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Case Comment

Section 35A and quorum requirements: confusion reigns

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***Comp. Law. 325** Engaged as it is in the Herculean task of drafting the Companies Bill, the DTI would be well advised to consider the implications of *Smith v. Henniker-Major & Co.* [1] This case has spawned four judgments in the higher courts, each giving a different reading to section 35A of the Companies Act 1985, leaving the law in a highly unsatisfactory state.

The facts were these. A company purported to assign a right of action against its solicitors to a director, S, who subsequently issued proceedings. The “meeting” of the board which approved the assignment was inquorate. The solicitors applied for summary judgment on the ground that the assignment did not bind the company and so S had no entitlement to sue them. S contended that he was a “person dealing with a company” within section 35A(1) with the result that “the power of the board of directors to bind the company” could be “deemed to be free of any limitation under the company's constitution” (it being further asserted that the quorum requirement of two in the company's articles was a “limitation”).[2]

Rimer J. had first bite at the cherry, and, while his judgment[3] has attracted some adverse comment,[4] it is logical and clear. He concluded that section 35A only applies to powers exercised by a properly constituted board. Unless quorate, the board cannot act and until the point is reached where there is a board capable of transacting business on the company's behalf, the provision is not engaged. The implications of this reasoning may be unpalatable given that the object of the provision and the underlying Directive[5] is security of transaction, but they are crystal clear. Any counterparty dealing with an inquorate board is not protected by section 35A and would have to rely on the indoor management rule.[6] A quorum requirement is not a “limitation” but rather a pre-condition to the exercise of board power. The onus is on the counterparty to verify that she is dealing with the board and/or to protect herself by insisting that the company execute a written contract or deed in the manner provided for by section 36A.

A majority of the Court of Appeal agreed that S could not rely on section 35A to validate the assignment but disregarded Rimer J.'s forceful reasoning. Instead, they sought to read down section 35A to say that a director in S's position was not “a person” within section 35A(1). Carnwath L.J. accepted that the phrase “person dealing with a company” is wide enough to include a director. However, he refused to accept that S who “was not simply a director dealing with the company, and having some incidental involvement in the decision”[7] could rely on section 35A to cure a problem that arose from his own failure to comply with the constitution.[8] In interpreting section 35A, the judge saw no reason why the court “should not be guided by what the common law would deem appropriate in a similar context”, drawing support from *Morris v. Kanssen* ,[9] a case in which the House of Lords refused to allow a director to rely on the indoor management rule. Schiemann L.J. reached a similar conclusion, construing the phrase “person dealing with the company” so as to exclude “the very directors who overstepped the limitations in the company's constitution”.[10]

This amounts to a deliberate attempt by the majority to engineer a result going against S while leaving open the possibility that genuine outsiders dealing with an inquorate board may be able to rely on the statute.[11] However, the gloss put on the statutory language is questionable. The term “person” is unqualified and demands an all-inclusive construction. The concept of “third parties” in the underlying Directive is similarly unqualified.[12] The point is reinforced by section 322A which qualifies section 35A

by providing that a transaction with a director or connected person is voidable at the instance of the company where the board of directors has exceeded any constitutional limitation on its powers. The natural way to read the provisions is to treat section 322A as restricting the otherwise all-embracing scope of section 35A.[13] The implication of the majority approach is that some transactions with director-counterparties will be invalid whereas others will be saved by section 35A only to be rendered voidable by section 322A.[14] However, there is little indication beyond the circumstances of the case itself as to the criteria that should be applied to determine whether a particular director-counterparty falls within section 35A(1). Carnwath L.J.'s reliance on the *Turquand* rule to fashion a criterion of exclusion only raises more questions, not least the legitimacy of using the common law to interpret section 35A.[15] Further litigation will be required to resolve the crucial questions left outstanding--what is meant by “board of directors”,[16] and is a quorum requirement a “limitation”?--a situation that is hardly desirable.

Robert Walker L.J.'s dissenting judgment is superior to those of the majority because it grapples with the circularity lying at the heart of section 35A. The counterparty will not have dealt with a board of directors having actual authority to bind the company because, by definition, the provision is concerned to validate transactions entered into in excess of board power. It follows that dealings with something less than the board must be capable of being treated as dealings with “the board” for the purposes of section 35A. In Robert Walker L.J.'s view, for section 35A to be engaged there must be at least “a genuine decision taken by a person or persons who can on substantial grounds claim to be the board of directors acting as such (even if the proceedings of the board are marred by procedural irregularities of a more or less serious character)”.[17] A procedural requirement can therefore be treated as a limitation on board power.[18] Thus, the judge tries to solve the problem by introducing the vague concept of a *de facto* board. While his approach is logical, it too would be a recipe for further litigation, a point he effectively concedes.[19]

It is difficult to escape the conclusion that we would be better off with the certainty of Rimer J.'s ruling even though it throws some onus back onto the counterparty. At least everyone would know where they stood. In its present form, clause 17 of the Companies Bill (the proposed replacement for sections 35A and 322A) would still apply only to acts of “the board”. The questions left open by *Henniker-Major* would remain open and the costs of resolving them would rest squarely on companies and those that do business with them. The DTI should take note, have yet another look at the Directive and revisit clause 17.

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1. [2002] EWCA Civ 762.

2. The question of whether S was “dealing … in good faith” for the purposes of s. 35A(1) and (2) was not in issue: see transcript, para. 30.

3. [2002] B.C.C. 544.

4. See Howell, “Section 35A and an Inquorate Board: One Won't Do” (2002) 23 *Company Lawyer* 96.

5. s. 35A implements Art. 9(2) of the First Council Directive 68/151/EEC, [1968] O.J. English Spec. Ed. (I) 41.

6. *Royal British Bank v. Turquand* (1856) 6 E. & B. 327.

7. A cryptic reference to *Hely-Hutchinson v. Brayhead Ltd* [1968] 1 Q.B. 549; [1967] 3 W.L.R. 1408; [1967] 3 All E.R. 98, CA.

8. Transcript, para. 110.

9. [1946] A.C. 459, HL.

10. Transcript, para. 129. Schiemann L.J. appears to have been beguiled by counsel for Henniker-Major's curious submission (noted at para.

49) to the effect that s. 35A should not be construed so as to allow a delinquent director to acquire rights against the solicitors who were themselves characterised as “persons dealing” within the meaning of s. 35A(1).

11. See *e.g.* Carnwath L.J.’s guarded dicta at para. 108.

12. Moreover, it is clearly established that the Directive has no inbuilt safeguards against conflicts of interest: see Case C-104/96, *Cooperatieve Rabobank “Vechten Plassengebied” BA v. Minderhoud* [1998] 1 W.L.R. 1025; [1997] E.C.R. I-7211; [1998] 2 B.C.L.C. 507; [1998] 2 C.M.L.R. 270, ECJ.

13. The approach favoured by Robert Walker L.J.: see paras 44-51.

14. A finding that the assignment was valid under s. 35A but caught by s. 322A would mean that S's title was merely voidable, a further complication that, no doubt, the majority were keen to avoid.

15. It is thought that the court should interpret s. 35A solely by reference to the statutory language, the underlying Directive and any jurisprudence thereon. In any event, the indoor management rule is of no use as a criterion of *inclusion* as opposed to exclusion--if the counterparty is protected at common law, the transaction will be valid subject to self-dealing restrictions and it matters not whether she is a “person dealing” because there will be no work for s. 35A to do.

16. Drawing on *TCB Ltd v. Gray* [1987] Ch. 458; [1987] 3 W.L.R. 1144; [1988] 1 All E.R. 108; (1987) 3 B.C.C. 503; [1988] B.C.L.C. 281, CA, Carnwath L.J. suggested that, as a minimum, there needs to have been “either an actual decision of the directors approving the transaction, or something represented as such a decision, by someone having apparent authority so to represent it”, but declined to lay down a general test: see transcript, paras 107-108.

17. *ibid.,* para. 41.

18. *ibid.,* paras 26, 33 and 35-39, relying on *TCB Ltd v. Gray* [1987] Ch. 458; [1987] 3 W.L.R. 1144; [1988] 1 All E.R. 108; (1987) 3 B.C.C. 503; [1988] B.C.L.C. 281, CA.

19. Transcript, para. 41.