THE ORIGINS OF THE DOCTRINE OF CONSTRUCTIVE NOTICE

Vera-Lynn Hamilton-Richards

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Memorandum

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The Origins of the Doctrine of Constructive Notice

The Alberta Business Corporations Act[1] (A.B.C.A.) has now abolished the long-standing doctrine of constructive notice. Section 17 of the Act states as follows:

> 17 No person is affected by or deemed to have notice or knowledge of the contents of a document concerning a corporation by reason only that the document has been filed by the Registrar or is available for inspection at an office of the corporation.

But where did the doctrine of constructive notice arise? What was its purpose in company law? It is suggested that the history of the development of company law in England must be looked at to determine the answers to these questions.

The repeal in England of the so called Bubble Act in 1825[2] appeared to be a negative move in the development of company law. Between the years of 1825 and 1844 there was no assistance given to persons who wanted to incorporate companies in a reasonable and speedy manner. Eventually, however, it was established that unincorporated companies were lawful associations at common law, even though their shares were not readily transferable. To overcome the disability of not being incorporated, property came to be vested in trustees and company contracts were made in the names of the trustees.

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1 R.S.A., 1981, Chapter B-15.

2 6 Geo. 4, c. 91, s.1.

Additionally, the unlimited liability of the members for the company's debts and contractual obligations could be avoided by the company's contracts providing that only its property and the amount which it could call up from its members as the amount unpaid on their shares should be answerable if the company defaulted.

Parliament, however, felt that these devices were unsatisfactory. In 1844 the first general Companies Act[3] came into being, drawing a distinction between private partnerships and joint stock companies. Any company with freely transferable shares or comprising more than 25 members might obtain incorporation by registering a deed of settlement. This was a form of contract containing provisions regulating the relationship between the members and providing for the transfer of shares.

Two other commercial associations also existed at the time of this Act - incorporated charter and statutory companies where the members were either free from liability or who had limited liability; and private partnerships with less than 25 members and quasi-partnerships with an unlimited number of members which had not reformed under the 1844 Act and which had unlimited liability.

Under the 1844 Act the members of the company still remained liable for its debts and contractual and other obligations. The only way members could escape personal liablity was by the company providing in its contracts that only the company's property and the amount unpaid on its members shares would be answerable if the company defaulted. This provision was effective if inserted in the contract in which the

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3 An Act for the Registration of Joint Stock Companies, 7 and 8 Vict., c. 110.

plaintiff sued[4], but not if it was merely contained in the company's deed of settlement - even if the plaintiff knew of it when he contracted with the company.[5] The doctrine of constructive notice was apparently not applicable at this point in time.

In 1855 the Limited Liability Act was passed. A company registered under the 1844 Act could now limit the liability of its members for its debts and obligations generally to the amount unpaid on their shares. In order to claim limited liability the company had to use "limited" at the end of its name and provide in its deed of settlement that the liability of its members should be limited. Additionally, the company had to have at least 25 members who had subscribed at least three-quarters of its nominal capital and had paid up at least one-fifth of the nominal value of their shares.

The period from 1825 to 1855 also was a time when the rules of common law and equity relating to companies were developed and expanded. For example, in equity, the director's fiduciary duties to their companies were established.[6] The common law courts established the ultra vires rule[7] and the rule which entitles persons dealing with a company to hold it bound by any transactions it has entered into in its name, despite any procedural or other irregularities.[8]

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4 Hallet v Dowdell (1852) 18 Q.B. 2.

5 Re Sea, Fire and Life Assurance Co.,Greenwoods Case (1854) 3 De G.M. & G. 459.

6 Benson v Heathorn (1842) 1 Y. & C.C.C. 326.

7 East Anglian Rlys. Co. v Eastern Counties Rly. Co. (1851) 11 C.B. 775; Mayor of Norwich v Norfolk Rail Co. (1855) 4 E. & B. 397.

8 Smith v Hull Glass Co. (1852) 11 C.B. 897; Royal British Bank v Turquand (1855) 5 E. & B., 248.

In 1856 the Joint Stock Companies Act replaced the Acts of 1844 and 1855. The use of the deed of settlement was discarded and every company was now to register their memorandum and articles of association. This Act was eventually repealed by the Companies Act of 1862, which retained many of the provisions in the Act of 1856, but which also added several important changes. For example, the Act of 1862 applied to all classes of companies, thereby allowing insurance companies to have limited liability for the first time.

The Companies Act, 1862, remained the principal Act in England until 1908 when it consolidated under the Companies (Consolidation) Act. By 1907, the 1862 Act, had been amended by numerous Acts, which had introduced such changes as allowing companies to reduce their share capital, to alter the objects for which they were formed to carry out, and eventually introducing the private company which could be incorporated with only two members in 1908.

According to the doctrine of constructive notice, the legal effect of transactions with a company depends on the operation of the rule that all persons dealing with the company have either actual or constructive notice of and understand the contents of the corporations publicly registered documents. The scope of the doctrine depends on which corporate documents are required to be registered and open for public inspection. In memorandum jurisdictions, the memorandum the articles of association and any special resolutions are on public record and are within the docrine's scope.[9] Persons dealing with the company are thus affected with notice of the contractual powers or limitations of the company and its representatives. This is a controlling factor in determining the validity of invalidity

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9 Ernest v Nicholls (1857) 6 H.L. Cas. 401

of a transaction. The purpose of the doctrine was to protect shareholders against the unauthorized acts of corporate agents by deeming notice to third parties of all express restrictions and requirements with regards to the corporation's carrying on of business.

In the large trading partnerships that existed in England prior to the passing of the registration acts, the liability resulting from the holding out or apparent authority of each partner to bind all others worked considerable hardship. Lord Wensleydale commented:

> "...that the law as to ordinary partnerships would be inapplicable to a company consisting of a great number of individuals contributing small sums to the common stock, in which case to allow each one to bind the other by any contract which he thought fit to enter into, even within the scope of the partnership business, would soon lead to the utter ruin of the contributories."[10]

In consequence of the hardship on contributories, the first registration acts were passed with the object of providing public record of the nature of these companies and of the terms upon which they conducted their businesses. Lord Stanley of Alderley, President of the Board of Trade in 1856, stated that the purpose of the Joint Stock Companies Bill of 1856 was as follows:

> "The principle of the Bill was to allow every man to employ his capital as he pleased, but at the same time to require that the public should be fully informed as to the nature of the partnerships into which he entered, and the terms upon which they conducted their business."[11]

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10 Supra, at p. 418.

11 Walter Horrwitz, "Historical Development of Company Law" (1946) 62 L.Q.R. 375 at p. 382.

In the case of Ernest v. Nicholls,[12] the House of Lords held that, insofar as the memorandum and articles of the Joint Stock Company were required to be registered and to become matters of public record, their contents were to be construed as matters of public knowledge.

The effect of registration of the memorandum and the articles of a company was to actually carry the notice doctrine one step further by imposing constructive notice on the outside contracting party. The constructive notice doctrine placed a duty on him to consult the registered documents for, whether he did so or not, he was charged with knowledge of their contents. When charged with that knowledge he could not allege that the company was estopped from denying limits upon authority contained in the memorandum and the articles. He was deemed to know these limits and could not assert any misrepresentation by the company in respect of them.

Lord Hatherly reiterated the doctrine of constructive notice in the case of Mahoney v. East Holyford Mining Co.,[13] as follows:

> "Every joint stock company has its memorandum and articles of association open to all who are minded to have any dealings whatsoever with the company, and those who so deal with them must be affected with notice of all that is contained in those two documents."

The doctrine of constructive notice played quite a significant role in common law due to decisions of the courts. If the courts had adopted the view that the purpose of the company's public documents was to give powers rather than to

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12 (1857) 6 H.L. Cas. 401.

13 (1875) L.R. 7 H.L. 869 at p. 893.

restrict powers which existed at common law, the doctrine would have had limited application in company law. Daniel Prentice[14] has commented:

> "It a characteristic of partnership law that each partner has authority to bind the partnership and his fellow partners provided he acts within the scope of the partnership business. When limited liability companies were first formed the courts, in determining the scope of corporate liability for the acts of senior officers, used the partnership and the unincorporated joint stock company - which was merely an extended partnership - as analogues. As has been pointed out, the validity of such an analogy was questionable. In dealing with these new entities there was little justification in fact for the assumption that directors had greater authority than that conferred by the constitutional documents of the company."

For example, any limitations placed on a partner's authority by the partnership agreement would not affect the third party unless he has actual notice. The outsider was entitled to assume the partner has the authority to bind the partnership within the scope of its business. The outsider was not allowed to make this assumption when dealing with an agent of a company whose authority is limited in the public documents. Constructive notice would operate to impute to the outsider notice of the limitations of the agent's authority.

The indoor management role, (also called the rule in Turquand's case[15]) is laid out in the judgement by Ferguson, J. in Sheppard v. Bonanza Nickel Mining Co. of Sudbury[16]:

> "Then where a party dealing with the company ascertains the existence (of power) on the part of the company to do the act, that is to make and give him the obligation, he may go

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14 "The Indoor Mangement Rule" Ziegel, Jacob S. (editor) Studies in Canadian Company Law; Butterworths, Toronto, 1967 at p. 310.

15 Royal British Bank v. Turquand (1856) 6 E. & B. 327; 119 E.R. 806.

16 (1866) L.R. 2 Ch. App. 16; 36 L.J. Ch. 32; 15 L.T. 198; 12 Jur.

> on with the dealing without enquiring as to any formality that may have been prescribed as preliminaries. He may presume without enquiring that these have been properly attended to."

The indoor management rule paralleled the development of the doctrine of constructive notice to protect outsiders from irregularities in corporate proceedings. Under this rule the company is bound by an apparent authority which a constructive knowledge of the memorandum and articles does not deny. The rule exists as an acknowledgement that constructive notice is not to be carried beyond the memorandum and articles to include matters of mere procedure. When an outsider dealing with a company ascertains the power on the part of the company to do the Act, he may go on with the deal without making any further enquiries as to any informalities that may be described as preliminaries. He may presume that these have been properly attended to. The indoor management rule is a complement to the doctrine of constructive notice. As Prentice[17] argues:

> "The indoor management and constructive notice doctrines were devised to draw a balance between two conflicting interests. On the one hand, there is the interest of the property owner, in this case a corporation, to protect itself against the dissapation of its property by the unauthorized acts of its agents. On the other hand, there is the general interest in promoting and facilitating smooth commercial intercourse. The doctrine of constructive notice is basically designed to further the former policy by placing a duty of inquiry on the outsider. The rule in Turquand's case is designed to further the latter policy as business could not be carried on if everybody who had dealings with a company had meticulously to examine its internal machinery in order to ensure that the officials with whom he dealt with had actual authority."

Alberta adopted the English system of incorporation. The province is a memorandum jurisdiction in which the memorandum of association, the articles of association and special resolutions

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17 Butterworths, Toronto, 1967 at p. 341.

were to be filed under the Companies Act.[18] Thus, the doctrine of constructive notice came to have wide application in Alberta.

Over the years, constructive notice was evaded, giving little protection to creditors or shareholders as it was originally intended to do. Draftsmen almost nullified the rule of limited corporate powers by carefully drafting a company's memorandum of association, giving it very broad powers. It became common to provide in a company's memorandum that the company may, for example, "carry on any business which in the opinion of the directors can be carried out advantageously in connection with or ancillary to the business of the company."[19]

The Alberta Business Corporations Act[20] was passed in Alberta in 1981. An Alberta corporation now has the capacity and the rights, powers and privileges of a natural person (Section 15). Protection is afforded to shareholders in that a corporation cannot carry on any business or exercise any power that is restricted by its articles from carrying on (Section 16). Additionally, it is not precluded from denying authority if the other party knows there is not that authority. If a person knows that the company may not perform a particular business deal, for example, then he must know that the agents of the company cannot make the business deal on behalf of the company. If a person knows that an agent has no authority he will not be protected and anyone who is in a special

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18 R.S.A. 1970, c.60.

19 Bell Howes Ltd. v. City Wall Properties [1966] 2 All E.R. 674 (C.A.); H. & H. Lodging Co. Ltd. v. Random Service Corporations Ltd. (1967) 63 D.L.R. (2d) 6 (B.C.C.A.).

20 R.S.A., c-B.15.

relationship with a company may not claim to be ignorant of those things which this relationship would bring to his attention.

We have thus completed the circle - from the initial presence of the doctrine of constructive notice and company law, to its effective removal under the Alberta Business Corporation Act.