UNDERSTANDING CORPORATE CAPACITY

RELEVANT TO ACCA QUALIFICATION PAPER F4 (SGP)

One of the things which determines whether a transaction entered into by a company is valid and binding on the company is the company's legal capacity to enter into that particular transaction. In the case of individuals, the question of capacity is determined by the person's age and by their ability to understand the nature of the obligation undertaken. Thus, a lack of capacity is seldom raised in contracts entered into between most normal adults. Although a company is not a person, it is nevertheless conferred legal personality and status by the Companies Act (Cap 50).

Section 19(5) provides that upon incorporation, a company shall be capable of 'suing and being sued and having perpetual succession and a common seal with power to hold land'. But what determines a company's legal capacity? The answer depends on the provisions of the company's memorandum of association, the operation of the doctrine of *ultra vires*, and the impact of relevant statutory provisions.

THE OBJECTS CLAUSE AND THE DOCTRINE OF ULTRA VIRES

Prior to the amendments made to the Companies Act in 2004, the contractual capacity of a company was defined and limited by a statutorily mandated objects clause in the company's memorandum of association. Section 22(1) required that the objects for which the company was incorporated should be stated in the memorandum. This statement, which typically stipulated the type of commercial activities that the company would be involved in, came to define the company's capacity. It then provided the premise on which the doctrine of *ultra vires* operated.

According to the doctrine of *ultra vires*, any act which fell outside those specified in the objects clause was beyond the company's capacity, ie *ultra vires*. In other words, the company was incapable of doing anything that went beyond its statement of objects. As Lord Cairns LC put it, 'the memorandum of association is… the area beyond which the action of the company cannot go'[1]. This, it was explained, was a consequence of the benefit of limited liability conferred on companies registered under the Companies Act; it was for those who dealt with and extended credit to the company, and who had no recourse against anyone else except the company, so that they should at least be entitled to know the scope of the company's legitimate activities so as to decide whether or not to transact with the company.

Under common law, *ultra vires* transactions are nullities and have no legal effect. Neither party to the transaction would be able to enforce it, and any benefits transferred would have to be restored. Lord Cairns LC explained: 'The question is not as to the legality of the contract; the question is as to the competency and power of the company to make the contract… if it was a contract void at its beginning, it was void because the company could not make the contract.[2]'

As the *ultra vires* contract was void *ab initio*, the common law was clear that it could not be ratified or authorised by the shareholders, not even by a unanimous decision.

Clearly then, the doctrine was capable of operating harshly, especially for outsiders who dealt with the company. The inequities of the consequences were exacerbated as the operation of the doctrine did not depend on whether a party contracting with the company had actual knowledge of the company's lack of capacity. Indeed, by the doctrine of constructive notice, anyone who dealt with a registered company was *deemed* to have had notice of the contents of its memorandum and articles of association. This meant that whenever a person contracted with the company, that person was treated as if they had seen and read the objects clause and was therefore fully cognizant of the limits placed on the company's capacity. The risk of the transaction turning out to be *ultra vires* thus fell squarely on the person dealing with the company.

FULL CAPACITY STATUTORILY CONFERRED

The 2004 amendments to the Companies Act removed the requirement for objects to be stated in a company's memorandum. Section 23(1) provided that a company 'has full capacity to carry on or undertake any business or activity, do any act or enter into any transaction'. Obviously, this provision is meant to exclude the applicability of the doctrine of *ultra vires*.

The exclusion is, however, incomplete because Section 23(1A) preserves the option of having objects *included*. The incorporators of a company may therefore choose to have an objects clause included in the memorandum. Furthermore, Section 23(1B) allows the inclusion of a clause in the memorandum of provisions that restrict the company's capacity and powers. As the operation of Section 23(1) is expressly qualified by, *inter alia*, the provisions of the memorandum or articles of the company, it would appear that for those companies exercising the option to restrict capacity, the doctrine of *ultra vires* remains relevant.

CONSTRUCTION

When would an act of a company be considered outside of its capacity? The answer to this question depends on a proper construction of the company's objects clause. In this regard, it is important to distinguish between a company's objects and the powers conferred on the company to carry out those objects. The objects provide the purposes for which a company exists, while the powers are the means by which these purposes are to be achieved.

It is only when the act is outside the company's objects (as opposed to its powers) that

the act is *ultra vires*. However, this does not mean that all transactions falling outside the company's stated objects are necessarily void.

In *Attorney-General v The Great Eastern Railway Co Ltd*[3], the House of Lords held that a company had the implied capacity and power to enter into transactions that were necessarily incidental to the carrying out of the authorised objects, even if those transactions did not fall strictly within the objects expressly provided for in the company's memorandum.

The company in question was authorised to construct a railway and to provide and maintain all the rolling stock and locomotive power necessary for the working of the railway. A contract entered into by the company to offer locomotive engines and other rolling stock for hire was held not to be *ultra vires*. Lord Selborne LC stated that the *ultra vires* doctrine 'ought to be reasonably, and not unreasonably, understood and applied, and that whatever may fairly be regarded as incidental to, or consequential upon, those things which the [memorandum] has authorised, ought not (unless expressly prohibited) to be held, by judicial construction, to be *ultra vires*'[4].

Often, a company's memorandum states both its objects and its powers. In *Rolled Steel Products (Holdings) Ltd v British Steel Corp*[5], Browne-Wilkinson observed that not all the activities listed or mentioned in the objects clause are necessarily objects in the strict sense explained previously. Some of these may really only be ancillary powers, existing not as independent objects, but to enable the company to achieve its stated objects.

The power to create a security over the company's assets would be such an ancillary power, as would the power (unless the company was a bank) to borrow money. Vinelott observed as follows:

'The question whether a stated 'object' is truly an independent object or purpose is always a question of construction. Even borrowing and lending monies are activities capable of being pursued as independent objects – for instance in the case of a bank or finance company; but commonly, where a sub-clause of the memorandum of association of a company states that one of the objects of the company is 'to lend or advance' or 'to borrow and raise' money, it is artificial to construe the sub-clause as anything other than a power conferred for the furtherance of what are, in truth, its 'substantive objects' or purposes.[6]'

Additionally, a company would have a number of powers (even if they were not expressly provided for in the memorandum) implied as being reasonably incidental to the achievement of its objects. For example, a trading company would have an implied power to lease premises, even if this power was not explicitly provided for.

LEGITIMATE POWER, WRONGFUL EXERCISE

How should an act be treated if it fell within the powers of the company, but was entered into to further a purpose that was not within the company's objects?

In *Rolled Steel Products (Holdings) Ltd v British Steel Corp*, the courts held that as long as the company legitimately possessed the power which had been exercised, the fact that the *purpose* for which that power was exercised was outside of the company's objects, or was used for some improper purpose, did not render the exercise of the power *ultra vires*. This 'wrongful' exercise of a corporate power had nothing to do with the capacity of the company but everything to do with the authority of the agents (usually the directors) who exercised the power on the company's behalf. Therefore, the resulting transaction was not void, but was voidable at the option of the company and only if the other contracting party had notice of the wrongdoing or breach of duty.

The question that must be asked is whether the corporate power being examined *could* have been exercised in pursuit of the company's objects. If the answer is 'yes', the exercise of the power is not *ultra vires*. The facts of the Rolled Steel case provide a useful illustration. The memorandum of Rolled Steel empowered it to give guarantees. The board of directors caused it to guarantee the obligations of a company controlled by a majority shareholder and director of Rolled Steel.

On the question of whether the guarantee was void as it was *ultra vires*, the English Court of Appeal held that it was not. It was clear the company had the capacity to give guarantees. The fact that the giving of the guarantee was an abuse of power did not mean that the transaction was *ultra vires*.

This view of *ultra vires* transactions (often referred to as the 'narrow' view) was approved by the Singapore Court of Appeal in *Banque Bruxelles Lambert v Puvaria Packaging Industries (Pte) Ltd*[7], and goes some way towards eroding the applicability of the *ultra vires* rule. In addition, Section 25 of the Companies Act has the effect of further ameliorating the common law consequences of the doctrine, as follows:

'No act or purported act of a company… shall be invalid by reason only of the fact that the company was without capacity or power to do such an act or to execute or take such conveyance or transfer.'

Where a party dealing with a company is concerned, the sting of the doctrine of *ultra vires* has been effectively removed as the transaction can no longer, by that reason only, be void. It should be noted that the doctrine of constructive notice, which up to now has worked hand in hand with the *ultra vires* doctrine to the detriment of those contracting with companies, has been abolished by Section 25A. A person is therefore not deemed to have notice or knowledge of the contents of the company's memorandum just because it is a registered document available for inspection. However, although weakened, the doctrine is not quite dead and buried, for Section 25(2) preserves the right of a member to apply to court for an order to restrain the *ultra vires* act.

Unlike the position in common law, an *ultra vires* transaction is not automatically void. Whether the allegedly *ultra vires* act will be restrained (and hence to that extent avoided) or not will depend on the court being satisfied that it would be just and equitable for the act to be restrained. Arguably, factors such as the potential damage or loss suffered by the outsider, the outsider's state of knowledge, and whether other third party rights are affected, could be considered by the court when deciding whether to grant the order.

The fact that an act is outside the capacity of the company may also be asserted or relied upon in proceedings against the company's directors who, in causing the company to enter into an *ultra vires* transaction, would be likely to be in breach of their own directors' duties.

CONCLUSION

Where outsiders are concerned, the legislative provisions are to be welcomed as they go some way towards moderating the drastic consequences of the *ultra vires* doctrine. Nevertheless, the doctrine has not been fully abolished. In the case of companies that retain a statement of objects in their memorandum, the doctrine continues to apply, albeit reincarnated as a mechanism for internal control, ie in the form of restrictions on the directors' exercise of powers. In this regard, an understanding of the doctrine remains useful.

REFERENCES

1 *Ashbury Railway v Riche* (1875) LR 7 HL 653, 671.
2 *Ashbury Railway v Riche* (1875) LR 7 HL 653, 672.
3 (1880) 5 App Cas 473.
4 Ibid., 478.
5 [1986] Ch 246.
6 *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1982] Ch 478, 497 (at first instance).
7 [1994] 2 SLR 35.

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