

## Chapter 5

### The Constitution of the Company

Here, basic guidance to the end-of-chapter questions will be provided.

**1. Define the following terms:**

- **model articles;**
- **entrenched article provisions;**
- **statutory contract;**
- **outsider;**
- **outsider rights;**
- **shareholders' agreement.**

Term	Definition
model articles	Articles that can be used by a company if it does not wish to register its own articles, or which can be used alongside registered articles. The model articles can be found in the Companies (Model Articles) Regulations 2008
entrenched article provisions	An article provision that can only be amended if 'certain conditions are met, or procedures are complied with, that are more restrictive than those applicable in the case of a special resolution (CA 2006, s 22(1))
statutory contract	The contract that exists between the company and its members, and between the members themselves, that is created via s 33 of the CA 2006
outsider	A person who is not a party to the s 33 statutory contract
outsider rights	Rights granted to a member other than in his capacity as a member
shareholders' agreement	An agreement entered into by two or more shareholders (the company may also be a party) that establishes rules regarding the relationship between the members, and/or the company

**2. State whether each of the following statements is true or false and, if false, explain why:**

- **a company's constitution consists of its memorandum and its articles;**
- **if a company drafts its own set of articles, then the model articles will not apply;**
- **a company cannot make its articles unalterable;**
- **the constitution forms a contract between the directors and the members;**
- **a member can enforce any term in the constitution.**

- **A company's constitution consists of its memorandum and its articles:** This statement is false. Whilst these documents do form part of the company's constitution, there are

other documents that can form part of the constitution (e.g. the certificate of incorporation).

- **If a company drafts its own set of articles, then the model articles will not apply:** This statement is false. The model articles will continue to apply insofar as the registered articles do not modify or exclude the model articles.
- **A company cannot make its articles unalterable:** This statement is true.
- **The constitution forms a contract between the directors and the members:** This statement is false. The constitution forms a contract between the company and its members, and amongst the members themselves.
- **A member can enforce any term in the constitution:** This statement is false. Only those constitutional terms that relate to membership rights can be enforced.

**3. 'The contract created by the company's constitution is a highly unusual one, but the ability to enforce the constitution provides the members with a powerful source of protection.' Discuss.**

### Introduction

- Every essay should begin with a succinct introduction that demonstrates that you understand the essay question. Briefly explain what the essay is about and set out what the essay will discuss and how it will be structured.
- This essay requires you to discuss (i) the nature of the s 33 statutory contract and; (ii) the extent to which it provides protection to members.

### The s 33 statutory contract

- Begin by explaining what s 33 states, namely that the constitution forms a contract between the company and its members, and between the members themselves.
- The s 33 contract is indeed unusual. Briefly set out the ways in which it differs to a standard contract. Table 5.2 on p 122 of the text sets out these differences.

### Enforcement of the s 33 contract

- The key issue in terms of the protection afforded to members by s 33 is the extent to which the members can enforce provisions in the company's constitution.
- Point out that as the constitution forms a contract between the company and its members, and between the members themselves, a member can enforce the constitution if it is breached by the company or another member.
- However, this protection is limited in one important respect, namely that it cannot be used to enforce outsider rights, namely those rights granted to a member in his capacity other than as a member (e.g. a director). What this means in practice is that the member must bring his claim as a member and can only enforce those constitutional rights that relate to his membership.
- Unfortunately, as noted at p 125, the courts have not been consistent in determining what amounts to a membership right and there have been cases where members have been permitted to enforce rights granted to them in a non-member capacity (e.g. as a

director). This might be justified where the company is a quasi-partnership company as, in such companies, the line between director and member is blurred.

## Conclusion

- Every essay should end with a conclusion. Briefly summarise the main points/arguments and, if possible, come to a conclusion regarding the essay topic (i.e. which of the opposing views has the stronger arguments).

### 4. Dragon Ltd has adopted the model articles for private companies, but has added several new provisions, namely:

- Article 18A provides that 'a director will be required to vacate office if the other directors so require.'
- Article 18B provides that 'any director removed under art 18A who holds shares in Dragon Ltd will be required to sell those shares to the directors of Dragon Ltd at a fair price.'
- Article 18C provides that 'any director removed under art 18A will be entitled to a loss of office payment of £10,000.'

Anna, a director and shareholder of Dragon, has argued repeatedly in board meetings that the company should appoint a qualified company secretary, but the other directors disagree and are growing tired of Anna's criticism of the company's management. Accordingly, the other directors use the power granted to them by art 18A and remove Anna from office. The directors also state that Anna must sell to them all her shares in Dragon. Anna seeks your advice regarding the following:

- (a) Are arts 18A and 18B valid and can they be enforced against her?
- (b) The directors are offering her the £10,000 loss of office payment provided for under art 18C, but Anna's service contract states that, if she is removed from office, she will be paid £20,000. Anna wishes to know if she can claim this £20,000.

- Where a problem question asks you specific questions, then it is usually a good idea to base your answer structure around those questions.

### The validity and enforceability of arts 18A and 18B

- There are two issues to consider here, namely (i) are arts 18A and 18B valid and, if so; (ii) can they be enforced against Anna.
- You could structure this in several ways, but perhaps the most logical way to structure this is to focus on each article provision and discuss its validity and enforceability.

#### Article 18A

- Article 18A empowers the directors to remove a director. When determining whether an article provision is valid, the key test to apply is that set out by Lindley MR in *Allen v*

*Gold Reefs of West Africa Ltd*, who stated that the power to alter the articles must be exercised 'bona fide for the benefit of the company as a whole ...'

- There is little doubt that art 18A is valid. It may certainly be in the company's interests to empower the directors to remove one of their own (e.g. where a director has engaged in certain types of wrongdoing). The validity of art 18A is evidenced in the fact that it is common for companies to amend their articles to include a power similar to art 18A (as the model articles do not contain such a power).
- Having established that art 18A is valid, the next question is whether the power be used against Anna. There is no doubt that the directors have the power to remove Anna, but the issue here is whether the directors have exercised this power properly.
- Section 171(b) of the CA 2006 provides that the directors must only exercise powers for the purposes for which they are conferred. It could be argued that the power afforded to the directors to remove a director was not designed to be used to remove a director who is raising legitimate concerns regarding the company's compliance with the law. Alternatively, it could be that Anna's criticism of management is vexatious or is excessively disruptive, in which case the exercise of the power may be more justified.

#### *Article 18B*

- Article 18B provides that any director who is removed under art 18A must sell their shares in Dragon to the other directors at a fair price. Accordingly, the other directors have told Anna that she must sell her shares to the other directors.
- This is an example of what is often known as a share expropriation provision, and their validity has been the subject of numerous cases. Where the provision is overly wide, then the courts will likely hold that it is invalid (as occurred in *Dafen Tinplate Co Ltd v Llanelly Steel Co*, discussed at p 115). However, where the expropriation power is more limited, it may be valid. So, for example, in *Sidebottom v Kershaw Leese & Co Ltd*, a provision that empowered the board to purchase the shares of any shareholder who competed with the company was held to be valid.
- Article 18B only operates where a director has been removed under art 18A. It could be argued that if a director has been removed for wrongdoing, then it would also be in the company's benefit that he no longer be a shareholder in the company. The issue that arises here is that art 18A may be used in cases where a director has not engaged in wrongdoing, and this breadth could have an impact upon the validity of Art 18B.

#### **The loss of office payment**

- Anna's contract entitles her to a loss of office payment of £20,000, but Art 18C states that she will be entitled to a payment of £10,000 and the directors are stating she will be paid £10,000 only. The issue here is whether she can claim the £20,000.
- There are specific rules regarding loss of office payments found in SS 215-226F of the CA 2006. Be careful that you apply the correct rules, as there are different rules for quoted and unquoted companies.
- As Dragon Ltd is unquoted, the key provision is s 217(1) which states that a company may not make a loss of office payment to a director unless it has been approved by a resolution of the members. Here, there does not appear to be a resolution of the members and so the payment would appear to be in breach of s 217.

- However, there is a notable exception in s 220(1)(a) and (b) which provide that member approval will not be required in relation to a payment made in good faith in discharge of an existing legal obligation. An example of such an obligation would be the loss of office provision in Ana's service contract.
- Accordingly, member approval is not required and Anna has a contractual right to claim the £20,000 payment as provided for in her service contract.