

LEGAL PROFESSION ADMISSION BOARD

SEPTEMBER 2013

LAW OF ASSOCIATIONS

Time: Three Hours This paper consists of **six** questions.

Candidates are required to attempt any **four** questions.

No question is compulsory.

All questions are of equal value.

If a candidate answers more than the specified number of questions, only the first **four** questions attempted will be marked.

All questions may be answered in one examination booklet.

Each page of each answer must be numbered with the appropriate question number.

Candidates must indicate which questions they have answered on the front cover of the first examination booklet.

Candidates must write their answers clearly. Lack of legibility may lead to a delay in the candidate's results being given and could, in some circumstances, result in the candidate receiving a fail grade.

This examination is worth 80% of the total marks in this subject.

Permitted Materials: This is an open book examination. Candidates may refer to any books and any printed or handwritten material they have brought into the examination room.

As some instances of cheating, plagiarism and of bringing unauthorised material into the examination room have come to the attention of the Admission Board, candidates are warned that such conduct may result in instant expulsion from the examination and may result in exclusion from all further examinations.

This examination should not be relied on as a guide to the form or content of future examinations in this subject.

Question 1

Don, Frank, Brian, Max and Angela are directors (the “**Directors**”) of the public company Property Investments Pty Limited (the “**Company**”). Don, Frank and Brian are executive directors whilst Max and Angela are non executive directors.

The Company has a complex and sophisticated finance and accounting system and structure (collectively referred to as the “**Company’s Finance and Audit Structure**”) which includes:

- (a) an executive Committee delegated with the day to day operations of the Company;
- (b) an Audit and Risk Management Committee (“**ARMC**”);
- (c) an internal Finance Department;
- (d) external auditors; and
- (e) a system for the consideration and approval of the Company’s preliminary and final accounts.

The Company’s Finance and Audit Structure, including the internal and external auditing structure, is of a high professional standard.

In September 2012 the Directors passed a resolution declaring (pursuant to section 295(4)(d) of the *Corporations Act*) that in their opinion the Company’s Financial Statements to June 2012 and Annual Report (the “**2012 Financial Statements**”) were true and fair. The Directors gave this declaration without reading the 2012 Financial Statements in any detail. This was the practice of the Directors because they believed that they could rely on the persons who participated in the Company’s Finance and Audit Structure to prepare and confirm that the Company’s 2012 Financial Statements were true and fair.

The Company’s 2012 Financial Statements did not disclose that the Company had substantial short term current liabilities of \$800million. Rather the Company’s 2012 Financial Statements classified the short term current liabilities of \$800million as “non current” liabilities. Classifying the short term current liabilities as “non current” liabilities gave a significantly false picture of the true financial position of the Company.

There is substantial evidence that the Directors were given, during the period leading up to the 2012 Financial Statements, financial information which revealed that the Company had \$800million short term current liabilities not, as described in the 2012 Financial Statements, \$800million “non current” liabilities.

ASIC has now commenced proceedings against the Directors. ASIC contends that the Directors, by declaring that in their opinion the Company’s 2012 Financial Statements were true and fair in circumstances in which the Company’s short term current liabilities of \$800million were misdescribed as “non current” liabilities, failed to exercise the degree of care and diligence required of them pursuant to section 180 of the *Corporations Act*.

(Question 1 continues)

(Question 1 continued)

The Directors argue that they were not liable for breach of section 180 of the *Corporations Act* because they had reasonably relied on the persons who participated in the Company's Finance and Audit Structure to prepare and confirm that the Company's 2012 Financial Statements were true and fair.

Advise the Directors having regard to section 180 of the *Corporations Act* and the relevant case law.

(20 marks)

Question 2

Mr and Mrs Love are the directors and only shareholders of Love Investment Pty Limited (the "**Company**"). Mr Love is the Managing Director and has de facto control of the conduct of the Company's business.

Mr Love arranged a loan for the Company from Money Bank (the "**Bank**") for \$800,000. In his discussions with the Bank Mr Love indicated that the loan was for investment purposes and that the Company was his investment Company. The Bank did not know or make inquiries as to the connection between the loan and the business carried out by the Company.

As security for the loan the Bank required a mortgage over the only property owned by the Company (the "**Property**"). A mortgage was subsequently executed over the Property. The mortgage document appeared to have been executed by the Company by the affixing of the Company's common seal accompanied by the signatures of Mr Love and Mrs Love. The signature of Mrs Love was forged by Mr Love. Under the signature of Mr Love was the description "Director" and under the forged signature of Mrs Love was the description "Secretary". Mrs Love, however, was not the Secretary of the Company. Searches conducted by the Bank had indicated that both Mr and Mrs Love were directors of the Company.

Mrs Love did not know or approve of the loan or mortgage to the Company.

The loan was approved and at the request of Mr Love the loan funds were released to Mr Love personally rather than to the Company. The funds were used for Mr Love's personal affairs as well as for the business conducted by the Company.

The Company is now in default and the Bank seeks possession of the Property. Mrs Love wants to resist the Bank taking possession.

Advise Mrs Love whether she can succeed in having the loan and mortgage declared invalid and set aside. Give reasons for your answer. You should have regard to the *Corporations Act* and the relevant case law.

(20 marks)

(Question 3 follows)

Question 3

Peter, Paul and Mary are each directors and shareholders of Crazy Donkey Music Limited (the “**Company**”). Peter is the majority shareholder in the Company, holding 70% of the issued shares. Peter is also the Governing Director of the Company and has de facto control of the Company. Paul and Mary hold 30% of the issued shares.

In August 2012, Peter appropriated a payment of \$100,000.00 from the sale of musical equipment owned by the Company for his own benefit. Paul and Mary were unaware of the transaction at the time. Subsequently, Paul and Mary raised it with Peter who told Paul and Mary that the money went to pay the Company’s expenses and that they should forget about it. Paul and Mary did not believe Peter’s explanation and after examining the Company’s books and records in detail, discovered that the payment of \$100,000.00 for the musical equipment was not used to pay Company expenses but was paid to Peter personally without explanation.

Within a short time, Paul and Mary confronted Peter and demanded repayment of the money. Peter refused. Paul and Mary then called a meeting of the Company and proposed a resolution that the Company commence proceedings against Peter for the return of the \$100,000. Peter, who was the majority shareholder, attended the meeting and voted against the resolution and the resolution failed.

Paul and Mary allege that the payment of \$100,000.00 to Peter in the circumstances was in breach of Peter’s duties as a director of the Company both under the *Corporations Act* and in equity.

Paul and Mary seek your advice as to whether they can apply to the Court to bring proceedings on behalf of the Company against Peter for the return of the \$100,000. In your answer you should identify the relevant principles that are needed to be satisfied pursuant to section 237 of the *Corporations Act*.

(20 marks)

(Question 4 follows)

Question 4

In 2012 Jim and Melone carried on a business of growing cotton (the “**Business**”) on property known as “**Tara**”. In October 2012 Jim and Melone were experiencing financial difficulty and asked Steven to lend the Business \$150,000. Steven agreed and the parties then signed a written agreement which contained terms to the following effect:

- (a) The loan from Steven was to be repaid on demand;
- (b) Whilst the loan remained outstanding all the profits from the Business were to be divided equally between Jim, Melone and Steven. The share of profits paid to Steven was to be regarded as interest on the outstanding loan;
- (c) Jim and Melone were restricted from purchasing any machinery or equipment for the Business over \$5,000 without the express consent of Steven;
- (d) The assets of the Business were owned by Jim and Melone jointly;
- (e) All expenses of the Business were to be met by Jim and Melone;
- (f) Business decisions were to be resolved jointly between Jim, Melone and Steven;
- (g) It was expressly stated that Steven was not a partner in the Business.

In March 2013 Jim made a credit purchase from the **Supply Centre** for machinery and equipment for the Business in the amount \$50,000. This was done without the consent of Steven. Whilst the Supply Centre believed that Jim was in partnership, the Supply Centre did not know who he was in partnership with.

Subsequently a fire on Tara destroyed all the buildings and other assets of the Business including the machinery and equipment that Jim purchased on credit from the Supply Centre. Jim and Melone were not insured and are now bankrupt. The Supply Centre has discovered that Steven had some involvement with the Business and now seeks to sue Steven for the cost of the machinery and equipment.

Advise Steven. Give reasons for your answer.

(20 marks)

(Question 5 follows)

Question 5

Mr Jones, Mrs Jones and their two daughters each hold one share in Premium Tailors Limited (the “**Company**”) and each is a director. The Company conducts a family business of providing Tailoring services (the “**Business**”).

The Company was established at the same time as Mr and Mrs Jones married and then upon their 21st birthday their daughters also joined the Business. Upon joining the Business each daughter was issued with one share in the Company and was appointed a director.

After 30 years of marriage Mr and Mrs Jones divorced. It appears that Mr Jones declared that he was now in love with a former assistant of the Company and he wished to marry her. Mr Jones wanted to sell his 25% interest in the Company to Mrs Jones and his two daughters so that he could be free to marry the former assistant. Mrs Jones and her daughters refused.

After the divorce considerable bitterness and animosity arose between Mr Jones on the one hand and Mrs Jones and their two daughters on the other.

At a meeting after the dissolution of marriage Mrs Jones and her two daughters passed a resolution that 2000 ordinary shares be issued in the Company to existing shareholders proportionate to their existing shareholding. The resolution was passed in accordance with the Company’s constitution. Mrs Jones and her two daughters knew at the time of passing the resolution that Mr Jones, because of his considerable financial constraints caused by the divorce, would not be able to purchase the newly issued shares in the Company. Therefore the resolution effectively meant that upon purchase of the 2000 shares by Mrs Jones and her two daughters Mr Jones’ shareholding in the Company would be considerably diluted and worthless.

Advise Mr Jones. Your advice should be given in the light that Mr Jones no longer wants to have any involvement in the Company. In giving your advice you should have regard to sections 232 and 233 of the *Corporations Act* and the relevant law relating to those sections.

(20 marks)

(Question 6 follows)

Question 6

Landscape Gardens Pty Limited (the "**Company**") carried on a business which included designing, restoring and creating landscapes for clients. Dane and Ingrid are the only shareholders and directors. Ingrid also acted as the Company's Managing Director being responsible for estimating, approving and paying invoices and the day to day running of the Company. Dane relied on Ingrid to ensure that the company could meet its debts when they came due and payable. Ingrid was a qualified Accountant.

During the period February 2012 to September 2012 the Company worked on a large project to construct a botanical garden in Central Wollongong. This project involved the Company purchasing materials from Green Trees Pty limited ("**Green Trees**"), a wholesale nursery and from Rocks and Walls Pty Limited ("**Rocks**"), a company that supplied material to be used in retaining walls. Ingrid negotiated with both these suppliers on her own and entered into contracts with Green Trees and Rocks on behalf of the Company. Dane was unaware of the negotiations and the ensuing contracts.

Due to underestimating the size of the botanical gardens project, Ingrid miscalculated the quantities of materials that she would need and the Company stood to incur heavy losses on the project. At this time, Ingrid became friendly with Svein, a man she had previously met skiing in Norway and decided to give up both landscaping and Dane. Ingrid has not been heard from again. The botanical gardens remained unfinished and Green Trees and Rocks remain unpaid. The Company does not have sufficient funds, nor does it have access to funds, to complete the botanical gardens and to pay Green Trees and Rocks. The Company has now been put into liquidation.

Advise Dane of his prospects of resisting the liquidator's action for insolvent trading. Your answer should include an analysis of the essential elements that are necessary to be shown by the liquidator to be successful against Dane and an analysis of any defences that Dane may have to any such application.

(20 marks)

END OF PAPER