fact sheet

Articles of Association: Table A and the Model Articles

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Introduction – What are Articles of Association?

Articles of Association are, simply put, the rules which dictate how a company is run and define the sometimes complex relationships between the company, its shareholders and directors. What is in the Articles can decide who wins a power struggle or control of the Board or whether a former Directors or employees must sell their shares when they leave.

The enactment of the 2006 Companies Act led to an overhaul of the standard form 'Table A' Articles and these were superseded (for companies incorporated on or after 1 October 2009) by the 'Model Articles'.

So what are the practical implications of all of this for the busy entrepreneur and his advisers? In this Fact Sheet we explain the key issues and what to look for when you read a company's Articles.

Some background explained

Before making a start we must first set out some background.

Long Form or Short Form?

Articles of Association can either be long form or short form. Until recently, short form Articles were by far and away the norm for private companies. The short form Articles would typically be no more than 5 or 6 pages; they set out key issues (for which see below) and incorporated the statutory boilerplate which was known as "Table A", a set of standard Articles set down by law as the default version.

In fact there were a number of slightly different versions of Table A which had been enacted over the years reflecting changes in company law. Which of those versions is relevant to a particular company will depend on when the company was incorporated. This is because the newer version does not affect an existing company: it keeps the constitution with which it was incorporated unless the company takes active steps to change its Articles.

The decision of the government to overhaul company law led to the Companies Act 2006. This was intended to simplify company law particularly for small private companies.

It was also decided that for private companies a simpler default constitution would be more appropriate. This took effect from 1 October 2009 when the new Model Articles replaced the old Table A Articles for newly incorporated companies.

Since this date, a new practice has now developed with Company Formation Agents using long form Articles of Association. These set out in full a modified version of the Model Articles incorporating the changes that the draftsman considered were an improvement to the standard. The key issues lie buried in the Agents' own "standard" that have now typically grown to 30 pages plus.

This Fact Sheet attempts to highlight the key issues for most companies in these new long form articles.

Before covering these we must first, though, give a brief overview of the principal practical points on company law that must be borne in mind as the backdrop to the Articles.

Key points of Company Law

A company is controlled and managed by its Board of Directors (not the shareholders): so who decides on the appointment or removal of Directors is fundamental. It is often said that the only job of a Venture Capitalist is to decide when to sack the Chief Executive!

Majority Shareholdings & Chairman's casting vote

The holders of a majority of the issued ordinary share capital (50.1%) can hire and fire the Directors. Before the Company Act 2006 took effect the Chairman of the Board (unless the Articles said otherwise) would have a casting (or second) vote at shareholders' meetings. This meant a 50/50 Company was effectively controlled by the Chairman.

That still applies to companies incorporated before 1 October 2009 (unless they have Articles which say otherwise).

For companies formed since that date the Chairman of the Board cannot by law have a casting vote at meetings of the shareholders: so a 50% shareholder cannot remove Directors as officers of the company if opposed by the other 50% shareholder.

However, the Chairman still can have a casting vote at Board Meetings so irrespective of the company's date of incorporation, the Chairman can exercise a casting vote (if the Board is deadlocked) to terminate the employment contract of a Director.

The next key threshold is 75% of the voting rights at a shareholders' meeting. This percentage is required to change the Articles, to authorise a buy-back of shares or to resolve to wind-up the company.

Pre Emption

A key power of the Board is to issue new share capital. The Companies Act 2006 removed the need for a private company with just one class of share to have shareholders' authority to issue new shares. Where there is more than one class of share in issue a resolution of the shareholders will be required to give the Board authority.

However, unless the Articles say otherwise or unless waived by the shareholders, if shares are to be issued for cash they must first be offered to the existing shareholders for 21 days in proportion to their shareholdings. A statutory exception to this under the Companies Act 2006 is shares issued under an employees' share scheme.

Drag Along

Buyers of private companies almost invariably want to acquire 100% of the shares

so if a small minority shareholder refuses to sell then this can be a challenge for both the other selling shareholders and the buyer. This brings us to the other important threshold: 90% of the issued shares. In the context of a company sale there is a procedure under company law that allows the buyer of 90% of the shares in a company to compulsorily acquire the remaining shares. However, the procedure may be costly to implement and there is a statutory right of appeal to the courts.

To overcome these issues bespoke Articles sometimes include a "Drag Along" article. This allows a purchaser of a specified percentage of the shares in the company (often much lower than the 90% statutory threshold) to acquire the remaining shares without invoking the statutory procedure. A Power of Attorney Article is often also included here to ensure that if a small shareholder refuses to comply with the provisions, other shareholders or a Director may act at his Attorney in the sale of the shares.

Key issues in the Articles of Association

1) Transfer of Shares

The simplest provision is one under which the Directors can veto any transfer of shares by a member.

Whilst this may not prevent circumvention by a declaration of trust very few buyers would accept such an elaborate arrangement.

The Model Articles follow Table A in having a default provision giving the Directors a veto on share transfers (model article 26 (5)).

If, instead, this position has been altered and the Articles include pre-emption rights on share transfers (i.e. rights of first refusal for existing shareholders before a transfer can be made) then these must be checked carefully. A common "add-on" are leaver provisions, which require an employee leaving the company to offer his shares for sale (sometimes at a below market value). This is typically known as a compulsory transfer article. Whilst the owner manager may want these included to apply to other team members, these will rarely be appropriate for the owner manager's own shareholding so care should be taken when drafting such provisions.

2) Quorum for Shareholders' Meetings

Unhelpfully the Model Articles do not themselves specify a quorum (i.e the minimum number of shareholders that must attend for the meeting to be able to make decisions). The default position is instead set out in the Companies Act 2006 (section 318): this is one for a single member company and 2 for all others.

The Articles should be checked to see if this default provision has been amended.

More important is what happens if a quorum is not present. The Model Articles state that the meeting must be adjourned.

The entrepreneur will want this qualified (and this was invariably done with Table A) so that at the reconvened meeting a single member can be a quorum.

This prevents a minority shareholder, perhaps a Director-shareholder, failing to attend meetings and thereby frustrating important business.

3) Quorum for Directors' Meetings

The Model Articles (like Table A) specify a quorum of 2 as the default position. However, Article 7(2) allows for a sole Director to have full authority to manage the company.

The business owner will want to check that this applies and has not been varied if the company has just one Director.

4) Directors' Conflicts of Interest in Company Transactions

The starting point in the Model Articles is that if a Director is interested in the business to be transacted at a Board meeting he is disqualified from voting and cannot count in the quorum.

There are "permitted causes" where an interested Director can vote, for example the giving of a guarantee by a Director, a share subscription, or schemes for employees where Directors participate on the same terms. However, the owner manager and his advisers will want to replace the Model Article provision to allow interested Directors full rights to vote and count in the quorum on matters in which they are interested. This is because it is likely to be their personal interests that become an issue not those of fellow Directors. Without this amendment to the Model Articles decision-making could easily be frustrated as with small owner-managed businesses it is common that Board decisions will involve the Directors.

5) Situational Conflicts (Section 175 Companies Act 2006)

The 2006 Act introduced a new provision (section 175) dealing with a *situation* where a Director may have a conflict: so this is not transactions (see paragraph 4 above). An example would be a Director with directorships of other companies which may be competitors of the company. The section was introduced as part of the codification and tightening up of Directors' duties.

The purpose of the section is to allow a company to give its Directors authority to permit such *situational* conflicts. Under old company law it was the shareholders only who could permit such conflicts.

These provisions allow the Board to sanction a *situational* conflict. The statute specifies, however, that conflicted Directors cannot vote or count in the quorum.

Recognising the difficulty this may create it is now common practice in private company Articles to reduce the quorum for Directors' meetings down to one if there is only one non-conflicted Director.

The Articles should be checked to see if this is covered.

6) Restriction on Share Issues

Before the Companies Act 2006 the Directors had to be given authority by the members to allot shares. Furthermore the Memorandum of Association included a share capital clause. If the company wanted to issue more shares than specified in its Memorandum it had to increase its authorised share capital.

The authorised capital requirement was abolished so post 2006 Act companies have no capital clause. For a company incorporated before 1 October 2009 the restriction in the Memorandum is imported into the Articles as a "hidden restriction". Many formation agents choose to adopt a cap in the Articles on the number of shares that can be issued. This should be checked.

The owner manager may wish to ensure that there is a restriction in the Articles that would prevent a Board that he may not control resolving to issue shares without his consent.

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