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Discussion on the Legal Nature of Company Articles of Association

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Abstract: The company's articles of association are a necessary document for the establishment of a company, which sets out the basic rules for the organization and operation of the company. The complexity of the contents of the articles of association determines the diversity of its legal nature. But for the legal nature of the articles of association, there are still arguments in the academic circles. Therefore, this article adopts a comparative analysis method to analyze two viewpoints, namely the contractual theory and rule of autonomy, in the two legal systems, and finds that neither can fully explain its legal nature, so the nature of the articles of association should be defined according to the different objects of adjustment, so as to determine its effectiveness according to its nature.

1. Questions

As a normative document for adjusting the organization and behavior of the company, the articles of association provide comprehensive regulations for the internal management affairs of the company. They establish the rights and obligations relationship between shareholders who establish the company and construct a legal framework that regulates the organization created by the shareholders. The complexity of the content of the articles of association leads to the complexity of its nature. In judicial practice, there are many disputes that arise from violating the provisions of the articles of association, most of which originate from different understandings and applications of the content and effectiveness of the articles of association in theory and practice. Apparently, a correct understanding of the nature of the articles of association is the basis for determining its validity, understanding the content of the articles of association correctly, and handling disputes related to the articles of association properly. Therefore, the nature of the articles of association should be regarded as the starting point of logical thinking and the theoretical basis for resolving disputes related. This article explores the legal nature of the articles of association, in the hope of providing a legitimate basis for correctly handling disputes related to the articles of association.

2. The Concept of Articles of Association

The articles of association are autonomous rules established by the shareholders or initiators of a company, reflecting the common intention of all shareholders, and having binding force on the internal organizational relationships and business conduct of the company, shareholders, and

company management. [1] For a company, the articles of association are the most important document, a necessary condition for the establishment of the company, a prerequisite for efficient operation, and an autonomous mechanism for safeguarding the interests of the company, shareholders, and creditors, and restraining the behavior of the company, shareholders, and senior management. The combination of company law and the articles of association provides important guarantees for regulating the organization and activities of the company.

3. Theories about the Legal Nature of the Articles of Association.

The nature of the articles of association has been a topic of ongoing debate in academic circles, with two prevailing views: the contractual theory in common law countries such as the United States and the United Kingdom, and the rule of autonomy in civil law countries. Both views have their respective advantages and disadvantages. Understanding the nature of the articles of association will directly affect the positioning and function of the articles of association in the legal system, as well as the relationship between the articles of association and company law.[2] Therefore, it is necessary to analyze and sort out the relevant theories.

3.1 Contractual Theory and its Evaluation

The contractual theory, mainly popular in common law countries such as the United Kingdom and the United States, argues that the company's articles of association are a document signed by the company's shareholders based on consensus reached through negotiation of the rights and obligations of setting up the company. It has binding force on the company and its members based on the explicit legal provisions, and is a product of shareholder autonomy, akin to a contract. This view originated from the theory of "contractual" companies proposed by economists, which sees companies as a legal mechanism that reflects a network of contractual relationships among individuals and uses long-term contracts to save transaction costs. [3] In case law, the articles of association as a statutory contract have rich connotations and have binding force on parties to the contract, including the company, shareholders, and other members. Directors, company secretaries, company initiators, and lawyers are excluded from the scope of the articles of association and cannot claim rights unrelated to membership based on them.

The contractual theory fully reflects the autonomy of the parties and is conducive to the enforcement of the articles of association. Its supporting theory is mature and easy to apply. From the development history of company law, company law originally evolved from partnership law, and partners are in a contractual relationship, so the internal historical logic of the two is consistent.

On the other hand, the contractual theory also presents many shortcomings. Firstly, regardless of the continental law system or the common law system, the content of the articles of association does not meet the requirements of a contract.

Secondly, the articles of association are not the same as the general contracts in civil law, but rather belong to organizational contracts. According to China's *Company Law*, for a public company established through fundraising, the articles are formulated by all initiators, not other subscribers, who only sign the resolution of the establishment meeting.

Thirdly, in addition to requiring the company name and address, business scope, etc., the company articles also require the recording of the company's structure, the method of its establishment, powers, rules of procedure. Furthermore, any amendment to the articles must follow the prescribed collective decision-making method and procedures

Fourthly, in applying the contract provisions of civil law to the articles of association, the effectiveness rules and interpretation rules of the general contract must be excluded. For example, the articles of association not only have internal effectiveness in adjusting the relationship between

shareholders but also serve as a code of conduct for the company's directors and executives. They should also be made public to parties outside the contract, such as the public and trading partners, to enable them to understand the company's decision-making mechanism and procedures and decide whether to invest in the company. [4] The company's articles of association are not a pure expression of the will of the drafters, as many of their contents are subject to mandatory provisions of company law. To prevent ambiguity between the company and each signatory of the articles of association, and to protect the trust of each reader in the articles of association that have been made public, the articles of association cannot be corrected retrospectively due to errors, or cancelled due to false statements or coercion, [5] which reflects the organizational nature of the company's articles of association, rather than a simple company contract.

Lastly, with regards to the legal consequences of violation, breach of contract only results in contractual liability, whereas breach of company articles can lead to other legal liabilities. The *Company Law* stipulates administrative legal liabilities for the acts of the initiators and shareholders that violate the capital contribution obligation. However, the *Civil Code* only provides for breach of contract liability, without specifying any other legal liabilities.

Above all, it is insufficient to explain the nature of the articles of association by contract, and it cannot be completely applied as the basis for explaining the effectiveness of the articles of association.

3.2 Rule of Autonomy and its Evaluation

The rule of autonomy is a prevailing theory of corporate law in countries and regions such as Japan, South Korea, and Taiwan, China. In contrast to the contract theory, it holds that the company's articles of association are established under the guidance of mandatory regulations of the state, and are the highest legally binding written document within the company. As such, they have universal binding force on the makers of the articles, the company's managers and new members, and all company members. At the same time, the articles of association can be amended by a majority vote of the company's members. The effectiveness of the articles is not affected by the withdrawal of shareholders who originally formulated or amended the articles. This theory is also the mainstream view in the academic community in China and has been adopted in judicial practice.

The rule of autonomy embodies the organizational and associative nature of a company. According to the civil law theory in the civil law system, a company is a legal person with independent will and behavior, separated from the personal will and behavior of its shareholders, and has independent property as its material basis for operation. A company, composed of natural persons, forms an independent company organ and realizes the company's will based on the principle of capital majority voting. The articles of association have a binding effect on the drafters, company initiators, company organs, and shareholders who join the company later. In this regard, the rule of autonomy can better explain why new shareholders must abide by the articles of association and why shareholders who oppose the amendment of the articles of association are still bound by them. [6]

At the same time, the autonomy of the company is autonomous under the guidance of mandatory national regulations, which makes up for the shortcomings of the contractual theory, which only emphasizes that the articles of association embody the free will of shareholders. On the one hand, the company law reserves free space for the company's articles of association to allow shareholders to make independent choices and individual arrangements. On the other hand, in order to protect transaction security and prevent the actual controllers of the company from using internal information advantages to infringe on the interests of other shareholders, the law also makes some mandatory provisions for the content of the company's articles of association. Therefore, the judgment of the effectiveness of the company's articles of association is more focused on whether

their contents are in line with the interests and justice of the company, rather than whether they are in line with the will of the shareholders. [7]

Similarly, the rule of autonomy also has its limitations. First, “autonomy” means that the rule-makers manage the rules. However, the articles of association are formulated by shareholders, while entities such as the company and the management are subject to the management of shareholders who formulate the articles of association, which obviously contradicts the original meaning of “autonomy”. In addition, this theory does not conform to the provisions of current Chinese law. Article 28 (2) of the *Company Law* stipulates that shareholders who fail to pay their capital contributions in accordance with the provisions of the Articles of Association shall not only pay in full to the Company, but also bear the liability for breach of contract to shareholders who have paid their capital contributions in full and on schedule. The "liability for breach of contract" here indicates that the Articles of Association are contracts in nature.

4. Typified Definition of the Nature of the Articles of Association

Although both the contractual theory and the rule of autonomy acknowledge the normative significance of the articles of association, the legal principles behind them are completely different. The former holds that the terms of the articles of association are the result of the agreement between the company and the shareholders and between the shareholders, while the latter emphasizes that the articles of association are the internal laws and the general will of the company and are binding on the company and relevant personnel.

In addition, the contractual theory asserts that adjustments should be made in the application of the rules of contract law, but does not specify the specific circumstances and exceptions of applying the general principles and rules of contract law. However, it will be unfair for the rule of autonomy to adopt the principle of capital majority decision on all issues. Evidently, neither theory can give a comprehensive and reasonable explanation to the legal issue of the nature of the articles of association. Therefore, an accurate interpretation of the nature of the articles of association requires a typological analysis of their contents in the light of specific circumstances in order to find a justification for judging their effectiveness. From the legal point of view contained in the articles of association, their contents can be roughly divided into the following three types:

1) As the articles of association of a company are considered as a contract, the contractual terms with legal effect are limited to the shareholders and between the shareholders and the company, excluding the directors, supervisors, and senior management of the company. [8] In the current *Company Law*, the articles of association of a company have contractual effect mainly in terms of the shareholders’ capital contribution obligations, including the default liability of shareholders of limited liability companies to other shareholders when they fail to fulfill their capital contribution obligations according to the articles of association (Article 28); the joint and several liability of shareholders of limited liability companies to other shareholders when they fail to fulfill their capital contribution obligations according to the articles of association (Article 31); and the joint and several liability of other shareholders to the company when the initiators of a joint-stock limited company fail to fulfill their capital contribution obligations according to the articles of association (Article 94). The terms “default liability” and “joint and several liability” indicate that the provisions of the articles of association regarding the shareholders’ capital contribution belong to the contractual relationship between the company and the shareholders and among the shareholders themselves.

2) As the rule of autonomy, the articles of association mainly cover the company’s internal management affairs, including: (1) internal management affairs of the company, such as the legal representative, business scope, operating period, or other reasons for dissolving the company; (2) the authority of the company’s organs, as well as the procedure for deliberation and voting; (3) the term of office of the directors, the powers of the executive director, the method of selection for the

chairman and vice chairman of the board of directors; (4) the proportion of shareholder representatives and employee representatives in the supervisory board; (5) the company's investments and provision of guarantees to others; (6) special provisions for the transfer of shares by directors, supervisors, and senior management of the company, as well as provisions for contracts or transactions between directors, managers, and the company.

3) The company's articles of association can be classified as either a contract or a rule of autonomy, depending on specific circumstances, mainly related to "other provisions" regarding shareholder rights, which reflects the spirit of freedom in the *Company Law*. Specifically, this includes voting rights, transfer of shares, inheritance of shares, and distribution of profits. The contents of the company's articles of association in this regard should be analyzed from two levels: First, if the "other provisions" of the company's articles of association treat all shareholders equally, the "capital majority decision rule" can be applied, and this section can be regarded as a rule of autonomy; Second, if the "other provisions" target individual shareholder rights, the "capital majority decision rule" should be used to limit or deprive individual share rights, unless there is a legitimate reason. Therefore, unless changed by law, the "other provisions" of the company's articles of association can only be regulated in the form of a contract with the consent of the shareholders, and cannot be deprived or restricted by the majority decision of the articles of association or the general meeting of shareholders without the consent of the shareholders. [9] In this case, the "other provisions" of the company's articles of association can only be regulated as a contract. However, to maintain the "characters based on shareholders" of a limited liability company, Article 75 of the *Company Law* stipulates that the legal heirs of natural person shareholders can inherit shareholder status with personal attributes, and allows the company's articles of association to make other provisions. The acceptance of the legal heirs of natural person shareholders as shareholders after their death depends on the intention of other shareholders. Therefore, in the issue of inheriting shareholder status, the company's articles of association can make other provisions as long as they do not violate mandatory legal provisions. In addition, it should be noted that mandatory provisions related to creditor interests and public interests do not allow other provisions in the articles of association, [10] in order to protect the interests of creditors and public interests.

5. Conclusions

As the articles of association cover everything from the company's organizational structure to the rules of procedure, their nature is also complex. When involving shareholders' investment responsibilities, they are contractual in nature, and the contractual theory applies. When the articles of association refer to the internal affairs of the company, they are autonomous norms; The nature of the content of "other provisions" on shareholders'' rights in the articles of association shall be determined according to the specific circumstances as mentioned above, and cannot be generalized.

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