Katten

CORPORATE ADVISORY

Managing Legal Uncertainty in Sole-Director Companies - Recent Developments

December 22, 2022

The model articles (Model Articles) contained in the Companies Act 2006 (CA 2006) are automatically incorporated into the constitution of a company incorporated pursuant to the CA 2006 to the extent they are not excluded or modified. Many companies are, therefore, subject to their provisions, which include how and to what extent a sole director may make decisions on behalf of the company. This article considers two recent, seemingly conflicting, cases on the actions of sole directors under the Model Articles and what steps sole directors, corporate shareholders, and potential acquirers of corporate groups containing sole director companies, should consider as a result.

Background

The Model Articles provide (amongst other things) the general rule that directors should take decisions by majority (Article 7.1) unless the company only has one director and no other provision of its articles require it to have more than one director, in which case the general rule does not apply and the director may take decisions without regard to any of the provisions of the articles relating to directors decision making (Article 7.2). The Model Articles also contain provisions relating to the quorum at directors' meetings and provide that no proposal may be voted on at an inquorate meeting (except a proposal to call another meeting) and that the quorum for directors' meetings must never be less than two (Article 11.2). Before the decision in *Fore Fitness* (discussed below), the general view taken of these provisions seemed to be that Article 11.2 dealt only with quorum requirements (and did not operate to require a minimum number of directors), that quorum requirements related to directors' decision making and that, therefore, when a company had only director, that director could take decisions without regard to Article 11.2 by virtue of Article 7.2.

The Decision in *Fore Fitness*

The decision in *Fore Fitness* cast some doubt upon this position. The case concerned whether a sole director had authority to cause a company to commence a counterclaim. The company's articles included Article 7 and 11 of the Model Articles, discussed above, and a bespoke article requiring that the quorum for meetings was two, one of whom must be an investor director and the other of whom an executive director. The court found that the director did not have authority to act alone. It held that the bespoke article required two directors for a quorum, so multiple directors were needed in order for a meeting to be quorate; a requirement for at least two directors to constitute a quorum was logically a requirement that the company have two directors to manage its affairs so Article 7.2 did not apply. The court appeared to take the view that the Model Articles could be specifically amended to allow for single directors; here they had not been — they had in fact been reinforced by the addition of the bespoke article. It was against this backdrop that *Re Active Wear* fell to be decided.

The Decision in *Re Active Wear Limited*

Active Wear Limited had Model Articles with no amendments and had had, at all relevant times, only one director. That director purported to appoint administrators and, because of the uncertainty caused by the decision in *Fore Fitness*, sought a declaration from the court that she had authority to do so. The court found that she had. The court applied the principles of construction in *Cosmetic Warriors* and *Arnold v. Britton* and found that the effect of Article 7

was unambiguous — a single director could take decisions 'without regard to any of the provisions of the articles relating to directors' decision making'. Those provisions included how decisions could be made — to hold that Article 11 required there to be at least two directors for effective decision making would deprive Article 7.2 of any practical meaning, which the court was unwilling to do. This view of the construction of Article 7 differed from that in *Fore Fitness*. However, in *Re Active Wear* there was no bespoke article relating to specific quorum requirements.

Remaining Uncertainty Following the Decision in *Re Active Wear*

On its face, the decision in *Re Active Wear Limited*[1] offers some clarity on the application of the Model Articles in companies with a single director. It does not, however, conclude the debate on the issue. In particular, when discussing the reasoning in *Fore Fitness*, the judge made two points which seem likely to lead to further uncertainty. First, the judge appeared to consider that the operation of Article 7.2 would apply only to a company with unamended Model Articles. Second, in situations where the number of directors of a company falls to one from a higher number he found a tension between the quorum requirements in Article 11 and the provisions of Article 7.2 and seemed to suggest that Article 7.2 was intended to apply only in situations where a company has never had more than one director. As a result, directors and potential buyers of companies with Model Articles and a single director should take steps to mitigate the risks associated with the uncertain legal landscape left by *Re Active Wear*.

Individual Companies and Corporate Groups

Sole directors of companies with amended Model Articles, or that have ever had more than one director, should consider steps to minimise the risk of a claim that they have acted outside their authority (in breach, amongst other things, of section 171 CA 2006). To the extent possible, key previous decisions made by a sole director in this situation should be put to the shareholders for ratification, and the articles of association should be amended to make clear that a sole director can act or, (if necessary) further directors appointed in order to ensure that the directors are able to take decisions and act in accordance with their statutory duties.

Similarly, corporate groups containing single director companies should take steps at the parent-company level either to appoint further directors or change the articles of relevant subsidiaries to avoid breaches of duty by any directors appointed throughout the group.

In addition, in a corporate group where one (or some) of the companies within the group may become insolvent but others may not, the validity of an appointment of an administrator by a sole director acting under the Model Articles will need to be carefully considered. Amendments to the articles to permit (or not to permit) such appointment by a sole director will need to be considered depending on the circumstances and the group's governance policy. On a personal level, directors may also wish to have their past decisions ratified by the parent of the group to minimise their exposure to a breach of duty claim during any subsequent administration.

Due Diligence and Buy-Side Transaction Risks

Buyers want to be certain as to the validity and certainty of corporate decision-making in a target group prior to entering into any acquisition.

As such, where a target is, or a target group includes, companies with a single director and Model Articles or companies where the number of directors has fallen to one from a higher number, careful due diligence should be carried out. In particular, where the articles contain bespoke provisions relating to quorum requirements, diligence should address whether these have been followed or the extent to which they remain relevant if the company has only a single director in place. Depending on the level of risk, buyers may insist upon warranties as to the sole-director company's capacity to take previous decisions, and its ability to enter into any relevant transaction documents. Any identified relevant past decisions may need to be ratified by an expanded board or by the shareholders of the relevant company and parties may also need to insist upon the appointment of further directors prior to any sole-director counterparty taking key deal decisions. In some cases, an indemnity may be sought for costs associated with any litigation brought in respect of an individual decision.

[1] [2022] EWHC 2340 (Ch).

Similarly, any appointments of administrators by a sole director acting under the Model Articles within the target group should be analysed and clarity sought as to the legitimacy of that appointment. The increased risk of litigation in such a situation should be a focus of negotiations around risk-allocation, and buyers should be wary of assuming any liability associated with such an appointment.

Where transactions have signed or closed, parties and their advisers may also wish to consider the risk that a challenge to the validity of a decision by a single director to enter into a transaction would cause a breach of any warranty given by the relevant party (including warranties as to capacity). Such a breach may have far reaching effect, given the typical consequences of a breach of a capacity warranty under standard deal documentation.

CONTACTS

If you would like to discuss any of the points raised in this article, please contact your Katten lawyer or any of the following:

Oliver Williams
+44 (0) 7770 5212
oliver.williams@katten.co.uk

Alex Potten
+44 (0) 20 7770 5223
alex.potten@katten.co.uk

Edward A. Tran
+44 (0) 20 7770 5254
edward.tran@katten.co.uk

David Wood
+44 (0) 20 7776 7650
david.wood@katten.co.uk

Katten katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax