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Checking Constitutional Documents: Memorandum of the Financial Law Committee of the City of London Law Society

The City of London Law Society ("CLLS") represents over 14,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms represent a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS comments on issues of importance to its members through its 18 specialist committees. This memorandum has been prepared by a Working Party composed of members of the Financial Law Committee. The Committee is made up of a number of solicitors from City of London firms who specialise in financial law.

1. Objective

The Committee formed a Working Party on Ultra Vires to consider the legal implications for corporate capacity and the enforceability of third party transactions of certain provisions of the Companies Act 2006 ("CA 2006") introduced on 1 October 2009. In particular, the changes to companies' memoranda and articles of association under the CA 2006 prompted a review of the legal basis for the practice of checking the constitutional documents of English companies[1] party to a transaction with a lender or other credit provider. The companies in question may be acting as borrowers, guarantors or security providers. This memorandum records the conclusions of the Members of the Working Party. It is not intended to lay down rules and it is expressly recognised that it is entirely for each law firm to decide on its own policy in adapting to changes introduced by the CA 2006.

2. Introduction

Law firms acting for lenders have traditionally carried out a detailed review of the memorandum and articles of each company party to the transaction in order to establish that the company has power to enter into the transaction and

[1] In this memorandum "company" means a company incorporated in England and Wales under the Companies Act 2006 or its predecessors. It does not include a company that is a charity, a statutory company, a company incorporated by Royal Charter, a building society, an open-ended investment company (OEIC) or an Industrial & Provident Society.

that the directors of such company have the requisite authority to exercise that power. Board minutes have been drafted in such a way as to ensure that there is appropriate evidence that directors have in fact duly authorised the transaction. As part of this process, it has been necessary to consider the quorum requirements for board meetings, whether directors may vote and be counted in the quorum and whether any restriction on the exercise of the directors' powers has been observed. Law firms have drafted or approved the drafting of board minutes which have reflected these matters.

When obtaining advice in relation to a specific transaction, lenders have generally not been prepared to rely on the statutory protection for third parties afforded by sections 35(1), 35A and 35B of the Companies Act 1985 ("CA 1985"), which have now been replaced by more or less equivalent provisions in sections 39 and 40 CA 2006 (set out in the Appendix). Instead, they have requested law firms to issue legal opinions in their favour confirming that the relevant companies have the capacity and power to enter into the transaction documents, that all necessary corporate or other action has been taken to authorise the execution of those documents and that the obligations the companies have assumed thereunder are legal, valid and binding. Law firms have been prepared to give these opinions based on the due diligence outlined above.

This is in contrast to the practice of some banks or other financial institutions in relation to certain transactions where external legal advice has not been sought because the volume and size of those transactions has meant that it is simply not practicable or cost effective to check the constitutional documents of the relevant companies in each and every case. As a result, those financial institutions have opted to rely on the statutory protection for third parties in the event that any irregularities in the constitutional documents or internal procedures of their customers come to light.

This paper does not seek to lay down any rules as to the checks that should or might be carried out by a law firm acting for a particular lender in a particular transaction. The purpose is to highlight the issues raised by the provisions of the CA 2006 as they relate to questions of corporate capacity and directors' powers; the net result of which, we would suggest, involve a change of emphasis in the due diligence practices of law firms.

3. Changes to the Memorandum

From 1 October 2009 the memorandum of association of a company incorporated on or after that date has ceased to be of any practical significance, following the company's formation, and does not contain a statement of the company's objects. For those companies incorporated before 1 October 2009 under the CA 1985 or earlier legislation (“existing companies”), the majority of the provisions of their memoranda, including existing objects clauses, are to be treated as provisions of their articles[2]. This means that any objects of an existing company originally contained in its memorandum will

[2] Section 28 CA 2006

serve as an internal limitation or fetter on the authority of the directors but will not, as a matter of law, result in a transaction with a third party being void by reason only of the company's lack of capacity.
Checks of the memorandum are now redundant for companies incorporated under the CA 2006. For existing companies, the relevant provisions of their memoranda are deemed to form part of their articles. For all companies, therefore, the articles now represent the key constitutional document.

4. Checking Corporate Capacity

In addition to deeming existing objects clauses to be provisions of the articles, the CA 2006 makes other changes relevant to corporate capacity. Section 31(1) CA 2006 provides that "unless a company's articles specifically restrict the objects of the company, its objects are unrestricted"[3]. This applies to new companies incorporated under the CA 2006 and to existing companies. The effect is to give companies unlimited objects unless those objects are specifically restricted in the articles. It is likely therefore that section 31(1) will reverse the practice under the old (pre 1 October 2009) regime of extensively listing the objects which the company can pursue. The position under the new (post 1 October 2009) regime is that a company will have to take steps expressly to exclude or limit any activities, by means of restrictions in its articles, otherwise its objects will be taken to be unrestricted.

These changes require a shift in the focus of any review of the constitutional documents carried out on behalf of lenders. Instead of looking for express objects declaring what a company can do, which has been the prevailing practice for some time, lawyers will want to review the constitutional documents in order to ensure that there are no *restrictions* on what the company can do.

5. Checking Directors' Powers

By virtue of section 31(1) CA 2006, a company which has unrestricted objects will have unlimited powers. Again, however, it is important to note that such powers may be subject to express restrictions in the articles to be observed as part of the internal management of the company.

As it is no longer necessary to check a company's constitutional documents for express powers, or to consider whether any powers arise by implication, lawyers will want to focus on whether there are any *restrictions* on those powers. These will have a bearing on the way in which the directors exercise the powers conferred on them. For example, the power to borrow will be implied but the exercise of that power may be restricted by the imposition of a borrowing limit.

[3] The CA 2006 private company (limited by shares) model form of articles contain no objects or powers in relation to dealings with third parties. The model form of articles are automatically adopted by a newly formed company except to the extent specifically excluded or modified (section 20 CA 2006). For the model form see The Companies (Model Articles) Regulations 2008 SI 2008 No.3229.

Equally, directors' powers may be restricted in their scope by virtue of express objects which an existing company has retained in its constitution. When acting for the borrower, therefore, it may be necessary to consider whether the directors are exercising any powers that would fall outside the scope of express objects which the borrower has opted to retain. The effect of section 28 CA 2006 is to make the specified objects serve as internal limitations on the directors' authority and thereby preserve the bargain with the shareholders as to the activities which the company can pursue. Whilst section 31(1) CA 2006 allows the company to undertake any activity, provided that there is no specific restriction in the articles, it does not override the bargain with the shareholders. Therefore, if the directors exercise their powers otherwise than for a purpose which is ancillary to the specified objects, they may potentially be exposed to shareholder challenge.

6. Protection of Third Parties

The level of due diligence undertaken by law firms in financing transactions will depend on the parties for whom they are acting. When advising borrowers, lawyers should consider continuing to undertake a thorough review of the borrower's constitutional documents. When acting for the lenders, it is suggested that law firms will want to review the constitutional documents of obligor companies in order to ascertain whether there are any restrictive provisions affecting the capacity of the company or the powers of the directors. There has been some debate, however, as to whether there is real benefit to lenders in requiring even this level of due diligence to be undertaken, in view of the combined effect of the changes introduced by the CA 2006 on 1 October 2009.

Third parties dealing with companies may be protected by virtue of sections 39 and 40 CA 2006[4]. The position of third parties under these new provisions is not markedly different from the position under sections 35(1), 35A and 35B of the CA 1985. The most notable difference in the new sections appears in section 40 which refers to the power of the *directors* to bind the company, rather than the power of the *board of directors* (as per section 35A(1)).

Section 39 CA 2006 provides 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 constitution". From this perspective, it is not necessary for a third party to investigate whether the relevant transaction falls within the activities which the company can pursue. Section 40 CA 2006 states that as far as a third party dealing with a company in good faith is concerned, "the power of the directors to bind the company....is deemed to be free of any limitation under the company's constitution". Again, a third party is not required to make enquiries into the company's constitutional documents

[4] Except where the company is a charity, unless certain limited circumstances apply (section 42 CA 2006).

in order to ascertain whether the directors can bind the company to the transaction.

Given these statutory assurances, and the fact that many companies are likely to take advantage of the other new provisions under the CA 2006 which permit them to have unlimited objects and unlimited powers (unless they choose expressly to restrict them), should lenders feel more comfortable about relying on the statutory protection available to them and less inclined to require a detailed review of the constitutional documents of companies party to the transaction? We believe that there are five reasons why relying on the statutory protection may not always be advisable. They relate to (i) the requirement that the third party must be acting in good faith; (ii) breach of directors' duties; (iii) the issue of connected parties; (iv) the risk of no or inquorate board meetings; and (v) the threat of shareholder challenge.

Good faith

The possibility that third parties might have knowledge of matters which would render them vulnerable to a challenge of lack of good faith has been one reason why lenders have generally been advised not to place reliance on any form of statutory protection but instead to carry out due diligence on the company's constitutional documents and board minutes in order to ensure that the directors have actual power to bind the company. The position remains the same under the CA 2006 where the good faith of the lender is a key factor in determining whether the statutory protection under section 40 will be available to safeguard the transaction. Knowledge of a breach of the articles alone is not enough to constitute bad faith. However, if the lender also knows that the directors are misusing their powers and the lender stands to benefit as a result, then the lender will most likely be in bad faith.

It might be argued that the constitutional documents of the obligors to the transaction do not need to be checked if the only concern is the good faith of the lender because good faith can normally be assumed. However, in practice good faith is likely to be judged retrospectively when it is too late to salvage the arrangement. The transaction, and the motives behind it, are most likely to be scrutinised by a liquidator when the company in question is insolvent. A lender's dealings with a company in financial difficulties may be viewed with a greater degree of suspicion than would otherwise normally be the case.

Breach of directors' duties

Section 40(1) CA 2006 only deems the directors' powers to be "free of any limitation under the company's constitution". It follows that a person who knows, or ought to know, that the directors are breaching a duty, other than a duty merely to observe a constitutional limit on their powers, is not able to rely on the statutory protection.

For example, section 172 CA 2006 imposes a statutory duty on the directors to exercise their powers in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, or in order to achieve an authorised purpose of the company. Before the duty was put on a statutory footing, the courts have held that, if the directors breach this duty in causing the company to enter into a transaction which is not in its best interests, and if the other party to the transaction, such as a bank taking a guarantee or security, was aware of that fact (or if circumstances were such as to put it on enquiry), then the transaction between the company and that party could be set aside: see *Rolled Steel Products (Holdings) Limited v. British Steel Corporation* [1985] 3 All ER 52. If the directors breach their statutory duty in such circumstances, it is arguable that the other party would not be acting in "good faith", for the purposes of section 40 CA 2006, if aware of the facts.

Directors are also under a statutory duty to disclose the nature and extent of any interest (direct or indirect) in a proposed transaction or arrangement with the company at a meeting of the directors (in compliance with section 177 CA 2006 and the company's articles of association). Failure to do so will render the transaction voidable at the instance of the company. It is arguable that the transaction would be voidable against a third party who knew, or ought to have known, that non-compliance with a disclosure requirement meant that there was no requisite quorum, or no requisite majority of directors, at the meeting purporting validly to authorise the transaction. Thus, if a third party were aware of these facts or put on enquiry, the protection of section 40 might not apply.

Connected parties

Section 40 is also not a safe haven where the transaction exceeds a limitation on the powers of the directors and the other parties include a director of the company, a director of its holding company or a person connected with any such director[5]. In such circumstances, the transaction is voidable at the option of the company. It is worth noting that the rights of a third party bank, which received the benefit of guarantees from various companies in the borrower's group, for example, would not be affected provided that the bank itself was not (i) a director of any of the companies or their holding companies or (ii) connected with a director of any such company[6].

[5] Section 41 CA 2006.
[6] Section 41(6) CA 2006.

A person connected with a director[7] includes, amongst others, members of a director's family and a body corporate with which the director is connected. In complex transactions it may well be preferable to undertake a review of all the constitutional documents of the group companies rather than attempt to establish with which companies the directors may be connected.

No or inquorate board meetings

A distinction must be drawn between a limitation imposed on directors' powers under a company's constitution and its internal authorisation procedures for the exercise of such powers. Section 40 covers the former but may not extend to the latter.

The question of whether the board meeting approving the relevant transaction was quorate can, therefore, pose problems. In spite of the change of wording from its predecessor referred to above, the statutory protection under section 40 may not be available if quorum requirements have been breached. A quorum requirement is relevant to the question of what constitutes a decision of the directors. This issue has come before the courts in different ways on several occasions but the courts have not been able to lay down a clear test to determine when third parties would be protected in these circumstances.

Of course, if there are doubts as to whether the statutory protection under section 40 extends to breaches of quorum requirements, the alternative approach is to rely on the rule deriving from *Royal British Bank v Turquand* (1855) 5 E & B 248. This states that outsiders dealing with a company are not concerned to enquire whether its internal procedures have been complied with. Where it is represented to an outsider that a transaction has been validly authorised, the outsider is entitled, under this rule, to assume compliance with all relevant procedures of a company, unless the outsider has notice to the contrary. However, a third party cannot rely on ostensible authority if he knows that a board meeting was not quorate (or knows of any other irregularity in the internal proceedings of the company) or if he is put on enquiry where proper enquiry would have revealed the defect. Hence lenders would be without protection from the common law if the directors' meeting approving the transaction was patently inquorate[8]. If the constitutional documents are to be reviewed with the aim of revealing any restrictive

[7] This has the same meaning as in Part 10 CA 2006.

[8] An example is where the board minutes show that two directors attended the board meeting to approve the transaction but the third party is on actual notice that the quorum for the board meeting expressly stated in the company's articles is three directors. Another example is where the transaction is required by the articles to be approved by a special majority of the directors (e.g. including at least one 'A' Director) and, to the third party's knowledge, is not so approved.

provisions, then it makes sense to check quorum requirements at the same time.

Shareholder challenge

Carrying out a review of the constitutional documents of the obligors can also help to minimise the threat of challenge to the transaction by the shareholders. Whilst section 40 should mean that a breach of the articles by the directors will not threaten the validity of the transaction vis-à-vis the lenders (unless they are acting in bad faith as explained above), it could lead to a potential dispute between the shareholders and the directors. Lenders are unlikely to want to be involved in a transaction which may be the subject of a dispute between shareholders and directors even if they do have the benefit of the statutory protection.

Shareholders might have grounds to challenge the transaction because the directors have abused their powers (by exercising them other than for the pursuit or attainment of existing objects which the company has retained in its constitution) or because they have been unfairly prejudiced by the directors' actions, amounting to a breach of their legitimate expectations[9].

7. Shareholder Resolutions

In this way, checking the articles of companies can serve a precautionary function, highlighting circumstances in which an approving shareholder resolution would be advisable, whether in relation to a breach of a restriction in the articles (exceeding a borrowing limit, for example) or in relation to the purpose behind the exercise of powers by the directors.

Indeed, obtaining a shareholders' resolution approving the transaction can be a useful safeguard where there are any concerns about the directors' authority, particularly in situations which might cast doubt on whether the directors are exercising their powers for a proper purpose or where there is concern about compliance with their duty under section 172 CA 2006. Similarly, shareholder ratification of a breach of the articles can afford equal protection to lenders[10].

[9] Section 994 CA 2006.

[10] A shareholders' resolution approving a transaction will only protect the lenders to the company where that company is solvent and the transaction does not involve a fraud on its creditors (see *Rolled Steel Products [1985] 3 All ER 86*).

8. **Conclusion**

While it is clearly for each practitioner to decide, on a case by case basis, what due diligence is appropriate, we believe that there are good legal reasons in law why law firms should continue to undertake a detailed review of the constitutional documents of obligor companies on behalf of their lender clients, as outlined above. Lenders may wish to rely on the statutory protection available to third parties in certain circumstances. It is our view, however, that where they are separately advised they will want to ensure that all proper checks have been made to bind the companies to the transaction, and continue to receive a legal opinion which gives comfort on such matters.

The Working Party on Ultra Vires
CLLS Financial Law Committee

June 2010

DISCLAIMER:

This memorandum was developed by a working party of the CLLS Financial Law Committee. The aim of this memorandum is not to give definitive advice or intended to lay down rules and it is expressly recognised that it is entirely for each law firm to decide on its own policy in adapting to changes introduced by the Companies Act 2006. No liability whatsoever is accepted by those involved in the preparation or approval of this memorandum, or the firms that they represent, to any company or individual who relies on it.

Appendix
Companies Act 2006

39. **A company's capacity**

(1) 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 constitution.

(2) This section has effect subject to section 42 (companies that are charities).

40. **Power of directors to bind the company**

(1) In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution.

(2) For this purpose:-

(a) *A person "deals with" a company if he is a party to any transaction or any other act to which the company is a party;*

(b) *A person dealing with a company –*

(i) *is not bound to enquire as to any limitation on the powers of the directors to bind the company or authorise others to do so.*

(ii) *is presumed to have acted in good faith unless the contrary is proved, and*

(iii) *is not to be regarded as acting in bad faith by reason only of his knowing that any act is beyond the powers of the directors under the company's constitution.*

(3) The references above to limitations on the directors' powers under the company's constitution include limitations deriving –

(a) *from a resolution of the company or of any class of shareholders, or*

(b) *from any agreement between the members of the company or of any class of shareholders.*

(4) This section does not affect any right of a member of the company to bring proceedings to restrain the doing of an action that is beyond the powers of the directors.

But no such proceedings lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

(5) This section does not affect any liability incurred by the directors, or any other person, by reason of the directors' exceeding their powers.

(6) This section has effect subject to -

Section 41 (transactions with directors of their associates), and

Section 42 (companies that are charities).

THE CITY OF LONDON LAW SOCIETY
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