

Company law section 14 of the companies act 1985 essay sample

[Business](#), [Company](#)



The Joint Stock Companies Act 1844, which enabled companies to be formed by “ deed of settlement” and the Limited Liability Act 1855, established a general incorporation procedure which offered limited liability to shareholders and gave recognition to the company as a separate legal persona. By the Joint Stock Companies Act 1856, the deed was replaced with today’s style of constitution, namely the registration of the Memorandum of Association and the Articles of Association. The contents of these are now regulated under the Companies Act 1985, and form the “ constitution” of the company. It is from the original 1844 Act that the wording was adopted for s. 14 of the Companies Act 1985 which makes reference to the contractual nature of the memorandum and articles between the company and its shareholders.

“ Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.” s. 14 Companies Act 1985

The memorandum deals with the external workings of the company. It has a specified minimum content in accordance with CA 1985, which includes the company’s name, domicile, objects, extent of liability and share capital of the company. In contrast, the articles regulate the internal workings of the company and can be drawn up by the founders of the company (or can be taken from Table A of the Companies Regulations 1985) and state the rights and obligations of the company and its shareholders.

Also sometimes considered part of the constitution is a shareholders agreement, which binds the parties under normal contract law. If falling under the statutory provision in s. 380 (CA 1985), the agreement must be registered in the same way as the memorandum and articles, though clauses in the shareholders agreement cannot contravene statutory provisions. In the case of *Russell v Northern Bank Development Corpn Ltd*, the House of Lords upheld a shareholders agreement on the basis that it could be interpreted as a voting agreement, even though it pertained to a restriction on increasing the share capital of the company.

Although s. 14 applies to both the memorandum and the articles, it is generally the interpretation of the provision relating to the company's articles, that has become the cause of much debate and controversy. Confusion is centred on two areas - who are the parties to the constitution and what rights are conferred on them?

Section 14 (CA 1985) makes it clear that there is a contract between the company and its shareholders. However, unlike a commercial contract in which the rights and obligations of both parties to enforce the contract are equal, and, when breached would entitle either party to seek judicial remedy, the contract between a company and its shareholders is not so explicit. Though the obligations contained within a company's articles are enforceable by both the company and its shareholders, and, in certain cases between shareholders too, the courts' interpretation of s 14 has had the effect of limiting the enforceability of these rights. Two principles emerge from the case law.

The first principle relates to the subject of insider and outsider rights. Rights, which are common between the members, are known as 'insider' rights, and rights in any other capacity are 'outsider' rights. Only rights violated in his capacity of a member (insider rights) can be enforced. Astbury J first introduced this doctrine in *Hickman v Kent or Romney Marsh Sheepbreeders Association*. In this case, the shareholder was unable to bring a suit against his company as the articles had an arbitration clause that all disputes should first go to arbitration. Thus it was held that the rights should be enforced according to the articles. In his summing up, Astbury J said:

"No right merely purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as, for instance, as solicitor, promoter, director, can be enforced against the company."

In an earlier case, *Eley v Positive Government Security Life Insurance Co Ltd*, the articles purported to give a right to the plaintiff shareholder to hold a position as the company's solicitor for the term of his life. In the House of Lords it was held that the plaintiff could not rely on the said article, when the company terminated his employment, as he was suing in his capacity of a solicitor, i. e. enforcing an 'outsider' right, which did not affect the constitutional rights of the shareholders even though he was also a shareholder.

The second principle was established in the case of *Foss v Harbuttle*. The 'rule' being stated by Griffin in the following way:

“ An individual shareholder has no absolute right to seek redress for a wrong purportedly committed against the company in which he is a member. The company in such an instance is the proper plaintiff to instigate such an action. Whether the company proceeds with the action will depend upon the will of the general meeting and its board of directors. Only in exceptional circumstances will the court interfere with a decision taken by the company to sanction the alleged wrongful act.”

There are two parts to this doctrine; firstly that the courts will not interfere in the internal management of the company. The grounds for this lie in the principle that the majority shareholders should be able to decide whether a complaint against the company warrants court action. The consequence of this is that a minority shareholder will find it very difficult to pursue a complaint in the courts. The reasoning behind this is that if all complaints minor or otherwise, had the unqualified right to be litigated, the courts would be flooded with such cases and the time and costs incurred by both companies and the courts would be considerable . It should be noted, however, that there are exceptions to this rule. Secondly, that if a wrong has been made against the company, it is the company who should sue in its own legal capacity, as embodied in the *Salomon v Salomon & Co Ltd* case.

This maxim was highlighted in *MacDougall v Gardiner* . The plaintiff wished to propose a motion to dismiss the company’s chairman. When the deputy chairman proposed to adjourn the meeting, a vote was taken on a show of hands. The plaintiff demanded that a recorded poll be taken, as was his right according to the company articles, it was refused. The Court of Appeal held

that the action was a matter of internal irregularity and did not contravene his personal rights. Disapproval of the bringing of the action can be found in the words of Baggallay LJ:

“ I apprehend that it is not the practice of the court to make declarations of so utterly useless a character as is here asked.”

Some academic writers have commented that perhaps the outcome of this case might have been different if the motion proposed was to dismiss the chairman, as opposed to a simple postponement of the meeting. If this is correct, then surely the judiciary is sending out confusing signals? If a member has a right, (when investing in a share of a company), to have the constitution adhered to, then a breach of the articles is an infringement of these rights, and judicial remedies may be sought. That the court should make a decision based on the degree to which a right has been contravened seems inequitable. Either a right has been breached, or it has not.

In *Wood v Odessa Waterworks Co* , both of the above principles were fulfilled. The company passed an ordinary resolution (a simple majority) to pay dividends to the shareholders by way of debenture bonds. The plaintiff objected to the directors plan and took them to court on the basis that the articles provided for the directors to declare a dividend ‘ to be paid’ to the shareholders . The court held that ‘ to be paid’ prima facie meant paid in ‘ cash’, and therefore the proposal was inconsistent with the articles and granted an injunction .

It would seem, the enforceability of rights given by the articles must be qualified, and that, in supporting the minority over the will of the majority, the courts in some cases will recognise certain rights to be indisputably enforceable (the right to vote, to receive properly declared dividends, to transfer shares etc.). Might the courts have made their judgment on the premise that a breach of the article would have unjustly affected the shareholders as a whole? If this is the conclusion to be drawn, then the case of *Pender v Lushington* makes for a confusing comparable.

In *Pender v Lushington* the articles of the company stated that each shareholder was limited to a maximum number of votes. In trying to defeat the provision, Pender had split his shareholding in order to pass a resolution proposed by him that would have had the effect of indirectly benefiting the interests of a rival company in which Pender had a substantial interest . The chairman refused to accept the nominee's votes and in doing so the resolution failed. The Court of Appeal held that Pender's split of his shareholding was not in breach of the article, and that the votes should have been accepted. Could it not be construed, that the effect of allowing Pender to blatantly manipulate the articles to the benefit of himself and possibly the other company, was detrimental to the shareholders as a whole?

As we have seen, members, in certain cases, have 'insider' rights that are enforceable under section 14, but only in their capacity as members; but what of members who hold both insider rights and outsider rights, i. e. shareholders who are also directors? It is sometimes argued that since directors are bound by the duty of compliance to comply with the articles,

they should also be entitled to enforce them as directors . Case law does not support this view.

In *Beattie v E & F Beattie Ltd* the defendant, also a director, was being sued for alleged improper remuneration and was trying to invoke an arbitration clause as was provided for in the articles. However, the Court of Appeal ruled that it was in his capacity of director and not a member that he was being sued and therefore he could not rely on the contractual status afforded by s. 14.

In *Quin & Axtens Ltd v Salmon* , a member who was also a director successfully won an injunction enabling him to enforce a veto over certain board action, which had been given to him in the articles . The House of Lords held, that the company was trying to bypass rules on the decision making process, contravening their articles . In bringing his action in his capacity as a member, the plaintiff was able to circumvent the ' outsider' rights issue, by enforcing his pure membership rights.

It can therefore be said that the company's constitution does bestow rights on the shareholders, but these rights are not defined. Case law is not conclusive as to which rights are enforceable by a member, only that judicial intervention can occur only if the case is brought by the plaintiff in his capacity as a member. If an infringement of rights can be remedied by the internal workings of the company, i. e. by ordinary or special resolution, then the courts may be unwilling to intervene. The contractual status between a company and its members cannot be treated in the same manner as that of

a commercial contract, in that an infraction of the contract would afford the right to seek judicial enforcement. If litigation were under consideration, existing case law would need to be carefully studied. This, we have seen, can often be both confusing and convoluted.

For shareholders who are both members and directors, the only rights they have which may be enforceable, are those of pure membership rights. Any rights, which director shareholders wish to enforce in their capacity as 'outsiders', should be sought through either a director's service agreement or through a shareholders agreement, both of which fall outside the jurisdiction of the articles.

In February 1995 the Government commissioned a report reviewing, amongst other things, the enforcement of the rights of shareholders under the articles of association. It identified two potential problems in respect of the rights of shareholders under s. 14. The first related to the wording of the section. In stating that the company and its members are bound as if they had been "signed and sealed by each member" the wording of the provision only makes reference to the members and fails to recognise the existence of the company as a separate legal entity that is bound by its own articles.

A consequence of this is that the limitation period for a debt due to the company is twelve years, whereby for a debt due by the company to one of its shareholders, it is only six years. The view of the Law Commission Report 1997 was that there was no reason to amend s 14 in this respect. The second problem related to the difficulty in identifying enforceable personal

rights conferred by the articles . A majority of respondents agreed that no hardship was being caused in identifying personal rights conferred by the articles; and it was therefore the view of the Law Commission that no reform of s. 14 should be recommended .

In March 1998 the DTI commissioned the Steering Group, as part of a long-term review of company law, to once again re-evaluate section 14. Their original proposal “ Developing the Framework”, included suggestions for new legislation to provide a non-exhaustive list of rights enforceable by personal action, and that directors’ rights as directors should be enforceable personally only under a director’s service contract and not under the constitution . They invited responses. The Law Society and The General Council of the Bar responded that the current definition was adequate and the latter concluded that to include directors within members rights would cause “ confusion, and impede efficient administration of a company” . The majority of those responding opposed amendment. However, the final report of the Steering Group suggested that existing difficulties could be explained to the parliamentary draftsman with a view to him proposing an acceptable improvement .

The Steering Group say that the idea that the parliamentary draftsman should put forward suitable wording was “ cautiously welcomed” . Perhaps it was more a case of not being seen to be dogmatic and rejecting wording that is not in existence, even though the legal theory for the wording has been rejected? This appears to also be the view of Brain Cheffings, relating to Australia’s amendment of similar legislation, where he concluded “ Since

Australia's experience indicates that reform will not be a straightforward exercise and since there is little direct evidence that section 14 is causing difficulty for shareholders, Parliament should let matters rest for the time being".

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