What if a Company Acts beyond its Objects? The Sri Lankan Legal Perspective

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Introduction

In the past the objects of a company were included in the Memorandum of Association and the primary aims were to protect the investors of the company and to determine the legal capacity of the company by the third parties. If the company acts beyond its objects, it was considered as ultra vires.

Doctrine of ultra vires emerged in the English Common Law. It consists of two words. Ultra means beyond and vires means power. Thus the expression of ultra vires implies acting beyond power. The doctrine was firmly established by the case of Ashbury Railway Carriage and Iron Company v Riche (1875) LR 7 HL. In this case the company entered in to a contact regarding a matter that was not included in the objectives of the company and later the company refused the agreement relying on the doctrine of ultra vires. The court decided the company had acted beyond its objects and therefore the contract was ultra vires and void. It further stated that such a contract could not have been ratified by the unanimous assent of the whole corporation.

The emergence of the constructive notice rule also supported the development of the ultra vires doctrine. As decided in the case of Earnest v Nichols (1857) 6 HL Cas 401, all persons dealing with a company are deemed to be familiar with the content of its public documents. Further in the case of Re David Payne & Co Ltd (1904) 2 Ch 608, a creditor could not obtain his money back due to the effect of the doctrine of constructive notice.

It was clearly evident that the application of the doctrine of ultra vires, together with the doctrine of constructive notice, caused many hardships to the persons who are dealing with the company. Moreover many restrictions curtailed the decision making process of the company and its capacity to act.

Modification of doctrine of ultra vires by the judiciary

A series of cases recognized the inappropriateness of the negative effects of the doctrine of ultra vires in the commercial transactions. The case of AG v The Great Eastern Railway Company (1880) 5 App Cas 473 HL has decided that doctrine of ultra vires 'ought to be reasonably, and not unreasonably, understood and applied, and that whatever may fairly be regarded as incidental to, or consequential upon, those things which the Legislature has authorized, ought not (unless expressly prohibited) to be held, by judicial construction, to be ultra vires.'

Furthermore, the indoor management rule was introduced by the case of Royal British Bank v Turquand (1856) 6 E & B 327 which specifies that the persons who deal with the companies are entitled to assume that internal company rules are complied with, even if they are not. This demonstrates that the court has restricted the application of the doctrine of ultra vires and enhanced the capacity of the company.

Modification of doctrine of ultra vires by the legislature

When compared to the modification by the judiciary, the legislative process in clarifying the nature and extent of the rule was slow. The legislature has allowed the companies to alter the object clause by a special resolution by Section 5 of the Companies Act of 1948 in England. Although the company's capacity was enhanced, the difficulties faced by the third parties remained the same.

Later with the effect of Section 9(1) of the 1972 European Communities Act, if the third party who enters into a contract with the company had acted in bona fide, such acts of the company were considered as valid. This section was replaced by Sections 35 (1) and 35 (2) of the Companies Act of 1985 and later on with the enactment of Companies Act of 1989, Section 35 (1) provided that any act of the company shall not be questioned on the lack of capacity. In the present context, the above situation could be seen in Section 39 (1) of the Companies Act of 2006 and it is not mandatory to include the object clause in the Articles of Association. This situation supports the enhancement of the capacity of the company.

Nonetheless, the directors' duty to act in accordance with the Articles of Association (Companies Act 2006, s. 171) and the ability to bring the derivative action Companies Act 2006, s 260(3) still remain. The present situation in England shows that the application of doctrine of ultra vires has been restricted to a considerable extent.

The Sri Lankan Perspective

The inception of the doctrine of ultra vires in Sri Lanka occurred not due to an Act. The case of Jupiter Cigarette & Tobacco Co Ltd v. Soysa 72 NLR 241 (PC) recognized the doctrine of ultra vires within the legal framework of Sri Lanka specified in Companies Ordinance No. 51 of 1938 and moreover applied the indoor management rule recognized in the Turquand case. From the words of Patrick Lowe & Sons and Others v Commercial Bank of Ceylon [2001] 1 Sri L R 280, it is evident that the above situation remained same under the Companies Act No. 17 of 1982.

Under Section 4 (1) of the Companies Act of 1982 of Sri Lanka, it was mandatory to include object clause in the Memorandum of Association. The proviso of Section 4 (3) further specified that ancillary powers included in the Memorandum of Association should not be exercised except with a special resolution of the company. Hence it is evident from the wording of the Act that the doctrine of ultra vires prevailed under the Companies Act of 1982.

The application of doctrine of ultra vires in the commercial context of Sri Lanka was demonstrated in the case of People's Bank v Yashodha Holdings (Pvt) Ltd (S.C C.H.C (Appeal) 21/2006 decided on 25.06.2009). Yashodha Holdings (Pvt) Ltd (Respondent) has advanced money as a short term loan with interest due thereon to finance the import of 14,907 metric tons of cement and this was not included in the object clause of the company. Hence the company has acted beyond its objects.

One question that arose before the court was that whether Section 35 (1) of the English Companies Act of 1989 could be applied in order to eliminate the loss occurred to the bank. However, it was evident before the court that the prevailing Companies Act of 1982 of Sri Lanka being a complete Act, English Law could not be applied as per Section 3 of the Civil Law Ordinance.

Nevertheless, the court was reluctant to apply the doctrine of ultra vires. Thus the court stated that 'this Court cannot show a Nelsonian eye to the fact that the Respondent will be unjustly enriched if the Appellant cannot recover the money advanced by it to the Respondent on a straightforward short term loan. If the transaction on the basis of which money was advanced to the Respondent is a nullity, then at least the money so advanced should be capable of being recovered'. Thus the court relied on the doctrine of estopel. Therefore, it is evident that the Sri Lankan courts have been hesitant to apply the doctrine of ultra vires even under the 1989 Act where it was mandatory to state the objects of the company.

The present Companies Act No 7 of 2007 does not mandate the requirement of the Memorandum of Association and it is mandatory to state the objects even under the Articles of Association (Companies Act 2007, s.13). On this basis it could be argued that the current Act has abolished the application of doctrine of ultra vires in Sri Lanka.

The next question arises when the company has included an object clause in the Articles of Association. This could be discussed in relation to a set of sections of the Act. Section 17 (1) states that when the company has set-out the objects, it should be considered as a restriction placed in carrying on any business or activity that is not mentioned in the articles of the company. However, Section 17 (2) (a) specifies that the capacity and powers of the company should not be affected by such restriction. Moreover, no act of the company, no contract or other obligation entered into by the company and no transfer of property by or to the company, shall be invalid by reason only of the fact that it was done in contravention of such restriction as per Section 17 (2) (b).

The doctrine's potential to haunt the business community seems to be still continuing under the Companies Act. According to Section 17 (3) (a), a shareholder or director can still make an application to court under Section 233 to restrain the company from acting in a manner inconsistent with a restriction placed by the articles. Furthermore, 17 (3) (b), mandates that a director will be liable if he did not act in compliance with the sections of the Companies Act as per Section 188.

The Sri Lankan legal framework thus suggests that the application of doctrine of ultra vires has been limited in the transactions between the company and the third parties. However, its effect could be still found internally.

Conclusion

The practicality was different from what was expected and caused many difficulties to the third parties, although the primary aim of recognizing doctrine of ultra vires was to protect the investors and the persons who deal with the company. Therefore both in Sri Lanka and England, application of doctrine of ultra vires has been limited and the capacity of the company has been enhanced even where there is a specified object clause. In a context where globalization has created easier ways of transactions, application of doctrine of utra vires could not be justified since it restricts a company's capacity to earn profits. Thus it could be argued that a complete recognition of the doctrine of ultra vires is no friendlier in the commercial context.