



The Articles of Association form a Contract

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Abstract

The Articles of Association form a Contract between parties in the formation of a company. It encompasses all of the components of what is legally an enforceable agreement. While there has been much debate on the topic particularly when there are also shareholder agreements in addition to the Articles, it is settled law that there is a contract between the parties.

The Paper examines the United Kingdom Companies Act 2006 in line with case law which gives insight into the importance of the Articles of Association. The perspective is specifically with a focus on the United Kingdom's approach. However, its practical application in terms of lessons to be learnt is relevant for many common law jurisdictions.

Having drafted Articles of Association in legal practice, the significance of this for many is not realised unless there is a dispute between the parties and terms in the Articles are examined. In making the argument that there is a contract resulting from this constitutional document case law provides inconsistent opinions.

Keywords: Contract; Articles of Association, UK Law.

The UK Companies Act 2006 is the key legislation that governs the manner and form in which companies operate. The articles of association are a key component of what is known as the constitution of the company. The Articles of Association regulates the internal affairs of the company.¹ Matters related to the internal rules of the company are guided by the articles of association.²

Section 33 (1) of the Companies Act 2006 states that “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 other to observe those provisions.” In *Rayfield v Hands*³, the statutory

¹ Davies, Paul L., Gower and Davies Principles of Company Law, 8th Edition, Sweet & Maxwell, 2008, pp. 62

² Van Duzer, Peter, Companies Act 2006 – A Guide for Private Companies, Jordan Publishing Limited, 2007, at pp. 40

³ [1960] Ch 1

contract could be treated as a contract between members inter se. The members can take legal action against each other to enforce a right that they have as members based on the articles of association and not in relation to a private dispute amongst each other. With reference to the articles of association, the courts have put in place limits to the enforceability by companies or members of what has been considered a statutory contract. “The contract formed by articles of association is of a type sometimes called a ‘relational contract’ ”.⁴ The contract in this contextual arena does not include everything that will arise in the relationship between the parties.

In *Borland’s Trustee v Steel*⁵, a member sought declaration that a right of pre-emption or first right of refusal in purchasing of member shares in the articles was valid. Hence the enforceability of the ‘contract’ demonstrated between members. However, this enforcement is qualified by the fact that the articles are a public document which portrays the company’s internal functioning. Enforceability of the contract formed by the articles of association is limited to the shareholders who may be referred to as members. Enforcement of a term of the articles is not permitted by non-members and the Contracts (Rights of Third Parties) Act 1999 is not applicable to the company’s articles. In *Hickman v Kent or Romney Marsh Sheepbreeders’ Association*⁶, Astbury J., stated that “An outsider to whom rights purport to be given by the articles in his capacity as such outsider, whether he is or subsequently becomes a member, cannot sue on those articles, treating them as contracts between himself and the company, to enforce those rights”. Further, in *London Sack & Bag Co v Dixon & Lugton*⁷, this position was affirmed with reference to the contract between the members inter se.

The present position which emanates from the case law buttressed by the statute conforms to the view that the contract formed by the articles are only enforceable between the members and the company or the members amongst themselves. In *Baring-Gould v Sharpington Combined Pick and Shovel Syndicate*⁸, the articles limited the rights of members. However, articles cannot limit or remove the members’ statutory rights. “The articles do give rise to obligations on the part of the company and the members.”⁹ This was a position that was recognized by Slade J.¹⁰

*Beattie v E. and F. Beattie Ltd*¹¹, endorses the view that articles were an enforceable contract only in relation to membership.¹² In *Wood v Odessa Waterworks Co*¹³, a member was able to sue the company to enforce his right to be paid his dividends in a certain way. This ably supports the view of the articles forming a contract between the company and its members.

⁴ French, Derek, Mayson, Stephen W., and Ryan, Christopher L., *Company Law*, 24th Edition, Oxford University Press, 2007, pp. 76

⁵ [1901] 1 Ch. 279

⁶ [1915] 1 Ch. 881

⁷ [1943] 2 All E.R. 763

⁸ [1899] 2 Ch. 80

⁹ Reece-Thomas, Katherine, *The Section 14 contract: limitation issues*, C.L.J, 1997 at pp. 328

¹⁰ [1978] 3 All E.R. 668

¹¹ [1938] Ch 708

¹² French, Derek, Mayson, Stephen W., and Ryan, Christopher L., *Company Law*, 24th Edition, Oxford University Press, 2007, pp. 77

¹³ [1889] 42 Ch. D 636

The enforcement by a shareholder of a provision of the articles of association had the indirect effect of protecting an outsider's position based on the articles¹⁴ in *Ram Kissendas Dhanuka v Sataya Charan Law*.¹⁵ In *Salmon v Quin and Axtens Ltd*¹⁶, the member sued to stop the company from acting on an unconstitutional decision which allowed him as an insider to enforce an outsider right indirectly.

Section 33 (2) states, "Money payable by a member to the company under its constitution is a debt due from him to the company". This is an ordinary contract debt. This 'contractual obligation' is between the company and members and usually a pre-requisite to an outsider (non-shareholder) becoming an insider (shareholder).

The statutory contract of the articles of association could not be anymore clearly defined. Yet, it is distinguishable from an ordinary contract in a number of ways. Firstly, by purchasing the shares a member accepts the terms of the articles of association which form a contract between that member and the company. Secondly, the articles of association can be altered by special resolution in which 75% of the shareholders agree to same. Thirdly, the articles cannot be challenged based on the doctrines of misrepresentation, mistake or undue influence. This was confirmed in *Bratton Seymour Service Co Ltd v Oxborough*.¹⁷ In *Scott v Scott*¹⁸, it was confirmed that rectification is not available and damages were not available to members suing under section 33 as in *Houldsworth v City of Glasgow Bank*¹⁹. While currently, damages may be available it is usually not relevant. The aforementioned reflects a contract albeit not the traditional basis of contract as established in contract law due to the variation from an ordinary contract. Nevertheless, its unusual classification as that of a contract as established in statute has the desired effect intended by Parliament of regularizing the way in which companies function.

"Contracts outside the memorandum and articles are sometimes called extrinsic contracts."²⁰ An extrinsic contract may be implied by reliance of S.33 of the CA 2006 where the article provides for the particulars related to what is being implied as in *Re New British Iron co., ex parte Beckwith*²¹. As a subject of much academic debate, the contractual effect of the constitution is rife with varying viewpoints.²² If the articles of association were an ordinary contract, it would be enforceable without complications and easily addressed by both parties if there was failure to comply with the contract. With the articles being a statutory contract the enforcement are not as simple. In *Bisgood v Henderson's Transvaal Estates Ltd*²³, a company attempting to enforce the provisions in the articles against a member in a different capacity such as a director will fail.

¹⁴ Smart, Philip St. J., *The enforcement of outsider rights: Lord Greene and the Privy Council*, J.B.L., 1989 at pp. 143

¹⁵ [1949] LR 77 I.A. 128

¹⁶ [1909] AC 442

¹⁷ [1992] BCLC 693 CA

¹⁸ [1943] 1 All ER 582

¹⁹ [1880] 5 App Cas 317

²⁰ Hicks, Andrew & Goo, S.H., *Cases & Materials on Company Law*, 6th Edition, Oxford University Press, 2008, at pp. 187

²¹ [1898] 1 Ch 324

²² *Ibid.*, at pp. 178

²³ [1908] Ch 1 743

Some types of provisions in the articles may not be enforceable by members as evidenced by the courts' imposition of restrictions. These restrictions fall into two categories. They are: matters relating to internal irregularities and areas regarding the enforcement of outsider rights.

The statutory contract made by shareholders through the articles of association is complex. "As shareholders and members of the association, they are entitled to a bundle of rights which are primarily financial, but which also include rights of participation and rights of alienation."²⁴

The rule in *Foss v Harbottle*²⁵, suggests that it is for the company to bring an action when there is a dispute regarding the company based on the will of the majority of its shareholders. The Law Commission reviewed the enforcement of shareholder's contractual rights with respect to the articles of association.²⁶ While it did not include "outsider rights", in discussion on the Hickman principle there was reference to the fact that it was challenging to reconcile in light of case law previous.²⁷ Only when a member sues as a member and not as an "outsider" can he compel the company to follow through with the contract by virtue of the articles of association which may indirectly enforce an "outsider's" rights.²⁸ Further, "a member's right to have the articles enforced are incidental to the member's right to have the affairs of the company conducted by the particular organ of the company specified in the memorandum and articles of association."²⁹

The exercise of the rights of every other member to have different articles enforced affects the exercise of each member's right by the contract formed under the articles to enforce those articles.³⁰ Moreover, in *Bratton Seymour Service Co Ltd v Oxborough*³¹, Steyn LJ said, "By virtue of sec. 14 the articles of association become, upon registration, a contract between a company and its members. It is, however, a statutory contract of a special nature with its own distinctive features. It derives its binding force not from a bargain struck between parties but from the terms of the statute. It is binding only in so far as it affects the rights and obligations between the company and the members acting in their capacity as members. If it contains provisions conferring rights and obligations on outsiders, then those provisions do not bite as part of the contract between the company and the members, even if the outsider is coincidentally a member. Similarly, if the provisions are not truly referable to the rights and obligations of members as such it does not operate as a contract. Moreover, the contract can be altered by a special resolution without the consent of all the contracting parties. It is also, unlike an ordinary contract, not defeasible on the grounds of misrepresentation, common law mistake in equity, undue influence or duress." This statement supports the overall doctrine of effecting the

²⁴ Hannigan, Brenda, Altering the articles to allow for compulsory transfer-dragging minority shareholders to a reluctant exit, J.B.L., 2007 at pp. 489

²⁵ [1843] 2 Hare 461

²⁶ Hicks, Andrew & Goo, S.H., Cases & Materials on Company Law, 6th Edition, Oxford University Press, 2008, at pp. 198

²⁷ Ibid., at pp. 198

²⁸ Wedderburn, K.W., Shareholders' rights and the rule in *Foss v Harbottle*, CLJ, 1957 at pp. 212-13

²⁹ Goldberg, G.D., The Enforcement of Outsider Rights under s.20(1) Companies Act 1948, MLR, 1972

³⁰ Drury, R.R., The Relative Nature of a Shareholder's Right to Enforce the Company Contract, CLJ, 1986

³¹ [1992] bcc 471

provision of the company's constitutionally binding the company to its members and its members to each other.

The enforcement of the articles by a member in his or her capacity as a member is the extent of the contractual obligation known as the Hickman Principle. The Hickman Principle has been the subject of academic debate in its applicability to enforcement. Subsequent case law clearly demonstrate that the courts have been able to navigate around it through the identification of the membership right.³² Still the Hickman Principle is effected and in spite of the criticisms there has been no reform adopted in regard to its application in the Companies Act 2006.

Enforcement of a personal right by a member may be defeated due to the categorization of the breach as "a mere internal irregularity".³³ The breaches of the articles which have resulted in the courts making decisions have varied based on the categorization of those breaches. Therefore, apparent confusion depending on the approach to the matter. In *MacDougall v Gardiner*³⁴, the decision by the Chairman of the Shareholder's meeting resulted in the court determining there to be an internal irregularity.³⁵ In *Pender v Lushington*³⁶, the Chairman refusing to recognize votes resulted in the court determining infringement of personal rights.³⁷ These decisions by the court in the enforcement of the statutory contract create difficulties as they cannot be reconciled.

The statute is intended to bring clarity to the confusion of historical case law. This is usually based on clear policy to effect the intent of the legislature. With irreconcilable case law, the best manner would be to choose the policy that is priority according to Smith.³⁸ The unusual contract resulting from the articles demonstrate the specificity of the intention of the legislature in the internal affairs of a company's operation. Further, the case law gives examples of who can enforce this contract in reality. However, the debate of whether the Hickman Principle continues to exist is arguably a very real phenomenon.

Conclusion

In spite of the Companies Act 2006, there is case law which presents uncertainties and remains in this state as there has not been reform which encompasses recommendations to address same. Inconsistency hampers the likely result in the court on the enforcement based on the case law we have seen. Insofar as there is implementation of modern reforms to address these inconsistencies with case law we may see a more reconcilable approach in the future with policy being explicitly enunciated in statute which can then be applied to these irregularities of the enforcement of this statutory contract.

³² Davies, Paul L., Gower and Davies Principles of Company Law, 8th Edition, Sweet & Maxwell, 2008, pp. 70

³³ *Ibid.*, at 71

³⁴ [1875] 1 Ch.D. 13

³⁵ *Ibid.*, at 72

³⁶ [1877] 6 Ch.D. 70

³⁷ Davies, Paul L., Gower and Davies Principles of Company Law, 8th Edition, Sweet & Maxwell, 2008, pp. 72

³⁸ Smith, R.J., Minority Shareholders and Corporate Irregularities, 1978, MLR 147

Legal practitioners ought to be extremely attentive to detail regarding drafting of these constitutional documents which from a transactional perspective often times appear mundane and routine. Ensuring that the Articles of Association are thorough within the requirements of the company will also mitigate against potential litigation should there be issues with shareholder agreements which conflict with those Articles.