KEY FACTS COMPANY LAW

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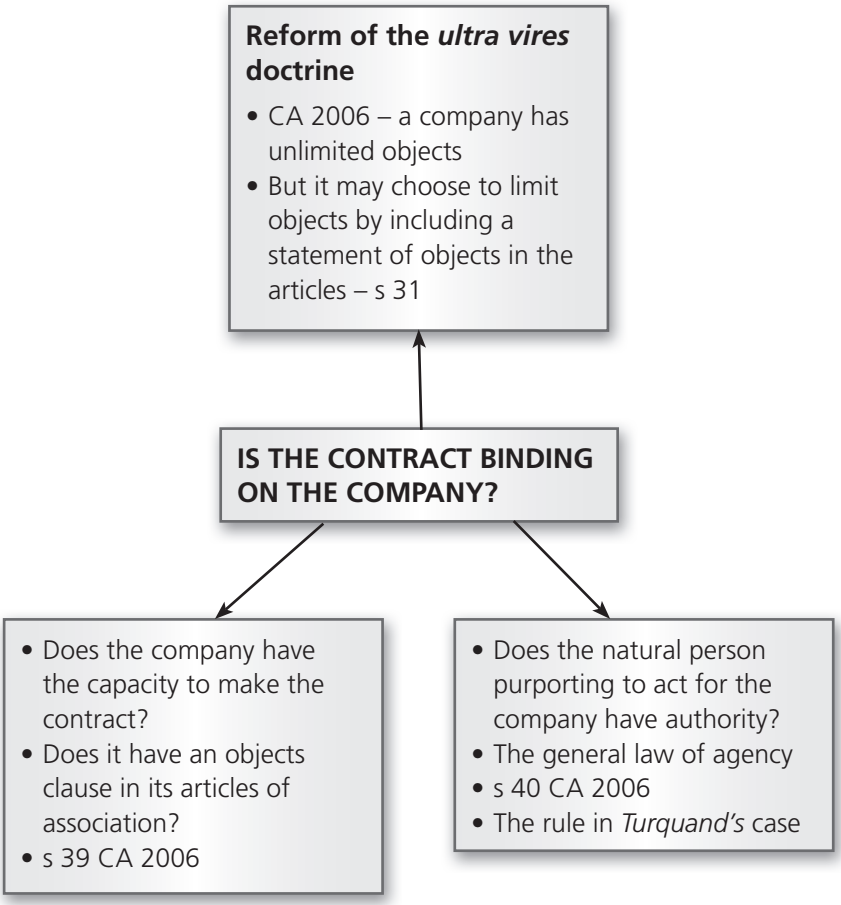
Company contracts



5.1 Introduction

1. Under previous companies legislation, every company was required to include an objects clause in its memorandum of association, which in theory set out the purpose for which the company was formed and limited the activities of the company as described below.
2. The Companies Act 2006 (CA 2006) has changed the law in this respect. Section 31(1) provides 'Unless a company's articles specifically restrict the objects of the company, its objects are unrestricted'. A company is no longer obliged to include an objects clause in its constitution, in which case it will have full capacity to transact business.
3. However, a company may choose to restrict its objects by including a statement of objects in its articles of association.
4. Companies registered under previous Companies Acts will have statements of objects in their old-style memoranda, now treated as being a provision in their articles (s 28), unless they choose to remove these by special resolution.
5. Directors have a duty to act in accordance with the company's constitution (s 171 CA 2006), so where a company has a statement of objects, failure to act within the objects will be a breach of duty.

5.2 The *ultra vires* doctrine: historical perspective

5.2.1 The contractual capacity of companies

1. Since 1856 successive Companies Acts have required that an objects clause be included in the memorandum of association and this remained the case, with some modification as to the nature of the objects clause, until s 31 CA 2006 was brought into force.
2. The objects clause sets out the activities for which the company was formed and any activity outside this statement of objects is said to be *ultra vires* the company (outside the company's capacity). At common law any such transaction was void.
3. The reasons for the rule were:
   - that members are entitled to know the purpose for which their investment is to be used;

- it was supposed to protect creditors, who were deemed to know the contents of the memorandum.

4. The *ultra vires* rule was strengthened by the doctrine of constructive notice. Because the memorandum is a public document, anyone dealing with a company was deemed to know its contents, including its objects clause, so was deemed to know if a transaction was beyond the capacity of the company. This sometimes led to very harsh results (*Re Jon Beauforte (London) Ltd* (1953)).
5. There is a tension between the need to ensure that the company's property is used for the benefit of the members, and the need not to place undue constraints on the directors' freedom to take the company forward. The objects clause and the *ultra vires* doctrine achieved the former at common law, but not the latter. Companies found the doctrine restrictive and ingenious draftsmen found ways around it.
6. The previous strictness of the *ultra vires* doctrine was ameliorated, first by s 9 of the European Communities Act 1972, consolidated as s 35 CA 1985, and then by the Companies Act 1989, which substituted a new s 35 in the 1985 Act. The principle is still relevant, in companies with restricted objects, as an internal mechanism which limits the directors' authority to enter into an *ultra vires* transaction.

5.2.2 Development of the law

1. In *Ashbury Railway Carriage & Iron Co Ltd v Riche* (1875) the House of Lords held that a company did not have the capacity to enter into a contract outside the objects clause and therefore such a contract could not be enforced by either party. One consequence of this was that a company could escape liability when it had acted outside its objects clause.
2. It became commonplace for companies to include long objects clauses with a number of separate clauses followed by a clause to the effect that each and every paragraph contained a separate object of the company – known as a *Cotman v Brougham* clause (*Cotman v Brougham* (1918)).
3. Another device used by companies was the 'subjective' objects clause, considered by the court in *Bell Houses v City Wall Properties Ltd* (1966). Two main objects were followed by a clause stating that the company had capacity 'to carry on any other trade or business whatsoever which can, in the opinion of the board of directors, be advantageously

carried on by the company in connection with or ancillary to any of the above businesses or the general business of the company'. The law was further complicated by the distinction found by the judges between objects and powers (*Re Introductions* (1968); *Re Horsley & Weight Ltd* (1982)).

4. In *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (1986) the Court of Appeal reviewed and clarified the law, holding that where the directors exercise a power stated in the objects clause that is reasonably incidental to the company's substantive objects, this will be within the capacity of the company unless it amounts to a breach of fiduciary duty and the third party has knowledge of this.

5.3 Reform

5.3.1 Reform prior to 2006 Act

1. The *ultra vires* rule has been the subject of controversy over a long period. Its application allowed companies to avoid transactions, often producing harsh results for third parties. Security of transaction for those dealing with companies has been an important objective in the reform of the law in this area.
2. In 1945 the Cohen Committee (Cmd 6659) recommended that a company should have the same capacity to enter into transactions as an individual as regards third parties. Different recommendations for reform were made by the Jenkins Committee (CMND 1749) in 1962 and the Prentice Report (1986) but none of these was implemented at the time.
3. In 1973, when the United Kingdom's entry into the EEC made it necessary to comply with Art 9 of the First Company Law Directive. Section 9(1) of the European Communities Act 1972 (consolidated as s 35 Companies Act 1985) provided: 'In favour of a person dealing with a company in good faith, any transaction decided on by the directors shall be deemed to be one which it is within the capacity of the company to enter into, and the power of the directors to bind the company shall be deemed to be free of any limitation under the memorandum or articles of association'.
4. This provision gave rise to considerable uncertainty. The main issues were the meaning of 'good faith' and whether the term 'directors'

should be interpreted as the board of directors or whether it covered a single director. The drive for reform continued.

5. The Companies Act 1989 amended s 35 of the Companies Act 1985, addressing some of the difficulties and providing 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(1)).
6. This section effectively abolished the *ultra vires* rule as far as transactions between the company and third parties were concerned, but the objects clause and the *ultra vires* doctrine still potentially had application with respect to the internal management of the company.
7. The section provided that a member could bring proceedings to stop the company from carrying out an act which, but for s 35, would be beyond the company's capacity, unless the company was under a legal obligation as a result of the act (s 35(2)). It provided further that directors have a duty to act within their powers as set out in the memorandum (s 35(3)).
8. The 1989 Act also inserted s 3A which allowed a company to simply state its object as being 'to carry on business as a general commercial company'. However, this short-form objects clause was not widely adopted in practice.

5.3.2 Companies Act 2006

1. All companies registered under the 2006 Act will have unlimited objects, unless a clause specifically restricting a company's objects is included in the articles: s 31(1). Companies registered under earlier Acts may still have a statement of objects in their old-style memoranda.
2. Section 31(2) and (3) provides that any change to a company's articles so as to add, remove or alter a statement of objects must be notified to the Registrar.
3. Section 39 re-enacts s 35(1) CA 1985, except that the word 'constitution' replaces 'memorandum'. The section provides that the validity of an act done by a company should not be called into question by reason of anything in the company's constitution.
4. There is no equivalent in the 2006 Act of s 35(2) and (3) CA 1985. These sections were considered unnecessary because of the fact that companies will have unlimited objects, unless expressly restricted,

together with the fact that s 171 places a duty on directors to abide by the constitution.

5.4 Agency principles and company law

5.4.1 Introduction: the general law of agency

1. Separate legal personality ensures that a company can contract with others, but being an artificial person, a company can only act through agents.
2. CA 2006 refers to 'an act done by the company'. The law of agency and ss 40–41 CA 2006 must be considered in deciding when an act is done by a company.
3. It is a general rule that, with some statutory exceptions, a person can only enforce a contract if he or she is a party to it. This is the doctrine of privity of contract.
4. The law of agency is a major common law exception to this rule and enables a person with the appropriate authority (the agent) to create a contract that binds his or her principal. Most commercial transactions are carried out through the law of agency.
5. In the law of agency, an agent will only be able to make a contract which binds the principal if the agent is acting within the authority given to him by the principal. A company's articles will usually give directors the authority to manage the company and directors will in turn delegate authority to others within the company to make contracts that bind the company.

5.4.2 Types of authority

Authority may be either actual or ostensible (sometimes called apparent authority).

1. **Actual authority** is described by Lord Diplock in *Freeman & Lockyer v Buckhurst Properties (Mangal) Ltd* (1964) as 'a legal relationship between the principal and the agent created by a consensual agreement to which they alone are the parties'. It is the authority that is given to the agent by the principal by way of a contact which sets out the scope of that authority. This may be done expressly in writing or orally, in which case it is known as express actual authority. It is also

possible for the principal to confer on the agent implied actual authority. This may arise:

- when an agent has express authority to perform a certain task, authority may be implied by virtue of the fact that it is necessary to enable the agent to complete the task;
- when implied authority is inferred by the conduct of the principal, for example a person appointed to a certain position may have implied actual authority to carry out the tasks usually associated with that position (*Hely Hutchinson v Brayhead Ltd* (1967)).

Both express and implied actual authority are conferred on the agent by the principal and the perceptions of the third party contactor are irrelevant.

2. **Ostensible (or apparent) authority** is the authority which the agent appears to the third party contractor to have by virtue of a representation made by the principal: *Freeman & Lockyer v Buckhurst Properties (Mangal) Ltd* (1964). In this case Lord Diplock set out four requirements for ostensible authority:
   (a) There must be a representation made to the third party by words or conduct that the agent has authority. In other words, the company must act in such a way that it appears to the third party that the agent has authority.
   (b) The representation must be made by the principal or by persons who had actual authority.
   (c) The third party must rely on the representation in entering into the contract.
   (d) The company must have capacity to enter into the contract. The provisions now contained in s 39 and s 40 CA 2006 mean that this requirement is no longer relevant.
3. In *Armagas Ltd v Mundogas SA* (1986), Lord Keith of Kinkel said 'Ostensible authority comes about where the principal, by words or conduct, has represented that the agent has the requisite actual authority, and the party dealing with the agent has entered into a contract with him in reliance on that representation'. It is important to note that ostensible authority depends on the perceptions of the third party contractor, not on the intentions of the principal. Further, an agent cannot represent himself as having authority: representation must come from the principal.
4. Ostensible authority may be conferred by a particular job title, for example company secretary (*Panorama Developments v Fidelis Furnishing*

Fabrics (1971)), and in certain circumstances to directors with particular responsibilities, such as a Finance Director.

5. The company may withdraw authority from a person who has acted with ostensible authority but third parties may continue to rely on the representation until they are notified of the change: *AMB Generali Holding AG v Manches* (2005).
6. An important difference between actual and ostensible authority is that a company cannot rely on ostensible authority of an agent to enforce a contract made outside its authority: *Re Quintox Ltd No 2* (1990).

5.5 Section 40 Companies Act 2006

5.5.1 The board of directors

1. Articles of association usually provide that the company's business shall be managed by the board of directors (Art 3 in the model articles for both public companies and private companies limited by shares) so all powers of management are delegated to the board. In this way the company appoints its agents and gives them authority.
2. The directors of a company have actual authority to bind the company if they are acting for the company or, in the case of a company with restricted objects, for the purpose of attaining the company's objects (*Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (1986)).
3. The directors, acting as a board, are agents of the company and a third party can usually rely on the actions of the directors in accordance with the ordinary principles of the law of agency.
4. However, difficulties may arise if the authority of the board is limited in some way by the company's constitution; for example the general meeting may have the right to veto the sale of certain assets. In such situations, s 40 CA 2006 applies and will provide security of contract to the third party.
5. The board of directors may delegate authority to others. Such delegation, to a single director, employees or others, is common practice.

5.5.2 The scope of s 40

1. Section 40 CA 2006 deals with the authority of directors to bind the company and, like s 39, it is intended to increase the security of persons dealing with a company.

2. Section 40 CA 2006 provides:

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

3. The meaning of 'person' in this section was considered in *Smith v Henniker-Major & Co* (2002), a case brought under the predecessor to s 40 (s 35A CA 1985). The claimant was a director of the company and the court considered whether a director of the company could rely on the section. It was held that in some circumstances a director would be covered by the section, but that a director who had taken part without authority in causing the company to enter into the transaction (as in this case) could not rely on s 40 to enforce it.

4. The decision to enter into the transaction in this case was made by an inquorate board and the question also arose whether the section covered procedural irregularities as well as limitations under the constitution. The Court of Appeal was divided on the issue, which remains unresolved.

5. 'Dealing' covers any transaction or act to which the company is a party (s 40(2)(a)), overruling the decision in *International Sales and Agencies v Marcus* (1982).

6. Under s 40(2)(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 (the burden of proving bad faith is placed on the company);

(iii) is not to be 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.

Note that s 40(2)(b)(i) above does not protect a contractor when the circumstances suggest that enquiries about other matters should have been made, for example whether the person who purported to act for the company had authority to do so: *Wrexham Associated Football Club Ltd v Crucialmove Ltd* (2007).

7. Section 40(3) provides that limitations on the directors' power under the company's constitution include limitations deriving from:

(i) a resolution of the company or any class of shareholder; and

(ii) any agreement between the members of the company or any class of shareholder.

8. A member can bring proceedings to restrain an act which is beyond the powers of the directors, unless the act has given rise to legal obligations (s 40(4)).

9. The section does not affect any liability incurred by the directors, or other person, as a result of exceeding their powers (s 40(5)).

10. These provisions apply only to 'a person dealing with the company' – the company itself cannot enforce a contract entered without actual authority unless it ratifies the transaction.

5.5.3 Section 41: Transactions involving directors

1. Section 41 CA 2006 restricts the protection given to persons dealing with a company in certain circumstances.

2. The transaction is voidable by the company and the person concerned is liable to account to the company for any profit and to indemnify the company for any loss arising from the contract when the parties to the transaction include:

- a director of the company or its holding company;
- a person connected with such a director;
- a person connected with a company with whom such a director is associated.

3. The transaction will not be voidable in the following circumstances:

- if restitution is no longer possible;
- if the company is indemnified for any loss;
- if avoidance of the transaction would affect rights that have been acquired *bona fide*, for value and without notice that the directors had exceeded their powers;
- if the transaction is ratified by the company in general meeting.

5.5.4 Other agents

1. Under s 40 CA 2006, neither the authority of the board to bind the company nor its ability to authorise others to do so can be called into question in favour of a person dealing with the company in good faith.

2. Thus the board may delegate authority to others, for example to a single director or an employee of the company. But in order to decide whether the board has in fact given authority to another person

application of the general law of agency will be necessary, as discussed above in section 5.4.

5.6 The indoor management rule

5.6.1 The rule in *Turquand's* case

1. The application of agency rules has always caused some difficulties in company law, particularly in the context of limitations on the authority of directors imposed by the company's constitution.
2. This is because persons dealing with a company will not usually be aware of such limitations and the doctrine of constructive notice exacerbated the problem, since anyone dealing with a company was deemed to know the contents of the memorandum and articles of association, whether or not he or she had actually seen these documents.
3. The rule in *Turquand's* case (the indoor management rule) developed alongside the doctrine of constructive notice and mitigates its effect.
4. Under this rule, where:
   - the directors have power to bind the company, but certain preliminaries must be gone through, and
   - there are no suspicious circumstances,

   A person dealing with a company is entitled to assume that all matters of internal procedure have been complied with (*Royal British Bank v Turquand* (1876); *Mahoney v East Holyford Mining Company* (1875); *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* (1982)).
5. However, if a contract is made without authority, a director of the company who knew or ought to have known of the lack of authority cannot rely on the indoor management rule: *Morris v Kanssen* (1946).

5.6.2 Is the rule in *Turquand's* case still relevant?

1. Section 40 CA 2006 is wider than the rule in *Turquand's* case since knowledge of a defect prevents the third party contractor from relying on *Turquand* (*Morris v Kanssen* (1946)), while knowledge of limitations on directors' powers does not stop a third party from relying on s 40. The introduction of s 40 (and its predecessors) has largely subsumed the rule in *Turquand's* case.

2. However, the rule may still have application where the limitation on the board's power to act is not strictly constitutional, such as when a decision to enter into a transaction is made by an inquorate board: *Smith v Henniker-Major & Co* (2002). But note that in this case the person seeking to enforce the contract was a director of the company and the rule in *Turquand's* case does not apply where if the person seeking to rely on it knew or should have known of the irregularity.