Chapter 4 – The constitution of the company

The objects clause of Covenant Ltd, a company incorporated in 2009, provide that the business of the company is to design and create websites for charities. The company’s two directors, Mike and Paul, own 25 per cent of the company’s shares, with the remaining shares split equally between three private investors (Ceri, Jo and Deborah). Ceri, Jo and Deborah are concerned that the company could become burdened by debt, so they pass a special resolution directing the board not to borrow any capital unless first approved by an ordinary resolution.

Covenant Ltd’s business prospects are not good and the directors believe that the company will need an injection of capital if it is to continue trading. Ceri argues that the company should expand its business by designing and creating websites for any corporate client, not just charities, and if the directors agree to this, she will lend the company £100,000. A meeting is convened, but Jo and Deborah do not believe that the company should take on more debt, although Jo does believe that the company should not limit its client base to charities. Accordingly, Jo and Deborah vote against the loan. Believing the loan to be in the interests of the company, the board accept the loan and use it to expand their business by taking on corporate clients. The expansion of business is a success and Covenant Ltd begins to make a profit. However, Deborah believes that the company should stick to its original aim of only designing websites for charities, and argues that, in not doing so, it is acting outside the scope of its constitution. The board, Ceri and Jo become tired of Deborah’s complaints and insert a provision in the articles, which provides the majority with the power to compulsorily purchase the shares of any minority member. They exercise this power and expel Deborah as a member.

Advise Deborah.

Introduction

- This question will require you to discuss the law in relation to several different areas, including:
  1. The balance of power between the board and the members
  2. The *ultra vires* doctrine
  3. Directors’ duties, notably the duty to act in accordance with the constitution, and
  4. The ability to alter the constitution, notably the articles.
- You are not told whether or not Covenant Ltd registered its own articles, or whether it registered no articles (in which case the model articles will apply). In problem questions, if you are not provided with details regarding the company’s articles, you can usually proceed on the basis that the model articles apply.

Direction not to borrow capital

- Ceri, Jo and Deborah (who between them hold 75 per cent) of Covenant Ltd’s shares have passed a special resolution directing Covenant Ltd not to borrow any capital, unless first approved by an ordinary resolution. You should discuss to what extent the company’s members can direct the company in this way.
• **Article 3 of the model articles for private companies** provides that subject to the articles, the power to manage the company is vested in the directors. Accordingly, the members normally cannot interfere in the directors’ exercise of power. However, the power vested in the directors is ‘subject to the articles,’ and **art 4(1)** provides that the ‘members may, by special resolution, direct the directors to take, or refrain from taking, specified action.’ Accordingly, the special resolution passed by Ceri, Jo and Deborah would appear to be valid and binding upon the directors of Covenant Ltd.

**Loan from Ceri**

• Ceri has loaned £100,000 to Covenant Ltd upon the condition that the company starts creating websites for any corporate client. Deborah is unhappy with this as she does not believe the company should take on more debt and she believes that the company should only create websites for charities. You should advise Deborah that there are two possible ways to attack the loan.

**Loan of £100,000**

• First, Deborah could argue that, by agreeing to the loan, Covenant Ltd has not complied with the direction issued by Ceri, Jo and Deborah that the company would not borrow any capital unless first approved by ordinary resolution. As noted above, this direction would appear to be valid and, in breaching it, it would appear that the company is acting **ultra vires** (discussed in the next section). You may also wish to mention that those in favour of the loan (Ceri and the two directors of Covenant Ltd) control between them 50 per cent of the shares, meaning that they could not pass the requisite ordinary resolution.

**Ultra vires**

• Deborah could argue that Covenant Ltd has acted ultra vires in two ways:
  1. By taking the loan of £100,000 from Ceri, it has breached the direction from its members, and
  2. Should Covenant Ltd take on non-charity clients, it will be acting in violation of its objects.

• You should discuss the rules relating to **ultra vires**. Were Covenant Ltd to create websites for non-charitable clients without changing its objects to reflect this, then it would undoubtedly be acting **ultra vires**. Point out that an **ultra vires** contract will not be called into question on the ground that it is **ultra vires** (**CA 2006, s 39(1)**), so such a contract would not be set aside. However, also point out that, if Deborah were to discover that Covenant Ltd was about to enter into such a contract, then she could apply to the court for an injunction to prevent the company from entering into the **ultra vires** contract (**CA 2006, s 40(4)**). Once a legal obligation has arisen, however, then the members’ ability to restrain an **ultra vires** act disappears.
You should also note that, if the directors act *ultra vires*, then it is also likely that they have breached the duty imposed by s 171(a), namely to act in accordance with the constitution. Accordingly, even if the *ultra vires* transaction remains valid, the directors may still be liable for breach of this duty. A breach of directors’ duties can be enforced via a derivative claim, which Deborah, being a shareholder, could bring on the company’s behalf. You will want to be aware of the ways in which different company law topics can overlap in this way.

**Alteration of articles and expulsion of Deborah**

- The board of directors, Ceri and Jo (who between them control 75 per cent of the company’s shares) have inserted a provision in the articles that provides the majority with the power to expel a member and compulsorily purchase that member’s shares. Whilst they have the requisite number of votes to alter the articles in this way, there are further limitations upon the majority’s ability to alter the articles, notably the alteration must be ‘bona fide for the benefit of the company as a whole’ (*Allen v Gold Reefs of West Africa Ltd* [1900]). The issue is whether or not compulsory transfer provision is in the best interests of the company.
- The courts have struggled to articulate a clear view in relation to article provisions that allow members to be expelled, and this is demonstrated in the differing decisions of the courts. In some cases, the courts have held that an article provision that allows a member to be expelled is valid (e.g. *Shuttleworth v Cox Bros & Co (Maidenhead) Ltd* [1927]). However, in other cases, the courts have held that a power to expel the member was invalid (e.g. *Brown v British Abrasive Wheel Co Ltd* [1919]). You will want to discuss these cases and highlight the lack of a coherent approach.
- More recently, the High Court has acknowledged this. In *Constable v Executive Connections Ltd* [2005], Mr Christopher Nugee QC (sitting as a deputy judge) stated that:

> I do not regard the law in this area as clear or easy to apply. There are no recent English cases and the older ones are to my mind quite difficult. Indeed the more one looks at the decided cases, the more hard it is to know precisely where the line is to be drawn between those cases where the introduction of a compulsory transfer provision will be upheld and those where it will not.

- In that case, he did state that it was unclear whether a ‘naked compulsory transfer provision’ (i.e. one that does not require any particular conduct on the part of the member being expelled) was permissible based on the current authority.
- For an excellent discussion of the law in this area, see B Hannigan, ‘Altering the Articles to Allow for Compulsory Transfer – Dragging Minority Shareholders to a Reluctant Exit’ [2007] JBL 471.