KEY FACTS COMPANY LAW

4th edition

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HODDER EDUCATION

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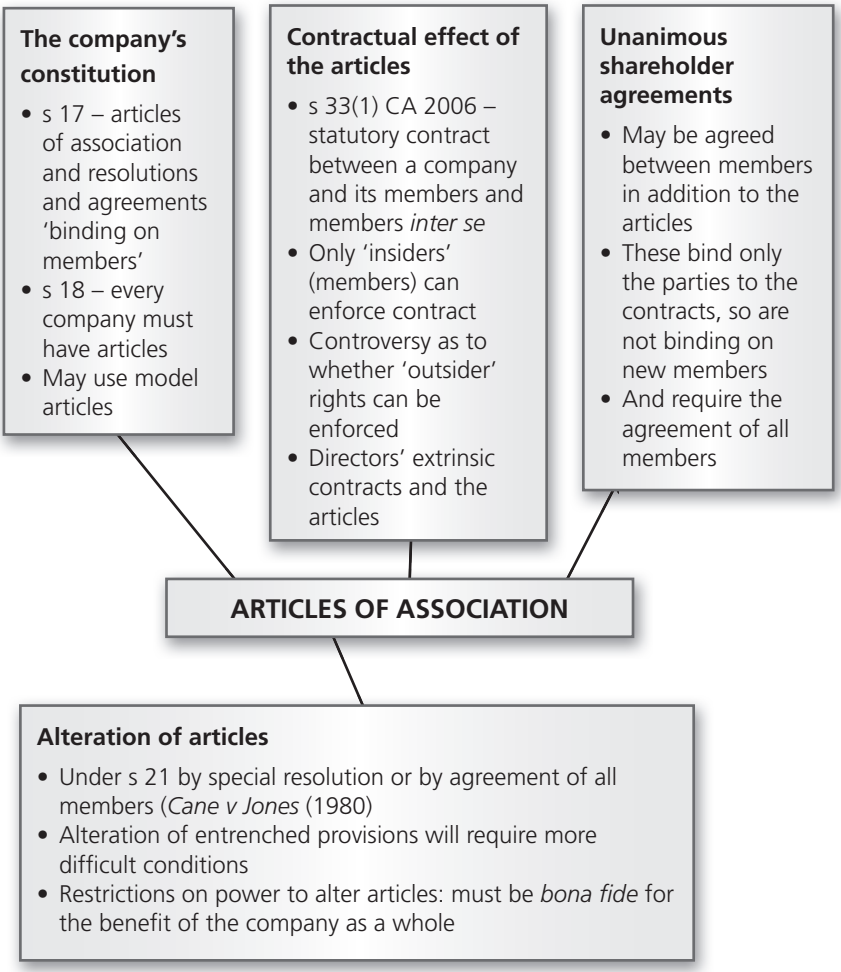
Articles of association



4.1 The company's constitution

1. Under previous Companies Acts every company was required to have two important constitutional documents: a memorandum of association and articles of association.
2. The Companies Act 2006 (CA 2006) has reduced the significance of the memorandum, which now simply contains an undertaking by each of the subscribers that they intend to form a company and agree to take at least one share each. The articles are now the company's main constitutional document. Information previously set out in the memorandum of association is now given as part of the application for registration.
3. Under s 17 CA 2006 a company's constitutional documents include:
   - the company's articles, and
   - resolutions and agreements 'binding on members' which, in terms of s 29, includes any special resolution and a broad range of other resolutions and agreements.
4. Section 18 provides that every company must have articles which contain the rules on how the company is to be run.
5. Previous Companies Acts included model articles, for example Table A CA 1985, which applied to both private and public companies and which could be adopted with or without amendments. Companies registered under previous Acts may continue to have as their constitution what has been termed an 'old style memorandum' and articles which may be in the form of Table A. Companies registered under previous acts may amend their articles to conform with the CA 2006 if the company agrees to do so by special resolution.
6. The CA 2006 gives power to the Secretary of State for Business Innovation and Skills to prescribe separate model articles for public companies, private companies limited by shares and private companies limited by guarantee: s 19(2).
7. A company may adopt the relevant model articles in whole or in part, as was the case under previous legislation. Model articles have been published for private companies limited by shares and for public companies.

4.2 Contractual effect of the constitution

1. The ownership of shares in a company gives rise to certain rights and obligations. A company is an artificial person in its own right as well as an association of its members, and is therefore able to contract with its members.
2. Section 33(1) CA 2006 (previously s 14 CA 1985) provides: 'The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions'.
3. Previous versions of this provision referred only to 'covenants on the part of each member to observe all the provisions of the memorandum and the articles', making no mention of the company's obligation. Although it has been generally accepted that there is a contract between the company and its members (*Hickman v Kent or Romney Marsh Sheepbreeders Association* (1915)), the change of wording to 'covenants on the part of *the company and of* each member' removes any doubt.
4. Under previous legislation the equivalent section referred to the memorandum and articles, although discussion focused on the articles since this document contained the rules for internal management of the company. Section 33 CA 2006 refers to the constitution and although the principal constitutional document is the articles of association, this may also include certain resolutions (see s 17).

4.2.1 Special features of the s 33 contract

Ordinary contract	s 33 contract
Terms agreed by parties	Member usually accepts terms by purchase of shares in company
Terms provide for obligations/rights which when performed come to an end	The constitution creates ongoing rights/obligations – sometimes referred to as a relational contract
Terms may only be altered by agreement	Articles can be altered by special resolution (s 21 CA 2006)
Rectification available	Rectification not available (*Scott v Scott* (1940))

Damages are the usual remedy for breach	Damages usually not appropriate (but may be claimed for liquidated sum, e.g. dividend); a declaration is the usual remedy

1. The distinctions between an ordinary contract and the statutory contract were noted in *Bratton Seymour Service Co Ltd v Oxenborough* (1992). In this case the Court of Appeal refused to imply a term into the articles imposing a financial obligation on members in order to give the articles 'business efficacy'. The articles are a public document and it is important that third parties, especially prospective members, are able to rely on the accuracy of these documents as registered.
2. However, in *Folkes Group plc v Alexander* (2002) the court construed an article by adding five words to correct what, according to the evidence, must have been a drafting error. This case should be treated as exceptional, and the general principle remains that external factors should not be taken into account when construing articles of association.

4.2.2 The scope of the statutory contract

1. The scope of the s 33 contract has been considered in a number of cases, which cannot easily be reconciled. The following points are established:
   (a) Once registered, the articles constitute a contract between the members and the company and between the members *inter se* (*Wood v Odessa Waterworks Co* (1889)). This is now more clearly stated in the 2006 Act than in previous legislation. This contract gives rise to:
   - contractual rights between the company and its members (*Hickman v Kent or Romney Marsh Sheep-Breeders Association* (1915));
   - contractual rights for shareholders against fellow shareholders (*Rayfield v Hands* (1960)).

   (b) Only an '**insider**' (a member in this context), can enforce the contract and only those rights that are held in his or her capacity as a member fall within the scope of s 33.

(c) A claim under s 33 made by an **'outsider'** (that is, a person claiming in a capacity other than that of member) will not succeed (*Eley v Positive Government Security Life Assurance* (1876); *Beattie v E and F Beattie* (1938)). It should be noted here that 'outsider' has been strictly defined and a claim based on rights held as a director will fail, even if the director is also a member.

(d) A member's statutory rights cannot be limited by the articles, for example in *Baring-Gould v Sharpington Combined Pick & Shovel Syndicate* (1899) a resolution in the articles purporting to limit members' rights under what is now s 111(2) Insolvency Act 1986 could not be enforced.

4.2.3 What rights can be enforced?

1. The statutory contract confers on a member, in his capacity as a member, the right to bring a personal action to enforce certain constitutional rights. There are conflicting cases on what may be enforced under s 33: see for example *MacDougall v Gardiner* (1875) where the refusal by the chairman to accept a request for a poll in breach of the articles was held to be an internal irregularity which could be put right by the company's own mechanisms and therefore was not enforceable by personal action. Compare this with *Pender v Lushington* (1877) below.

2. The following rights contained in the articles have been enforced by members:

- a provision in the articles requiring directors to purchase shares from a member wishing to leave the company (*Rayfield v Hands*);
- a right to exercise a vote at a general meeting (*Pender v Lushington* (1877));
- payment of a dividend, duly declared (*Wood v Odessa Waterworks Co*) – in this case a member was able to demand payment in cash as implied by the articles, even though the general meeting had agreed to payment by way of debenture;
- a right to enforce a veto by directors on certain acts (*Salmon v Quin & Axtens* (1909)).

3. The company may enforce a provision in the articles, for example in *Hickman v Kent or Romney Marsh Sheepbreeders Association* (1915) the company was able to stop an action by a member and require that the dispute between it and its members be referred to arbitration as provided in the articles.

4.2.4 Enforcing 'outsider rights'

1. It is well established that no contract is created under s 33 between the company and an outsider, even a director. It is less clear whether 'outsider' rights can be enforced by a person bringing a claim as a member, on the basis that every member has the right to have the company's business conducted in accordance with the articles: see for example *Salmon v Quin & Axtens*.
2. This was suggested by Professor Lord Wedderburn in an important article in 1957 and has been the subject of academic debate since then.
3. It has also been suggested that if the provision in the articles relates to a constitutional matter, for example those listed above in section 4.2.3, then a member will be able to enforce the article as a contract, even if this indirectly enforces outsider rights.
4. But if the matter relates to an aspect of internal organisation or management of the company, for example the right to be paid a salary or the right to be the company's solicitor (*Eley v Positive Government Security Life Assurance Co Ltd* (1876)), then the provision will not be enforceable.
5. The provisions relating to unfair prejudice in Part 30 CA 2006 provide an alternative way for members and directors to enforce certain rights which might be unenforceable under s 33 (see further chapter 14) and in the case of small private companies shareholder agreements may be used to protect rights under the general law of contract.

4.3 Directors, the articles and extrinsic contracts

1. Under s 171 CA 2006, directors must act in accordance with the constitution but in their capacity as directors they have no contractual relationship with the company under s 33.
2. However, a company can make contracts with its directors and others, which expressly or impliedly incorporate terms contained in the articles, for example articles about directors' remuneration may be incorporated in a contract of service.
3. Where an article provides for the employment of a director but there is no contract, the court may imply an extrinsic contract (*Re New British Iron Co, ex parte Beckwith* (1898)).

4. These rights can be enforced against the company without relying on the articles, but alteration of the articles may vary the terms of the contract.
5. The articles can be altered at any time by special resolution, thus varying the terms of the contract, but terms cannot be altered retrospectively (*Swabey v Port Darwin Gold Mining Co* (1889)).
6. If provisions from the articles are incorporated into extrinsic contracts, alteration of the articles may result in breach of the extrinsic contract. A third party cannot prevent alteration of the articles, but in such cases the company may be liable to pay damages (*Southern Foundries (1926) Ltd v Shirlaw* (1940)).

4.4 Shareholder agreements

1. A shareholder agreement may be used in addition to the articles. Such an agreement may be made between all or some of the members and others including directors and is enforceable as an ordinary contract.
2. An example is *Russell v Northern Bank Development Corporation Ltd* (1992), where an agreement was made between all the shareholders and the company. It is held that an attempt by the company to restrict its statutory right to alter its articles was invalid but that the members were able to agree, by way of a shareholder agreement, to use their votes in a certain way (see also section 4.5.1 below).
3. Shareholder agreements will only bind the parties to it, so problems may arise on the transfer of shares as the new shareholder will not be bound by the agreement.
4. Because shareholder agreements require agreement by all members to be fully effective, they are generally only suitable for use by small private companies.

4.5 Alteration of articles

1. Other than in the case of an entrenched article, a company may alter its articles by:
   - special resolution (s 21 CA 2006);
   - agreement by all members (without a resolution) (*Cane v Jones* (1980)).

2. A company may not prevent its articles being altered, but it may entrench certain provisions by requiring something more than a special resolution to change them. Such entrenched provisions can only be included:
   - on formation of the company, or
   - after incorporation, by agreement of all the members of the company.
3. In the case of companies registered under previous legislation, certain provisions may have been included in the memorandum in order to make them more difficult to change. Such provisions will now be treated as if they were part of the articles (s 28 CA 2006) and may be treated as entrenched.
4. Notice of entrenchment must be given to the Registrar.
5. Provision for entrenchment does not prevent alteration of the articles by agreement of all the members or by order of the court.
6. Notice of alteration must be given to the Registrar within 15 days of alteration: s 26 CA 2006.

4.5.1 Restrictions on power to alter articles

Apart from the possibility of entrenchment, there are a number of restrictions on a company's power to alter its articles.

1. It has long been recognised that there are statutory limitations on amendment of articles (*Allen v Gold Reefs of West Africa Ltd* (1900)):
   - s 25 CA 2006: a member is not bound by a change which requires him/her to take more shares or in any way increase the member's liability, without the written agreement of the member.
   - ss 630–635 CA 2006: any alteration which varies class rights must follow the procedures laid down in these sections (see chapter 7, section 7.3 below).
2. A company may not include a provision in its articles that would restrict alteration of the articles (*Punt v Symons & Co* (1903)). It has further been held that a contract made by the company not to alter its articles is also unenforceable (*Russell v Northern Bank Development Corporation* (1992)). However, in the same case it was stated that it is possible for individual members to enter into a contract setting out how they might use their votes in certain situations.

3. Alterations to the articles are effective only if they are made *bona fide* for the benefit of the company as a whole. This principle, articulated in *Allen v Gold Reefs of West Africa Ltd* (1900), has been interpreted and further developed as the courts have applied it in different situations.
   - A member cannot challenge an alteration which was carried out *bona fide* for the benefit of the company as a whole, even if such alteration has affected the member's personal rights, as long as the altered article was intended to apply indiscriminately to all members: *Greenhalgh v Arderne Cinemas Ltd* (1951).
   - The court will generally accept the majority's *bona fide* view of what is for the benefit of the company as a whole, as long as the alteration is not one which no reasonable person could consider to be for the benefit of the company: *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* (1927).
   - In some cases (for example *Greenhalgh*) the courts have sought to distinguish between the company as a separate entity and the company as an association of members and in deciding on the validity of certain amendments have applied a test based on whether the amendment was for the benefit of the 'individual hypothetical member'.
   - This concept has raised difficulties of application and other tests, such as the 'proper purpose' test, have been applied in other jurisdictions, notably Australia.
   - However, in *Citco Banking Corporation NV v Pusser's Ltd* (2007) the Privy Council confirmed that the benefit of the company as a separate commercial entity was the primary test in establishing the validity of an amendment to articles.
4. Cases in this area often involve minority shareholders challenging the decision of the majority and in many instances the protection available under ss 994–996 CA 2006 will provide a more effective remedy (see chapter 14).
5. Amendment of the articles may put the company in breach of a separate contract and liable to pay damages: *Southern Foundries (1926) Ltd v Shirlaw* (1940).