

## Section 6

# Basic legal concepts relevant to financial services

### Introduction

Section 6 covers part 6 of the Unit 1 syllabus, ie some of the more general legal concepts and legislation to the provision of financial services such as wills, trusts, contracts, agency agreements, powers of attorney and bankruptcy.

The legislation that is related specifically to the regulation of financial services is covered in more depth in Unit 2.

### **6.1 Legal persons**

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Legal persons in the context of financial services refers to those who have a separate legal existence and can, therefore, enter into contracts or be sued in a court of law. It is important to remember that this includes individuals in a personal/private capacity and those individuals acting in a formal capacity such as executors, as well as groups of individuals such as trustees. It also includes organisations such as limited companies.

## 6.2 Personal representatives and wills

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The people who carry out the procedures necessary to distribute the estate of someone who has died are known as the deceased person's **personal representatives**.

The exact procedure to be carried out in order to distribute a deceased person's estate depends on whether or not there is a valid will. The following comments apply to the law of England and Wales (Scottish law differs both in the procedures involved and in the terminology used).

If there is a valid will, the executor(s) apply for a *grant of probate*. The *executors* are appointed (ie named in the will) by the *testator* (the person making the will) to ensure that the actions specified in the will are carried out. The grant of probate gives the executors legal authority to carry out the testator's instructions, as set out in the will. An executor can also be a beneficiary of the will. The duties of an executor can be time-consuming and onerous and it is not uncommon for executors to appoint a solicitor to carry out all or part of their duties.

If there is no will (or the will is invalid), a *grant of letters of administration* is issued to an appropriate person, who is known as the *administrator*. This will often be the surviving spouse or another close relative. The administrator's responsibility is to deal with the estate as prescribed by the *rules of intestacy* (see Section 6.2.1).

A will is a written declaration of an individual's wishes regarding what they want to happen after they have died. Although primarily concerned with how the person wishes to dispose of their assets, a will can also deal with other matters, such as giving instructions about burial.

The terms of a will only take effect on the death of the testator, the person who made the will. Before then, the testator can revoke (cancel) or modify the will at any time. Modifications are recorded in a document known as a *codicil*.

To make a valid will, two formalities must be followed:

- ◆ the will *must* be in writing;
- ◆ the will *must* be properly executed.

The minimum age for making a valid will under English law is 18.

The will should be a clear and unambiguous statement of the deceased's wishes in respect of their estate, and must be signed by the testator in the presence

of two witnesses, who must not be beneficiaries under the will (or the spouses of beneficiaries).

In the event of marriage or remarriage or entering into a civil partnership, a will is automatically revoked, unless specifically written in contemplation of the change of status.

In the UK, approximately seven out of ten people die *intestate*, without leaving a valid will. Writing a will is the first step in gaining control over an estate and is, therefore, a vital part of financial planning.

The cost of writing a will is quite reasonable and should not be viewed as a barrier to making a will. A financial adviser's role should not involve the writing of a will but it is important that clients understand the benefits of a valid will and the risks of not having one. If the client has no will, the financial adviser should recommend that they seek professional advice from a solicitor.

In certain circumstances it may be advantageous, following the death of the testator, for the beneficiaries under a will to vary the way the estate has been allocated. This can be achieved by executing a *deed of variation*. All those who would have benefited from the provisions of the will must be over 18 years of age and be in agreement on the terms of such a variation. A deed of variation is often executed for tax purposes: a change in beneficiaries or in the relative shares received could reduce the inheritance tax liability, for example. In order to be effective for tax purposes, the deed of variation must be executed within two years of the death and HM Revenue & Customs must be informed within six months of its execution. The variation must not be entered into for any consideration of money or money's worth.

### **6.2.1 Intestacy**

A person who has died without having made a valid will is said to have died **intestate**. This includes the situation where the deceased has left a will but where the will turns out to be invalid.

If a will makes valid provision for the distribution of some of the assets of the estate, but not of others, this is referred to as *partial intestacy*.

The distribution of the estate of a person who has died intestate is determined by a complex set of rules known as the rules of intestacy. They are very specific and there is no flexibility or discretion for their variation by the person dealing with the estate. The destination of property under the intestacy rules depends

on the size of the estate and the deceased's family circumstances. In many cases – especially if the estate is a large one – the distribution of the assets may not be as the deceased would have wished. In particular, it is not necessarily true – as many people believe – that a surviving spouse or civil partner will receive the whole estate.

The main rules are as follows. Please note that for the purpose of these rules, the word 'spouse' includes civil partner.

- ◆ If the deceased leaves a spouse but no children: the spouse gets the first £200,000 plus half the remainder; the balance goes to the deceased's parents or, if they are dead, to the deceased's brothers and sisters.
- ◆ If there is both spouse and children: the spouse gets the first £125,000; half of the balance goes to the children; the other half of the balance goes into a trust from which the spouse receives income for life, and the capital goes to the children when the spouse dies.
- ◆ If there are children but no spouse: the estate is shared equally among the children.
- ◆ If there is neither spouse nor children: the estate goes to the deceased's parents or (if they are dead) to the deceased's brothers and sisters.

### 6.3 Trusts and trustees

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A **trust** (also known as a *settlement*) is a method by which the owner of an asset (the *settlor*) can distribute or use that asset for the benefit of another person or persons (the *beneficiaries*) without allowing them to exert control over the asset while it remains in trust. Depending on the nature of the trust, the beneficiaries may eventually become the absolute owners of the asset.

The settlor is the person who creates the trust and who originally owned the assets placed in the trust (the *trust property*). Once it is placed in trust, the asset is no longer owned by the settlor (unless he is also a trustee – see below).

The beneficiaries are the people or organisations that will benefit from the trust property. They may be named specifically or referred to as a group, eg 'all my children'.

The *trustees* are the people, appointed by the settlor, who will take legal ownership of the trust property and will administer the property under the terms of the trust deed. The trustees, who can include the settlor, are named

in the trust deed. Trustees must be aged 18 or over and of sound mind. If a trustee dies, the remaining trustees, or their personal representatives, can appoint a new trustee.

Trustees must:

- ◆ act in accordance with the terms of the trust deed. If the trust deed gives them discretion to exercise their powers (eg discretion over which beneficiaries shall receive the trust benefits), the agreement of *all* of the trustees is required before a course of action can be taken;
- ◆ act in the best interests of the beneficiaries, balancing fairly the rights of different beneficiaries if these should conflict. For example, some trusts provide income to certain beneficiaries and, later, distribution of capital to other beneficiaries; the chosen investment must preserve a fair balance between income levels and capital guarantee/capital growth.

Under the Trustee Act 2000, trustees who exercise investment powers are required to:

- ◆ be aware of the need for suitability and diversification of assets;
- ◆ obtain and consider proper advice when making or reviewing investments;
- ◆ keep investments under review.

## 6.4 Companies

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**Companies** are legal entities, quite separate from their shareholders (see Section 2.3) or their individual employees. Shareholders of a *limited liability company* cannot be held personally responsible for the debts of the company, the limit of their liability being the amount that they have invested in company shares. This is the most they could lose if the company were to become insolvent with large debts.

The nature of the company, and the rules about what it can and cannot do, are set out in its memorandum and articles of association. In relation to a company's ability to borrow money, for example, the memorandum normally includes the power to borrow, but may place limits or restrictions on that power in terms of amounts or purpose. This will be significant if the company wishes to take out a mortgage or other form of loan.

The actions of the company are, of course, carried out by people and, when making a contract with a company or lending money to a company, it is essential to check that the persons committing the company to a particular course of action are authorised and empowered to do so.

## 6.5 Partnerships

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A **partnership** is an arrangement between people who are carrying on a business together for profit. Unlike a company, a partnership is not a separate legal entity and the partners jointly own both the assets and the liabilities of the partnership (see, however, notes on limited liability partnerships in Section 6.5.1).

Partnerships should have a written agreement that sets out in detail the relationship between the partners, including proportions in which they share the partnership's profits and what will happen when a partner leaves, retires or dies (see also Section 5.2.2.2).

### 6.5.1 Limited liability partnerships

Since 2001, it has been possible to run a business as a **limited liability partnership (LLP)**. This means that partners have a limited personal liability if the business should collapse: their liability is limited to the amount that they have invested in the partnership, together with any personal guarantees they have given, eg to a bank that has made a loan to the business.

As with companies, limited liability partnerships have to be registered with Companies House; they are clearly more like companies than are standard partnerships but the taxation of LLPs is not the corporation tax regime that applies to companies. LLPs are taxed in the same way as other partnerships: each partner is taxed on a self-employed basis, with their individual share of the profits being treated as their own personal income and subject to income tax.

## 6.6 Law of contract

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Most business agreements, particularly in the world of financial services, are established as legally binding contracts. Some are made orally, some in writing and some by deed. Not all contracts can be made orally but all contracts generally are subject to certain basic requirements for them to be binding.

The basic requirements for contracts to be binding on the parties involved are:

- ◆ *offer and acceptance*: there must be an offer made by one party (the offeror) and there must be an unqualified acceptance by the other. This acceptance must be communicated to the other party. In practice there may be a number of counter-offers before agreement is reached;
- ◆ *consideration*: the subject of the contract (often a promise to do something or supply something) must be matched by a consideration (which is frequently, but not necessarily, the payment of money). This is given by one of the parties (the promisee) to the person making the promise, that is, the other party to the contract (the promisor). A promise to pay is valid consideration;
- ◆ *capacity to contract*: each of the parties to the contract must have the legal capacity, or power, to enter into the contract. Certain parties have only limited powers to enter into a contract, for example, minors and those of unsound mind. For financial institutions such as insurance companies, capacity to contract depends on being authorised by the FSA;
- ◆ the terms of the contract must be *certain, complete and free from doubt*;
- ◆ there must be an intention to create a *legal relationship*, as distinct from a merely informal arrangement;
- ◆ *legality of object*: contracts cannot be made for illegal or immoral purposes;
- ◆ the contract must not have been entered into as a result of *misrepresentation, or under duress or undue influence*.

Some contracts have to be recorded in a specific legal form: all agreements for the sale of land must be made in writing and conveyances of land (the actual transfer of ownership) must be performed by deed.

Generally, there is no duty of disclosure between parties to a contract; most contracts are based on the principle of *caveat emptor* ('let the buyer beware'). However, there are exceptions: for example, insurance contracts are based on

the principle of *utmost good faith*, ie all material facts must be disclosed. For an insurance policy, this means that the person applying for the policy must supply all the facts that a prudent underwriter would need to decide the terms on which the policy could be issued. Non-disclosure by the customer makes the contract voidable at the option of the insurance company.

If a party fails to perform his side of the contract and does not have a legal excuse for doing so, then this is a *breach of contract*. Several court remedies are available in these circumstances. The main ones are to seek damages, an order for specific performance or an injunction. Of these, by far the most frequently sought is damages, where the injured party seeks to obtain financial compensation for his loss. The intention is to put him in the position he would have been in had the contract not been breached by the other party, as far as it is possible to do so with money. In certain circumstances, an order for specific performance can be obtained to compel the other party to complete the contract. Alternatively, an injunction can be sought – this is a court order *preventing* someone from doing something.

## 6.7 Law of agency

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An **agent** is a person who acts on behalf of another, who is called the *principal*. The agent can conclude contracts on behalf of his principal. In law, the acts of the agent are treated as being those of his principal.

In any kind of agent-principal relationship, it is important to ascertain how much power and authority has been vested in the agent, just as it is important that the agent is fully aware of what he can and cannot do. Some agents are given very wide authority while some are severely restricted in what they can do.

An agent should only act within the authority given to him by his principal. This should be strictly observed, because, if an agent exceeds his power, it could result in his principal being liable on the contract. This happens when, although the agent acts outside of his actual authority, he acts within what is known as his *apparent authority*. Apparent authority is where something either done or said by the principal leads to the impression that he has authorised the agent's actions.

Another result is that the agent may be made liable. This is protective of the third party who, if he is unable to rely on the agent's claim that he has authority, must be able to hold him personally responsible. It would otherwise be unfair

to the third party, who would have entered in good faith into the contract only to find himself without recourse to either the principal (if there is no apparent authority) or to the agent.

If the agent does exceed his authority, the principal can, if he chooses to do so, agree after the event to what the agent has done. This is called *ratification*.

This very brief introduction to agency cannot cover all the detail of agency law but it will serve to illustrate how important it is for advisers to know, understand and act within the extent of their authority.

Financial advisers who operate as company representatives of a product provider (tied agents) are acting as agents of that product provider. Independent advisers, on the other hand, act as agents of the customer who seeks their advice.

## **6.8 Ownership of property**

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The law of England and Wales defines two distinct types of property; in this context, the word *property* is used to refer to all types of assets, rather than its more narrow reference to land and buildings. The two types are:

- ◆ *realty*: property is deemed to be real if a court will restore it to a dispossessed owner and not merely provide compensation for loss. Real property tends to be distinguished by being immovable, eg land and what is attached to it, also known as real estate;
- ◆ *personalty*: all other property is called personalty.

### **6.8.1 Joint ownership**

There are two types of **joint ownership**, both of which are described in terms of *tenancy* (but the meaning of tenancy here does not relate to the letting of property). These phrases refer to the joint ownership of any form of asset (or liability):

- ◆ *joint tenants*: the whole property is deemed to be owned by each of the owners, so that if one owner dies, the property automatically transfers into the ownership of the other. The transfer on death to the surviving owner is automatic and cannot be overridden by any provision in the deceased person's will;

- ◆ *tenants in common*: each owner has an identifiable share of the property; if one owner dies, his share of the property passes to whoever is entitled to inherit it under the terms of the will or under the rules of intestacy.

The concept of joint tenants or tenants in common can apply equally to debts, such as mortgages. In the former case, all borrowers are equally liable for the whole debt, while in the latter each is responsible for a portion of the debt. Banks, building societies and other commercial lenders always insist that joint mortgages are written on a joint tenancy basis.

## 6.9 Power of attorney

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An **attorney** is a person who is given the legal responsibility to act on behalf of another person. This may be necessary in the cases, for example, of an elderly person who is incapable of managing their own finances or of someone living abroad. The person who makes a power of attorney is called the *donor* and the person who acts for him is called the *donee* or simply the attorney.

A person who does not himself have the legal capacity to enter into a contract (eg a minor or a mentally incapacitated person) cannot appoint someone else as their attorney; and in fact, an ordinary power of attorney would automatically cease if a person were to become mentally incapacitated. The Enduring Powers of Attorney Act 1985 created a new type of power, called an *enduring power of attorney*, which does continue if the donor becomes mentally incapacitated. Enduring powers of attorney have to be registered with the Public Guardianship Office if the attorney believes that the donor is becoming mentally incapacitated. Once the enduring power has been registered, the attorney can continue to act despite the donor's mental capacity. An enduring power of attorney can be revoked only with the consent of the Court of Protection.

From October 2007, when the Mental Capacity Act 2005 came into force, *enduring powers of attorney* have been replaced by *lasting powers of attorney* (LPAs) under which attorneys are able to make decisions not only about financial matters, but also about personal and health matters. An LPA is established while a person still has a mental capacity, but only comes into force when they have become incapacitated. Following the implementing of the Mental Capacity Act, the Public Guardianship Office has been renamed as the Office of the Public Guardian. Existing enduring powers of attorney can remain in force, but all new arrangements must be lasting powers of attorney.

## 6.10 Insolvency and bankruptcy

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**Insolvency** arises when:

- ◆ a person's liabilities exceed his assets; or
- ◆ a person cannot meet his financial obligations within a reasonable time of their falling due.

*Bankruptcy* takes the position a stage further and arises when a person's state of being insolvent is formalised under the terms of a county court order. A person can petition to have himself declared bankrupt or a creditor may petition to have someone else declared bankrupt. The bankruptcy level, ie the amount of money owed for which a person can be made bankrupt, is only £750.

The primary UK legislation on insolvency is the Insolvency Act 1986, but this has been subject to amendments over the years. In 2000, an EU Regulation on Insolvency Proceedings was adopted and it came into force in 2002. As a regulation rather than a directive (see Section 1.3.1) it had direct effect in the UK; to clarify the position in the UK, a number of statutory instruments were issued including, for example, the Insolvency (Amendment) Rules 2002.

In 2007, there were around 13,000 company liquidations in England and Wales, of which around 7,300 were voluntary liquidations. In the same year there were around 106,000 individual insolvencies, of which around 64,000 resulted in bankruptcies and the remainder were dealt with through *individual voluntary arrangements* (see Section 6.10.1).

As a result of the Enterprise Act 2002, which came fully into force in April 2004, most bankruptcy orders now remain in force for 12 months, during which time the person is said to be an *undischarged bankrupt*. During this time, a bankrupt person's possessions are, in effect, surrendered to an Official Receiver, who can dispose of them and use the cash to pay off the creditors. The only exceptions are clothing and household items, and work-related items. Although bankruptcy cancels most kinds of debt and allows people to make a fresh financial start, it comes at a price: it normally makes it more difficult to obtain credit in the future and it can affect employment prospects.

One practical effect of bankruptcy is that a person will be unable to borrow, other than nominal amounts, during the period that the order is in force. Even after the end of the period, the person must, by law, disclose the existence of a previous bankruptcy when applying for a mortgage. This may mean that it will

be more difficult for him to obtain a loan or that he may be charged a higher rate of interest to cover the greater perceived risk.

### **6.10.1 Individual voluntary arrangements**

An individual voluntary arrangement (IVA) is an alternative to bankruptcy, under which the debtor arranges with the creditors to reschedule the repayment of the debts over a specified period. An IVA can be set up only if creditors who represent at least 75% of the debt agree to the arrangement. The scheme must be supervised by an insolvency practitioner.

In recent years, a large market has arisen for firms that assist individuals with significant personal debts to enter into IVAs. In most cases they are able to arrange for interest to be frozen, for a reduction in the amount of the debt, and for legal protection from creditors if the terms of the IVA are met. The firms are generally able to persuade the bank or other lender to write off part of the debt in exchange for reasonable guarantee of receiving repayment of the remainder. In many cases this is better for the bank than simply writing off the debt or selling it to a debt recovery firm.

An individual with an IVA will find it difficult to obtain credit while the IVA is in place, and credit-worthiness is likely to be impaired even after the end of the arrangement.

## **Test your knowledge and understanding with these questions**

**Take a break before using these questions to assess your learning across Section 6. Review the text if necessary.**

**Answers can be found at the end of this unit.**

1. In what sense could a company be described as a 'legal person'?
2. Harry has died without leaving a will. His estate will be distributed by:
  - (a) an administrator.
  - (b) a solicitor.
  - (c) a probate officer.
3. Which of the following statements about a will is correct?
  - (a) An executor cannot be a beneficiary.
  - (b) A beneficiary cannot be a witness.
  - (c) A witness cannot be an executor.
4. Marian, who was married but had no children, although her parents were still alive, died without leaving a will. If her estate was £300,000, how much will her husband inherit?
5. What is 'consideration' in relation to a contract?
6. Can a contract be made verbally?
7. In agency law, what is 'ratification'?
8. Why do mortgage lenders insist that joint mortgages are always on a joint tenancy basis?

9. Whose consent is required before an enduring power of attorney can be revoked?
  - (a) The donee.
  - (b) The donor.
  - (c) The Court of Protection.
  
10. What is the normal period for which a bankruptcy order remains in force?

## **Answers**

1. A company is a 'legal person' in that it has a separate legal existence and can, for instance, enter into contracts. The contract is not with the directors but is with the company.
2. (a) An administrator.
3. (b) A beneficiary cannot be a witness.
4. £250,000 (ie £200,000 plus half the balance).
5. It is the payment (or a promise to pay) for the goods or services that are the basis of the contract.
6. Yes, many can – eg contracts for the purchase/sale of unit trusts can be made by telephone, with a recording of the conversation providing proof. Contracts for the sale of land, however, must be in writing.
7. The process by which the principal formally agrees to stand by a contract made by his agent, even though the agent has exceeded the authority granted to him by the principal.
8. If one borrower should default on the contract, the lender will wish to be able to obtain full repayment from the remaining borrower.
9. (c) The Court of Protection.
10. 12 months.

