

“The Doctrine of Ultra Vires: The Rise and Fall”

Rohan Jajodia

Sinhgad Institutes NBN College of Commerce, Lonavla

Companies are formed with a particular goal for their business. There has to be some official document in black and white that governs and regulates the scope of business of companies. Or else there would just be all companies entering into all sorts of business activities ending up into an unregulated market and chaos. For this purpose, the Memorandum of Association of a company has an **object clause** *inter alia* other clauses. The object clause of the Memorandum states the objects for which the company is formed. This necessarily implies that the company can't go beyond the object clause and do any sort of activities. If they do so, the act is known as *ultra vires*. A company is bound by its object clause and therefore, whatever business it carries out has to be within the meaning and purview of the object clause given in the Memorandum of Association.

The phrase "Ultra vires" is a combination of two Latin words that mean "beyond the powers". If an act requires backing of legal authority and is done with such legal authority, it is termed in law as an *intra vires* act, literally meaning "within the powers" and if the same is done without a legal authority, it is an *ultra vires* act. Subsequently, acts that are *intra vires* are termed "valid" and the ones that are *ultra vires*, "invalid". The Doctrine of *ultra vires* typically applies to a corporate body, like a limited company, or a government department or may be a local council so that any act done by such body, which goes beyond its capacity, will be considered void. This doctrine was enacted to protect the interest of the investors and creditors of the company. It literally means that the company and / or the Directors have exceeded the powers vested in them by the Memorandum of Association. The Doctrine is also attracted when the Directors exceed the powers delegated to them, but in such case they are held personally liable for their acts.

ORIGIN:

The doctrine of *Ultra vires* was first mentioned in 1875 in the landmark judgement of *Ashbury Railway Carriage and Iron Company (Limited) v Hector Riche*¹, where, as per clause 3 of the Memorandum of Association of Ashbury Railway Carriage and Iron Company, it was involved in the "maintenance, making - selling or lending on hire, railway carriages". Acting beyond its' scope, the company extended a loan and entered into a contract for building of railway in Belgium with Riche. At a later point in time, the company refused to execute the contract by saying that this act of extending loan to Riche for building of railways is beyond its' object clause. Riche sued the company for non-performance of the contract and the company pleaded the doctrine of *Ultra Vires*. Riche argued that the contract was ratified by the Directors of the company and hence, should be enforceable. It was held that even if all the shareholders or directors ratify a contract, if it is beyond the object clause

¹(1875) LR 7 HL 653

it is rendered void. It will be as good as never entered into. Therefore, the company could not be made to perform this contract.

This rule came into existence as a preserver of the corporate fund in the hands of "that impalpable thing the corporation"². There are three very pertinent and imperative reasons for the conservation of corporate capital by way of doctrine of ultra vires :

Firstly, the contributors of the capital, namely, the company's share-holders, agree to part with their money permanently on the faith that it shall be invested in the stated objects and in no others.³

Secondly, "the creditors give credit to the company on the faith of the implied representation that the capital shall be applied only for the purposes of business."⁴

Thirdly, stability in corporate business can be best attained by stabilising business and by preventing proliferation of activities. That also prevents concentration of economic power.⁵

Further affirming the judgement of this case was the judgement of *Attorney General v. Great Eastern Railway Co*⁶, in which it was held that the doctrine laid down in the *Ashbury* case was legit, but the doctrine "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 also has its presence in India. The Bombay High Court for the first time applied the doctrine of ultra vires in *Jahangir R. Modi V ShamjiLadha*⁷. The landmark case of *Laxman Swami Mudaliar v LIC of India*⁸ upholds the Doctrine of Ultra Vires in India. It was held in this case that an *ultra vires* act continues to be *ultra vires* even if all the shareholders agree to it. The judgements mentioned above had the same effect. The result was evasion of the Doctrine of Ultra Vires. The companies started framing such an object clause that included every possible business activity. This was done to expand the scope of business by the companies thereby, avoiding to attract the Doctrine of Ultra Vires. The objects were vague and wide and the clause was made in a manner where the ancillary objects were made independent of the main objects.

To check if an is *ultra vires* or not, the main object of the company must first be ascertained, then the special provisions or powers (if any provided in the memorandum) for effecting that special purpose must be looked for. If the said act neither falls within the main object nor the

²Flitcroft case, (1882) 21 Ch D 519 at pp. 533-34

³Waman Lal v. Scindia Steam Navigation Co., AIR 1944 Bom 131 at p. 135

⁴Flitcroft case, (1882) 21 Ch D 519 at pp. 533-34.

⁵D.L. Mazumdar: *Towards a Philosophy of the Modern Corporation*, 119, (1967)

⁶(1880) 5 App Cas 473

⁷(1866-67) 4 Bom HCR 185

⁸1963 AIR 1185

special powers expressly provided by the statute, then the question to be answered is whether the act is incidental to or consequential upon. An act will not be considered *ultra vires* if it :

- (a) Falls within the purview of the main object ;
- (b) Falls within the special powers explicitly given by the statute ;
- (c) Falls neither within the main object nor the special powers given by the statute but is incidental to or consequential upon the main object

The doctrine of *ultra vires* assumed a vital part in the improvement of corporate development. Despite the fact that to a great extent it is now obsolete in present day private company law, the precept stays in full drive for government companies. An *ultra vires* act is one beyond the objectives and powers of a company. The earliest known lawful perspective on such acts was that such acts were void. Under this approach a company was framed just for specific and limited purposes and could do just what it was approved to do in its corporate charter.

To decide such a case it does not matter whether the business is authorized to enter a particular business or not, but the question is : Has the main object failed? Is it equitable that the company should be allowed to continue to operate?⁹

As was quoted by Browne-Wilkinson L.J. in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation*¹⁰ : “The question whether a transaction is outside the capacity of the company depends solely upon whether, on the true construction of its memorandum of association, the transaction is capable of falling within the objects of the company.”

It is noteworthy to see, that the Doctrine of *ultra vires* has gradually and steadily been given wide interpretation and extended by the courts, to cover not only orders and decisions made in excess of power delegated, but also to cover various other heads of judicial review, such as, failure to observe and implement rules of natural justice, irregular delegation of power, unreasonableness, breach of jurisdictions, improper motives, and similar other inconsistencies that can be considered wrong enough to amount to *ultra vires*.

CONSEQUENCES OF ULTRA VIRES TRANSACTIONS

A contract that goes beyond the objects clause of the company's memorandum is an *ultra vires* contract and therefore, cannot be enforced by or against the company as was decided in the cases of *In Re, Jon Beaufore (London) Ltd*¹¹ and in *S. Sivashanmugham And Others v. Butterfly Marketing Private Ltd*¹².

Like most other acts, a borrowing beyond the power of the company (i.e. overhauling the objects clause of the memorandum of the company) is termed *ultra vires* borrowing.

⁹Milton Boulter , *Corporations and the Doctrine of Ultra vires*

¹⁰[1986] Ch 246

¹¹(1953) Ch. 131

¹²(2001) 105 Comp. Cas Mad 763

However, the courts have initiated certain principles and provisions in the interest of justice to protect such lenders who are unaware of the ultra vires borrowing by the company. This is due to the fact that it is an assumption on the part of a third party that the company is acting within its authority and not beyond the powers delegated to it.

It has been held in *White and another v South Derbyshire District Council*¹³ that :

"An ultra vires act is not necessarily void for all purposes and the law would strive to protect innocent third parties who had relied upon the apparent validity of such an act"

Therefore, even in a case of ultra vires borrowing, the lender can avail any of the following reliefs:

(1) Injunction — This relief can be exercised if the money lent to the company by the lender has not been spent. In such a case, the lender can get an injunction to stop the said company from parting with the borrowed money.

(2) Tracing— The lender has the option of recovering the lent money so long as it is found in possession of the company in the original form, as it was lent.

(3) Subrogation— In case the borrowed money is utilized in paying off the lawful debts of the borrowing company, the lender has the right of subrogation and subsequently, he will then be standing in the shoes of the creditor who has been paid off by the company with his money and therefore, can sue the company to the extent of the money advanced by him. But, it is important to note here that this right of subrogation does not give the lender the same priority and importance like that of the original creditor.

OTHER EFFECTS:

(4) Personal liability of Directors- The directors have the duty to supervise and make sure that the funds of the company are used only for the legitimate business of the company, as mentioned in the Memorandum of Association. His duty is also to make sure that everybody works well within the frame of their authority. If the funds of the company are utilized for a purpose foreign to the memorandum or if someone, including the directors themselves acts beyond the object clause, the directors will be personally liable for it.

(5) Ultra vires property- If a company spends money in an ultra vires act, by purchasing some property, the company's right over that property is held secure. This is because that asset, even though wrongfully acquired, represents the company's corporate capital.

(6) Ultra vires contracts - An ultra vires contract is *Void Ab Initio*, and is incapable of being *intra vires* by ratification, lapse of time, estoppel, acquiescence or any delay. No performance of either parties can give an unlawful contract validity or right of acting upon it.

EXCEPTIONS TO THE DOCTRINE OF ULTRA VIRES:

¹³[2013] P.T.S.R. 536 90 (UK Case)

There are, however, certain exceptions to this doctrine, certain circumstances, when this doctrine isn't applicable, which are as follows:

1. An act, that is intra vires the powers of the company but is outside the authority of the directors specifically, may be ratified by the shareholders in a proper manner and format.
2. An act which is intra vires to the company but is done in an irregular way, may be made valid with the consent of shareholders. However, the law does not need the consent of all the shareholders.
3. If the company acquires any property by way of an investment, which is ultra vires, the company's right over this property shall still deem to be secured.
4. While applying the doctrine of ultra vires, the consequences that are incidental or consequential to the act will not be considered invalid unless they are explicitly prohibited by the Company's Act.
5. There are a number of acts under the Company law, which although are not expressly stated in the memorandum, but are still deemed impliedly within the authority and power of the company and subsequently they are not deemed ultra vires.
6. If any act of the company is deemed ultra vires of the Articles of Association, the company has the option to alter its articles in order to validate the said act.

ULTRA VIRES v ILLEGALITY

An Ultra Vires act is not necessarily an illegal act. Although, in most cases it turns out to be illegal but an ultra vires act doesn't necessarily imply illegality. The two are overlapping terms, but are not the same. It will be easier to understand by way of an example. Suppose an automobile company involved in manufacture provides accommodation to its employees and spends a good chunk of money in that. This act is neither illegal nor prohibited by the statute; but it goes beyond the scope of the company's object clause and the company is also spending on this act, therefore, it is ultra vires of the company.

Whereas, taking another example, where the same company hires a gangster to murder a competitor, the act is illegal as well as ultra vires. Therefore, it is important to understand the difference between an illegal act and an ultra vires act because every ultra vires act cannot be treated as an illegal one.

CRITICISMS:

The doctrine of Ultra Vires has been surrounded with a lot of controversy. It has done more harm than good because of the fact that after implementing this doctrine and bringing the faulty companies under the purview of this doctrine, the companies have now started

manipulating the object clause under the Memorandum of Association. The companies use the tactics of making a wide and vague object clause that includes almost all sorts of possible business activities and is such that makes the ancillary objects of the company independent of the main objects. Whereas, ideally the ancillary objects are made to assist or act as a support to the main objects. The vague and wide object clauses imply a situation where a company is free to do any and all sorts of business activities thereby escaping any liability under the Doctrine of Ultra Vires. This has resulted in all companies entering into all the markets and making the markets highly unregulated and chaotic.

The purpose of the doctrine was to bar the companies from entering into activities beyond their scope, but the companies now have included everything within their scope via their objects clause, so that nothing can be "ultra vires" for them.

ABOLITION

About scrapping down of the doctrine, the first report known is of the Cohen Committee which was submitted in the 1945. It suggested the abrogation of this doctrine, calling it to be the deceptive insurance for all the shareholders and a trap for the third parties dealing with the company. The members of the committee considered that the whole idea of the doctrine of ultra vires has no positives, in fact, it is a reason for pointless prolixity and vexation. Similar views were given by the Bhabha Committee which was appointed by the Government of India with the object of overhauling of the company legislation in India. The member of the committee presented its report in 1952 based on which the old Companies' Act of 1913 was revoked and the new Companies' Act of 1956 was acquired to and brought into effect from 1st April 1956. The Bhabha committee had similar views on the Doctrine of Ultra Vires as did the Cohen Committee. This Doctrine was merely an illusory protection for the shareholders and a loss for the third party that deals with the company.¹⁴

As the status quo is, under the new Companies Act, 2013 the doctrine of ultra vires gives a right to the members and depositor(s) of the companies to file an application to the Tribunal on behalf of its' members or depositors to restrain the company from committing any act which is ultra vires of the articles or memorandum of association of the company vide Section 245(1)(a) of the new Companies Act, 2013.

CONCLUSION

The English Court of Appeal, in *Rolled Steel Products Ltd v. British Steel Corporation*¹⁵, has expressed its opinion that a confusion has crept into the common law systems because of the multiple use of the phrase "ultra vires" in its different senses and connotations, and that this

¹⁴Hari Ram Yadav, *Doctrine of Ultra Vires under Companies Act, 1956*

¹⁵[1985] 3 All E.R. 52.

phrase, in the context of company law should be strictly confined to transactions that are beyond and above the corporate capacity of a company and should not include transactions that are merely in abuse of powers of the company.

It is unavoidable that this doctrine has created a fuss in the companies regulations, but it is as important to have this doctrine. Its striking down will only result in utter confusion and a hay wire situation. Striking it down will result in another set of problems. Therefore, it is highly recommended that this doctrine be more specific and pin pointed on what can be considered ultra and intra. It shouldn't be open to interpretation or be subjective. A uniform and clear doctrine of what a company can or cannot do is what is the need of the hour. To put it on better terms ,

"Where before the emphasis in case law was upon the decision of the non-illegality of an ultra vires act, so that a defence to the act might not be sustained, the express abolishment of the ultra vires defence raises a new problem making the old distinction necessary, but from a new point of view".¹⁶

¹⁶John E. Kennedy , *Corporations: Powers -- Ultra Vires -- Problems Remaining after Legislative and Judicial Modification of the Doctrine*