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Object Clause vs. Third Party Mortgage/Guarantee

Forrukh Rahman*

The need for an objects clause within a company's memorandum of association started from the early days of company law when it was believed that shareholders would have only a minimal interest in the management of the business, being concerned more as to the nature of their investment. Having decided to invest in, for e.g., the pharmaceuticals, bank, they could be certain that their investment would be used in that particular field.

The objects clause was descriptive of the activities for which a company had been incorporated and investors could rely upon the company being restricted to its stated sphere of activity. The transactions which fell outside of this are *ultra vires* and void. The third parties who dealt with companies were taken to know what the capacity of a company was by virtue of the public nature of its memorandum.

Rapid changes in business during the latter half of the nineteenth century and the increase in the development of new markets placed the law in something of a dilemma. The law had to balance between the certainty that investors knew the nature of its proposed activities and as also flexibility in order to keep economic developments and maintain and increase profitability.

The courts tried to construe objects clauses as widely as possible in order to avoid declaring activities ultra vires often with the disastrous consequences on third parties. For example in Re Introductions Ltd [1970] 1 All ER 887, CA, a company's bank found itself in the undesirable position of being unable to enforce the repayment of a loan because it had known what the purpose of the borrowing which was beyond the capacity of the company. It became necessary to hold more of a balance between third parties and the company's shareholders.

Historically, company law had made a distinction between clauses in the memorandum of association which are the objects of the company and clauses which are merely powers. The effect of the distinction is said to be that powers can be exercised only in pursuit of the objectives, whereas the objectives are ends in themselves. Generally, a company has implied powers to enter into transactions which are reasonably understood to be incidental to the attainment of its objects. [Deuchar vs. Gas Light & Coke Co [1925] AC 691HL].

Persons who were involved in drafting of companies' memoranda attempted to address this problem through careful drafting of objects clauses which encompassed as many activities as possible. They began a practice of including certain powers in a company's objects clause so as to give greater certainty as to the legal those legal validity. However, courts were of the view that where an objects clause contains a mixture of objects and powers, such powers cannot be raised from their status to object clause. The courts searched for the main objects and declared activities which are actually mere power as ultra vires hence void.

To deal with these draftsmen began to draft objects clauses with separate objects provisions with some success. These clauses concluded with a statement to the effect that 'each and every one of the above paragraphs shall be treated as a separate and independent object of the company'. Other initiatives of the draftsmen for e.g. inclusion of subjectively worded objects clause were also successful. In Bell Houses Ltd v City Wall Properties Ltd [1966] 2 All ER 674, CA, a subjectively worded objects clause which permitted the directors to carry on any trade or business whatsoever which can, in the opinion of the Board of Directors, be advantageously carried on by the Company in connection with or ancillary to any of the main businesses was held to be valid act within the limit of its objects.

In England, the Companies Act 1989 finally abolished the doctrine of ultra vires in relation to third parties dealing with a company although the right of a company's members to require the company act in accordance with its stated objects was not abolished.

In India and Bangladesh, the English legal principles are generally followed in this regard. Particularly, the courts in Bangladesh rarely have the opportunity to give their decisions on the matter as petitions filed on the ground of ultra vires are very rare. It seems that the courts are still waiting for an opportunity to give its decision on the matter. However, no legislation was yet passed abolishing the doctrine of ultra vires in relation to third parties in Bangladesh.

Hence, although Members of the company in Bangladesh are still entitled to require that the company in which they have invested adhere to its stated objects. However, where the company is empowered by the implied powers and also by the well drafted memorandum of association containing clauses like express powers, separate objects provisions, subjectively worded objects as stated above to engage in almost any activity, the need for complying with the objects clause may be minimized.

Although the Banks in Bangladesh before financing a company often seek legal opinion as to whether any security in the form of mortgage/guarantee given by a third party company shall be acceptable or not based on its object clause. It is true that such clause may not be implied as stated above; however, it seems that memorandum of association supporting such activities containing in clauses like express powers, separate objects provisions, and subjectively worded objects may be able to give the legal validity of mortgage/guarantee given by a third party company, even if there is no express object in this regard. This issue has to be resolved on case to case basis taking into account the clauses of respective Memorandum.

Surprisingly, few banks often take extreme stand in this regard seeking inclusion of mortgage/guarantee clause in all circumstances. This unnecessarily delays the sanction and disbursement putting the bank in the risk of loosing the customer.

On the other hand, where the memorandum cannot be interpreted as authorizing third party mortgage/guarantee few banks are taking an undertaking from the mortgagor/guarantor that the said clause shall be incorporated in the Memorandum after obtaining permission from the Hon'ble High court in a situation and accepting third party mortgage/guarantee. This practice is not lawful as the Bank is still entering into a void transaction. No resolution can post facto validate an *ultra vires* act of the company.

In such circumstances, it is advised that the issue has to be resolved on case to case basis only taking into account the clauses of respective Memorandum. If after seeking legal advice it is found out that there are no express object/powers, separate objects provisions, and subjectively worded objects in the Memorandum it is lawful to ask the proposed borrower to seek high court's permission. No sanction/disbursement may be made if the third party mortgage/guarantee is the main collateral. The Bank should not seek any illegal undertaking in this regard as this would put the directors of the borrower Company into jeopardy.

Since India and Bangladesh almost entirely follows the developments taking places in the UK in this regard, the principle developed in the UK on abolition of the doctrine of ultra vires in relation to third parties e.g. Banks, dealing with a company may be followed in Bangladesh as well. To put the banks at ease, a judicial decision in this regard is therefore required.

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