NOTES - DOCTRINE OF ULTRA VIRES - EFFECTS AND EXCEPTIONS

(Guest)

DOCTRINE OF ULTRA VIRES-EFFECTS AND EXCEPTIONS

CONCEPT

The object clause of the Memorandum of the company contains the object for which the company is formed. An act of the company must not be beyond the objects clause, otherwise it will be ultra vires and, therefore, void and cannot be ratified even if all the members wish to ratify it. This is called the doctrine of ultra vires, which has been firmly established in the case of Ashtray Railway Carriage and Iron Company Ltd v. Rich. Thus the expression ultra vires means an act beyond the powers. Here the expression ultra vires is used to indicate an act of the company which is beyond the powers conferred on the company by the objects clause of its memorandum. An ultra vires act is void and cannot be ratified even if all the directors wish to ratify it. Sometimes the expression ultra vires is used to describe the situation when the directors of a company have exceeded the powers delegated to them. Where a company exceeds its power as conferred on it by the objects clause of its memorandum, it is not bound by it because it lacks legal capacity to incur responsibility for the action, but when the directors of a company have exceeded the powers delegated to them. This use must be avoided for it is apt to cause confusion between two entirely distinct legal principles. Consequently, here we restrict the meaning of ultra vires objects clause of the company's memorandum.

Basic principles included the following:
1. An ultra vires transaction cannot be ratified by all the shareholders, even if they wish it to be ratified.
2. The doctrine of estoppel usually precluded reliance on the defense of ultra vires where the transaction was fully performed by one party.
3. A fortiori, a transaction which was fully performed by both parties could not be attacked.
4. If the contract was fully executory, the defense of ultra vires might be raised by either party.
5. If the contract was partially performed, and the performance was held to be insufficient to bring the doctrine of estoppel into play, a suit for quasi contract for recovery of benefits conferred was available.
6. If an agent of the corporation committed a tort within the scope of his or her employment, the corporation could not defend on the ground the act was ultra vires.

ORIGIN AND DEVELOPMENT

Doctrine of ultra vires has been developed to protect the investors and creditors of the company. The doctrine of ultra vires could not be established firmly until 1875 when the Directors, &C., of the Ashbury Railway Carriage and Iron Company (Limited) v Hector Riche, (1874-75) L.R. 7 H.L. 653 was decided by the House of Lords. A company called "The Ashbury Railway Carriage and Iron Company," was incorporated under the Companies Act, 1862. Its objects, as stated in the Memorandum of Association, were "to make, and sell, or lend on hire, railway carriages and wagons, and all kinds of railway plant, fittings, machinery, and rolling-stock; to carry on the business of mechanical engineers and general contractors; to purchase, lease, work, and sell mines, minerals, land, and buildings; to purchase and sell, as merchants, timber, coal, metals, or other materials, and to buy and sell any such materials on commission or as agents." The directors agreed to purchase a concession for making a railway in a foreign country, and afterwards (on account of difficulties existing by the law of that country), agreed to assign the concession to a Société Anonyme formed in that country, which société was to supply the materials for the construction of the railway, and to receive periodical payments from the English company.

The objects of this company, as stated in the Memorandum of Association, were to supply and sell the materials required to construct railways, but not to undertake their construction. The contract here was to construct a railway. That was contrary to the memorandum of association; what was done by the directors in entering into that contract was therefore in direct contravention of the provisions of the Company Act, 1862.

It was held that this contract, being of a nature not included in the Memorandum of Association, was ultra vires not only of the directors but of the whole company, so that even the subsequent assent of the whole body of shareholders would have no power to ratify it. The shareholders might have passed a resolution sanctioning the release, or altering the terms in the articles of association upon which releases might be granted. If they had sanctioned what had been done without the formality of a resolution, that would have been perfectly sufficient. Thus, the contract entered into by the company was not a voidable contract merely, but being in violation of the prohibition contained in the Companies Act, was absolutely void. It is exactly in the same condition as if no contract at all had been made, and therefore a ratification...
ation of it is not possible. If there had been an actual ratification, it could not have given life to a contract which had no existence in itself; but at the utmost it would have amounted to a sanction by the shareholders to the act of the directors, which, if given before the contract was entered into, would not have made it valid, as it does not relate to an object within the scope of the memorandum of association.

Later on, in the case of Attorney General v. Great Eastern Railway Co.4, this doctrine was made clearer. In this case the House of Lords affirmed the principle laid down in Ashbury Railway Carriage and Iron Company Ltd v. Riche5 but held that the doctrine of ultra vires “ought to be reasonable, and not unreasonable understood and applied and whatever may fairly be regarded as incidental to, or consequential upon, those things which the legislature has authorized, ought not to be held, by judicial construction, to be ultra vires.”

The doctrine of ultra vires was recognised in Indian the case of Jahangir R. Modi v. Shamji Ladha and has been well established and explained by the Supreme Court in the case of A. Lakshmanaswami Mudaliar v. Life Insurance Corporation Of India8. Even in India it has been held that the company has power to carry out the objects as set out in the objects clause of its memorandum, and also everything, which is reasonably necessary to carry out those objects.9 For example, a company which has been authorized by its memorandum to purchase land had implied authority to let it and if necessary, to sell it. However it has been made clear by the Supreme Court that the company has, no doubt, the power to carry out the objects stated in the objects clause of its memorandum and also what is conclusive to or incidental to those objects, but it has no power to travel beyond the objects or to do any act which has not a reasonable proximate connection with the object or object which would only bring an indirect or remote benefit to the company.

To ascertain whether a particular act is ultra vires or not, the main purpose must first be ascertained, then special powers for effecting that purpose must be looked for, if the act is neither within the main purpose nor the special powers expressly given by the statute, the inquiry should be made whether the act is incidental to or consequential upon. An act is not ultra vires if it is found:

(a) Within the main purpose, or
(b) Within the special powers expressly given by the statute to effectuate the main purpose, or
(c) Neither within the main purpose nor the special powers expressly given by the statute but incidental to or consequential upon the main purpose and a thing reasonably done for effectuating the main purpose.
The doctrine of ultra vires played an important role in the development of corporate powers. Though largely obsolete in modern private corporation law, the doctrine remains in full force for government entities. An ultra vires act is one beyond the purposes or powers of a corporation. The earliest legal view was that such acts were void. Under this approach a corporation was formed only for limited purposes and could do only what it was authorized to do in its corporate charter.

This early view proved unworkable and unfair. It permitted a corporation to accept the benefits of a contract and then refuse to perform its obligations on the ground that the contract was ultra vires. The doctrine also impaired the security of title to property in fully executed transactions in which a corporation participated. Therefore, the courts adopted the view that such acts were voidable rather than void and that the facts should dictate whether a corporate act should have effect.

Over time a body of principles developed that prevented the application of the ultra vires doctrine. These principles included the ability of shareholders to ratify an ultra vires transaction; the application of the doctrine of estoppel, which prevented the defense of ultra vires when the transaction was fully performed by one party; and the prohibition against asserting ultra vires when both parties had fully performed the contract. The law also held that if an agent of a corporation committed a tort within the scope of the agent's employment, the corporation could not defend on the ground that the act was ultra vires.

Despite these principles the ultra vires doctrine was applied inconsistently and erratically. Accordingly, modern corporation law has sought to remove the possibility that ultra vires acts may occur. Most importantly, multiple purposes clauses and general clauses that permit corporations to engage in any lawful business are now included in the articles of incorporation. In addition, purposes clauses can now be easily amended if the corporation seeks to do business in new areas. For example, under traditional ultra vires doctrine, a corporation that had as its purpose the manufacturing of shoes could not, under its charter, manufacture motorcycles. Under modern corporate law, the purposes clause would either be so general as to allow the corporation to go into the motorcycle business, or the corporation would amend its purposes clause to reflect the new venture.

State laws in almost every jurisdiction have also sharply reduced the importance of the ultra vires doctrine. For example, section 3.04(a) of the Revised Model Business Corporation Act, drafted in 1984, states that “the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.” There are three exceptions to this prohibition: it may be asserted by the corporation or its shareholders against the present or former officers or directors of the corporation for exceeding their authority, by the attorney general of the state in a proceeding to dissolve the corporation or to enjoin it from the transaction of unauthorized business, or by shareholders against the corporation to enjoin the commission of an ultra vires act or the ultra vires transfer of real or personal property.

Government entities created by a state are public corporations governed by municipal charters and other statutorily imposed grants of power. These grants of authority are analogous to a private corporation's articles of incorporation. Historically, the ultra vires concept has been used to construe the powers of a government entity narrowly. Failure to observe the statutory limits has been characterized as ultra vires.
In the case of a private business entity, the act of an employee who is not authorized to act on the entity's behalf may, nevertheless, bind the entity contractually if such an employee would normally be expected to have that authority. With a government entity, however, to prevent a contract from being voided as ultra vires, it is normally necessary to prove that the employee actually had authority to act. Where a government employee exceeds her authority, the government entity may seek to rescind the contract based on an ultra vires claim.

**EFFECT OF ULTRA VIRES TRANSACTIONS**

A contract beyond the objects clause of the company's memorandum is an *ultra vires* contract and cannot be enforced by or against the company as was decided in the cases of *In Re, Jon Beaufore (London) Ltd.*., (1953) Ch. 131, *In S. Sivas hanmugham And Others v. Butterfly Marketing Private Ltd.*, (2001) 105 Comp. Cas Mad 763.

A borrowing beyond the power of the company (i.e. beyond the objects clause of the memorandum of the company) is called *ultra vires* borrowing.

However, the courts have developed certain principles in the interest of justice to protect such lenders. Thus, even in a case of *ultra vires* borrowing, the lender may be allowed by the courts the following reliefs:

1. Injunction — if the money lent to the company has not been spent the lender can get the injunction to prevent the company from parting with it.
2. Tracing — the lender can recover his money so long as it is found in the hands of the company in its *original form*.
3. Subrogation — if the borrowed money is applied in paying off lawful debts of the company, the lender can claim a right of subrogation and consequently, he will stand in the *shoes of the creditor* who has paid off with his money and can sue the company to the extent the money advanced by him has been so applied but this subrogation does not give the lender the same priority that the original creditor may have or had over the other creditors of the company.

**EXCEPTIONS TO THE DOCTRINE OF ULTRA VIRES**

*There are, however, certain exceptions to this doctrine, which are as follows:*
1. An act, which is *intra vires* the company but outside the authority of the directors may be ratified by the shareholders in proper form.

2. An act which is *intra vires* the company but done in an irregular manner, may be validated by the consent of the shareholders. The law, however, does not require that the consent of all the shareholders should be obtained at the same place and in the same meeting.

3. If the company has acquired any property through an investment, which is *ultra vires*, the company's right over such a property shall still be secured.

4. While applying doctrine of *ultra vires*, the effects which are incidental or consequential to the act shall not be invalid unless they are expressly prohibited by the Company's Act.

5. There are certain acts under the company law, which though not expressly stated in the memorandum, are deemed impliedly within the authority of the company and therefore they are not deemed *ultra vires*. For example, a business company can raise its capital by borrowing.

6. If an act of the company is *ultra vires* the articles of association, the company can alter its articles in order to validate the act.

**CASE NOTES:**


It was held that the articles of association were a matter between the shareholders inter se, or the shareholders and the directors, and did not create any contract between the plaintiff and the company and article is either a stipulation which would bind the members, or else a mandate to the directors. In either case it is a matter between the directors and shareholders, and not between them and the plaintiff.

*The Directors, &C., of the Ashbury Railway Carriage and Iron Company (Limited) v Hector Riche* (1874-75) L.R. 7 H. L. 653.

The objects of this company, as stated in the Memorandum of Association, were to supply and sell the materials required to construct railways, but not to undertake their construction. The contract here was to construct a railway. That was contrary to the memorandum of association; what was done by the directors in entering into that contract was therefore in direct contravention of the provisions of the Company Act, 1862.
It was held that this contract, being of a nature not included in the Memorandum of Association, was ultra vires not only of the directors but of the whole company, so that even the subsequent assent of the whole body of shareholders would have no power to ratify it. The shareholders might have passed a resolution sanctioning the release, or altering the terms in the articles of association upon which releases might be granted. If they had sanctioned what had been done without the formality of a resolution, that would have been perfectly sufficient. Thus, the contract entered into by the company was not a voidable contract merely, but being in violation of the prohibition contained in the Companies Act, was absolutely void. It is exactly in the same condition as if no contract at all had been made, and therefore a ratification of it is not possible. If there had been an actual ratification, it could not have given life to a contract which had no existence in itself; but at the utmost it would have amounted to a sanction by the shareholders to the act of the directors, which, if given before the contract was entered into, would not have made it valid, as it does not relate to an object within the scope of the memorandum of association.

Shuttleworth v Cox Brothers and Company (Maidenhead), Limited, and Others, [1927] 2 K.B. 9

It was held that

- the contract, if any, between the plaintiff and the company contained in the articles in their original form was subject to the statutory power of alteration and
- if the alteration was bona fide for the benefit of the company it was valid and there was no breach of that contract;
- there was no ground for saying that the alteration could not reasonably be considered for the benefit of the company;
- there being no evidence of bad faith, there was no ground for questioning the decision of the shareholders that the alteration was for the benefit of the company; and,
- the plaintiff was not entitled to the relief claimed.

In Re New British Iron Company, [1898] 1 Ch. 324

It was held that the article is not in itself a contract between the company and the directors; it is only part of the contract constituted by the articles of association between the members of the company inter se. But where on the footing of that article the directors are employed by the company and accept office the terms of art. 62 are embodied in and form part of the contract between the company and the directors. Under the article as thus embodied the directors obtained in a contractual right to an annual sum of 1000l as remuneration. It was held also that although these provisions in the articles were only part of the contract between the shareholders inter se, the provisions were, on the directors being employed and accepting office on the footing of them, embodied in the contract between the company and the directors; that the remuneration was not due to the directors in their character of members, but under the contract so embodied.
ying the provisions; and that, in the winding-up of the company, the directors were entitled to rank as ordinary credito
rs in respect of the remuneration due to them at the commencement of the winding-up.

*Rayfield v Hands and Others, [1957 R. No. 603.]*

Field-Davis Ltd. was a private company carrying on business as builders and contractors, incorporated in 1941 under t
he Companies Act, 1929, as a company limited by shares, having a share capital of £4,000, divided into 4,000 ordinary
shares of £1 each, of which 2,900 fully-paid shares had been issued. The plaintiff, Frank Leslie Rayfield, was the registe
red holder of 725 of those shares, and the defendants, Gordon Wyndham Hands, Alfred William Scales and Donald Da
vies were at all material times the sole directors of the company. The plaintiff was a shareholder in a company. Article
11 of the articles of association of the company required to inform the directors of his intention to transfer shares in t
he company, and which provided that the directors “will take the said shares equally between them at a fair value.” In
accuracy with this the plaintiff so notified the directors, who contended that they need not take and pay for the plai
ntiff's shares, on the ground that the articles imposed no such liability upon them.

The plaintiff's claimed for the determination of the fair value of his shares, and for an order that the directors should p
urchase such shares at a fair value. It was found that the true construction of the articles required the directors to pur
chase the plaintiff's shares at a fair price. Article 11 is concerned with the relationship between the plaintiff as a memb
er and the defendants, not as directors, but as members of the company.

*Guinness v Land Corporation of Ireland, (1883) L.R. 22 Ch. D. 349*

The Land Corporation of Ireland, Limited, was incorporated under the Companies Act on the 12th of July, 1882, as a co
mpany limited by shares. By the memorandum of association of a company limited by shares it was stated that the obj
ects of the company were, the cultivation of lands in Ireland, and other similar purposes there specified, and to do all
such other things as the company might deem incidental or conducive to the attainment of any of those objects.

The 8th clause of the articles of association, provided that the capital produced by the issue of B shares shall, so far as is
ecessary, be applied in making good to the holders of A shares the preferential dividend of £5 per cent., which they
are to receive on the amounts paid up on their shares. This action was brought by one of the B shareholders on behalf
of himself and the others, to restrain the directors from issuing any A shares on the footing of their being entitled to th
e benefit of that article, and to restrain the directors from applying in accordance with it the capital arising from the B
shares.

It was held that the application of the B capital provided for by the articles is not an application of capital to carrying o
n the business of the company, but is providing an inducement to people to take shares and subscribe capital to carry
on the business and that article 8 was invalid, as it purported to make the B capital applicable to purposes not within t
he objects of the company as defined by the memorandum of association, and in a way not incidental or conducive to
the attainment of those objects, and that the directors must be restrained from acting upon it. The articles of associati
on of a company cannot, except in the cases provided for by sect. 12 of the Companies Act, 1862, modify the memora
ndum of association in any of the particulars required by the Act to be stated in the memorandum.
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