A COMPARATIVE STUDY OF THE ULTRA-VIRES RULE IN CORPORATE LAW

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I. INTRODUCTION

The term *ultra vires* as such simply means 'beyond the powers of' Even in company law this term has various connotations depending upon the context. An act can be *ultra vires* the company's memorandum of association, *ultra vires* the company's articles or merely outside the scope of the powers of the company's officers. These distinctions are important as different consequences ensue depending upon the nature of the *ultra vires* act. Thus while in case of the last two categories of acts the general assembly ordinarily reserves the right to ratify the *ultra vires* transactions, this is not the case with a dealing that is beyond the objects stated in the memorandum of association. Such transactions as per the traditional *ultra vires* doctrine are simply a nullity.

It is with the latter kind of transactions which are beyond the objects stated in the memorandum of association that this article is primarily concerned with and any reference to the term *ultra vires* doctrine or rule in this article is also to be construed accordingly.

II. ORIGIN OF THE ULTRA VIRES RULE IN CORPORATE LAW

It was in 1855 when Limited Liability Act was introduced in England that for the first time there was a widespread need for the application of a strict rule in the interests of creditors. With the introduction of the limited liability it was deemed proper that the use of the shareholders and the creditors' funds with the company should be only for certain specified objects. The elaboration of such a rule was facilitated by the Act of 1856, which specified that a company should include an objects clause within is memorandum that would define the contractual capacity of the company.[1]

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1 Gower, PRINCIPLES OF MODERN COMPANY LAW (4th ed.) at 85.

However insofar as the 1856 Act failed to stipulate any method by which the alteration of the objects clause could be achieved, the status of the clause and its effect on contractual capacity was unclear.[2]

Fortunately such a vexing question also did not arise clearly until after the passing of the Companies Act 1862 which expressly provided that but with two exceptions[3] "no alterations shall be made by any company in the conditions contained in the memorandum of association."[4] The position in this regard was not finally settled until 1875 when the House of Lords decided the celebrated case of *Ashbury Railway Carriage & Iron Co.* v. *Riche*[5]. The House of Lords held that a contract that was *ultra vires* the company's objects was altogether void. Lords Cairns L C after stating that the subscribers "are to state the objects for which the proposed company is to be established and then the company comes into existence for those objects and for those objects alone" and after refeffing to the words at the end of section 12 (re-enacted in an amended form in section 4 of the Act of 1948) to the effect that "no alteration shall be made by any company in the conditions contained in its memorandum of association" proceeded as follows :

> "...If that is the purpose for which the corporation is established... it is a mode of incorporation that contains in it both that which

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2 For example, the omission of any alteration powers in relation to the objects clause could, on the one hand, have been indicative of the legislature's desire to prohibit any alteration to a company's object clause subsequent to the company's registration. Alternatively by failing to expressly state that the alteration of an objects clause was prohibited the 1856 Act could have been interpreted as allowing alterations to the clause (following the consent of the company's membership) in which case, any attempted restriction on corporate capacity would have been seriously weakened.

3 Reogranisation of share capital and, with consent of the board of trade, alteration of name. *Ibid.*

4 Section 12.

5 (1875) LR 7 HL 653. In this case the objects of a company were to carry on the business as manufacturers of railway carriages, wagons and railway plants, fittings, etc. to business as mechanical engineers and general contractors and to work in mining minerals etc. The company had entered into a contract in relation to finance the construction of a railway line in Belgium and the question was raised in the action challenging the contract.

is affirmative and that which is negative. It states affirmatively the ambit and extent of vitality and power which by law are given to the corporation, and it states, if it is necessary to state, negatively, that nothing shall be done beyond that ambit, and that no attempt shall be made to use the corporate life for any other purpose than, that which is so specified."[6]

III. Theoretical Justification of the Rule of *Ultra Vires*

There are various reasons, which have been suggested in justification of the rule of the *ultra vires.* According to Palmer, the reasons for the development of the rule are —

(1) As a matter of constitutional law Parliament as the sovereign power in the country does not grant more power to delegated bodies than it has authorized.

(2) As a practical consideration it was thought that the rule would protect investors in the company and creditors of it against the unauthorized use of the funds.[7]

IV. Subsequent Erosion of the *Ultra Vires* Doctrine

No sooner had the *ultra vires* doctrine been propounded by the *Ashbury Carriage Company* case that the reaction against it started. Both the business community and the courts became aware of the disadvantages of the *ultra vires* doctrine, and attempts started at reducing the rigors of the absolute doctrine. On the part of the court there has always been noticeably a conscious move towards validating transactions if possible by various legal interpretations. On the part of the company management and those dealing with the companies there were various types of attempts at the evasion of this rule.[8]

Attempts at avoidance of the company managers broadly took the following shapes :—

(1) Wide powers were introduced in the objects clause of the memorandum of association and all sorts of powers to do all

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6 *Id.* at 670.

7 Palmer, Company Law (21st ed.) at 73.

8 S.C. Sen, The New Frontiers of Company Law (1971) at 106.

sorts of businesses were introduced. In such cases, the memorandum hardly gave any proper indication as to what was really the main business of the company.

(2) In the memorandum sometimes as "all power" purpose clause was incorporated giving the company the power to do any type of business that the management may want to do.

(3) In some memorandum a clause was introduced that all the objects stated in the memorandum in the objects clause were to be considered as main objects of the company.

The courts therefore strove to curb this abuse in two ways. First, they applied the *ejusdem generis* rule to the construction of the objects clauses saying that when the main objects specified in the first few paragraphs were followed by general words the latter should be construed as covering their exercise only for the purposes of the main objects. This however was avoided by the practice of inserting in the objects clause a clause to the effect that all the specified objects are deemed to be independent and in no way ancillary or subodrinate to one another. Although this was challenged in *Cotman* v. *Brougham*[9] and was severely criticized in the judgment nonetheless it was considered to be valid and legal.[10]

The net result was that if the management was careful to have a wide objects clause in the memorandum of association there was no effective protection for the shareholders to prevent application of assets of the company in objects other than those that were originally in the minds of the investors.[11]

Mitigation of Hardships by Judicial Decisions

In *Simpson* v. *Westminster Palace Hotel*[12] where the questions of *ultra vires* was involved in connection with the hotel company which had powers under the objects to carry on a hotel business in the city of Westminster and the directors had let out a part of the premises. The House of Lords held that the letting was not *ultra vires* on the grounds

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9 [1918] AC 514.

10 *Supra* note 8 at 107.

11 *Supra* note 8 at 107.

12 (1860) 8 LHC 712.

that the letting was temporary and preliminary and conducive to the ultimate object of being devoted to the proper purpose of the hotel. In *Attorney General* v. *Great Eastern Railway*[13] the House of Lords while affirming the principles laid down in the *Ashbury Railway Company Case*[14] qualified the rule in the said case by laying down the principle that the *ultra vires* doctrine was one to be reasonably and not unreasonably understood and applied and whatever may be regarded as incidental to or consequential upon those things which the legislature had authorized and those things which have been specified in the memorandum as objects ought not, unless expressly prohibited, to be held by the judicial construction to be *ultra vires.* These two cases established what has since been known as the implied power formula. A large number of decisions extended the application of the doctrine by holding that companies have various types of implied powers.[15]

V. The Harmful Effects of the *Ultra Vires* Rule and The Need for Reform

With such liberal judicial interpretations of the objects clause and clever draftsmanship the objects clause has failed in keeping the company confined to a limited number of activities. The rather unfortunate result thus has been that while on one hand the *ultra vires* rule has not been able to effectively protect the sharesholders' property, it has on the other created avoidable risks for third parties transacting with the company.

In the practical working of the companies the *ultra vires* rule creates difficulties both for the management as also for persons dealing with the company. For the management, their powers of doing business become subject to restrictions. The doctrine also entails additional work to be undertaken by persons and their agents in the preparation of a company's constitution prior to its incorporation. For third persons apart from the risk of their legitimate expectations being thwarted there is additional delay and incurrence of expenditure in ensuring that the transaction is within the objects stated in the company's memorandum.

The critics have even gone to the extent of stating that in the *Ashbury Railway Carriage Company* case the court got obsessed with the question

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13 (1880) 5 AC 473.

14 *Supra* note 5.

15 *Supra note* 8 at 109.

of protection of the property of the shareholders. There were two things that the court should have taken into consideration. One was, of course, the protection of the shareholder's property but the other was of social obligation of the company or social safeguards of third parties in respect of dealings and transactions with the company. Shareholders when they invest in shares of a company ask for one protection, namely, limited liability. This limitation of further liability is the basic part of the bargain and that is the only protection, which the statute had given to them. It does not seem correct that in addition to the rights and protection of limited liability a further protection should have been given to the shareholders at the cost of the rest of the society. It appears that in choosing between the protection of property of the shareholders and the social commitments and obligations of a person the House of Lords failed to take adequate note of the more important consideration and permitted its obsession for protection of individual property to carry it away and lay down the foundation of a doctrine that has since then impeded business and commerce through companies and has in any event been an illusory safeguard to shareholdes.[16]

However, while considering the question of the reform of the *ultra vires* rule, on the above counts one has to also consider some other equally important aspects; such as the fact that the liberal interpretation of the objects clause works both ways, to increase the scope for the company's operations as well as to bring a transaction with a third party within the *vires* of the company. Moreover in actual practice the courts have even allowed relief to the third parties in many cases keeping the ends of justice in mind. Exceptions to the *ultra vires* rule have been carved out to protect third party claims. To elaborate,

(i) If some property is acquired by the company on account of the *ultra vires* transaction and used by the company to pay its own debts, the supplier of the property on account of the principle of subrogation will step into the shoes of the creditors whose claims have been paid off by the company and acquire their rights against the company.[17]

(ii) If the property acquired by the company on account of an *ultra vires* transaction exists *in specie* or if it can be traced, the person handing it over can recover it from the company.[18]

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16 *Ibid.*

17 *Blacburn Building Society* v. *Cunliffe.*

18 *Sinclair* v. *Brougham* [1914] AC 398.

Inspite of these factors that may appear to mitigate the harshness of the *ultra vires* rule the fact remains that this doctrine has often enough perpetrated injustice upon innocent third parties.

If at all relief to third parties has been allowed then it has been only in those cases where a part of the contract has been performed. On the other hand in the case of executory contracts.[19], there is no remedy available to the third parties for the realisation of their legitimate expectations.

Moreover, even where the contract is executed (the promise by only one party having been performed) the law relating to the grant of relief to the third party is complex and lacking in principle. The courts have dealt with situations *ad hoc* according to the kind of contract involved and the mere fact that one party has fulfilled his promises under an *ultra vires* contract does not in itself entitle him to sue the other party for non-fulfilment of his obligations.[20]

The hardship that may be caused to completely innocent people is best illustrated by *Re Jon Beauforte (London) Ltd.*[21] There a company formed to make ladies dresses decided to change to the manufacture of veneered panels an activity which could not be brought within its objects clause however liberally construed. Unhappily no one seemed to have realised this and the necessary steps to alter its objects were never taken. The company entered into contracts for the construction of a factory, for the purchase of veneers, and the purchase of coke but failed to make success of its new enterprise and went into liquidation. It was held that none of the three contractors could prove in the liquidation as the transaction was *ultra vires* the company's objects. Also, no relief of any other kind was allowed to the contractors at common law as the case was not covered by any of the exceptional situations. Even the supplier of coke who argued cogently that this might well have been needed for an *intra vires* activity, failed because the fuel had been ordered on note paper describing the company as "veneered panel manufacturers." This judgement that followed an extremely doctrinaire approach shocked the conscience of the legal community and made the scholars wake up to the need for the reform of this victorian doctrine.

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19 Executory contracts being contracts in which none of the parties has performed his part of the contract.

20 Pennington, COMPANY LAW (3rd ed.) at 93.

21 [1953] Ch 131, noted 69 LQR 166.

Not surprisingly, overtime the *ultra vires* rule has been almost abolished in many a legal jurisdictions (U.S.A., Canada, New Zealand, Australia, Ireland and United Kingdom amongst others) which reflects the growing disenchantment with this doctrine. There has been a noticeable shift in favour of third party protection, which is in line with the modern concept of a company's social responsibility.

VI. Reform of the *Ultra Vires* rule in United Kingdom[22]

The first statutory reform of the *ultra vires* rule was made, following the recommendations of the Cohen Committee. The Cohen Committee had recommended that in favour of third parties a company should have all the powers of a natural person. If this recommendation had been implemented the *ultra vires* rule would have been abolished in relation to third party dealings. However the reform that was actually made in the passing of section 5 of the Companies Act 1948 only allowed companies to alter their objects clause by special resolution. Though the validity of a company's capacity to enter into a transaction could be secured by an alteration of the objects clause, the reform did little to protect third parties in a situation where an alteration had not been made.

In 1962 the Jenkins Committee recommended the abolition of the constructive knowledge rule in relation to third party dealings. Other than where a third party had actual knowledge of the contents of a company's constitutional documents, the consequences of this proposal would have enabled a third party to enforce any transaction against the company.

However, the recommendations of both the Cohen and Jenkins Committee reports failed to attain statutory recognition. It was only with UK's entry into the European Community that the *ultra vires* rule was subjected to a major reform. Directives were issued by the council of ministers of the European Community for the harmonisation of the company law in the member states.

Article 9 of the First Directive on Company Law provides :

(1) Acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company

22 This article draws upon Stephen Griffin's paper titled *The Rise and the Fall of the Ultra Vires Rule in Corporate Law* which explains the evolution of the *ultra vires* doctrine since its inception to virtual abrogation by the Companies Amendment Act passed in 1989. see www.solent.ac.uk/law/mjls/papers/griffen.htm.

unless such acts exceed the powers that the Law confers or allows to be conferred on those organs.

However, Member States may provide that the company shall not be bound where such acts are outside the objects of the company if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof.

(2) The limits on the powers of the organs of the company arising under the statutes or from a decision of the competent organs may never be relied on as against third parties, even if they have been disclosed.

(3) If the national law provides that authority to represent a company may, in derogation from the legal rules governing the subject, be conferred by the statutes on a single person or on several persons acting jointing, that law may provide that such a person in the statutes may be relied on as against third parties on condition that it relates to the general power of representation.

Section 35(1) of the Companies Act 1985 in attempting to comply with Article 9(1) referred above, provided that :

'In favour of a person *dealing* with a company in *good faith* any transaction decided on by the *directors* is deemed to be one within the capacity of the company to enter into and the power of the *directors* to bind the company is deemed to be free of any limitation under the memorandum or articles.'

In purporting to comply with Article 9(2), section 35(2) provided that :

'A party to a transaction so decided on is not bound to inquire as to the capacity of the company to enter into it or as to any such limitation on the powers of the directors, and is presumed to have acted in *good faith* unless the contrary is proved'.

There were however certain points of inconsistency between section 35 and Article 9, viz.

(i) In the use of the words 'dealings' and 'transaction' as opposed to Article 9's use of the term 'acts', section 35 failed to include gratuitous

dispositions within its remit of contractual dispositions which would fall outside the ambit of the *ultra vires* rule.

(ii) Although Article 9 provides that a transaction may be set aside where a third party had actual knowledge of the fact that the transaction fell outside the objects of a company (or where the third party could not have been unaware that the act was outside the objects of the company), section 35 used the term 'good faith' as the yardstick measure for those transactions which were to fall outside the protection of the section. Although a third party with actual knoweldge of a transaction having exceeded a company's objects clause would necessarily be deemed to have acted otherwise than in good faith, a third party may also have been considered to have acted in bad faith notwithstanding the absence of any actual notice of a company's objects clause having prohibited the transaction. For example, notwithstanding the abolition of the constructive notice rule, where a third party in possession of a copy of a company's memorandum, blatantly refused to digest its contents, then in such a situation when the third party does not have actual notice of the *ultra vires* natures of the transaction but still could not have been unaware that the act was outside the objects of the company. However, the term 'good faith' retained an ability to invalidate contractual acts beyond those, which would be deemed invalid under Article 9. For example, it could still be argued that inasmuch as the third person did not bother to look into the company's documents, such person may be deemed not to be acting in good faith. This would just undo the effect of abolishing the doctrine of constructive notice.

(iii) In its use of the term 'directors', as the authorising body of a corporate transaction, section 35 failed to follow the language of Article 9,in so far as Article 9 defines the authorising body as the 'organs of the company'. Article 2 of the First Directive seeks to define the meaning of 'organs of the company' by providing that the term should include.

> 'persons who either as a body constituted pursuant to law or as members of any such body are authorised to represent the company in dealings with third parties (and in legal proceedings) or take part in the administration, supervision or control of the company'.

The definition of 'organs of the company' so provided by Article 2, is permissive of the right of a properly authorised director to contractually bind a company. However, under section 35 the use of term 'directors' effectively limited the validity of transactions decided otherwise than by the collective board of directors. As vry few decisions relating to corporate contracts are taken by the collective board of directors, board meetings usually being confined to broad policy issues, section 35 in its adoption of the term 'directors' was indeed contrary to commercial practice.

Thus as a result of section 35 of the Companies Act 1985, the *ultra vires* rule had been put to rest but the ghost of the rule still remained. Its potential to haunt the business community continued to be an unwelcome nuisance.[23]

In December 1985, the Department of Trade and Industry appointed Professor Dan Prentice to examine the legal and commercial implications of abolishing the *ultra vires* rule. The Prentice report recommended the complete abrogation of the rule by conferring a company with the capacity of a natural person; a recommendation, which would have brought the UK in line with other common law jurisdictions. In additon to confering a company with the capacity of a natural person, the report recommended that the rules relating to directors' authority should be amended to avoid the imposition of excessive restrictions upon the authority of company directors. The latter recommendation was crucial in so far as the ability of a company to impose limitations on the given authority of its directors was an indirect means by which the contractual capacity of a company could still be called into question.

Consequent upon the Prentice Report the 1989 Act brought about a number of changes in the Companies Act 1985. The provisions introduced/ amended therein and relating to the *ultra vires* rule in corporate law are:

Section 35(1) the Companies Act 1985, which after amendment by the 1989 Act, provides that, 'the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum'.

Section 35(2) the Companies Act 1985 which provides that : 'a member of a company may bring proceddings to restrain the doing of an

23 *Ibid.*

act which but for *subsection* (1) would be beyond the company's capacity; but no such proceedings shall lie in respect of an act done in fulfilment of a legal obligation arising from a previous act of the company.

Section 35(3) states, 'It remains the duty of the directors to observe any limitations on their powers flowing from the company's memorandum, and action by the directors whic but for subsection (1) would be beyond the company's capacity may only be ratified by the company by special resolution. A resolution ratifying such action shall not affect any liability incurred by the directors or any other person; relief from any such liability must be agreed to separately by special resolution.'

In accordance with section 35A(5) the Companies Act 1985, the board or a person authorized by the board will (subject to the ratification of the act by the general meeting) remain personally liable to the company in respect of a transaction, which was entered into outside the scope of the company's constitution.

Having stated the relevant provisions one may now consider the cumulative effect of the Amendment Act upon the *ultra vires* doctrine. Clearly section 35(1) in its amended form drastically curtails the application of the *ultra vires* rule. By virtue of section 35(1) Companies Act 1985 now even if an act of the company is outside of the objects stated in the memorandum of association it would not become invalid merely on this ground. Section 35(1) Companies Act would allow a third party to enforce even an *ultra vires* claim against the company.

At the same time it would not be correct to infer that the *ultra vires* doctrine has been completely abolished. Some vestiges have been retained in the form of the still existing requirement to state the objects clause within a company's memorandum, section 35(2) and section 35(3). Although the Companies Act 1989, did not (contrary to the recommendations of the Prentice report) remove the need for a company to include an objects clause within its memorandum, nevertheless, it did seek to avoid the practice of prolonged clauses, commonly used after the decision in Cotman v. Brougham. This was achieved by introducing a standard type of objects clause which now permits companies to pursue any activity within a commercial context. For existing companies, the option to adopt this new form of clause is exercised by the passing of a special resolution. By adopting an objects clause in line with s3A, it should be noted that where a company wishes to place a limitation on its power to exercise commercial

objects, it must do so by making separate provision for the limitation within the terms of a '3 A type' objects clause.

Where limitations on the exercise of corporate objects and powers are included in an objects clause, such limitations will not, however, deflate the capacity of a company in its dealings with third parties; this possibility is precluded by section 35(1) CA 1985. However, such limitations will regulate the board of directors in relation to the board's own powers and a transaction falling foul of a stipulated limitation will, whilst not *ultra vires*, render any director acting contrary to the terms of the limitation (subject to a special resolution of the general meeting ratifying the director's act) to be made potentially liable for any corporate loss which may arise as a consequence of pursuing the unauthorised transaction. Silimarly, corporate powers which are not covered by the section 3A definition but which the company wishes to include within its objects clause will require to be expressly mentioned; such powers could include the ability to make charitable or political donations.

Section 35(3) castes a duty upon the directors to observe the limitations on their powers flowing from the company's memorandum. Though by virtue of section 35(1) in case of any breach o such duty the resultant acts would not be void but as per section 35A(5) the directors would have to bear personal liability for such acts. Moreover under section 35(2) where a company's act has yet not given rise to legal obligations, a member of the company may even bring proceedings to restrain an act that is *ultra vires* the memorandum of association. These latter provisions reconcile protection of third party interests with protection of shareholder's property.

The 1989 Act also introduced some new sections into the relevant parts of the 1985 Act.

A new section 35A(1) CA 1985 provides that,

> 'In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution'.

The effect of section 35A(1), is to promoe a company's board of directors to the position of being able to determine the exact scope of a

company's ability to delegate authority. Previously the company's memorandum and articles of association would have been the primary source for the determination of such issues. Although section 35A(1) uses the term 'limitations under the company's constitution', in accordance with section 35A(3), the term 'constitution' is given an extended meaning because it includes limitations deriving from a resolution of the general meeting, a meeting of any class of shareholders and limitations derived from a membership agreement.

Also, in an attempt to surmount the difficulties associated with the interpretation of the wording used in old section 35(1), a new section 35A(2)(a) provides that a person deals with a company if he is 'a party to any transaction or other act to which the company is a party'. As such, the section should no longer be construed as solely applicable to commercial actions. In addition, and contrary to the recommendations of the Prentice report, sections 35A(2)(b) & (c) purport to clarify the meaning of 'good faith' by providing that a person is not to be regarded as having acted in bad faith solely as a result of knowing that a corporate act was beyond the powers of the directors under the company's constitution; indeed a person is presumed to have acted in good faith unless the contrary is proved. Unfortunately, no legislative guidance is given as to what will constitute bad faith, although it is likely that this term will be construed to include a fraudulent or dishonest act. This matter is one, which has been left to the discretion of the judiciary.

Moreover, section 35B CA 1985 states that,

> A party to a transaction with a company is not bound to enquire as to whether it is permitted by the company's memorandum or as to any limitation on the powers of the board of directors to bind the company or authorise others to do so.

Whilst, section 35B removes the third party's need to concern himself about the existence of a limitation on authority, the section nevertheless preserves the requirement for an authority to act, i.e. the transaction must still be sanctioned by the board, or the person with whom the third party deals must have an authority to act in relation to a specific transaction, an authority derived from the board. Thus while the *ultra vires* nature of the transaction would not be a good defence for the company, the fact that the act was not authorized by the board would still be.

Furthermore, as per section 322A insiders are not to be protected by the abolition of the constructive notice rule and will not be able to seek the automatic protection of sections 35A and 35B. The transaction's validity in this case would depend upon the passing of an ordinary resolution. The insider and any other director of the company who authorised the contract will remain personally liable to account for any gain made or loss incurred as a result of the transaction. Where, however, an innocent *bona fide* third party acquires rights as a result of the insider transaction, the company will, in such a case, be unable to avoid it.

In the words of Stephen Griffin[24] the impact of the Companies Amendment 1989 in relation to the *ultra vires* rule may be summed up as follows :

> 'Undoubtedly, shareholders and creditors who could have previously relied upon a company's constitutional documents to ensure that their investments were only employed in the pursuit of legitimate purposes, are the theoretical victims of the legislative reforms. However, whilst theoretical victims, in practice their loss should be of little significance. The limited liability company can no longer be viewed as a suspicious invention of the business community, its standing and regulation is now well established. The protection of shareholders and creditors is apply represented elsewhere within the companies' legislation. The *ultra vires* rule, an outdated Victorian legacy, had the ability to place unnecessary burdens on the contractual capacity of corporations. Its abrogation was both essential and long overdue.'

VII. Doctrine of *ultra vires* in India

The doctrine of *ultra vires* was first recognised in India in 1866 in *Jehangir R. Modi* v *Shamji Ladha*[25] and since then this rule has been applied and acted upon in a number of decisions. The doctrine was affirmed

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[24] Lecturer in Law (UW Aberystwyth) who in his article, *The Rise and Fall of the Ultra Vires Rule in Corporate Law* makes these statements while subscribing to the virtual abolition of the *ultra vires* rule in corporate law.

[25] (1866-67) 4 Bom HCR 185.

by the supreme court in *A. Lakshamana Swami Mudaliar* v. *Insurance Corporation of India*.[26]

In 1952 the Company Law Committee had the occasion to consider the *ultra vires* rule in relation to the objects clause of the company and specially it considered whether any distinction could be made between the main and the subsidiary objects of the company. After due deliberations, the committee concluded that they were not in a position to suggest realistic measures by which any distinction could be drawn between the main and the subsidiary objects. They therefore left the matter to the responsible judgment of the management and the periodical vigilance of the shareholders.[27]

It was only in the year 1965 with the enactment of Companies Amendment Act, 1965 that the distinction between the main objects and the subsidiary objects fo the company came to light. The Act was passed on the basis of the recommendations made by the Vivian Bose commission.[28] As a result of the recommendations, the Indian Companies

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[26] AIR 1963 SC 1185. In this case the directors of a company were authorised to make payments for any charitable or general public or useful object. In accordance with a shareholders resolution the directors paid two lakhs rupees to a trust formed for the purpose of promoting technical and business knowledge. The court said that directors could not spend company's money on any charitable object, which they might choose. They could spend only for such charitable objects as would be useful for the attainment of the company's own objects. The payment was held *ultra vires*.

[27] See V. D. Kulshreshtha, CHANGING DIMENSIONS OF COMPANY LAW IN INDIA (1971) at 25.

[28] The Commission made a thorough inquiry for about six years in the case of a company, Dalmia Jain Airways Ltd., and suggested amendments aimed at preventing some of the evils of the kind, which came to light as a result of the inquiry. The report of the commission of inquiry disclosed that this company, the Dalmia Jain Airways Ltd. was floated ostensibly for the purpose of carrying on air transport business. But even from its very inception the promoters had never intended that the huge sum of over 319 lakhs raised by public subscription towards the share capital should be utilised for such business. They had only intended to form a private company for carrying on a totally unrelated adventure, namely, purchasing surplus motor vehicles and spare parts and machinery left by the U.K. and the American forces at the conclusion of the last war, and after reconditioning the vehicles selling them at a profit. The attempt was to run a skeleton air transport as a make believe show. The memorandum of association of the company included an omnibus

Act was amendment in 1965. The amendment section 13 provides that in the case of a company in existence immediately before the commencement of the Company's Amendment Act 1965, its memorandum must state its objects [clause (c)] and in the case of a company formed after such commencement its memorandum must state [vide clause (d)];

(i) The main objects of the company to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of the main objects, and

(ii) Other objects of the company neither included in the main objects nor included in the ancillary objects.

The purpose of this amendment is to enable shareholders and others interested to have a clear idea of the main objects and the other objects.[29] Moreover, in the case of an existing company that is existing prior to the Amendment Act, if any new business not germane to the business which it is already carrying on, is to be started, the provisons of section 149(2-A) clause (a) read with subsection (2-B) should be complied with, and in the case of a company formed after the amendment Act, if any business coming under the 'other objects' clause (d) is to be started, again the provisions of the said section 149(2-A) rad with subsection 2B of that section should be complied with.

In brief the chief requirement of section 149 [2A] is that in case of a company in existence before the commencement of the amendment Act of 1965 no new busness not germane to the business that it was carrying

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clause that gave power to the company to deal in vehicles of all kinds and which even specified cycles, carriage and perambulators. The prominence given to the ostensible object made the public believe that the company would really conduct the business of air transport. The memorandum being comprehensive within its scope and the dealing in motor vehicles and spare parts, the persons in control, without reference to the shareholders and even to the Controller of capital issues who had authorised the issue of share capital, were able to divert the funds so obtained into the surplus motor vehicles and spare parts business. Though its funds were freely utilised for acquiring the surplus motor vehicles and spare parts, the public company did not get the profits from the deal. The profits went to the private company, which entered into a contract for the purchase, and the public company suffered a huge loss in the result.

[29] See GUIDE TO THE COMPANMIES ACT, Part I at 212.

on at the comencement of the Companies Amendment Act 1965 can be started without the passing of a special resolution to this effect in the general assembly. Likewise in the case of a company formed after the commencement of the said amendment no business in relation to the other objects can be commenced without obtainign an approval in the manner as aforesaid.

The idea behind a provision such as section 149(2) was to limit management's freedom in changing at will the objects to be actually pursued by the company. This, in the case of the companies coming into existence after the 1965 Amendment was achievec by categorizing all the objects stated in the memorandum into the main and the other objects. While the main objects were to be the objects that the company would actually pursue on its incorporation any additional objects were to be stated separately as 'other objects' would by virtue of the section 149(2) necessitate the general assembly's approval. Thus while keeping the shareholders aware of where their funds were in fact beign deployed this provision would also give them a say in any change in the company's activities.

However, the 1965 amendment was found to be failing in the achievement of its purpose due to reasons that were not far to seek. While section 13 after the amendment provided for the classification of the objects into different categories yet it did not make any stipulation as to the number of objects that could be included in the main objects clause nor did the act provide for rules of construction for such objects clause and thus it was still left open to the management to have a number of sub clauses in the main object clause.[30] In fact in one case it was found that as many as 106 sub clauses had been included in he main objects clause itself.

This dismal scenario continued for long even after the 1965 amendment until the department of company affairs finally issued instructions to the registrars of companies to put an end to such practice. The department in a letter addressed to the registrars of companies gave the following instructions;

'The mattr has been examined by the department and it is felt that it is necessary for the companies incorporated under the companies Act,

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30 *Supra* note 27 at 28.

1956 to have clearly defined the spheres of business activities and promoters of companies should be persuaded at the time of the incorporation of companies to have a few reasonably well defined objects under the main objects clause and a limited number of other objects which should be consistent with the intended or proposed activities of the company and within the financial capability of the company as determined by its capital structure.

I am directed to bring the above views of the department to all the registrars of companies with a request to ensure that the above broad outlines are kept in mind while registering companies under the Companies Act, 1956 they should also ensure that the companies carry on only the business that they are allowed to carry on under their memorandum of association and any transgression in this behalf should be taken up with the companies as soon as it comes to notice.[31]

Hence in practice now the ROCs usually insist upon having only one object in themain objects clause with this object being reflected in the company's name as far as possible. For a diversified company stating of different objects is allowed provided those objects are not completely unrelated and are intended to be pursued by the company immediately after incorporation or within a reasonable time from the date of incorporation or within a reasonable time from the date of incorporation. In this regard the ROC must satisfy himself by reference to the certain documents, information or explanations furnished by the company.

Thus on the whole now it woudl be very difficult for the management to pursue any object outside of main objects clause without letting the shareholders be in the know of it. This world also go along way in preventing the shareholders from being befooled by unscrupulous management. The combined result of the 1965 amendment and the actual practice of the ROCs pursuant to the department's instructions has been to disallow a company from drifting away from its main objects unless it is with the approval of the shareholders themselves. Thus in its this aspect of keeping the company confined to set objects the *ultra vires* doctrine in India has been made more effective.

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[31] Department's file No. 8/15(13)/82-cl-v, dated 22-12-1982.

VIII. Conclusions

As stated above in India it is no longer possible for the company's management to change the company's line of activity without letting the shareholders be aware of this fact. Thus the working of the *ultra vires* doctrine in India post the 1965 Amendment ensures that an investor in a gold mining company would not find himself holding shares in a fried fish shop. This has been a positive development. However the doctrine of *ultra vires* in its present form still operates as a trap for the unwary creditors as there is no legal protection for a third party entering into an *ultra vires* transaction with a company. Here, perhaps the legislators can take a cue from the reform of the *ultra vires* rule in England brought about by the 1989 Amendment.

To rid the Indian legal system of the evil effects of the *ultra vires* doctrine appropriate changes in the Companies Act, 1956 would have to be made. It would not suffice to merely state that the third party transactions would remain valid where the outsider has no notice of the company's objects. Since by reason of the doctrine of constructive notice every outsider is imputed with the knowledge of the contents of a company's memorandum and articles of association, this doctrine itself would have to be abolished (as in England) if any meaningful protection to the third parties is to be extended. The reform of such a longstanding and now outdated rule would require careful drafting and avoidance of problematic expressions that may blunt its operation by bringing in the constructive notice doctrine throughthe backdoor.

While maintaining the validity of even *ultra vires* claims upon a company the directors should be made personally liable to reimburse the company for *ultra vires* application of its funds. Similarly, for further protection of shareholders property they should be vested with a preemptive power to restrain execution of *ultra vires* transaction, wherever possible, without injury to a third party. These would be provisions which even while protecting the interests of the outsiders give a security to shareholders' funds.