

The Rise and Fall of the *Ultra Vires* Rule in Corporate Law

Stephen Griffin

The purpose of this paper is to examine the historical development of the law in relation to its regulation of a registered company's capacity to enter into contractual relationships. The paper's focal point of discussion will be concerned with the applicability of the *ultra vires* rule; a rule which when it was originally conceived sought to restrict contractual capacity to specified objects contained within the company's memorandum of association. Accordingly, the paper will discuss the justification for the application of the *ultra vires* rule to incorporated companies, the subsequent judicial curtailment of the rule and finally, the eventual statutory abrogation of the rule in relation to a company's contractual dealings with third parties.

The *Ultra Vires* Rule

Prior to legislative reforms, culminating in those contained within the Companies Act 1989, the *ultra vires* rule was a regulatory device which sought to prevent a registered company from entering into any type of transaction which exceeded the scope of the company's contractual capacity; contractual capacity being determined by the contents of a company's object clause.¹ Where a transaction was *ultra vires* and void not even the unanimous consent of all shareholders would be able to reverse the effect of the transaction's invalidity.

The application of the *ultra vires* rule to corporations was first evident in the form of contractual restraints placed upon statutory companies which had been formed in the nineteenth century in the wake of an expansion in economic activity.² Statutory companies, formed primarily in connection with the utility industries were created by individual Acts of Parliament. The creating statute would inevitably contain limitations upon the statutory company's contractual capacity. A statutory company which transgressed its contractual capacity would be deemed to have acted *ultra vires* and

¹ The object clause is contained within the company's memorandum of association. The memorandum of association together with the articles of association constitute the company's constitutional framework. The constitutional framework represents a binding agreement between the company and its membership.

² For a detailed historical account of the emergence and application of the *ultra vires* rule, see Rajak (1995) 26 Cambrian Law Review 9.

accordingly the transaction would be deemed void.³

Until the introduction of the Joint Stock Companies Act 1856, the *ultra vires* rule had no application to a joint stock company. A joint stock company was one created in compliance with registration procedures laid down by a governing statute, the first such governing statute being the Joint Stock Companies Act 1844. Prior to 1856, the contractual capacity of a joint stock company was of a similar nature to that of a business partnership. Accordingly, any contractual act or transaction would be valid providing it was ratified by the unanimous consent of the company's membership.

The 1856 Act⁴ was aimed at altering the aforementioned partnership type relationship and was deemed necessary following the enactment of the Limited Liability Act 1855. The 1855 Act permitted joint stock companies to be incorporated on the premise that the members of such companies would be afforded the protection of limited liability. Consequently, the position of prospective company creditors was rendered insecure because the logical consequence of the introduction of limited liability meant that a company's membership was able to avert their own personal liability for corporate debts. To protect creditors, and also to secure the investment interests of existing and future shareholders, the legislature considered it appropriate to regulate the ambit of corporate capacity.

The 1856 Act specified that a company should include an objects clause within its memorandum, a clause which would define the contractual capacity of the company. However, in so far as the 1856 Act failed to stipulate any method by which an alteration of an objects clause could be achieved, the status of the clause and its effect on contractual capacity was unclear. 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 objects clause subsequent to the company's registration. Alternatively, by failing to expressly state that an 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

3 See eg, *Eastern Counties Railway Co v Hawkes* (1855) 5 HLC 331.

4 The Companies Act of 1856 replaced the deed of settlement with the memorandum and the articles of association.

capacity would have been seriously weakened.

The problem surrounding the interpretation of the 1856 Act was to some extent improved by the implementation of the Companies Act 1862 which, *inter alia*, attempted to resolve the ambiguity surrounding the status of the objects clause. The 1862 Act provided, in respect of the company's memorandum, that save for two exceptions, the memorandum could not be altered.⁵ However, the 1862 Act, while planting the seeds from which the application of the *ultra vires* rule would subsequently flourish, was not, however, conclusive as to the extent and nature of the legal effect of an objects clause. The ambiguity existed because the 1862 Act failed to prevent a company from including objects which could cover every conceivable form of corporate transaction. The clarification of the legal nature and contents of an objects clause required judicial elucidation. The elucidation was applied in *Ashbury Railway Carriage and Iron Co v Riche*.⁶

In *Ashbury* the House of Lords was obliged to decide between two interpretations of the 1862 Act, namely:

- a) that the legislature must be deemed to have conferred all the powers of a natural person upon a company unless such powers had been taken away either expressly or by implication,⁷ or alternatively;
- b) that any matter which was not authorised expressly or by necessary implication within a company's objects clause must be taken to have been forbidden.

The House of Lords preferred this latter interpretation on the premise that it secured the protection of creditor interests. However, the House justified its decision in terms of both shareholder and creditor protection. Shareholders would be protected because a company would be unable to alter the direction of its business other than to follow its stated objects. Therefore,

5 In accordance with section 12 of the 1862 Act, the two exceptions provided for a company's ability to (a) alter its objects clause to effect a change in a company's name and (b) alter the objects clause to effect a reorganisation of share capital.

6 (1875) LR 7 HL.

7 This view was supported by Blackburn J, in an equally divided Exchequer Chamber - *Ashbury Railway Carriage and Iron Co v Riche* (1874), LR Ex 224.

a prospective shareholder of a company could, by examining a company's memorandum, decide whether to invest in a company on the basis of its set objects. If a company subsequently attempted to deviate from its objects clause a shareholder could either seek an injunction to restrain the company from entering into an *ultra vires* transaction and/or where a company's main object (substratum) had failed, seek an order for the winding up of the company.⁸ In addition, where a company entered into an *ultra vires* transaction, any shareholder would be afforded the right to have the offending transaction set aside.

Corporate creditors would be protected because in entering into a credit agreement with a company they could, by examining the objects clause, discover the purpose and nature of the business for which the credit facilities were to be employed. However, somewhat perversely, a company's unsecured creditors had no right to petition for an injunction to prevent a company from entering into an *ultra vires* transaction,⁹ nor had the creditor the right to apply to the court for a winding up order on the failure of a company's substratum.¹⁰ Therefore, the unsecured corporate creditor was in a hapless position. Further, in the majority of commercial transactions unsecured creditors would be unlikely to attain actual notice of a company's objects clause due, on their part, to a lack of knowledge, inclination, or funds to expend on legal advice in relation to the construction of an objects clause.

A company's ability to include an elaborate and extensive set of business purposes within its objects clause was also precluded following the House of Lords decision in *Ashbury*. By employing the *eiusdem generis* rule of construction the House of Lords restricted the context in which objects were to be given effect. As such, objects were not to be given their true literal

8 The action for this type of winding up order is now embodied in s 122(1) (g) of the Insolvency Act 1986.

9 A secured creditor was, however, permitted to seek an injunction, see *Cross v Imperial Continental Gas Association* [1923] 2 Ch 553.

10 See eg, *Lawrence v West Somerset Mineral Railway Co* [1918] 2 Ch 250, *Mills v Northern Railway of Buenos Aires Co*, (1870) 5 Ch App 621. However note the judgment of Mocatta J in *Bell Houses Ltd v City Wall Properties Ltd* [1966] 1 QB, where the learned judge suggested that a third party could invoke the *ultra vires* rule against a company. In subsequent cases the suggestion was never followed, albeit that following the implementation of the Companies Act 1989, it may now be possible for a third party to contend that a transaction should be set aside (subject to s 35(3) CA 1985) on the basis that a company has exceeded its capacity.

meaning but instead had to be construed in the context of the company's main corporate object (the substratum rule). Accordingly, in *Ashbury*, an object which provided that the company could operate as 'general contractors' had to be construed in relation to the company's principal business objective which was one of mechanical engineering.¹¹

The Judicial Departure from the Ashbury Ruling

While accepting the validity of the *ultra vires* rule, the judiciary were, in cases after *Ashbury*, to weaken the strict application of the rule. While giving theoretical protection to both shareholders and creditors, the *ultra vires* rule, together with the constructive notice rule (under which a third party when contracting with a company was deemed to have constructive knowledge of the company's objects clause) was not conducive to commercial practice. The first authoritative example of the judicial departure from the approach taken in *Ashbury* was in *AG v The Great Eastern Railway Company*.¹² Here, the House of Lords, only five years after it had laid down the strict interpretation of the *ultra vires* rule, sought to weaken the *Ashbury* approach, by providing that the *ultra vires* rule should be applied reasonably. According to the House, it was legitimate for a company to pursue a course of business other than the one defined as the company's principal object, providing that the business purpose in question was reasonably incidental to the principal object. In addition, the House concluded that a company was entitled to employ any power reasonably incidental to the use of a company's stated objects, irrespective of the fact that the power use was not expressly provided for within the company's objects clause.

One of the most significant decisions in connection with the dilution of the applicability of the *ultra vires* rule occurred in *Re David Payne*.¹³ Prior to *Re David Payne* it had generally been considered that where a company entered into a contract and as a consequence of the resulting transaction subsequently pursued an activity outside its stated objects, then the contract

11 In *Ashbury* the disputed contract was concerned with the company's employment as finance agents for a Belgian railway company. The said activity was held *ultra vires* and void on the basis that it had nothing to do with mechanical engineering.

12 (1880) 5 App Cas 473 HL.

13 [1904] 2 Ch 608.

which facilitated the breach of contractual capacity would itself be of an *ultra vires* nature.¹⁴ The *Re David Payne* decision redefined the significance and effect of the *ultra vires* rule in so far as it emphasised that the rule was not concerned with how a particular transaction had been conducted or how a company power had been employed, but rather, whether or not the company in question had the capacity to conduct the transaction or employ the relevant power in question.

In *Cotman v Brougham*¹⁵ the applicability of the substratum rule was impliedly abolished; albeit that the abrogation of the substratum rule was not effected by a judicial concern for its potentially adverse effect upon commercial practice. In *Cotman*, the House of Lords departed from both the substratum rule and the *eiusdem generis* rule of construction on the premise that it was obliged to accept that where a company's memorandum had been approved by the registrar of companies, such approval was conclusive evidence of the fact that all the requirements of the Companies legislation had, in relation to company registration procedures, been adhered to.¹⁶

In *Cotman* the memorandum failed to clearly specify the objects of the company; it did not limit and identify the objects in a plain and unambiguous manner. The House of Lords doubted whether the memorandum should have been approved by the registrar of companies. However, as stated, as it had been approved, the House was obliged to accept its validity. Accordingly, the validity afforded to the nature of the objects clause resulted in the acceptance of a set of objects which were not to be restrictively construed by reference to a main object. As such, no object contained within the company's objects clause was to be construed as subsidiary or ancillary to any other object.

Although the substratum rule in its application to third party transactions was impliedly abolished by the *Cotman* decision, it should be noted that in relation to a shareholder petitioning for the winding up of a company, the rule remained intact. Lord Parker of Waddington clearly made the distinction between the position of a shareholder and the position to be afforded to a third party transaction. Lord Parker stated that:

14 See eg, *Davies' case* (1871), LR 12 EQ 516.

15 [1918] AC 514.

16 Now s 13 of Companies Act 1985.

'... the question whether or not a company can be wound up for failure of substratum is a question of equity between a company and its shareholders. The question whether or not a transaction is *ultra vires* is a question of law between the company and third party.'¹⁷

In *Bell Houses Ltd v City Wall Properties Ltd*¹⁸ the scope of a company's permissible contractual capacity was to be further widened by the registrar of companies' approval of an objects clause which authorised a company to carry on any business whatsoever which, in the opinion of the directors, could be advantageously carried on by the company in conjunction with or ancillary to any of the businesses specified in the objects clause.

Following the decisions taken in *AG v The Great Eastern Railway Co*, *Re David Payne*, *Cotman v Brougham* and *Bell Houses Ltd v City Wall Properties Ltd*, the *ultra vires* rule had reached a point whereby its practical application was severely limited. However, it would be very misleading to suggest that it had been relegated to a rule of marginal importance.

The Confusion between Objects and Powers - The Misapplication of the *Ultra Vires* Rule

In *Re David Payne* the legal effect of the use of corporate powers was explained in the following manner. Where the use of the corporate power, (borrowing in the case of *Re David Payne*) was within the capacity of the company, the transaction to which the power use was applied would be voidable where the third party had actual notice that the purpose of the contract was to pursue a matter which was not authorised by the company's memorandum. The resulting transaction would be unenforceable unless it was ratified by a majority of the company's shareholders. Where however, the third party had no notice of the purpose to which the corporate power was to be applied, then the transaction would be valid, as held in *Re David Payne*.

17 *Cotman v Broughman*, per Lord Parker of Waddington at p 520. For an example of the application of the substratum rule in relation to a shareholder petitioning for a winding up order see, *Re German Date Coffee* (1882) 20 Ch D 169, but note *Re Kitson & Co Ltd* [1946] 1 All ER 435, where the Court of Appeal held that it was permissible for a company's substratum to have two, as opposed to one, principal objects.

18 [1966] 2 QBD 656.

Unhappily, the correct rationale of *Re David Payne* was subsequently confused with the *ultra vires* rule. In part, this confusion may be attributed to the reliance on a passage taken from the judgement of Buckley J in *Re David Payne*. In the offending passage, Buckley J had remarked that:

‘A corporation cannot do anything except for the purposes of its business borrowing or anything else; everything else is beyond its power and *ultra vires*.’¹⁹

This statement was relied upon in subsequent cases to support the view that if a company used an express or implied power, other than to pursue a transaction validated by the company's objects clause, then such a power use would be *ultra vires*. Such an interpretation was not representative of the correct rationale found in *Re David Payne*, indeed, if it had been, the loan transaction in *Re David Payne* would itself have been declared *ultra vires*. It is clear that the passage quoted from the judgement of Buckley J was an inappropriate representation of the true rationale of the decision.²⁰

Unfortunately, subsequent cases were to misleadingly construe the rationale of the decision taken in *Re David Payne*. In misconstruing *Re David Payne*, such cases confused the concept of corporate capacity with matters relevant to a lawful exercise of corporate powers. The starting point for this confusion was the case of *Re Lee Behrens and Co Ltd*.²¹ Here, the directors of a company granted a pension to the widow of a former managing director. Eve J, in finding that the company had an implied power to reward the spouses of faithful and long-standing servants of the company, nevertheless held that the pension award had been an *ultra vires* transaction. The learned judge considered the transaction *ultra vires* on the premise that it was not a *bona fide* transaction, having been entered into for a purpose other than to

19 Per Buckley J, *Re David Payne* at p 612.

20 In *Rolled Steel v British Steel Corporation* [1985] 3 All ER 52, Slade LJ suggested that the correct interpretation to be attributed to Buckley J's contentious statement was that in the use of the term '*ultra vires*' Buckley J had meant *ultra vires* the directors, as opposed to *ultra vires* the capacity of the company. This observation would explain the use of the term *ultra vires* in the context of the decision taken in *Re David Payne*.

21 [1932] 2 Ch 46.

benefit and to promote the prosperity of the company.²² With respect to the learned judge, the issue of contractual capacity should not have been concerned with determining matters of good faith or the promotion of the prosperity of the company. Eve J confused the issue of contractual capacity with matters relevant to the determination of an abuse of directors' powers. The transaction may have been considered voidable as a result of a breach of directors' powers but should not have been declared *ultra vires*.²³ Unfortunately, the rationale of the decision in *Re Lee Behrens* became widely accepted as applicable to the determination of an *ultra vires* transaction. The confusion between the nature of an *ultra vires* transaction and an abuse of corporate powers was to be commonly repeated in subsequent cases.²⁴

The Judicial Separation of the *Ultra Vires* Rule and the Law Applicable to Corporate Powers

The ambiguity resulting from the misinterpretation of *Re David Payne* was to remain entrenched in the judicial application of the *ultra vires* rule until the decision of Pennycuik J in *Charterbridge Corporation v Lloyds Bank*.²⁵ Here, a company (Castleford Ltd), agreed to enter into a mortgage with Lloyds Bank. The mortgage was taken over freehold properties with the objective of securing the indebtedness of other companies within a group of companies to which Castleford belonged. Without repaying the mortgage, Castleford subsequently sold the freehold properties to the Charterbridge Corporation. As the legal title to the properties remained with the Bank, Charterbridge, unaware at the time of contracting, of the existence of the mortgage with the Bank, claimed that the mortgage transaction had been an *ultra vires* disposition. The claim was based on the premise that the

22 *Ibid*, at p 51.

23 Eve J's confusion was clearly illustrated by his belief that the pension policy could have been ratified by the shareholders in general meeting. This could not have been the case if, as Eve J concluded, the pension policy had been an *ultra vires* disposition.

24 The principles of law enunciated in *Re Lee Behrens* were also relied upon in *Introductions Ltd v National Provincial Bank Ltd* [1969] 2 WLR 791, *Parke v Daily News Ltd* [1962] Ch D 927, *Re Ward M Roith Ltd 1967* 1 WLR 432 and *Re John Beaufortie* [1953] Ch D 131. For an excellent discussion on the confusion between corporate capacity and directors' powers see, C Baxter, *Ultra Vires and Agency Untwined* [1970] CLJ 280, see especially pp 286-293.

25 [1970] Ch 62.

transaction had not been entered into for the benefit of Castleford, but rather, that it had been executed for the benefit of other companies in the group of companies to which Castleford belonged.

As Castleford's objects clause included a power to mortgage its properties, Pennycuick J found that the company had the capacity to enter into the mortgage with Lloyds Bank. Pennycuick J opined that:

'... where a company is carrying out the purposes expressed in its memorandum and does an act within the scope of a power expressed in its memorandum that act is an act within the powers of the company. The memorandum of a company sets out its objects and proclaims them to persons dealing with the company and it would be contrary to the whole function of the memorandum that objects unequivocally set out in it should be subject to some implied limitation by reference to the state of mind of the parties concerned.'²⁶

In declaring that the transaction was not to be regarded as *ultra vires*, his lordship clearly rejected the reasoning behind the decision in *Re Lee Behrens*. Therefore, the 'benefit test' advanced in *Re Lee Behrens*, had no application to the determination of whether a transaction could be labelled *ultra vires*. Pennycuick J expressed the matter in the following way:

'... where the directors misapply the assets of their company that may give rise to a claim based on breach of duty. Again a claim may arise against the other party to the transaction, if he has notice that the transaction was effected in breach of duty. Further in a proper case the company may be entitled to have the transaction set aside. But all that results from the ordinary law of agency and has not of itself anything to do with the corporate powers of the company.'²⁷

26 *Ibid* at p 69.

27 *Ibid*.

Accordingly, Pennycuik J separated the issues involved in determining whether a transaction was of an *ultra vires* nature or, alternatively, one performed following an abuse of corporate powers. The confusion, so apparent in earlier authorities, had finally been identified and in this instance, resolved. The explanation and determination of the confusion between *ultra vires* transactions and transactions involving an abuse of corporate powers was subsequently to be confirmed in *Re Halt Garages*²⁸ and *Re Horsley Weight Ltd.*²⁹

Following the decisions in *Charterbridge Corporation v Lloyds Bank*, *Re Halt Garages* and *Re Horsley Weight*, the confusion associated with *ultra vires* transactions and transactions involving an abuse of corporate powers had, to a large extent, been resolved. However, the separation between an *ultra vires* transaction and one involving an abuse of corporate powers was not universally accepted. In some instances the 'benefit test', advanced in *Re Lee Behrens*, remained a relevant factor in the determination of an *ultra vires* transaction. For example, in *International Sales Ltd v Marcus*³⁰ Lawson J found that where a company had an express power to draw cheques, the power use would nevertheless be *ultra vires* where the power was employed to pursue an activity unauthorised by the company's memorandum (in this case a gratuitous disposition). Unfortunately, in reaching the conclusion that the transaction was an *ultra vires* disposition, Lawson J placed reliance upon the analysis of the law expounded by Eve J in *Re Lee Behrens*. Indeed, Lawson J remarked:

"I have also in this context read the judgement of Eve J ... which reinforces my conclusions that the handouts were *ultra vires*."³¹

However, the confusion between *ultra vires* transactions and an abuse of corporate powers was to be forcefully and finally resolved in *Rolled*

28 [1982] 3 All ER 1016.

29 [1982] 3 All ER 1045 CA.

30 [1982] All ER 511.

31 *Ibid*, at page 557.

SteelProducts Ltd v British Steel Corporation.³² In this case the Court of Appeal clarified and explained the nature of an *ultra vires* disposition. In a bold and positive leading judgement, Slade LJ killed off the applicability of questions related to directors' powers and corporate benefit when considering issues appertaining to the determination of a company's capacity to contract.

In accepting the true rationale of the decision taken in *Re David Payne*, Slade LJ destroyed any suggestion that the doctrine of *ultra vires* was interwoven with issues relating to an abuse of corporate powers. His lordship opined:

"The basic rule is that a company incorporated under the Companies Act has the capacity to do those acts which fall within its objects as set out in its memorandum ... or are reasonably incidental to the attainment of those objects. Ultimately, therefore, the question whether a particular transaction is within or outside its capacity must depend on the true construction of the memorandum. Nevertheless, if a particular act is of a category which on the true construction of the company's memorandum is capable of being performed as reasonably incidental to the attainment or pursuit of its objects it will not be rendered *ultra vires* the company merely because in a particular instance its directors in performing the act in its name are in truth doing so for the purposes other than those set out in its memorandum. Subject to any express restrictions on the relevant power which may be contained in the memorandum, the state of mind or knowledge of the persons dealing with it is irrelevant in considering questions of corporate capacity."³³

Following the decision in *Rolled Steel*, the *ultra vires* rule was rightly restricted to determining issues of contractual capacity. In resolving the nature of a company's contractual capacity the irrelevance of considering the extent of an improper exercise of corporate powers had finally been confirmed.³⁴

32 [1985] 3 All ER 52.

33 *Ibid* at page 85.

34 See A Clarke - *Ultra Vires after Rolled Steel* (1986) 7 Co Law 155.

The Statutory Reform of the *Ultra Vires* Rule

In relation to incorporated companies, the judicial construction of the *ultra vires* rule was for the most part aimed at curtailing the severity of its strict application in *Ashbury*. Parliament, on the other hand, was slow to act to either clarify the nature and extent of the rule or remedy its commercial inequalities.

The first statutory reform of the *ultra vires* rule was made, following the recommendations of the Cohen Committee.³⁵ Parliament, in passing Section 5 of the Company Act 1948, made it possible for companies to alter their objects clause by special resolution. This alteration power allowed companies a greater flexibility in relation to future transactions. However, although 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. Indeed, if for example, a company decided not to alter its objects clause to ensure the company's capacity was brought within the bounds of a proposed transaction, it followed that the company could subsequently refuse to proceed with the transaction on the basis that its performance would have constituted an *ultra vires* act. The likelihood of a company wishing to withdraw from a transaction would be rare but such a scenario could, for example, have occurred in a situation where a company's financial stability had declined to such an extent that the proposed transaction became an inopportune venture.

The implementation of a company's ability to alter its objects clause did little to modify the effect of the *ultra vires* rule. However, had the full set of recommendations advanced by the Cohen Committee report been given full statutory force the position would have been quite different. 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. Notwithstanding that the Cohen Committee had proposed to abolish the *ultra vires* rule in connection with third party dealings, the report still sought to retain the ability of the rule to safeguard shareholder interests. In effect, the Cohen Committee proposed that the objects clause should be relegated to the position of forming a constituent part of a company's articles

35 1945, (Cmnd 6659) para12.

of association, thereby affecting the exercise of directors' powers as opposed to a rule regulating the external contractual capacity of the company. Had the Committee's complete set of recommendations been enacted, then the confusion which emerged from the line of cases which followed on from the decision in *Re Lee Behrens*, would never have occurred.

In 1962 the Jenkins Committee recommended the abolition of the constructive knowledge rule in relation to third party dealings.³⁶ Other than where a third party had actual knowledge of the contents of a company's constitutional documents, the consequence of this proposal would have enabled a third party to enforce any transaction against the company. Indeed, the Jenkins Committee suggested that actual knowledge should not in itself defeat a third party transaction where the third party had honestly and reasonably failed to appreciate that the contents of an objects clause prevented the company from entering into the transaction.

Although the recommendations of both the Cohen and Jenkins Committee reports failed to attain statutory recognition, the *ultra vires* rule was to be subjected to a major reform following the UK's entry into the European Community. Section 9 of the European Communities Act 1972 was passed to comply with the EC's First Directive on Company Law.³⁷

The First Directive, Article 9(1) provides:

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

Article 9(2) provides:

'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

36 1962 (Cmd 1749) para 48. This proposal would have been wider than the Cohen Committee's recommendations because although the Cohen Committee wished to attribute the capacity of a natural person to a company the report did not propose the abolition of the constructive notice rule.

37 Directive 68/151, OJ, L 65/8.

been disclosed.’

The Article further provides that while individual member states are permitted to stipulate within national legislation that companies may escape liability in a situation where it can be proved that the other contracting party knew or could not have been unaware that the contractual transaction went beyond a company's objects, disclosure of the company's constitution should not of itself be sufficient proof of that knowledge.

Article 9(1) is clearly concerned with the capacity of a company to enter into contractual transactions. Read in conjunction with article 9(2), the effect of article 9(1) seeks to confer a company with an absolute contractual capacity in relation to its dealings with third parties. In addition, for the purpose of third party transactions, an abuse of a corporate power can never be relied upon as a valid excuse to invalidate the transaction. The implementation of the full force of Article 9 would have abolished the *ultra vires* rule in relation to third party transactions.

The First Directive was implemented into UK law by s 9 of the European Communities Act(EC) 1972. Section 9 EC Act 1972 was subsequently replaced, its wording unaltered, by s 35 of the Companies Act 1985. Section 35(1) in attempting to comply with Article 9(1), 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), s 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.'

In a situation where a third party acted in good faith in entering into a transaction with a company, the intention of s 35(1) was clearly one which sought to abolish the *ultra vires* rule in relation to third party dealings. Section

35(2), written in a similar vein to Article 9(2), sought to abolish the constructive notice rule.

The Inconsistency between Article 9 and Section 35³⁸

Whereas Article 9 deems that all acts ‘done by the organs’ of a company are to bind the company, s 35 only made acts binding where a person dealt with the company and as a result of such a dealing, a transaction was proposed. In the use of the words ‘dealing’ and ‘transaction’ as opposed to Article 9’s use of the term ‘acts’, s 35 failed to include gratuitous dispositions within its remit of contractual dispositions which would fall outside the ambit of the *ultra vires* rule.³⁹

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), s 35 used the term ‘good faith’ as the yardstick measure for those transactions which were to fall outside the protection of the section. It is suggested that the use of the term ‘good faith’ retained an ability to invalidate contractual acts beyond those which would be deemed invalid under Article 9. Although a third party with actual knowledge of a transaction having exceeded a company’s objects clause would necessarily be deemed to have acted otherwise than in good faith,⁴⁰ 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, and 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 a contention of bad faith could have been made out. In *Barclays Bank Ltd v TOSG*⁴¹, Nourse J considered the test for

38 This inconsistency produced much academic debate, see eg, Prentice (1973) 89 LQR 518 and Wyatt (1978) 94 LQR 182.

39 In *International Sales and Agencies Ltd v Marcus* [1982] 3 All ER 551, Lawson J held that the words ‘dealing’ and ‘transaction’ did imply a contractual relationship.

40 *Ibid*, Lawson J considered ‘good faith’ to be equivalent to the knowledge criteria test in Article 9.

41 [1984] BCLC 1.

'good faith' to be one whereby:

'a person acts in good faith if he acts genuinely and honestly in the circumstances of the case.'⁴²

In its use of the term 'directors', as the authorising body of a corporate transaction, s 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 s 35 the use of the term 'directors' effectively limited the validity of transactions decided otherwise than by the collective board of directors. As very few decisions relating to corporate contracts are taken by the collective board of directors, board meetings usually being confined to broad policy issues, s 35 in its adoption of the term 'directors' was indeed contrary to commercial practice.

The Companies Act 1989

As a result of s 35 CA 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.

In December 1985, the Department of Trade and Industry appointed Professor Dan Prentice to examine the legal and commercial implications of

42 *Ibid* at page 18.

abolishing the *ultra vires* rule. The Prentice Report⁴³ recommended the complete abrogation of the rule by conferring a company with the capacity of a natural person;⁴⁴ a recommendation which would have brought the UK in line with other common law jurisdictions. In addition to conferring 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.

The legislature's opportunity to act on the recommendations of the Prentice Report and to give effect to the reform of s 35 CA 1985, was taken as a consequence of a general legislative review of corporate law. This review culminated in the enactment of the Companies Act 1989. Part V of the 1989 Act⁴⁵ concerned itself with matters pertinent to the issue of corporate capacity and directors' authority.

The 1989 Act introduced a number of amendments to the 1985 Companies Act. Section 35(1) CA 1985, as amended by the 1989 Act,⁴⁶ now 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’

Although s 35 (1) would perhaps have been more appropriately worded if it had stated, ‘...an act would not be called into question by reason of anything which had been excluded from a company's memorandum’, it is clear

43 ‘The Reform of the *Ultra Vires* rule: A Consultative Document’ DTI 1986. For academic commentary on the report, see eg, Hannigan: *The reform of the ultra vires rule* [1987] JBL 346, Frommel: *Reform of the ultra vires rule: a personal view* (1987) 8 Co Law 11, Pennington: *Reform of the ultra vires rule* (1987) 8 Co Law 103.

44 ‘The Reform of the *Ultra Vires* rule: A Consultative Document’ DTI 1986, p18.

45 See, ss 108-112 CA 1989.

46 See, s 108 CA 1989.

that the statutory intention of the section is to abrogate the *ultra vires* rule in relation to third party interests

While a company is not (contrary to the recommendations of the Prentice Report) theoretically possessed of the capacity of a natural person, capacity is nevertheless unrestricted by the contents of a company's memorandum. However, it should be noted that the authority of individual directors to bind a company may be restricted by the company's board of directors; a restriction which could potentially diminish the ultimate ability of a company to enter into a contractual relationship.

Although the Companies Act 1989, did not (contrary to the recommendations of the Prentice Report⁴⁷) 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*.⁴⁸ This was achieved by introducing a standard type of objects clause which now permits companies to pursue any activity within a commercial context.⁴⁹ 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 s 3A, 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 '3A 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 s 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.⁵⁰ Similarly, corporate powers which

47 The Prentice Report, Ch V.

48 *Supra*, n 17.

49 Introduced as s 3A CA 1985 (*see s 110 CA 1989*).

50 *See*, s 35(3) CA 1985, introduced by s 108 CA 1989.

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.

Although the consequences of pursuing corporate purposes other than those specified within the objects clause would not, as a result of the newly constructed s 35 (1), render the transaction void, it should be observed that the wording of s 35(3) CA 1985⁵¹ does, at first glance, provide a somewhat contradictory picture. 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 which 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 circumstances where a transaction exceeds the company’s capacity as a consequence of an improper exercise of directors’ powers (powers contained within the memorandum), *prima facie*, s 35(3) would appear to suggest that the corporate transaction would be unenforceable, save where the general meeting passed a special resolution to adopt it. Nevertheless, such an interpretation must be flawed because s 35(3) expressly acknowledges that the transaction in question would have been unenforceable ‘but for s 35(1)’. In other words, a transaction outside a company’s corporate capacity, which took place as a result of an abuse of directors’ powers contained within the memorandum, retains its validity as a result of s 35(1).

The purpose of s 35(3) would thus seem to be restricted to a situation whereby the company itself seeks to enforce a transaction which is beyond the directors’ powers, rather than where a third party seeks to enforce a transaction under s 35(1)). Where a company seeks to enforce a transaction, which would, but for s 35(1), be outside its capacity, the company in general meeting must adopt the irregular transaction by special resolution. A resolution ratifying such an action will not affect any liability incurred by the

51 *Ibid.*

directors (for breach of powers) or any other person; relief from any such liability must be agreed separately by an additional special resolution.⁵²

In retaining the concept of an objects clause, the 1989 Act has maintained one of the initial justifications of the *ultra vires* rule, namely, shareholder protection. Indeed, the ability of a shareholder to prevent the company from pursuing a transaction which is outside its objects clause is expressly maintained by the reforming Act. Section 35(2) CA 1985⁵³ now provides that:

‘A member of a company may bring proceedings to restrain the doing of an 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.’

However, the maintenance of shareholder protection may be illusory because a corporate act may not be avoided where it is in the furtherance of an existing legal obligation. Accordingly, this would, as noted by Lord Wedderburn,⁵⁴ indicate that all commercial transactions would be outside the ambit of s 35(2) in so far as a company will always have to enter into some form of legal obligation prior to the commencement of the commercial act. Indeed, it would be highly unlikely that a shareholder (other than shareholder/director) could ever intervene to prevent a company from agreeing to enter into a commercial transaction prior to the performance of the resulting contractual obligation.

In addition to severely restricting the ambit of the *ultra vires* rule, section 108(1) of the Companies Act 1989 in its attempt to produce a climate of contractual freedom, has sought to reduce the restrictions placed upon the authority of company directors. The reforms applicable to directors' authority are aimed at complementing those made in connection with matters relating to the overall scope of a company's capacity to enter into contractual relationships.

52 See Poole, *Abolition of the ultra vires doctrine and agency problems* (1991), 12 Co Law 43.

53 Introduced by s 108 CA 1989.

54 Vol 3 HL Debates col 681, 7 November (1989).

The 1989 Act has introduced new sections into the relevant parts of the 1985 Act. A new s 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 s 35A(1), is to promote 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 s 35A(1) uses the term ‘limitations under the company's constitution’, in accordance with s 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.

In an attempt to surmount the difficulties associated with the interpretation of the wording used in the old s 35(1), a new s 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,⁵⁵ ss 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.

Where a third party is unable to rely on s 35A, a transaction involving a breach of directors’ authority or one which falls outside the good faith requirement may nevertheless be ratified by an ordinary resolution of the general meeting. The ratification of a transaction which was entered into with

55 The Prentice Report, p 32.

an authority which exceeds a limitation on the board's powers so specified within the memorandum, may be achieved by a special resolution of the general meeting (s 35(3) CA 1985).

The legislature's decision not to confer individual directors with the authority to bind the company as of right was in contrast to the recommendations of the Prentice Report⁵⁶ However, the legislature's decision was perhaps understandable in so far as its acceptance would have condoned a radical departure from the traditional position of the delegation of authority being vested in the company's board of directors. In accordance with the Prentice Report, the ability of an individual director to bind the company would have existed without any form of delegation of authority from the board. Therefore, an individual director would have been capable of binding the company in matters for which the director possessed no expertise. Additionally, a director would have been capable of binding the company to a transaction, the nature of which had been disapproved of by the company's board of directors.

Although the Companies Act 1989 denies individual directors an unfettered right to contractually bind the company, s 35A is permissive of an individual director's right to bind the company in a situation where the director's act is derived from a delegation of authority from the board. Section 35A(3) CA 1985 provides that the power to bind the company is deemed free of any limitation under the company's constitution. Therefore, a company officer, with authority delegated from the board to, for example, bind the company in a specific type of contract, will be able to exercise that power, irrespective of whether or not the company's constitution prohibits the company from entering into the type of contract in question.

In compliance with s 35A(4) CA 1985, a shareholder retains the right to prevent the company's pursuit of a contractual agreement in a situation where it is inevitable that the board, in pursuing the transaction, would exceed its authority or authorise others to do so. However, where a contract is to be performed in fulfilment of a previous legal obligation, no shareholder intervention will be possible. It should be noted that in accordance with s 35A(5) CA 1985, the board or a person authorised 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

56 The Prentice Report, p 28.

scope of the company's constitution.

Providing a third party acts in good faith, no shareholder action (save for the limited right under s 35A(4)) will be able to prevent the enforcement of a contract with the company, even where the contract type is not permitted by the company's constitution or where the enforcement of the contract might otherwise have been regarded as a fraud on minority interests. In accordance with s 35A(2) CA 1985 the minority shareholders' position is weakened because a third party's actual knowledge of a limitation on a director's authority will not necessarily preclude the third party from having acted in good faith.

Unlike the old s 35 CA 1985, the effect of the Companies Act 1989 has been to abrogate the constructive notice rule without any form of restrictive limitations in relation to independent third parties. Under the old s 35, the abolition of the constructive rule had no effect unless the contract in question was of a commercial nature and was one decided upon by all the directors. However, although a third party is not deemed to have constructive notice of an act which is beyond the company's constitution, he must nevertheless assure himself that the person with whom he dealt was authorised to act by the board. This is implicitly confirmed by the new s 35B CA 1985 which provides 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, s 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, that is 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.

The abolition of the constructive notice rule, in so far as the rule affects the ability of an authorised person to bind the company, is nevertheless subject to one exception in the guise of s 322A CA 1985. This provision provides that where the board enters into a contract with an insider, that is a director or connected person, and the board exceeds any limitations on its powers, then

the transaction will be rendered voidable at the company's option. The transaction's validity will therefore depend upon the passing of an ordinary resolution. Accordingly, 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 ss 35A and 35B. 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.

The removal of the doctrine of constructive notice to all areas of company law, save for company charges, will (when implemented), be made as a result of s 142 (1) CA 1989, which purports to create s 711A CA 1985. However, s 711A (2) CA 1985 provides that the abolition of the constructive notice rule will:

‘...not affect the question as to whether a person is affected by notice of any matter by reason of a failure to make such enquiries as ought reasonably to be made.’

The wording of s 711A (2) is vague and poorly constructed and would appear to be in direct conflict with s 35B CA 1985. Nevertheless, in so far as the section relates to questions of corporate capacity and directors' authority, it is suggested that it should be construed as reinforcing the fact that it remains a third party's responsibility to ensure that a purported company agent has at least a general authorisation to act on behalf of the company in relation to the area of corporate policy to which the purported transaction relates.

In abolishing the doctrine of constructive notice, the Companies Act 1989 has, to some extent, extinguished the need for the *Turquand* rule.⁵⁷

57 *Royal British Bank v Turquand* (1856) 6 E&B 327. This rule provides, that in dealing with a company, a third party is not bound to ensure that all the internal regulations of the company have been complied with in respect to the exercise of an authority to bind the company. The operation of the rule is subject to a number of exceptions. For example, a third party cannot plead the rule where that party has actual knowledge that a transaction falls outside the authority conferred by the company's constitution, see eg *Howard v Patent Ivory Manufacturing Co* (1833) 38 Ch D 156. While the indoor management rule is applicable to the internal procedures necessary to validate any given exercise of authority, ie it would be applicable to a situation where an ordinary resolution (but not a special resolution) was required to validate an exercise of authority, the rule, taken on its own, could not extend to issues relating to the ability of a board of directors to confer authority. Thus, a third party will not be entitled to rely on the indoor management rule to assume that an officer has been given authority by the board to act in excess of his actual or usual authority, see Griffin,

However, this rule may still be of assistance in matters concerning the board's delegation of authority. For example, where the board delegates authority to a company agent, but in doing so places internal restrictions on the ability of the agent to carry out his functions (a matter not covered by s 35A(3) CA 1985), then in accordance with the *Turquand* rule, the third party will not, unless he has actual notice, be deemed to have knowledge of those restrictions. The *Turquand* rule will also continue to be of assistance in those cases where no valid appointment of a company officer had been made.⁵⁸

Conclusion

The *ultra vires* rule was applied to incorporated companies in the mid-nineteenth century to protect both shareholders and creditors from the exploitation of the commercial advantages associated with the introduction of the concept of limited liability. Initially, the protection may have been considered justifiable because the then radical concept of limited liability, had a potential to encourage the fraudulent abuse of investment funds.

The judiciary undoubtedly played a significant role in attempting to curtail the potency of the *ultra vires* rule, albeit that the judicial confusion concerning its applicability to abuses of corporate powers should not be forgotten. Indeed, prior to the UK's accession into the EC and the subsequent reforms to the *ultra vires* rule which followed thereafter, the rule conferred little practical relief in relation to the protection of shareholder and creditor interests. Its main purpose was negative in character because its continued existence resulted in the drafting of prolonged objects clauses which demanded thorough scrutinisation by third parties eager to confirm a company's capacity to contract. The abrogation of the *ultra vires* rule was, in so far as it retained a theoretical nuisance value, a most necessary step.

The legislative reform, culminating in the 1989 Act, has abolished the *ultra vires* rule in relation to third party dealings. In addition, the 1989 Act, in its promotion of contractual freedom, has sought to reform issues relating to directors' authority. Such reforms were inevitable in order to prevent a company's contractual capacity being set aside on the subsidiary issue of a deficiency in agency powers. Indeed, the danger of transactions being set aside

Directors Authority: The Companies Act 1989 (1991) 12 Co Law 98.

58 See, *Mahony v East Holyford Mining Co* (1875) LR 7 HL.

on the grounds of such a deficiency is considerably eroded by the 1989 Act's abolition of the constructive notice rule in relation to a company's constitutional documents. In addition, the 1989 Act, when combined with the indoor management rule as derived from the case of *Royal British Bank v Turquand*, deems that the ability of a third party to rely upon the actual or ostensible authority of an officer of the company is to be without prejudice of limitations having been placed upon agency powers by the company's constitution, board of directors or general meeting. Indeed, and perhaps controversially, a third party's actual knowledge of any limitation on the scope of an officer's authority will not in itself invalidate a transaction.

Although the language of the 1989 Act is, in its treatment of issues relating to corporate capacity and directors' authority, difficult and liable to conflicting interpretations,⁵⁹ it would appear that its purpose of removing the *ultra vires* rule, together with its general promotion of contractual freedom in respect of corporate transactions, has been achieved. 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 aptly 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.

Stephen Griffin
Lecturer in Law
UW Aberystwyth.

59 See especially, Ferran, *The reform of the law on corporate capacity and directors' and officers' authority* (1991) 12 Co Law 124 and 177.