

Applications of the Doctrine of Ultra Vires in Developed Countries and Developing Countries

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ABSTRACT

Ultra vires is the term used for the acts of a company beyond the powers prescribed by the object clause of the memorandum. Ultra vires acts of a company are void and cannot be ratified even if all the directors wish to ratify it. The development of the doctrine of ultra vires can be traced back to the establishment of limited liability principle in 1855. However, the doctrine became more stern and solid after the Ashbury railway carriage case of 1885. The doctrine of ultra vires was developed to protect the creditors and investors. The doctrine of ultra vires was applicable in all countries, however in modern days; it has been abolished in the developed countries. The doctrine is still observed by the developing countries.

KEYWORDS: ultra vires, object clause, memorandum, application of ultra vires, effects of ultra vires.

1 INTRODUCTION

Company is A legal entity, allowed by legislation, which permits a group of people, as shareholders, to apply to the government for an independent organization to be created, which can then focus on pursuing set objectives, and empowered with legal rights which are usually only reserved for individuals, such as to sue and be sued, own property, hire employees or loan and borrow money. However, the powers exercised by the company being a legal entity are subject to certain restrictions. The memorandum of the company contains an object clause which states about the object for which the company is formed. The company must not go beyond the object clause. There acts must be limited to the object clause otherwise they will be termed as ultra vires (Rajak, 1995).

The term ultra vires is the combination of two words. 'Ultra' means beyond, and 'vires' means powers (ultra vires. n.d.). Thus ultra vires means an act beyond the powers. If an act is beyond the powers conferred to a company by the object clause of the memorandum will be termed as ultra vires. The ultra vires act cannot be ratified even if all the directors of the company wish to ratify it (Wedderburn, 1957). This is known as doctrine of ultra vires.

The ultra vires act, which is beyond the object clause of the memorandum, is void. An illegal act is also void. However, an ultra vires act is void even if the act in general is legal. Similarly, an illegal act is void even if it is provided by the object clause of the memorandum.

1.1 Exceptions to the doctrine of ultra vires

There are certain exceptions to the doctrine of ultra vires.

- An act which within the object clause of the company but outside the authority of directors can be ratified by the share holders (French et al, 2013).
- The share holders may validate an intra vires act performed in irregular manner.

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- If the company acquired any property through an ultra vires investment, even then the company right over that property shall be secured.
- An incidental or consequential effect of an act shall not be considered as ultra vires, unless it is expressly prohibited by the statute.

1.2 Origin of the doctrine of ultra vires

The ultra vires doctrine of the company was first introduced in relation to statutory companies. The importance of the doctrine was increased after 1855 with the establishment of principle of limited liability. Before 1855 the companies were governed by the rules of partnership. Such rules usually protect the investors. However, after the development of principle limited liability, the creditors and investors found themselves less protected. In order to ensure the investors and creditors to be protected, a path way towards the development of doctrine of ultra vires was made. The companies were required to have two important documents, the memorandum of association and article of association (Gonga, 2002). The memorandum should state about the object of the company and the company should not go beyond its object. Thus doctrine of ultra vires was evolved.

The doctrine of ultra vires was firmly established after the decision of House of Lords in the case of *Ashbury Railway Carriage and Iron Company v. Hector Riche*. The facts of the case were as such that The Ashbury Railway Carriage and Iron Company was incorporated under companies' act 1862. The objects of the company were to make and sell, or lend on hire, railway carriages and wagons and all kinds of material for the construction of railway. The directors of the company purchased concession for making railway in a foreign country. However, the company enter into contract with another corporation in that country to provide material for the construction of railway and receive periodical payments from the English company. The contract was against the object of the company which stated that the company should sell the materials for the construction of railway and the contract here was to construct a railway. The House of Lords declared the contract as void as it was a clear violation of the object of the company (Rajak, 1995).

2 Effects of ultra vires contracts

The doctrine of ultra vires has been developed to protect the interests of the creditors and investors in cases if the company acts beyond its object. However, if the company enter into an ultra vires contract with a person, how can the interests of that person are protected? The principle governing such kind of contracts is that "buyer should be vigilant". Cases regarding the doctrine of ultra vires clause of the company's memorandum have developed certain effects of the ultra vires contracts. Give below are some of the effects of ultra vires contracts made by the company.

- a) The contracts which are beyond the object of the company as specified in the object clause of the memorandum of the company are ultra vires and cannot be enforced either by the company or against the company. This effect was established by the decision of the court in *Re, Jon Beau fore (London) Ltd* (1953).
- b) The borrowing of the company beyond the powers granted to it by the object clause of memorandum is ultra vires borrowing. They cannot be enforced against the company. However, the courts of law have developed certain principles for protecting the interests of bonafied lenders. The following reliefs may be granted, by the court, to the lenders even if the borrowing is ultra vires:
 - Injunction-- the lender can get the injunction to prevent the company from parting the money lent by it in case if the lent money has not been spent.

- Tracing-- another relief for the lender is that he may recover his money if found that the money lent by the company is not spent and is in its original form.
- Similarly, another relief for the lender is the subrogation. It means that if the money borrowed by the company is for the payment of the lawful debts of the creditors, the lender can step into the shoes of the creditors and claim his money. However, such kind of subrogation does not give the lender priority over the other creditors.

3 Application of the doctrine of ultra vires

The main theme of the doctrine of ultra vires is to protect the interests of investors and creditors. It prevents a company from investing its capital other than the purpose prescribed in the object clause of the memorandum of the company. The doctrine of ultra vires assures the creditors and investors that their money cannot be used for a purpose other than the agreed object at the time of investing their money in the company. Thus, this doctrine also enables the investors and creditors to have a thorough knowledge of the object of the company, so that their investment should not be used in unauthorised activities. Moreover, the company may go into insolvency while doing an unauthorised business and the creditors of the company cannot be paid in such circumstances, this doctrine prevents the company from doing unlawful business which may result in insolvency. Thus, it protects the creditors.

Initially the doctrine of ultra vires was observed by all the developed and developing countries alike. However, with the passage of time the corporate business in developed countries expanded with more speed than in the developing countries. Amendments were made to the doctrine of ultra vires in order to bring it in conformity with the current scenario of the corporate business.

3.1 Doctrine of ultra vires in Developed countries

The doctrine of ultra vires was strictly observed after 1885 from the Ashbury railway carriage case. However, the virtual abolition of the ultra vires clause was made by the section 35 of the companies' act 1985 as amended by the companies' act 1989. This enabled the company to act beyond the powers granted to it by the memorandum. Section 35 stated that the any act of the company shall not be called into question merely on the ground of having lack of capacity by reason of anything in the company's memorandum. It means that a company can be engaged in a lawful business whether such business is provided by the object clause or not. The temporary elimination of ultra vires rule becomes firm and permanent by the companies' act 2006 that came into force in October 2009. The act removed the requirement of the memorandum of association for a company that actually has the object clause. The company can now do any kind of business it wishes to do unless it is specifically prohibited by its constitution.

Advantages. The abolition of the ultra vires rule resulted in the prosperity of the companies. A single registered company can do several different businesses at the same time. A company can also make contracts for the improvement of its business. The elimination of object clause not only removes the legal formalities for the company to expand its business but also helps in the economic growth and prosperity of the company.

Disadvantages. The main disadvantage of the elimination of ultra vires rule is that the creditors and investors do not have any idea about what kind of business should be carried out by the capital raised from them. The investment in the company has become like gambling for the creditors and investors. Moreover, monopolies may be created by the large corporations in the market, thus creating hurdles for nascent companies to flourish.

3.2 Doctrine of ultra vires in developing countries

In developing countries like Pakistan and India, the doctrine of ultra vires is fully effective. Two important documents are required for the registration of the company. One is the memorandum of association and the other is the article of association. Memorandum of association which is usually known as the external constitution of the company must contain the object clause. The object clause of the company shall state about the type of business carried out by the company. The object clause of the company must be open to general public and investors. The company shall not deviate from the object specified in the memorandum of association. The acts beyond the object of the memorandum shall be considered as ultra vires.

Advantages. The main advantage of doctrine of ultra vires is to protect the interests of creditors and investors. This doctrine prevents the capital of company to be utilized in the activities other than prescribed by the object clause of the memorandum. It enables the investors and creditors to know about the business that should be carried out by the company through the money raised from them. Thus, assures them that their money shall not be used in unauthorised activities. Similarly, the doctrine also puts check on the directors and prevents their deviation from the prescribed object.

Moreover, the strict adherence of the companies to their object clause prevent them from starting business other than allowed by the object clause, thus discourage monopolies of large corporation in the market. In other words the business market remains open for a number of companies to take initiatives and develop businesses.

Similarly, the economy of developing countries mainly depends on the revenue collected from various corporations. The doctrine of ultra vires encourages people to register new companies as the object clause of a company may not cover all aspects of business. Thus, increases the economic growth of the country.

Disadvantages. Besides the advantages of ultra vires doctrine, it has several disadvantages too. One of the disadvantages of this doctrine is that it narrows the scope of business carried out by a company. It prevents a company from widening its business by making contracts with other corporations mere on the grounds of lack of capacity as prescribed by the object clause.

Another main disadvantage of ultra vires doctrine which in fact was the cause of its abolition in developed states is that it permitted the corporations to take the benefits of the contract and then refuse to perform the obligation on the ground that the contract was ultra vires and thus void.

4 Conclusions

The doctrine of ultra vires is developed to protect the investors and creditors. This doctrine prevents the companies to act beyond the powers granted to it by the object clause of the memorandum. An ultra vires contract cannot be enforced by the company. The main reason for the development of the doctrine was to protect the interests of the creditors and investors in to order assure them that their investment shall not be invested in unauthorized activities by the company. However, the doctrine was misused by the corporations which resulted in the abolishment of the doctrine in developed countries. The companies after taking the benefits of the contracts usually refused to perform the obligations on the grounds that the contract was ultra vires. Although the abolishment of doctrine has removed the evils of its misuse, yet it brings its own evils too. The abolishment of doctrine has created ambiguity about the object of the company. The investors and the creditors do not have any idea about what kind of business shall be raised through their investments. However, the doctrine still remains effective in developing countries.

No doubt, the abolishment of the doctrine by the developed countries is in the interest of both the states and the corporations. The reason is that usually large corporations are working in developed states. The revenues collected from these corporations are proportional to their business. The larger the business

of the company, the greater amount of tax should be paid by them. However, the developing countries, where small and private companies are working, the ultra vires rule is strictly observed and the companies are restricted to their object clause. Tax is collected from the newly formed companies through registration fees. It is in the interest of the developing countries to register more companies. For this reason they have made it much easier to register a company as compared to the developed states.

It is concluded from the discussion that doctrine of ultra vires has both useful and harmful effects. Different jurists argue that rigidity is the main defect of law and suggest that laws must be in conformity with needs of the society. The same rule has been applied to the doctrine of ultra vires. The doctrine has been eliminated from the developed countries as there was a need for its abolishment. While according to the needs of the developing countries, the rule is still observed by them.

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