CM ADVOCATES LLP

CAN A COMPANY REFUSE TO HONOUR A CONTRACT BECAUSE ITS DIRECTORS FAILED TO FOLLOW INTERNAL PROCEDURES?

Understanding the Turquand Rule in Kenya

INTRODUCTION

A director of a manufacturing company enters into a contract on behalf of the company with a supplier for the purchase of equipment worth KES 18 million. The supplier verifies the company's details and confirms that the director is listed as a director of the company. The equipment is delivered and the company begins using it. Six months later, the company refuses to pay, arguing that the director did not obtain the board approval required under the company's internal procedures before entering into the contract.

Can the company escape liability simply because its own internal procedures were not followed?

This is where the **Turquand Rule**, also known as the **Indoor Management Rule**, comes in. The rule protects third parties dealing with a company in good faith by allowing them, in appropriate circumstances, to assume that the company's internal procedures have been properly complied with.

Anyone who deals with a company be it lending it money, supplying it goods, signing a contract with its directors faces a basic problem: a company is not a human being sitting across the table. It is a legal fiction that can only act through human agents (directors, officers, employees), and those agents' authority is usually limited by the company's own internal documents (its articles of association, board resolutions, shareholder resolutions). How is an outsider supposed to know whether the person signing on the company's behalf actually had the power to do so?

The Turquand Rule is the common law answer to this problem. It protects outsiders who deal with a company in good faith by allowing them to assume that the company's internal rules and procedures have been properly complied with, even where, in fact, they have not. In Kenya, the rule has both a common law pedigree and a modern statutory expression in the **Companies Act, 2015 (No. 17 of 2015) (the Act)**.

This article examines the origin of the rule, its rationale, its statutory codification under Kenyan law, and its treatment by Kenyan courts.

ORIGIN OF THE RULE

The rule takes its name from the English case of ***Royal British Bank v Turquand (1856) 6 E&B 327*** where a mining and railway company's deed of settlement (the equivalent of its articles of association) empowered its directors to borrow money on bond, but only up to an amount authorised by a resolution of the company in general meeting. The directors borrowed £2,000 from the Royal British Bank and gave the bank a bond under the company's seal. No resolution specifying the amount the directors could borrow had been passed. When the company (through its liquidator, Turquand) was sued on the bond, it argued that the borrowing was invalid because the internal resolution required by the articles had never been passed. The Court of Exchequer Chamber held that the bond was valid and enforceable against the company. The bank was entitled to assume that the necessary internal resolution had been passed. The bank could not be expected to attend the company's internal meetings or verify its internal minute books; it was enough that the directors had power, under the public articles, to borrow if a resolution was passed. Whether that internal step was actually taken was a matter of the company's own indoor management, not something an outside party has to investigate.

This decision drew a crucial distinction:

- An outsider has constructive notice of matters affecting the company that form part of the public record such as the Articles of Association, regardless of the whether they had read the documents or not.

- An outsider is entitled to assume that internal processes were followed prior to dealing with an outsider.

The rule therefore operates as a counterweight to the harshness of the doctrine of constructive notice, which would otherwise have made every outsider a guarantor of a company's internal compliance.

Justification for the Rule

The application of the Turquand rule is justified for commercial practicality and fairness:

1. Practical impossibility of verification by an outsider of the company’s compliance with internal processes as the have no access to minutes of the company or board resolutions.
2. Protection of commercial certainty. If every contract with a company could later be unwound because of some undiscoverable internal irregularity, no one could safely transact business with companies.
3. Allocation of risk to the party best placed to prevent the harm. The company and its officers are best placed to ensure that internal procedures are followed therefore they bear the risk of their own non-compliance.

THE DOCTRINE OF CONSTRUCTIVE NOTICE AND ITS ABOLITION IN KENYA

Historically, the Turquand Rule operated as an exception to the doctrine of constructive notice. This doctrine could be harsh as it meant an outsider might be bound by limitations they never actually knew of and could not reasonably have discovered simply because they were technically registered somewhere. In many common law jurisdictions, including Kenya, this doctrine has now effectively been abolished by statute for purposes of dealings between a company and outsiders, and the Turquand-type protection has been placed on an even firmer statutory footing. In particular, **Section 33** of the Act effectively abolished it where a company exceeds its objects as set out in its constitution, such a violation does not invalidate the act so done.

THE TURQUAND RULE IN STATUTE

The Companies Act, 2015

The Act, on Capacity of Company, contains the key provisions that codify and, in some respects, go further than the common law Turquand Rule. In particular **Section 34(1)** on the power of directors to bind company captures as follows:

> "**34. Power of directors to bind company**
> In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is free of any is limitation contained in the company's constitution.
>
> (2) For purposes of subsection (1)—
>
> a) a person deals with a company if the person is a party to a transaction or other act to which the company is a party; and
> b) a person dealing with a company—
>
> i) is not bound to enquire as to any limitation on the powers of the directors to bind the company or to authorise others to do so;
> ii) is presumed to have acted in good faith unless the contrary is proved; and
> iii) is not to be regarded as having acted in bad faith only because the person knew that a particular act is beyond the powers of the directors under the constitution of the company.

This Section is significant and more generous than the traditional common law Turquand rule as knowledge of an irregularity on the directors' want of authority does not defeat good faith. Bad faith must be shown by something more than bare knowledge of a constitutional limitation.

A member of the company may still apply to court to restrain a proposed act that exceeds the directors' powers under **Section 34(4)**. However, this cannot undo obligations that the company has already incurred.

The protection under **Section 34** does not give directors a free pass. Even where their actions bind the company, directors may still be personally liable for acting beyond their powers or breaching their duties. **Section 34(5)** protects the transaction but does not protect the director from personal liability. Any liability incurred by a director or another person acting on behalf of the company remains unaffected. The protection is also limited where the transaction involves a director or a person connected to a director. In such cases, the company may be able to avoid the transaction if its internal requirements were not followed. A director who authorised or participated in the transaction may also be required to account for any gain and indemnify the company for any loss.

There are, however, circumstances in which the company cannot avoid the transaction.

These include where restitution is impossible, the company has been indemnified, a third party acquired rights in good faith without knowledge of the circumstances, or the company has affirmed the transaction.

In short, **Section 34** protects genuine third parties dealing with a company, but it does not allow directors or other insiders to take advantage of their own failure to follow the company's internal procedures.

JUDICIAL APPLICATION OF THE TURQUAND RULE

Kenyan courts have consistently applied and endorsed the Turquand Rule, both before and after the 2015 Act.

In ***Samuel Mureithi Murioki &another; v Kamahuha Limited [2018] KECA 38 (KLR)*** the Court of Appeal while addressing the Company's claim that it did not own the suit property and could not transfer it and that it never passed a board resolution to transfer the property despite an agreement executed on the company's behalf by its directors to be contradictory and could not stand. Additionally, on the failure to pass a board resolution for the sale, that whether the company had complied with its internal procedures as to the execution of contracts was an internal management issue that cannot afford a defence or defeat a third party's claim when dealing with the company.

The court in S***amuel Mureithi v Kamahuha Limited*** adopted the holding in ***Ashok Morjaria v Kenya Batteries [1981] Ltd. & 2 others, [2002] eKLR***, where the Turquand rule was reiterated as follows:

> *"So where, as here, a director of a company executes a loan agreement on behalf of the company and stamps it with a company stamp, as the second defendant did, the company cannot wriggle away from its obligations to pay by contending that the borrowing was not authorised, or one director's signature was not enough or the company seal was not affixed to the agreement if what he did was within his ostensible authority as director of the company as in deed it was."*

These decisions confirm that Kenyan courts treat the rule as a living, applied principle and now operates comfortably alongside, and is reinforced by, the statutory provisions of the Companies Act, 2015.

The implications of these decisions and the provisions of **Sections 34** and **36** of the Companies Act, is third parties genuinely and in good faith transacting with a company are entitled to assume internal procedures were followed. Mere knowledge of the failure to abide by internal procedures does not infer bad faith. For directors and companies, failure to comply with internal requirements will not relieve the company of the obligations incurred by its competent officers.

A key area where this has been litigated is on an advocate's retainer, on two key scenarios: an advocate as an "outsider" relying on apparent authority to accept instructions and the client company denying having instructed the advocate to act. In the first instance, an advocate instructed by a company through its directors to undertake certain actions, is regarded as a third party dealing with the company.

In ***East African Safari Air Limited v Anthony Ambaka Kegode & another [2011] KECA 160 (KLR)***, a newly-appointed managing director instructed Walker Kontos Advocates, via a board resolution, to sue former directors for allegedly misappropriated company funds. The defendants moved to strike out the suit, arguing the "new" directors had been appointed ultra vires the articles, so the resolution instructing the advocates and the suit itself was a nullity. The High Court agreed and struck out the suit, condemning the advocates to pay costs personally. The Court of Appeal reversed the High Court's decision instructing the application before the High Court be heard on merit. In doing so, the Court of Appeal relied on the Rule in Turquand to the effect that the advocate did not need to go beyond a search at the Companies Registry to verify that the director instructing them had authority to do so unless the advocate had, or ought to have had, knowledge of fraud or mischief on that director's part. The advocates in that case had relied on the notice of change of directors filed with the Registrar, and were entitled to do so.

On the client denying that it ever instructed its advocates, Turquand is invoked by the advocate against the client. This was exactly the issue in ***Muriithi Kireria and Associates Advocates v Crescent Construction Company Ltd [2025] KEHC 17396 (KLR)***. The client company sought judicial review of a Taxing Master's decision on the basis that it had never authorised the advocates to act for it. The advocates responded by invoking the doctrine of Indoor Management together with the principle of estoppel, pointing to the company's own payments to the firm and its evident awareness of the litigation as inconsistent with a genuine denial of authority. The Court agreed with the advocates dismissing the application for review on the basis of estoppel despite the absence of a board resolution authorising the advocate to act for the Applicant coupled with the Applicant's inordinate delay in instituting the proceedings.

The Companies Act, 2015 provisions discussed earlier in this article have been applied directly to a fee dispute in ***Milton Mugambi Imanyara t/a Mugambi Imanyara & Co Advocates v Merit Development Limited [2024] KEHC 15674 (KLR)***. The defendant company argued that a letter instructing the advocate and setting the legal fees had not been properly executed in accordance with its memorandum and articles of association. The court rejected that defence, holding that this argument lacked merit in light of the Turquand rule as established in Royal British Bank v Turquand, since a company cannot escape liability because its officers failed to comply with internal management regulations. The court held that this principle is echoed in sections 33 and 34 of the Companies Act and ultimately held that a valid retainer existed between the parties.

The Turquand Rule, born in a mid-19th century English railway financing dispute, remains a cornerstone of Kenyan company law. Far from being a historical curiosity, it has been deliberately preserved and, in key respects, strengthened by Parliament under the Companies Act, 2015. Kenyan courts continue to apply it robustly to protect the security of commercial transactions. The rule strikes a balance by shielding honest outsiders from a company's hidden internal failings.

HOW CM ADVOCATES LLP CAN HELP

At CM Advocates LLP, we advise companies, directors, shareholders, lenders, investors, suppliers and professional service providers on issues relating to corporate authority and commercial transactions. Our diverse legal team can assist with:

- Reviewing corporate authority before entering into contracts or transactions with a company, including reviewing company records, constituting documents and relevant resolutions.

- Advising on directors' powers and authority, including the legal consequences where directors act outside the company's internal procedures.

- Drafting and reviewing commercial contracts to help businesses manage the risks arising from questions of authority, approval and execution.

- Advising advocates and professional service providers on corporate retainers, including disputes where a company subsequently denies that its officers had authority to give instructions.
- Resolving disputes involving unauthorised or irregular corporate transactions, including claims based on the Turquand Rule.
- Advising directors and shareholders on their rights and potential personal liability where corporate procedures have not been followed.
- Representing clients in court and alternative dispute resolution proceedings involving corporate authority, contractual obligations and related commercial disputes.

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