LENDING TO COMPANY GROUPS - THE PROBLEMS OF CORPORATE POWER AND DIRECTORS' AUTHORITY

FRANCIS NEATE

Slaughter and May, London

Mr Justice Paul deJersey opened by referring to complexity, uncertainty and expense. On my way here, I came via the island of Hawaii, which was really quite an intelligent route I think, and I was sitting on a beach there last week dreaming of getting a breakfast with Marmite, which I am delighted to say I had today (this is the sort of thing one dreams about on beaches in Hawaii) and I was also trying to think of something interesting to say about the ultra vires doctrine. I was trying it out on my wife and after I had tried to explain it to her, she said "what on earth is it for then?". I thought about that for a bit, and complexity, uncertainty and expense went through my mind, and it suddenly dawned on me that what it was for was the benefit of banking lawyers like you and me, and it gives us all the opportunity to come to this marvellous place and talk about it for a whole hour and a half - but for heaven's sake, not much longer than that.

I was also intrigued to read Mr Justice deJersey's paper in advance and to discover that there are even doubts here about your attempts to abolish the ultra vires doctrine. The reason I find that rather amusing is that in England we have just tried to abolish it yet again in the Companies Act 1989. Those provisions came into effect in February 1991, we have not yet got any case law on them, but there is a lot of criticism that the provisions are unclear and that what we ought to have done was to follow the recommendations of the Prentice Report, written in 1986, which said that what we ought to do was to enact that a corporation has all the powers of a natural person. I discover that that is exactly what you did many years ago, yet you still have not managed to abolish the ultra vires doctrine completely.

The DTI decided apparently not to follow the recommendation of the Prentice Report, for reasons which are obscure.

Perhaps I ought to summarise very quickly what the present legal position is in England. In the Appendix I have included the text of the relevant statutory provisions because it seemed to me that if I was going to talk about English law, I ought to give you this material because you would, presumably, be about as familiar with it as I am familiar with your law - which means, not at all.

Our first attempt to abolish the ultra vires doctrine was in the European Communities 1972 - a whole twenty years ago. That took place in s9 of that Act which became s35 of the Companies Act 1985. I think the two sections were more or less identical. They were widely regarded as unsatisfactory and we all just simply ignored them. We assumed that the ultra vires doctrine had not been abolished and some years later the **Rolled Steel** case, at least implicitly, confirmed that belief. (**Rolled Steel Product (Holdings) Limited v British Steel Corp Limited** [1986] Ch 246). I will not go into the detail of why. In 1986 the DTI commissioned the report by Professor Prentice which recommended the total abolition of the doctrine and the substitution of the powers of a natural person which I have already referred to. The DTI ignored that report, but in the Companies Act 1989, they introduced into the Companies Act 1985 a new s35 and s35A (see the Appendix). That is what our law now is and at the moment we are all trying to work out what we think its practical effect is going to be. I would just like to speculate for a few minutes on that.

In s35 we have a new attempt to abolish the ultra vires doctrine so far as it affects outsiders, but to preserve it as an internal control mechanism. Some doubts have been expressed about the effect of the new wording and just to show you the kinds of absurdities we can all go to, I will mention two of them. You will notice sub-s(1) refers to the validity of an "act done" by a company. Some have argued that a company cannot do anything except through a duly authorised agent. If the act is ultra vires, it is impossible for the company to authorise an agent to do the act. Therefore, any ultra vires act cannot be an "act done" by the company. Therefore, sub-s(1) does not work. That is the kind of circular reasoning which is simply wonderful, but I do not believe that it will appeal to a judge and I am looking forward to watching the experience of the first barrister who tries that particular argument on, because it would emasculate the section altogether.

The section goes on to refer to the validity of an act not being called into question "by reason of anything in the company's memorandum". It has been argued that that does not include things which are not in the company's memorandum. Consequently, since the ultra vires doctrine is mainly about objects or powers which are never included in the company's memorandum in the first place, again the section has failed to do what it intended. Again, I would like to see what happens to the first advocate who tries to put that argument forward.

The best way to find out about the new s35 is to read the first document put out by the Bank of England's new Legal Risk Review Committee. I have set out in the Appendix an extract from paragraphs 10 to 15 of the Annex to Appendix I of that report and the arguments for and against the effectiveness of the new s35 are briefly referred to there. It is fairly common knowledge that that particular Annex was written by Mr Justice Hoffman and those paragraphs contain what I think one could describe as the robust interpretation of s35. It is clear that if you get in front of Mr Justice Hoffman, that is what you are going to get and the general view is that the ultra vires doctrine itself, so far as outsiders are concerned, has gone. Nevertheless, it is new legislation. It is going to have to be interpreted by the courts. And until that happens, obviously a degree of uncertainty is going to remain.

That is enough on the ultra vires doctrine itself. I think we need to go on just to look at two more fairly important points, the first of which is not really within the scope of our discussion today, but is very hot in England at the moment.

The first point is this. The reforms in the Companies Act 1989 only apply to limited companies. They do not apply to other organisations, incorporated under other Acts, notably local authorities, building societies (both of which are very big players in the financial markets), and others such as friendly societies, the odd insurance company, or companies incorporated by special Act of Parliament. These bodies are not affected by these reforms.

In the swaps case which you may have heard about, **Hazell v London Borough of Hammersmith and Fulham** ((1991) 2 WLR 372), a local authority was held to have acted ultra vires in entering into a very large number of currency and interest rate swaps. That is, at the moment, the hotter issue in London. What the case establishes is that the ultra vires doctrine, in so far as these kinds of bodies are concerned, is not merely not dead, it is very much alive indeed. However, enough said about that. It is really outside the scope of today's agenda.

The other point I would like to make is this. The concept of ultra vires, at least in the way I was educated about it, has always had two limbs. The first question is - is it within the **company's** capacity? This requires you to look at the objects clause. The second question is - is it within the **directors'** capacity? That has nothing to do with the objects clause at all. The two limbs are very frequently confused and, of course, they are confused, inter alia, because anything that is not within the company's capacity cannot be within the directors' capacity. But when one asks - "is it within the directors' capacity?", what one means is - is it being done bona fide in the interest of the company, and for no other reason? These two limbs are often confused and one does not bother to identify which part of the rule is being broken. Take for example the question "can a company give its money away?". Obviously a charitable company can, but the interesting question is whether any other company can. I venture to argue that the question whether a company can give its money away raises questions under **both** limbs of the ultra vires rule. And I think both questions again arise in the kind of case which we are dealing with today when you ask yourself: can a subsidiary guarantee the debts of its parent when it will receive none of the money which is going to be lent to the parent and will receive no other obvious benefit?

As far I can make out (although I do not quite see it in the commentaries) these questions all remain relevant when we have to consider s35A of our new law which purports to deal with the second limb of the concept of ultra vires, ie the powers of boards of directors. Section 35A starts with the famous words that the old section started with: "In favour of a person dealing with a company in good faith ...". That is different from your law and, it seems to me is likely to be the starting point of our problems. As I understand it, your law has the words "actual knowledge" and there is some debate about what that means; we start with "in good faith".

Section 35A goes on to refer to the power of the board of directors to bind the company which "... shall be deemed to be free of any **limitation under** the company's constitution" (my emphasis). The question I have is simple: is the fiduciary duty of a director to his company to take account of the interests of his company and nothing else, a **"limitation under"** the company's constitution? I do not think it is. It never appears anywhere in the company's constitution. It is judge-made law. It is essential to make company law work at all. And I just do not see it being taken away by that particular wording.

Section 35A(2) does provide a fair amount of help to the person who is put on inquiry, but it does not seem to me to solve his problem. It puts the burden of proof on the person who says you are not acting in good faith to prove it. It also says that a person 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. In other words you read the objects clause and you find the proposed act is ultra vires, you are not by that fact alone deemed to be not in good faith. Also s35B (which is also set out in the Appendix) says you are not bound to inquire into that.

None of that really gets me home on the question which is worrying me and which, it seems to me, is the problem we are faced with regularly in practice. That is this - in the large majority of the difficult cases in this area of the law, there is usually a breach of fiduciary duty by the directors, ie a breach of their fundamental obligation to the company which is never written into, and is, therefore, not a "limitation under", the company's constitution at all.

It is not surprising that in a large number of these cases you also find an ultra vires act in the sense of something outside the objects clause and/or a breach of the director's more specific duties to the company such as the obligation to declare an interest. You frequently find that because, of course, the breach of fiduciary duty usually involves the director in some kind of conflict of interest.

All of this was, for example, considered in **International Sales and Agencies v Marcus** ([1982] 3 All ER 551) which was decided under the old law and is a fairly good example of how all these difficulties come together. In that case, as far as I can see, the judge more or less ignored the old s35. Once he had established that there had been a flagrant breach of duty by the director, (he was using the company's money to pay somebody else's debts) and the failure of the recipient to inquire where the money came from (he obviously knew where it came from - and chose not to make further inquiries), as far as the judge was concerned, that was that. The company had been robbed. There was no doubt about that. The company always is robbed. It was robbed in the two cases Mr Justice Paul deJersey was talking about. As far as the judge was concerned, he was not going to let that happen and the money had to be paid back.

I think our courts' attitude is going to remain exactly the same. Where there is a breach of fiduciary duty and the person dealing with the company is put on inquiry - and let us just leave that on one side for the moment - I think the courts are simply going to continue to apply the old law. The question then is: "how does that affect us banking lawyers?" This is the interesting question because I think even under your law you still have to ask yourself that question.

Let us look at the classic problem case which we all have to deal with. That is the case where you are acting for your bank, which is going to take a series of cross-guarantees, possibly cross-debentures as well, from companies in a group. If you are sensible, unlike the ANZ in the case Mr Justice deJersey talked about, you actually take them at the time, you do not take a promise to give them later. In such a case, you know you start with a problem from the outset. It is the group finance director who negotiates the whole package. He is the one who is going to decide where the money goes, if it has not gone already, and he will tell the directors of the subsidiaries to execute whatever is put in front of them. You know that, he knows that, we all know that.

Under our old law and your old law you had to deal with at least three problems in such a case:

(a) Each subsidiary had to have a specific object, ie to guarantee the parent.

(b) Secondly, you had to override any conflict of interest which the directors of the subsidiary might have, eg because they were directors of other subsidiaries or of the parent or employees of the parent - they were certainly going to be paid by the parent.

(c) Finally, you had to authorise the directors to enter into the transaction notwithstanding that it was not or might not be in their own company's interests.

I am not sure whether my firm has ever had a standard form of shareholders' resolution to achieve these objectives, but in the Appendix I have included a form of notice of an extraordinary general meeting which I stole from a recent transaction which appears to me to contain the resolutions that are necessary in a case of this kind. The essential question is whether under the new English law banking practitioners in this kind of case will continue to require this kind of thing?

As far as I am concerned, the answer is very clearly, yes. My firm is certainly doing so, for the reasons I have already given. I think we are right to do so. The problem is this. Once you are put on inquiry by the nature of a transaction, there is no knowing where to stop. And we are paid large sums of money as banking lawyers by our clients to ensure that the transaction is 100% safe. Not 95% - but 100%. In the light of our new law, the only possible way I can do that is to continue exactly as I did in the past. I do not see how any sensible banking lawyer can do anything else.

The interesting question I would leave you with is this: in our case, the need to continue as before arises because our law requires you to be in good faith. Your law appears to require (except in the case of special connections) "actual notice". The question for you, as banking practitioners in Australia, is: does that difference in wording make a difference?

I wish to make three further remarks. The first is this. The Legal Risk Review Committee refers at one point in the part of their report I have quoted, to some minor uncertainties which may still cause delay "as cautious lawyers still carry out lengthy procedures checking memorandum and articles of association". Rubbish! That is the sort of irritating nonsense - and I am delighted to say this, even if it was actually written by Mr Justice Hoffman - the sort of irritating nonsense one gets from judges. It takes about five minutes to read the objects clause of a memorandum of association. What takes the time is getting a copy of the damned thing in the first place. What really takes the time in transactions like this is persuading the stubborn, self-important, power-drunk group finance director, to do things properly. He, of course, has never read his memorandum and articles and he has never heard of the concept of fiduciary duty.

The second point (I am not sure whether this applies in your law) is that all the limitations of our old law, even if they have been abolished or at least reduced, so far as outsiders are concerned, still apply internally - they apply to the directors. In other words, the directors remain bound by the limitations in the memorandum and articles. Consequently, in the case I have outlined, it is the duty of the company's lawyer to insist on all these procedures being followed anyway, even if you, the bank's lawyer, decide not to. So all you are really doing is trying to help the stubborn, self-important, power-drunk group finance director to avoid his own problems. He will, of course, be the last to acknowledge your altruism, but that is the fact of the case.

Finally, we get to the question that I find most interesting which is whether directors also owe a duty to creditors, which Mr Justice deJersey raised and seems to be implicit in your **Qintex** decision. I think that is the wrong way of putting the question. I nearly at one point labelled this part of the talk "Has Lord Templeman Lost His Marbles?", because it was he who at one point introduced this ridiculous suggestion that directors owe a duty to creditors. They do not even owe duties to shareholders, let alone creditors, they never have. They owe duties **to the company**. It is high time our judges began to realise this. In the present context, the correct way to put the question is this. If an act is not in the interests of the company, can a resolution of the shareholders (authorising the directors to do it), put an end to any prospect of subsequently challenging it? This is the real question. Can the shareholders say "I do not care about the creditors, and you directors need not bother about them either"? The answer is, obviously, no. But the directors' duty, it seems to me, is clearly owed to the company and the company is a peculiar amalgam of different interests, some of which become more or less important as things go along - shareholders' interests, employees' interests (which have been introduced by statute but no-one has told us how to enforce them), creditors' interests, even (perhaps) interests of the public at large, ie the concept of the good corporate citizen. All of these interests are an amalgam of what the expression "the company" means and what we ought to be emphasising to our courts and to our judges is that the idea that a creditor can sue a director for breach of a duty (except for offences under the Insolvency Act) is a nonsense. It is time they all stopped talking in terms which suggest this is possible. The real question is: can the directors take a decision which is contrary to the interests of creditors, but not contrary to the interests of shareholders, and is there anybody who can authorise them to do that? I think that what is happening is that the courts are slowly moving towards realising that the answer to that question is, no. Consequently, when I recommend my banking client to put my resolutions in front of the group companies and arrange for them to be passed, I have to say to my banking client "I cannot guarantee to you, particularly if the shareholders, in authorising the directors to do this, are manifestly disregarding the interests of creditors, that those resolutions will be effective to make this transaction valid. However I do not know the grounds on which the courts are going to arrive at that conclusion".

Thank you.

APPENDIX

COMPANIES ACT 1985 (in its original form)

(replacing Section 9 of the European Communities Act 1972)

35. Company's capacity: power of directors to bind it

(1) In favour of a person dealing with a company in good faith, any transaction decided on by the directors is 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 is deemed to be free of any limitation under the memorandum or articles.

(2) A party to a transaction so decided on is not bound to enquire as to the capacity of the company to enter into it or as to any such limitation on the powers of the directors, and is presumed to have acted in good faith unless the contrary is proved.

COMPANIES ACT 1985

(as amended by Sections 108 and 109 of the Companies Act 1989)

"35. A company's capacity not limited by its memorandum

(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 memorandum.

(2) A member of a company may bring proceedings to restrain the doing of an act which but for subsection (1) would be beyond the company's capacity; but no such proceedings shall lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

(3) It remains the duty of the directors to observe any limitations on their powers flowing from the company's memorandum; and action by the directors which but for subsection (1) would be beyond the company's capacity may only be ratified by the company by special resolution.

A resolution ratifying such action shall not affect any liability incurred by the directors or any other person; relief from any such liability must be agreed to separately by special resolution.

(4) The operation of this section is restricted by section 30B(1) of the Charities Act 1960 and section 112(3) of the Companies Act 1989 in relation to companies which are charities; and section 322A below (invalidity of certain transactions to which directors or their associates are parties) has effect notwithstanding this section.

35A. Power of directors to bind the company

(1) In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be 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 other act to which the company is a party;

(b) a person shall not 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; and

(c) a person shall be presumed to have acted in good faith unless the contrary is proved.

(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 in general meeting or a meeting of any class of shareholders, or

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

(4) Subsection (1) does not affect any right of a member of the company to bring proceedings to restrain the doing of an act which is beyond the powers of the directors; but no such proceedings shall lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

(5) Nor does that subsection affect any liability incurred by the directors, or any other person, by reason of the directors' exceeding their powers.

(6) The operation of this section is restricted by section 30B(1) of the Charities Act 1960 and section 112(3) of the Companies Act 1989 in relation to companies which are charities; and section 322A below (invalidity of certain transactions to which directors or their associates are parties) has effect notwithstanding this section.

35B. No duty to enquire as to capacity of company or authority of directors

A party to a transaction with a company is not bound to enquire as to whether it is permitted by the company's memorandum or as to any limitation on the powers of the board of directors to bind the company or authorise others to do so."

REPORT OF THE LEGAL RISK REVIEW COMMITTEE

February 1992

(Paragraphs 10 to 15 of the Annex to Appendix I)

Questions arising under the Companies Acts

10. Even when efforts are made to eliminate the ultra vires doctrine, uncertainties can continue. Submissions we received demonstrated some concern that remnants of the doctrine may still prove hazardous even in relation to Companies Act companies. Slight concern was expressed that, rather than giving a company all the powers of a natural person, Section 35(1) only provides that the validity of transactions should not be questioned on the grounds of lack of capacity by reason of anything in the memorandum. Some commentators have argued that problems of capacity come from matters which are left out of the memorandum rather than contained in it. The better view is thought to be that the logic of the ultra vires rule is that express statements of powers imply a prohibition on matters omitted and lack of capacity therefore stems from something in the memorandum.

11. Some concern was expressed over whether enough has been done to avoid the risk that the ultra vires doctrine would be resurrected as a restriction on authorisation - on the argument that, even if a company is be treated as having the capacity to do anything, its officers cannot be regarded as having been authorised to act outside its stated objects. Section 35(3) of the Companies Act 1985 (as amended) states that directors are still obliged to comply with any limitations on their powers flowing from the memorandum. It also requires a special resolution to ratify actions which would, but for Section 35(1), have been beyond the company's capacity. It is not made completely clear that Section 35(1) continues to apply whether or not the transaction is ratified.

12. The danger of resurrecting the ultra vires doctrine is, however, directly addressed and substantially overcome in other amendments to the Companies Acts. Sections 35A and B clearly state that innocent third parties should no longer be at risk from the doctrine of ultra vires. They provide that, in favour of a person dealing with a company in good faith, the power of the board of directors to bind the company or authorise others to do so is deemed to be free from limitations under the constitution; third parties are not required to enquire into any such limitations; and even knowing that an act is beyond the powers of the directors does not in itself amount to bad faith.

13. Very few uncertainties therefore remain and those that do stem from the fairly complicated wording of the Companies Act 1989 amendments. The first is that Section 35A refers only to the powers of the board of directors. It is not completely clear that its protection will extend to cover third parties if the board of directors is improperly constituted (eg does not have the correct quorum) or if the constitution gives powers directly to persons other than the board of directors (eg the managing director). The second is that Section 35A refers only to those who are parties to transactions with the company and not those indirectly involved. The third is that the protection given by Section 35A may be restricted if one of the parties to the transaction is a director or connected person (even if the other parties involved were not aware of this). Finally there is uncertainty over what exactly will be regarded as amounting to bad faith.

14. These remaining uncertainties with the Companies Act are relatively minor and unlikely to produce injustices of the degree caused by the ultra vires doctrine. The statutory provisions could be interpreted widely (particularly in the light of the First Company Law Directive) and, even if they are not, common law and equitable doctrines of ostensible authority, the "indoor management" rule, the protection of third parties for value without notice, coupled with the statutory projections, should give sufficient protection. Even minor uncertainties can, however, cause delay and mean that cautious lawyers will still carry out lengthy procedures for checking the memorandum and articles and authorisation.

15. The Prentice Report recommended that companies should have the capacity to do any act whatsoever and it should be recognised that any director (not just the board of directors) has the power to bind the company. Had these principles been enacted rather than the more complicated route chosen in the Companies Act 1989 some of the uncertainties mentioned above might have been eliminated. In general, however, the approach of the Companies Act - in particular the provision that mere knowledge of a limitation should not in itself endanger a transaction - greatly increases certainty and allocates risks more fairly than the doctrine of ultra vires.

XYZ LIMITED

NOTICE IS HEREBY GIVEN that an EXTRAORDINARY GENERAL MEETING of the above-named Company will be held at [ ] on [ ], at [ ] a.m./p.m. for the purpose of considering and, if thought fit, passing the following resolutions which will be proposed as SPECIAL RESOLUTIONS :-

SPECIAL RESOLUTIONS

1. That, notwithstanding any existing provision of the Memorandum and Articles of Association of the Company and notwithstanding any personal interest, the Board of Directors of the Company be and is hereby specifically empowered, authorised and directed to approve, execute and deliver in such form as the Board of Directors of the Company may determine [the Agreement] (the draft of which dated [ ] was produced to the Meeting and signed for the purpose of identification by the Chairman of the Meeting).

2. That, notwithstanding any existing provision of the Memorandum and Articles of Association of the Company, the entering into, delivery and performance of [the Agreement] referred to in paragraph 1 above be and is hereby constituted one of the main objects of the Company.

BY ORDER OF THE BOARD,

....

Director/Secretary