring cheques to be signed by two or more persons where one account holder forges the signature(s) of the other account holder(s), the bank has a separate duty to each of the account holders and must recredit the amounts paid out: *Jackson* v. *White and Midland Bank Ltd* [1967] 2 Lloyd's Rep 68, followed in *Catlin* v. *Cyprus Finance Corporation* (London) Ltd [1983] 1 All ER 809.

Duty not to disclose details of customer's account

The duty is subject to express or implied consent. In *Tournier* v. N*ational Provincial and Union Bank of England* [1924] 1 KB 461, the plaintiff entered into an agreement with his bank to pay off his overdraft by weekly instalments. When he failed to observe the agreement, the manager disclosed the information to the firm where the plaintiff was due to take up employment, including an allegation that the plaintiff was betting heavily. The employer failed to renew Tournier's contract after the initial three-month period. The Court of Appeal identified the following exceptions to the general rule of non-disclosure: (i) where disclosure is under compulsion by the law; (ii) where there is a duty to the public to disclose; (iii) where the interests of the bank require disclosure; and (iv) where disclosure is at the express or implied consent of the customer.

Compulsion of the law includes in particular the Banker's Books Evidence Act 1879 which provides: 'On the application of any party to a legal proceeding a court or judge may order that such party be at liberty to inspect and take copies of any entries in a banker's book for any of the purposes of such proceedings': s.7. The first case in nearly 100 years was *Williams and Others* v. *Summerfield* [1972] 2 QB 513, where a claim that its application in criminal cases was contrary to the fundamental principle against self-incrimination was rejected. The term 'Banker's books' includes 'a microfilm, magnetic tape or any other form of mechanical or electronic data retrieval mechanism', but not letters. Bankers are additionally obliged to make disclosure under the Companies Act 1985 and the Insolvency Act 1986 as well as under tax legislation and in respect of garnishee orders and Mareva injunctions which have been extended to freezing accounts containing money supposed to be proceeds of a crime. In *Chief Constable of Kent* v. *V and Another* [1982] 3 WLR 462, the defendant was accused of defrauding an old lady and paying the money into his bank account. The account was frozen because the police thought there was a risk of the money being removed from the bank.

The banker's duty of care in other areas

Banks may be liable in negligent mistatement where they give references for a customer to third parties: *Hedley Byrne & Co. Ltd* v. *Heller & Partners Ltd* [1964] AC 465. There is also liability in respect of customers

for negligent statements. In *Box* v. *Midland Bank Ltd* [1979] 2 Lloyd's Rep 391, a customer sued, claiming that the losses which led to his bankruptcy resulted from the negligent advice of the bank manager concerning availability of finance. A further unsuccessful claim for negligent advice was in the extraordinary decision in *Williams & Glyn's Bank Ltd* v. *Barnes* [1981] Com LR 205, which included an allegation that the bank had been negligent in lending the customer £1M to buy more shares in the company he controlled when it should have known that the business was at risk.

The bank may be vicariously liable to a customer or anybody else for the negligence of its agents and employees if they were acting within the scope of their apparent authority when the negligent act or omission occurred. In *Woods* v. *Martin's Bank Ltd* [1959] 1 QB 55, the bank was vicariously liable for negligent investment advice of a branch manager to a man who was not at that time a customer of the branch. The bank claimed that giving investment advice was not within his apparent authority but this was rejected; the court placed great weight on the fact that publicity issued by the bank offered investment advice as a service, even though the bank had actually forbidden its managers from giving direct investment advice.

15.15 The Customer's Duties to the Bank

The customer owes the three following duties to the bank.

Duty of care in drawing cheques

A bank may claim contributory negligence where it is liable for negligence in payment of a customer's cheques, This was accepted in *Lumsden & Co.* v. *London Trustee Savings Bank* [1971] 1 Lloyd's Rep 114, where the bank … negligently failed to obtain a reference before opening an account in a false name for a fraudulent clerk who paid into the account cheques embezzled from the plaintiff firm. Damages were reduced by 10 per cent because of the firms's negligence in drawing cheques, using the payee's surname only and facilitating the embezzlement. Claiming contributory negligence under the Law Reform (Contributory Negligence) Act 1945 was removed by s.11(1) of the Torts (Interference with Goods) Act 1977 but restored by s.47 Banking Act 1979.

Duty of care in respect of passbooks, loose-leaf statements and so on

There is no duty of care to examine these documents and the customer is not estopped from subsequently disputing entries.

Duty to present cheques for payment within a reasonable time

Where cheques are not presented within a reasonable time, the drawer or the person on whose account the cheque is drawn will be discharged to

the extent of any actual damage suffered as a result of the delay: s.74. Cheques are stale and will not be paid after a certain time, generally six months.

15.16 Bankers' Protection: The Paying and the Collecting Banker

A bank has two functions in respect of cheques. The banker for the drawer must honour the cheque on presentation for payment to him/her, and the banker acting for the person entitled to receive payment must collect the payment for the customer. In both functions the bank is vulnerable to liability for conversion. Thus, if the paying banker pays the cheque to a person with no title, s/he is liable to the drawer, and the collecting banker who collects for anyone other than the person entitled to receive payment is liable to that person. The Bills of Exchange Act 1882, supplemented by the Cheques Act 1957 and 1992, contains detailed rules protecting paying and collecting banks where they have paid or collected to or for the wrong person acting within well defined norms of good practice. There are special rules applicable to crossed cheques. The rules relating to crossings are contained in ss.76–81A. The crossing is an instruction to the paying banker to pay the cheque in accordance with the crossing. The crossing may be one of four types.

General crossings

General crossings are parallel lines, with or without the words 'and company' or any abbreviation thereto. If the words 'not negotiable' are added, the negotiability of the cheque is restricted: s.76(1). The paying banker must pay the cheque only to another banker and not over the counter: s.79.

Special crossing

A special crossing is when, inside the parallel lines, either with or without the words 'not negotiable', the cheque bears the name of a specific bank: s.76(2). The paying banker can pay the cheque only to the banker named in the crossing (s.79), otherwise s/he is liable to the true owner of the cheque for the loss incurred. Crossings can be added by the drawer or a holder, and a general crossing can be converted to a special crossing by a subsequent holder. A holder may add the words 'not negotiable' to the crossing. The crossing is a material part of the cheque and no person can obliterate or alter or add to it except as authorised by the Act: s.78. Banks allow the 'opening' of a crossed cheque subject to stringent controls; this was used particularly for collecting cash for payment of wages.

'Not negotiable' crossing

Once crossed 'not negotiable', any subsequent holder cannot be a holder in due course in respect of the cheque. This removes its negotiability and it can only be transferred subject to defects in title: s.81. The crossing 'not negotiable' on a bill of exchange makes it neither negotiable nor transferable: s.8(1).

'Account payee (only)' crossing

The Cheques Act 1992 provides that a cheque crossed in this way is non-transferable. The crossing is now automatically overprinted on to cheques issued by the bank to general customers.

15.17 The Protection of the Paying Banker

Payment in due course

Section 59 protects persons paying bills to the holder at or after maturity of the bill or cheque in good faith and without notice of any defect of title. The reference to 'holder' excludes a situation where the bill is paid to a person holding under a forged endorsement. This distinguishes bills of exchange from cheques since, for cheques, where the banker on whom the cheque is drawn pays the cheque in good faith and in the ordinary course of business, s/he will be discharged even though payment is to someone holding under a forged endorsement or one made without authority: s.60. The importance of the section is diminished by the Cheques Act 1957, the fact that few cheques are negotiated, and the increased predominance of the crossed cheque.

Payment of a crossed cheque

Where a banker on whom a crossed cheque is drawn pays it in good faith in accordance with the crossing, whether general or special, the banker paying the cheque and, if the cheque has come into the hands of the payee, the drawer, shall respectively be entitled to the same rights and be placed in the same position as if payment of the cheque had been made to the true owner: s.80. The protection has been extended to include non-transferable cheques: s.2, Cheques Act 1992. Once the drawer has given the crossed cheque to the payee, s/he is free from liability to any other party to the cheque.

This must be seen in conjunction with the Cheques Act 1957, whose main aim was to reduce the need for banks to check endorsements on cheques. The paying banker is absolved from liability where s/he pays a cheque where there is an absence or irregularity in endorsement: s.1. A banker is not negligent for this purpose only because of his/her failure to

concern him/herself with any purported endorsement of a non-transferable cheque: s.81A, Bills of Exchange Act (BOE) 1882. This has removed the main problem relating to negligence.

No protection is afforded against payment of cheques where the signature of the drawer is forged, even if undetectable; nor is there protection for materially altered cheques. The protection is for the bank; the legislation does not confer title on persons to whom payment has been made and they can be recovered as payments under a mistake of fact (see p. 465 above).

15.18 The Protection of the Collecting Banker

The collecting banker is protected by s.4 of the Cheques Act 1957. Since the protection is essentially identical with that previously provided under s.82 of the Bills of Exchange Act 1882, previously decided cases are still relevant. The essential protection is that, where a banker, in good faith and without negligence (a) receives payment for a customer of a cheque; or (b) having credited a customer's account with the amount of the cheque receives payment thereof for him/herself, and the customer has no title, or a defective title, to the cheque, the banker does not incur any liability to the true owner of the cheque by reason only of having received payment thereof: s.4.(1).

The requirement of a banker–customer relationship is not a problem, since this exists even where the customer has opened the account with the cheque in issue: see *Ladbroke & Co*. v. *Todd* (1914) 111 LT 43 (see below). The collecting banker's negligence is the main issue, which arises on two possible occasions: on opening an account and in collecting cheques.

Negligence on opening an account

Banks lose protection where they fail to take up references: in *Ladbroke & Co*. v. *Todd*, a man was allowed to open an account with a cheque crossed 'A/C payee only' claiming that he was the person named as the payee. The bank took no references and, sued by the drawer, was held negligent. They are also negligent for failing to follow up references. In *Marfani & Co. Ltd* v. *Midland Bank Ltd* [1968] 2 All ER 573, the plaintiff traded with a firm called 'Eliaszade' which employed a Mr Kureshy, who was known to a Mr Ali as 'Eliaszade'. K opened an account in the name of Eliaszade, giving Mr Ali and another man as referees, and the bank checked the reference with Mr Ali, a valued customer. K stole a cheque made out to Eliaszade, paid it into his account, withdrew the proceeds and left the country. There was no negligence in taking one reference, especially from a valued customer.

The bank was negligent for failing to ascertain the occupation of a married customer's husband in *Lloyd's Bank Ltd* v. *E. B. Savory & Co.* [1932] AC 201, but would now need to require the information from both

male and female customers. This reduces opportunities for embezzlement from an employer, but risks being out of date almost immediately. In *Orbit Mining and Trading Co. Ltd* v. *Westminster Bank Ltd* [1962] 3 All ER 565, Harman LJ stated that the majority decision of the House of Lords that the collecting bank had been negligent in not enquiring as to the employers seemed 'a hard doctrine' and 'It cannot … be the duty of the bank continually to keep itself up to date as to the identity of a customer's employer.'

Negligence when collecting cheque

There are numerous cases on negligence, classifiable as follows:

(i) collecting, without enquiry for the private account of an official of a company, a cheque payable to that company and endorsed by that official;
(ii) collecting without enquiry for the private account of a partner a cheque payable to the firm: *Baker* v. *Barclays Bank Ltd* [1955] 2 All ER 571;
(iii) collecting for the private account of an official a cheque payable to him/her in his/her official capacity: *Bute (Marquess)* v. *Barclays Bank Ltd* [1954] 3 All ER 365;
(iv) collecting without enquiry cheques drawn by a company or firm in favour of third parties and paid in for the credit of an employee or the wife of an employee of the drawer: *Lloyds Bank Ltd* v. *E. B. Savory & Co.*; and *Nu-Stilo Footwear Ltd* v. *Lloyds Bank Ltd* (1956) 7 LDB 121;
(v) collecting without enquiry for the private account of an attorney or agent a cheque made payable to him/her but drawn by him/her on behalf of his/her principal: *Midland Bank Ltd* v. *Reckitt and Others* [1933] AC 1;
(vi) collecting without enquiry cheques payable to the private account of an employee of the drawer when the cheque is signed by the employee: *Lloyds Bank Ltd* v. *Chartered Bank of India, Australia and China* (1928) 44 TLR 534; and
(vii) collecting a cheque crossed 'A/C payee (only)' for the account of somebody other than the payee.

The Cheques Act 1957 provides that the absence of, or irregularity, in endorsement will not constitute negligence and is extended to cover non-transferable cheques by s.3, Cheques Act 1992. The banker's liability is reduced by contributory negligence on the part of the customer: s.47 Banking Act 1979 (see p. 468 above).

15.19 Analogous Instruments and Bankers' Drafts

Bankers' protection is extended to analogous instruments, including bank drafts, by the Cheques Act 1957. Analogous instruments include cheques

drawn to 'Cash or order': *Orbit Mining and Trading Co. Ltd* v. *Westminster Bank Ltd*; and *Gader* v. *Flower* (1979) 129 NLJ 1266 (see 3.7 above). The Cheques Act 1957 extends the protection of s. 80, Bills of Exchange Act 1882 to such instruments and banks can claim protection as a collecting bank for bankers' drafts as well as for cheques, and as a paying banker in respect of crossed drafts under s.80. Protection in respect of uncrossed drafts is under s.19, Stamp Act 1853.

15.20 The Collecting Banker as Holder in Due Course

Collecting bankers who, through their negligence, lose protection of s.4, Cheques Act 1957, may sometimes be able to collect as a holder in due course, since the definition of good faith in the Bills of Exchange Act 1882 is 'A thing … done honestly, whether … negligently or not' (s.90): *Lloyds Bank Ltd* v. *Hornby* (1933) *Financial Times*, 5 July.

Banks give value in five situations: (i) where they cash cheques for a customer or any other holder; (ii) where cheques are paid in for the express purpose of reducing the customer's overdraft; (iii) where customers have express authority to draw against uncleared items; (iv) where the customer's cheques against uncleared items have been honoured as a regular practice (estoppel); and (v) where the banker has a lien on the cheque. For the purposes of (ii), merely crediting a cheque to an overdrawn account is not sufficient; it must be shown that the bank ceased charging interest on the overdraft as soon as the cheque was paid in without waiting for collection: *Westminster Bank Ltd* v. *Zang* [1966] AC 182 (see below). A person with a lien on a bill or cheque has supplied value: s.27(3). A banker's lien arises over cheques paid into a customer's overdrawn account or paid into one account when another is overdrawn: *Re Keever* [1966] 3 All ER 631. In *Barclays Bank Ltd* v. *Astley Industrial Trust Ltd* [1970] 1 All ER 719, a garage company had an overdrawn account at the bank. Five cheques were paid into this account, drawn by the defendants. It was later found that the transactions in respect of which these cheques had been drawn were fraudulent, and the cheques were stopped. The bank successfully sued for payment, alleging a lien in respect of the overdraft on the garage account and claiming title as holders in due course. In *Halesowen Presswork & Assemblies Ltd* v. *Westminster Bank Ltd* [1972] 1 All ER 641, the plaintiffs had two accounts at the bank: a No. 1 account that was frozen by mutual consent, and a No. 2 account that was the plaintiff's trading account maintained in credit. A cheque was paid in for the No. 2 account in the morning and the company went into liquidation in the afternoon. The bank successfully claimed the right to set the proceeds of the cheque against the overdrawn No. 1 account. Liens depend upon possession, and banks lose the lien if they part with the cheque to enable the customer to sue, even though they subsequently recover it: *Westminster Bank Ltd* v. *Zang* (see below).

As part of its aim to reduce the need for endorsement, the Cheques Act 1957 provides: 'A banker who gives value for, or has a lien on a cheque payable to order which the holder delivers to him for collection without indorsing it, has such rights as he would have if, upon delivery, the holder had indorsed it in blank': s.2. But it will not protect a banker where the cheque is paid in for collection for an account other than that of the person named as payee or endorsee, including cheques drawn to an individual and paid in for collection to the account of a company controlled by that person: *Westminster Bank Ltd* v. *Zang* (above). Zang drew a cheque payable to 'J. Tilley or order' and Tilley paid it into the account of Tilley Autos Ltd, a company he controlled. The cheque was not endorsed. The bank credited the cheque to the account, where it reduced the overdraft. The company did not draw against the uncleared cheque. The cheque was dishonoured and the bank returned the cheque to Tilley for him to sue, but then recovered the cheque and themselves sued as holders in due course. The court held that they had not given value for the cheque simply by paying it into an overdrawn account, since the customer had not drawn against it as an uncleared item, nor had there been any agreement that they could, and the bank had lost its lien in parting with possession. In addition they could not sue, since the cheque had not been endorsed to them and they were not holders under the Cheques Act 1957, s.2.

15.21 Electronic Funds Transfer (EFT)

Banking operations are increasingly taking place electronically. EFTs are defined in the Banking Services: Law and Practice Report by the Review Committee (1989) Cm 622 (the Jack Committee) as 'payment messages transmitted either through magnetic material such as magnetic tapes, disks and cassettes; or through purely electronic media such as telephones, telex and electronic transmission between computers, or between a terminal and a computer'. The Committee identified six EFT systems in the UK:

(i) Clearing House Automated Payment System (CHAPS): this is an electronic sterling credit transfer system for same-day settlement of individual orders to pay sums in excess of £10 000. It is frequently used in conveyancing.
(ii) Bankers Automated Clearing Services (BACS): this provides a high-volume, low-value, automated batch clearing service for payment and collection transactions, including direct debits, standing orders, salaries and pensions.
(iii) Automated Teller Machines (ATM): these are cash-dispensing machines operated by the insertion of a plastic card and entering a Personal Identification Number (PIN).
(iv) Electronic Funds Transfer at Point of Sale (EFT-POS) this is an electronic payment system transferring money from a customer's to a retailer's account. The customer authorises the transaction by signing

a receipt slip, or entering his/her PIN into a terminal. The transaction is sent through one of the processing systems such as Switch.

(v) Home and office banking systems enable funds to be transmitted through direct access to the bank's computer through television, telephone or personal computer.

(vi) The Society for Worldwide Interbank Financial Telecommunications (SWIFT) allows for the rapid transfer of instructions between network members acting as a means of transferring funds.

The Jack Committee identified a number of problems with EFT. The replacement of the signature used in paper-based transactions by an electronic key is a less reliable way of authenticating the customer's instructions and is open to error and fraud. There are problems relating to the operational security of the system, including safeguarding the payment card and the PIN, ensuring the privacy of transactions, and preventing the alteration or erasure of messages on magnetic material. It is also more difficult to pinpoint the liability for loss due to fraud or technical failure in EFT transactions, which raises issues concerning the allocation of losses and the burden of proof. The main area for problems here has related to the so-called 'phantom withdrawals' from an ATM. The banking ombudsman places the burden of proving that the machine was not at fault with the bank, after which the burden switches to the card-holder to prove that s/he did not use the card, and that a third party has not had access to the card and the PIN. This is a heavy burden to discharge. A further problem is that it is more difficult with EFT to establish when it is impossible for the customer's instruction to be countermanded.

The only UK legislation relating to EFT is s.89, Banking Act 1987, which amends s.187 Consumer Credit Act 1974 and excludes EFTs from the definition of debtor–creditor–supplier agreements (DCSAs). This excludes the operation of s.75 from payments by debit card (see Chapter 14). The use of cards is, however, covered by the Code of Banking Practice (see 'Good Banking': Code of Banking Practice (2nd edn, 1994). This regulates the issue of cards, which will only be issued when they have been requested in writing, or to replace or renew cards that have already been issued (r.17.1). It also requires that the cards and PINs are to be separately issued, with the PIN being advised only to the customer (r.18.1). There are standards of care for customers relating to maintaining security. Thus customers should not allow anyone to use their card and PIN, that they should take all reasonable steps to keep the card safe and the PIN secret at all times, including never writing the PIN on the card or on anything usually kept with the card and never writing down the PIN without a reasonable attempt to disguise it; and any PIN advice should be discarded immediately (r.18.2). Customers should be encouraged to select their own PIN to help them in remembering it (r.18.3).

Where cards are lost, the customer must tell the card issuer as soon as reasonably practicable that their card has been lost or stolen, or that someone else knows their PIN (r.19). The Code establishes that liability

for loss is borne by the card issuer where there is misuse of a card which has not been received by a customer; for all transactions after having been informed that the card has been lost or that the PIN is known to someone else; where there are faults in the machines or other systems unless the fault was obvious or communicated by a message or notice on display (r.20.1). The liability of the card issuer is limited to those amounts wrongly charged to customers' accounts and any interest on those amounts (r.20.2).

Customers' liability is limited to a maximum of £50 in the event of the card being misused before the customer has notified the issuer of the loss or theft of the card, or that someone else knows the PIN. But customers are liable for all losses where they have acted fraudulently and may be liable for all losses where they have acted with gross negligence, which includes a failure to comply with the requirements relating to security of the card and the PIN. In the case of disputed transactions, the burden of proving fraud or gross negligence or that the customer received the card is on the card issuer. In such cases customers are expected to co-operate with the card issuers in their investigations (r.20.3–5).

Recommended Further Reading

Richardson's Guide to Negotiable Instruments, James J. Richardson (Butterworths, 8th edn 1991).

Questions

1 A bill of exchange is defined in s.3(1) Bills of Exchange Act 1882. What is the legal definition of a cheque?

2 Certain formalities only apply to bills of exchange, of which the most significant is 'acceptance'. What is acceptance? Why are bills generally accepted even where there is no legal requirement? What do you understand by 'qualified acceptance'?

3 A bill or cheque payable to order is negotiated by 'the indorsement of the holder completed by deliver'. What is the distinction between a blank and a special endorsement?

4 There are three types of holder for value. What are they?

5 A person can only be a holder in due course of a cheque or bill when he or she complies with six criteria. What are they?

6 What do you understand by the phrase 'the cash equivalence of the bill of exchange or cheque'?

7 A banker pays a cheque without authority in three cases. What are they?

8 With regards to cheques, what types of crossing are there, and what is their significance?

9 The law provides for the protection of the paying and the collecting banker. Against what is protection required and how can a collecting banker lose this statutory protection?

10 A collecting banker can claim as a holder in due course when it has given value on a cheque. What are the five situations in which a banker gives value?

Part VII

Consumer Protection

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16 Consumer Protection

Learning Objectives

After reading this chapter you will know about:

1. the law relating to false trade descriptions, false price indications and false statements as to services, accommodation and facilities
2. the law relating to product liability of manufacturers
3. the protection of the consumer relating to contracts for unsolicited goods and services and cancellable agreements for goods and services
4. The Unfair Terms in Consumer Contracts Regulations 1994

16.1 Trade Descriptions

The Trade Descriptions Act 1968 created three offences: false trade descriptions (s.1.); false price indications (s.11); and false statements as to services, accommodation and facilities (s.14). The second has been replaced by Part III of the Consumer Protection Act 1987. The Trade Descriptions Act 1972 requires an indication of origin on certain imported goods and makes it an offence for anyone, in the course of a trade or business, to supply or offer to supply goods manufactured or produced outside the UK with a UK name or mark unless accompanied by a conspicuous indication of the country of origin, or unless the UK mark is not visible on reasonable inspection.

16.2 False Trade Descriptions

Section 1(1) Trade Descriptions Act (TDA) 1968 provides:

> Any person who, in the course of a trade or business:
> (a) applies a false trade description to any goods; or
> (b) supplies or offers to supply any goods to which a false trade description is applied;
> shall, subject to the provisions of the Act, be guilty of an offence.

The section creates two separate strict liability offences: applying a false description to goods, and supplying goods to which a false trade description has been applied. The second offence is committed by (a) supplying the goods; and (b) offering to supply them. However, s.6 provides: 'A person exposing goods for supply or having goods in his possession for supply shall be deemed to offer to supply them', and includes a mere invitation to treat. It is a defence that the person did not know and could not with reasonable diligence have ascertained, that the goods did not

conform to the description or that the description had been applied to the goods (see 16.4 Defences, below).

'Any person'

This includes a limited company, and s.20 contains special provisions making any director, manager, secretary or other similar officer jointly liable if the offence is proved to have been committed with their consent or connivance. The person will normally be a seller of goods, but it can be a buyer. In *Fletcher* v. *Budgen* (1974) *The Times*, 12 June, a car dealer negotiating for the purchase of a car told the seller that the car was beyond repair and only fit for scrap. The dealer bought the car for £2 and then, having repaired it, advertised it for sale at £136.

'In the course of a trade or business'

The Act is not aimed at private sellers, and is restricted to commercial transactions only. However, the sale of a car by a car hire firm was a sale in the course of business: *Havering London Borough* v. *Stevenson* [1970] 3 All ER 609, whereas in *Davies* v. *Sumner* [1984] 1 WLR 1301, where the defendant was a self-employed courier and used his car almost exclusively in connection with his business, the sale of his car in part-exchange for a new car, also to be used for his business, was not a sale in the course of his business. This decision was followed in *R & B Customs Brokers Co. Ltd* v. *United Dominions Trust Ltd* [1988] 1 WLR 321, where sales by a business of two or three cars over a five-year period were not regarded as made in the course of a business.

A person who, as a hobby, buys, rebuilds and then sells cars would not be selling in the course of a business (*Blackmore* v. *Bellamy* [1983] RTR 303) unless s/he also runs a business and the sale is in the course of that business: *Southwark London Borough* v. *Charlesworth* (1983) 147 JP 470; see also *Fletcher* v. *Sledmore* [1973] RTR 371. A private individual can be held liable under s.23 (see below) where, as a result of his/her 'clocking' his/her car before selling it to a dealer, s/he causes the dealer to commit an offence: *Olgiersson* v. *Kitching* [1986] 1 WLR 304.

'Applies'

This is explained in s.4. A person applies a false trade description to goods if s/he:

(a) affixes or annexes it to or in any manner marks it on or incorporates it with:
    (i) the goods themselves, or
    (ii) anything in, on, or with which the goods are supplied; or
(b) places the goods in, on, or with anything which the trade description has been affixed or annexed to, marked on or incorporated with, or places any such thing with the goods; or

(c) uses the trade description in any manner likely to be taken as referring to the goods.

In *Donnelly* v. *Rowlands* [1970] 1 WLR 1600, the defendant, a milk retailer, supplied his milk in bottles capped with a foil top marked with his name and address, although the bottles themselves bore a variety of names – CWS, Express and so on – depending upon their origin. The court held that the words on the bottle referred to the bottle and not the milk, and that there was no false trade description.

Under s.4(2) an oral statement may amount to a trade description but any action on such a claim must be brought within six months.

'False trade description'

The definition of a false trade description is contained in ss.2 and 3 of the Act. Thus section 2(1) states that a trade description is an indication, direct or indirect, and by whatever means given of any of the matters specified thereby with respect to any goods. There then follows a list:

(a) quantity size or gauge;
(b) method of manufacture or production;
(c) composition;
(d) fitness for purpose, strength, performance, behaviour or accuracy;
(e) any other physical characteristics;
(f) testing by any person and the results thereof;
(g) approval by any person or conformity with an approved type;
(h) place or date of manufacture, production etc;
(i) person by whom manufactured or processed; and
(j) other history, including previous ownership or use.

A false trade description is one that is false to a material degree and includes descriptions which, though not false, are misleading: s.3. Falsely indicating that goods or services are as supplied to the Royal Family or simulating the Queen's Award to Industry logo are separate offences under s.12. False indications of supply to 'any person' are caught under s.13.

The statement of value relating to goods – 'worth double' – is regarded as equivalent to advertising puffs and is not prohibited by the Act.

Avoiding liability through the use of a disclaimer is particularly relevant with regard to false odometer readings on second-hand cars. Here the offence is committed if the reading is false and undisclaimed, whether or not the seller is aware that it is false. For the dealer to escape liability the disclaimer 'must be as bold, precise and compelling as the trade description itself and must be as effectively brought to the notice of any person to whom the goods may be supplied'. In other words, it must equal the trade description to the extent to which it is likely to be communicated to a prospective purchaser: *Norman* v. *Bennett* [1974] 3 All ER 351. Once the trade description is made, a casual remark or 'small print' in a document are not enough to disclaim it.

16.3 False Statements as to Services, Accommodation and Facilities

This offence is established by s.14, which provides:

(1) It shall be an offence for any person in the course of any trade or business –
  (a) to make a statement which he knows to be false;
  (b) recklessly to make a statement which is false;

as to any of the following matters in the course of any trade or business:

(i) the provision of,
(ii) the nature of,
(iii) the time at which, manner in which, or persons by whom services, accommodation or facilities are provided, or
(iv) their examination, approval or evaluation by another person, or
(v) the location or amenities of accommodation.

Making a false statement about services includes false representations concerning professional and other qualifications, in the course of a trade or business, which includes 'profession'. In *R* v. *Breeze* [1973] 2 All ER 1141, the defendant was convicted for falsely placing the letters ARIBA (Associate of the Royal Institute of British Architects) after his name. It is difficult to obtain a conviction, since it must be shown that the defendant either knew the statement was false or made it recklessly regardless of whether it was true or false. Recklessness does not imply dishonesty; the prosecution only has to show that the defendant did not have regard to the truth or falsity of his/her statement, even though it cannot be proved that s/he deliberately closed his/her eyes to the truth. In *MFI Warehouses* v. *Nattrass* [1973] 1 All ER 762, the court found the defendants negligent in respect of an advertisement which the chairman had considered for five to ten minutes without appreciating its implications. However, in *Airtours plc* v. *Shipley* (1994) 158 JP 835, the company appealed successfully against conviction for including a statement that a hotel had a swimming pool by establishing that the brochure had been produced within the set guidelines and procedures of the company's errata policy.

In *Ashley* v. *Sutton London Borough Council* (1994) 159 JP 631, DC the plaintiff sold a mail-order book giving information on how to win at gambling with fixed odds. The book was sold subject to a money-back guarantee for purchasers who had not gambled successfully within ninety days, but refunds were not made. His appeal against a conviction under s.14, in which he argued that the sale of the book was a supply of goods and not services, was rejected. The court held that the grossly inflated price indicated that it was the information that was being sold rather than the book, and that the purchasers were buying a service.

A problem of enforcement is that the defendant must have had this knowledge or recklessness at the time the false statement was made. The significance of the timing can be seen in *Cowburn* v. *Focus Television Rentals Ltd* [1983] Crim. LR 563. The defendants advertised: 'Hire 20

feature films absolutely free when you rent a video recorder'. This was doubly untrue, since the person was only entitled to six films and they were not free because packaging and postage had to be paid. Following a customer's complaint, the defendants made sure that the customer received twenty films and reimbursed his cost of postage and packaging, but were still convicted, since the statements were false when made and had been made recklessly.

The main effect of this, however, is that it excludes promises and forecasts about the future. In *Beckett* v. *Cohen* [1972] 1 WLR 1593, the accused agreed to build a garage 'as the existing garage' and 'within ten days'. The court held that he was liable for breach of contract but was not criminally liable. This has been of particular importance in connection with claims made in tour operators' holiday brochures. In *Sunair Holidays Ltd* v. *Doss* [1970] 2 All ER 410, the divisional court held that a statement in a brochure 'all twinbedded rooms with … terrace' was accurate when made because the appellants had contracted with the hotel for the provision of such rooms for their clients, and there was no offence even though the hotel provided a room without a terrace.

In *R* v. *Sunair Holidays Ltd* [1973] 1 WLR 1105, a similar decision was reached concerning a misdescription of hotel facilities. The court stated: 'S.14 does not deal with forecasts or promises as such. We put in the qualifying words "as such" for this reason. A promise or forecast may contain by implication a statement of present fact. The person who makes the promise may be implying that his present intention is to keep it or that he has the power at present to perform it. The person who makes the forecast may be implying that he now believes that his prediction will come true or that he has the means of bringing it to pass. Such implied statements of present intention, means or belief, when they are made, may well be within s.14 and therefore punishable if they were false and made knowingly or recklessly. But if they are punishable, the offence is not the breaking of a promise or the failure to make a prediction come true. It is the making of a false statement of an existing fact, somebody's present state of mind or present means.' This was approved in *British Airways Board* v. *Taylor* [1976] 1 All ER 65, which concerned the operation of an overbooking system for air flights. The House of Lords held that the statement, 'I have pleasure in confirming the following reservations for you – London/Bermuda Flight BA 679 – Economy Class – 29 August Dep 1525 hours Arr 1750 hours' was a false statement within s.14(1).

False statements in a brochure are made when communicated, so that each communication constitutes a fresh offence: *R* v. *Thomson Holidays Ltd* [1974] QB 592. An extreme example is *Wings Ltd* v. *Ellis* [1984] 3 All ER 577, where the travel company recalled brochures after discovering a mistake but, seven or eight months later, a customer booked a holiday on the basis of one of the old brochures. The House of Lords found the company rightly convicted of making a statement knowing it to be false. The statement was made when the brochure was published and again when read. The defendants did not make a false statement knowingly or

recklessly when the brochure was published, but they did when it was read because they had by then the knowledge that the statement was untrue.

16.4 Defences

There is a general defence under s.24(1), where the defendant establishes that the offence was because of a mistake or reliance on an act or default of another person. There is another defence in s.24(3) exclusively relating to charges under s.1(1)(b). A further defence under s.25 relates to the innocent publication of an advertisement and, finally, s.23 provides for an additional or alternative defendant.

Mistake or reliance on an act or default of another person

Under s.24 (1) it shall be a defence for the accused to prove that s/he comes within both the following paragraphs:

(a) that the commission of the offence was due to a mistake or to reliance on information supplied to him or to the act or default of another person, an accident or some other cause beyond his control; and
(b) that he took all reasonable precautions and exercised all due diligence to avoid the commission of such an offence by himself or any person under his control.

In order for the defence to succeed both aspects must be established: (i) the act or default of another person; and (ii) that the defendant took 'all reasonable precautions'.

'Another person'

The words 'another person' cause problems where the defendant is a company and decisions have weakened the Act. In *Beckett* v. *Kingston Bros (Butchers) Ltd* [1970] 1 QB 606, the defendant successfully avoided prosecution for false trade descriptions by establishing that the fault lay with the employee. This means that, unless the employee in question can be established as the *alter ego* of the company, the company can escape from liability. The leading case is *Tesco Supermarkets Ltd* v. *Nattrass* [1971] 2 All ER 127. The company owned a number of supermarkets and had set up a reasonable and efficient system of instruction and inspection for ensuring compliance with the Trade Descriptions Act. In the supermarket in question, the shop displayed a poster advertising a special offer on soap powder, but had run out of packets at the special price and the manager had failed to supervise the actions of an assistant who put out packets at the normal price. The company was charged under s.11(2) of the Trade Descriptions Act 1968 and appealed against conviction to the House of Lords. The justices and the divisional court had both held that the company and not the manager was 'another person'.

In the House of Lords, Lord Reid stated: 'A living person has a mind which can have knowledge of intention or be negligent and he has hands to carry out his intentions. A corporation has none of these; it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company … Normally the board of directors, the managing director and perhaps other superior officers of a company can carry out the functions of management and speak and act as the company. Their subordinates do not. They carry out orders from above and it can make no difference that they are given some measure of discretion. But the board of directors may delegate some part of their functions of management, giving to their delegate full discretion to act independently of instructions from them. I see no difficulty in holding that they have thereby put such a delegate in their place so that within the scope of the delegation he can act as the company … But here the board never delegated any part of their functions. They set up a chain of command through regional and district supervisors, but they remained in control. The shop managers had to obey their general directions and also to take orders from their superiors. The acts or omissions of shop managers were not acts of the company itself.'

The Director General of Fair Trading's Review of the Trade Descriptions Act (Cmnd 6628, 1976) concluded that 'the imposition of vicarious liability for offences arising from the act or default of employees would be unjustified'.

'All reasonable precautions' and 'all due diligence'

In *Simmons* v. *Potter* [1975] RTR 34, the defendants, who were second-hand car dealers, pleaded the defence in relation to the sale of a car that had been 'clocked' by a previous owner. They had checked the mileage with the previous owner and this had confirmed their impression that the reading shown was correct. The court held that they had not taken 'all reasonable precautions'.

In *Harringey London Borough* v. *Piro Shoes Ltd* [1976] Crim. LR 462, the defendants were unable to succeed in respect of the defence in connection with shoes that were wrongly labelled 'all leather' when they instructed their managers not to let the shoes leave the shop without the label being removed. The court held that, since the offence under s.1 was committed by the mere fact of the goods being 'exposed for sale', the instructions to the manager should have been to remove the offending label before the goods were displayed. The offence was therefore committed by another person but the defendants had not taken 'all reasonable precautions'.

In *Sharratt* v. *Geralds The American Jewellers Ltd* (1970) 114 SJ 147, the defendants were charged with supplying a wristwatch marked 'diver's watch' and 'waterproof'. After being immersed in water for one hour, the watch filled with water and stopped. The defendants had not tested the

watches, but relied on the manufacturer's reputation. The magistrate found that they had taken all reasonable precautions and exercised all due diligence under s.24(1)(b). Allowing an appeal from the prosecution, Lord Parker CJ stated: 'Whatever ''all due diligence'' might mean, there was clearly an obligation to take any reasonable precautions that could be taken… The elementary precaution of dipping the watch in a bowl of water would have prevented the offence.' This was followed in *Garrett* v. *Boots Chemists Ltd*, 16 July 1980 (unreported), where Boots were charged with selling pencils with a higher lead content than permitted. On the issue of reasonable precautions, Lord Lane CJ stated: 'what might be reasonable for a large retailer might not be reasonable in the village shop'. The court found that the failure of Boots to test a random sample of the pencils constituted a failure to take all reasonable precautions.

Special defence to s.1(1)(b)

Section 24(3) provides: 'it shall be a defence for the person charged to prove that he did not know, and could not with reasonable diligence have ascertained, that the goods did not conform to the description or that the description had been applied to the goods'. This defence is essentially one of innocent supply of goods. The difference between s.24(3) and s.24(1) is that s.24(3) requires only that the exercise of 'reasonable diligence' would not have shown up the offence. The difference is illustrated in *Barker* v. *Hargreaves* [1981] RTR 197, where a second-hand car dealer advertised a car as being 'in good condition throughout'. He had obtained an MOT certificate for the car but it was, in fact, badly corroded. The dealer's conviction under s.1(1)(b) was upheld by the divisional court. In his judgment, Donaldson LJ distinguished between the two subsections and stated that, whereas in s.24(1) a defendant can rely on information received from other people (subject to taking all reasonable precautions and exercising all due diligence), when it comes to s.24(3) it is no answer that he was misled by others: 'What he has to do is show that it was a latent defect, that is to say, a defect which could not with reasonable diligence have been ascertained.'

Innocent publication of an advertisement

This defence of innocent publication under s.25 provides a defence for a newspaper which innocently publishes a misleading advertisement, provided that the advertisement was received in the ordinary course of business.

Additional or alternative defendants

Section 23 provides: 'Where the commission by a person of an offence under this Act is due to the act or default of some other person that other person shall be guilty of the offence, and a person may be charged with and convicted of the offence by virtue of this section whether or not proceedings are taken against the first-mentioned person.' In order for the

'other person' to be convicted under this section two things must be established: (i) the first person must have been guilty of an offence under the Act or guilty except for the availability of the statutory defence under section 24 or 25; and (ii) the guilt or potential guilt must have been due to the 'other person'.

The details of the first point were established in two decisions. In *Cottee* v. *Douglas Seaton (Used Cars) Ltd* [1972] 3 All ER 750, M's car was affected by rust damage in the engine compartment, so he filled it with plastic filler, painted it over and sold the car to the respondents, having made no attempt to disguise the work. The defendants disguised the repair and sold the car to W, another dealer, who was unaware of the work. W sold the car to S. The car was involved in an accident and the repairs were discovered. The respondent was charged under s.23 on the ground that W was guilty of an offence under s.1(1)(b). The justices dismissed the case and the prosecution appealed. The appeal was dismissed on the grounds that, since W had not committed an offence under s.1(1)(b), the respondents had not committed an offence under s.23.

In *Coupe* v. *Guyett* [1973] 2 All ER 1058, the defendant, a car repair workshop manager employed by the owner of the business, Miss Shaw, recklessly made a false statement as to repairs carried out on a car. Miss Shaw was the sole proprietor of the business but took no active part in it. She was charged under s.14(1)(b) and the defendant was charged under s.23. Miss Shaw was acquitted on the grounds that she personally neither made nor authorised nor was even aware that the false statement had been made. The defendant was acquitted on the ground that, since the owner had committed no offence, it was not possible for a s.23 conviction to be made against him. On appeal the court held that, if the justices had acquitted Miss Shaw solely on the basis of the statutory defence, then it would have been possible for them to convict the defendant, but that if Miss Shaw was entitled to be acquitted on other grounds, the defendant could not be convicted under s.23.

A private person can be convicted under s. 23. Thus a private motorist who 'clocks' a car before selling it to a dealer can be guilty under the section where s/he causes the dealer to commit an offence under s.1(1)(b): *Olgiersson* v. *Kitching* [1986] 1 WLR 304.

16.5 False or Misleading Indications as to Price

The offence created by s.11, TDA 1968 was replaced by Part II of the Consumer Protection Act (CPA) 1987. A person now commits an offence under s.20(1) CPA 1987 'if in the course of any business of his, he gives (by any means whatever) to any consumers an indication which is misleading as to the price at which any goods, services, accommodation or facilities are available (whether generally or from a particular person)'.

The decision under the old law in *John* v. *Matthews* [1970] 2 QB 443 still applies. Here, a packet of cigarettes was displayed in the bar of a working

men's club marked '3d. off' (3p off) when they were being offered at full price. The court held that no offence was committed because the Act did not extend to domestic situations and that a club with private membership enjoyed private or domestic status.

Section 20(2) concerns situations where information relating to prices is correct when given, but becomes false later. If consumers might reasonably be expected to rely on the information which is now misleading, the trader commits an offence unless s/he has taken all reasonable steps to prevent them from doing so. The following are 'misleading' for the purposes of the Act:

(a) an understatement of the price;
(b) the stating of the price without making it clear, if it is the case, that it applies only to cash customers, or that it does not apply to part-exchange deals, or applies only in certain circumstances, or does not apply in certain other circumstances;
(c) failing to make it clear, if it is the case, that service is charged extra, or that some other additional charge is made;
(d) a false indication that a price is expected to be increased or reduced or maintained (whether or not for a particular period);
(e) making a false price comparison, for example falsely stating that the price is reduced or comparing the price of a car with that of another model without stating that the price for the other model has since been reduced.

Decisions under the old law would still constitute offences. Thus, in *Richards* v. *Westminster Motors Ltd* [1976] 2 QB 795, an offence was committed where the price at which goods were advertised did not include VAT. In *Read Bros. Cycles (Leighton) Ltd* v. *Waltham Forest LBC* [1978] RTR 397, the court convicted a retailer who advertised a motor-bike at one price and, when a customer wished to purchase it by trading in his own bike in part-exchange, informed the customer that the motor-bike would cost another £40. And in *Clive Sweeting* v. *Northern Upholstery Ltd* (1982) *The Times*, 28 June, a retailer was convicted where he advertised a suite of furniture at a special-offer price without indicating that the offer only applied to suites of one colour and not the whole range.

The confusion in the following situations could still occur: in *Nattrass* v. *Marks & Spencer Ltd*, 25 June 1980, the defendants had advertised a special offer on fish fingers and had also reduced the price on most, but not all, of the packets, and an offence was committed when a sales assistant sold a packet at the pre-promotional price. However in *Manley* v. *Marks & Spencer Ltd* (1981) 89 ITSA Monthly Review 212, the court found that, in a similar situation, there was merely a mistake by the sales assistant and that it was clear that the goods were being sold at the promotional price.

There is a Code of Practice as a guidance for traders, but compliance is not necessarily a complete defence (s.25) and the Secretary of State may regulate the giving of price information, making specific practices a criminal offence: s.26.

Defences

It is a defence where the defendant can prove (s.24):

(a) his acts or omissions were authorised by regulations made under section 26;
(b) the offending price indication was given, other than in an advertisement, on the media;
(c) he was an innocent publisher or advertising agency who was unaware, and had no grounds for suspecting, that the advertisement contained a false price indication;
(d) the misleading price indication related to a recommended price, which did not apply to the price at which the item was available from the defendant, and which the defendant could reasonably believe was generally being charged, and which was false only because a supplier was not following the recommendation.

It is also a defence for a person to show that s/he took all reasonable steps and exercised all due diligence to avoid the commission of an offence: s.39. In *Berkshire County Council* v. *Olympic Holidays Ltd* [1994] Crim LR 277, a customer booked a holiday with a travel agent using a computer, and the first screen display contained a warning that the reservation was not confirmed; no price was quoted. The customer was given a print-out of a second screen display, which included the quoted price. However the customer's invoice was substantially more than that on the screen. The travel agent was acquitted, since the magistrate found that he had taken all reasonable steps and exercised due diligence. An appeal was dismissed; it was held that the misleading information was caused by an unexplained fault in the computer which had never occurred before. The magistrates had found that the agents had tested the software and that the same transaction had produced the correct information on a repeated test.

Additional or alternative defendant

Part III contains an equivalent provision to s.23 TDA 1968, whereby another person can be guilty of an offence because someone else has committed an offence through his/her fault. The only difference with s.40 is that the other party can only be liable for the offence where it was committed by that person 'in the course of any business of his' and there can be no liability of a private person, as in *Olgiersson* v. *Kitching* [1986] 1 WLR 304.

16.6 Product Liability

A manufacturer may be liable for his products in four ways: (i) under the Sale of Goods Act (SOGA) 1979; (ii) tortious liability for negligence;

(iii) under the Consumer Protection Act 1987; and (iv) under a collateral contract of guarantee.

16.7 The Sale of Goods Act 1979

Protection in respect of defective goods based on the implied term of satisfactory quality in s.14(2) SOGA 1979 has been discussed. However, since the basis of liability is contractual, the manufacturer is only liable where the buyer dealt directly with him/her. The buyer will generally sue the retailer, who will then claim an indemnity against his wholesaler, who will eventually claim against the manufacturer.

Where a person purchases goods to give as a gift to somebody else, the handing over of the gift transfers no benefit to the statutory protection: *Heil* v. *Hedges* [1951] 1 TLR 512. The Consumers' Association has suggested that the rights could be assigned by writing on the gift tag: 'To Grandad with all my love and all my rights under the Sale of Goods Act 1979', but admits that this is legally doubtful.

16.8 Tortious Liability: Negligence

The decision in *Donoghue* v. *Stevenson* [1932] AC 562 established the manufacturer's liability to the ultimate consumer where the consumer could establish negligence. The problems related to the tort of negligence have already been discussed. The problem with tortious liability is that the burden of proof is on the consumer, who is unlikely to be aware of the manufacturing process and any potential breaches of manufacturing safeguards. The doctrine of *res ipsa loquitur* is therefore of tremendous importance. It was used successfully in *Chapronière* v. *Mason* (1905) 21 TLR 633, involving a bath bun with a stone in the middle, but was unsuccessful in *Daniels* v. *White* [1968] 160 LT 128, where carbolic acid was found in a bottle of lemonade, since the manufacturer established that he had a safe manufacturing operation with adequate quality control.

16.9 The Consumer Protection Act 1987, Part I

Part I of the Act implements a European Directive relating to product liability. Under the Act a person who is injured by a defective product has a right of action against the manufacturer irrespective of whether or not the manufacturer was negligent. The basis of the claim is s.2, which requires the plaintiff to establish four things:

(a) that the product contained a defect;
(b) that the plaintiff suffered damage;
(c) that the damage was caused by the defect; and

(d) that the defendant was producer, own-brander or importer into the EC of the product.

Defective product

A product is defective 'if the safety of the product is not such as persons generally are entitled to expect'. Safety includes risks of death or personal injury, but also extends to cover risks of damage to property. In determining whether a product is defective, all the circumstances must be taken into account, including (CPA 1987, s.3(2)):

(a) the manner in which, and purposes for which, the product has been marketed, its get-up, the use of any mark in relation to the product and any instructions for, or warnings with respect to, doing or refraining from doing anything with or in relation to the product;
(b) what might reasonably be expected to be done with or in relation to the product; and
(c) the time when the product was supplied by its producer to another; and nothing in this section shall require a defect to be inferred from the fact alone that the safety of a product which is supplied after that time is greater than the safety of the product in question.

Products are widely defined and include goods, electricity, gas and vapours. There are three exceptions: land, primary agricultural products, and unprocessed game. The definition of land includes 'things comprised in land by virtue of being attached to it': s.45. This includes buildings, and excludes builders from liability under the Act for any defects. Agricultural products are excluded from liability unless they have undergone an 'industrial process' giving them 'essential characteristics'. This presumably includes any processing of the product such as freezing, canning or otherwise transforming the product – meat into sausages, potatoes into frozen chips – when the processor is the producer for liability purposes, not the farmer.

Damage to the plaintiff

Damages can be claimed for death or personal injuries and for loss of, or damage to, property (including land) which is:

(a) of a description of property ordinarily intended for private use, occupation or consumption; and
(b) intended by the person suffering the loss or damage mainly for his/her own private use, occupation or consumption.

It is not possible to claim damage to business property, and private property loss or damage cannot be claimed unless it exceeds £275.

There can be no claim for any damage to the defective product itself or to any product which was supplied with the defective product comprised within it. Where a defective product is incorporated into a larger product,

there will, of course, be two defective products and the plaintiff can sue either producer but cannot claim in respect of damage to the defective component nor any damage to the larger item supplied with the defective component comprised in it.

The defendant

A claim can be brought against the producer, the own-brander or the importer. The own-brander is only liable if s/he has branded his/her goods in such a way as to hold him/herself out as being the producer. Liability can be escaped where the product is labelled in such a way as to remove this impression: 'Manufactured for Safeburys by A plc'. The term 'importer' is restricted to the person responsible for importing the product into the European Community. Thus, if a product is imported into France by A and then imported from France into the UK by B, only A will be liable as an importer.

Where it is difficult to identify the importer or producer, and the supplier fails to identify them when requested, the supplier may be liable as if s/he had been the producer.

Defences

The following defences are provided by s.4 of the Consumer Protection Act 1987:

(i) The defect is due to compliance with any statutory requirement or rule of the EC.
(ii) The defendant did not supply the product, for example, it was stolen from his premises.
(iii) The defendant supplied the product otherwise than in the course of a business and the defendant did not produce it (or own-brand it or import it into the EC) with a view to profit.
(iv) The defect did not exist in the product at the time it was supplied by the defendant.
(v) A component manufacturer is not liable where the defect is attributable to the design of the larger product in which the product is included, or where the defect is attributable to instructions given by the manufacturer of the larger product.
(vi) That the defect was not discoverable at the time s/he supplied the product. The defendant must show 'that the state of scientific and technical knowledge at the relevant time was not such that a producer of products of the same description as the producer in question might be expected to have discovered the defect if it had existed in his/her products while they were under his control. This is the 'development risks' defence.

The burden of proof is on the defendant. A further defence of contributory negligence is also established in s.6(1), with the burden of proof

once again on the defendant. The basis of this defence is that the plaintiff has failed to take reasonable care and is thereby partly responsible for his/her own injuries.

Exclusion of liability

Prohibition of exclusion of liability is provided by s.7 of the Act, which provides: 'The liability of a person by virtue of this Part to a person who has suffered damage caused wholly or partly by a defect in a product, or to a dependant or relative of such a person, shall not be limited or excluded by any contract term, by any notice or by any other provision.'

Limitation of actions

Legal proceedings must be brought before the expiration of a deadline. There are two rules with regard to claims under the Act:

(i) Proceedings must be commenced within three years of when the injury or damage occurred or, if the injury, and so on were not discovered until later, within three years of when the plaintiff became aware of the injury or damage; and
(ii) No proceedings may be commenced more than ten years after the producer supplied the product. If the own-brander or importer is being sued, then the ten years run from when he supplied the product.

16.10 The Consumer Protection Act 1987, Part II

Part II of the Act replaces the Consumer Protection Acts 1961–71, and the Consumer Safety Act 1978. It:

(i) enables the Secretary of State to prevent the marketing of unsafe goods;
(ii) makes it an offence for a trader to supply consumer goods which fail to comply with a general safety requirement; and
(iii) entitles a consumer to bring an action for damages against a trader in respect of damage or loss suffered as the result of an infringement of safety regulations.

Preventing marketing of unsafe goods

The Secretary of State can issue two types of instruction under s.13.

The prohibition notice

This can only be issued when the Secretary of State is made aware that dangerous goods are on the market and, to prevent any delay in protecting

the public, the local trading standards office can serve a 'suspension notice' where it has reasonable grounds to think that safety requirements have been infringed: s.14. This prohibition operates for up to six months but, where no infringement is discovered, the trader may be entitled to compensation: s.14(7). Failure to comply with a prohibition notice is a criminal offence. Customs officers have power to seize and detain goods at ports for up to two working days to allow trading standards officers to satisfy themselves whether the goods infringe trading standards: s.31.

The notice to warn

This is served on a manufacturer when it appears that a product has a dangerous design fault and states the steps required by the manufacturer, which may be to publish a warning notice in the newspapers or even to contact individual purchasers. Failure by the manufacturer to comply with the notice to warn is a criminal offence.

Offence to supply consumer goods in breach of a general safety requirement

This offence is created by s.10 of the Act. Consumer goods are those 'which are ordinarily intended for private use or consumption'. A number of things are excluded from this, including water, food, aircraft (except hang-gliders), motor vehicles, controlled drugs, licensed medicinal products and tobacco.

The general safety requirement is that goods should be reasonably safe, and the definition of 'unsafe' is similar to the definition of 'defect' in Part I of the Act. In deciding whether goods are unsafe the court will have regard to all the circumstances, including the purpose for which the goods were marketed, their 'get-up', any instructions or warnings given, and any published standards of safety. It is a defence for a trader to prove that s/he complied with the requirements of safety regulations or any approved standard of safety.

The offence is not only committed by a trader supplying the goods, but also by a trader who agrees or offers to supply them or exposes or possesses them for supply. There is a limited defence for a retailer who neither knew, nor had reasonable grounds for believing, that the goods were not reasonably safe. The offence does not apply to goods intended for export from the UK, or goods not supplied as being new.

The general defence of due diligence is also available for anyone charged with an offence under s.10 or an offence under safety regulations. The essence of this is that the defendant took all reasonable steps and exercised all due diligence to avoid committing the offence: s.39. For an importer or wholesaler this may require proof of tests on more than infrequent random samples of the goods.

Civil actions for losses arising from infringement of safety regulations

An action can be brought against a manufacturer even where the plaintiff did not purchase the goods from the manufacturer, and even if s/he did not buy the goods. There is no need to establish the negligence of the manufacturer, and the claim is independent of Part I of the Act. Civil liability cannot be excluded or restricted by any exemption or exclusion clause.

Limitations on criminal and civil liability under the Act

Liability under Part II only attaches to persons who are acting 'in the course of carrying on a business'.

The General Product Safety Regulations 1994

These Regulations (SI 1994/2323) parallel Part II CPA 1987. Reg. 5 GPSR 1994 disapplies the provisions of s.10 CPA 1987 to the extent that they impose general safety requirements which must be complied with if products are to be (a) placed on the market, offered or agreed to be placed on the market, or exposed or possessed to be placed on the market by producers; or (b) supplied, offered or agreed to be supplied, or exposed or possessed to be supplied by distributors.

For distributors, the Regulations disapply s.10 CPA 1987 in relation to the supply of goods, and thus merely replace the statutory provisions; for producers, the disapplication relates to 'placing on the market', which may be narrower than the s.10 CPA 1987 'supply', which is broadly defined in s.46 CPA 1987.

'Producer' means manufacturers who are established in the European Community, and extends to any person presenting him/herself as a manufacturer by affixing his/her name, trade mark or other distinctive mark to the product, or to a person who reconditions the product. Where the manufacturer is not established within the Community the producer is the importer, the manufacturer's representative, and other professionals in the supply chain whose activities may affect the safety of the product placed on the market. This last category must be contrasted with 'distributors', who are professionals in the supply chain and whose activity does not affect the safety properties of a product: Reg. 2(1). Thus the distinction between producers and distributors is blurred, and many persons may be brought within the definition of producer (for example, persons transporting and storing food, since the conditions in which the goods are stored or transported may affect their safety). It could also cover people fitting or installing electrical and other products.

The Regulations cover a wider range of products than CPA 1987, since regulation extends to 'any product intended for consumers or likely to be used by consumers, supplied whether for consideration or not in the

course of a commercial activity and whether new, used or reconditioned': Reg. 2(1). There is an exclusion in respect of any product 'which is used exclusively in the context of a commercial activity even if it is used for or by a consumer': Reg. 2(1). This clearly covers infrastructure such as escalators in shops, ski-lifts and railway carriages, but whether it extends to shampoos supplied to salons, or to supermarket trolleys is unclear. The Regulation adds that 'this exception shall not extend to the supply of such a product to a consumer', which is not very clear.

No producer shall place a product on the market unless it is a safe product: Reg. 7. This is (Reg. 2(1)): 'any product which, under normal or reasonably foreseeable conditions of use, including duration, does not present any risk or only the minimum risks compatible with the product's use, considered as acceptable and consistent with a high level of protection for the safety and health of persons, taking into account in particular –

(a) the characteristics of the product, including its composition, packaging, instructions for assembly and maintenance;
(b) the effect on other products, where it is reasonably foreseeable that it will be used with other products;
(c) the presentation of the product, the labelling, any instructions for its use and disposal and any other indication or information provided by the producer;
(d) the categories of consumers at serious risk when using the product, in particular children, and the fact that higher levels of safety may be obtained or other products presenting a lesser degree of risk may be available shall not of itself cause the product to be considered other than a safe product'.

If a product conforms to the specific rules of the UK law, which it must satisfy before it can be marketed, there is a presumption that the product is safe: Reg. 10(1). Where specific rules exist, safety is to be assessed having regard to: (a) voluntary UK national standards giving effect to a European standard (for example, BSI standards); or (b) Community technical specifications (for example, standards of the European Committee for Standardisation (CEN)), or, failing either, UK standards or codes of good practice in the product sector or the state of art and technology: Reg. 10(2).

Producers are also required to provide consumers with the relevant information to enable them to assess the risks inherent in a product throughout its normal or reasonably foreseeable period of use where such risks are not immediately obvious, and to adopt measures to enable the consumer to be informed of the risks which the product might represent and to take appropriate action, including withdrawing the product, to avoid those risks. These measures include marking products or product batches for the purposes of identification; sample testing; complaint investigation and informing distributors about such monitoring: Reg. 8.

Distributors have a duty to help ensure compliance with Reg. 7, and in particular shall not supply products which the distributor knows or should have presumed, on the basis of information in his/her possession and as a

professional, are dangerous products; and shall participate in monitoring the safety of products by passing on information on the product risks and co-operating in the action to avoid those risks: Reg. 9.

Reg. 12 creates offences for producers and distributors contravening Regs 7 or 9(a). It is also an offence under Reg. 13 for a producer or distributor to offer or agree to place on the market any dangerous product, or to expose or possess such product for placing on the market, or to offer or to agree to supply any dangerous product or expose of possess any such product for supply. For the purposes of Reg. 12, the producer has strict liability, whereas the distributor is liable only if s/he knows or ought to have known that the product was dangerous. However, Reg. 13 creates strict liability offences for both producer and supplier. For both offences, however, it shall be a defence for a person to show that s/he took all reasonable steps and exercised all due diligence to avoid committing the offence: Reg. 14(1). A distributor cannot use the due diligence defence in Reg. 14(1) or in s.39(1) CPA 1987, where s/he has contravened Reg. 9(b), which requires participation in product monitoring and co-operating in avoidance of risks: Reg. 14(5). Persons charged under GPSR 1994 who allege that the offence was caused by the act or default of another, or to reliance on information give by another, cannot rely on the defence, without leave of the court, unless notice under Reg. 14(3) is served seven days before the hearing on the person bringing the proceedings: Reg. 14(2).

Where the commission of the offence is caused by the act or default of another person in the course of a commercial activity, the other person is guilty of an offence: Reg. 15(1). Where a body corporate is guilty of an offence in respect of an act or default committed with the consent or connivance of, or attributable to neglect of any director, manager, secretary or other officer, s/he shall also be guilty of that offence and liable to be prosecuted and punished: Reg. 15(2). Actions must be commenced within twelve months of the date of the offence (Reg. 16), and persons guilty of any offence shall be liable on summary conviction to imprisonment for three months or a fine not exceeding level 5 on the standard scale, or both: Reg. 17.

For enforcement of the GPSR 1994, s.13 CPA 1987 applies to products as it applies to relevant goods under that section with regard to prohibition notices and notices to war: Reg. 11(a). The requirements of the Regulations constitute safety provisions for the purposes of suspension notices, forfeiture and power to obtain information under ss.14, 16 and 18 CPA 1987: Reg. 11(b). The Regulations are enforceable by the weights and measure authorities in Great Britain: Reg.11(c).

16.11 Collateral Contract of Guarantee

The manufacturer of goods, even though s/he does not market them directly, may make a collateral contract with the consumer, and 'guarantees' and 'warranties' issued by him/her may form the basis of the contract

between consumer and retailer. The manufacturer may be liable in respect of these promises.

The guarantee or warranty previously sought to remove any purchaser's rights under the law, but this is regulated by s.5, Unfair Contract Terms Act 1977, which provides:

> (1) In the case of goods of a type ordinarily supplied for private use or consumption, where loss or damage –
> (a) arises from the goods proving defective while in consumer use; and
> (b) results from the negligence of a person concerned in the manufacture or distribution of the goods, liability for the loss or damage cannot be excluded or restricted by reference to a guarantee of the goods.

A guarantee is 'anything in writing if it contains or purports to contain some promise or assurance (however worded or presented) that defects will be made good by complete or partial replacement, or by repair, monetary compensation or otherwise': s.5(2)(b). The section 'does not apply as between the parties to a contract under or in pursuance of which possession or ownership of the goods passed': s.5(3). This appears to allow a manufacturer to exclude him/herself from liability where the consumer purchased the goods direct from him/her, but merely means that the attempted exclusion from liability will be under some other section.

16.12 Contracts for Unsolicited Goods and Services

The Unsolicited Goods and Services Act 1971 regulates the practice whereby dealers send goods to people without their having requested them, subject to a proviso that, if the person does not return the goods within a stated period, they will be deemed to have purchased the goods and will be invoiced for them. Where this happens, the person receiving the goods is entitled to treat the goods as an unsolicited gift and retain them free of charge after a certain time. The period of time is thirty days, where the person serves written notice on the sender that the goods were unsolicited. Where no notice is sent, the goods can be retained by the recipient after six months: s.1.

The Act also regulates the forms for order for entries in trade or business directories (s.3) and also makes it a criminal offence to send unsolicited books describing or illustrating human sexual techniques: s.4.

16.13 Cancellable Agreements for Goods and Services

The Consumer Protection (Contracts Concluded away from Business Premises) Regulations 1987 allow a cooling-off period to a private purchaser contracting to buy goods or services during an unsolicited visit by

the trader to his house, place of work or someone else's home. Companies, corporate bodies or persons contracting in connection with a business are not covered, and only 'unsolicited' visits are covered, but this includes visits following a telephone call by the trader. The purchaser must be given written notice of his/her right and a tear-off form for use in exercising the right. The customer can cancel within up to seven days by written notice in any form; notice is effective on posting.

Excluded from the regulations are contracts:

(i) for goods costing £35 or less (including VAT);
(ii) to buy, sell, dispose of, lease or mortgage land;
(iii) to finance, or provide bridging finance, for the purchase of land;
(iv) for the construction or extension of a building or other erection on land;
(v) for the supply of food, drink or other goods usually supplied by regular roundsmen;
(vi) which provide credit of £35 or less;
(vii) covered by other legislation: Insurance Companies Act 1982, Financial Services Act 1986, Banking Act 1987; or
(viii) made on the terms of mail order catalogues expressly giving right to cancellation.

16.14 Unfair Terms in Consumer Contracts

The Unfair Terms in Consumer Contracts Regulations 1994 SI 1994/3159 implement the EEC Council Directive 93/13 on unfair terms in consumer contracts. The regulations came into effect on 1 July 1995 and relate to terms in contracts between business suppliers and consumers who are natural persons acting for non-business purposes. This means that the regulations do not cover (i) supplies to persons acting for business purposes; and (ii) supplies where neither party acts for business purposes. It applies to all kinds of contracts – not just contracts for the sale of goods – and covers contracts for the sale of land, mortgage and loan documentation, insurance contracts and contracts for transport or professional advice. Contracts for the supply of goods includes contracts for lease or hire. The regulations do not apply to contracts of employment, succession rights, rights under family law, the incorporation and organisation of companies or partnerships, and any term incorporated to comply with or reflecting statutory or regulatory provisions of the UK; or provisions or principles of international conventions to which the member states or the Community are party (Schedule 1).

The regulations apply to any term concluded between a seller or supplier and a consumer where the term has not been individually negotiated, Reg. 3(1), with the exception that, in so far as it is in plain, intelligible language, no assessment shall be made of the fairness of any term which (i) defines the main subject-matter of the contract; or (ii) concerns the

adequacy of the price or remuneration, as against the goods or services sold or supplied: Reg. 3(2). A term shall always be regarded as not having been individually negotiated where it has been drafted in advance and the consumer has not been able to influence the substance of the term: Reg. 3(3). The burden of proving that a term has been individually negotiated is on the seller or supplier: Reg. 3(4).

'Unfair terms' is defined as meaning any term which, contrary to the requirement of good faith, causes significant imbalance in the parties' rights and obligations to the detriment of the consumer: Reg. 4(1). An assessment of the unfair nature of the term shall take into account the nature of the goods or services and refer to all circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent: Reg. 4(2). Reg. 4(3) states that in determining whether the term satisfies the requirements of good faith, particular regard shall be had to Schedule 2, which refers to: (a) the strength of the bargaining position of the parties; (b) whether the consumer had an inducement to agree to the term; (c) whether the goods or services were sold or supplied to the special order of the consumer; and (d) the extent to which the seller or supplier has dealt fairly and equitably with the consumer.

Any unfair term in a contract concluded with the consumer shall not be binding on the consumer: Reg. 5(1). In addition, the seller/supplier shall ensure that any written term of the contract is in plain, intelligible language, and if there is doubt about the meaning of a written term, the interpretation most favourable to the consumer shall prevail: Reg. 6. The regulations apply notwithstanding any term which applies under the law of a non-member state, if it has a close connection with the territory of the member states: Reg. 7. Further, it is the duty of the Director General of Fair Trading to consider any complaint that any contract term drawn up for general use is unfair, unless the complaint is frivolous or vexatious: Reg. 8(1). If s/he thinks any contract term is unfair following a complaint, s/he may bring proceedings for an injunction against any person using or recommending use of such a term in consumer contracts: Reg. 8(2). But s/he may have regard to undertakings given to him/her as to the continued use of such a term: Reg. 8(3).

Schedule 3 contains an illustrative list of terms which may be regarded as unfair, and includes:

(a) excluding or limiting liability of a seller or supplier in the event of the death of a consumer or personal injury resulting from an act or omission of the seller or supplier;
(b) inappropriately excluding or limiting the legal rights of the consumer … in the event of total or partial non-performance or inadequate performance of any of the contractual obligations;
(c) making an agreement binding on the consumer whereas provision of services by the seller or supplier is subject to a condition whose realisation depends on his own will alone;

(d) permitting the seller/supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for (him) to receive equivalent compensation from the seller/supplier where the latter cancels the contract;
(e) requiring a consumer who fails his obligation to pay a disproportionately high sum in compensation;
(f) authorising the seller/supplier to dissolve the contract on a discretionary basis with that same facility not given to the consumer, or permitting him to retain sums paid for services not yet supplied where he dissolved the contract;
(g) enabling the seller/supplier to terminate a contract of indeterminate duration without reasonable notice except where there are serious grounds for doing so;
(h) automatically extending a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express this desire not to extend the contract is unreasonably early;
(i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;
(j) enabling the seller/supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract;
(k) enabling the seller/supplier to alter unilaterally without valid reason any characteristics of the product or service;
(l) providing for the price of goods to be determined at the time of delivery or allowing a seller/supplier to increase their price without giving the consumer the right to cancel the contract if the price is too high in relation to that agreed on the conclusion of the contract;
(m) giving the seller/supplier the right to determine whether the goods or services are in conformity with the contract, or exclusive right to interpret any contract term;
(n) limiting the seller/supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality;
(o) obliging the consumer to fulfil all his obligations where the seller/supplier does not perform his;
(p) giving the seller/supplier the possibility of transferring his rights and obligations under the contract, where this may reduce the guarantees for the consumer, without his agreement;
(q) excluding or hindering the consumer's right to take legal actions or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract.

Recommended Further Reading

Texbook on Consumer Law, David Oughton and John Lowry (Blackstone Press 1997).

Questions

1 Section 1, Trade Descriptions Act 1968 creates two criminal offences in respect of goods. What are they?
2 Give examples of 'false trade descriptions' in respect of goods.
3 What is the major problem with regard to establishing liability of a person concerning false statements as to services, accommodation and facilities?
4 One of the defences under the Trade Descriptions Act 1968 often involves the *alter ego* doctrine. What is the defence, and what is the significance of the doctrine?
5 How may a manufacturer be liable for defects in his/her products?
6 Persons in receipt of unsolicited goods may be entitled to treat them as an unsolicited gift after a certain period of time. How long is the period of time?
7 The Unfair Terms in Consumer Contracts Regulations overlap with what other piece of legislation?
8 To what terms do the regulations apply in agreements between a seller or supplier and a consumer.
9 Give examples of the types of agreement to which the regulations do and do not apply.

17 Competition Law

Learning Objectives

After reading this chapter you will know about:

1 the role of the Director General of Fair Trading and the Office of Fair Trading in regulating monopolies, mergers, restrictive and uncompetitive practices
2 the regulation of restrictive trade practices under Community law
3 the regulations preventing abuse by undertakings of a dominant position in Community law

17.1 Aims of Competition Law

Competition law regulates the market power of companies and individuals, restraining them from entering agreements restricting competition by fixing the price of goods or services and dividing the available market between them. It also regulates mergers and prevents dominant companies from abusing their position through excessive pricing or discrimination against customers. This interference with the free market is in the interests of the consumer.

17.2 UK and EC Competition Law

UK competition law is in the Fair Trading Act 1973, the Competition Act 1980 and the Competition Act 1998. The 1998 Act has made changes to the previous two statutes. This last Act has revolutionised UK competition law relating to restrictive trade agreements and the abuse by companies of their dominant trading position. UK competition law now parallels the approach adopted by EC competition law. Both systems are now effects-based, the paramount concern being the effect on actual or potential competition. This chapter considers (i) UK competition law; and (ii) Community competition law.

17.3 The Fair Trading Act 1973

The Act is in twelve parts, of which Part I establishes the position of the Director General of Fair Trading (DG), the Consumer Protection Advisory Committee (CPAC) and the Competition Commission (replacing the Monopolies and Mergers Commission). The other parts deal with

the extensive powers of the DG , appointed by the DTI with responsibilities also under the Competition Acts 1980 and 1998, the Consumer Credit Act 1974 and the Estate Agents Act 1979. The DG has the following main duties:

(i) regulating monopolies, mergers and restrictive and uncompetitive practices;
(ii) supervising trading practices;
(iii) reporting bad trading practises to the DTI and making recommendations;
(iv) taking action against traders who are persistently unfair to the consumer;
(v) encouraging trade associations to produce voluntary codes of practice; and
(vi) publishing information and advice to consumers.

This work is done by the Director General's organisation – the Office of Fair Trading (OFT). By reviewing trading practices in the light of complaints and other information collected by the OFT, the DG can recommend action to the Secretary of State of the DTI. The DG can also recommend action including proposals for legislation to any other government minister.

17.4 References to the Consumer Protection Advisory Committee (CPAC)

Under Part II of the Act, the DG can publish papers about practices against the consumers' interests and his proposals for dealing with them. The report is sent to the CPAC, which decides whether it agrees with these or wishes to modify them. The CPAC must report within three months to the appropriate minister, who may introduce regulatory legislation by statutory instrument. Examples of regulations concern mail order advertisements, guarantees and notices about consumers' rights, disguised business sales and so on.

17.5 Control of Rogue Dealers

Under Part III of the Act the DG has a 'bloodhound' as well as a 'watchdog' function with regard to persons carrying on a business who persist in a course of conduct which (a) is detrimental to the interests of consumers, whether economic or relating to health, safety or otherwise; and (b) is regarded according to specified criteria as being unfair to consumers. The criteria involve contraventions of duties, prohibitions or restrictions imposed by criminal law as well as breaches of contract, or breaches of civil duty.

The DG will first try to obtain a satisfactory written assurance that the trader will refrain from continuing the course of conduct or any similar

behaviour in the conduct of that business. The texts of the undertakings appear in the Annual Report. Failing a written assurance, or in the event of the breach of an assurance, the DG may bring proceedings under s.35 either in the High Court or in the county court. The power of the courts include (a) obtaining an undertaking to refrain from the specified course of conduct; or (b) the making of an order on similar terms. The court also has power to obtain undertakings from, or make orders against, accessories, directors or officers of companies and other members of a group of interconnected bodies corporate. Legal aid is generally available to defend these actions, and appeals lie to the Court of Appeal. Breach of an undertaking given or order made constitutes contempt of court punishable by imprisonment or a fine.

17.6 Voluntary Codes of Practice

The DG has a duty to encourage trade associations to prepare and to disseminate codes of practice for safeguarding and promoting the interests of UK consumers: s.124(3). Codes include the Association of Manufacturers of Domestic Electrical Appliances; Association of British Travel Agents; Scottish Motor Trade Association; Vehicle Builders and Repairers Association; National Association of Shoe Repair Factories and St. Crispin's Boot Traders' Association; Association of British Launderers and Cleaners; Footwear Distributors' Federation; Radio, Electrical and Television Retailers' Association; Mail Order Publishers' Authority; and so on.

The OFT publishes leaflets about specific codes and the names and addresses of a number are in the OFT's pamphlet, 'Fair Deal, A Shopper's Guide'. Many members of associations display identification symbols at their premises and many have provisions referring disputes to arbitration.

17.7 Monopolies

The modern history of monopolies follows the pattern of non-intervention by the courts leading to statutory intervention. The whole area of the law is within the Fair Trading Act 1973 under control of the DG and the Competition Commission (CC). This consists of not less than ten and not more than twenty-seven members appointed by the Secretary of State. Its principal functions are to investigate and report on any question referred to it under the Act relating to:

(a) the existence, or possible existence, of a monopoly situation;
(b) a transfer of a newspaper or newspaper assets under Part v of the Act, which is designed to prevent undue concentration, by reason of mergers, in one newspaper proprietor;

(c) the creation, or possible creation, of a merger situation qualifying for investigation under Part V of the Act; and
(d) the efficiency and costs of, the service provided by, or the posible abuse of a monopoly by public bodies such as nationalised industries supplying goods or services by way of business, public bus service operators, statutory water undertakers and the like (Competition Act 1980, s.11.).

Monopoly references

The DG or the Secretary of State may make a monopoly reference if it appears to them that a monopoly position exists as regards (i) the supply of goods of any description; (ii) the supply of services; or (iii) the export of goods of any description from the UK, either generally or to a specific market. The Competition Commission (CC) then investigates and reports.

The criteria for a monopoly in respect of goods or services are that at least one-quarter of the goods or services supplied in the UK are provided by one person or one group, or an agreement or agreements are in operation preventing the supply of goods and so on of that description.

Scope of the reference and the reports of the Commission

The Commission may be required simply to report on the facts, but may also be asked to report whether the conditions operate or are expected to operate against the public interest. In deciding this, all relevant matters are to be taken into account and the Commission can require the attendance of witnesses, administer oaths and insist on the production of documents and other evidence. On completing the investigation, it submits a reasoned report. A monopoly reference must specify a time limit for making a report, and if this is not observed the reference lapses.

The report must be laid before both Houses of Parliament unless contrary to the public interest. Where it finds that a monopoly exists, the appropriate minister is given power to make an order by statutory instrument. Thereafter, the DG has a surveillance role. If enforcement action is needed, 'any person' may bring a civil action and the Crown may apply for an injunction or other appropriate relief. As an alternative to the order, the DG can obtain undertakings to remedy the adverse effects specified in the report. This has the advantage of being able to be framed in a less formal way to meet the complex economic and commercial problems arising and may be renegotiated later in the light of changing circumstances.

17.8 Mergers

The power to order that a merger shall not go ahead lies with the Secretary of State under s.73. The duty to keep situations under review

where there might be a merger situation calling for investigation is on the DG. Many companies seek the confidential guidance of the OFT as to whether the DG might advise the Secretary of State to make a merger reference to the Commission. It is the duty of the DG to make a recommendation to the Secretary of State, who will in turn make any reference to the Commission – the DG may not refer merger situations personally. The Secretary of State may make a reference when it appears that two or more enterprises (at least one in the UK) have ceased to be distinct enterprises under s.64. The Secretary of State must also be of the view that, as a result, either a monopoly situation is or would be created (that is, one-quarter of the market would be supplied), or the value of the assets taken over exceeds £5m. If the merger has already taken place, it must have been within the six months prior to the reference.

The procedure is that the DG as Chair of the Interdepartmental Mergers Panel is normally able to complete preliminary investigations and advise the Secretary of State within four weeks. If the Secretary of State decides to make a reference, the Commission must report within six months, with a possible extension of a further three months. It normally reports within three to four months. The Commission must then both establish that a merger situation exists and that it operates, or may be expected to operate, against the public interest. The Secretary of State has power to make orders as a result but more usually the DG is requested to obtain undertakings.

As regards newspaper mergers, the transfer of a newspaper or its assets to a newspaper proprietor whose own newspapers have an average daily circulation of 500 000 (including that of the newspaper concerned in the transfer) is unlawful and void unless written consent is given by the Secretary of State: s.58(1).

17.9 Agreements and so on Preventing, Restricting or Distorting Competition

The provisions of Part I of the Competition Act 1998 replace the previous regulation of this area by the Restrictive Trade Practices Acts 1976 and 1977, the Resale Prices Act 1976 and the Restrictive Practices Court Act 1976 which established the court that ensured the enforcement of the statutory provisions. All statutory references in this section are to the Competition Act 1998 unless otherwise stated.

Agreements between undertakings, decisions by associations of undertakings or concerted practices that may affect trade within the UK, and have as their object or effect the prevention, restriction or distortion of competition within the UK are prohibited unless they are exempt in accordance with Part I: s.2(1). This applies in particular to agreements and so on which (a) directly or indirectly fix purchase or selling prices or any other trading conditions; (b) limit or control production, markets, technical development or investment; (c) share markets or sources of

supply; (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; and (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts: s.2(2). The prohibition applies only to agreements and so on that are intended to be implemented in the UK: (s.2(3); such agreements are void: s.2(4). This is referred to as the Chapter I prohibition: s.2(8). The Chapter I prohibition does not apply to agreements excluded by Schedules 1 to 4 of the Act. These relate to mergers and concentrations (Schedule 1); competition scrutiny under other enactments (Schedule 2); planning obligations and other general exclusions (Schedule 3) and professional rules (Schedule 4); s.3(1). The section gives the Secretary of State the right to amend schedules 1 and 3 from time to time and to exclude agreements from the prohibition in certain circumstances. The Act also provides for individual and block exemption from the Chapter I prohibition.

Individual exemptions

The Director may grant an exemption for a particular agreement if a request for exemption has been made under s.14 by a party to the agreement, and the agreement is one to which s.9 applies. The exemption may be granted subject to such conditions or obligations as the Director considers it appropriate to impose; and has effect for such period as s/he considers appropriate, which must be specified at the time of the exemption. The exemption my be effective from an earlier date than the date granted: s.4. The procedure for application requires notification to the Director and an application for a decision by him/her. The Director may then make a decision as to whether the Chapter I prohibition has been infringed; and, if it has not been infringed, whether that it because of the effect of an exclusion or because the agreement is exempt. If an agreement has been notified to the Director, no penalty is to be imposed in respect of any infringement during the period beginning with the date of notification, and ending with the date on which the application is determined: s.14. The question of whether the agreement is exempt from the prohibition is determined according to the criteria for individual and block exemption, which covers any agreement that (a) contributes to (i) improving production or distribution, or (ii) promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit; but (b) does not (i) impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives, or (ii) afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in questions: s.9. If the Director has decided that an agreement does not infringe the Chapter I prohibition, s/he takes no further action in respect of the agreement unless s/he has reasonable grounds for believing that there has been a

material change of circumstances; or s/he has reasonable suspicion that the information on which s/he based his/her decision was incomplete, false or misleading. No penalty may be imposed in respect of any infringement, but the Director may remove this immunity by giving written notice to the party on whose application the decision was made that s/he is removing immunity from a date specified in the notice, which may be earlier than the date of the notice where the Director has reasonable suspicion that the information on which his/her decision was based was incomplete, false or misleading: s.16. If the Director has reasonable grounds for believing that there has been a material change of circumstances since the granting of the individual exemption, s/he may by notice in writing (a) cancel the exemption; (b) vary or remove any condition or obligation; or (c) impose one or more additional conditions or obligations: s.5(1). The same is true where s/he has a reasonable suspicion that the information on which s/he based his/her decision was incomplete, false or misleading in a material particular: (s.5(2)); or where there has been failure to comply with an obligation: s.5(4). Breach of a condition imposed on the exemption has the effect of cancelling the exemption: s.5(3).

Block exemptions

If agreements within a particular category of agreement are, in the opinion of the Director, likely to be ones to which s.9 applies, the Director may recommend that the Secretary of State shall make an order specifying that category for the purposes of a block exemption: s.6(1). The Secretary of State may make a block exemption order as recommended, or subject to modifications: s.6(2). An agreement within a category specified in a block exemption order is exempt from the Chapter I prohibition: s.6(3). A block exemption order may impose conditions or obligations and may provide (a) that the breach of a condition has the effect of cancelling the block exemption in respect of the agreement; (b) that if an agreement does not comply with an obligation, the Director may, by notice in writing, cancel the exemption in respect of the agreement; and (c) that the Director may in specified circumstances cancel a block exemption in respect of a particular agreement: s.6(5). The order may provide that the order is to cease to have effect at the end of a specified period: s.6(7). A block exemption order may allow a party to an agreement which does not qualify for the block exemption created by the order, but which satisfies specified criteria to notify the Director of the agreement. Once an agreement has been notified, it is to be treated from the end of the notice period specified in the order, as falling within a category specified in a block exemption order unless the Director (a) is opposed to its being so treated; and (b) gives written notice of his/her opposition before the end of the notice period. If s/he does, the notification under subsection 1 is to be treated as a notification for individual exemption under s.14. Before making recommendations in respect of a block exemption, or the

variation or revocation of an exemption order, the Director must comply with the procedure laid down in s.8. An agreement is also given parallel exemption from Chapter I prohibition if it exempt from the Community prohibition (a) by virtue of a Regulation; (b) because it has been given exemption by the Commission; or (c) because it has been notified to the Commission under the appropriate opposition or objection procedure and (i) the time for opposing, or rejecting to, has expired without the Commission opposing the agreement; or (ii) the Commission has opposed, or objected to, the agreement but has withdrawn its opposition or objection: s.10(1). There is a further possibility of exemption relating to EC competition law called a section 11 exemption.

Notification for guidance

A party to an agreement may notify the Director of the agreement and apply to him/her for guidance as to whether or not the agreement is likely to infringe the Chapter I prohibition: s.13(1) and (2). The Director may indicate (a) whether the agreement is likely to be exempt from the prohibition under a block exemption, a parallel exemption or a section 11 exemption; or (b) whether s/he would be likely to grant the agreement an individual exemption if so asked: s.13(3). No penalty will arise in connection with an agreement notified under this section during the period between the date of notification and the date on which the application is determined: s.13(4). Once the Director has given guidance in accordance with s.13(3), the Director is to take no further action in respect of the agreement unless s/he has reasonable grounds that there has been a material change of circumstances since the guidance; (b) or a reasonable suspicion that the information on which his/her guidance was based was incomplete, false or misleading; (c) one of the parties applies to him/her for a decision under section 14; or (d) a complaint has been made to him/her by a third party: s.15(1) and (2). No penalty may be imposed under this section (s.15(3), but the Director may by written notice remove the immunity given as from the date specified in his/her notice: s.15(4), and where s/he has reasonable suspicion for believing that a party to the agreement gave him/her information, upon which s/he based his/her guidance, which was incomplete, false or misleading, the date specified may be earlier than the date on which the notice is given: s.15(5).

Limited immunity for small agreements

An agreement for this purpose means an agreement which falls within a category prescribed for the purposes of this section but which is not a price-fixing agreement. The criteria by which an agreement is prescribed may in particular include the combined turnover of the parties to the agreement and the share of the market affected by the agreement (both determined in accordance with prescribed provisions): s.38. A party to a

small agreement is immune from the effect of section 35 (penalty provisions – see below) but this immunity may be removed following investigation by the Director. The parties must be given written notice of the Director's decision to withdraw immunity, and any withdrawal date must be after the date on which the decision to withdraw is made and have regard to the time likely to be required by the parties to ensure that there is no further infringement.

17.10 Abuse of Dominant Position

This Chapter II prohibition of the Competition Act 1998 replaces the previous controls imposed on trading practices by sections 2–10 of the Competition Act which are repealed. All statutory references in this section are to the Competition Act 1998 unless otherwise stated.

Subject to section 19, any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the UK: s.18(1). In particular, conduct may constitute an abuse if it consists of (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; or (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts: s.18(2). A 'dominant position' means a dominant position within the United Kingdom, and this means the UK or any part of it. The prohibition does not apply to mergers and concentrations (Schedule 1) or general exclusions (Schedule 3). The Secretary of State may amend Schedule 1 at any time by order and can disapply the Chapter II prohibition in certain circumstances under Schedule 3.

Notification

The Act provides for notification to the Director by a person who thinks his/her conduct may infringe the prohibition. The notification can be for guidance (s.21) or for a decision: s.22. If, in respect of an application for guidance, the Director has determined that the conduct is unlikely to infringe the prohibition, s/he is to take no further action unless s/he has (a) reasonable grounds for believing that there has been a material change of circumstance; or (b) reasonable suspicion that the information on which s/he based his/her guidance was incomplete, false or misleading; or (c) a complaint about conduct has been made to him: s.23(1) and (2). No penalty may be imposed in respect of any infringement, but the Director may remove the immunity if (a) s/he takes action in respect of the conduct in subsection 2; (b) s/he considers that it is likely that the

conduct will infringe the prohibition; and (c) s/he gives notice in writing to the undertaking on whose application the guidance was given that s/he is removing immunity from a date specified in his/her notice, which date may be earlier than the date of the notice if the Director has reasonable suspicion that the information on which s/he based his/her guidance was incomplete, false or misleading: s.23(4) and (5). Section 24 contains similar provisions in respect of a notification for a decision under s.22.

Limited immunity for conduct of minor significance

The criteria whereby conduct falling into this description may be prescribed may, in particular, include the turnover of the person whose conduct it is, and the share of the market affected by the conduct (both determined according to prescribed provisions): s.39(2). A person is immune from any penalty provision in respect of conduct of minor significance, but the immunity may be withdrawn following investigation by the Director and the sending by him/her of a written notice of his/her decision to withdraw the immunity at a date specified in the notice. The withdrawal date must be subsequent to the date on which the decision is made, and have regard to the amount of time which the person or persons affected are likely to require in order to avoid further infringement: s.39.

17.11 Investigation and Enforcement of Chapter I and Chapter II Prohibitions

The Director may conduct an investigation if s/he has reasonable suspicion that either of the prohibitions has been infringed, and may authorise one of his/her officers to exercise the powers given to him/her under sections 26 or 27: s.25. The Director may require a person to produce a specified document which s/he considers relates to any matter relevant to the investigation: s.26(1). The Director may specify the time and place at which and the manner and form in which it is to be produced. The power extends to taking copies or extracts from the document, or requiring an explanation of the document from past and present officers of the undertaking, or, if it is not produced, to require a statement as to where it is: s.26(4) and (5). Any officer authorised in writing by the Director may enter any premises in connection with an investigation under s.25(2) on having given at least two working days' written notice to the occupier: s.27(1) and (2). The notice requirement is disapplied for premises which the Director has reasonable suspicion are being occupied by a party to an agreement under investigation or an undertaking whose conduct s/he is investigating, or if the investigating officer has taken all reasonably practicable steps to give notice but has been unable to do so: s.27(3). An investigating officer may (a) take with him/her such equipment as appears to him/her to be necessary; (b) require any person on the premises (i) to produce any document which s/he considers relates to the investigation;

and (ii) to provide any explanation of it that the officer may require; (c) require any person to state where any such document is to be found; (d) take copies of, or extracts from, any document produced; and (e) require any information which is held on computer and is accessible from the premises and which the named officer considers relevant to the investigation to be produced in a form in which it can be taken away, and in which it is visible and legible: s.27(4) and (5). There is a power to enter premises under a warrant issued by a JP where there are reasonable grounds for believing that (a) there are documents on premises which have not been produced as required under s.26; (b) there are documents which would not be produced but would be concealed, removed, tampered with or destroyed; or where an investigating officer has attempted to enter premises but has been unable to do so: s.28(1) and (2). Persons failing to comply with a requirement under section 26, 27 or 28, or destroying or falsifying documents, or giving false or misleading information, are guilty of an offence and liable to imprisonment and/or a fine under sections 41, 42 or 43. Persons are protected from being required to produce or disclose a privileged communication: s.29.

If the Director has made a decision that an agreement infringes the Chapter I prohibition or that conduct infringes the Chapter II prohibition, s/he may give directions to bring the infringement to an end by modifying or terminating the agreement, or modifying or ceasing the conduct in question: ss.31 and 32. If the person fails to comply with a direction under ss.31 and 32, the Director may apply to the court for an order requiring the defaulter to make good his/her default within a specified time; or, if the direction related to the management or administration of an undertaking, requiring the undertaking or its officers to do it: s.33(1). There is a power on the part of the Director to order interim measures to be taken where s/he has a reasonable suspicion of an infringement of a Chapter I or Chapter II prohibition but has not completed his/her investigation if s/he considers this to be in the public interest: s.34. On making a decision that there is an infringement of a Chapter I or II prohibition, the Director may require an undertaking to pay him/her a penalty in respect of the infringement: s.35(1) and (2). Notice of the penalty must be in writing and specify the date before which it must be paid, which must not be earlier than the end of the period within which an appeal against the notice may be brought under section 45. The penalty must not exceed 10 per cent of the turnover of the undertaking. Penalties are to be paid into the Consolidated Fund: s.35(5) and (6). The Director may recover unpaid penalties as a civil debt: s.36. The Director must publish guidance as to the appropriate amount of any penalty and any alteration to that guidance.

Appeals from decisions by the Director

Any party to an agreement in respect of which the Director has made a decision and any person in respect of whose conduct the Director has made a decision, may appeal to the Competition Commission: s.45. There

is also a right of appeal for third parties: s.46. The appeals will be determined by an appeal tribunal: the Competition Commission Appeal Tribunals. There is a further right of appeal to the Court of Appeal on a point of law or from a decision concerning the amount of a penalty. The right is with leave and can be brought by a party or by a person who has a sufficient interest in the matter: s.48.

17.12 Basis of EC Competition Law

The inspiration of the EC system was American law, which aimed at developing free interstate trade by prohibiting anti-competitive agreements, and notification of agreements to competition law authorities, whether between competitors at the same level of the market (that is, horizontal arrangements,) or between persons at different levels of supply (that is, vertical arrangements). The European Commission regulates closely all vertical and horizontal arrangements and looks at market power, the efficiency benefits of an agreement and the effect on consumers.

The basic principle is set out in the EC Treaty in Article 2 and in particular Article 3(f) which envisages 'the institution of a system ensuring that competition in the common market is not distorted'. The framework for regulation of competition between private undertakings (as opposed to public undertakings and restrictions on state aids) is in Article 85 (which regulates restrictive practices), Article 86 (which regulates abuse of a dominant position), together with Regulation 17 (which establishes the machinery for the enforcement of the law).

17.13 Determination of Infringement at Community Level

EC competition-law-enforcing authority

The powers of investigation and determination are vested in the Commission. It is the responsibility of the Commissioners and the specialised staff of DG IV which comprises an Administrative Unit and four Directorates: A, B, C and D. These have the following duties: A: inspection, documentation, studies of market structures; B: control of restrictive practices and abuse of dominant position under arts 85/86 EEC; C: corporate combinations, coal and steel, energy and transport and intellectual property rights; and D: monitoring state aids, state monopolies and public undertakings, and discrimination in the public sector.

Investigation by the Commission

Infringements of art. 85/86 can be investigated by the Commission either: (i) *ex officio* at the initiative of Directorates B and C; or (ii) at the

instigation of interested parties: that is, member states, undertakings and individuals.

Investigations *ex officio* are at the discretion of the Commission, but there is a duty to investigate third party complaints, which are the main source of information. A mere complaint will not suffice: there must be a description of the alleged infringement and details of the parties concerned; the complaint must also be substantiated. The Commission decides whether the complaint is admissible. Generally investigations take two to three months.

The alleged offender is not obliged to submit to the enquiry but will generally co-operate. In order to carry out the investigation, an agreement will generally be reached between the Commission, the undertaking and the relevant national authority; for example, in the UK this is the Competition Policy Division of the Office of Fair Trading. At the conclusion of the investigation, the Commission will make a statement and, where warranted, particularise the objections to the conduct of the undertaking. Under Reg. 17 there is a provision for oral hearings, the purpose of which is to enable the undertaking under investigation to challenge the Commission and put forward points before a final decision is taken. Where an infringement is proved, the Commission may make recommendations to the offending party, issue an injunction terminating the offending practice, and apply sanctions where appropriate. These include:

(i) restrictive practice agreement declared void;
(ii) imposition of fines and penalties: the maximum fine is up to 10 per cent of the turnover of the companies concerned – in July 1991 TetraPak was fined a record £52m for competition law infringement; and
(iii) fines for giving ‘intentionally or negligently’ false information leviable against any party giving evidence.

The inquisitorial and quasi-judicial function of the Commission in these procedures should be noted. Its decisions are subject to judicial review by the ECJ, which may annul decisions *in toto* or in part, and can reduce or increase fines or penalties.

17.14 Determination at National Level

UK enforcement authority

Investigation of possible breaches of Community competition law can be made by the appropriate national authorities, which can institute proceedings against an offending undertaking. In the UK the Office of Fair Trading which, under the Director General of Fair Trading.

Sanctions and judicial review

At the national level, sanctions are governed by national law, and decisions of the enforcement authorities are subject to judicial review, depending on the system established. Thus, in the UK, there is judicial review by the ordinary courts.

Conformity of community competition law

To ensure conformity of competition policy throughout the Community, the interpretation of Community law is the sole responsibility of the ECJ and art. 177 EC Treaty allows, and in some cases requires, national tribunals and courts to apply to the ECJ for preliminary rulings on interpretation. There is an overlapping jurisdiction of the Community and the member state but generally an action, once commenced by the Community, will have priority over an action taken by national authorities; however, actions initiated by national authorities continue until completion, even if the Commission should in the meantime become engaged.

Euro-defences

One particular form of national enforcement is through the use of Euro-defences before a national court. Thus, in *Aero Zipp Fasteners Ltd* v. *YKK Fasteners (UK) Ltd* [1978] CMLR 888, the plaintiffs raised the defence of Arts 85 and 86 as a defence in an action for infringement of a patent.

17.15 Extraterritorial Extension of Rules

Application of the rules is not confined to the geographical area of the common market. There is also extraterritorial application of Community rules, and the rules are further extended through trade agreements with non-member states. Doubt as to whether the jurisdiction of the EC institutions applied against foreign undertakings was removed by *ICI Ltd* v. *EC Commission* [1972] CMLR 557. ICI Ltd operated a price-fixing cartel relating to dyestuffs in conjunction with a number of other companies. The Commission fined four German companies, one French company, one Italian company, three Swiss companies and ICI Ltd (the UK was not a member of the EEC at the time). The companies established outside the EC objected to the extraterritorial application of Community competition law.

Criteria for extraterritorial extension

The Advocate General advanced three criteria for the applicability of community law:

(i) imposition of direct and immediate restrictions on the common market by the agreement or concerted practice;
(ii) the reasonably forseeable character of the effect; and
(iii) the substantial nature of the effect produced in the Community.

He concluded: 'Article 85 gives as the sole criterion, the anti-competitive effect in the Common Market, without taking into account either nationality or the locality of the HQ of the undertakings responsible for the breaches of competition.'

Investigation by the Commission of foreign undertakings

The Commission may operate against foreign undertakings by way of the normal investigative procedures: *Geigy and Sandoz* v. *EC Commission* [1972] CMLR 557; *Franco-Japanese Ballbearings Agreement* [1975] 1 CMLR D 8; *French and Taiwanese Mushroom Packers* [1975] 1 CMLR D 83; *Hoffman–La Roche Decision* [1976] 2 CMLR D 25; and *Re Brazilian Coffee* [1976] 1 CMLR D 13.

Possible double sanction

There are problems of double jeopardy and double sanction, but these are risks that the undertaking must run: *Boehringer Mannheim* v. *EC Commission* [1970] ECR 769 (fines under EEC and US Anti-Trust Laws; ECJ reduced fine).

17.16 Restrictive Practices Contrary to Article 85(1)

Article 85(1) provides:

> The following shall be prohibited as incompatible with the Common Market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition with the Common Market, and in particular those which:
>
> (a) directly or indirectly fix purchase or selling prices or any trading conditions;
> (b) limit or control production, markets, technical development or investment;
> (c) share markets or sources of supply;
> (d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
> (e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Undertakings

Articles 85 and 86 are addressed to private undertakings (as compared to Art. 90, which is addressed to public undertakings). There is no definition of 'undertakings', either public or private, but an enterprise or undertaking must be a physical person, corporation or an association of persons or corporations engaged in profit-making activity. It must have autonomous legal existence and personality, an economic autonomy, and be involved in the trade, manufacture or distribution of goods and services. It may include the exercise of a liberal profession.

This definition causes problems in respect of subsidiary companies which, while juristically autonomous, may not enjoy economic autonomy. Thus, an agreement between a Dutch subsidiary and its Danish parent company was only a 'distribution of tasks within a single unit' and therefore not within the scope of EC competition law: *Re Christiani & Nielsen* 69/195 [1969] CMLR 1336; see also *Re Kodak* 70/332 [1970] CMLR D19. This would seem to mean that the prohibitions addressed to undertakings in Art. 85(1) are only applicable if the undertakings are capable of competing with each other. They do not seem to apply to a situation where there was nobody to compete with at all: where there was the manufacturer of a unique product: *Commercial Solvents Case* [1974] CMLR 309; and *Re Brazilian Coffee* [1976] 1 CMLR D13.

Agreements by undertakings

As with domestic law, this term is not restricted to contractual agreements; it extends to cover 'gentlemen's agreements' even when these are oral: *ACF Chemiefarma* v. *The Commission* [1970] ECR 661. In *Polypropylene OJ* [1986] L230/1 the Commission stated: 'An agreement exists if the parties reach a consensus on a plan which limits or is likely to limit their commercial freedom by determining the lines of their mutual action or abstention from action in the market. No contractual sanctions or enforcement procedures are required. Nor is it necessary for such an agreement to be made in writing.'

Decisions by associations of undertakings

This includes resolutions by or recommendations of a trade association to its members irrespective of whether or not they are binding, and the question of the legal personality of the association is irrelevant. Even the rules of the association can be 'decisions' for this purpose.

Concerted practices

This is 'a form of coordination between enterprises that has not yet reached the point where there is a contract in the true sense of the word but which, in practice, consciously substitutes a practical cooperation for

the risks of competition' (*ICI Ltd Case* [1972] CMLR 557). It has been held that the requirement of independence precludes 'any direct or indirect contact between … operators the object or effect whereof is either to influence the conduct on the market of an actual or potential competitor or to disclose to such a competitor the course of conduct which they themselves have decided to adopt or contemplate adopting' (*Cooperative Verenigen Suiker Unie VA* v. *EC Commission* [1975] ECR 1663).

Affecting trade and preventing, restricting or distorting competition

The two aspects here are cumulative and not alternatives. There are several points to note.

Nature of the effect on competition

The court is concerned with potential rather than concrete, proved effect: *Consten SARL and Grundig-Verkaufs GmbH* v. *EC Commission* [1966] CMLR 418; *Société Technique Miniére* v. *Machinebau Ulm GmbH* [1966] CMLR 357; and *Re WEA – Filipacchi Music SA* [1973] CMLR D43.

De minimis

The potential or actual effect must not be insignificant. An agreement may escape art. 85 (1) where its effect or potential effect on the market is economically insignificant: *Volk* v. *Vervaecke* [1969] CMLR 273; and *Beguelin Import* v. *SAGL Import/Export* [1971] ECR 949.

Effect must be on interstate trade

The effect or potential effect of an agreement between undertakings within a member state may be felt throughout the Community. This was not recognised by the Commission in the early cases, but the approach has hardened considerably. In *Re German Ceramic Tiles Discount Agreement* [1971] CMLR D6, the agreement was discriminatory because it tended to protect German producers from competition from imports. In *Brasserie de Haecht* v. *Wilkin and Wilkin* [1968] CMLR 26, agreements tying bars and cafes in Belgium also tended to restrict competition from imports.

The Commission is also concerned with agreements between undertakings which do not have as their object trade within the Community, but which may affect competition within the Community because of certain clauses. Thus an exclusive distribution agreement giving rights in an area outside the Community, but with a proviso that the foreign undertaking should not resell the products within the community or other products, irrespective of origin, which might be in competition with goods offered by the other party to the agreement will infringe art. 85(1). However, in *Re SABA* [1977] ECR 1875, SABA produced televisions and tape recorders, and the goods could only be delivered to approved undertakings. The Commission granted negative clearance, and this decision

was appealed to the court where the decision was upheld, with the court stating: 'the Commission was justified in recognizing that selective distribution systems constituted … an aspect of competition which accords with Article 85(1), provided that resellers are chosen on the basis of objective criteria of a qualitative nature … and that such conditions are laid down uniformly … and are not applied in a discriminatory fashion': *The Grossfillex-Fillisdorf Agreement* [1964].

Prevention, restriction or distortion of competition

Prevention refers to the elimination of competition or the prevention of its occurrence; restriction means limiting competition geographically, quantitatively or generally to render it less effective; and distortion means to change the field of operation so as to place the parties in an unequal position. The restrictions and so on will generally be assessed taking into consideration their length, scope, economic effect and effect on competition. The restrictions can be classified according to planned effect.

Non-competition restrictions Not all of these will be void. Where a business is sold, the vendor will usually undertake not to compete with the purchaser within a certain area of business for a fixed period and a particular geographical area. In *Reuter* v. *BASF AG* [1976] 2 CMLR D44, Reuter sold his business to BASF and accepted restrictions on his trading activities for a period of eight years, together with undertakings of confidentiality in respect of know-how. The Commission held that where a sale of a business included the goodwill and know-how, non-competition clauses are allowed, if not for a longer period than would be needed by a third party to set up a similar business, and geographically limited to the area in which the company competed prior to its disposal or areas where it might have expanded its business. The period will depend upon the type of know-how transferred, with more complex areas protected for a greater period. Generally, five years is the maximum period likely to be permitted.

Collusive tendering In *Suiker Unie and Others* v. *The Commission* [1976] 1 CMLR 295, there were secret agreements to allocate tenders between companies in the sugar cartel.

Pricing restrictions Oral agreements and concerted practices between competitors will be caught by the law, as well as restrictions relating to discounts and rebates. It also extends to agreements not to undercut a competitor's prices in his/her principal territory: *Re European Glass Manufacturers* [1974] 2 CMLR D51.

Resale price maintenance This involves a vertical arrangement under which a supplier requires a purchaser to resell goods at a certain price. This is expressly prohibited under the block exemption for distribution agreements (see below). Collective resale price maintenance involves an

agreement between suppliers as to the price at which they will resell goods.

Information exchange The Commission has condemned agreements for the exchange of information. In *Re European Glass Manufacturers* [1974] 2 CMLR D51 it was stated to be unlawful to communicate to a competitor details of pricing policy, price lists, discount structures and dates when prices would be increased. In *Welded Steel Mesh Cartel: The Community* v. *Trefilunion SA and Other* [1991] 4 CMLR 13, the circulation of sales figures among competitors was forbidden, and price agreements were held to be illegal even though non-binding.

Other restrictions Other restrictions include tying the purchase of one product with the purchase of another; clauses obliging the licensees of intellectual property to assign to the licensor improvements developed by the licensee; clauses forbidding the licensee of intellectual property from challenging the validity of the licensed patent; and clauses preventing parallel imports and rules for exhibiting at trade fairs: *Sippa OJ* [1992] 5 CMLR 529.

Application to 'horizontal' and 'vertical' agreements

In Consten–Grundig, the ECJ rejected the argument that art. 85(1) applied only to horizontal agreements, and it is clear that agreements are covered between parties at different levels in the economic process.

Practices falling outside art. 85(1)

The recognition that agreements of minimal economic importance should be excluded from the effect of art. 85(1) was embodied in the Commission Notice of 1970 concerning 'Agreements, Decisions and Concerted Practices of Minor Importance', amended by the Notice of 1977. Agreements which fall within the limits established by the Notice do not have to be notified to the Commission with a view to obtaining negative clearance (see below).

Effect of breach of art. 85(1)

Any agreements or decisions prohibited pursuant to art. 85(1) shall be automatically void: art. 85(2). There are the possibilities of obtaining a negative clearance or claiming exemption under art. 85(3).

Negative clearance

The Commission may certify that 'on the basis of the facts in its possession, there are no grounds under art. 85(1) … for action on its part'. Undertakings anticipating entering agreements to which art. 85(1) applies

may notify the Commission of the agreement with a view to obtaining such a negative clearance. Negative clearance does not operate like an exemption and it may be withdrawn by the Commission.

Exemptions from art. 85(1)

Art. 85(3) provides for exemptions from the operation of art. 85(1). Thus, if an agreement or practice cannot be given a negative clearance, it can be granted an exemption if the conditions of art. 85(3) are satisfied in the view of the Commission. Exemption can only be granted by the Commission and not by the national authorities. Article 85(3) provides that:

> the provisions of paragraph 1 may … be declared inapplicable in the case of:
> – any agreement or category of agreements between undertakings;
> – any decision or category of decisions by associations of undertakings;
> – any concerted practice or category of concerted practices;
> which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
> (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
> (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

There are block exemptions and individual exemptions.

Block exemptions

In order to reduce the number of individual applications, the European Council of Ministers has given the Commission power to grant 'block' exemptions in respect of certain categories of agreements, decisions and concerted practices. These have the effect that any agreement falling within their scope will be exempted from art. 85(1) and the parties will not need to obtain individual exemption for the agreement from the Commission. Block exemptions exist for agreements relating to:

- exclusive distribution;
- exclusive purchasing;
- patent licensing;
- motor vehicle distribution and servicing;
- research and development;
- specialisation;
- know-how licensing; and
- franchising.

The block exemptions list provisions which, if included in agreements, will not infringe art. 85(1); those that would infringe the article except for

the exemption regulation and provisions that are expressly prohibited. Agreements containing provisions that are not expressly permitted by the exemption regulation but which do not include a prohibited provision may benefit from the 'opposition procedure' whereby such agreements may be sent to the Commission and, if there is no adverse response within six months, the agreement is exempted.

Individual exemptions

In order for an agreement and so on to be granted exemption under art. 85(3), the practice must be notified to the Commission. The regulations distinguish two types of agreement with regard to the time of notification: existing and new agreements. Existing agreements are those in existence before the accession of the member state to the Community. They must be notified within six months of accession. New agreements have to be notified when they come into force. In practice, the application for exemption is joined with the request for negative clearance and made on Form A/B. A decision in respect of art. 85(3) may be issued for a specified period and may be subject to conditions. It may be renewed but can also be amended or revoked under Reg. 17, art. 8.

There are no sanctions for failure to notify an agreement, but the system is promoted through the advantages gained from notification. The main advantage is that of escaping potential sanctions. Thus, if an agreement has been notified, sanctions can only be applied in respect of the period during which the practice was used prior to notification. In addition, an agreement that has been notified remains valid pending a decision unless the Commission declares otherwise. Certain agreements do not require notification under Reg. 17, art. 4(2).

17.17 Abuse of a Dominant Position: Article 86

Article 86 provides:

> Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:
>
> (i) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
> (ii) limiting production, markets or technical development to the prejudice of consumers;
> (iii) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
> (iv) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

The article aims to prevent the 'abusive' exploitation of a dominant position within the common market where such conduct has an effect on trade between member states. Where art. 85 regulates agreements between undertakings, art. 86 usually concerns the activities of companies acting alone. In *Euroemballage Corporation and Continental Can Company* v. *The Commission* [1973] ECR 215, the court stated: 'Article 85 concerns agreements between undertakings, decisions of associations and concerted practices, while Article 86 concerns unilateral activity of one or more undertakings.'

The Court of Justice has considered the provisions of art. 86 under three basic headings: the existence of a dominant position; an abuse of that position; and the effect on trade between member states.

The existence of a dominant position

To establish whether a dominant position exists, the position of the undertaking must be considered in the context of a specific product and geographical market. This is generally known as the 'relevant market'.

Common market or substantial part of it

Article 86 requires the dominant position to be held 'within the common market or in a substantial part of it'. From *BP* v. *The Commission* [1978] ECR 1513 it would appear that a small member state – the Netherlands – may constitute a 'substantial part' of the common market; the case concerned the Dutch market for petrol, which only represented 4.6. per cent of the Community market as a whole. The Court did not comment on this issue. In *Napier Brown & Co. Ltd*. v. *British Sugar* [1990] 4 CMLR 196, Great Britain was 'a significant part of the common market'. From this it would be logical to state that a small, densely-populated area such as Greater London or Paris could also constitute a 'substantial part' of the common market, but this remains undecided.

Relevant product market

Definition of the relevant product market presents greater problems. The crucial test appears to be whether or not there are readily available and acceptable substitutes for the product in question. The question of substitutability must be viewed from the point of view of the consumer and the producer. If a product is 'substitutable' in respect of either, it cannot form its own 'product market' but it may belong to a larger product market. In *United Brands* v. *The Commission* [1978] ECR 207, the court decided that the banana market was a separate product market rather than merely forming part of a larger soft-fruit market. The problems can be appreciated here concerning whisky. Is the relevant product market whisky, grain spirits or alcoholic beverages other than wine, or is vodka substitutable for whisky?

The Commission normally attempts to narrow the product market as much as possible in order to increase the possibility of establishing the

existence of a dominant position. In *Hoffman–La Roche Decision* [1976] 2 CMLR D 25, the Commission held that each of the thirteen vitamin groups manufactured by the company constituted a separate product market as no group was interchangeable with any other. This view was supported by the court in 1979. In *Hugin* v. *The Commission* [1979] ECR 1869, one manufacturer's products were held to constitute a separate market, although interstate trade was not affected. Similarly, in *Magill TV Guide/ITP, BBC and RTE* [1989] 4 CMLR 757, weekly TV listings guides were a separate market from daily listings, since they were not substitutable.

Criteria for market dominance

Having established the 'relevant market', it is then necessary to establish whether an undertaking has a dominant position in respect of that market. This is a question of the degree of economic power exerted over the market by the undertaking. An undertaking with a monopoly position clearly has a dominant position. In *Suiker Unie* v. *The Commission* [1976], the court held that an 85 per cent share of the market constituted a dominant position, since it enabled the undertaking 'to impede effective competition of the market in question'. In *United Brands* v. *The Commission* [1978] ECR 207, a market share of 40 to 45 per cent was regarded as a dominant position by a new test in which the emphasis was shifted to the ability to behave independently of competitors and customers. It is unlikely that a market share of less than 30 per cent would be sufficient to amount to a dominant position.

In the *BP Case*, the concept of dominance was defined by AG Warner as being 'that the undertaking concerned has a position of such economic strength as to have power, at least, to behave to an appreciable extent independently of its competitors and customers'. The court went on to comment in the *Hoffman–La Roche* v. *The Commission* [1979] ECR 461 that 'the view may legitimately be taken that very large (market) shares are in themselves … evidence of the existence of a dominant position'.

The abuse of the dominant position

The nature of abuse

Article 86 does not prohibit the mere existence of a dominant position: for there to be a breach of the law there must be an abuse of that position. Various examples of conduct considered to be abusive are given in the article, but these are not exhaustive.

The court has attempted to lay down a comprehensive definition of the term 'abuse' in (*Hoffman–La Roche* v. *The Commission* (1979):

> The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and

> which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.

Possibly more illuminating are examples of conduct found to constitute an abuse of a dominant position. These can be considered under a number of headings.

Examples of abuse

Mergers In the earliest case, *Euroemballage Corporation and & Continental Can Company* v. *The Commission* [1973] ECR 215, the court held that in certain circumstances, the take-over of a competitor may amount to abusive conduct.

Refusal to supply This can amount to an abuse under art. 86, but the scope is not completely clear. In *CSC–ICI* v. *The Commission* [1974], the customer was also a competitor and thus the refusal to supply was designed to eliminate competition. The Commission has attempted to extend this to a refusal to supply a customer who is not a competitor. In the *BP Decision*, the Commission held that the giving of preference to its regular customers during a petrol shortage and the reduction of supplies to occasional customers meant that BP had abused its dominant position. The Commission's decision was annulled by the court, which held that 'A duty on the part of the supplier to apply a similar rate of reduction in deliveries to all its customers in a period of shortage without having regard to obligations contracted towards its traditional customers could only flow from measures adopted … by the Council … or, in default of that, by the national authorities.' In *Leyland DAF Ltd* v. *Automotive Products plc* [1994] 1 BCLC 245, administrative receivers were appointed over the assets of Leyland DAF at a time when Leyland owed Automotive Products (AP) £750 000. The administrative receiver wanted AP to carry on supplying components, but AP refused unless the outstanding debt was paid. Leyland claimed that the refusal to continue supplies was an abuse of a dominant position under art. 86. The Court of Appeal upheld the High Court decision that there was no legal obligation to continue to supply Leyland, and that it was not an abuse of art. 86, since AP were not in a dominant position and, even if they were, their refusal to supply did not constitute a breach of that position but was a commercial decision taken in their interest. Undertakings cannot suddenly cease to supply a long-standing customer which continues to place the same type of order as has been satisfied in the past.

Unfair pricing In *United Brands* v. *The Commission* [1978] two forms of unfair pricing were singled out as examples of abusive conduct. The first was the charging of excessive prices and the second was discriminatory

pricing in different member states. Low pricing also constitutes an abuse where the dominant undertaking cuts prices with the aim of driving out existing or new competitors where the dominant undertaking can bear the losses of such a policy: *ECS/AKZO* [1986] 3 CMLR 273.

Limiting production, markets or technical development This is contained in para. (b) of art. 86. In *United Brands*, forbidding a distributor from selling the product in certain circumstances was found to limit markets to the prejudice of customers with respect to para. (b). In *British Telecommunications* v. *The Commission* [1973] 1 CMLR 457, a provision whereby BT insisted that, where a third party sent a telex, that third party could not charge less than BT, was prejudicial to customers in Europe.

Applying dissimilar conditions to equivalent transactions Article 86(c) prohibits the application of dissimilar conditions to equivalent transactions and places dominant undertakings under an obligation to treat companies fairly. Price discrimination may come within this heading. Dominant undertakings operating a differential pricing system must be prepared to justify it.

Tying The *Hoffman–La Roche Case* examined the application of art. 86(d) to various forms of action constituting an inducement to existing customers to obtain all, or most of, their supplies from an undertaking holding a dominant position on the relevant market. Thus an undertaking that ties purchasers by an obligation or promise on their part to obtain all or most of their requirements exclusively from the undertaking in question commits an abuse under art. 86, even if the tie is entered into in return for the grant of a rebate to the customer, and even if it is at the request of the customer. The court went on to hold that the operation of fidelity rebates constituted abusive conduct. The court also considered the so-called 'English clause', which enables the buyer to demand a reduction in price from the seller if s/he is able to show that s/he can obtain the same product from other sellers at a lower price. If the seller then refuses to lower his/her price, the clause entitles the buyer to purchase from the other seller without losing his/her right to rebates from the main seller. The court held that this was designed to assist the seller in maintaining his/her dominant position and would, of itself, constitute an abuse.

In *Michelin* v. *The Commission* [1985] 1 CMLR 282, the linking of Michelin dealers through a refund system was held to constitute an abuse of a dominant position, since it limited the dealers' choice of supplier and prevented them from being able to choose the most favourable offer and change suppliers without economic disadvantage.

Acquisition and exercise of intellectual property rights The ownership of an intellectual property right will often place the owner in a monopoly position. EC competition law draws a distinction between the ownership

of intellectual property rights and their exercise. Article 30 EEC provides that quantitative restrictions on imports and all measures having equivalent effect shall be prohibited between member states. In relation to intellectual property rights, art. 36 provides that art. 30 will not prevent the protection of industrial (intellectual) property rights. Article 222 provides that the treaty shall in no way prejudice the rules in member states governing the system of property ownership.

Owners of intellectual property rights must exercise those rights with care and in accordance with the treaty provisions. Companies in a dominant position must take into account both art. 85 and the various EC block exemptions for licensing intellectual property rights, as well as art. 86. Cases in this area include *Van Zuylen Frères* v. *Hag AG* [1974] ECR 731, which was concerned with the right to import Hag products into Luxemburg bought from Hag AG in Bremen in breach of a trade mark held by Van Zuylen Frères which held trade marks in respect of Belgium and Luxembourg. In the course of its judgment, the ECJ stated: 'The exercise of trade mark rights is such that it contributes to the preservation of national frontiers and is therefore detrimental to the free circulation of goods between Member States, all the more so since, unlike other industrial property rights, it is not subject to limitation in time.'

Consequently it cannot be admitted that the exclusivity of the trade mark right, which can be the result of the territorial limitation of national legislation may be invoked by the holder of a mark in order 'to prohibit the marketing in a Member State of goods legally produced in another Member State under an identical mark having the same origin'. The Commission has consistently taken the view that trade mark rights should not be exercised in order to prevent parallel imports of products legitimately bearing the same mark. See *Remington Rand Case* (1969) and *Centrafarm* v. *Sterling Drug* [1976] 1 CMLR 1.

In *Tetra Pak Rausing S.A.* v. *Commission* [1991] 4 CMLR 334, the Commission held that the acquisition of an exclusive licence of a patent constituted an abuse of TPR's dominant position. The fact that the exclusive licence fell within the terms of patent licensing block exemption under art. 85 did not prevent that licence from being contrary to art. 86. In the television listings case (*Magill*), the failure to license copyright in lists of weekly TV programmes was an abuse of a dominant position. Whether it is contrary to the law to refuse to grant a licence will depend on the circumstances of a particular case.

Recommended Further Reading

Competition Law of the UK and EC, Mark Furze (Blackstone Press 1998).
Cases and Materials on EC Competition Law, Julianne O'Leary (Blackstone Press 1998).

Questions

1 The Fair Trading Act 1973 established an office, a committee and a commission. What are they and who is in overall charge of them?
2 What are the criteria for establishing a monopoly in respect of goods or services?
3 Give examples of the type of agreements which are prohibited under Part I of the Competition Act 1998 unless exempt.
4 What is a resale price maintenance agreement?
5 With regard to restrictive practices contrary to art. 85(1) EC Treaty, what does the article prohibit, and to whom?
6 What is the difference between ‘horizontal’ and ‘vertical’ agreements?
7 For the purposes of art. 86 EC Treaty, what do you understand by the phrase ‘relevant product market’ and the concept of ‘substitutability’?
8 Give examples of abuse of the dominant position.

Part VIII

Personal and Corporate Insolvency

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18 Personal Insolvency

Learning Objectives

After reading this chapter you will know about:

1. the alternative forms of the Individual Voluntary Arrangement (IVA) and the bankruptcy procedure for insolvent individuals
2. the procedure leading to a bankruptcy order and the powers of the trustee in bankruptcy over the bankrupt's property
3. the priority of creditors

The Insolvency Act 1986 provides for insolvent individuals to enter voluntary arrangements with creditors, or for their bankruptcy. The procedures aim to resolve creditors' claims and release debtors from an impossible situation. Criminal penalties arise if investigations reveal that an individual has breached legal standards and penalties automatically attach to bankruptcy. The principal voluntary arrangement and the bankruptcy procedure are contained in the Insolvency Act 1986 and the Insolvency Rules.

18.1 Individual Voluntary Arrangements (IVAs)

The IVA is an alternative to bankruptcy, available before or after the presentation of a bankruptcy petition, or even after the debtor has been declared bankrupt. It involves drawing up proposals for a scheme of arrangement or composition to be submitted for the creditors' approval. A scheme of arrangement could involve an agreement with non-supplier creditors to a deferral of repayment of debts to enable the debtor to continue in business, where s/he believes that s/he can trade out of his/her current financial difficulties. A composition involves creditors agreeing to accept a percentage payment in full and final satisfaction of their debts as an alternative to bankruptcy, where the money realised may be exhausted by the legal expenses.

The proposals are submitted by a licensed insolvency practitioner (LIP) as nominee who agrees to act in relation to the composition or scheme, and includes a statement of affairs of the debtor, the names of the creditors, a statement as to how liabilities are to be dealt with, and an account of the assets included in the arrangement, including those to be provided by third parties. The nominee returns a copy to the debtor endorsed with the date when s/he received it. Pending approval of the proposal, the debtor will generally seek a moratorium against the

commencement or continuation of legal proceedings, or processes against him/herself or his/her property by applying to the court for an interim order.

The interim order

An interim order is made where the court thinks it will assist in the consideration and implementation of the composition or scheme of arrangement: s.255. Immediately following the application, the court may stay any legal process against the property or the person of the debtor, and legal proceedings against him/her may be stayed or allowed to continue on such terms as the court thinks fit: s.254. Once the order is made and for as long as it is in force, bankruptcy proceedings cannot be started against the debtor, and where proceedings have been initiated they are stayed. In addition, no proceedings, execution or other legal process may be commenced or continued against debtors or their property without consent. The order is effective for fourteen days and automatically expires unless extended by the court at the request of the nominee or the debtor: s.256. Application can be by the debtor, or, where a bankruptcy petition has already been presented against the debtor, by the official receiver; or, where the debtor has already been declared bankrupt, by the trustee in bankruptcy: s.253, accompanied by an affidavit explaining why the application has been made and a copy of the proposed arrangement endorsed by the LIP.

Nominee's report

The nominee submits a report to the court at least two days before the expiration of the interim order, recommending whether a creditors' meeting should be called to consider the proposals: s.256. The report is filed and can be inspected by any creditor. Copies are sent to any creditor who has presented a bankruptcy petition against the debtor; and, where the debtor is already bankrupt, to the official receiver. If the court thinks that the proposal should be considered by a creditors' meeting, the order will be extended to enable the meeting to be convened between fourteen and twenty-eight days after the report of the nominee.

Creditors' meeting

Creditors must have at least fourteen days' notice of the meeting, and the notice must name the court where the report is filed and give the rules for voting at the meeting. With the notice are also sent copies of the proposal, the debtor's statement of affairs, the nominee's comments on the proposal, and a proxy form. Notification is sent to all creditors named in the statement of affairs and all others of whom the nominee is aware. The meeting, normally chaired by the nominee, considers the proposals and decides whether to approve or reject them; the scheme may be amended,

but changes must be agreed to by the debtor. No proposal or modification can affect the rights of a secured or preferential creditor without their agreement: s.258. The proposals must be accepted by at least three-quarters in value of the creditors voting in person or by proxy. The weight of a creditor's vote is calculated at the amount owed at the date of the meeting. Creditors cannot vote in respect of unliquidated or unascertained debts, although in the latter case the chairman may allow a vote on the basis of an estimated value. Secured creditors can only vote in respect of any unsecured part of their claim. As there will not have been enough time for creditors to prove their debts, and some may have made inflated claims, the chairman can admit or reject creditors' claims in whole or in part: s.259.

The decision of the meeting is reported within four days to the court and to everybody who received notice of the meeting. It identifies the creditors who voted and how they voted. If the proposal is rejected, the interim order is discharged: s.259; this will generally result in the commencement or continuation of bankruptcy proceedings. If the proposal is approved, it takes effect immediately and binds every person notified of the meeting and entitled to vote, irrespective of how they voted: s.260. Any bankruptcy petition is dismissed and if the debtor is already an undischarged bankrupt, the court can annul the bankruptcy order or give directions to facilitate implementation of the composition or scheme: s.261. The nominee becomes the supervisor of the scheme or composition: s.263, and must be put in possession of all assets included in the arrangement and, if the debtor is an undischarged bankrupt, must discharge all fees, costs and so on of the trustee in bankruptcy and the official receiver.

Challenging the decision

The decision can be challenged within twenty-eight days of the report on the grounds of prejudice to a creditor's interests or a material irregularity in relation to the meeting by the debtor, a creditor, the nominee or, if the debtor is an undischarged bankrupt, by the trustee in bankruptcy or the official receiver. If upheld, the court may revoke or suspend the approval of the arrangement or order a further creditors' meeting to consider a revised proposal. In the event of any irregularity in the original meeting, it may order the meeting to be reconvened to reconsider the original proposal. The interim order can be extended to cover a further meeting: s.262.

Supervision of the arrangement`

The supervisor is under court supervision and may apply for directions. A dissatisfied debtor or creditor can ask the court to confirm, reverse or modify any act or decision of the supervisor. The court can also replace the supervisor and appoint others to work with them: s.263. The supervisor

must keep proper accounts and records and, at least once every twelve months, prepare an abstract of all receipts and payments, of which copies must, within two months, be sent to the court, the debtor and the creditors. On the completion of the arrangement in accordance with the proposals, the supervisor must within twenty-eight days send the court, the creditors and the Secretary of State a report to that effect, accompanied by a report summarising receipts and payments and explaining variations between the proposal as approved and as implemented.

If the debtor refuses to co-operate with the supervisor, the supervisor or a creditor can apply to the court for the voluntary procedure to be changed into a bankruptcy.

18.2 Bankruptcy

In a bankruptcy, the estate of an insolvent person passes into the control of a trustee who uses it to pay off that person's debts. The debtor remains an undischarged bankrupt until the order is discharged. The aim is to ensure a fair distribution of the bankrupt's assets and to prevent unfair preference of certain creditors. It also frees honest and unfortunate debtors from financial problems so that they can make a fresh start with past debts wiped out. An inquiry into the reasons for the bankruptcy may result in criminal penalties.

Persons who can be made bankrupt

Any natural person with contractual capacity is capable of being made bankrupt, including aliens who fulfil the general residence or business activity qualification. The limited contractual capacity of minors limits the possibility of their being made bankrupt. Persons of unsound mind can be made bankrupt subject to the control of the court of protection. The estates of deceased persons can be administered in bankruptcy.

The bankruptcy petition

The proceedings begin with a petition for a bankruptcy order lodged in the bankruptcy court (for debtors within the London area), or at the county court of the area where the debtor resides or carries on business if the court has bankruptcy jurisdiction. The petition may be presented by:

(i) a creditor or two or more creditors jointly;
(ii) the supervisor or any other person bound by a voluntary scheme or composition made as part of a voluntary arrangement under the Act;
(iii) the official petitioner where a criminal bankruptcy order has been made against the debtor: s.264; or
(iv) the debtor.

Creditor's petition

The petitioner must establish that the debtor is unable to pay the debt(s) specified in the petition: s.268. This is usually by one of two methods. The first is the statutory demand, whereby the creditor serves a statutory demand on the debtor requiring him/her to pay, compound for or secure the debt. His/her failure to comply within three weeks establishes inability to pay his/her debts. In *Re A Debtor* (No 50A–SD–1995) [1997] 2 WLR 57, High Court set aside a statutory demand in respect of a default judgment which had been given over six years previously. The proceedings were barred by s.24 Limitation Act 1980. The second is to claim that the enforcement of a judgment debt owed to the petitioner has been unsuccessful: s.268.

The petition must also comply with the following conditions:

(i) the debtor must be domiciled or personally present in England or Wales when the petition is presented or, at any time during the previous three years, have been ordinarily resident or have a place of residence or carried on business in England or Wales: s.265;
(ii) the debts claimed must be at least £750 and for a liquidated sum payable immediately or at some future time: s.267;
(iii) the debt must be unsecured: s.269; and
(iv) there must be no application pending to set aside the statutory demand on which the petition is based: s.267.

The court *may* dismiss the petition in three circumstances:

(i) if satisfied that the debtor is able to pay all his/her debts;
(ii) if the petitioner has unreasonably refused to accept an offer to secure or compound for a debt made by the debtor following the statutory demand. A refusal to agree to an arrangement is not an unreasonable refusal of an offer: *Re A Debtor* (No. 2389 of 1989), *ex parte Travel & General Insurance Co. plc* v. *The Debtor* [1990] 3 All ER 984. In *Re A Debtor* (No. 32 of 1993) [1995] 1 All ER 628, the petitioner, an insurance company, presented a petition in respect of a £33 638.86 debt and rejected payment of £15 000 in full settlement. The county court found the refusal unreasonable and dismissed the petition under s. 271(3), but on appeal the court held that the position should be considered only as between the actual creditor and debtor and it could not be said that no unreasonable creditor would have refused the offer; or
(iii) if the court regards it as appropriate because of some breach of rules or for some other reason.

The court *must* dismiss the petition:

(i) where the statutory demands have been fully complied with;
(ii) if the debtor has established a reasonable prospect of paying the debt; or

(iii) if the petition should not have been presented under the Act because of the debtor's failure to satisfy the domicile requirements: s.271.

Petition by supervisor or creditor under an IVA

Such persons may petition on two grounds:

(i) that the debtor has failed to comply with his/her obligations under the arrangement, or failed to do things which have been reasonably requested by the supervisor; or
(ii) that the debtor has supplied false or misleading information in his/her statement of affairs or any other document or at a creditors' meeting: s.276.

Petition by the DPP as official petitioner

Under the powers of the Criminal Courts Act 1973 the DPP may bring a petition against a person convicted of an offence where a loss in excess of a specified amount has been incurred. This may only be made if in the interest of the public: s.277.

Petition by the debtor

The petition must be accompanied by a statement of affairs detailing the financial position of the debtor: s.272. This will generally result in an automatic bankruptcy order except where:

(i) the unsecured debts are below the small bankruptcies level (£20 000);
(ii) the value of the debtor's assets is at least equal to the minimum amount (£2000); or
(iii) during the five years prior to the presentation of the petition, the debtor had not been adjudged bankrupt or made an arrangement with his/her creditors: s.273.

The court may appoint a qualified insolvency practitioner to report on the possibility of an individual voluntary arrangement, following which it may (i) make an interim order to assist in the implementation of a voluntary arrangement; or (ii) make a bankruptcy order and issue a certificate for summary administration: s.275. This involves a simplified form of administration by the official receiver.

The consequences of the bankruptcy order

Bankruptcy begins with the making of the bankruptcy order, which is published in the *London Gazette* and a local newspaper, as a result of which:

(i) the debtor becomes an undischarged bankrupt;
(ii) subject to exceptions, the official receiver becomes the receiver and manager of the bankrupt's estate pending the appointment of a trustee in bankruptcy: s.287;

(iii) unsecured creditors lose their rights of action against the debtor and can only prove in the bankruptcy for the amounts owing to them;
(iv) the bankrupt commits an offence if s/he obtains credit of £250 or more without disclosing his/her status or by engaging, directly or indirectly, in any business under a name different from the one under which s/he was made bankrupt without disclosing that name to all persons with whom business is transacted: s.360.
(v) it is a criminal offence for the bankrupt to act as a director or take part in the management of a registered company without the court's consent: s.11, Company Directors Disqualification Act 1986.

The role of the official receiver

The official receiver becomes the receiver and manager of the bankrupt's estate pending the appointment of a trustee in bankruptcy (s.287), subject to the following exceptions:

(i) in criminal bankruptcies or summary administrations, the trustee becomes the trustee immediately: s.297;
(ii) if, following a debtor's petition, an insolvency practitioner has been appointed to consider the possibility of a voluntary arrangement, the court will appoint the practitioner as trustee: s.297; and
(iii) if the order follows non-compliance with the terms of a scheme or composition, the supervisor of the scheme or composition may be appointed trustee at the time the order is made: s.297.

The official receiver can sell any goods that are perishable or that may diminish in value, and take steps to protect the property of the debtor. S/he must also investigate the bankrupt's conduct and affairs and, if s/he thinks fit, report his/her investigations to the court. The bankrupt must submit to him/her within twenty-one days a statement of affairs containing details of debts, liabilities and assets (s.288), except in the case of a debtor's petition, when it will have been submitted when the petition was presented. The official receiver can dispense with the statement of affairs in appropriate circumstances: s.288.

The official receiver may apply to the court for a public examination of the bankrupt, and creditors for more than half of the bankrupts' debts can order him/her to make the application. The court orders a public examination only where large sums are involved, where there are a considerable number of creditors or where it is in the public interest. The bankrupt must attend the public examination and answer questions concerning his/her affairs, dealings and property and the cause of his/her business failure. Unreasonable refusal to answer questions is contempt of court. Questions can be put by the official receiver, the trustee and any creditor whose debt is proved. In a criminal bankruptcy the official petitioner may ask questions: s.290.

The trustee in bankruptcy

The trustee in bankruptcy can be appointed by (i) the creditors at a general meeting of creditors, s.292; or (ii) the court: s.297.

Appointment of trustee by the creditors

The official receiver has twelve weeks to decide whether to call a creditors' meeting and give notice to the creditors. A meeting must be called at the request of creditors representing one-quarter in value of the total debts. Notice must be sent to the court and to every creditor named in the statement of affairs or known to the official receiver twenty-one days before the meeting, accompanied by a proxy form and a proof of debt form. The meeting must be held within four months of the bankruptcy order.

The official receiver, or his/her nominee, chairs the meeting. Only creditors whose debts have been admitted by the chairman can vote; creditors with unliquidated debts can vote only if the chairman has estimated the value of the debt. Voting is on the basis of the value of the creditors' debt and an ordinary resolution requires a simple majority in value of those voting in person or by proxy. The first meeting is to appoint a trustee and to set up a creditors' committee. The person appointed as trustee must give written confirmation that s/he is qualified and prepared to act. The appointment is certified by the chairman, and the certificate is filed in court and returned to the official receiver with the date endorsed on it for the official receiver to hand to the trustee: s.292.

Appointment by the court

This arises in the following circumstances: (i) in a summary administration, it may appoint someone other than the official receiver; (ii) on a debtor's petition, the insolvency practitioner who reported on the bankrupt's affairs can be appointed trustee; and (iii) where the order results from non-compliance with a voluntary arrangement, a supervisor may be appointed.

Appointment by the Secretary of State

This arises where: (i) there has been no appointment at the creditors' meeting: s.295; (ii) the official receiver is acting as the trustee: s.296; and (iii) there is a vacancy and a creditors' meeting has not been held: s.300.

Resignation or removal of the trustee

Trustees may resign on the grounds of ill-health, retirement from practice, conflict of interest, or any change in personal circumstances making continuance in office impracticable. A creditors' meeting is called and if it agrees to release the trustee from his/her duties, the chairman must notify the official receiver within three days. If the creditors refuse to accept the

trustee's resignation, s/he may apply to the court. Trustees vacate their office automatically on ceasing to be a qualified insolvency practitioner or if the bankruptcy is annulled: s.298.

A trustee can be removed by court order or by a creditors' meeting, except in the case of a summary administration. Where appointed by the Secretary of State, the trustee can be removed by him/her: s.298.

The role of the trustee in bankruptcy

The trustee's task is to get in, realise and distribute the bankrupt's estate in accordance with the Act. The main duties of the trustee are to:

(i) obtain possession and control of the bankrupt's property; for example, by collecting debts due to the bankrupt;
(ii) convert the bankrupt's assets into money as quickly and as effectively as possible;
(iii) make proper distribution of the proceeds among the creditors;
(iv) call a creditors' meeting at the request of one-tenth in value of the creditors;
(v) keep proper accounts;
(vi) act in utmost good faith; and
(vii) call a final meeting of the creditors when the administration is complete.

Trustees, on their own authority, have the same power of disposal of the bankrupt's property as the bankrupt: s.311. They can demand production of books, papers, documents or records relating to the bankrupt's affairs: s.312, and apply to the court to force the bankrupt to do any act necessary for the administration of the estate: s.363. In addition, with the permission of the creditors' committee, the trustee can:

(i) carry on the bankrupt's business;
(ii) bring or defend legal proceedings in respect of the bankrupt's property;
(iii) mortgage or pledge assets to raise money for the estate;
(iv) make a compromise or other arrangement on any claim by or against the bankrupt; and
(v) appoint the bankrupt to manage the business, Schedule 5.

The property available in the bankruptcy

The bankrupt's estate available for distribution among the creditors is 'all property belonging to or vested in the bankrupt as the commencement of the bankruptcy': s.283. This is subject to the rights of persons other than the bankrupt, such as a secured creditor. The commencement of the bankruptcy is the date when the order was made: s.278. The property only vests in the trustee when his/her appointment takes effect: s.306. These dates may be some weeks apart. Property includes 'money, goods, things

in action, land and every description of property wherever situated, and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property': s.346. The property vests in the trustee automatically without legal formalities: s.306. In *Re Landau* [1997] 3 All ER 322, L took out a retirement annuity policy in 1982. In May 1990 he was made bankrupt. He was discharged in May 1993, and in February 1994 he retired and claimed under the policy. The court upheld the trustee's claim that the benefits of the policy were property belonging to the bankrupt at the commencement of the bankruptcy and vested in him under s.306. In *Performing Rights Society Ltd* v. *Rowland* [1997] 3 All ER 336 the court held that royalties in respect of works completed prior to a writer member's bankruptcy was a transmissable property right which vested in the trustee in bankruptcy on his/her appointment.

Some property is not available for distribution and other property may be claimed for distribution even though disposed of prior to the order. The trustee may also disclaim property that is likely to prove a drain on the estate rather than a benefit.

Unavailable assets

The unavailable assets of the bankrupt comprise:

(i) trade and personal property;
(ii) property held by the bankrupt as a trustee;
(iii) personal income to support the bankrupt and his family;
(iv) the benefit of rights of action for damages for personal injury or damage to reputation;
(v) the family home; and
(vi) interests in property defeated by bankruptcy, such as a lease that is automatically revoked where the leaseholder is made bankrupt.

Trade and personal property

The tools, books, vehicles and other items of equipment necessary to the bankrupt's employment, business or vocation, and such clothing, bedding, furniture, household equipment and provisions as are necessary to satisfy the basic domestic needs of the bankrupt and his family are not available for distribution: s.283. However, the trustee may order the replacement of certain items with something cheaper, so that valuable antiques and silver cutlery can be realised.

Income payments order

The bankrupt may continue to be employed or to be self-employed, and the trustee can then request the court to make an income payments order, under which the bankrupt or his/her employer will make payments out of the bankrupt's income to the trustee: s.310. The bankrupt must receive

notice of the hearing and, at least seven days before the hearing, must be notified that s/he must attend unless s/he consents in writing to the proposed order. The court must ensure that the income retained by the bankrupt is sufficient for his/her reasonable domestic needs and those of his/her family: s.310.

The family home

A spouse who is not the legal owner of the matrimonial home nevertheless enjoys rights of occupation in respect of the home. These can be registered as a charge against the property, only removable by a court order under the Matrimonial Homes Act 1983. Where there is an application to realise the bankrupt's interest in the matrimonial home, the court must have regard to (i) the interests of the creditors; (ii) the conduct of the spouse with regard to the bankruptcy; (iii) the needs and resources of the spouse; (iv) the needs of any children of the family; and (v) all relevant circumstances (except the needs of the bankrupt). Where the application is more than one year after the vesting of the property in the trustee in bankruptcy, the interests of the creditors are paramount.

Where the home is jointly owned by the bankrupt and the spouse, an application to realise the bankrupt's interest in the home must be made to the court dealing with the bankruptcy and is subject to the same factors: s.336. Where the bankrupt has a beneficial interest in the home and is living there with children aged under 18, s/he can only be evicted with a court order: s.337. The children must have been living in the house both when the petition was presented and when the bankruptcy order was made.

Recoverable property

The trustee has the power to increase the distributable assets by setting aside the following transactions entered into prior to the bankruptcy order:

(i) dispositions made after the presentation of the petition;
(ii) preferences;
(iii) transactions at an undervalue;
(iv) transactions defrauding creditors;
(v) extortionate credit transactions;
(vi) assignments of book debts; and
(vii) incomplete enforcement procedures and distress by landlords.

Dispositions after presentation of the petition

A disposition of property or payment of money made between the presentation of the petition and the appointment of the trustee is void unless previously sanctioned by the court or subsequently ratified. In the absence of the court's approval, the person to whom the property was transferred or the payment made holds it as part of the debtor's estate: s.284(1).

Since the petition is not advertised to guard against malicious petitions there is a partial protection to third parties in that no action is possible against a person who received the property or money from the debtor under a transaction entered into (i) in good faith; (ii) for value; and (iii) without notice of the presentation of the petition in the period between the presentation of the petition and the making of the bankruptcy order: s.284(4). The protection extends to a person acquiring that property or any interest in it from a protected person, irrespective of whether that person acted in good faith, for value and without notice of the presentation of the petition. The protection of s.284(4) does not extend to transactions made after the commencement of the bankruptcy (that is, the date of the bankruptcy order), but there is limited protection for debts incurred after the order but before the trustee's appointment. Thus, where a bankrupt has incurred a debt to a bank or other person by virtue of a payment having been made, that is void under s.284(1); this is deemed to be a debt incurred before the commencement of bankruptcy provided that the bank or other person did not have notice of the bankruptcy before the debt was incurred, or it is not reasonably practicable for the payment to be recovered from the person to whom it was made.

This makes the debt provable when it would otherwise not have been, and covers a situation where a bank continued to operate a debtor's bank account without notice of the bankruptcy order, and increased the existing overdraft by paying third-party cheques. The protection is limited because gazetting the order is deemed to be notice to the world and it would probably only apply where publication is delayed for practical reasons or pending an appeal against the order.

Preferences and transactions at an undervalue

A preference is a payment made or a security given by a debtor to a creditor which puts that creditor in a better position than s/he would otherwise have been. The burden of proof is on the trustee to show (i) that the debtor was insolvent when the preference was made; (ii) that in making it the debtor was influenced by a desire to put the creditor in a better position than s/he would otherwise have enjoyed; and (iii) the preferential act was within the six months prior to the presentation of the petition except where to an associate of the debtor, when the period is extended to two years. In the latter case there is also a presumption that the debtor desired to put the creditor in a better position: s.340. The trustee in bankruptcy can recover property that has been the subject of a voidable preference subject to s.342.

A transaction at an undervalue is the disposal of assets by the bankrupt: (i) as a gift; (ii) where s/he received no consideration; (iii) where the consideration was significantly less than that s/he had provided; and (iii) where the transaction was in consideration of marriage: s.339. Where such a transaction ocurrs in the five years before the presentation of the

petition, and the debtor was insolvent at the time, the trustees can apply for an order restoring the parties to their original positions: ss.341 and 342.

An order can be made under ss.339 and 340 against the property of, or imposing an obligation on, any person, whether or not s/he is the person with whom the bankrupt entered into the transaction or the person to whom the preference was given. Thus, if A gives property to B, and B sells it to C, and A's gift to B can later be impeached under ss.339 or 340, the trustee may recover the property from C. However C's position is more protected, since the Insolvency (No. 2) Act 1994 which has modified s.342. This prevents recovery against C where s/he has acquired the property in good faith and for value: s.342(2)(a), and the new s.342(2A) specifies circumstances when it is to be assumed that C has not acted in good faith: s.342(2A) (a) and (b). These are (a) where C had notice at the time of the transaction of the relevant surrounding circumstances and of the relevant proceedings, defined in s.342(4) and (5); and (b) where C is an associate or a person connected with the bankruptcy.

The trustee shall not require payment from a person who received a benefit from the transaction or preference in good faith, for value and without notice of the relevant circumstances, except where s/he was a party to the transaction or where the payment is in respect of a preference given to that person at a time when s/he was a creditor of the individual: s.342(2)(b).

Associates of an individual are the husband or wife, or a relative, or the spouse of a relative of the individual, or of his husband or wife: s.435(1). 'Relative' includes children of half-blood, stepchildren, adopted children and illegitimate children; 'husband' or 'wife' includes former husbands or wives, and reputed husbands or wives: s.435(8). 'Associates' extends to persons with whom the debtor or his/her spouse or any relative of the debtor or the spouse is in partnership: s.435(3), any person whom s/he employs or by whom s/he is employed: s.435(4), and extends to a trustee of trust whose beneficiaries include the debtor or his/her associates: s.435(5). A company is an associate of a person or that person and his/her associates who control it: s.435(7), including *de facto* control as a shadow director or exercising one-third or more of the voting power of the company or of a company controlling it: s.435(10).

Transactions to defraud creditors

These are also transactions at an undervalue: s.423(1), but the court must be satisfied that they were for the purpose of putting assets beyond the reach of actual or potential creditors, or of otherwise prejudicing any claimant or potential claimant: s.423(3). The court may make an order restoring the parties to their original positions and protecting the interests of victims of the transaction. Potential applicants in the case of bankruptcy include the trustee, the official receiver and any victim of the transaction. The remedy is also available to the supervisor of a voluntary arrangement or any person who is a victim: s.424. There is no time

limitation, and application can be made in respect of any transaction prior to the presentation of the petition.

Extortionate credit transactions

The trustee can apply to the court in respect of any extortionate credit transaction entered into by the bankrupt within the three years prior to the bankruptcy order (not the presentation of the petition). An extortionate credit transaction is one which is grossly exorbitant, or which grossly contravenes the principles of fair dealing. There is a presumption that any credit transaction that is challenged is extortionate, and the lender must then rebut this presumption. The court can make a wide range of orders and any property recovered falls into the general estate of the bankrupt: s.343.

Assignments of book debts

Book debts are those owed to a trader by persons with whom s/he has dealings. A general assignment of existing or future book debts by a person engaged in a business is void against the trustee in bankruptcy unless:

(i) the debts assigned were paid prior to the presentation of the bankruptcy petition;
(ii) the assignment was registered under the Bills of Sale Act 1878 as an absolute bill of sale;
(iii) the assignment relates to debts due under specified contracts;
(iv) the assignment relates to debts due at that date from specified debtors;
(v) the assignment forms part of a transfer of the business in good faith and for value; and
(vi) the assignment was an assignment of assets for the benefit of creditors generally: s.344.

Incomplete enforcement procedures and distress by landlords

Where a judgment creditor levies execution and the sheriff is notified of a bankruptcy order before the proceeds of sale have been handed over to the creditor, the sheriff must deliver the goods to the official receiver or trustee in bankruptcy as requested, subject to a first charge on the goods in respect of his costs.

Where the execution is in respect of a judgment for more than £500 and goods are sold or money is paid in order to avoid a sale, the sheriff must retain the balance for fourteen days. If during that period the sheriff has notice of a petition, s/he cannot dispose of the balance until after the fourteen days have expired, or for as long as the petition is pending; and, if an order is made, s/he must pay the balance to the official receiver or to the trustee in bankruptcy, subject to retention in respect of his/her costs: s.346.

The rights of a landlord or any other person to distrain (seize and sell) upon the goods of an undischarged bankrupt for rent due are only available for the rent for the six months prior to the commencement of the bankruptcy: s.347(1). Where the amount recovered is for more than six months, or for a period after distress was levied, it shall be held as part of the bankrupt's estate. In addition, where there are insufficient assets to satisfy the claims of preferential creditors, the landlord must surrender goods or money to the trustee, in which case the landlord will to that extent rank as a preferential creditor.

Proof of debts

A creditor can prove in respect of any debt against the bankrupt's estate whether the claim is present or future, certain or contingent, ascertained or unascertained. Creditors identified in the statement of affairs must be sent the form for proving their debts and submit their claims to the trustee or to the official receiver as required by the Insolvency Rules. The claim may need to be verified by affidavit. Where the value of the claim is uncertain, the trustee may admit the creditor's proof on the basis of his valuation: s.322. If the trustee rejects the whole or part of a claim, the creditor can within twenty-one days apply to the court for a variation of the valuation.

Proofs can be inspected by the bankrupt and by any proving creditor, who may appeal against the decision of the trustee with regard to any proof within twenty-one days. Creditors can vary or withdraw proofs with the trustee's consent, and they can be varied or rejected by the court if the trustee shows that the proof was improperly admitted or should be reduced. There must be a set-off of mutual debts or dealings between the bankrupt and the creditor, who can only prove in respect of the balance owed to him/her.

Four categories of debt cannot be proved: (i) any fine imposed for an offence; (ii) any obligation arising as a result of an order made in matrimonial proceedings; (iii) obligations arising under a confiscation order under s.1, Drug Trafficking Offences Act 1986; and (iv) any debt that may not be proved by virtue of any rule of law, such as illegal debts and statute-barred debts.

Secured creditors can only prove for any unsecured balance of their debts and have the option of (i) realising the security and proving for the balance; or (ii) valuing their security and proving for the unsecured balance. In the latter case, the trustee can serve twenty-eight days' notice of his/her intention to redeem the security at that valuation. Secured creditors may serve notice on the trustee, requiring him/her to decide whether or not to elect to redeem the security, in which case the trustee must decide within six months. The valuation can be changed with the consent of the trustee or the court at any time, but where the trustee serves notice of his intention to redeem the security at the valuation, any revaluation by the creditor must be within twenty-one days. Where creditors later realise

their security for an amount greater than its valuation, the amount realised replaces the estimated value for the purposes of calculating any proof.

Secured creditors can surrender any security to the estate and prove as unsecured creditors for the whole amount.

Priority of creditors

Creditors are ranked in priority, and the debts within each category are paid *pari passu*. The order of priority is (i) expenses of the bankruptcy; (ii) specially preferred debts; (iii) preferential creditors; (iv) ordinary unsecured creditors; and (v) deferred debts.

Expenses of the bankruptcy

These have priority over all other debts by s.324, and include the court fees incurred, fees due to the official receiver, and all expenses properly chargeable or incurred by the official receiver or the trustee while acting in connection with the estate, including the remuneration of persons properly employed by the trustee.

Specially preferred debts

Where an articled clerk or apprentice has paid a fee to cover his/her training with the bankrupt, any sum in respect of the unexpired period of training is specially preferred: s.348.

Preferential debts

The categories of preferential debts are the same for individual bankruptcy and company liquidations. Under s.386 of the Act, any reference to preferential debts for both purposes refers to the debts listed in Schedule 6 of the Act (money owed to the Inland Revenue for income tax deducted at source; VAT, car tax, betting and gaming duties, beer duty; social security and pension scheme contributions; remuneration and so on of employees; and levies on coal and steel production). These various heads of claim are subject to specific regulation of which the most important are:

(i) PAYE deductions for the twelve months prior to the bankruptcy order;
(ii) VAT for the six months prior to the bankruptcy order;
(iii) Car tax, general betting duty, bingo duty, gaming licence duty, agents' liability for general betting and pool betting duty in respect of collected stakes within the period of twelve months prior to the bankruptcy order; in addition, there is now liability in respect of excise duty on beer for the period of six months prior to the order;
(iv) national insurance contributions for twelve months prior to the bankruptcy order;

(v) outstanding contributions in respect of state and occupational pensions;
(vi) arrears of wages or salary for employees for four months prior to the bankruptcy order, subject to a limit of £800 per employee;
(vii) accrued holiday pay; and
(viii) advances by third parties used to discharge claims in respect of preferential claims under (vi) and (vii) above.

Ordinary creditors

These are the general trade creditors of the bankrupt and any non-preferential PAYE, VAT and so on, and all assessed taxes: s.328.

Deferred debts

These debts do not rank equally and the first to be paid is statutory interest on debts proved from the date of the bankruptcy order. The rate is the greater of (i) that under s.17, Judgments Act 1838; and (ii) the rate of interest for which the bankrupt would have otherwise been liable: s.328. The second is claims against the bankrupt's estate by the bankrupt's spouse arising from credit provided for the bankrupt: s.329.

Recommended Further Reading

Bankruptcy of Individuals, Roger Gregory, 2nd edn (CCH Editions, 1992).
Individual Voluntary Arrangements, Stephen A. Lawson (Jordans, 1992).

Questions

1 The individual voluntary arrangement (IVA) relates to drawing up proposals for a scheme of arrangement or composition to be submitted to creditors for their approval. What is a scheme of arrangement and a composition?
2 What order of the court is used to facilitate an IVA?
3 How do undischarged bankrupts suffer restrictions on their ability to raise cash and engage in business?
4 What is a preference, and what is its importance for a trustee in bankruptcy?
5 What options are open to a secured creditor of a bankrupt?
6 Name five preferential debts. After what other debts to they rank for repayment?

19 Corporate Insolvency

Learning Objectives

After reading this chapter you will know about:

1. the operation of receivership and the difference between administrative receivers and other receivers, including their power to continue to operate the company in an effort to sell it as a going concern
2. the nature and aims of the administration order and the ways in which the administrator can salvage a sick business
3. the possibility of the Company Voluntary Arrangement (CVA) as a way in which a company can come to an arrangement with its creditors and the defects of the current system
4. the difference between the members' and the creditors' voluntary liquidation
5. the way in which a company can be placed in compulsory liquidation by the court
6. the powers of the liquidator with regard to the company's assets, including the right to recover previously disposed-of assets
7. the liability of the directors of companies in insolvent liquidation to contribute to the assets of the company and the possibilities of disqualification

On a company becoming insolvent, there are informal and formal ways to resolve the situation. A small company with few creditors may informally negotiate a debt extension and larger companies in multi-bank situations may use the London Approach, involving the banks remaining supportive and continuing banking facilities while seeking a solution involving rescheduling and a possible debt-for-equity swap. The danger of informal procedures is that there is no protection from action by other creditors while the terms of a workout are being agreed.

The Insolvency Act tries to ensure the survival of the business through the formal options of (i) receivership; (ii) administration; (iii) company voluntary arrangement; and (iv) liquidation. All references are to the Insolvency Act 1986 unless otherwise indicated, and to the Insolvency Rules 1986.

19.1 Receivership

Secured creditors appoint receivers, either under a power contained in the security instrument or by application to the court. Their primary functions are to realise the assets comprised in the security and to apply the

proceeds after deduction of their expenses in discharging the secured loan. They then return surplus proceeds or unrealised assets to the company, which may carry on or go into liquidation.

Where the receiver is appointed in respect of the whole or substantially the whole of the assets of the company, s/he assumes control of the company while negotiating the sale of part or the whole of the business.

Administrative receivers and other receivers

There are two types of receiver, with radically different powers: 'administrative receivers' and other receivers. The term 'receiver' includes a receiver or manager, or a receiver of part only of that property and a receiver only of the income arising from the property or part of it: s.29(1), whereas an administrative receiver means a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holders of a floating charge; or a person who would be such a receiver or manager but for the appointment of some other person as the receiver of part of the company's property: s.29(2). Thus an administrative receiver can only be appointed under a general charge over the whole, or substantially the whole, of the company's assets. Further, the appointment of a receiver of part of the company's property will not prevent the holder of a floating charge over the whole, or substantially the whole, of the company's assets from appointing an administrative receiver.

Where two creditors have charges over the whole, or substantially the whole, of the company's assets and one has appointed an administrative receiver, the other cannot appoint an administrative receiver, since there can only be one administrative receiver at any given time. Where, however, the chargeholder who has not made the appointment ranks in priority over the one who has, s/he can apply to the court to remove the administrative receiver appointed and appoint his/her own nominee: s.45.

Power to appoint an administrative receiver

The power to appoint an administrative receiver must be expressly stated in the security instrument. Two or more persons may be appointed, and the instrument must specify whether they have authority to act individually or jointly: s.231(1) and (2).

An administrative receiver must be a qualified insolvency practitioner: s.230. S/he is deemed to be the agent of the company until it goes into liquidation: s.44(1)(a). Hisher acts are valid notwithstanding any defect in his/her appointment or qualifications: s.232, and persons dealing with him/her in good faith, even if aware of the defect, are fully protected, including directors and officers of the company.

Administrative receivers have the same statutory powers as an administrator, except in so far as they are inconsistent with the terms of the security instrument under which s/he is appointed: s.42(1); but a person dealing

with the administrative receiver in good faith and for value is not concerned to enquire whether s/he is acting within his/her powers: s.42(3). The powers administrative receiver are set out in Schedule 1 of the Act and include most of the powers that were traditionally expressly conferred under floating charges over the whole of the company's undertaking and assets before the Act. The powers set out in the Schedule are to:

(i) take possession of and get in the company's assets and, in order to do so, institute legal proceeding, refer disputes to arbitration, compromise them, or prove for debts owed to the company by an insolvent debtor;
(ii) carry on the company's business;
(iii) borrow money, using the company's assets as security;
(iv) make any payment necessary or incidental to the performance of his/her functions, issue cheques in the name of the company and effect and maintain insurance;
(v) employ agents, solicitors and other professionals to assist him/her;
(vi) sell the assets;
(vii) execute company documents in the company's name and use its seal (Companies Act 1989 provisions enabling the company to dispense with the seal are not available to a receiver);
(viii) grant leases of company's property;
(ix) establish subsidiaries, transfer parts of the company's business to them and sell the subsidiaries;
(x) employ and dismiss employees;
(xi) call up uncalled capital;
(xii) present or defend a petition for winding up; and
(xiii) do all things necessary for the realisation of the property, and anything incidental to the exercise of the receiver's other powers.

Administrative receivers can apply to the court for power to dispose of any secured property of the company: s.43(1), but they must discharge the secured debt from the net proceeds of the sale plus any sum fixed by the court and equalling the amount which would have been realised by a sale in open market by a willing vendor: s.43(3). They can require the continued supply of gas, water, electricity or telecommunications services without paying for services supplied before their appointment: s.233.

The powers of other receivers are governed by the common law and the Law of Property Act 1925: s.109. Their task is to demand and recover the income of the property by any means provided by the law. For that purpose they can use the name of the mortgagor, or the mortgagee, and give effectual receipts. They can exercise any power delegated by the mortgagee under the Act and have limited powers of insurance. Power to sell the mortgaged property only exists if granted in the security instrument. A receiver who is wrongfully appointed is a trespasser against the company's assets and risks heavy damages: *Ford & Carter* v. *Midland Bank* (1979) 129 NLJ 543; but the court has discretionary powers under s.34 to order the appointor to indemnify an invalidly appointed receiver.

Administrative receivers are, however, a particular types of receiver and the general rules applicable to receivers appointed out of court apply to them unless inconsistent with the special statutory rules governing them.

Invalidity of receiver's appointment

The receiver's appointment may be invalid as the result of the invalidity of the security. Charges can be illegal as financial assistance (s.151, Companies Act 1985), or vulnerable as a voidable preference, or under provisions for avoidance of floating charges (ss.239 and 245, Insolvency Act 1986) and are void for non-registration (s.395, Companies Act 1985).

The power to appoint a receiver must arise and be validly exercised. The power of appointment will usually be stated in the debenture and will generally arise on (i) the presentation of a petition for winding up or administration; (ii) calling a meeting to pass, or the passing of, a resolution for winding up; (iii) levying of distress or execution against company assets; (iv) breach of a term of the debenture; (v) cessation of trading; (vi) assets charged in jeopardy; and (vii) the inability of the company to pay its debts under s.123, Insolvency Act 1986, or otherwise.

A demand for payment of outstanding debt and interest may be required before appointment is possible (*Crine* v. *Barclay's Bank*, *Byblos Bank* v. *Al-Khudhainy* [1987] BCLC 32), in which event a demand for 'all sums due' is sufficient: *Bank of Baroda* v. *Panessar* [1986] BCLC 497. The company must be given the opportunity to comply with the demand, and the demand and notice of appointment should not be handed over at the same time. The period allowed to comply is hours and not days: *Cripps (Pharmaceuticals) Ltd* v. *Wickenden* [1973] 1 WLR 944.

Formalities of appointment of receivers

A body corporate cannot act as a receiver: s.30, nor can an undischarged bankrupt: s.31. Legal requirements for appointment will depend upon the security instrument, but appointment under s.109, Law of Property Act 1925 must be in writing, which does not include telex or fax. Receivers must accept appointment before the end of the next working day after they receive it or it will not be valid: s.33. Acceptance is normally in writing but this is not required if there is written confirmation of the acceptance within seven days. Acceptance/confirmation must state time and date of receiving the instrument of appointment and of acceptance (s.33, rule 3.1). Once accepted, the appointment is effective from the date of receiving the instrument of appointment: Rule 3.1(5). After appointment the receiver must within seven days lodge the appropriate form at Companies House: s.405, Companies Act 1985. All invoices, business letters and so on must indicate that a receiver has been appointed: s.39.

Administrative receivers must notify the company of their appointment and advertise it in the *London Gazette* and an appropriate newspaper to

bring it to the notice of creditors: s.46(1), Rule 3.2(1) and (3); and within twenty-eight days notify all the company's creditors of whose addresses they are aware: s.46(1). Administrative receivers must demand a statement of affairs from the officers of the company and those who were officers, employees or involved in the formation of the company within the previous twelve months (s.47) and must prepare a report on (i) the events leading up to their appointment; (ii) what they have done and intend to do about the disposal of the company's property and carrying on its business; (iii) the state of account between the company and the appointing debenture holder; and (iv) the amounts due to preferential creditors and the prospects for other creditors.

The report contains a summary of the statement of affairs, but information seriously prejudicial to the receivership can be excluded: s.48(6). The report and statement of affairs must be lodged at Companies House and an application for limited disclosure must be made where the receiver wants any part of the documents withheld from public inspection: Rule 3.5. Copies must be sent to the debenture holders, any liquidator and all known unsecured creditors; or, for the latter, the receiver may advertise where free copies can be obtained. A meeting of unsecured creditors must be called to consider the report: s.48(2). The creditors may decide to establish a creditors' committee: Rules 3.9–3.15.

Receivers must report to the Secretary of State concerning all those who were directors or shadow directors at the date of the appointment, or within the previous three years: s.7(3), Company Directors Disqualification Act 1986. Directors, promoters, officers and employees have a statutory obligation to supply information to, and co-operate with, an administrative receiver: s.235. They may apply to court for an order for the examination of directors and others: s.236.

Effect of the receivership

The company's undertakings and assets are controlled by a new agent, but ownership and contracts are unaffected. Assets covered by the floating charge under which the receiver is appointed are protected against execution by unsecured creditors, including garnishee and charging orders. But landlords can distrain for rent arrears if the receiver remains in occupation.

Contracts of employment

The appointment of a receiver by the court terminates all contracts of employment between the company and its employees, even though s/he carries on the business of the company, because s/he is not the agent of the company. Appointment out of court does not terminate contracts of employment, which remain in force unless the appointment is incompatible with employees' functions. In *Mack Trucks (Britain) Ltd* [1967] 1 WLR 780, an employee was given notice and instantly re-employed by the receiver on the same terms. The court held that the appointment of the

receiver out of court did not automatically terminate current service contracts, and that the new contract accepted by the employee was offered by the receiver as agent for the company and there was no break in the employees continuity of employment for the purposes of the length of notice. In *Griffiths* v. *Secretary of State for Social Services* [1973] All ER 1184, the appointment of the receiver was not inconsistent with the continued employment of the managing director.

An administrative receiver or receiver appointed under the security instrument is not personally liable in respect of contracts of employment existing at the date of appointment unless s/he 'adopts' them, but no act or omission within fourteen days of his/her appointment constitutes adoption: s.37(1) and (2) and s.44(1)(b) and (2). Receivers used to avoid adopting contracts by issuing a letter to employees stating that, although their services were being retained, this was not to be taken as an adoption. This practice was rejected by the Court of Appeal in *Re Paramount Airways* (No. 3) [1994] BCC 172 and meant that any keeping on of employees after the fourteen-day period would constitute adoption. Since this could have exposed receivers to tremendous liability and discourage attempts to rescue the business, the effect of the case was mitigated by the Insolvency Act 1994, of which s.2 relates to administrative receivers. This provides for the adoption of the contracts but limits liability to qualifying liabilities designed to exclude wages arrears for services provided prior to the adoption of the contract, unpaid pension contributions during this same period, and contractual entitlements to payments in lieu of notice. The section does not apply to non-administrative receivers, who would still be exposed to liability under s.37(1) although protected by the right of indemnity.

Directors remain in office and retain their powers subject to the obligation to give effect to the directions of the receiver in relation to the assets under his/her control: *Gomba Holdings Ltd* v. *Homan* [1986] 1 WLR 1301; *Newhart Developments* v. *Co-op Commercial Bank* [1978] QB 814; and *Watts* v. *Midland Bank* [1986] BCLC 15.

Contracts terminate on the making of a winding-up order against the company, or if the receiver sells the assets or closes the business. If the business is sold in whole or in part as a going concern, contracts are transferred to the purchaser: Transfer of Undertakings (Protection of Employment) Regulations 1981 (see Chapter 12).

Liability on contracts

The receiver is personally liable on contracts entered into by him/her in carrying out his/her functions, unless liability is excluded in the contract, subject to a right of indemnity out of the company: s.37(1)(a) and (b); and s.44(1)(b) and (c); s/he is not generally liable on contracts existing at the time of his/her appointment, but the contracts can be specifically enforced against the receiver: *Freevale Ltd* v. *Metro Store Holdings Ltd* [1984] BCLC 72; and *Kenometrics plc* v. *Modern Engineers of Bristol (Holdings) plc* [1985] BCLC 213.

In *Rother Iron Works Ltd* v. *Canterbury Precision Engineers Ltd* [1974] QB 1, a bank appointed a receiver under a debenture containing a floating charge on the assets and undertaking created by the plaintiffs, who had previously contracted to sell goods to the defendant for £159 while already owing them £124 under a previous contract. The court approved the validity of the defendant's action in setting off the two claims, even though the goods were delivered after the receiver's appointment. The court held that the debenture holder could not be in a better position than the plaintiff. It is different where the set-off claimed does not arise out of the same contract (or is not closely associated with it) and does not arise until after the receivership. In *Business Computers Ltd* v. *Anglo-African Leasing Limited* [1977] 1 WLR 578, the plaintiff company went into receivership on 13 June 1974, being owed £10 587.50p by the defendants in respect of the purchase of two computers. The plaintiffs had also contracted to buy a computer on hire-purchase from the defendants under a third contract. The repudiation of the hire-purchase contract by the receiver was accepted on 8 August. The defendant's claim to set off £32 000 damages under the hire-purchase contract against their liability of £10 587.50p was refused, since the right did not arise until after the receiver's appointment. It is the same in respect of liens. In *George Barker (Transport) Ltd* v. *Eynon* [1974] 1 WLR 462, the plaintiff transport contractors had a general lien under a contract for collecting goods and delivering them to consignees. On 2 September they collected a consignment, when they learned that the bank had appointed a receiver on 31 August. They were entitled to claim their right of lien against the receiver, since the contract survived the receivership and their right had arisen when the contract was concluded, and it was immaterial that it had not been exercisable until after that date. Pre-receivership VAT liability can be set off against a post-receivership VAT refund.

Duties of the receiver

The receiver's primary duty is to realise the assets in the interests of the debenture holder and they are entitled to damage the principal's interest if this is a necessary result of the execution of their primary functions: *Kernohan Estates Ltd* v. *Boyd* [1967] N 127. They have no duty to act on the instructions of their principal: *Meigh* v. *Wickenden* [1942] 2KB 160, and they are not required to disclose information to the principal that might harm the interests of the debenture holder: *Gomba Holdings Limited* v. *Homan* [1986] 1 WLR 1301.

For the receiver's duty to obtain the best possible price for assets to the company and to guarantors, see Chapter 10 (*Cuckmere Brick Co. Ltd* v. *Mutual Finance Ltd* [1971] 2 All ER 633; *Standard Chartered Bank Ltd* v. *Walker* [1982] 1 WLR 1410; *American Express Banking Corp.* v. *Hurley* [1985] 3 All ER 564; and *Downsview Nominees Ltd* v. *First City Corpn Ltd* [1993] AC 295).

Receivers must satisfy preferential creditors in priority to claims under the debenture (s.40), but there is no general duty to ordinary creditors.

Administrative receivers must provide information of the progress of the receivership, particularly to creditors, and they must file annual accounts and provide copies to their appointor and the creditors' committee: Rule 3.32.

Conclusion of receivership

Administrative receivers may resign on giving seven days' notice to the appointor, the company (or its liquidator) and the creditors' committee, except where resigning by arrangement with an administrator: Rule 3.33. They must vacate office on ceasing to be qualified insolvency practitioners, or where an administrator is appointed by the court: s.11(1)(b) and s.45. Their right to remuneration and expenses is protected: s.11(4). They can only be removed by an application to the court: s.45(1). On the death of an administrative receiver, the appointor must notify the Registrar of Companies and others.

The receivership terminates when the receiver has realised all the assets, and paid the preferential creditors, prior chargees and the appointing creditor. Any surplus funds are returned to the company: *Re G. L. Saunders Ltd* [1986] 1WLR 215. Receivers are personally liable to make payments in the following order:

(i) the costs of realising the assets, collecting debts, and claims against third persons;
(ii) all other proper expenses of the receivership, including the receiver's remuneration;
(iii) the costs and expenses of the trustees of the trust deed and their remuneration if the trust deed gives it priority;
(iv) the costs of the debenture-holder's action;
(v) where the loan is secured by a floating charge, the debts and liabilities which would be preferential in a liquidation of the company;
(vi) any prior encumbrances ranking in priority; and
(vii) the loan secured by the security instrument, together with interest.

The administrative receiver must give notice of termination to the company or its liquidator and the creditors' committee: Rule 3.35. S/he must notify the ROC by way of an endorsement on the notice required by s.405(2), Rule 3.35(2).

19.2 Administration Orders

An administration order places the management of a failed or ailing company under the control of an administrator with a view to securing the survival of as much of the company as possible, or ensuring the most orderly and advantageous realisation of its assets. The relevant provisions are in Part II, Insolvency Act 1986.

Petitioning for administration order

The company or its directors or creditors, or all or any of those parties together or separately may petition for the appointment: s.9.(1). In *Re Equiticorp International plc* [1989] BCLC 597, Millett J held that a petition can be presented by directors collectively, or by a single director with the authority of a board resolution, but individual directors cannot petition on their own behalf. This follows a similar formulation with regard to a winding up petition in *Re Instrumentation Electrical Services Ltd* [1988] BCLC 550. Directors are encouraged to apply for an order, since it is a way of avoiding liability for wrongful trading under s.214. The court must dismiss the petition where there is already an administrative receiver appointed unless the creditor who appointed the receiver has consented to the order, or where the security in respect of which the receiver was appointed is challengeable as a transaction at an undervalue or a preference (ss.238–40), or under the provisions for avoiding floating charges: s.245.

The fact that an administrative receiver, where appointed, can veto the appointment of an administrator, and the appointment of an administrative receiver can follow a petition for an administration order (s.10(2)(b)) has led to the anti-administration floating charge. In *Re Croftbell Ltd* [1990] BCLC 844, a debenture holder applied to dismiss a petition for an administration order under s.9(3) on the grounds that an administrative receiver was already in place. The company was a member of a group and its only substantial asset, apart from debts owed to it by its parent, was the share capital of another company which owned a valuable site. The purchase of the share capital had been financed by the debenture holder and another lender (V). The company had executed a fixed charge over its newly-acquired shareholding to V, a debenture in favour of the debenture holder over 'the whole of its undertaking and all its property and assets' and a pledge of its shares to the debenture holder. The company submitted that the debenture did not satisfy the test in *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284; that the pledge of shares and the fact that the company had not traded indicated that it had been formed solely to acquire and hold the shares, which meant that the debenture could not be regarded as a charge on a distinct class of assets which in the ordinary course of time would change. In the alternative, the company held that it should not be allowed to prevent the appointment of an administrator, as it was a mere artifice aimed at circumventing just such a step by the company. Vinelot J held that *Re Yorkshire Woolcombers Association Ltd* was not an exhaustive definition of a floating charge for all purposes. He rejected the company's claim that the debenture had no operation whatsoever, since it created a floating charge over present and future property. The debenture-holder's power to appoint an administrative receiver could not turn on the intentions of the company when the debenture was executed, or the debenture holder's knowledge of these intentions. Intentions may change, and when the power to appoint an

administrative receiver was exercised a company might have considerable assets outside the scope of a fixed charge.

Partial moratorium after petition

Section 10 imposes a moratorium over the company's affairs until the making of the order or the dismissal of the petition. No steps can be taken towards voluntarily winding up the company and, although a petition for compulsory winding up can be presented, no order can be made: s.10(2)(a). The court has tried to minimise the potential damage by restricting advertisement of that petition: *Re A Company (001992)* [1989] BCLC 9; *Re A Company (001448)* [1989] BCLC 715. Rights of creditors to enforce securities or to continue or commence proceedings against the company or its property can only be with the leave of the court, except for the appointment of an administrative receiver: s.10(2)(b).

There is no power to appoint a provisional administrator to protect the assets between the petition and the order, but the period is short and the court can place controls on the activities of directors under ss.9(4) and (5): *Re Gallidoro Trawlers Ltd* [1991] BCLC 411. The moratorium is intended to prevent creditors undermining the purpose of the administration procedure by enforcing their rights on becoming aware of the petition. The purpose was stated by the Lord Advocate in the House of Lords on 23 October 1985: 'The object of this part of the Bill is to impose a moratorium, to suspend creditors' remedies while not affecting their substantive rights.' Generally it is the secured rather than the unsecured creditors who will be prejudiced, and the reported applications for leave to continue or take proceedings against a company in administration have mainly been by secured creditors (see below, 'Effect of the order').

Factors affecting granting order

Before it makes an administration order the court must be satisfied that (a) the company is, or is likely to become, unable to pay its debts; and (b) the administration order is likely to achieve one or more of the following purposes:

(i) survival of the company and the whole or any part of its undertaking as a going concern;
(ii) a scheme of arrangement under s.425, Companies Act 1985;
(iii) a voluntary arrangement under Part I; and
(iv) a more advantageous realisation of the company's assets than on a winding up.

An administration order cannot be made after a company has gone into liquidation, or where it is an insurance company or a recognised bank: s.8(4).

The definition of 'likely' in s.8(1)(b) by Hoffmann J that there is a reasonable prospect that the order would achieve one or more of the statutory

purposes (*Re Harris Simons Construction Ltd* [1989] 1 WLR 368) is now universally accepted: *Re SCL Building Services Ltd* (1989) 5 BCC 746; and *Re Chelmsford City FC* (No. 2) [1991] BCC 133. The Insolvency Rules (Rule 2.7) envisage a minimum of five days between petition and the hearing. This has been shortened to the extent of granting the order before the presentation of the petition: *Re Cavco Floors Ltd* [1990] BCLC 940; and *Re Chancery plc* [1991] BCC 171.

Effect of the order

Once an order is made, the moratorium under s.11 operates until it is discharged. Any winding-up petition against the company is dismissed, any administrative receiver must vacate his/her office and any other receiver at the request of the administrator. No resolution can be passed or order made for the company's winding-up and no administrative receiver appointed. In addition, no other steps can be taken to enforce any security over the company's property, or to repossess goods under any hire-purchase agreement; and 'no other proceedings and no execution or other legal process' commenced or continued, and no distress levied against the company or its property except with the administrator's consent or the leave of the court; s.11(3).

In *Bristol Airport* v. *Powdrill* [1990] BCLC 585, an attempt to enforce a possessory lien against an aircraft owned by a company in administration and in *Re Sabre International Products Ltd* [1991] BCLC 479 an attempt to enforce a lien for non-payment of a company's account were 'other steps' for the purposes of s.11(3) and necessitated an application to the court. However, in *Re Barrow Borough Transport Ltd* [1989] 2 WLR 858, an attempt to obtain the late registration of a charge did not require a separate application under s.11. And in *Air Ecosse* Ltd v. CAA (1987) 3 BCC 492, the commencement of proceedings to reallocate routes under an air operator's licence to another carrier was held to be a mere administrative process and not within 'other proceedings', even though damaging to efforts to sell the company.

Every invoice, order for goods or business letter issued must contain the administrator's name and a statement that the affairs, business and property of the company are being managed by the administrator. The administrator, the company and its officers are liable to a fine on default: s.12. Unregistered charges are void against the administrator.

The company's officers must submit a statement of affairs to the administrator within twenty-one days of being required to do so, or such further time as the court may allow: s.22, and the administrator must within three months of his/her appointment (or such further time as the court may allow) send to the Registrar and all creditors a statement of his/her proposals and lay them before a meeting of creditors summoned for the purpose on not less than fourteen days' notice: s.23(1). The period of three months may be shorter if the proposals are drawn up quickly. The period can also be extended by the court to cover unforeseen

contingencies: *Re Newport County AFC* [1987] BCLC 582. This statement must be sent to all members of the company, or the administrator must publish a notice stating an address to which the members should write for copies to be sent to them free of charge. In the meantime the administrator must take the company's property into his/her custody and control and, with the court's approval, manage the company's affairs. Administrators may be reluctant to exercise their full powers until the proposals are accepted, but they can apply to the court for directions: s.14(3). Problems have concerned a sale of assets prior to the meeting. For judicial guidance compare *Re Consumer and Industrial Press Ltd* (No. 2) (1988) 4 BCC 72; and *Re N. S. Distribution Ltd* [1990] BCLC 169.

If the creditors' meeting accepts the administrator's proposals (by a simple majority in value of those present and voting) – with or without modification – the administrator can then act in accordance with them and no longer needs the court's approval. Dissatisfied creditors or members can apply to the court within twenty-eight days. The court has no power, however, to upset a voluntary arrangement or scheme of arrangement. The meeting may establish a 'creditors' committee' to exercise the functions conferred on it by or under the Act, and it can give the administrator seven days' notice to appear before it to provide information relating to the execution of his/her functions: s.26. An administrator has no power to disregard current company contracts (*Astor Chemicals* v. *Synthetic Technology* [1990] BCC 97) but, exceptionally, such a power may be conferred by the courts: *Re P & C and R & T (Stockport) Ltd* [1991] BCC 98.

If the proposals are not approved and no modified version can be agreed upon, the court has a wide range of discretionary powers to enable it to make the most suitable arrangements following the collapse of the proposals and the discharge of the administration order.

Powers of the administrator

Administrators can do 'all such things as may be necessary for the management of the affairs, business and property of the company': s.14(1). Schedule 1 to the Act sets out a comprehensive but non-exhaustive list of powers expressly conferred on the administrator, (see p. 552 above), but administrators additionally have powers to remove directors, to appoint new directors, and to call shareholders' and creditors' meetings: s.14 (2)(a) and (b). Directors may only exercise powers interfering with the administrator's powers with the administrator's consent: s.14(4). Directors retain their statutory duties: the requirement to make annual returns. The administrator's powers cannot be restricted by the Memorandum or Articles: s.14(4). Administrators are the company's agents: s.14(5), and persons dealing with them in good faith and for value are not concerned to inquire whether administrators are acting within their powers: s.14(6).

Administrators can dispose of assets subject to a floating charge, but the charge holder retains priority over the proceeds of sale: s.15(1),

(3) and (4). They may also apply to the court to dispose of assets subject to other charges (including fixed charges, hire-purchase, conditional sale agreements, chattel leasing agreements and retention of title agreements): s.15(2), and the court determines the net value that would be realised on a sale in the open market by a willing vendor. The administrator then pays the net proceeds, together with such amount as is needed to make up any deficiency as regards this value, towards discharging the sums secured or payable under the hire-purchase or retention of title agreements: s.15(5). Neither receivers nor liquidators have this power. For guidance on prevailing judicial attitudes, see *Re ARV Aviation Ltd* [1989] BCLC 664. Administrators wishing to revise their plans should return to the creditors (s.25) but the court can give permission in emergencies: *Re Smallman Construction Ltd* (1988) 4 BCC 784.

Administrators do not incur personal liability on any contracts made unless expressly agreed. On an administrator relinquishing his/her position, any outstanding liabilities under those contracts or under contracts of employment adopted by him/her are charged on the property of the company in priority to any floating charge: s.19(5). The same applies in respect of his/her remuneration and expenses: s.19(4). In *Paramount Airways* (No. 3) [1994] BCC 172, the Court of Appeal held that administrators could by implication adopt contracts of employment of employees of an insolvent company, which would result in the employees' entitlements having priority over the administrator's claim for remuneration and expenses as well as over any floating charge: s.19(5). The result of the case was the swift passage of the Insolvency Act 1994, s.1 of which recognises the possibility of implied adoption of employee contracts but reduces the liability in the same way as for administrative receivers (see p. 554 above). Administrators, like liquidators, can set aside transactions between the company and its creditors (ss.238–46, see below) and, in common with liquidators and administrative receivers, can require supplies of utilities to be maintained and undertake investigations into events prior to the insolvency regime and to recover the company's books, papers and other property.

Regulating conduct of administrators

The conduct of administrators is regulated in a number of ways.

Unfair prejudice

Creditors or members may petition to the court on the grounds (a) that the company's affairs, business and property are being, or have been, managed by the administrator in a manner that is unfairly prejudicial to the interests of its creditors or members generally, or of some part of its creditors or members (including at least him/herself); or (b) that any actual or proposed act or omission of the administrator is or would be so prejudicial (s.27): *Re Charnley Davies Ltd* [1990] BCC 605 (see s.459, Companies Act 1985; and Chapter 8 in this volume).

Duty of administrator to call creditors' meetings

Administrators can be requested to summon a meeting of creditors by one-tenth in value of company's creditors, or by the court: s.17(3)(a) and (b).

Duty of administrator to have order discharged

Administrators may apply for the order to be discharged or varied: s.18(1), but must do so where the purposes of the order have been achieved or are incapable of achievement, or where required to do so by the creditors' meeting: s.18(2)(a) and (b).

Misfeasance proceedings

Administrators are subject to misfeasance proceedings under s.212(1)(b) (see p. 576), but can seek relief under s.727, Companies Act 1985. *Re Home Treat Ltd* [1991] BCC 165. Release under s.20 does not prevent proceedings under s.212: *Re Sheridan Securities Ltd* (1988) 4 BCC 200.

Discharge of the administration order

Administrators can apply at any time for the order to be discharged, and must do so if required to do so by a creditors' meeting or where they are of the opinion that the aims of the order have been or cannot be achieved. Where the administrator's proposal relates to a company voluntary arrangement (CVA), s/he can become the 'supervisor' of the arrangement when it has been approved.

19.3 Company Voluntary Arrangements (CVAs)

CVAs are regulated by ss.1–7 and reflect the Cork Committee view that the complexity and expense of a s.425, Companies Act 1985 reconstruction should not prevent companies from instigating simple moratoriums or compositions. The Committee reported: 'In our view a voluntary arrangement … is only likely to be used, first, where for some reason it is not appropriate to appoint an Administrator and, secondly, where the scheme is a simple one involving a composition or moratorium or both for the general body of creditors which can be formulated and presented speedily … we are convinced that the facility to promote such arrangements without the obligation to go to court will prove of value to small companies urgently seeking a straightforward composition or moratorium' (para. 430).

The procedure can be used before or after the commencement of proceedings for an administration order or winding-up order, when the administrator, the liquidator or the board of directors intend making a proposal 'to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs'. It does not extend to

members and is not intended to affect their rights. Neither creditors nor members may propose a CVA; where the proposal is made by the directors there is no requirement of insolvency.

The proposal must provide for a supervisor of the scheme, known as 'the nominee', who must be a qualified insolvency practitioner. The proposal must provide a short explanation as to why, in the proposer's opinion, a CVA is desirable (IR86, Rule 1.3). Where the nominee is another insolvency practitioner (that is, not the liquidator or administrator of the company) s/he must, within twenty-eight days, submit a report to the court as to whether, in his/her opinion, the proposal should be submitted to meetings of the company and creditors: s.2. Where the nominee is the liquidator or administrator of the company, s/he summons meetings of the company and creditors as such time, date and place as s/he thinks fit: s.3(2).

If both meetings accept the proposals – in whole or as modified – then they are binding on all notified creditors and on the company: s.4. There is no need for class meetings of members or creditors and no formal approval of the court is required; the chairpersons of the meetings simply report the result of the meeting to the court: s.4(6). No proposal that affects the rights of secured or preferential creditors can be approved without their consent: s.4(3) and (4). The creditors' meeting requires acceptance by a majority representing 75 per cent in value of the creditors present in person or by proxy, and voting on the resolution: Rule 1.19. The members' meeting accepts the proposal by simple majority (Rule 1.20) unless the articles determine the voting procedure: Rule 1.18.

On approval by both members' and creditors' meetings, the CVA takes effect as if made by the company at the creditors' meeting, s.5(2)(a), and binds dissenting creditors and all creditors with notice of and entitled to vote at the creditors' meeting: s.5(2)(b). An application can be made to the court by those entitled to vote at either meeting, the nominee of any person who has replaced him/her, and the liquidator or administrator for the revocation or suspension of the approvals given by the meetings or for the summoning of further meetings to consider any revised proposal or reconsideration of the original proposal on the grounds:

(a) that a voluntary arrangement approved by the meetings unfairly prejudices the interests of a creditor, member or contributory of the company; or
(b) that there has been some material irregularity at or in relation to either of the meetings: s.6.

Once the arrangement is approved, the court can stay all winding-up proceedings, discharge an administration order and give directions to facilitate the composition or scheme: s.7. The person carrying out the functions conferred by that approval on the nominee is known as 'the supervisor' of the voluntary arrangement: s.7(2). The supervisor has a duty to submit accounts to the court, Registrar of Companies and all

affected parties at least every twelve months or, if there is no trading, a progress report: Rule 1.26. On completion of the CVA, the supervisor must send notice to all creditors and members that it has been fully implemented, together with a financial report, with copies to the Registrar of Companies and the court: rule 1.29.

Defects of CVAs

The most serious disadvantages are the absence of any moratorium, and no protection against creditors exercising their 'unilateral' remedies. Consequently, by the time of the meeting, there may be very little of the business to save since, on receipt of the proposals, creditors entitled to do so will recover goods held subject to reservation of title, repossess plant on leasing or hire-purchase terms, disconnect telephone, electricity, gas or water services, and send in the bailiffs or sheriffs.

In addition, since supervisors do not have the investigative powers or power to reopen transactions enjoyed in the past by administrative receivers, administrators and liquidators, creditors distrust the motives of directors who propose a CVA. The solution is to petition for an administration order triggering the moratorium under s.10 while proposals are formulated. Furthermore, any alleged misconduct by officers can be investigated and the disqualification of the directors is possible.

Further difficulties involve persuading directors and others to use the system, making the procedure cost-effective for relatively small cases, and engendering a 'rescue culture' in society as a whole, especially the courts. Suggested reforms include (i) a protection order on the lines of an interim order in individual voluntary arrangements; (ii) clarification of the tax status of 'debt forgiveness' schemes for both creditors and debtors; (iii) VAT bad debt relief immediately available on any part of an unpaid debt; and (iv) greater incentives for directors to seek help.

The existing provisions under s.425, Companies Act, which are expensive and appropriate only for major reconstructions, exist alongside this new mechanism but are rarely used.

19.4 Company Winding Up

There are two methods for winding up a company in s.73: a voluntary winding up, and winding up by the court.

Voluntary winding up

This is initiated by a resolution of the company in general meeting and there are, principally, two resolutions possible: (i) a special resolution; and (ii) an extraordinary resolution to the effect that the company cannot by reason of its liabilities continue in business and that it is advisable to wind up: s.84.

Members' and creditors' voluntary winding up

A members' voluntary winding up is where the directors have made a statutory declaration of solvency in accordance with s.89, under which they declare – supported by a statement of company's assets and liabilities as at the latest practicable date – that the company will be able to pay its debts in full within a maximum period of twelve months from the commencement of the winding up: s.90. This declaration must be made either within the five weeks immediately preceding the resolution, or on the same day as (but before) the passing of the resolution. If the resolution is passed, then the Declaration must be registered within fifteen days of the resolution. Directors are liable to fines where such declarations are made without reasonable grounds.

The resolution must be advertised in the *London Gazette* within fourteen days: s.85. The commencement of the winding-up dates from the time of the resolution: s.86; and the effect on the company is that, from then on, the company shall cease to carry on its business except so far as may be required for a beneficial winding up: s.87.

Progress of a members' voluntary winding up

The company in general meeting appoints one or more liquidators: s.91. If the liquidation extends beyond a year, the liquidator must call company meetings at the end of each year from the commencement of the winding up and present interim reports to the meeting: s.93. When the company's affairs are wound up, the liquidator calls a final meeting of the company and presents a final report as to the winding up: s.94(1). Within one week of the meeting, s/he sends to the Registrar a copy of the account and a return as to the holding of the meeting: s.94(3). The company is automatically dissolved three months after the registration of the return of the final meeting: s.201.

If the liquidator decides that the company is insolvent, s/he must call a meeting of the creditors within twenty-eight days of forming that opinion, giving the creditors seven days' notice: s.95. The meeting must be advertised in the *London Gazette* and in two newspapers circulating in the relevant locality. The liquidator presides over the creditors' meeting, submits a statement of affairs of the company, and the liquidation proceeds as a creditors' winding up.

Progress of creditors' voluntary winding up

There is no declaration of solvency, and the company must call a creditors' meeting as well as a general meeting. The creditors' meeting must be summoned for a day, not later than the fourteenth day after the date the resolution to wind up is passed. Creditors must be given seven days' notice and the meeting must be advertised in the *London Gazette* and in two newspapers circulating in the relevant locality. The notice must state either the name and address of an insolvency practitioner who, before the meeting, will furnish free of charge such information as they might

reasonably require, or a place in the relevant locality where, on the two business days before the meeting, a list of names and addresses of creditors is available for inspection free of charge: s.98.

At the meeting, the directors must lay before the meeting a statement of the affairs of the company and appoint a director to preside: s.99. At their meetings, members and creditors may nominate a liquidator. The liquidator will be the creditors' nominee, but where the meetings have nominated different persons, any director, member or creditor may apply to the court within seven days for the members' nominee to be liquidator instead of or jointly with the creditors' nominee, or for the appointment of some other person: s.100.

The creditors may appoint a liquidation committee of not more than five persons, in which case the members may appoint not more than five representatives to the committee. The liquidation committee works with the liquidator and sanctions exercise of power by the liquidator where required: s.101. On the liquidator's appointment, all the powers of the directors cease, except so far as the liquidation committee or the creditors authorise them: s.103.

The winding up procedure continues exactly as for the voluntary members' winding up except for the fact that annual meetings and final meetings of creditors as well as members must be called: ss.105 and 106. The dissolution is in the same way: s.201.

Winding up by the court

Jurisdiction for the winding up of companies is given to the county court where the paid up share capital does not exceed £120 000, and otherwise to the High Court (Chancery Division): s.117. The process begins with the presentation of a petition by one of a group of recognised persons on one of the statutory grounds.

Grounds for winding up

The grounds for winding up a company are contained in s.122(1) (a)–(g):

(a) the company has by special resolution so resolved;
(b) the company was a public company incorporated as such and it has not been issued with a certificate under s.117, Companies Act 1985 and more than a year has elapsed;
(c) it is an Old Public Company;
(d) the company does not commence business within a year from incorporation or suspends business for a whole year;
(e) the number of members is reduced below two (Note: this does not apply to a private company which may have one member);
(f) the company is unable to pay its debts; and
(g) it is just and equitable that the company should be wound up.

In addition, the Secretary of State may present a petition on the grounds of public interest (s.124A) arising from (a) a company investigation under

Part XIV, Companies Act 1985; or (b) a report or information obtained under the Financial Services Act 1986; information obtained under s.2, Criminal Justice Act 1987; or any information obtained under s.83, Companies Act 1985 (powers for assisting overseas regulatory authorities), for the company to be wound up if the court thinks it just and equitable.

Inability to pay debts is defined in s.123:

(i) if a creditor for a sum of £750 serves at the registered office of the company a written demand for payment and the company has for three weeks neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor: s.123(1)(a); or
(ii) if execution or other process issued on a judgment, decree or order of any court in favour of a creditor is returned unsatisfied in whole or in part: s.123(1)(b); or
(iii) if the company is unable to pay its debts as they fall due: s.123(1)(e); or
(iv) if the value of the company's assets is less than the amount of its liabilities, including contingent and prospective liabilities: s.123(2).

The serving of a statutory demand under s.123(1)(a) has long been recognised as a useful procedure whereby an unpaid creditor can place the company in a predicament where it must either settle the debt in question or be deemed unable to pay its debts and be wound up by the court on a creditor's petition. The disadvantage is the three-week delay. Increasingly, creditors favour the more direct approach of s.123(1)(e) and present a petition stating that the company is indebted to them for an amount exceeding the statutory minimum required for a statutory demand; that the debtor has given no notification that the amount is disputed; and that the company is unable to pay its debts and should be wound up. This approach was supported by the the Court of Appeal in *Taylor's Industrial Flooring Ltd* v. *M & H Plant Hire (Manchester) Ltd* [1990] BCLC 216.

Persons entitled to petition

A winding-up petition can be presented by the company, the directors, the Secretary of State, the DTI, the receiver, contributory(ories) or creditor(s): s.124. The term 'contributory', as defined in s.79, appears to limit a petition to members of a company who are required to contribute to the winding up of the company by holding partly-paid shares. This is not the case, and the word must be simply understood to include members and past members of the company. Members' rights to petition are limited since, apart from petitioning under s.122(1)(e), they can only petition in respect of shares held and registered in their name which (i) were originally allotted to them; or (ii) have been held by them for at least six months out of the previous eighteen; or (iii) have devolved on them through the death of a former holder: s.124(2).

In addition and in spite of s.125(1) which states that 'the court shall not refuse to make a winding up order on the ground only that the company's assets have been mortgaged to an amount equal to or in excess of those assets, or that the company has no assets', petitions will only be allowed where the petitioner demonstrates that s/he has a financial interest in the winding up: *Re Chesterfield Catering Co. Ltd* [1977] Ch 373. The court will also reject a petition on the just and equitable grounds if of the opinion that another remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up: s.125(2) (see Chapter 8).

Creditors can only petition where their claim is for £750 and more, although joint petitions are possible. The debt must be undisputed and enforceable by an action in debt, although a petition can be presented, even if the actual amount of the debt is disputed, as long as there is an undisputed debt above the current statutory minimum: *Re Tweeds Garage* [1962] Ch 406. The court will not always grant a petition where there are creditors of more importance in value who do not support the petition.

Effect of winding-up order

Commencement of the winding up is from the date of the presentation of the petition: s.129(2) (unless the company is already in voluntary winding up). This is important, since 'any disposition of the company's property, and any transfer of its shares, or alteration in the status of the members, made after the commencement of the winding up is, unless the court otherwise orders, void': s.127. As a result of this, banks may cease to operate the company's account on the presentation of a petition. If they continue to operate an account, they may be forced to refund any money paid out to the liquidator. In *Re Gray's Inn Construction Co. Ltd* [1980] 1 WLR 711, the Court of Appeal held that both payments into and out of an account in debit constituted dispositions of property for the purposes of s.127, although the bank's liability to refund the sum paid out was postponed to claims against those receiving payment. In *Re Barn Crown Ltd* [1994] 4 All ER 42, the court held that payments into an account in credit did not constitute a disposition of property and was not caught by s.127.

Appointment of a liquidator

The court may at any time from the presentation of the petition appoint a provisional liquidator to carry out the functions conferred on him/her by the court: s.135. In *Re Brackland Magazines Ltd and Others* [1994] 1 BCLC 190, the court ordered that directors who had contested the appointment of a provisional liquidator should personally bear the legal costs incurred. The official receiver becomes the liquidator of the company on the making of a winding-up order and continues in office until another person is appointed: s.136(2). S/he is also the liquidator during any vacancy:

s.136(3). When s/he is liquidator of the company, the official receiver may summon separate meetings of contributories and creditors for the purpose of choosing a person to be liquidator in his/her place: s.136(4). This is discretionary and s/he has up to twelve weeks to decide whether to call the meeting: s.136(5). It is possible for one or more creditors, representing a quarter of the company's creditors, to formally request that the official receiver should convene the meeting. Where the meetings are convened, s.139 provides for the appointee of the creditors to be the liquidator subject to rights of appeal as above under creditors' voluntary winding up.

The official receiver can at any time apply to the Secretary of State to appoint a person in his/her place and if no person is appointed under the meeting in s.136(4) it is his/her duty to decide whether to refer the need for an appointment to the Secretary of State. Where the winding-up order is made immediately upon the discharge of an administration order, the court may appoint the administrator as liquidator: s.140. Where the order is made when there is a supervisor of a voluntary arrangement, the court may appoint the supervisor. In neither case will the official receiver become liquidator.

Where creditors and contributories have met to decide on the appointment of a liquidator, they may also establish a liquidation committee.

The powers of the liquidator

These are defined in s.167. The liquidator has the right to exercise any of the powers in Parts I and II of Schedule 4 with the sanction of the court or the liquidation committee (payment of debts, compromise of claims and so on; institution and defence of proceedings; carrying on of business of the company); and, with or without that sanction, to exercise any of the powers in Part III of that Schedule.

The conclusion of the winding up

The liquidator calls a final creditors' meeting, which receives the final report and decides whether the liquidator should be released under s.174. The Registrar registers the return of the meeting and notice of vacation of office, and after three months the company is dissolved: s.205.

Proof of debts

Creditors establish their right to share in the assets of the company by proving their debts against the company with the liquidator. All debts can be proved, liquidated and unliquidated, certain and uncertain, contingent present and future (Insolvency Rules 1986, SI 1986, No. 1925, Rule 12.3) with the exception of certain non-provable debts: Rule 12.3(2), (2A) and (3). The liquidator has the task of assessing the value of any debt that is uncertain, and the Insolvency Rules provide for an appeal by the creditor.

Priority of debts

The liquidator ranks the debts in order of priority, and the assets of the company are used to satisfy these debts in this order. All debts within each category abate equally if the assets are insufficient. The priority ranking is:

(i) secured creditors with fixed charges;
(ii) expenses of the liquidation, including the liquidator's remuneration;
(iii) preferential creditors as defined by the Insolvency Act;
(iv) secured creditors secured by a floating charge over assets;
(v) ordinary unsecured creditors;
(vi) deferred creditors; and
(vii) return of capital to shareholders.

All debts in each category rank *pari passu* (on equal footing), except for deferred debts. The most important category is preferential debts, which are given priority under s.175, Insolvency Act 1986. They are categorised by reference to s.386 and Schedule 6, and are the same as for personal insolvency (see Chapter 18, p. 548).

Assets of the company

All the assets of the company belonging to the company at the commencement of the liquidation are available for the creditors. This includes payments from contributories regarding payments due in respect of partly-paid shares.

Unavailable assets

Not all the property will be available for distribution: the following are excluded.

Property held by the company as agent, trustee or bailee for another Property which the company holds for the benefit of another person does not pass to the liquidator. In *Re Kayford Ltd* [1975] 1 All ER 604, the court held that money sent in by customers of a mail-order company and paid into a special account pending delivery of the goods ordered was held on trust to be returned to the customers.

Dispositions after winding up petition: s.127, IA86 In respect of compulsory winding up by the court, the date of the commencement is the date of the presentation of the petition rather than the date on which the winding-up order was made: s.129. In addition, all dispositions of property between these dates will be void unless authorised by the court: s.127. Thus the liquidator may recover property already disposed of, or make banks and so on liable to refund money they have wrongfully paid out

during the period: *Re Gray's Inn Construction Co. Ltd* [1980] 1 WLR 711; and *Re Western Welsh International System Buildings Ltd* (1988) 4 BCC 449). The completion of an assignment of a lease within the period is not within the scope of the section if in accordance with an unconditional contract made prior to the presentation of the petition: *Re French's Wine Bar Ltd* (1987) 3 BCC 173.

Retention of title Property in the possession of a company under a contract containing a retention of title clause to the supplier pending full settlement will not pass to the liquidator if correctly stored and marked to indicate that it belongs to the supplier. In the extreme cases where such goods are sold by the buyer as agent for the seller, and the clause extends into the proceeds of sale which must be held in a separate account, these sums of money will not pass either (see Chapter 10).

Property disclaimed by the liquidator The liquidator can disclaim onerous property which is defined to include (i) any unprofitable contract; and (ii) any other property that is unsaleable or not readily saleable, or is such that it may give rise to a liability to pay money or perform any other onerous act. The notice of disclaimer terminates the rights, interests and liabilities of the company from that date. A person suffering loss as a result of the disclaimer must prove as a creditor in the liquidation in respect of the loss. There are special rules relating to the disclaimer of leases. Disclaimer can be done at any time by the liquidator, but persons interested in the property can cut the period during which the right may be exercised by serving written notice on the liquidator requiring him/her to elect to disclaim or not. In such case, the period of time is then reduced to twenty-eight days from the notice or such longer period as the court may allow: ss.178–82. In *Hindcastle* v. *Barbara Attenborough Associates Ltd* [1996] 2 WLR 262, the House of Lords held that the effect of disclaimer of a lease releases the company from liability but does not affect the rights and liabilities of any other person. Therefore, a director who had guaranteed payment of the rent remained liable under his guarantee. This reverses the decision in *Stacey* v. *Hill* [1901] 1 KB 660.

Avoidance of transactions prior to the winding up

The liquidator may increase the assets available for distribution by avoiding transactions entered into prior to the winding up.

Transactions at an undervalue

The administrator/liquidator can request the court to set aside transactions at an undervalue during the relevant time before the onset of insolvency, namely two years, or a transaction between the presentation of a petition for an administration order and the making of the order. The company must have been unable to pay its debts for the purposes of s.123

at the time, but in the case of transactions to connected persons, this is presumed: s.240(2). The onset of insolvency is the same as for voidable preferences. In *Re M. C. Bacon Ltd* [1990] BCLC 324 (for facts see next section), the court held that the creation of a charge was outside the scope of s.238 as it was not a gift, nor did it deplete the company's assets.

A company enters into such a transaction if:

(a) the company makes a gift to that person, or enters into a transaction on terms whereby the company receives no consideration; or
(b) the company enters into a transaction where the consideration is significantly less than the value of the consideration supplied by the company.

The court will not make an order if satisfied that the company entered into the transaction in good faith and where there were reasonable grounds for believing that it would benefit the company. There is no territorial limit on s.238 proceedings. In *Re Paramount Airways Ltd* [1991] 3 WLR 318, the administrator was able to claim in respect of funds paid into a bank account in Jersey.

The nature of the order made is listed in s.241, which protects purchasers of the property in good faith and for value: s.241(2) and (2A) as amended by the Insolvency Act (No. 2) 1994.

Voidable preferences

The administrator/liquidator can set aside payments and charges which have been made to put a creditor or guarantor or surety of a creditor into a better position in the event of the company going into an insolvent liquidation. Such transactions and so on must have taken place within the relevant time prior to the onset of insolvency, which is six months in respect of outsiders: s.240(1)(b), and two years in respect of persons connected with the company: s.240(1)(a), and the company must have been unable to pay its debts within the meaning of s.123. The section also catches transactions made between the presentation of a petition for an administration order and the making of the order: s.240(1)(c). The preferences will only be voidable where the company was motivated by a desire to confer a benefit on the person preferred. The onset of insolvency is the date of the presentation of a petition for an administration order where the section applies as a result of an administration order or where a company goes into liquidation immediately upon the discharge of an administration order or the date of the commencement of the winding up where the company goes into liquidation at another time. In *Re M. C. Bacon Ltd* [1990] BCLC 324, the High Court held that the new section invalidated the decisions made under the earlier statutory provisions on fraudulent preferences. In this case, the company had an unsecured overdraft limit of £300 000 with its bank. In 1986 it lost its major customer and two of the directors stood down from active management; at this stage the bank indicated that some form of security might be required. In May

1987 a report by the bank concluded that the company was technically insolvent, but that it could probably trade out of this. The bank demanded fixed and floating charges over the company's assets as a condition of continuing to operate the bank account. The charge was created and registered. In September 1987 the company went into liquidation and the liquidator sought to have the bank's charge set aside as a transaction at an undervalue or as a voidable preference. The court drew attention to the distinction between 'intention' and 'desire', and concluded that the company did not necessarily desire that which it intended to achieve. It accordingly held that the charge was not voidable. Thus, where the company is forced into a position of granting a preference owing to pressure from the creditor, it will not be avoidable. In the case of a connected person, defined in s.249, an intention to advantage the person is presumed: s.239(6), *Re DKG Contractors Ltd* [1990] BCC 903; and *Re Beacon Leisure Ltd* [1991] BCC 213.

Possible court orders are retransfer of property, release or discharge of security, repayments to administrator or liquidator, revival of guarantees and so on: s.241. There is special protection for bona fide third party purchasers in good faith and for value, s.241(2) and (2A), as amended by the Insolvency Act (No. 2) 1994. Proceeds of a successful claim are held on trust for the unsecured creditors: *Re Yagerphone Ltd* [1935] 1 Ch 392. In *Re M. C. Bacon Ltd* (No. 2) [1990] 3 WLR 646, the liquidators were unable to claim the costs of the abortive action against the bank as part of the expenses of the liquidation.

Avoidance of floating charges

Floating charges created in favour of outsiders within one year before the onset of insolvency are invalid under s.245(3)(a) unless the chargee can prove that the company was not unable to pay its debts at that time or became so as a consequence: s.245(4). In the case of connected persons, the period is extended to two years under s.245(3)(a) and is not conditional upon the company being unable to pay its debts at the time of the creation of the charge. The onset of insolvency is the date of the presentation of a petition in respect of which an administration order is made, or the date of the commencement of the winding up: s.245(5).

There is an exception as regards the aggregate of:

(a) the value of money paid, or goods or services supplied to the company at the same time as, or after, the creation of the charge;
(b) the value of the discharge or reduction, at the same time as or after, the creation of the charge of any debt of the company; and
(c) any interest payable in pursuance of (a) or (b): s.245(2)(a).

The exception in respect of cash, goods and services paid or supplied to the company at the same time as, or after, the creation of the charge is important; since it means that contemporaneous advances or supplies of goods and services can at least partially, if not entirely, validate the floating charge. Where the consideration consists of goods or services, the

security will only be valid to the extent that the charge for that supply was reasonable: s.245(6).

In respect of the earlier equivalent provision, the proviso related to cash paid to the company at the same time and in consideration of the charge, and the court did not take this too literally. In *Re F & E Stanton Ltd* [1929] 1 Ch 180, a payment made five days before the formalities creating the floating charge were completed fell within the proviso even though the company went into liquidation five days after the charge was created. However, in *Re Shoe Lace Ltd* [1992] BCLC 636, the court decided that the degree of contemporaneity depended upon the ordinary meaning of the words used. On that basis, although loans had been made between April and early July in consideration of the proposed creation of a debenture, they could not be said to have been made at the same time as the creation of the debenture, which was finally executed on 24 July 1990. The floating charge was therefore invalid. This decision was not followed in *Re Fairway Magazines Ltd* [1993] BCLC 643, where the judge held that a charge created in favour of the applicant was created at the same time as the payment of £15 000 even though the payment was made on 28 August and the charge was executed on 27 September. However, the Court of Appeal endorsed the High Court decision in *Re Shoelace* on appeal under the name *Power* v. *Sharp Investments Ltd* [1994] 1 BCLC 111. The Court of Appeal held that, where an advance preceded the formal execution of a debenture, the payment will not be regarded as being made at the same time as the creation of the charge unless the interval is so short that it can be regarded as minimal. The advantage of this for banks and suppliers under the terms of a current account can be seen in *Re Yeovil Glove Co. Ltd* [1965] Ch 148, where the bank's act in meeting company cheques totalling some £110 000 subsequent to the creation of the debenture was held to be new cash even though the charge was created in respect of an existing debt with no obligation on the bank to make further advances and the overdraft remained virtually unchanged. This shows the advantageous operation of the rule in *Clayton's Case* (1816) 1 Mer. 572, which provides that credits to a current account discharge debts in the order in which they were incurred in the absence of specific appropriation.

A loan by an unsecured creditor under a floating charge on the understanding that the loan will be for immediate settlement of his/her existing debt does not fall within the exception: *Re Destone Fabrics Ltd* [1941] Ch 319. If a company redeems a charge prior to liquidation or administration, the liquidator or administrator cannot require the chargeholder to repay the money received, although it may be recoverable as a preference: *Mace Builders (Glasgow) Ltd* v. *Lunn* [1987] Ch 191.

Extortionate credit transactions

The liquidator may apply to the court in respect of extortionate credit transactions within the three years prior to the commencement of the liquidation. There is a presumption that the transaction is extortionate.

The court can (i) set aside the whole or part of the transaction; (ii) vary the terms of the transaction or terms under which an security is held relating to the transaction; (iii) require any person to refund sums paid by the company; (iv) require the surrender of any security; or (v) provide for accounts to be taken between any persons.

Transactions defrauding creditors

These provisions update the general avoidance mechanism formerly contained in s.172, Law of Property Act 1925, which was held to relate to a company in *Re Shilena Hosiery Ltd* [1980] Ch 219. The key factor is a transaction at an undervalue, which must be in order to put assets beyond the reach of creditors or prejudice their interests: s.423(3). Acting on legal advice will not necessarily remove a transaction from the scope of the section: *Arbuthnot Leasing International Ltd* v. *Havelet Leasing Ltd* (No. 2) [1990] BCC 636. Those who can apply are listed in s.424, and include individual claimants who are victims. The possible court orders are listed in s.425, and are similar to those in s.241. There are no time limits specified, but the test for intention under s.423(3) is more difficult to satisfy than under ss.238 or 239.

Unregistered charges (See Chapter 10, p. 314).

Remedies for mismanagement

The liquidator may also increase the assets available for distribution by way of the personal liability of directors of the company to restore property which they have removed from the company, or to contribute to the assets of the company to the extent that the court orders.

Summary remedy against defaulting directors

Recent decisions of the court have identified that the directors of a company which is insolvent or near insolvent may owe a common law duty to creditors of the company to preserve the assets of the company from dissipation: *Winkworth* v. *Edward Baron Development Co. Ltd* [1987] 1 All ER 114; and *West Mercia Safetywear* v. *Dodd* [1988] BCLC 250. In *Re Purpoint Ltd* [1991] BCLC 491, the director of the company in liquidation was held liable to contribute £12 666.79p towards the assets of the company in total, including a sum in respect of the purchase by the company of a car on hire-purchase when (a) it was unnecessary for the company's business; and (b) the company was insolvent; and cash sums withdrawn by the director and unaccounted for.

In *Re DKG Contractors Ltd* (1990) BCC 903, Hoffmann J referred to two exceptions where any act not *ultra vires* could be sanctioned by all the shareholders, namely that creditors are entitled to have the assets of a company kept intact and that a fraud on the creditors cannot be authorised. He thus held that payments totalling over £400 000 which had been

paid to the director in the ten-month period before liquidation justified an order for repayment under s.212. In this case, orders in respect of the same sum under s.239 (voidable preference) and s.214 (wrongful trading) were concurrent.

Where misfeasance proceedings are successful, a director can be ordered to return property to the company or compensate it for any loss caused. An action can be commenced by the official receiver, liquidator or any creditor, or even a contributory with leave of the court even though s/he will not personally benefit from any order: s.212(5).

Fraudulent trading

If during the winding up 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 may declare any persons who were knowingly parties to the carrying on of the business liable to contribute to the company's assets: s.213(1) and (2). The phrases 'intent to defraud' and 'fraudulent purpose' mean that a person can only be liable where his/her conduct was deliberately and actually dishonest according to the notions of ordinary decent business people: *Re EB Tractors Ltd* [1987] BCC 313. In *Re William C. Leitch Brothers Ltd* [1932] 2 Ch 71, the court held that this would be established where the directors carry on business with no reasonable prospect of the debts being paid. In addition, in *Re Gerald Cooper Chemicals Ltd* [1978] Ch 262, the court held that a person could be liable if only one creditor was defrauded and by one transaction.

This section extends beyond directors, since it is directed against 'any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned'. In view of the high degree of intention required to be proved for liability under this section, it is more likely that it will be overtaken in popularity by the wrongful trading provision under s.214 and s.213(2).

In *Re Maidstone Buildings Provisions Ltd* [1971] 1 WLR 1085 the court held that a company secretary who failed to advise the directors that the company was insolvent and should cease trading was not among 'parties to the carrying on of the business'. The phrase can cover directors and outsiders who concur in the carrying out of the business, but passive participants cannot be liable unless fraudulent trading is claimed against those actually carrying on the business. Thus, in *Re Augustus Barnett & Son Ltd* [1986] BCLC 170 a parent company successfully applied for a claim to be struck out on the grounds that there was no allegation that the board of the subsidiary in liquidation had carried on business with intent to defraud creditors. The subsidiary had only been able to continue trading because of statements by the parent of continued financial support, including 'letters of comfort' agreeing to financial support. This would not be a problem where the allegation against the parent company was of wrongful trading. The offence of wrongful trading was designed to

overcome the technical problems of establishing liability for fraudulent trading.

Wrongful trading

The offence of wrongful trading establishes an objective duty of care alongside the subjective duty, but only as regards a director of a company which has (a) gone into insolvent liquidation; and (b) where, at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation: s.214(2). Under this section, directors owe a statutory duty of care to creditors and can be made liable to contribute towards the assets of the company in liquidation. A director has a defence if s/he took 'every step with a view to minimising the potential loss to the company's creditors as he ought to have taken': s.214(3). For the purposes of s.214 (2) and (3):

> the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained or reached or taken, by a reasonably diligent person having both:-
>
> (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company; and
> (b) the general knowledge, skill and experience that director has: s.214(4).

Section 214 provides a remedy against former directors: s.214(1), and shadow directors: s.214(7). Shadow directors are defined in s.251. The section specifically does not rule out a parent company from qualifying as a shadow director, as does the definition in s.741(3), Companies Act 1985. It will be more difficult for a group of companies to place one or more of its subsidiaries in insolvent liquidation unless every step has been taken to minimise loss to creditors. In *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, the court held that, where a body corporate was a director of a company, whether *de jure*, shadow or *de facto*, it did not follow that its own directors must be shadow directors of that company. This decision clearly recognises that directors, whether *de jure*, *de facto* or shadow, can be liable under s.214. The judge made a clear distinction between the definition of a shadow and a *de facto* director. This clear distinction was not maintained in *Re Tasbian Ltd* (No. 3) [1991] BCLC 792 where the Court of Appeal found a company doctor brought in to rescue a failing company as liable under s.214 either as a *de facto* or shadow director.

Rescuing banks must be careful to limit their activities to monitoring, and not issuing directions or instructions, or they may then be considered as a shadow director. In the first reported case involving a bank, *Re A Company (No. 005009 of 1987)* [1989] BCLC 13, the bank tried

unsuccessfully to have a summons against itself struck out. In *Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd* [1991] 1 AC 187 the bank was not a shadow director because it nominated only two out of five directors, so that it could not be said that the directors were accustomed to act on the direction or instructions of the bank. Section 214 will lead to a substantial increase in claims by liquidators against the directors of insolvent companies, particularly where the financial management was incompetent.

The first successful examination of s.214 came in *Re Produce Marketing Consortium Ltd* [1989] BCLC 513. The court held that the directors ought to have concluded that as at July 1986 there was no reasonable prospect of the company avoiding insolvent liquidation (it went into liquidation in October 1987), and ordered that both defendants should contribute £75 000 to the assets of the company. The liability was joint and several. In a later case, the court could not identify the point at which the directors should have been aware that the company could not survive because of the inadequate records kept by the directors, and established that the court was, in such cases, entitled to fix itself the start date. It also established that the measure of compensation should be the debts incurred subsequent to that date: *Re Purpoint Ltd* [1991] BCLC 491. This latter point was also made in *Re DKG Contractors Ltd* [1990] BCC 903. The *Produce Marketing* case also raised the issue of the court relieving directors wholly or in part from liability in respect of s.214 under s.727, Companies Act 1985. The court decided that s.727 had no application to liability under s.214. In *DKG Contractors*, although the court found no reason to offer relief under the section, its application to s.214 liability was not ruled out.

There is doubt as to whether any wrongful trading award would be caught by a floating chargeholder as a charge on after-acquired property. This was assumed to be the case in *Re Produce Marketing Consortium Ltd* but is disputed by analogy with the position of a preference (see *Re Yagerphone* [1935]). Directors ordered to contribute under ss.213 and 214 can be disqualified by the court: Company Directors Disqualification Act (CDDA) 1986, s.10. This was done in both *Purpoint* and *DKG*.

In *Re Oasis Merchandising Services Ltd* [1997] 2 WLR 764, the liquidator of an insolvent company commenced proceedings against five directors under s.214. But since the company had no assets to fund the proceedings and the creditors were unwilling to do so, the liquidator, with the consent of the liquidation committee and the Companies Court, made an equitable assignment of the fruits of the action to a specialist litigation support company in return for the assignee agreeing to fund the action. The court awarded a stay of the action on the grounds that it was champertous and an abuse of the process. An appeal by the litigation support company was dismissed, on the grounds that the assets of a company at the commencement of the winding were assignable by the liquidator under his/her powers in Scedule 4, but not his/her statutory rights as liquidator.

19.5 Criminal Liability Arising from Insolvency

Criminal charges can be brought under the following: (i) fraud in anticipation of winding up: s.206; (ii) transactions in fraud of creditors: s.207; (iii) misconduct in course of winding-up: s.208; (iv) falsification of company books: s.209; (v) material omissions from statement of affairs: s.210; and (vi) false representations to creditors: s.211.

19.6 Disqualification of Directors Arising from Insolvent Liquidation

As well as being disqualified under s.10, Company Directors Disqualification Act, for up to fifteen years, directors may be disqualified under s.2, Company Directors Disqualification Act, where convicted of an indictable offence in connection with the promotion, formation, management or liquidation of a company. On summary conviction, the maximum period is five years, and on indictment, the maximum period is fifteen years. A director of a company in the course of winding up may be disqualified under s.4, Company Directors Disqualification Act where s/he has been found guilty of fraudulent trading (whether convicted or not) under s.458, Companies Act 1985, or has been guilty of any fraud or breach of duty in relation to the company.

The court has a duty to disqualify unfit directors of insolvent companies for a minimum period of two years: s.6. The tests for unfitness are established in Part II of Schedule 1, but these have been extended by judicial decision to include negligence and non-payment of company debts. The key case on liability arising from non-payment of company debts with particular regard to the non-payment of Crown debts is *Re Sevenoaks Stationers (Retail) Ltd* [1990] 3 WLR 1165, which lays down criteria for the period of disqualification (see Chapter 8, p. 000). Section 6 is weakened by the fact that proceedings can only be initiated by the Secretary of State or, if s/he so directs, where a company is being wound up by the court, by the official receiver. The court continues to have jurisdiction to hear cases on disqualification even though the winding up of the company is concluded: *Re The Working Project Ltd* [1995] 1 BCLC 226.

19.7 Dissolution of a Defunct Company

A company can be dissolved without being wound up when it appears to have ceased to function. The Registrar sends a letter to the registered office asking whether the company is still functioning. If there is no reply within one month, the Registrar, within fourteen days, sends a registered letter notifying the company that if no answer is received within one

month a notice will be published in the *London Gazette* with a view to striking the company's name off the register. In the event of a confirmative reply or no reply, the notice is published and the company is struck off within three months of that date: ss.652–3, Companies Act 1985. Application can be made within twenty years for the company to be restored to the register, and in that event the company will be deemed to have continued in existence as if its name had not been struck off.

19.8 Power of Court to Declare Dissolution Void

The court may within two years of the dissolution declare it void. Application can be made by the liquidator or any other interested person: s.651, Companies Act 1985.

Recommended Further Reading

Applications to Wind Up Companies, Derek French (Blackstone Press, 1993).
Pennington's Corporate Insolvency Law, 2nd edn (Butterworths, 1997).
Farrar's Company Law, 5th edn (Butterworths, 1998).

Questions

1. Distinguish between an administrative receiver and 'other' receivers. What qualifications must the former have that the latter do not require?
2. How has the Insolvency Act 1994 resolved the problem of the adoption of contracts of employment by administrative receivers and administrators?
3. Who can petition for an administration order, and what must be established before the court will make the order?
4. What is a moratorium, and how does the use of a moratorium facilitate the administration process?
5. The administrator has enormous powers to dispose of assets of the company even though they are charged. In this respect, how does the law distinguish floating charges from other charges?
6. What are the defects associated with CVAs, and how can they best be avoided?
7. What distinguishes a members' voluntary winding up from a creditors' voluntary winding up?
8. The major ground for a compulsory winding up is that the company is unable to pay its debts. How is the company's inability to pay its debts established?
9. There are restrictions on contributories petitioning for the winding up of a company. What are contributories and what are the restrictions?
10. What is the importance of the fact that preferences will only be voidable where the company was motivated by an intention to confer a benefit on the person preferred?

11 Floating charges created within a certain period before the winding up can be avoided in certain circumstances. What is the relevant period, and what are the conditions?

12 Wrongful trading can give rise to liability on the part of directors whether they are *de jure*, *de facto* or shadow directors. What is the difference between these terms?

13 What is the difference between a shadow director under the Insolvency Act 1986 and a shadow director under the Companies Act 1985?

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