Are outsider rights effectively protected by the companies act ?

Introduction :

The memorandum or articles of association of a company are regulated by the Companies Act 2006. These articles are part of a company’s constitution. The provisions found in these articles, inter alia, confer rights and impose obligations on the people involved in the company. To a great extent, “substantive matters, central to company’s operation, are left to be regulated by the articles”. As a result, it is not uncommon for contention to arise within companies regarding the effects and enforcement of the provisions in the articles. It is predominantly accepted that the provisions are binding in nature. However, the questions of who can sue or rely on the provisions and what they can sue for have sparked a heated debated which may be considered to be unresolved. (www.lawteacher.net)

**S.33 Companies Act 2006**

Section 33 of the Companies Act 2006 provides for a ‘statutory contract’ between the company and its members.

Companies Act 2006, S.33 Effects of company’s constitution

1. “The provisions of a company’s constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions”

This is a substantial re enactment of previous sections, however, the modern formulation does finally lay to rest one previous uncertainty – “that the constitution constitutes a contact between the members and the company, and between the members inter se The other remaining question, which S. 33 has not resolved is to what extent are ‘outsider rights’ enforceable by members ? In another words each shareholder can be held liable to each other under the articles. ([www.lawyersnjurists.com](http://www.lawyersnjurists.com))

 According to R. Drury, an insider right is not absolute, “they cannot be seen in isolation but only in relation to the rights enjoyed by other members” . In other words, insider rights are those that are common among all members. Conversely, an outsider right is one that is specific to a limited group or individual as opposed to anyone who is a member. This means that an insider can have a unique outside right in addition to their insider rights.

In Bisgood v Henderson’s Transvaal Estates Ltd Buckley LJ ([1908] 1 Ch. 734 ) stated that “The purpose of the memorandum and articles is to define the position of the shareholder as shareholder, not to bind him in his capacity as an individual.”

However, it appears that there are two distinct lines which contradict each other. One line suggests that a member cannot enforce rights other than membership rights or ‘insider rights’, and the other suggests that a member may enforce ‘outsider rights’ as long as he sues the company in his capacity as a member, and not as an outsider.

In the case of Eley v Positive Government Security-Life Assurance Co Ltd ((1876) 1 Ex D 88)in the articles it stated that Mr. Ely was to be the company’s solicitor. Mr. Eley later became a member. The directors then chose to use other solicitors and Eley sued for breach of the statutory contract on the term of the articles. It was held that Eley could not enforce the provision in such a way, as he was attempting to enforce his rights as solicitor, not as member.

The court rules that the provision in the articles was “either a stipulation which would bind the members, or else a mandate to the directors. In either case it is a matter between the directors and shareholders, and not between them and the plaintiff”

# This decision was later supported in the case of Browne v La Trinidad( (1887) 37 Ch D 1 (27 October 1887) where a pre-incorporation agreement specified that Browne should become a director of a company for a specified length of time. The agreement later became part of the articles, but no specific contract between Browne and the company was drawn up. The company sought to remove Browne from office before the agreed time, and it was held that it was free to do so.

# Lindley LJ stated: “it would be remarkable that, upon the shares being allotted to him, a contract between him and the company, as to a matter not connected with the holding of shares, should arise.”

**The issue of outsider rights**

Outsider rights:

Any rights conferred on a member other capacity other than that of a member is seen by the courts as ‘outsider’ rights. Such ‘outsider’ rights are not enforceable under the statutory contract contained in the constitution. ([www.researchgate.net](http://www.researchgate.net))

This judicial approach was precisely captured by Astbury J in Hickman v Kent or Romney Marsh Sheep- Breeders Association (1915) 1 Ch 881 at 897 as follows

“It is difficult to reconcile these two classes of decisions and the judicial opinions therein expressed, but I think this much is clear, first, that no article can constitute a contract between the company and a third person; secondly, that 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 member,

From this statement it seemed that the issue of ‘outsider rights’ would not be enforceable, whether or not the ‘outsider’ was a member. However, much academic debate ensued, and three main explanations of the case were put forward by Gower, Lord Wedderburn, and Goldberg.

Firstly, Gower proposed that ‘outsider’ rights can never be enforced ie. The Hinkman principle.

Secondly, Lord Wedderburn gave the view that ‘outsider’ rights can be enforced by a member as long as he sues as a member, using Salmon as support.

Thirdly, Goldberg ‘middle way’ is proposed

Views of the members of the house of lords :

View of Gower:

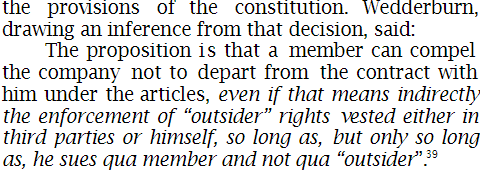
Gower’s view is based on a more traditional view in that S. 33 contract is: ‘the memorandum and articles have no direct contractual effect in so far as they purport to confer rights and obligations on a member otherwise than in his capacity of a member’ This view can be interpreted as the strictest interpretation of the law in this area, although it is consistent with the dicta in Hinkman, it fails to adequately explain cases such as Salmon v Quin & Axtens. ((1909) 1 Ch 311 (CA), affirmed (1909) AC 442 (HL) ) Gower seems to ignore these inconsistent cases, and instead bases his view on a theory of law, instead of how it has operated in practice.

In contrast, Lord Wedderburn opinion on the matter is dually the most famous, and most liberal. He argues that ‘a member can compel the company not to depart from the contact with him under the articles, even if that means indirectly the enforcement of ‘outsider’ rights vested in third parties or himself, so long as, but only so long as, he sues qua member and not qua ‘outsider’

View of Wedderburn:

In Wedderburn’s opinion, if as a member sues as a member, he can always enforce ‘outsider’ rights. His explanation of those cases where ‘outsider’ rights have been unenforceable is the technical one in which the ‘outsider’ choses not to sue in his capacity as a member. However, the problem with this approach is that in essence it goes against the decision and dicta in Hinkman, which purported to finalise the debate on the issue by reviewing the two lines of cases.

From the decision of the house of lords in the case of Salmon v Quin & Axtens. Wedderburn drew an inference and stated that a member can compel the …..



39 - Wedderburn OP cit note 17 at 212-213

View of Gregory

Gregory agrees with Wedderburn in that the judge, Astbury J, misinterpreted the previous cases, by failing to take into account relevant consideration. Gregory further relies on Eley stating that “both Amphlett B, at first instance, and Lord Cairns, in the Court of Appeal….expressly stated that the article was binding as between the parties to the statutory contract” He contends that as Eley sued as a solicitor and not as a member, there was no conflict with Wedderburn’s proposition.

View of Goldberg:

In contrast to Wedderburn and Gower opinion, Goldberg has sought to find a middle way, by providing the following explanation of the cases “a member has no right under [s.33] to have enforced a right or power bestowed by the… articles on a person otherwise than in his capacity as a member of the company, whether or not that person is in fact a member, unless the enforcement of that latter right or power is incidental to the enforcement of the members’ contractual right… to have any of the company’s affairs conducted by the particular organ of the company specified in the… articles.”

From this one can understand the importance of the question as to whether the company acted constitutionally or not. If the company has not acted constitutionally, the member can then enforce the statutory contract to ensure that the company does so, even by enforcing an ‘outsider’ right. Other than this no further enforcement of ‘outsider’ right is permissible.

The doctrine of indoor management:

The doctrine of indoor management, also known as the Turquand rule is a 150-year old concept, which protects outsiders against the actions done by the company.

Any person who enters into a contract with the company shall ensure that the transaction is authorised by the articles and memorandum of the company. There is no requirement to look into the internal irregularities, and even if there are any irregularities, the company shall be held liable since the person has acted on the grounds of good faith.

To absorb the concept of this doctrine, it is important to understand the concept of the doctrine of constructive notice. Both the concept of indoor management and constructive notice is explained below.(www. cleartax.in)

**Origin of Doctrine of Indoor Management**

The doctrine originated from the landmark case **Royal British Bank V Turquand (1856) 6 E&B 327**. The facts of the case are as follows. The Articles of the company provide for the borrowing of money on bonds, which requires a resolution to be passed in the General Meeting. The directors did acquire the loan but failed to pass the resolution. The repayment on loan defaulted, and the company was held liable. The shareholders refused to accept the claim in the absence of the resolution. Held, the company shall be liable since the person dealing with the company is entitled to assume that there has been necessary compliance with regards to the internal management.

## Example for Doctrine of Indoor Management

* Abc received a cheque from Xyz company. The Articles of Association of Xyz company provided that cheques issued by the company need to be signed by two directors and countersigned by the secretary. The directors nor the secretary who signed the cheque was appointed properly and thus the cheque issued was not valid. Abc sued the company for the irregularities in the procedure. Is Abc liable for relief?

Answer: Abc is entitled to relief and the company has to pay the amount of the cheque since the appointment of directors is a part of the internal management of the company and a person dealing with the company is not required to enquire about it.

Conclusion

This article has discussed some of the issues around s.33 by exploring cases dated as far back as 1915, all of which are still applied in our courts today, in turn hindering the success behind any of the statutory reforms that have been made regarding member rights through the articles of association. As argued, it is confusing why a party to a such a contract who is both a director and a member (shareholder), is subject to the same articles of association, is able to enforce the articles if an issue effects their position as a member, but not have a contract to fall back on if the company breaches the same articles and effects their role as an outsider.

s.33 of the CA 06 has been a contentious matter, particularly on the issue of members seeking to enforce outsider rights. In the example considered, the Hickman principle would certainly deny the claimant enforcement of any right conferred upon him in his capacity as a director or outsider. However, Lord Wedderburn’s, highlighting of the conflicting Salmon case has sparked debate amongst numerous academics, most of which seem to disagree with Hickman. In any event, with the inconsistency on this issue the only way the claimant would be able to guarantee that the provision is enforced and he keeps his position for life is if he enters into an extrinsic contract with the company separate from the articles.

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