Legal Aspects of Corporate Finance

Unit 1 Incorporation and the Corporate Constitution

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Unit Overview

Unit 1 introduces the concept of incorporation as a legal entity and the types of company available to entrepreneurs. It outlines and discusses the reasons for incorporating and briefly introduces the process of forming a company. The unit also outlines the main components of the company's constitution and explains the internal and external dynamics of this, and the ways in which companies act through their organs and officers.

Learning outcomes

When you have completed the study of this unit and accompanying study material, you will be able to:

- explain how, and why, a company has a separate legal personality
- define what 'limited liability' means and how the concept works in practice
- find your way through a company's constitutional documents, and see how the different parts interact
- discuss how far, and why, third parties need to be concerned about what is in a company's constitution
- discuss ways in which a company interacts with the outside world
- explain what a group means and how a group differs from the individual companies within it.

Reading for Unit 1

Black BS (2001) 'The legal and institutional preconditions for strong securities markets'. *UCLA Law Review*, 48, 781–855.

Blair MM (2003) 'Locking in capital: What corporate law achieved for business organizers in the nineteenth century'. *UCLA Law Review*, 51, 387–432.

Worthington S (2016) *Sealy & Worthington's Text, Cases, and Materials in Company Law*. 11th Edition. Oxford UK: Oxford University Press. Pages cited.

Department for Trade and Industry (2003) *The White Paper on Modernising Company Law. Sixth Report of Session 2002–03*. HC 439.

EC (2001) *Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE)*.

Companies House (2009) 'Company Formation'.

EU Council Directive 68/151, 'Company law'.

Law Commission Report (1996) 'Involuntary Manslaughter'.
Westlaw: Meridian Global Funds *v* Securities Commission [1995] 2 AC 500. Available via the University of London Online Library.

1.1 Introduction

This unit forms the foundation for all other units in the *Legal Aspects of Corporate Finance* module. It deals with the fundamental aspects of setting up a company. It not only describes the mechanical aspects of incorporation but also explains the main reasons for doing so and the different types of company that can be incorporated. The unit goes on to discuss a company's constitution, including the different functions of the various parts of a constitution, how the constitution can be altered and how far it affects third parties who deal with a company. Finally, at the end of the unit you will study how a company 'acts' and what a 'group' of companies is.

Reading 1.1

As a good introduction to the importance of corporate law for the functioning of efficient capital markets, you should now read Bernard Black's article on the institutional and legal preconditions for strong securities markets. This is a long article and you should concentrate on the Introduction and Parts I and II. You are, of course, encouraged to complete the full article, but we note that only the foregoing parts are essential for exam purposes.

Note the list of 'institutions' that Professor Black identifies as necessary for a strong securities market. Many of these derive from the various laws that are the subject of this unit.

Black (2001) 'The legal and institutional preconditions for strong securities markets'. *UCLA Law Review*, 48, 781–855.

1.2 Corporate Personality and Limited Liability

In this section you will study company law, which was developed in order to facilitate investment in large, risky projects, though today most companies are relatively small. A company is a separate legal entity and its shareholders are not liable for its debts (though they may lose what they have invested).

1.2.1 Historical development and policy issues

Without company law, businesses would be run either by sole traders or partnerships – that is, by individuals who, alone or together, own the assets of the business, take any profits that are made and are personally liable for all the debts of the business.

Many businesses, particularly small ones, are still run in this way today, but there are two significant drawbacks:

- the owners of the business have unlimited liability and could be made personally bankrupt if the business fails
- for large enterprises, where a large amount of capital is needed and/or there is a large number of investors, a partnership is simply too unwieldy.

Modern company law therefore developed in order to facilitate the establishment of large-scale enterprises, generally either trading companies or companies being formed to undertake a major project, such as a canal,

railway or mine. Many of these ventures were risky and, after considerable public debate, it was recognised that prospective investors would be unwilling to risk their capital if they could be made personally liable for all the debts of the business. The principle of limited liability was therefore ultimately accepted by parliament.

As a result a group, or 'company', of investors was allowed to be incorporated on the basis that the individual investors would not have any liability for the company's debts beyond the amount that they had each invested (or committed to invest). It was accepted as a matter of policy that, without this, the large amounts of capital needed to fund the industrialisation of Great Britain, and the expansion of commercial interests around the world, would simply not be forthcoming.

It was not until the 19th century that company law was formulated in the UK and foundation principles, limited liability, the rules of incorporation and disclosure of information, and the establishment of a Registrar of Joint Companies laid down. These principles were to be found in such legislation as the Joint Stock Companies Act 1844, the Limited Liability Act of 1855, and the Joint Stock Companies Act 1856. The establishment of other basic principles in such cases as *Salomon v Salomon* 1897 AC 22 have also played an important part in constructing the framework of the law. You will study that case, which demonstrates the separate legal entity concept of a company, in a reading towards the end of this section.

The 20th century saw a haphazard development of the law – as problems arose or deficiencies became apparent, new law was created to deal with them, which was added on to the existing law. There appears to have been no forward overall thinking to cater for the needs of a developing business and commercial world. Two major reports were published, the Cohen Committee Report in 1946 and the Jenkins Committee Report in 1962. Recommendations contained in these reports were incorporated in the 1948/67/80/81 Acts. The 1985 Act consolidated the legislation that had been passed prior to that date. European Union Law has also had an important effect. In 1989, a further act was passed in order to implement the Seventh EC Company Law Directive. This had resulted in a patchwork of regulation that was in the view of the government immensely complex and seriously out of date. As a result, in 1998 a Company Law review was launched by Margaret Beckett, then President of the Board of Trade. In a Foreword to the Consultation paper, she stated:

> Modern companies are one of the three pillars of our approach to competitiveness; and we are determined to ensure that we have a framework of company law which is up-to-date, competitive and designed for the next century, a framework which facilitates enterprise and promotes transparency and fair dealing.

The task of establishing such a framework was given to a Steering Group established by the DTI in 1998 consisting of company law experts, academics and business people supported by a widely based consultative committee, together with working groups and working parties. The Steering Group

produced nine consultation documents with their final report being published in 2001. Two White Papers were presented to Parliament – the first in 2002 and the second in 2005. In a foreword to the latter, Patricia Hewitt, the Secretary of State for Trade and Industry, stated, 'The review has been universally recognised as providing a thorough and authoritative assessment of the sorts of changes which need to be made'.

The result of what must be considered as the most in-depth review of company law that has taken place is the Companies Act 2006, which has 47 parts and runs to over a thousand sections. The Act came fully into force in October 2009, but there are a few which, due to EU directives, came into force sooner. The DTI (now the Department of Business, Innovation and Skills) pointed out that 'Changes to the First Company Law Directive (made by Directive 2003/58/EC) were implemented in the UK on 31 December 2006 (DTI EU Company Law Directives). These changes relate to electronic communications designed to ensure increased facilities for e-communications with the registrar of companies. The Directive also requires companies to include information similar to that already required on hard copy letters, and on electronic communications such as websites and emails.

1.2.2 Why incorporate?

The main reasons for incorporating are as follows:

- the owners or investors can enjoy limited liability
- it is easier for existing investors to realise their investment at a later date and for additional investors to be introduced
- there are often tax advantages to incorporating (see Unit 3)
- borrowing may be easier because of the ability of a company to grant a 'floating charge' (something that individuals cannot do – you will see further in Unit 3).

There are, of course, some drawbacks to incorporating, mainly:

- a lot of information about the business, including its financial statements, has to be made public
- financial statements have to be audited
- there are many ongoing reporting and maintenance requirements
- certain formalities have to be observed in the way a company is run
- the need to protect creditors means that there are restrictions on several aspects of the way in which a company deals with its investors
- directors can incur personal liability (including criminal liability) for breach of numerous provisions of company law which regulate how a company must behave.

Reading 1.2

You should now study the paper by Margaret Blair about the economic function of incorporation and how law facilitates this function. The paper uses as a case study the great industrial innovations of the 19th century and argues that the corporation, this innovative legal institution, played a major role in improving the business and financial efficiency of difficult industrial projects. The author concludes that:

> the popularity of corporate status as a way to organize production grew out of the unique ability of this legal form in the nineteenth century to promote and protect the interests not only of shareholders and other investors, but of a wide range of enterprise participants who made specialized investments in reliance on the continued existence and financial viability of the corporation. This ability grew out of the fact that a corporate charter created a separate legal entity, whose existence and governance were separate from any of its participants. Entity status and separate governance made it possible to do something more than engage in a series of business transactions, or relationships, or even projects. It made it possible to build lasting institutions. Investments could be made in long-lived and specialized physical assets, in information and control systems, in specialized knowledge and routines, and in reputation and relationships, all of which could be sustained even as individual participants in the enterprise came and went.

Blair (2003) 'Locking in capital: What corporate law achieved for business organizers in the nineteenth century'. *UCLA Law Review*, 51, 387–432.

1.2.3 Companies as legal entities

It follows from incorporation that a new, and artificial, legal 'entity' comes into existence – the company. The company is entirely separate from the real persons who set it up and who are its 'members'. However, a company is not a natural person and statute determines what the company can and cannot do. The 2006 Act states:

> from the date of incorporation […] the subscribers of the memorandum, together with such other persons as may from time to time become members of the company, are a body corporate by the name stated in the certificate of incorporation […] That body corporate is capable of exercising all the functions of an incorporated company (Section 16(1)(2)(3))

What is achieved is the separation of ownership of a business from the investors in that business. In the early days of company law, however, some found it hard to accept the idea that a company is a separate legal person, particularly when a sole trader incorporated his business and, to all outward appearances, continued to run it exactly as before. It was left to the courts to reinforce the change in business culture which incorporation (and limited liability) entailed.

1.2.4 What limited liability means

As indicated in Section 1.2.1, the owner of an unincorporated business would be liable, without limit, for all the debts of the business. The essence of 'limited liability' is that a member of a company cannot lose more than the amount he or she has invested (or agreed to invest) in the company. This is achieved through those provisions of company law that deal with

insolvency. For a principle that represented something of a revolution when first introduced, the relevant statutory provision is surprisingly brief:

> in the case of a company limited by shares, no contribution [i.e. on a winding up] is required from any member exceeding the amount (if any) unpaid on the shares in respect of which he is liable as a present or past member (Section 74(2)(d) of Insolvency Act 1986).

This has to be understood in the context of what 'shares' are and what amounts are due in respect of shares. These points are covered in detail in Unit 2. For present purposes it is enough to note that, if shares are 'fully-paid' (*ie* the amount agreed to be paid to the company when the shares were first issued has been paid in full), then the person who owns the shares has no liability to pay anything more towards the debts of the company if it becomes insolvent. If the shares are not fully paid, the member's liability is restricted to the amount that is unpaid.

The idea that the members of a company might have limited liability was considered so novel that it was felt important to give notice of that fact in the very name of the company. This was done by requiring that the last word of the name of a limited company should be 'Limited', a requirement which still exists (though modified in relation to public companies, whose names must end 'Public Limited Company' or 'PLC').

In a case that was decided over 100 years ago, for example, a man had incorporated his business by selling it to a newly-formed company in which he held all the shares except six, which were held by members of his family (since at that time a company had to have at least seven shareholders). The company became insolvent and the main question for the court was whether the man was liable for the company's debts. Today, the answer seems obvious, but at the time the case had to be appealed to the highest court (which held that the man was not liable – a result that was much criticised).

Reading 1.3

To understand the development of the concept of separate legal personality, turn to Worthington, and read the House of Lord's judgment in *Salomon v Salomon*, on pages 37–42. The views expressed by the House of Lords were considered by some to be rather revolutionary.

Worthington (2016) Extract from Chapter 2 'Corporate personality and limited liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 37–42.

1.2.5 Lifting the veil

A company has its own legal identity, separate from its members and directors, which the courts 'lift' or 'pierce' in exceptional circumstances. In other words, they ignore the fact that the company is a separate legal entity and look through the company to the person or persons who own or control it.

This is done only in very unusual situations, mainly (but not solely) where fraud or unethical business practices are involved and where the company is in reality a sham. In essence, this has happened where the courts have felt that

the justice of the case has required them to look behind the company itself. It is, however, difficult to extract a very precise general rule from these cases.

In *Re Bugle Press* [1961] Ch 270, a company had three shareholders. Two of them wanted to buy out the third, but he would not agree. So the two shareholders formed another company and caused it to make an offer for all the shares in the first company. They, of course, planned to accept the offer in respect of their own shares, with the result that the second company (given the split of shareholdings between the three shareholders) would then be able to buy out the third shareholder compulsorily under a mechanism in the Companies Act which permits this in the context of takeovers when an offeror has acquired 90% of the shares in a company (see further in Unit 7). The court held that the company specially set up by the two shareholders was a mere sham and disregarded it.

Further examples of lifting (or not lifting) the corporate veil can be found in *Adams v Cape Industries plc* [1990] Ch 433, which you will read soon in Worthington.

Reading 1.4

Please note the comments on pages 63–65 of Worthington, in which it is claimed that the expression 'piercing the corporate veil', after the decision *Prest v Petrodel*, 'is now reserved for instances where the court does indeed ignore the separate legal personality of the company'. The aim of the 2006 Act is to make the Directors and other officers of the company liable for its wrongs, therefore limiting the need for 'lifting the veil' to exceptional cases. The 2006 Act imposes statutory duties on Directors and imposes penalties for breach of their duties, ss 170–78. The role of Directors is discussed on pages 7–11 in the Department of Trade and Industry White Paper, 'Modernising Company Law', which you will read below.

Worthington (2016) Extract from Chapter 2 'Corporate personality and limited liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 63–65.

1.2.6 Proposed change of philosophical approach

As indicated in 1.2.1, company law developed in response to the need to encourage individual investors to provide large amounts of capital for major projects. Over time, however, the benefits of limited liability have resulted in most enterprises (large and small) now being conducted through the medium of limited companies. It thus turns out that, today, the vast majority of companies are small.

In recognition of this, the UK government embarked on a wide-ranging reform of company law. An official proposal document (known as a 'White Paper') published in 2002 entitled 'Modernising Company Law' notes (in paragraph 1.2) that 'current company law is designed around the needs of big public companies'. However, it states that in future 'the starting point for company law should be the small firm […] Company law should make it easy to start and run businesses' (Paragraph 1.3.). The reforms will therefore sought to simplify the law, particularly where small companies are concerned.

Readings 1.5 and 1.6

Read paragraphs 1.1 to 2.5 and paragraph 6.2 of *The White Paper on Modernising Company Law*, which sets out the government's proposals for reform in the areas covered in this unit.

Then turn to Worthington and read Chapter 1, 'Introduction', and 'Companies in action', pages 1–20, paying particular attention to European Law; also read Chapter 2 on companies as legal entities, pages 34–62, and on legal personality, limited liability and lifting the corporate veil, pages 63–82.

Department of Trade and Industry (2003) Extract from *The White Paper on Modernising Company Law*.

Worthington (2016) Extracts from Chapter 1 'The company and its incorporation' and Chapter 2 'Corporate personality and limited liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 1–20; 34–62; 63–82.

Optional Reading 1.1

If you have time, I also recommend the article 'Legal personality' by Professor WM Geldart (1911).

Geldart WM (1911) 'Legal personality'. *Legal Quarterly Review,* 27, 90.

Review Question 1.1

1. What economic developments led to the development of corporations as a form of business organisation?
2. Define the concept of legal personality.
3. Define the concept of limited liability.
4. Is limited liability a necessary attribute of legal personality?
5. What makes a limited company a much easier and more flexible vehicle for large-scale enterprises when compared with a partnership?

1.3 Types of Company

In this section, there is a description of several different types of company. The most common type is a limited company with a share capital, the vast majority of which are private companies.

1.3.1 The main distinctions

Under the Companies Act several different types of company can be formed, the main distinctions being:

- public/private
- limited/unlimited
- limited by shares/limited by guarantee.

Note sections 3-6 of 2006 Act.

In practice, the number of different types of company that can now be formed is five:

- public company limited by shares
- private company limited by shares
- private company limited by guarantee
- private unlimited company with shares

- private unlimited company with no shares.

Limited by shares

A company limited by shares (public or private) is by far the most common type of company. The concept of shares and share capital is dealt with in detail in Unit 2. For present purposes it is enough to note that 'limited by shares' refers to a company that has issued shares where the liability of the members is limited to the amount (if any) unpaid on their shares (as described in 1.2.4 above).

Limited by guarantee

With a company limited by guarantee, no shares or share capital are involved. The limit on a member's liability comes about through a provision in the company's constitution, which says simply that, on a winding up, each member undertakes to contribute up to a specified amount (often only £1) if necessary to satisfy the company's debts. Companies limited by guarantee are generally used only for non-profit-making purposes, mainly in the charitable, social and educational fields.

It is not possible for a company limited by guarantee to be a public company. It used to be possible for a company limited by guarantee to have a share capital, but this is no longer allowed for new companies.

Public company

The companies legislation used to define 'private company' and leave public company to mean, in effect, any company that was not a private company. (This is still the case in many Commonwealth jurisdictions.) However, the reverse is now true in the UK, 'public company' being defined as one whose constitution states that it is to be a public company and which complies with certain other requirements, the main one being in section 763 of the 2006 Act, that the company must have a minimum authorised allotted share capital of £50,000 or its Euro equivalent. A private company does not have such a minimum capital requirement.

The fact that a company is a public company does not necessarily mean that its shares are, or must be, listed on a stock exchange; but for a company that has its shares listed and traded on a regulated market, the rules applicable to that market must be observed. Part 43 of the Companies Act 2006 amends Section 89 of the Financial Services and Markets Act 2000. It introduces Section 89A which deals with Transparency rules, allowing the 'Competent Authority' to make rules for the purposes of the Transparency Obligations Directive (the 'Competent Authority' being the Financial Services Authority). The Directive was printed in the official journal of the European Union on 31 December 2004, but did not come into force until 20 January 2005. Due to a 24-month implementation period, the deadline for bringing it into force was 20 January 2007.

The aim of the Directive is to achieve both investor protection and market efficiency. Therefore, it requires Member States to impose obligations, firstly

on issuers of securities that are traded on a regulated market in the Member States to disclose certain information, and secondly, on shareholders and parties able to exercise control of voting rights to disclose information to the issuer of those shares in question. The obligations on issuers include the disclosing of annual and half-yearly financial reports. Both reports must be available to the public for at least five years. The annual report must comprise:

a) the audited financial statements
b) the management report
c) a statement by a responsible person that the financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer.

A statement is also required by a responsible person that the management report includes a fair review of the development and performance of the business and the position of the issuer.

As far as the shareholders are concerned, they are currently required to disclose substantial shareholdings in accordance with Part 6 of the Companies Act 1985, and regulations laid down by the Department of Trade and Industry (now the Department of Business, Innovation and Skills). Since January 2007, such disclosure has had to be in accordance with the rules laid down by the FSA as 'the competent authority'. In 2013, the FSA was replaced by the Financial Conduct Authority ('FCA') acting as UK Listing Authority ('UKLA') as delegated by the Financial Services Market Act. Part 6 will be repealed in as much as it relates to shareholders' disclosure obligations. The disclosure obligation is set in motion when the size of a shareholding reaches or exceeds or moves below certain thresholds. Previously the 'disclosure obligations' applied to 'public companies'. From January 2007 it applies to shareholders holding shares that are traded on a regulated market and to which voting rights are attached. From that date shareholders with shares in a non-traded company are no longer affected by the disclosure rules.

The basis of the disclosure obligations laid down by Part 6 of the 1985 Act is 'interests in shares'; under the directive the obligation is narrower. It applies to those traded shares 'to which voting rights are attached'. The threshold for disclosure under the Directive is 5% and 1% increments. Whereas the FSA published a policy statement on 27 October 2006 setting out the near final rules for the implementation of the Transparency Directive, for major shareholding notification it retains 'the current notification threshold of a 3% holding and every 1% thereafter'.

It also applies the Disclosure Obligations to a wider range of issuers than the Directive requires (*ie* issuers on all regulated and prescribed markets – including AIM and Plus markets, formerly OFEX). As has already been pointed out, the Transparency Directive rules came into effect on 20 January 2007.

The reason for the notification obligation is to enable the shareholder and the general public to be made aware, as soon as possible, of a significant

change in the holding of shares with voting rights. This should prevent any uncertainty as to who may be in a position to influence or control the company, since such uncertainty could prejudice the affairs of a company.

The disclosure obligation requires that penalties be imposed for failure to comply with the provisions adopted in accordance with the Transparency Directive.

The only type of public company that can now be incorporated is one limited by shares.

Private company

The Companies Act defines a private company as any company other than a public company. As its name implies, a private company is one whose shares are not intended to be widely held. Before 1980 private companies had to restrict the number of their shareholders to a maximum of 50. Although there is no longer a numerical limit of this sort, in practice the constitution of a private company will almost invariably contain restrictions on the transfer of its shares. In addition, a private company is not allowed either to have its shares listed or to offer its unlisted shares to the public.

A private company may be limited by shares, limited by guarantee or unlimited.

The companies legislation treats private companies differently from public companies in several important respects – for example, the ability to purchase or redeem their own shares out of capital (see Unit 2).

The 2006 Act has introduced important changes to private companies. As from 1 October 2007 they are able to dispense with General Meetings, the normal method of decision-making will be by written resolution and whereas the 1985 Act required unanimity (section 381A), the new Act does not require unanimity for such resolutions. The required majority will be the same as that for shareholder meetings, a simple majority of the eligible shares for ordinary resolutions, or 75%for special resolutions. The position is now governed by section 288 of the 2006 Act, which does not allow written resolutions in two cases – the removal of a director or an auditor, before the expiration of their terms of office. Such resolutions may be in electronic form or posted on a website. Shareholder meetings will all be on a 14-day notice, unless alternative conditions are contained in the company's Articles.

From 6 April 2008 private companies formed after that date do not require a company secretary. If a private company does decide to have a company secretary, the secretary will have the same authority and responsibilities as pre-Act and will continue to be registered at Companies House.

An important new procedure for reducing the share capital of private companies has been introduced by the 2006 Act (*ie* the solvency statement procedure). Section 641 allows a company to reduce its share capital by passing a special resolution supported by a solvency statement. Such a statement must meet the requirements of section 643. If the reduction is

carried out this way the formal approval of the Court is not required. Section 641(2) does not allow a company to use this method of capital reduction, if as a result of the reduction there would no longer be any member of the company holding shares other than redeemable preference shares.

Unlimited company

An unlimited company is simply one that does not have the liability of its members limited (whether by reference to amounts unpaid on their shares or by guarantee). In other words, in a winding up, the members may be compelled to contribute whatever is necessary to satisfy all the debts of the company, without limit.

It is only a private company that may be unlimited. It may, but does not have to, have a share capital.

Given the obvious benefits of limited liability, you may wonder why someone would want to have an unlimited liability company. One of the main reasons is that (subject to certain conditions) accounts do not have to be published (see further in Unit 5), so that the financial affairs of such a company can be kept confidential. In addition, it is easy to return capital to shareholders of an unlimited company (an issue discussed further in Unit 2). Of course, an unlimited company still enjoys the other benefits of being incorporated.

Community Interest Company (CIC)

Part 2 of the Companies (Audit, Investigation and Community Enterprise) Act 2004, which came into force on 1 July 2005, contains provisions relating to a new company, the Community Interest Company. These provisions make it easy to set up a company that intends to use its profits and assets for the benefit of the community, and not for private advantage. CICs are limited companies with special features – namely, the 'community interest test' and 'asset lock'. They can be registered at Companies House in the same way as a normal trading company, but their registration has to be approved by a Regulator who has a monitoring and enforcement role.

The 'test' that those who wish to establish this type of company need is to satisfy the Regulator that its purpose could be regarded by a reasonable person as being in the community's or wider public's interest. It also needs to confirm that access to the benefits it provides will not be confined to an unduly restricted group. The 'asset lock' is a restriction on distributing profits and assets to members of the company, which must be used for the benefit of the company. The company will be allowed to use its assets as collateral for any loans it may need to raise. The Regulator will be responsible for ensuring the correct use of the assets and that the lock is maintained. Shareholders who think that it is being breached are able to ask the Regulator to take what he considers is the appropriate action. The funds to establish such companies will be provided by grants, donations or bank loans.

Mr John Hanlon was appointed as the first Regulator in April 2005. His main duties are:

- to consider applications to form a CIC
- to ensure that it complies with its legal obligations
- to take enforcement action where serious infringements occur.

The Regulator has an important role to play in aiding the establishment of this type of company, to provide help and guidance to those considering forming such a company. According to Companies House in Cardiff, as at the beginning of December 2006, 603 such companies have been incorporated.

The European Company – 'Societas Europaea' or SE

Council Regulation (EC) was passed on 8 October 2001. Article 1 states, 'A company may be set up within the territory of the Community in the form of a European public limited-liability company (Societas Europaea or SE) on the conditions and in the manner laid down in this Regulation'. The legislation governing the SE did not come into force until 2004. There are a number of ways in which, in accordance with Article 2, an SE can be formed, including merger. Thus a Public Limited Company formed under the law of a Member State, with registered offices and head offices within the community, may form an SE by means of a merger provided that at least two of the companies involved are governed by the law of different Member States. The object of creating a European Company is to give it its own legislative framework, thereby allowing it to avoid the legal and practical constraints arising from the existence of fifteen different legal systems.

The general provisions relating to an SE are contained in Title I of the Regulations and relate to such matters as legal personality, division of capital into shares, and employee involvement. The latter has caused considerable pre-act controversy, and the need for a further Council Directive complementing the Statute for a European Company with regard to the involvement of employees in the European Company. This defines employee participation: 'it does not mean participation in day to day decisions, which are a matter for the management, but participation in the supervision and strategic development of the company'. The Directive gives several ways that such participation can take.

1.3.2 Changing type

It is generally possible for a company of one type to alter its status so as to become a company of another type. The most common change is from private to public, when a company has grown to the point where it needs outside sources of capital. However, with certain limitations and subject to certain safeguards, companies can also change from public to private and from limited to unlimited and *vice versa*. A company can change its status by re-registration. Sections 43/53 of the Companies Act 1985 contain the present law for re-registration. Sections 89/111 of the 2006 Act deal with re-registration of a company's status from 1 October 2008. It introduces important changes in the rules such as Section 109, which enables a public company to re-register as an unlimited private company without first having to re-register as a private limited company.

Large and small companies

There is no general formal distinction in the Companies Act between large and small companies. Not surprisingly, large companies tend to be public companies, while small firms are more often private companies. There are, however, certain exemptions for small and medium-sized companies in relation to the requirements to prepare and file accounts (discussed more fully in Unit 5). For this purpose small and medium-sized companies are defined by reference to turnover, balance sheet total and number of employees.

Other types

Almost all companies are incorporated under the Companies Act (or one of its predecessors), but companies do exist under other legislation, such as regulation 'mutual' or 'friendly' societies and companies that have been incorporated under their own special Acts of Parliament or by Royal Charter.

In general, the relevant Act will determine how these companies are to be treated. However, they are liable to be wound up under the Insolvency Act just like companies incorporated under the Companies Act.

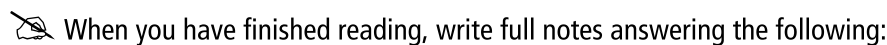
Readings 1.7 and 1.8

You should now read pages 21–24 in Worthington, Chapter 1, sections on the purpose of company law, classification of companies and partnerships.

See also the Council Regulation (EC) 2157/2001 on the Statute for a European company.

Worthington (2016) Extract from Chapter 1 'The company and its incorporation' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 21–24.

EC (2001) *Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE).*



- What is a 'public company'?
- What is a 'private company'?
- Define the concept of 'company limited by shares'.
- Define the concept of 'company limited by guarantee'.
- Why is a company limited by shares more likely to be used for carrying on a business?

1.4 How a Company is Formed

Forming a company is relatively simple and quick. Certain basic decisions need to be made on things such as share capital and 'objects'. The constitutional documents are then prepared and filed with the Registrar of Companies. After checking these, he or she issues a 'certificate of incorporation', which brings the company into existence. Sections 7–16 of the 2006 Act commenced on 1 October 2009. The Companies Act 1985 set out the rules prior to the repeal of that Act's relevant parts.

1.4.1 System of company registration before 1 October 2009

In order to form a company, certain documents need to be completed and filed with the Registrar of Companies. The most important document is

what is called the 'memorandum of association', which forms part of the company's constitution. This must state:

- the name of the company
- that it is to be a public company (if this is the case)
- the location of the registered office (*ie* England/Wales/Scotland)
- the objects of the company (see 1.6.1 below)
- that the liability of the members is limited (unless the company is unlimited)
- details of the share capital (unless it has no share capital; see Unit 2)
- the amount to be contributed by each member on a winding-up (if the company is limited by guarantee).

At least two people, known as the subscribers, must sign the memorandum and undertake to take at least one share in the company's capital (unless it is limited by guarantee). These people become the company's initial members. If the company is a private company, it is acceptable to have a single subscriber, as single-member private companies are now permitted.

The memorandum is almost invariably accompanied by 'articles of association' (see 1.7 below), which form the other part of the company's constitution and set out the firm's internal regulations. A statement naming the first directors must also be filed, together with certain other papers.

1.4.2 Certificate of incorporation

The Registrar of Companies checks all the papers filed to make sure that they comply with the Companies Act. If the Registrar is satisfied that they do, he or she registers them (which means that they are put on a public file) and issues a certificate that the company is incorporated. (Assuming everything is in order, the certificate of incorporation can be issued on the same day that the papers are filed.) The certificate of incorporation brings the company into existence.

A public company cannot begin to do business until it has also satisfied the Registrar that its allotted share capital is at least £50,000 (of which at least 25% must be paid up, plus the whole of any premium) and has supplied certain other information about its preliminary expenses and various other matters. This should include a statement of compliance. Once the registrar is satisfied that all the requirements of the Act have been met, he/she will issue a trading certificate on application by the company in accordance with section 762 of the 2006 Act. A trading certificate has effect from the date on which it is issued and is conclusive evidence that the company is entitled to do business and exercise any borrowing powers.

1.4.3 Company formation after 1 October 2009

Section 7 of the 2006 Act replaced sections 1(1) of the 1985 Act. There will be no change in the requirement for those wishing to form a company to subscribe their names to the memorandum of association. However,

subsection (1) enables a single person to form any sort of company, not just a private company. Subsection (2) continues the rule that a company may not be formed for an illegal purpose.

The memorandum will be of less importance than was formerly the case. It will still perform one very important function – evidence of the intention of its subscribers to form a company and become members of it on incorporation. It will also be evidence in the case of a company limited by shares to take at least one share in the company. The view of the Company Law Review (CLR) was that the constitution of the company should be in one document only, and that should be the Articles of Association. This view has been followed. Section 9 of the Act requires that besides the memorandum:

- an application for registration
- the documents required by that section, and
- a statement of compliance.

Must also be delivered to the registrar. The application must contain many of the facts that were formerly included in the memorandum, such as the company's proposed name, whether it is to be a private or a public company, and a copy of any proposed articles of association. The statement of compliance will replace the Statutory Declaration required by section 12 of the 1985 Act, which requires either a solicitor engaged in the formation of the company or a director or person named as the company secretary to confirm that all the requirements of the 1985 Act have been complied with before a solicitor or commissioner of oaths. The statement of compliance is a statement that all the requirements of the Act as to registration have been complied with. As yet the Registrar has not specified under section 1068 of the 2006 Act the form the statement must take or the persons who may make it.

The certificate of incorporation brings the company into existence. Section 16(2) of the 2006 Act states: 'The subscribers to the memorandum, together with such other persons as may from time to time become members of the company, are a body corporate by the name stated in the certificate of incorporation'.

1.4.4 'Off-the-shelf' companies

The parties to a proposed transaction sometimes find that they need a new company immediately and cannot wait for the normal incorporation process to be completed. Certain professional firms therefore keep a stock of 'ready-made' or 'off-the-shelf' companies available for use in such situations. These are simply companies that have been incorporated and then remained dormant. When activated, the shares are transferred to the new owners, the directors are replaced and a warranty is given that the company has not traded or incurred any liabilities. The new owners may also want to change the company's name and objects.

Readings 1.9 and 1.10

First read pages 25–33 of Worthington, 'Incorporation, registration and the role of the registrar'.

You are encouraged to visit the UK Companies House website and read their concise guide on the formation of companies in the United Kingdom.

There you will see that the four basic documents for the valid formation of a company are the memorandum of association, the articles of association, Form 10 (which relates to the appointment of the first directors and the Company's Secretary) and Form 12 (the declaration on the application for registration whereby the promoter or his or her solicitor declare that all legal requirements have been complied with).

Note that section 270 of the 2006 Act abolishes the need for a private company to have a company secretary as from the 6 April 2008.

When you have finished reading, please answer the following questions.

- Imagine you are involved in the incorporation of a company from scratch, and write down a list of the main things you would need to decide to enable the constitutional documents to be prepared and filed.
- What documents must be delivered to the Registrar of Companies in order to incorporate a company? (Hint: Look at Sections 10 and 12, 1985 Companies Act; Sections 9–13, 2006 Act)
- When does a company officially begin its existence? (Hint: Look at Section 16, 2006 Companies Act.)
- Why can a public company not necessarily start business as soon as it is incorporated? (Hint: Look at Section 761, 2006 Companies Act.)

Worthington (2016) Extract from Chapter 1 'The company and its incorporation' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 25–33.

UK Companies House website.

1.5 A Company's Constitution

The 2006 Act will introduce a major change in company law. While formerly there were two main documents involved in the company's constitution, the memorandum of association and articles of association, from 1 October 2009 the constitution is found in the company's articles and any resolutions to which Chapter 3 of the Act applies.

1.5.1 Articles of association

Section 18 of the 2006 Act requires a company to have articles of association prescribing regulations for the company. The articles will govern the way in which the company is run, containing all its main internal rules and regulations dealing with, for example, the allocation of powers between the members of a company and its directors. Section 19 gives the Secretary of State power to prescribe model articles for different companies. Should a company fail to register articles, then the model articles prescribed for that type of company will apply to it – they will be, in effect, 'default articles'. The reasoning behind this is that a safety net is provided by model articles, enabling directors and members of such companies to make decisions where a company has failed to provide the necessary rules in its registered articles or failed to register articles at all.

Section 29 of the 2006 Act lays down the rules relating to resolutions and agreements affecting a company's constitution.

1.5.2 Alteration of constitution

Section 21 of the 2006 Act provides that in general a company's articles can be amended by special resolution, subject to special rules relating to charities. Also the rules governing 'entrenchment' must be observed. The 1985 Act permitted companies to entrench certain elements of their constitution by placing them in their memorandum and provided that they could not be altered. The 2006 Act allows companies to state in their articles that specified provisions contained therein may be amended or repealed only if procedures are complied with, which are more restrictive than those applicable in the case of a special resolution. But section 22 allows for amendment to the company's articles in cases of unanimous agreement of the members or order of the court.

1.5.3 Constructive notice

The documents that set out a company's constitution are placed on a public register by the Registrar of Companies, as are any subsequent alterations to the constitution. Thus, it has been successfully argued in the past that the entire world has 'constructive notice' (deemed notice) of what is in the constitution. In *Ernest v Nicholls* (1857) 6 HL Cas 40, the House of Lords held that a person dealing with a company is deemed to have notice of the company's registered documents. In other words, it is said, a person dealing with a company could have looked at the public register and, if they did not, then they should still be treated as if they knew what was in the constitution (or in anything else on the public register). This could mean, for example, that a transaction could not be enforced against a company because of some limitation in the constitution. Such an approach has given rise to numerous problems for those dealing with companies without checking their public documents first.

In *Re Jon Beauforte (London) Ltd* [1953] 1 Ch 131, decided before the reforms mentioned below, a company's stated objects were to manufacture dresses. In fact, it made wooden panels. When the company became insolvent the claims of most creditors were disallowed on the basis that they knew it made wooden panels and they were deemed to know that it was authorised only to make dresses.

The Companies Act 2006 now contains provisions that deal specifically with problems concerning the capacity of a company and the authority of its directors to bind it. (These are discussed more fully in Sections 1.6.3 and 1.8.4 below.) Section 40 of the 2006 Act states that the powers of the directors to bind the company to anyone dealing with the firm in good faith is deemed to be free of any limitation under the company's constitution. This means that when section 40 came into effect, on 1 October 2009, a third party dealing with the company in good faith need not worry whether a company is acting within its constitution or not. The 'Doctrine of Constructive Notice' will have been finally abolished some forty years after the Jenkins

Committee raised the issue of its reform. A person is not regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution.

1.5.4 Indoor management rule

The effect of the constructive notice doctrine had been previously mitigated by a rule known as the 'indoor management' rule. In outline, this stated that, where everything appeared to have been properly done on the face of the relevant documents, then someone dealing with the company was able to assume that all internal matters had been properly attended to.

Readings 1.11 and 1.12

Please read the first part of Worthington's Chapter 3, pages 83–92, and pages 116–18, paying particular attention in the latter sections to the interaction between the indoor management rule and agency rules, and constructive notice and its abolition.

I suggest that from an historical point of view you try to read the first EU directive on company law: Council Directive 68/151 [1968] OJ 68.

Worthington (2016) Extracts from Chapter 3 'Corporate activity and legal liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 83–92; 116–18.

EC (1968) *First Council Directive 68/151 OJ 68.*

Review Question 1.2

Bearing in mind your previous reading from the key text's first chapter (pp. 26–27) and your study of Chapter 3, please write notes on the following questions.

1. What are the definition and the role of the memorandum of association?
2. What are the definition and the role of the articles of association?
3. How can a company alter its constitution?
4. What is the doctrine of 'constructive notice', what does it imply and is it really dead?
5. Define the 'indoor management' rule and discuss its importance.

1.6 Corporate Capacity

A fundamental change which over the years has been attempted piecemeal has finally been completed by the passing of section 31(1) of the 2006 Act, which abolishes the need for a company to have an 'objects' clause, a clause that has provided much work for those lawyers involved in company law, some of whom may be sorry to see its passing. The purpose of the 'objects' clause was to delineate the activities a company could undertake.

Section 31(1) now provides 'Unless a company's articles specifically restrict the objects of the company, its objects are unrestricted'.

1.6.1 'Objects clause'

The following is a historical look at the law relating to object clauses.

Since a company is an artificial legal entity created by statute, it can do only what statute says it can. In keeping with the reasons behind the development of company law (*ie* the need for capital for specific projects), the law envisaged that a company would have a stated purpose (and that

investors would be invited to put up capital for that purpose and not for something completely different). There was a requirement that the memorandum had to state 'the objects of the company'.

So far as the law was concerned, it has always been envisaged that the statement of objects would be brief. Two factors have, however, combined to work against this. First was the desire of those involved in setting up a company to ensure that it should have flexibility in what it might decide to do at a future date. (Originally, an alteration of a company's objects was not allowed at all; even up until 1948, court approval was required.) Second was the *ultra vires* doctrine, which stated that, if a company does something outside the scope of its objects clause, then the relevant contract or transaction cannot be enforced against the company.

In *Re Introductions* [1970] Ch 199, a company's objects were to promote exhibitions (which it did for a time). Later it went in for pig breeding, something that was not mentioned in its objects clause. A bank lent the company money for its pig-breeding business and took security for the loan. The company became insolvent and the bank's security was held to be invalid because the company had no power to carry on its pig-breeding business. The bank tried to argue that the security was valid because the company's objects clause included a reference to borrowing money and giving security. But the court said that this *was* merely a power and could only be exercised as ancillary to a stated object.

In *Bell Houses* v *City Wall Properties* [1966] 1QB 207, a company's objects were property development. It later agreed to introduce another company to sources of development finance in return for a commission. The second company then refused to pay the commission, and argued that the property-development company had no power to act as an introduction agent. However, the latter's objects clause allowed it to carry on any business 'ancillary' to its main business, and the court accepted that what the property-development company had done was 'ancillary' and accordingly that the commission was recoverable from the second company. Although the effect of the *ultra vires* doctrine was modified (see 1.6.3 below), the two factors referred to above have resulted in objects clauses that generally run to several pages in length. The typical clause may begin by describing, in very broad terms, what the company is initially being set up to do, but it will go on at great length to list all sorts of other businesses which the company might choose to carry on in future and also to specify various different acts which the company might perform in the process.

This led to a distinction being drawn between 'true' objects and mere 'powers'. For example, if the objects clause contained a statement that the company may borrow money (a perfectly normal thing for a company to do), it was said that this cannot be an object in the strict sense (except for a bank); hence it must be only a power, and a power can only be exercised in furtherance of an object in the strict sense. (The *Re Introductions* case referred to above is an example of this line of reasoning.)

The numerous difficulties that were caused as a result of the above (and the hardship often caused to third parties who acted in good faith) led to reform of the law in two ways, discussed below.

1.6.2 General commercial company

The 1985 Companies Act allowed the objects clause to state that the company is to carry on business as a general commercial company. In this case, section 3A states: 'the object of the company is to carry on any trade or business whatsoever' and the company also has 'power to do all such things as are incidental or conducive to the carrying on of any trade or business by it'.

This meant that, so long as something could fairly be described as part of a 'trade or business', it could not be attacked as being outside the objects of the company.

1.6.3 Limitation of ultra vires doctrine

There were various attempts at reform designed to improve the position of third parties dealing with a company in good faith. The pre-2006 Act position was that the objects clause was, in effect, relegated to being a purely internal matter. Shareholders could restrain the directors from doing something that was outside the scope of the objects clause, but only if the company was not already committed to the transaction in question. Subject to this, the 1985 Companies Act stated that:

> The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum (s 35).

Section 35 B was inserted later and provides that someone who was a party to a transaction with a company was not bound to enquire whether it was permitted by the company's memorandum (s 35B).

The upshot was that a third party dealing with a company did not have to worry about whether the company had the legal capacity to enter into the transaction proposed. This was not, however, the end of the story as there were separate issues that concerned the power of the directors to bind the company (see 1.8 below). Please note that the *ultra vires* doctrine still applies to some other types of legal entity not incorporated under the Companies Act, such as local authorities.

The doctrine is not entirely dead as far as the company itself is concerned since the powers of the company can be specifically restricted by its articles; if that is the case the directors may still exceed their authority and be liable to the shareholders. Worthington points out 'These provisions do not go so far as to provide that every company actually *has* the capacity to do anything, but they prevent the validity of any act being called into question on the ground of lack of capacity arising from anything in the company's constitution (CA 2006 s 39 (1)). This is just as beneficial for outsiders, but preserves the right of the company to sue its insiders (directors or other agents) for their breaches of the company's constitution (ie for acting outside

the powers given to the directors: CA 2006 s 171, or beyond their agency contract with the company) and recover damages for the loss caused to the company (*eg* arising from the prohibited transaction)' (Worthington, 2016: p. 92).

1.6.4 Alteration of objects

Where a company amends its articles in order to add, remove or alter a statement of the company's objects, it must give notice to the registrar who will register it, and the amendment is not effective until entry of that notice on the register. Sections 31(2) and 3(3) state that any such amendment does not affect any rights or obligations of the company or render defective any legal proceedings by or against.

Reading 1.13

Read Worthington, Chapter 3, section on the company's statement of objects on pages 92–93, and further extracts relating to *ultra vires* on pages 572–73 and 670–71.

Note the different senses in which the expression 'ultra vires' can be used and the specific meaning which it has in the present context. Note also how the ultra vires doctrine developed as well as the earlier attempts at reform in this area.

Worthington (2016) Extracts from Chapter 3 'Corporate activity and legal liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 92–93; 572–73; 570–71.

Review Question 1.3

1. What is the doctrine of 'ultra vires'?
2. What is the current state of the law relating to the ultra vires doctrine?
3. Is there a limitation imposed on the content of an 'objects clause'?

1.7 Articles of Association

As you have already seen, a company's articles of association are its internal rules. The 1985 Companies Act provided a model set of articles, which many companies followed, though companies are free to lay down their own internal rules. It is also open to shareholders to supplement the articles by private arrangements such as a shareholders agreement.

1.7.1 Internal Rules

The articles deal with such matters as:

- who can become shareholders, and how
- the issue and transfer of shares
- the increase, reduction and reorganisation of share capital
- meetings of shareholders
- the appointment and removal of directors
- the powers of the directors
- meetings of the board
- dividends and capitalisation of profits.

As noted in 1.5.1 above, the articles take effect as a contract between all the shareholders for the time being. Incoming shareholders are automatically bound by the articles.

1.7.2 Table A – Model Articles replacement

As the introduction to this section indicated, regulations made under the Companies Act 1985 provided a model set of articles (generally known as 'Table A'), which companies were free to adopt (or not) as they wished, with or without amendments. If a company did not adopt articles, Table A applied automatically. Equally, Table A applied insofar as a company's articles did not exclude or modify it.

A major criticism of the model set of articles contained in the 1985 Act was that they did not differentiate between public and private companies. The White paper published in 2005, 'Company Law Reform', produced a 'Draft Model Articles of Association for Private Companies Limited by Shares'. Draft Articles of Association for Public Companies were produced in June 2006. Further, the 2006 Act contains a power to enable the Secretary of State for Trade and Industry through secondary legislation to prescribe stand-alone articles for different types of company. These will replace Table A contained in the 1985 Act.

Previous Companies' Acts also contained a Table A and, when dealing with pre-1985 companies, it is important to be sure which version of Table A actually applies. The same is true for amendments to the 1985 form of Table A, since any such amendments did not automatically amend the articles of a company that had adopted Table A.

1.7.3 Shareholders' agreements

It is not uncommon, particularly with joint venture companies, for shareholders to enter into shareholders' agreements that cover some of the same ground as the company's articles. The reasons for doing this are generally:

- to preserve confidentiality for the business arrangement between the parties (since articles are a public document, whereas a shareholders' agreement will not be)
- to ensure that rights given to particular classes of shareholders cannot be altered without the consent of the relevant shareholders – since an agreement cannot be altered without the consent of all parties – whereas articles can (presently) be altered on the basis of a 75% vote (though see further in Unit 2 on the sometimes difficult question of a variation of 'class rights').

The sorts of things generally provided for in a shareholders' agreement are:

- individual shareholders are given the right to appoint a certain number of directors

- important decisions (usually spelt out in some detail) are reserved to the shareholders on the basis of a qualified majority, say 75%
- commitments may be made as to future funding (with possible provision for dilution of a shareholder who does not provide his share of additional funding)
- detailed pre-emption rights are spelt out to cover a situation where one shareholder wants to sell
- provision may be made for the compulsory buy-out of a shareholder in breach of his obligations
- a special procedure may be laid down for resolving 'deadlock' between the shareholders on important issues.

The case of *Russell v Northern Development Bank* [1992] 1WLR 588 (HL) upheld the effectiveness of shareholders' agreements, but only on the basis that such an agreement could not bind the company itself (at least, not as regards the non-alteration of its articles). As such, a shareholders' agreement is binding only between the contracting shareholders.

In that case a company had four shareholders, and they were concerned that their respective percentage shareholdings should not be diluted by a future increase of share capital in which they were unable or unwilling to participate. The shareholders therefore entered into an agreement that they would not vote to increase the company's capital unless they all agreed. The company was also a party to this agreement. The court held that this agreement could not bind the company since the Companies Act gives a company the right to increase its capital with a simple majority vote (see 1.5.2 above), but it also held that the agreement could still bind the shareholders among themselves as an agreement separate from the articles (see pages 256-58 of Worthington, 2016).

1.7.4 Reform introduced by the 2006 Act

As we have already noted, a company's constitution is found in the Articles, and the Memorandum is no longer part of the constitution. Section 22 of the 2006 Act allows for 'provision for entrenchment', which makes it more difficult for the constitution to be altered. Such clauses are only alterable if conditions or procedures more stringent than a special resolution are met. This will enable the members to entrench clauses in the articles that can only be changed if all the members agree to such change, which formerly was the main advantage of shareholder agreements. However, there still remains the advantage of confidentiality that such agreements have since they are not public documents, which in itself provides a reason for their continued use.

Reading 1.14

Look back at pages 25–27 and 83–93 of Worthington, and then study pages 228–29 and 255–61 of Chapter 4.

Note that there are limitations (largely developed through case law) on the amendment of a company's articles where this might be unfair to minority shareholders. (This is a topic considered further in Unit 2.)

Worthington (2016) Extracts from Chapter 4 'Shareholders as an organ of the company', and review of earlier reading in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 25–27; 83–93 and 228–29.

Review Question 1.4

1. Look at the Secretary of State's Draft Model Articles for Private Companies Ltd by Shares (available from https://www.gov.uk/guidance/model-articles-of-association-for-limited-companies) and identify for yourself the provisions dealing with restrictions on becoming a member; powers delegated to directors; declaration and payment of dividends.
2. What is the role of the articles of association?
3. Draw up a list of the matters that the articles are likely to regulate.
4. What was the legal contribution of the case *Russell v Northern Development Bank* (pages 258–60)?
5. What sort of issues is a shareholders' agreement most likely to regulate?

1.8 How a Company Acts

A company necessarily acts through other people. Whoever has authority to act for it, is determined, in the first place, by the constitution. This is usually the board of directors. Other people may be given authority by delegation from the board. Outsiders dealing with a company are given some protection against the risk that the board may exceed its authority. If a company commits a criminal offence, officers who authorised the act in question may also be guilty of an offence.

1.8.1 The company's agents

Since a company is a legal 'entity' created by statute, it can act only through other people – in effect, its 'agents'. These are people who have authority to act for the company and who derive their authority either:

- directly from the company's constitution (*eg* the board of directors)

or

- indirectly by delegation from the board (*eg* under a power of attorney or agency agreement, or through some less formal arrangement).

1.8.2 Position of directors

With virtually all companies the directors are the company's primary 'agents'. Their authority to act for the company will be spelt out in the articles. In principle, this refers to the board acting as a whole (as opposed to an individual director) but, in practice, the powers of day-to-day management are generally delegated to a managing director. Again, this will

be determined by the company's articles. Where larger companies are concerned, management functions may be split across several directors, such as finance director, sales director and so on. (For a fuller discussion of the position of directors, see Unit 4.)

In *Hely-Hutchinson v Brayhead* [1968] 1QB 549, the chairman of the board also acted as *de facto* managing director with the acquiescence of the rest of the board. The board later refused to honour an undertaking entered into by the director concerned. The court held that his position as chairman gave him no authority to commit the company, but that the board, by allowing him to act as *de facto* managing director, had given him (implied) authority to commit the company.

Where persons other than the directors are concerned, the agent's authority should be derived directly or indirectly from the board – for example, under a board resolution or by sub-delegation from someone authorised by the board.

1.8.3 Position of third parties

It follows from the fact that a company acts through agents that a person dealing with a company will (or should) be concerned to know that the agent has authority to commit the company to the transaction in question. (If not, the transaction will not bind the company.) As indicated earlier, particular problems have arisen in the past when a company's articles contained some limitation on the directors' powers and the third party failed to check these. (The pre-1985 Table A, for example, which is still used by some older companies, contains a limitation on the powers of the directors to borrow money.)

Section 39 of the 2006 Act deals with this difficulty, at least where the directors are concerned, and states:

> The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of any thing in the company's constitution. It is subject to section 42 (charitable companies).

This provision is supported by two related provisions which state, in brief, that someone dealing with a company is not bound to enquire as to any limitation on the powers of the board and that, even if that person does know that something is beyond the powers of the board, he or she is still to be regarded as acting in good faith unless the contrary is proved.

A constant problem that arises in this area of the law is deciding who in fact acts for the company as Worthington points out (p. 84) in their query: 'whose acts will count, but also which acts will count as the company's acts *for the particular legal purpose in issue*?' On the next page, they go on to state that, 'The most significant contribution in answering the question, "Whose acts count as the company's acts *for this purpose*?" comes from the [Meridian] case', details of which are on the same page (and in your next reading).

A much more difficult question arises, despite the statutory protection, when it can be argued that the directors are not acting in the best interests of the company, even though there may be no argument over their technical authority to commit the company to the transaction proposed. However, the issue is very much bound up with a discussion of the duties of directors, and it is considered in detail in Unit 4.

Reading 1.15

Now read *Meridian Global Funds v Securities Commission* [1995] 2 AC 500, which provides useful background to the theory of how a company 'acts'. I recommend that you pay particular attention to the speech of Lord Hoffman, from page 3.

Meridian Global Funds v Securities Commission [1995] 2 AC 500

1.8.4 Ostensible authority

Where a person does not check the authority of the 'agent' he is dealing with, he may also be able to rely on the 'ostensible authority' doctrine for protection. This states, broadly, that if a company allows someone to be held out as having a particular authority to bind the company, then the company will not be able to say later that the agent in question did not in fact have that authority. For example, if a company gives someone the title, 'purchasing manager', it will not be allowed to escape from routine purchase contracts made by that person. Similarly, a person held out as 'finance director' could generally be assumed to have authority to deal with the company's bankers on day-to-day matters (but not, probably, on a major new borrowing).

In *First Energy v Hungarian International Bank* [1993] BCLC 1409, a senior manager of a bank communicated an offer of credit facilities to a customer from the bank's head office. The customer accepted the offer but the bank then refused to make the credit facilities available. The court held that the manager had no authority to offer credit facilities as such but that his position did give him ostensible authority to communicate an offer of credit facilities from the bank's head office. The case is quoted in Note 2 on page 116 of Worthington.

Compare *Criterion Properties plc v Stratford UK Properties LLC* [2004] 1 WLR 1846 (HL) where the bank was bound by the agreement. But note the authors point out that 'it is not possible to rely upon the ostensible authority of an individual if the person transacting with the company knew that the act was beyond the actual authority of the acting official'.

The protection given to third parties dealing with the company by section 40 of the 2006 Act is lost where the party to a transaction with the company is an 'insider', such as a director of the company or person connected to that director. Section 252 of the 2006 Act defines persons connected to directors, which include members of a director's family and a body corporate with which a director is connected. Such a transaction will be voidable by the company. Whether or not it is voided, any insider and any director of the

company who authorised the transaction is liable to the company for any gain he has made as a result of the transaction, and must indemnify the company for any loss or damage resulting from the transaction. This does not apply to anyone other than a director of the company if he shows that at the time the contract was entered into, he did not know that the directors were exceeding their powers.

1.8.5 Ratification

If the board, or some other 'agent', of a company does purportedly commit the company to a transaction which goes beyond the scope of the board's or agent's authority, then the company can, if it wishes, ratify what the agent has done and thus become bound by the transaction. If the board has exceeded its authority, then it is the shareholders who should ratify. In other cases it will usually be the board that should ratify. Section 239 of the 2006 Act applies to the ratification by a company of conduct by a director amounting to negligence, default, or breach of duty or trust, in relation to the company. The decision to ratify must be made by resolution of the members of the company, and without reliance on the votes in favour by the director or any connected person. Section 252 defines what is meant by connected person, and may include fellow directors.

1.8.6 The question of liability

As you will have seen from the discussion above, it is part of the normal principles of agency that if an agent makes a contract on behalf of a disclosed principal, it is the principal, and not the agent, who is bound by the contract and entitled to the benefit of it.

In the same way, if the directors (or some other duly authorised agent) commit the company to a transaction, it is the company that is bound and not the directors (or other agent) personally.

However, any 'agent' who exceeds his or her authority (with the result that the company is not bound) may find that they do incur some personal liability since they may well be in breach of their 'warranty of authority'.

1.8.7 Criminal liability

A statute may provide that a company commits a criminal offence if it does, or fails to do, a particular act. There are many examples of offences in the companies legislation. Clearly, a company can incur criminal liability in such circumstances. Moreover, it is usually provided that where a director or other officer of the company is involved in the relevant act or omission (*eg* he or she approved it, or it occurred through their 'neglect'), then the director or officer is also guilty of an offence. See section 387 of 2006 Act for an example of offence relating to the keeping of accounting records. The module contains further examples. In practice, of course, the threat of personal liability is often a more potent encouragement to compliance with the law.

At one time it was thought that a corporation could not be indicted for any offence. The development of the law to the position that a company may now be indicted for corporate manslaughter is one of the most fascinating developments of the law relating to corporations, and the methods developed by the courts to attribute liability to companies. Firstly, through the development of extending the doctrine of 'vicarious liability' to criminal law, some statutes impose an absolute liability on an employer or principal, which means they are liable for the acts of their employees or agents even if they have not authorised or consented to the carrying out of such acts, or even where they have forbidden such acts or omissions. Whether or not a statute imposes vicarious liability depends on its construction. See *Mousell Bros Ltd v London and North Western Railway Co* [1917] 2 KB 836.

The courts developed the principle of 'identification', where they were unable to impose liability under the vicarious liability rule. In *Leonard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, where the origin of this doctrine is to be found, Lord Haldane LC (p 713) stated: a corporation 'It has no mind of its own any more than it has a body; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation'. See also *Tesco Supermarkets Ltd Ac v Nattrass* 1972 AC 153. However, in *Meridian Global Funds v Securities Commission* [1995] AC 500, (Privy Council) Lord Hoffman criticised this view as being a misleading 'general metaphysic of companies'. He stated that the person responsible for the acts of the company depended on the construction of the statute concerned rather than metaphysics and that person could be the person directed to carry out a particular act.

As regards corporate killing, Turner J reviewed the law in *P & O European Ferries (Dover) Ltd (1991)* 93 Cr App R 72 (pp. 83–84), and concluded that if 'a corporation, through controlling the mind of one its agents, does an act which fulfils the prerequisites of the crime of manslaughter, it is properly indictable for the crime of manslaughter'.

The Law Commission reported on Legislating for the Criminal Code Involuntary Manslaughter Law Com No 237 1996. It recommended 'that there should be a special offence of corporate killing, broadly corresponding to the individual offence of killing by gross carelessness – that, for the purposes of the corporate offence, a death should be regarded as having been caused by the conduct of a corporation if it is caused by a failure, in the way in which the corporation's activities are managed or organised, to ensure the health and safety of persons employed in or affected by those activities'. In July 2007, the Corporate Manslaughter and Corporate Homicide Act became law.

Readings 1.16 and 1.17

Turn again to Chapter 3 of the key text, pages 92–130 and 149–64.

Also read The Law Commission Report on Involuntary Manslaughter No 237.

Note that there are limitations (largely developed through case law) on the amendment of a company's articles where this might be unfair to minority shareholders. (This is a topic considered further in Unit 2.) Note that s 35A (see 1.8.4 above) only helps if the third party is dealing with the board or someone authorised by the board, and the indoor management rule (1.5.4 above) remains relevant in other cases. A company's civil liability in tort (for the concept of tort and liability in tort you will no doubt recollect the relevant discussion in the module, *Introduction to Law and to Finance*) is approached quite differently from its liability under criminal law.

Worthington (2016) Extracts from Chapter 3 'Corporate activity and legal liability' in *Sealy & Worthington's Text, Cases, & Materials in Company Law*. pp. 92–130; 149–64.

Law Commission Report (1996) *Legislating the Criminal Code: Involuntary Manslaughter*.

Review Question 1.5

1. What is the importance of the rule in s 40 of the 2006 Act (p. 101)?
2. Define the concept of 'ostensible authority' and discuss its importance.
3. How does the board of directors bind the company with its acts or omissions?
4. Can an executive officer bind the company even though he or she is not a member of the board of directors?
5. What are the internal effects of an act by the board of directors in the event that the board lacked the authority to carry out the particular act?

1.9 Groups of Companies

Groups of companies are common today. A group is not, however, a legal entity (even though consolidated 'group' financial statements have to be prepared). Each company in a group remains a separate legal entity, and its directors must have regard to the interests of that company alone rather than the wider group interest.

1.9.1 Preliminary

Today many companies are part of a group of companies, where separate activities of the group as are carried on by separate companies within the group. This sort of structure has two particular advantages:

- if something goes wrong with one business, the principle of limited liability for each separate company means that the problem need not affect the rest of the group. See *DHN Food Distributors v Tower Hamlets London Borough Council* [1976] 1 WLR 852, where the Court of Appeal lifted the corporate veil of a group of companies. However, the Court of Appeal in the later case of *Adams v Cape Industries plc* [1990] Ch 433 did not follow DHN and refused to lift the veil. The court in *Adams* re-asserted the orthodox view in *Salomon*. It is now unlikely a court will lift the corporate veil
- if a particular business is to be sold off, this is much easier to do (in practical terms) when the business is in a separate company.

However, the first of these advantages will be weakened if the group borrows on a centralised basis and the borrowings are secured by cross-guarantees from all companies in the group. Loan agreements may also contain cross-default clauses under which a default by any group company may entitle the lender to call in its loan to another company in the group.

Note too that there is a potential tax disadvantage in that losses in one group-company could not, in principle, be offset against profits earned by a different company in the group. However, the tax regimes in many countries do in fact treat groups, at least to some extent, as if they were a single entity for tax purposes. Thus, for example, losses or unutilised allowances may be able to be 'shared' around the group (discussed also Unit 3).

Definitions

The companies legislation uses the terms 'group', 'holding company', 'parent' and 'subsidiary'. Essentially group means a parent and all its subsidiaries. However, two different sets of definitions are used depending on the context. The first context is a general one and the definitions (holding company and subsidiary) work on the basis of whether one company controls another (whether through owning or controlling a majority of the voting rights or having the right to appoint or remove a majority of the directors).

The second set of definitions (parent undertaking and subsidiary undertaking) is used in the accounting context and covers a broader concept of 'undertaking' (rather than company), a term which can include businesses that are not incorporated, such as partnerships. It also broadens the concept of control to include the exercise of a 'dominant influence' where the interest in another undertaking is as little as 20%.

1.9.2 The interests of a group

A question that sometimes arises is whether a particular company in a group can (or even should) have regard to the wider interests of the group as a whole (rather than its own narrow interests). This can happen, for example, when subsidiaries are asked to give cross-guarantees for borrowings by other companies in the group.

As you will have seen, each company is in law a separate legal entity, and the mere fact of being a member of a group does not make one company liable for the debts of another company in the group. Hence, the only possible answer to the question is that the directors of each company in a group must have regard only to the interests of the individual company when considering a particular course of action and must not agree to something purely because it is in the interests of the group as a whole (or of some other company in the group). (Again, see further in Unit 4, which looks at the scope of directors' duties.) Note that a problem can arise if one of a group of companies is in financial difficulties, and the question arises as to whether another company in the group can make a contribution to the assets of the company in difficulty. Worthington points out (p. 51) that in New Zealand and Ireland the courts have a discretion to order this. Section

895 in Part 26 of the 2006 Act enables companies to apply to the court for an order sanctioning an arrangement or reconstruction agreed with a majority of members or creditors.

1.9.3 Financial statements

One respect in which a group of companies is treated as if it were a single entity is in relation to the preparation of group accounts. Not only must each company in the group prepare individual financial statements in the usual way, but consolidated financial statements must also be prepared by the parent company covering the group as a whole.

Essentially, the consolidated accounts combine the turnover, profit/loss, assets and liabilities of all the companies in the group, after excluding intra-group transactions. (This is covered more fully in Unit 5.)

Reading 1.18

Return to Chapter 2 of Worthington and study pages 48–52 in the context of groups of companies, and read the section on insolvency and corporate groups on page 855, paying particular attention to the judgment of Templeman in Re Southard and Co Ltd [1979] 3 All ER [see also Templeman on Southard extract on page 51].

Note the positions regarding groups that exist in some other countries.

Worthington (2016) Extracts from Chapter 2 'Corporate personality and limited liability' in *Sealy & Worthington's Text, Cases, and Materials in Company Law*. pp. 48–52; 855.

Review Question 1.6

1. How is a 'group of companies' defined?
2. What is a holding company and what a subsidiary?
3. Could the directors of the parent company be held accountable for the acts and omissions of the directors of the subsidiary company?
4. Are there any implications for financial statements and accounts of a group of companies?

1.10 Conclusion

In this unit you have initially studied the importance of corporations for investment, economic development and the functioning of financial markets. Furthermore, you examined the basic components of company law, including the concepts of legal personality, limited liability, the formation of companies and the importance of the company's constitution for external creditors and the internal division of powers among managers and shareholders. You are now well equipped to study and critically analyse more technical questions of corporate law and their relationship with corporate finance.

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