Solicitors Regulation Authority | SQE

SQE2 sample question and discussion of answer

Case and matter analysis (Business organisations, rules and procedures)

Last reviewed on 8 February 2023

Candidates will undertake 16 assessments in SQE2. To pass SQE2 candidates will need to obtain the overall pass mark for SQE2.

This sample question and discussion of answer is an example of a case and matter analysis assessment. This is a computer-based assessment and candidates will have 60 minutes to complete the task.

For further detail see the SQE2 Assessment Specification.

Please note that the sample questions are provided to give an indication of the type of tasks that candidates could be set. They do not represent all the material that will be covered in SQE2. Future questions may not take exactly the same format.

Question and additional candidate papers

Email to Candidate

From: Partner
Sent: 11 December 202#
To: Candidate
Subject: Nick Dutton and Alex Hayman

Yesterday I spoke to some new clients, Nick Dutton and Alex Hayman. They are excited about a new product they have been developing. They explained that this is a device which will enable electric cars to run further than at present before they have to be re-charged. They intend to set up a new company to develop and produce this device. They have worked in the car industry for some time, and have already had some small success in developing car parts. They will work together in this new business venture and we will act for them both.

<u>The Initial Meeting and Proposal</u>

Nick and Alex have some money of their own to invest in the business. Frank Wells, who is an experienced businessman, is willing to invest in their project. Frank's sister, Mary Freeman, has also agreed to contribute some capital.

Nick and Alex have worked out that they will need £65,000 as start-up capital. Nick and Alex between them have £15,000 to invest: they will be putting in £7,500 each.

An initial meeting has taken place and Frank and Mary have agreed to provide the remaining £50,000: Frank will invest £32,500 and Mary will invest £17,500. It was further agreed that the company will be called ElectroEndurance and that Nick Dutton would be the Company Secretary.

After the meeting Frank and Mary sent Nick and Alex a letter summarising their position **(Attachment 1)** and an outline of their proposal **(Attachment 2)**.

<u>Important Background Information</u>

As you will see from the attached letter, Frank and Mary have made it clear that, since they are taking on a significant risk, they expect an early return on their investment in the company. However, Frank and Mary are both happy to discuss and negotiate their initial proposal.

Nick and Alex realise that without the investment from Frank and Mary they cannot go ahead with the development and production of their new device. However, if Nick and Alex are as successful as they hope, they would like to take the business forward themselves. They therefore want to know how secure they will be in their positions as directors of the company. They have also said they would prefer to minimise outside involvement in the company. So far as possible they want profits to go into development of the product and recruiting specialist employees, and they want to be in control of making decisions about use of profits.

Nick and Alex have indicated that they expect to agree with each other on decisions to be made within the company. They expect that Frank and Mary will also agree with each other. However, they recognise that the four of them may not always be in agreement.

<u>Advice and Analysis Required</u>

Nick and Alex would like advice about this proposal and suggestions for negotiating a better position for themselves **bearing in mind what might be acceptable to Frank and Mary**.

I would like you to provide this advice and analysis for me to use as the basis of a letter to the clients. In providing your advice please bear in mind that Nick and Alex have no experience of forming a company, or running a business through a company. They have only a very basic sense of what it means to be shareholders and directors in a private limited company.

However, **they would like brief explanations of the relevant law** where appropriate so please include these in your advice and analysis. Do **<u>NOT</u>** include advice about incorporation of a company, nor a detailed procedure plan which might eventually be required: the advice we have been asked for is preliminary only at this stage. Please also do **<u>NOT</u>** include taxation advice at this stage.

Please set out your advice and analysis on the following:

i. If the company is structured in the way suggested in the proposal (Attachment 2) can Nick and Alex be removed by Frank and Mary as directors of the company? What changes would you recommend Nick and Alex try to negotiate to strengthen their position as directors?

ii. What alternative proposals to those made in Attachment 2 might Nick and Alex consider, as ways of structuring the investment to be made by Frank and Mary? You should suggest proposals which will benefit our clients, bearing in mind what you think might be acceptable to Frank and Mary. For any suggestions you make, you should note the advantages and disadvantages from both Nick and Alex's, and from Frank and Mary's points of view. This will enable Nick and Alex to understand the position fully before entering negotiations.

Note to Candidates:

You should assume that there is no conflict of interest between Nick and Alex. You should assume Nick and Alex's interests are identical in this matter, and will not conflict at a later date. In particular, you should <u>NOT</u> consider any separate legal advice which either of them may wish to take in due course.

I have dealt with all client care matters, so you do not need to consider these.

ATTACHMENT 1

The Homestead
Falconer's Rise
Doncaster DN12 1AD

8 December 202#

Dear Nick and Alex

We thought you would like to have written confirmation from us of our proposal for how we become involved in your new business venture. This, you explained, is the development by you both of a new product to enable electric cars to run further than at present before they have to be re-charged. You have not yet incorporated the company to develop and produce this device, but you explained that you will be consulting a solicitor. I suggest that you take some advice on our proposal from your solicitor, and that we meet again after that.

Frank has £32,500 to invest in the company. Mary will invest £17,500. Our suggestion is that we will use this investment to become shareholders in the company, but neither of us wish to become involved in the day to day running of the company, and do not wish to be appointed as directors.

Since we are making such a substantial investment, we must see some return as early as possible. You told us that you do not expect the company to make any profit for its first 18 months of operation. Our suggestion therefore is that, in return for our investment, you issue some preference shares and some ordinary shares to each of us. This seems to us to be a good way for you to get the capital you need to get started, whilst allowing us to receive a share of profits early on in the life of the company. In the Company Structure and Investment Proposal attached, we have included some wording which we suggest is put into the company's articles to set out the rights attaching to the preference shares.

Once you have taken some legal advice, you may find that there are elements of our proposal, or points arising from it, which you would like to discuss with us. By all means contact us in due course and we will be happy to consider any reasonable alternative proposals.

With best wishes

Frank and Mary

ATTACHMENT 2

Company Structure and Investment Proposal dated 8 December 202#

Proposed Name	ElectroEndurance Limited
Proposed Directors	Nick Dutton Alex Hayman
Company Secretary	Nick Dutton
Registered Office	75 Hopswood Drive, Doncaster, DN11 7BQ Tel no: 01302 598211
Shareholders	<u>Frank Wells</u>: 10,000 £1 20% cumulative preference shares; and 22,500 £1 ordinary shares <u>Mary Freeman</u>: 5,000 £1 20% cumulative preference shares; and 12,500 £1 ordinary shares <u>Nick Dutton:</u> 7,500 £1 ordinary shares <u>Alex Hayman</u>: 7,500 £1 ordinary shares
Articles of Association	Schedule 1 of the Companies (Model Articles) Regulations 2008 with one amendment comprising an additional article setting out the rights attaching to the preference shares: The holders of preference shares shall be entitled to receive a fixed cumulative preferential dividend at the rate of 20% per annum upon the amount paid up thereon. On a winding up of the company in any circumstance, any excess of capital available for distribution to the shareholders shall be distributed equally among all shareholders in proportion to the nominal value of their total shareholdings of all classes of shares held. The holders of the preference shares shall be entitled to receive notice of any resolutions put before the members of the company but shall not be entitled to vote on any such resolutions nor count in the quorum at any general meeting.
Shareholders' Agreement	None
Directors' Service Contracts	Nick Dutton and Alex Hayman – terms, including salary, to be agreed.

Discussion of answer

Case and Matter Analysis: Points to note

The assessment criteria for case and matter analysis are as follows:

Skills

1. Identify relevant facts.

2. Provide client-focused advice (ie advice which demonstrates an understanding of the problem from the client's point of view and what the client wants to achieve, not just from a legal perspective).

3. Use clear, precise, concise and acceptable language.

Application of law

4. Apply the law correctly to the client's situation.

5. Apply the law comprehensively to the client's situation, identifying any ethical and professional conduct issues and exercising judgement to resolve them honestly and with integrity.

Marking is by solicitors who have been trained as assessors and whose marking has been standardised. It is based on global professional judgements rather than a tick box or checklist approach.

The starting point for these global professional judgements is the standard of competency of the assessment, namely that of the just competent Day One Solicitor (The Threshold Standard). Markers are flexible as to the approach taken by the candidate.

Marking is based on performance on each of the assessment criteria judged on a scale from A – F as follows:

A: Superior performance: well above the competency requirements of the assessment

B: Clearly satisfactory: clearly meets the competency requirements of the assessment

C: Marginal pass: on balance, just meets the competency requirements of the assessment

D: Marginal fail: on balance, just fails to meet the competency requirements of the assessment

E: Clearly unsatisfactory: clearly does not meet the competency requirements of the assessment

F: Poor performance: well below the competency requirements of the assessment

For further details of the marking see the Assessment Specification and the Marking and Moderation Policy (to be published). The Assessment Specification provides further information about what is meant by clear, precise, concise and acceptable language, and correct and comprehensive application of law.

Key legal points include the following:

Citations (eg provisions of the Companies Act 2006 or the Companies (Model Articles) Regulations 2008) are not required.

Removal of director/s

Shareholders have the power to remove a company director by ordinary resolution.

How shareholders pass an ordinary resolution to remove a director, as applied to this scenario and particularly the balance of power in the proposed company structure.

NB No detailed procedure plan is required

Strengthening the position of the directors

Suggestions might include:

Long fixed term service contract

Weighted voting rights on a resolution to remove a director

Shareholder agreement providing that Frank and Mary will not remove Nick and Alex as directors, nor appoint further directors

Alternative proposals for structuring the investment

Suggestions might include:

Loan of part/all of the investment monies

Adjusting the balance of shares

Adjusting the rights attached to the shares

Consideration of the advantages/disadvantages of any alternative suggestions would include application to the current scenario including recognition of the parties' interests:

- Extent of the investment being offered
- How soon a return is expected
- Importance of income/capital return
- Continuing involvement of the investors in the company
- Control of destination of company's profits

Note on sample answers:

Two sample answers are provided (Sample A and Sample B). Neither answer is perfect nor a model answer and there are further points which could be made in both. You should not assume that everything in the samples is correct. A is a stronger answer than B but both at least reach the Threshold Standard.

SAMPLE A **(see note on sample answers, page 10)**

Under the current investment proposal Frank and Mary will together hold 70% of the voting shares in the company. While not total control of the company, this means they can pass resolutions requiring a simple majority (ordinary resolutions), but not special resolutions which need 75%. Frank and Mary will also hold preference shares, meaning that each year a dividend is available they will receive a 20% return on the amount invested in these shares before any other shareholders receive anything. If they don’t receive a dividend in any one year the entitlement will cumulate, so that any year they don't receive a dividend, the amount they should have received is rolled over to the next year.

1. Can Frank and Mary remove Nick and Alex as directors?

As detailed above, under the current investment proposal, Frank and Mary would together hold 70% of the votes. Shareholders may remove directors by passing an ordinary resolution, which requires more than 50% of the votes. A general meeting called to pass such a resolution and attended by both Frank and Mary would be quorate. Votes at a general meeting are taken on a show of hands (1 vote per person), so that the votes would be equal if all four shareholders attended the meeting. However, since Frank and Mary each own at least 10% of the company’s ordinary shares, either of them can demand a poll vote at any time, meaning that voting will be done on the basis of 1 vote per share. Their 70% joint shareholding means that Frank and Mary would be able to remove both Nick and Alex as directors, and could also appoint new directors to the board.

There are some ways that Nick and Alex's position as directors could be strengthened as set out below:

i) Entering a shareholder agreement that Frank and Mary will not remove Nick and Alex as directors nor appoint additional directors.
ii) Including in the company’s articles what is known as a 'Bushell v Faith' clause. This would increase the weight of Nick and Alex’s voting rights when the shareholders were trying to remove them as directors.
iii) Provide for a fixed term in Nick and Alex's service contracts. If these were terminated early the company would have to pay them damages.
iv) Include a termination payment in Nick and Alex's service contracts.

Each of these methods, or a combination of them, would make it more difficult for Frank and Mary to remove Nick or Alex from their directorships.

2. Alternative proposals for structuring the investment

i) Debt and Preference equity
Frank and Mary could invest by way of a loan as well as taking preference shares. The terms of the loan could include a rate of interest higher than would be offered by a bank, and also include the dates when capital was to be repaid, which could be spread. The advantage for Frank and Mary is that they could receive payment of interest from the start rather than waiting until a dividend is paid. However if Frank and Mary did not take any ordinary shares they would not benefit from the increase in the value of those shares if the company is a success. In addition they would not have any of the rights, including the voting rights which come with ordinary shares, and so might feel that they did not have a level of involvement in the company which reflected their investment.

The advantage of the loan from Nick and Alex's view point is that they could hold all the company's ordinary shares and also that they would only pay the dividend on the preference shares once the company is profitable. They have said that they want to keep outside involvement to a minimum and taking a loan would mean they could pay off part of the investment. One disadvantage is that Frank and Mary may want some form of security for the loan. Also Nick and Alex would not be likely to receive dividend payments for a long time.

ii) Debt and mixed equity
A mixture could be negotiated so that Frank and Mary take some ordinary shares and some preference shares and also make a loan. This may be the best and most flexible option and could give Nick and Alex greater control than under the current proposal. If Nick and Alex could negotiate that Frank and Mary hold less than 25% of the ordinary shares between them, then this would remove Frank and Mary's power to block special resolutions. However this may not be a realistic goal: it is important to bear in mind that Frank and Mary are taking on a significant risk in the amount of investment they are offering for this new venture. Since they have made it clear that they have no wish to be involved in the day to day running of the company, it is likely that they will insist on a degree of control as shareholders. It would also be reasonable to expect that Frank and Mary will want the value of their investment to reflect the success of the company and so they may be unwilling to reduce their holding of ordinary shares to this extent.

SAMPLE B (see note on sample answers, page 10)

Under the current proposal Frank and Mary combined would have a large majority in the company, sufficient to remove directors. I would only go forward with this proposal if Nick and Alex have enormous trust in both of them.

A way to mitigate this would be to negotiate a shareholders' agreement which would prevail over the articles of association and can contain a clause that prevents the removal of Nick and Alex as directors and prevents any overly intrusive things being done to the company (changing of name, transferring of IP) without unanimous consent of all shareholders. This would enable the company to benefit from Frank's experience in business without taking away control from Nick and Alex. Regardless of the model that is opted for it is still advisable to have a shareholders' agreement as it cements the rights of all parties.

They could also provide for a long fixed term in Nick and Alex's service contracts. Although this will require shareholder approval, it would make it less likely that they would be removed because of the expense for the Company.

Alternative Structures

A. Debt capital

A first potential option is to swap the suggested equity investment for debt capital. Rather than investing the funds and becoming shareholders Frank and Mary will become creditors. This gives Nick and Alex the added bonus of Frank and Mary having no say in the working of the company for as long as it is solvent and paying off the loan. The upside for Frank and Mary is the lack of risk. In the case of an insolvency the creditors are in a much better position than shareholders to recover their funds. The downside (which might see this rejected) is that, apart from the interest, Frank and Mary will not see much return upon investment. Even if the company does really well, they will not see their pay out increase and might reject the proposal on these grounds.

B. Mixed Capital

To mitigate the downside to the above proposal we might put forward a mixed capital plan. Mary and Frank would still receive preference shares but we would reduce their ordinary shares to 7000 £1 each and lend the rest. This way they do not get a majority controlling stake over the company but they still get the bonus of a dividend payment when the company does well and if the company goes under they have the security of also being creditors. The upside is: Nick and Alex maintain control over the company. Downside for Nick and Alex is that Frank and Mary now get a preference dividend plus debt payments which can become costly.