# TYPES OF COMPANIES

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Sec. 3(1) a company incorporated under the Companies Act may be either—

(a) A company that issues shares, the holders of which have the liability to contribute to the assets of the company, if any, specified in the company's articles as attaching to those shares (in the Act referred to as a "**limited company**") ; or a company Ltd by shares

It is divided into 2

a. Private Ltd Co.
b. Public Ltd Co.
   i. Ordinary public Co.
   ii. Public Listed (Public Quoted) Co.

(*b*) A company that issues shares, the holders of which have an unlimited liability to contribute to the assets of the company under its articles (in the Act referred to as an "**unlimited company**"); or

(*c*) A company that does not issue shares, the members of which undertake to contribute to the assets of the company in the event of its being put into liquidation, in an amount specified in the company's articles (in the Act referred to as a "**company limited by guarantee**").

According to the above definition we may say that there are three main types of companies that can be registered under the Act. They are,

1. Limited Company- i.e. a company limited by shares. Such a company may be either
   a. A Private Company 1-50 shareholders 1 to unlimited Director
   b. A Public Company 1 to unlimited shareholders directors 2-unltd

2. Unlimited Company 1-unlimted sh. H. 1 – unltd directors
3. Company Limited by Guarantee members 2-unltd 1-unltd directors

**PRIVATE COMPANIES**

Section 27 provides that the articles of a private company shall include provisions which—

(*a*) Prohibit the company from offering shares or other securities issued by the company to the public; and

(*b*) Limit the number of its shareholders to fifty

**Characteristics of a Private Company**

1. There can be a maximum of fifty members (Sec.27)
2. There should be at least one director (Sec.202)
3. No upper age limit for the Directors (Sec.210)
4. The name should end in the words "(Private) Limited" or by the abbreviation "(Pvt) Ltd" (Sec.6)
5. It need not deliver financial statements to the Registrar (Sec.170).
6. As per Sec.30, it may by unanimous resolution of its shareholders dispense with (avoid) the keeping of an (Director's) interest register.
7. Either a registered Auditor or members of the CASL may function as the Auditor
8. In a Private company with all the shareholders' approval in writing, any decision can be taken regarding the company. Such a decision may be even contrary to articles (Section 31). However, unanimous agreement should not violate the solvency test.

**<u>COMPANIES LIMITED BY GUARANTEE</u>**

**Articles of a Company Limited by Guarantee**

Sec. 33 (1) provides that the articles of a company limited by guarantee shall state—

(*a*) the objects of the company; and

(*b*) the amount which each member of the company undertakes to contribute to the assets of the company, in the event of such company being put into liquidation.

**Charitable Companies**

Sec. 34(1) provides that where the Registrar is satisfied that an association about to be formed as a company limited by guarantee is to be formed for promoting commerce, art, science, religion, charity, sport, or any other useful object, and intends to apply its profits or other income in promoting its objects, and to prohibit the payment of any dividend to its members —

*(a)* the Registrar may by license direct that the association be registered as a company limited by guarantee, without the addition of the word "Limited" to its name; and

*(b)* the association may on registration enjoy all the privileges and be subject to all the obligations of a limited company.

## OFF SHORE COMPANY

An off-shore company is a company that is registered in Sri Lanka, but it does its business abroad and not in Sri Lanka. Any company whether it is incorporated in Sri Lanka or it is incorporated in abroad may make an application to the Registrar of Companies to be registered as an Off-Shore Company.

**Granting the certificate**

According to section 262(1), before granting the certificate, the Registrar may consider the national interest or the interest of the national economy.

**Privileges and Benefits Granted to an Off-Shore Company**

Sec.262 (2) provides that a certificate of registration issued to an off-shore company, shall exempt the company from complying with any other provision of the Act.

**Prohibition on carrying on business in Sri Lanka**

As per Sec.264 (1) an off-shore company shall have power to carry on any business outside Sri Lanka; but shall not be entitled to carry on any business within Sri Lanka.

## OVERSEAS COMPANIES

According to Sec.488 "overseas company" means any company or body corporate incorporated outside Sri Lanka, which has established a place of business within Sri Lanka.

As per Section 489 (7) a company incorporated outside Sri Lanka shall not establish a place of business within Sri Lanka or be registered as an overseas company, where the business being carried on by that company does not conform to the stipulations made by or under the Foreign Exchange Act No.12 of 2017, Extra Ordinary gazette No.2045/56 dated 17.11.2017.

# PROMOTERS

The persons who create a company are known as Promoters. In Twycross Vs Grant, a promoter was defined as 'one who undertakes to form a company with reference to a given project, and set it going, and who undertakes the necessary steps to accomplish that purpose'.

All the persons who are involved in the formation of a Company are not treated as Promoters. Because agents and servants of the Promoters such as Lawyers, Accountants etc. are not treated as Promoters. Therefore, Promoters can be defined as persons who intend to form a company and take the necessary steps to carry out that intention. Promoters are the parents of a company. Their functions are also similar to parents.

Promoters have generally two functions, if any person does these functions, he will be a promoter even though he is a Lawyer or an Accountant. The functions are

1. Intention to form a company and
2. Taking all the necessary steps to carry out that intention

**Duties of Promoters**

When forming a company, a Promoter makes contracts and does all the necessary activities not for him personally, but he does these activities for the benefit of the company which he promotes. Therefore, he acts similar to an agent and therefore he has fiduciary duties similar to an agent.

Therefore,

1. He must act bona fide (in good faith/with a good intention) for the benefit of the proposed company and its shareholders
2. He should not mix his personal interest with the companies' interest
3. He must not make secret profits when he promotes the Company.

However, if the Promoter discloses his activity to the Company, he is permitted to make profits. A promoter is permitted even to purchase a property with the sole motive of reselling it to the Company at a profit. But he should disclose the total profits made by him to the proper persons in the company. The proper persons are

1) An independent board of directors of the company

Independent board of directors means the persons in the board must not be the relatives, friends, employees or nominees of the promoter.

2) To the existing and prospective shareholders of the company

If there is no such an independent board of directors, the promoter must disclose the profits to the existing and prospective Shareholders of the company

**Remedies available to the Company against the Promoter**

If a promoter fails to make full disclosure of the profits made by him to the proper persons in the company, the company has any of the three remedies against the promoter.

The company may

1) Sue (file a case against) the promoter to claim damages for the breach of his fiduciary duty.
2) Rescind (cancel) the contract and recover purchase money from the promoter if the promoter has sold his own property.
3) Sue to recover the profit from the promoter.

**Liability of the promoter for untrue statement in the prospectus (Sec.41(c))**

If there is an untrue statement in the prospectus, a person, who subscribes for (buys) any shares or debenture in the company on the faith of the untrue statement contained in the prospectus, can sue the promoter for the loss or damages, sustained by him as the result of such untrue statement and claim compensation from the promoters and directors.

**Payment of Promotion Costs and for Services**

A promoter's activities involve before the company is formed; therefore, the issue arises whether the promoter can claim money for his services which he carried out without the company's permission. In general, a promoter is not entitled to claim money for the costs the promoter has incurred in forming the company or to recover a payment for the services rendered in forming that company.

Then how can a promoter claim money for the expenses and services?

Following methods can be used to reimburse a promoter for the costs and services

- Adding a clause in the Articles of the company permitting the payments to a promoter for costs and services rendered by him. However, the promoters have no right to compel the company to effect such payment, because articles is not treated as a contract between a company and a promoter.

- The promoters are given the option to buy a specified number of shares from the company at the nominal value within an agreed period of time. If after the formation of the company, the share prices of the company increase, the promoter can exercise his option and purchase such number of shares at the nominal value, thereby making a profit which will set off his expenses relating to the promotion of the company.

- The promoters may be allowed to make a profit by entering in to transactions with the Company and thereby cover the promotional cost incurred by such promoter, but in such an event a proper disclosure of the profits must be made by the promoter.

# ARTICLES OF ASSOCIATION

The Articles of Association is the most important document in a company. It is treated as a company's constitution. Under the Companies Act No.7 of 2007, Sec 4(1) to register a company, the articles of association signed by each of the initial shareholders must be submitted together with the other documents.

**Application of model Articles-Sec.14**

As per Sec.14, the articles of association set out in the First Schedule to the companies act (which is referred to as "**model articles**") shall apply in respect of any company other than a company limited by guarantee, except to the extent that the company adopts articles which exclude, modify or are inconsistent with the model articles. Therefore, the model articles set out in the First Schedule is the default articles of the company; the company can modify it according to its requirements.

Therefore, a company may follow the "model articles" set out in the First Schedule to the companies act or it may modify or amend the model articles and follow it. A company may even prepare a new set of articles excluding the application of the model articles.

**Contents of Articles**

As per section 13, the articles of association of a company **may** provide for—

(*a*) the objects of the company;
(*b*) the rights and obligations of shareholders of the company; and
(*c*) the management and administration of the company.

In addition to the above, a company may include any other provisions in the articles, but such provisions should not violate the companies act.

**Articles of a Private Company**

Section 27 provides that the articles of a private company **shall** include provisions which—

(*a*) Prohibit the company from offering shares or other securities issued by the company to the public; and

(b) Limit the number of its shareholders to fifty, not including shareholders who are—

(i) employees of the company; or

(ii) former employees of the company who became shareholders of the company while being employees of such company and who have continued to be shareholders after ceasing to be employees of the company.

**Articles of a Company Limited by Guarantee**

Sec. 33 (1) provides that the articles of a company limited by guarantee **shall** state—

(*a*) the objects of the company; and

(*b*) the amount which each member of the company undertakes to contribute to the assets of the company, in the event of such company being put into liquidation.

**ADOPTION OR AMENDMENT (ALTERATION) OF ARTICLES - SECTION 15**

(1) Subject to the provisions of this Act and any conditions contained in its articles, a company may at any time by special resolution —

(*a*) adopt new articles;

(b) if it has articles which differ from the articles of association set out in the First Schedule (model Articles), adopt such articles as its articles; or

(c) alter its articles.

(2) Where a company by a special resolution alters its articles, it shall give notice of such resolution to the Registrar (by way of Form 39) within ten working days, setting out in full the text of the resolution and of any new articles or of any alterations to the company's articles.

If a company fails to give such a notice, the company and every officer of the company who is in default shall be guilty of an offence and be liable on conviction to a fine.

**<u>Procedure to change / amend the Articles</u>**

- Call a shareholders' meeting by giving 15 working days' notice
- In the notice the proposed alteration should be included
- At the meeting at least 75% (¾) of shareholders who vote should cast their votes in favour of the special resolution
- Within ten working days, after passing the special resolution, the company should give notice to the Registrar regarding the alteration by Form 39.

**Articles of the Companies Formed Under Companies Act No.17 of 1982**

Under the Companies Act No.17 of 1982, every company was required to have two documents as company's constitution

(1) Memorandum of Association and
(2) Articles of Association.

Under the new Act, instead of having two documents as company's constitution, only one document is required, that is the Articles of Association. Under the 2007 Act, a company need not have a Memorandum of Association.

As per sec.486, the companies formed under the Companies Act No.17 of 1982 or under earlier statutes may continue to have the memorandum and articles, but those two documents will be collectively identified as articles under the Companies Act No.7 of 2007. Therefore, the memorandum of association of such companies are treated as part of the articles of association.

**<u>OBJECTS CLAUSE AND 'ULTRA VIRES' RULE</u>**

**Objects Clause**

Section 2(2) provides that a company shall have, both within and outside Sri Lanka, the capacity to carry on or undertake **any business** or enter into any transaction; however, a company may restrict this capacity by its articles. Because section 13(a) provides that, the articles of association of a company **may** provide for the objects of the company. Here we can see that the words used by section 13 is 'the articles **may** provide for the objects. Therefore, <u>it is not compulsory</u> to state the objects clause in the articles.

It seems that this freedom is applicable mainly to private companies, as far as companies limited by guarantee and public companies are concerned this freedom is not available. Because Sec.33 (1) (a) provides that a company limited by guarantee **shall** have articles which sets out the objects of the company. Therefore, it is compulsory to state the objects.

As per Section 37, a Public Company is required to specify in the prospectus, the business it intends to do in the first five years. Therefore, the act impliedly requires a Public Company to state its object.

**Meaning of 'Ultra Vires'**

Ultra Vires is a common law (English Law) rule. Ultra Vires means 'beyond the powers' or 'beyond authority'. As per this rule if a company states its objects in the articles, such a company is permitted to do only the business specified in the objects clause, and that company should not enter into any other business.

If the company makes any contracts or does any business activity, which is not authorized by the object clause, such a contract or business activity will be treated as ultra vires. All the ultra vires contracts are void (invalid) and therefore the company and the other party to the contract are not bound by such a contract.

Example- If a company's object clause provides that the company's object is **manufacturing garments**; the company is not entitled to deal in **stationeries**.

Ultra Vires rule affects the investors and those who deal with the company, because if any contract entered into by the company is found to be outside its scope of objectives, the innocent parties had no remedy under the law.

***Ultra Vires rule is not applicable to companies in Sri Lanka after the enactment of Companies Act No.7 of 2007.***

**ULTRA VIRES RULE UNDER THE COMPANIES ACT NO.7 OF 2007**

As per sec.13, a company is given a freedom either to mention its objects in the articles or to avoid the mentioning of the objects clause. If the articles does not provide for the objects, the company will have the same freedom to contract similar to a natural person and it can carry on any business or it can make any contract.

**<u>Section 17 of the Companies Act provides that,</u>**

(1) Where the Articles of a company sets-out the objects of the company, there shall be deemed to be a restriction placed by the Articles in carrying on any business or activity that is not within those objects, unless the articles expressly provide otherwise.

(2) Where the Articles of a company provide for any restriction on the business or activities in which the company may engage:

(a) the capacity and powers of the company shall not be affected by such restriction; and

(b) no act of the company, no contract or other obligation entered into by the company and no transfer of property by or to the company, shall be invalid by reason only of the fact that it was done in contravention (violation) of such restriction.

(3) Nothing in subsection (2) shall affect:

(a) the ability of a shareholder or director of the company to make an application to court under section 233 to restrain the company from acting in a manner inconsistent with a restriction placed by the Articles, unless the company has entered into a contract or other binding obligation to do so; or

(b) the liability of a director of the company for acting in breach of the provisions of section 188.

***As per Sec.17(1), the company and its directors are bound to do only the business stated in the objects clause. As per section 17 (2) even though such a restriction is there, the capacity and powers of the company are not affected by such restriction. Therefore, all the acts and contracts entered into by the company will be valid even though they were done in contravention of such restriction. Therefore, the Companies Act, by Section17(1), while emphasizing to carry on only the business specified in the Articles, the Companies Act, by Section17(2) it validates or gives legal status to contracts made outside the objects clause.***

As per Sec.233 (2) **before** an ultra vires contract is made, a director or a shareholder of the company may file a case restraining (preventing) a company or a director from engaging in that contract. However as per Sec.233 (4) if the contract or act has already been done, no remedy is available to the company or shareholders.

## EFFECT OF ARTICLES (SEC 16)

As per Sec 16, the articles of a company shall bind the company and its shareholders as if there were a contract between the company and its shareholders, in particular all money payable by any shareholder to the company under the articles shall be a debt due from that shareholder to the company.

**Hickman Vs Kent Sheep Breeders Association**

In this case, the articles provided that the disputes between the company & its members must be referred to arbitration. One of the members of the company was removed from his membership. He filed a case in the court against the co. to get an injunction against the removal. The court dismissed his case and said that even if the removal was unfair, the member was not entitled to file a case in the court to get an injunction, because he is bound by the provisions of the articles. As per the articles, his dispute has to be referred to arbitration and not to the court.

Articles is not treated as a contract between a company and other persons such as its Directors, Secretary, Promoter, Lawyer, Accountant etc. Therefore, even though there are provisions in the articles regarding a Director, Secretary, Promoter, Lawyer or an Accountant, those provisions in the articles cannot be enforced by those persons.

**Elley Vs Positive Life Assurance Company**

Elley was a member of the company and he was appointed by the articles as the company lawyer for life. But he was removed from the post after 5 years of service. He filed a case against the company stating that as per the articles he was entitled to serve as company lawyer until death. The court held that Elley had two capacities in the company one is its Member the other one is its Lawyer. Articles can be used by a member only regarding his membership rights and not regarding any other right. Here the issue is not regarding membership but regarding his post of company Lawyer. The articles is not a contract between a company and its Lawyer. Therefore, the company has the power to remove him from the post of company's lawyer.

# COMPANY CONTRACTS

Contracts made by a company can be divided into two categories: -

(a) Pre-Incorporation Contract (Before incorporation)
(b) Company Contract (After incorporation)

## Pre incorporation contracts

As per Section 23 (1), "pre-incorporation contract" means-

(*a*) a contract purported to have been entered into by a company before its incorporation; or
(*b*) a contract entered into by a person on behalf of a company before and in contemplation of its incorporation.

Therefore, pre-incorporation contract means either a contract made by a company, before it is registered (incorporated) or a contract made by a person on behalf of the company before it is registered. Example: purchasing a property in the name of the company before the company is registered

## Is pre-incorporation contract valid and binding on the company?

Position before Companies Act No.07 of 2007

Before the Companies Act No.07 of 2007, we were following the English law principle regarding pre-incorporation contracts. As per the English case of **Kelner v Baxter [1866]** a pre-incorporation contract is not valid and not binding on the company and it cannot even be ratified by the company after it is incorporated, because the company was not existing at the time pre-incorporation contract was made and it was not a party to that contract.

Therefore, before the Companies Act 2007 came into operation, a pre incorporation contract was treated, similar to a contract made by a child before it was born. Therefore, a pre-incorporation contract was not treated as a valid and binding contract on the company.

**Position after Companies Act No.07 of 2007**

Under the Companies Act No.07 of 2007, after the company is registered, a pre incorporation contract can be ratified by the company. If a company ratifies a pre-incorporation contract, it will be valid and binding on the company.

Section 23(2) states that notwithstanding anything to the contrary in any law, a pre-incorporation contract may be ratified by a company within the period specified in the contract or if no such period is specified, within a reasonable time after the incorporation.

Sec.23 (3) states that a pre-incorporation contract that is ratified shall be as valid and enforceable as if the company had been a party to the contract at the time it was entered into.

**Warranties Implied in Pre-Incorporation Contracts (Sec. 24)**

In a pre-incorporation contract, the promoter or any other person who makes a contract on behalf of a proposed company gives two warranties (undertakings) to the other party to the contract

(1) that the company will be incorporated; and
(2) that the company will ratify the contract after the incorporation

However, if either the company is not incorporated or if the company fails to ratify the contract, then such a promoter will be liable to pay damages to the other party for the breach of implied warranty.

**Properties Received by the Company without Ratification**
Sec.25 states that where a company has acquired property under a pre-incorporation contract without ratification, a court may order the company to return that property to the person from whom it got it.

**Method of ratification**
A pre-incorporation contract may be ratified by a company in the same manner as a contract may be entered into on behalf of a company under **section 19**.

**Company Contracts (after incorporation)**

As per Sec.2, immediately after a company is incorporated, it may make any contract or enter into any business or activity in its own name in Sri Lanka or in abroad. As the company does not have physical existence, these contracts have to be made through human beings, that is, through authorized persons such as directors, offices, agents etc.

**Method of Contracting –Sec.19**

As per Sec.19, similar to a natural person, a company may make oral contracts, written contracts and contracts under deeds. According to sec 19(1) a contract may be entered into by a company as follows:—

(*a*) Signing Deeds
A contract which, if entered into by a natural person is required by law to be 1. in writing 2. signed by that person and be 3. notarially attested, may be entered into on behalf of the company in writing signed under the name of the company by —

(i) two directors of the company;
(ii) if there be only one director, by that director;
(iii) if the articles of the company so provide, by any other person or class of persons; or
(iv) one or more attorneys (agents) appointed by the company,

and be notarially executed;

(*b*) Making written contracts
a contract which, if entered into by a natural person is required by law to be in writing and signed by that person, may be entered into on behalf of the company in writing signed by a person acting under the company's express or implied authority;

(*c*) Making oral contracts
an obligation which if entered into by a natural person is not required by law to be in writing, may be entered into on behalf of the company in writing or orally, by a person acting under the company's express or implied authority.

Company seal is not mandatory

As per Sec.19, the company seal (common seal) is not compulsory for a contract to be made by a company. This is a major change introduced by the Companies Act No.7 of 2007. However, if a company wishes to maintain a company (common) seal, it can do so.

Attorneys (Agents) Sec.20

Subject to its articles, a company may by an instrument in writing, appoint a person as its attorney either generally or in relation to a specified matter. Any act of the attorney carried out in accordance with such instrument, shall be binding on the company.

## INDOOR MANAGEMENT RULE

**(Rule in Royal British Bank Vs Turquand (1856))**

This rule is also known as, Rule in Royal British Bank Vs Turquand, Turquand Rule, Indoor Management Rule or Internal Management Rule. This rule is a protection available to innocent outsiders.

In Royal British Bank Vs Turquand, the articles of a company provided that the directors have the power to borrow money on behalf of the company, but before borrowing, the directors should get the consent (approval, assent) of the shareholders by way of an ordinary resolution. Two directors of the company borrowed money on behalf of the company from Royal British Bank, but without the shareholders' approval. When the bank demanded the money from the company; the company refused to pay stating that the loan is not binding on the company, as the directors had borrowed the money without shareholders' approval.

The court held that the company is liable to pay the money to the bank even though the money was borrowed by the directors without members' approval. Because, passing an ordinary resolution is an internal matter; a copy of an ordinary resolution is not sent to the Registrar of Companies, therefore the bank is entitled to assume that the ordinary resolution has been passed.

The court in Turquand case has made two rules

1. Indoor management rule - applicable to internal documents of a company -this rule is beneficial to outsiders

2. Constructive notice rule - applicable to the public documents of a company -this rule is not beneficial to outsiders

**The indoor management rule**

The indoor management rule is that 'a person dealing with a company **has no obligation to ensure** (verify) that the company went through its internal regulations, because '**Internal irregularities** of a company **will not affect outsiders'**.

Internal regulations mean the documents of the company which are **not available for inspection to the public** at the Registrar of Companies or at any office of the company. Examples of internal documents are: ordinary resolutions, board resolutions, unaudited accounts etc.

**Constructive Notice Rule**

The indoor management rule does not apply to public documents, public documents mean the documents of the company which are **available for inspection to the public** at the Registrar of Companies or at any office of the company, Examples of public documents - Articles of Association, Form 1, 13, 18, 19, 20, special resolution, annual return (Form 15) etc. As per the Turquand Rule regarding public documents there is '**constructive notice**'.

Constructive notice means attributed knowledge. It is the duty of the outsiders to check the public documents and verify (ensure) that the proposed contract is authorized by the public documents. As per the Turquand rule **even though the outsiders do not check** the public documents, **the law presumes** (assumes) that they checked the public documents and know their contents and therefore if public documents do not authorize a contract, that prohibition will affect the validity of the contract, and therefore the outsider has no protection in the law.

**No constructive notice under the Companies Act**

As per Section 22 - a person shall not be affected by or deemed (assumed/presumed) to have notice or knowledge of the contents of the articles of a company or any other document relating to a company, by reason only of the fact that it has been delivered to the Registrar for filing or is available for inspection at any office of the company. But regarding Register of Charges, there is constructive notice as per section 105(3).

## **Application of Turquand Rule under the Companies Act No.7 of 2007**

Indoor Management Rule – it is beneficial to outsiders therefore the companies act has recognized it by Sec.21.

Constructive Notice Rule – it is not beneficial to outsiders; therefore, the companies act has removed its application by Sec.22. (Exception- registers of charges sec.105(3)).

## **Authority of directors, officers and agents to enter into contracts Sec.21**

A company **may not** assert **against a person** dealing with that company or with any person who has acquired rights from the company that:-

(*a*) the articles of the company have not been complied with; or

(*b*) the persons named in the annual return, are not the directors or the secretary of the company, or

(*c*) where a company holds out a person as a director, officer or agent of the company, the company cannot assert that such person —
(i) has not been duly appointed; or
(ii) does not have authority to exercise the powers

(*d*) document issued by any director, the secretary or by any officer or agent, with actual or normal authority to issue the document, is not valid or genuine.

The above provisions shall apply even if that person acts fraudulently or forges a document that appears to have been signed on behalf of the company, unless the person dealing with the company or who has acquired rights from the company has actual knowledge of such fraud or forgery.