THE UNIVERSITY OF ZAMBIA
SCHOOL OF LAW

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PROBLEMS OF INCORPORATION AND THE NEED FOR LAW REFORM IN ZAMBIA

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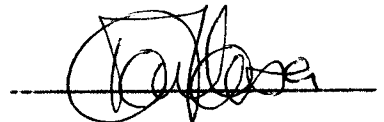

SUPERVISOR

PROBLEMS OF INCORPORATION AND THE NEED FOR LAW REFORM IN ZAMBIA

BY

ALEX KALIKITI

OCTOBER 1993

UNIVERSITY OF ZAMBIA

DEDICATIONS

To my parents (Mr. and Mrs Kalikiti) for all the moral and financial support rendered to me in my education.

To my elder brothers and sister for the financial and moral support and for being a source of inspiration for me to work harder. And of course my young brother and sisters who have borne the burden of my expenses and continuous absence from their company.

To all of you I say thank you and God be with you.

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It is quite impossible to enumerate all the people to whom I am indebted for help and advice. But, I continue to be indebted to Dr. T. K. Mabula, my supervisor, whose patience, understand in pointing out all the mistakes and errors was unbelievable. Her criticisms and suggestions were invaluable. These suggestions have been carefully considered and acted nowhere I felt in agreement with them. Dr. Mabula's assistance has been very helpful to me as scholar.

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The value of their contributions remains invaluable, although the responsibility for all remaining errors and defects, however remains mine alone.

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CHAPTER ONE

HISTORY OF COMPANIES ACT IN ZAMBIA

INTRODUCTION:

1. HISTORY OF THE COMPANIES ACT IN ZAMBIA

There are many subjects crying out for legislative reform. Company law may not be politically the most popular, but the lawyer who really cares must see injustice and a moral business conduct going unpunished. This is so because our companies Act[1] is about 60 years out of date and we are permitting hundreds of companies to operate under legislation which is out dated. It has become a paradise for the confident trickster who uses the short comes in the Act for his own benefit and at the expense of creditors and shareholders.

This situation has arisen because when the Act was passed the pattern of investment was very different from the present pattern, it was mainly formed for investors in order for them to open up new industries.

The Zambian companies Act was based on the English companies Act, which has since undergone so many amendments it is almost like a new Act compared to our own Act. Despite the fact that the people we adopted the Act form have seen it's inadequacy and amended it several times to March with the change times, the Zambian Act has achieved

only a few insignificant amendments, such that if you look at the marginal notes of the top of chapter 686 you will find no fewer than 15 amending statutes from 1925 to 197 of which one is a federal Act[2].

But, before we go on to look of the problems caused by their adequacies in the companies Act we will first give a brief history of how the companies Act come into being in Zambia.

The statutes which enabled a corporation to be created by statute (rather than by letters, patents, speech Acts or Royal charter) are:[3]

The stock companies Act	1844
The stock companies Act	1845
Companies clause consolidation Act	1845
Joint stock companies winding up Act	848
and 48 amendment	1849
Joint stock companies Act	1856
Joint stock companies Act	1857
Joint stock companies Act	1858
Companies Act	1862
Companies clause Act	1863
Companies Act	1863
Companies Act	1867
Companies Act	1867
Companies Act	1877

Companies Act	1879
Companies Act	1880
Companies winding up Act	1890
Directors ability Act	1890
Companies Act	1900
Companies (Consolidation) Act	1908

These are some of the important of the old company law of england that became part of our received law' in Zambia. There are many other Acts dealing with minor aspects of these, it is said that the 1856 Act, a consolidating Act, is really the father of modern company law. If that is the case one can only say he was a naive father many of the precautions built in the 1855 Act just disappeared, no minimum capital, no approved auditors, limited hability with no safe guard of any significance other than notice to the world by the use of the world limited[4].

The 1908 companies consolidation Act was of course, part of the law of England on the critical date 17th August 1911 when Northern Eastern Rhodesia and North Western Rhodesia became by the Order in council Northern Rhodesia with power to make it's own laws to override or amend the received law.

It was the 1908 Act which was the basis of our own companies proclamation of 1921 which in due course became our companies Ordinance, which was chapter 216 of the

previous edition of the laws and is now the companies Act chapter 686 of the current Revised Edition of the laws of Zambia.

1.1 FORMALITIES FOR REGISTRATION OF A COMPANY IN ZAMBIA

The formation of a company is often undertaken by a promoter. When it is desired to form a company certain preliminary steps are necessary e.g it has to be decided whether it should be a public or private company.

In order to register a company certain documents have to be filed at the registry of companies, of these the most important are the memorandum and articles of association.

1.2 Memorandum of Association

The memorandum is the constitution of the company and it sets out the requirements that a company must fulfill before it can be registered and are set out in section 8 of the companies Act. And of there the most important is the objects clause which states the purpose for which a company has been formed. This has lead to the ultra vires doctrine which has brought a lot of hardships to third parties dealing with the company. (This will be discussed in detail later in the paper.)

The memorandum also provides for the amount of share capital with which a company proposes to be registered[4], but of course the Act does not provided for a minimum share

capital which has lead to a situation in which just about anybody with a few kwachas can form a company in Zambia. this has also lead to hardships being faced by creditors, this will also be discussed later in full in the paper.

1.3 Articles of Association

The articles of association is a document regulating the rights of the members of the company among themselves, and the manner in which the business of the company shall be conducted. It deals with the issue of shares, transfer of shares, alteration of capital, borrowing powers, general meetings, voting rights, directors, their appointment, winding up and various other matters[6]. Of the matters dealt with in the articles we shall concentrate on the directors, because the conduct of company directors has in recent years became a matter of great public concern. And in this paper we will try to see how this anomaly can be redressed.

In practice the memorandum and articles of association are usually bound and filed as one document. The companies Act does however, provide in the first schedule a specimen of articles and unless there is an express provision in the articles excluding the application of table 'A' it shall be applicable to that company[7]. However, companies limited by guarantee must always prepare their own articles of association. A company may however only file a memorandum.

In addition to the memorandum and articles a company should also file the following documents:

1.4 Form seven(7)

This is the notice of situation of the office or change of situation of office. It merely states the exact location of the company and should be signed by the secretary, director or and the manager of the company.

1.5 Form Twelve (12)

It is a list which sets out the list of directors.

1.6 Form fifteen(15)

This is the declaration of compliance i.e an oath taken by the person engaged in the formation of the company stating that the requirements of the companies Act have been complied with. These documents are to be filed and an appropriate fee paid to the revenue.

If these documents are found to be in order the Registrar issues a certificates of incorporation[8]. This is the company birth certificate.

A company only comes into existence when the certificate of incorporation has been issued.

On the other hand a public company formed as such may not commence business until it has obtained the registrars

certificate issued under section 34 of the companies Act; for this purpose the registrar requires evidence that the company has alloted shares of a normal value on which at least one quarter of nominal value of the shares and the whole of any premium has been received.

After this the company comes into being or is born with all the attributes of an incorporated company. It is these attributes and the hardships they have caused which we are going to look at in the next chapters and how these could be amended to reduce the hardships caused and unscruplous business man taking advantage of the same and finally end by giving recommendations to improve the situation.

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1. Companies Act Chapter 686 of the Laws of Zambia

2. Act No 41 1959.

3. J. Dare The Law relating to companies in Zambia' <u>Law association Journal</u> Vol. 11 June 1985 22

4. Section 8(3) of the companies Act Chapter 686 of the Laws of Zambia. (mimimu share capital is K100,,000)

5. Article 72 table A' first schedule of the companies Act

6. Section 29 of the companies Act chapter 686 of the laws of Zambia.

7. Ibich. Section 39.

8.

CHAPTER TWO

LAW RELATING TO DIRECTORS

2.0 DIRECTORS

One of the advantages of the company is that it enables a person to have a financial interest in a business in the management of which he is unable to take part.

The management of a company is therefore usually entrusted to a small body of persons commonly called `directors'.

This view can be viewed in the historical perspective, starting from the first English general incorporation statute of 1944, which provided for the discharge of certain corporate functions by the directors, ie. section 44 of the joint stock companies Act.

The Act did not provide that a company should have directors, but should a company decide to appoint directors their powers and duties were provided under section 27.

This requirement in effect made a board of directors an inherent part of a company and was confirmed in the companies Act, 1945. sections 81 and 90 of the joint stock

companies Act of 1945 made it an imparative for a company to have directors and for the management and superintendence of the affairs of the company to be vested in the directors.

This was the position until after November, 1929, when the statuary requirement that a company must have directors was restored section 176 of the 1948 Act provides that,

> every company registered on or after the first day of November 1929 (other than a private company) shall have at least two directors, and every company. registered before that date (other than a private company), and every private company shall have a director.

This means that every public company must have at least two directors and a private company one director[1].

But, since the Zambia companies Act was modelled after the English companies (consolidation) Act 1908 there has been no statutory requirement for directors. That every company has a director is probably the result of a false assumption that a board of directors is an integral part of a Zambian company as it is of an English company.

2.1 SHOULD THERE BE A CHANGE IN THE LAW AS TO A DIRECTOR'S STANDARD OF SKILL?

At the moment the law upon this important subject is to be found not in a coherent body of legislation but

bona fide yet perfectly irrational"[2].

Another less extreme example of a situation in which the requirements of bona fides and subjective standard of skill can fail to provide a company with adequate protection is supplied by the facts brought out by Mr. Milner Hollands report[3] on behalf of the Board of Trade, into the affairs of the Savoy Hotel Limited. The directors of the Savoy, on the belief that it was for the benefit of the group that their existing business should continue unchanged, devised a scheme to deny any one who might obtain voting control of the Savoy company, and thereby indirectly control of it's wholly, owned subsidiary (the Berkeley company), the power of selling the Berkely hotel and other property for what might be property development purposes involving the demise of the hotel. Counsel for the Savoy took the view that the directors could properly embark upon their scheme if they were bonafide of the opinion that it would be in the better interest of the company that the new state of affairs so produced should be brought into existence...[4]" yet on the any rational and objective view there was a crucial objection to the scheme, namely that it would have forever deprived the company of the power or re-deploying its assets. Whether by ether changing the user of it's property or selling it to a purchaser for a price reflecting a more remunerative user.

2.2 OBJECTIONS TO AN OBJECTIVE TEST OF SKILL

Consideration will now be given to a number of objections that have been raised to the requirement of an objective standard of skill on the part of directors.

That it will stifle directors' initiative and an enterprising spirit in boardrooms. If the statutory imposition of an objective standard of skill was based on that of say, the reasonable man of business then this objection would largely be met since it would then be made to the courts that an allowance for entrepreneurial initiative had to be made in any event directors would surely take some comfort from the fact that the combination of the wide range of permissible conduct that would be allowed to directors by a stand that permitted a decision that could have been taken by a reasonable man of business (or board of directors) and the restraint the court would feel in substituting their own judgment, upon a commercial issue would very often result in a judicial judgment adverse to directors only where bad faith was found.

Indeed the extreme likelihood that directors would only be penalised for breach of their duty of skill in a some what limited number of situations can be preferred in answer to the objection that increasing control on the

conduct of directors may be fast threatening to became counter-productive.

It has also been contended that the objective standard of skill would be inappropriate for imposition upon directors of small family companies and non executive directors in the case of the former director it is unlikely, that any proceedings would be persued against him for breach of the standards save in rare cases where there were sufficient assets in a liquidation to encourage a liquidator to do so for the benefit of the company's creditors[5].

It has further been argued that the holding of a directorship is not a professional employment, yet while company directorships are not one of the older professions, nevertheless business management is now regarded as an important professional pursuit.

The common law is becoming increasing strigent in it's enforcement of the duty of care and it's imposition of high professional standards upon the older professions and there is no good reason why this new profession should be subject to such a lower standard of care.

It is also feared by some people that the imposition of more enacting standard of competence upon directors

could lead to an avalanche of litigation. In fact, quite the opposite is likely to be true and the present legal limitations upon the actions by minority shareholders in combination with the likely circumstances in family companies that the majority share holders are themselves the directors will ensure that the provision imposing an objective standard will in many situations be a paper tiger, but not in the extreme situation where it could be involved. The disinterested shame holder has been replaced by the disinterested institution, and neither of them realises anything is a miss until the company is on the brick of liquidation. It is in the exceptional case where the lack of skill of the relevant directors is egregious that the additional protection of share holders would be welcome and more over any addition to the inadequate armoury of liquidators could only be beneficial[6]. Section 9 of the Insolvency Act providing for the disqualification of directors of companies, two of which have gone into liquidation in five years is a blunt instrument for the cont of dangerously incompetent directors. Although, on the other hand, it must be recognised that the dishonest or even highly prescient director would always be difficult to recover from whatever duties or limitations are imposed upon him, since when he appreciates that his company is no longer prospering his undoubtedly then prevailing high level of expenditure will be channelled into passing assets towards his wife, family and Swiss accounts which assets

apart from everything else, will be heard to repossess even under the drawback provision of bankruptcy law.

The other deterant is the expense of the pursuit sometimes exceeds the value of the prize and thus external constrant on the prosecution of litigation applies to company law as much as in any other branch of the law.

Many boardroom decisions are reached by consensus or in recognition that certain directors have responsibility for and expertise in particular areas of the company's business. These common circumstances and the fact that many boardroom decisions when implemented, have passed through a number of middle management, no longer accord with the board's original concept of them, render problematic the attribution and apporticument of liability to and among a board of directors. However it is felt that courts will not find such problems impossible to cope with. It has in the past been thought impossible for the courts to be called upon to pass judgment upon commercial decisions, yet under the law as it presently stands the courts had in the case of Re Burton and Decikem to make a decision as to whether a proposed arrangement could reasonably be considered by an intelligent and honest board of director as being in the company's interests. However, the courts could not be considered in that case had they been called up to unearth and calculate the incalculable.

The court would, in the mean time, be required simply to undertake a careful exercise of judgement.[7]. Where the imposition of an objective standard of skill upon a director would cause injustice, there is a discretion in the courts under the law as it stands to provide him with relief since section 448 of the companies Act of 1948 already provides him with relief in that it provides "In any proceedings for negligence, default, breach of duty, or breach of trust against an officer of the company, if it appears to the court that he is liable in respect of negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably and that having regard to all circumstances of the case including those connected with his appointment, he ought fairly to be excused, that court may relieve him either wholly or partly, from his liability on such terms as the court may think fit. Of course, this relief is discretionary only but, it could be less restrictively granted than in the past with the imposition of a higher standard of skill.

Care must obviously be taken not to reach the position where a director is almost, in law, to be equated with a trustee. The latter has very strict duties specifically designed to minimise the chance of loss, while a director must be an entrepreneur whose motto is lnothing ventured nothing gained". However, it is felt that to impose an objective standard of skill would not divorce the chances

[illegible] loss from benefit of speculative profit, but rather [illegible] in the law of this [illegible] a change in [illegible] [illegible] date when the country [illegible] could escape [illegible] [illegible] board's [illegible] that it was unreasonable to expect [illegible] to travel to another part of the country for monthly board meetings.

The Act should also be amended so that it provides that every company should have at least two directors. The idea of this is to meet the problems now arising on the death of a sole director and to check the present spate of irresponsible incorporations of 'one man' companies. There is a danger of abuse through the incorporation with limited liability of many small, undercapitalised businesses and incorporation is nowadays frequently used e.g. simply as a cheap means of protecting a name.

The Act should also contain a general statement of the basic principles underlying the fiduciary relationship of directors towards their companies. A director who, in any transaction relating to the securities of his company or any other company in the same group, makes improper use of a particular piece of confidential information which might be expected materially to affect the value of such securities should be liable to compensate a person who suffers from his action.

2.3(0) DUTIES OF DIRECTORS

There should also be included a section requiring a director to disclose only material interest in contacts but including contracts which do not come before the board. If a director has a material interest in a contract (other than a service contract with a director) whereby any individual, firm or body corporate undertakes the management and administration of a substantial part of any business of the company, a copy of the contract and a return stating the directors' interest should be delivered to the registrar. This is so because investment companies sometimes appoint agents to manage their business and the directors may have an interest in the managing agency and so draw part of their remuneration for the management of the company indirectly through the agency.

This should also extend to the prohibition of loans by a company to another company in which the directors of the lending company have a controlling interest.

2.4(1) DIRECTORS POWERS AND SHARE HOLDERS CONTROL

There should be greater disclosure of matters relating to directors in the publishing of financial statements. This can be done by providing that there should be

reduce on frauds by directors ie. where they sell the assets to third parties at an overvaluation and they keep the difference, or they sell the assets to themselves or a relative and an under valuation to the detriment of the company such a situation could be avoided if the general meeting were to approve of the sell of assets before there are disposed of.

2.2 WINDING UP

the courts should be empowered to order public examination of directors of an insolvent company where there is some prima facie case of culpability. The Act does not at present provide a sufficient deterrent to dissuade directors from continuing the business of a company which they know to be helplessly insolvent.

The Act should be amended to provide a summary procedure to deal with actionable negligence by directors and officers, and to bring within its scope a recover of any property of the company.

In the case of winding up a penalty should be extended for fraudulent trading where the facts are discovered in other circumstances then in the course of winding up.

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3. R. Instine, "The dbity of directors' Journal of business law May 1979

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5. J. Dare 'The law relating companies in Zambia' Law association Journal Vol 11 June 1986

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7. [1977] 2 WLR 64

8. Charlesworth, Company Law, London, Steve, & Son 1965 Jenkins Company Law Committee, June (1962) .... 1749.

CHAPTER THREE

THE OBJECTIVES AND ULTRA VIRES DOCTRINE OF A COMPANY

3.0 THE OBJECTIVES OF COMPANY AND THE ULTRA VIRES DOCTRINE

The objects of a company are set out in the 'objects clause' of it's memorandum of association.[1] Objects clauses define the area within which a company may act; the company can not exceed these powers because that act will be ultra vires and any ultra vires act is void and creates no rights against the company. Such a transaction cannot be ratified, even by all the members[2], and that company cannot enforce the contract against the outside party[3]. The outsider is also bound by an ultra vires contract ie he can not enforce it against the company[4].

The main purpose of the ultra vires rule was to ensure that an investor in a gold mining company did not find himself holding shares in a fried fish shop and to give those who allowed credit to a limited company some assurance that it's assets would not be dissipated in unauthorised enterprises.[5]

However, recent judicial utterances[6] have suggested that the principle function of the rule is to protect shareholder by informing them of the business in which

their money may be used and that the protection that the creditors receive is purely coincidental. More over, the co committee concluded that[7] in consequence of the width of modern object clauses the doctrine of ultra vires is an illusory protection for the shareholders and yet maybe a pitfall for third parties dealing with the company.

Due to this, the ultra vires rule has, led to unjust results. A decision often cited in this connection is in re Jon Beauforte London Ltd[8]. Where the objects of the company were to carry on the business of consumers and gown makers. The company decided to produce veneer panels and erect a factory for this purpose, although this actively was not within the objects clause. When the company went into liquidation claims were brought by the builder of the factory, a firm which supplied veneer and a company which had supplied coke to the factory. All claims were rejected, and this rejection upheld by the court of Appeal. The claimants know the purpose for which the goods were required, they were deemed to know that the purpose was ultra vires and so could not claim against the company.

3.1 THE ZAMBIAN COURT

The Zambian court had the opportunity of examining the ultra vires rule and the injustice that results from if in the case of Kernezoss V Hermis Safaris Limited[9].The plantif

was claiming from the defendant company a same of money to the value of K9,729:20 for goods sold. The case for the plantiff was that. he had entered into an oral agreement with the general manager of the defendant company to supply 7,484 bags of burnt maize at K150 per bag. Half of the bags had already been collected by the defendant company and three other half was ready for collection at the plantiff's farm in Mukushi. The defendant company had refused to pay for the bags collected as well as for those which had not been collected on the ground that it had no power to purchase and resell burnt maize.

The issue was to determine whether the purchase of burnt maize was within the objects clause of the company. If not the claim was void on account that it was ultra vires the defendant company.

The court held that the contract was ultra virss the defendant company. The Judge narrowly construed clause 3f of the defendant memorandum and did not address himself to the Bell House case[10]. Clause 3f was almost as broad as a similar clause in the Bell houses case (this included power to carry on any other trade or business whatsoever which could in the opinion of the board of directors can be advantageously carried on by the company in connection with or as an ancillary to any of the above business on the general business of company and this clause was upheld by

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the court.

And clause 3f read"to purchase take on lease in exchange lure or otherwise any real property any rights or prestige which the company may think necessary or convenient for the purpose of it's business and in particular any lease building easement machinery plant and stock in trade".

It was wide enough to include the purchase of maize, the fact that it was subjective made it even possible to purchase any real and personal property. for persons dealing with the company it was not potentially ultra vires, but the judge chose to use the main objects rule to interpret this object that meant that the general words were taken in connection with what were shown by the context to be the dominant or mean object to which he could relate the general words this is potentially unrealistic.

The judge was not bound to follow the main objects rule of construction nor the broad construction adopted in the Bell houses case.

If he did not wish to cause hardship to the planitiff as he seemed to have regretted holding the contract ultra vires he would have saved himself regret by adopting the broad construction in Bell houses case. He would even have

alleged the plantiffs hardship by granting remedies available, which were to trace his property and the right to sue the general manager with whom he had dealt with on the bases of breach of warranty of authority. Sinclair V. Brougham[10]. It would therefore appear that the hardship suffered by the plantiff in the Kernezos case was not really a result of the law, but rather a result of the learned judge's perception of the law. That is why it is now up to the legislator to rectify the situation and as judge Sakala had rightly pointed out the best course to follow would be abolish the doctrine altogether or provide protection to the innocent persons as they have done in the United Kingdom.

This was done because the objects clause ceased to protect share holders and persons dealing with the company. This situation arose because the objects clause were drafted too widely and were there were not drafted widely the doctrine was a trap for persons dealing with the company.

Thus the new section 35 of the United Kingdom companies Act provides that

> "in favour of person dealing with a company in good faith a transaction decided on by the directors shall be deemed one within the capacity to enter into....."

A party to such a transaction shall not be bound to inquire as to the capacity of the company to enter into such transactions and shall be presumed to have acted in good faith unless the contrary to proved.

The above provision was intended to mean that if for example a person enters into a contract with a company which although lawful is ultra vires the company and he does not actually know that it is ultra vires. Provided that it has been decided by the directors he can assume that it is ultra vires and will be able to enforce the contract against the company and the company will not be able to pleade ultra vires. That is why is if the judge had wanted to do justice he would have held the director liable on the contract, even though an aggrieved party can raise breach of warranty of authority. Since him being in control of the company he should have known that the transaction was ultra vires.

The ultra vires doctrine has been widely criticised professor R.r. Pemungton in companies in the common market, refers to the horrors of the ultra vires rule. Professor Gower writes" the ultra vires doctrine has outlived it's usefulness"[2]. The ultra vires doctrine is only applicable to corporations. Other forms of business organisation, such as partnerships, can by agreement amongst the members, engage in any transaction in connected with the ordinary

course of their activities.

The harshness of the ultra vires rule is perhaps highlighted in the case of small family business where it is entirely fortuitous whether the trade is carried on by a company or partnership. It seems rather anomalous that whether the family can carry on business and a particular or transaction defends upon the circumstances of whether they are incorporated or not.

In the case of large companies where the shareholders are divorced from the day-to-day management of the business, the problem has a different perspective unless the validity of the ultra vires contract to made to depend upon the prior approval or subsequent ratification of a general meeting. That is why it is recommended here that the company should have the same contractual powers as are individual and that the powers of a company stated in the memorandum of association should take effect solely as a contract between the company and it's share holders as to the powers exercisable by the director,s and could be altered by a special resolution without the necessarily of obtaining the sanction of the court. This recommendation was also proposed by the cohen committee; but the Jenkins committee appeared to have rejected this proposal for two main reasons. The first was that directors would have too wide powers, and the second was that investors,

shareholders and creditors would have too little knowledge of the existing and proposed activities of the company in which they were interested. The Jenkins committee seems to have over looked one point and that is that the objects clause will still be there to make sure that shareholders and investors know what the company they want to invest in is engaged in doing. But, the object clause will not apply to third parties dealing with the company. And secondly the width of many existing objects clauses at present gives to directors many existing objects clauses at present gives to directors extremely wide powers.

More over the Act[13] only provides that the director's report shall state the principal activities of the company and it's subsidiaries (if any) in the course of the year and any significant change in those activities. However, this latter objection has something of 'bolting the stable door after the horse has gone'. The directors report merely informs the reader of what was the position during the previous financial year after the changes have been made. It does not necessarily inform the potential investor and creditor of what is being done at present, nor of possible future alterations in the companies business[14].

Even if the precise form of the recommendation of the cohen committee is not acceptable, several other possibilities exist[15]. In modern civil law, capacity to

have rights and powers pertains to juristic persons in the same full extent as to individuals, except natural abilities such as capacity to marry and to make a will, but including name, honor and credit. For third persons benefit who deal with the corporation, the laws usually freeze this full capacity into a 'formal' i.e an absolute fixed sum faculties, independent of the purpose of incorporation and restrictions imposed through charter or by-laws. Even though a juristic person ought not to make certain transactions according to the constitutional' documents and resolution of shareholder's meetings, it can yet do them with legal effect. Any transaction with third parties therefore, is valid at least if there is no fradulent collusion between the agents and the third parties[15].

From the above argument it follows that, it does not make a lot of sense in holding contract ultra vires when an innocent bonafide persons deals with a company which knows that what it is doing to beyond it's powers and the people who are in charge are allowed to hide behind the veil of incorporation i.e if the act is ultra vires the company why did they engage in the act in the first place because as directors of the company they are supposed to know the limits of the company's powers and it is them that are supposed to be held liable on the contract and not an innocent third party who does not even know what is company

has power to do. But, of course it might be argued that there is the constructive notice principle this will be dealt with more extensively in the next chapter and how it works against a third party especially in a third world country).

The ultra vires doctrine works very much against the individual and helps to enrich the real culprits. In this case the people who are behind the running of the companies because they themselves cannot be brought to book because they are a separate legal entity from the companies they purport to run. Keeping the ultra vires doctrine is like letting a criminal benefit from his crime letting directors take advantage of a transaction which they know or at least should know to be ultra vires and still enter into the transaction is committing a fraud on the other party and later claim that they can't pay for the goods delivered. They benefit and the third person suffers and their company continues to flourish at the expense of individual persons. The ultra vires doctrine should be abolished only to do justice.

In light of this conclusion the following recommendations should be taken into account when amending the out dated companies Act.

(i) a contract entered into between a company and another party (including shareholders onctracting otherwise than in their capacity as shareholders). Dealing with the company in god faith should not be hold to be invalid as against the other party on the ground that it was beyond the powers of the company. He should not, however, be allowed to enforce the contract without submitting to perform his part of it so far as it is unperformed.

(ii) In entering into any such contract the other party should be entitled to assume, without investigation, that the company is in fact possessed of the necessary power, and should not, by reason of his omission so to investigate, be deemed not list to have acted in good faith, nor deprived of his right to enforce the contracton the ground that at the time of entering into it he had constructive notice of any limitation on the powers of the company, or on the powers of any director or other persons to act on behalf of the company, imposed by it's memorandum or article of association.

(iii) The other party should not be deprived of his right to enforce the contract on the ground that

he had actual knowledge of the contents of the memorandum and reasonably failed to appreciate that they had the effect of precluding the company (or any director or other persons on it's behalf) from entering into the contract in question.

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CHAPTER FOUR

CONSTRUCTIVE NOTICE PRINCIPLE

4.0 CONSTRUCTIVE NOTICE PRINCIPLE

A person who has entered into an ultra vires contract with a company will find it difficult, if not impossible to sustain an action where he is presumed to know from actual inspection of the memorandum or otherwise that the company has no power to make the contract.

This is the principle of constructive notice which provides that a person is treated as having knowledge of the contents of a company's registered documents whether or not he has taken the trouble to read them, at least where he is seeking to enforce against the company a right which is inconsistent with the provisions of those documents"[1]

Since the law assumes that persons contracting with a company will have inspected it's memorandum it will enforce an ultra vires contract made with a company which on the face of it is ultra vires, ie where, if the contract and the memorandum had been compared; the contract would have appeared to be ultra vires. The rule applies whether the memorandum has infact been inspected or not[2].

The contracting party who cannot enforce the contract against the company may sue the agent who negotiated the contract on the company's behalf (usually the director) for damages for breach of warranty of authority. Every agent warrants that his principal has power to make the contract which the agent is making on his behalf. Where the company is a statutory one and it's powers are therefore contained in a statute, it is not possible to sue the directors since everyone is deemed to know the contents of a statute and ignorance of the law is no excuse[3].

The doctrine of constructive notice of the memorandum could, of course, prevent an action against the directors of a registered company for breach of warranty, since the other contracting party could not rely on a warranty where he had knowledge of it's falsetly, even though that knowledge was merely constructive.

However, though the point is not free from doubt, it is not thought that the doctrine of constructive notice will be allowed to prevent an action for breaching warranty; where the directors have made misleading statements as to the operation of the company public document as district from their content e.g where the directors state that the limit of borrowing have not been exceeded.

Furthermore it is likely that the director who willfully misrepresent their own powers, or those of the company; will be liable in the tort of deceit to a person dealing with the company in spite of the doctrine of constructive notice which deems that the outsider knows the company's powers and cannot be misled. The company could also be sued being vicariously liable for the deceit of th directors.

However, an action in deceit agaist the company and or the directors would of course be difficult, if not impossible, to sustain where the other party knows either from actual inspection of the memorandum or otherwise that the company has no power to make the contract.

In mahoney V East Holyford mining Co Lod Hatherley said that persons dealing with the company even if they do not have actual notice of the company objects because they have not inspected the memorandum, have constructive notice of its provisions, it they are deemed to know them, because the memorandum like most of the documents registeredwiththe register of companies, is open to public inspection and could be inspected.

Accordingly, if they make a contract which is to their knowledge, actual or constructive, ultra vires the company, and the company takes the point, they cannot at common law

enforce it, as is shown by Re Jon Beaufole Ltd[5].

If however they have supplied goods or performed services under such a contract they cannot at common law obtain payment, and if they have lent money the general rule is that they cannot recover it.

In Britain this concept has, however, been radically affected by section 35 of the British companies Act 1985 which provides that if a person enters into an ultra vires contract with a company and does not know that it is ultra vires provided that it has been decided on by the directors he can assume that it is inltra vires and he will be able to enforce the contract against the company and the company will be unable to plead ultra vires. This was done in order to alleviate the hardship caused to third parties dealing with the company because it is not alwaysposible to check the company registry for a company's documents, this situation is even worse for a third world country like Zambia where the information is out dated and not properly filed. Such that you cannot find the information you want at the appropriate time.

4.1 HOW THE RULE WORKS AGAINST THIRD PARTIES DEALING WITH A COMPANY

The doctrine of constructive notice is a fallacy which can be said to be true of third world countries, as an interview with the Registrar of companies revealed [6]. In reality the situation is very different from theory and all it does is create hardships and incovinience for people who go to the registry to look for information about companies they want to deal with. The registry is centralised it is only in Lusaka that is were all companies file their records and documents.

In the course of the investigation it was revealed that in some cases if took the registry months to locate the company files in question and sometimes the people just gave up because the company files in question could not be found. Secondly if they did find the files they in most of the cases had outdated information which was totally irrelevant and could not be used; e.g information files still showed names of directors who are no longer serving directors or worse still they still obtained the names of first directors. Moreover, when a company passes a special resolution they are not filed not even when they make an alteration to the memorandum or articles of association[7].

How practicable is a situation where somebody travels all the way from another part of Zambia to Lusaka to get some information about a company only to be told that the company in question's records cannot be found or if found there is outdated information. And let us suppose the individual were to engage into a transaction with the company and the court later holds the contract ultra vires who suffers in the this case because the company could not engage in the transaction in question and the their party is presumed to have had constructive notice of this.

That is why it is submitted here that the constructive notice principle should be abolished in order to alleviate the hardships suffered by people as a result of this principle which can not work in a third world country.

The Registrar of companies when asked about thus situation confirmed that it was true and advanced the following reasons for the short comings.

The first reason is that, whilst the offices of the registry are situated at the ministry of commerce and industry, kwacha house, the files of companies are kept at the old bank of Zambia building. This creates a very cumbersome process if the registry is to retrieve files of companies because they have to travel to the old Bank of Zambia building and the files there are not filed property because of the space.

The second issue concerns the outdated information. On this, the registrar stated that through it was their duty to up date the information, but because of the shortage of man power even if a company does not file new information or resolutions passed, there is nothing they can do about it because they lack the machinery and manpower to enforce or work an efficient system.

It was suggested to the Registrar that, decentralising the system might help to alleviate the hardships of filing because each provincial headquarter will have registry and the Lusaka one can be used as the principle registry.

The Registrar refused that, this is not the solution and stated that the only solution lay in computerising the system the gave an example that even large countries like south Africa which has far more companies then Zambia has only one registry in Pretoria.

However, the problem with computerising is the cost, it is costing South Africa about 23 Million Rands, this could not be a foreseeable solution in the new future as the solution to the problem.

Therefore the only available solution of the moment lies in legislation and the courts to see to it that unscruplous people do not take advantage of such a situation to their advantage at the disadvantage of innocent third parties dealing with the company. That is why legislation has been passed in England to cover innocent third parties who enter into contracts with the company in good faith[7].

But, since legislation is for behind business reality in Zambia it is up to the courts to look behind the smoke screen and look at the realities behind any company and the contracts entered into and the motives behind such contracts if only to do justice. Otherwise the culprits will use the short comings in the law to enrich themselves at the expense of third parties who deal with the company.

The Zambia High Court had the opportunity of examining the constructive notice rule in the case of <u>vin mals limited v Zambia Bata shoe company</u>[9] limited in which the defendant caused to be inserted in the Times of 15th and 16th January and advertisement to the effect that some property was being sold among them, one executive house on modzimoyo close park lands Kitwe, the plantiff, having seen the advertisement wrote to the defendant offering to buy the said property at consideration of K1.6 million. The plantiff later received a reply signed by the

management accountant of the defendant company. A contract was subsequently signed. The payment was made in two installments which was accepted but later returned it was on these main facts that the plantiff brought this action for among other things specific performance.

One of the defenses raised was that the sale of the property by the company could only be done after passing a special resolution in terms of the clause 68 of the companies articles of association. And since the articles of association were public documents the plantiff was deemed to have constructive notice of it's contents.

The court held that a person dealing with a company might have constructive notice of the articles but he will not be presumed to know of the internal irregularities in the company and further still that he was induced to enter into the contract by the advertisement in the paper together with the conduct of Mr. Mbiwe the accountant.

In this case it is submitted that the judge must have taken into consideration the practical realities and the British amendment to the companies Act[10] ie if a person enters into a contract with a company and is bonafide person with no frand involved even though the act is ultra vires the company and he should have had constructive notice he can still enforce the contract against the company. In

this case had the judge followed the lqw strictly of constructive notice he would have done a lot of injustice to the plantiff who was a bonafide purchaser of the property.

From the above argument it is clear that if lawyers in Zambia are not prepared to use their having in the interest of their clients such as in the case cited above will never see the light of day and justice will not be done nor seen to be done. This is more important in a society such as ours. Legislators everywhere never keep pace with the needs of society but, lawyers and courts should be prepared to ensure that the law never falls too far behind the social and economic realities in any society.

That is why the judge could not allow the members of the company to hide behind the objects clause and constructive notice of the company because to have done so would have resulted in unjustice to the third party.

It is therefore submitted here that in order to avoid such issues arising r@gain which might course injustice the constructive notice principle should be done away with it only in the interest of justice and because of the reasons given above which people suffer in order to find the documents on any complaining. The constructive notice principle is not practical in a country like ours unless the system was computerised.

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CHAPTER FIVE

LIMITED LIABILITY AND SHARE CAPITAL

5.0 LIMITED LIABILITY AND SHARE CAPITAL

5.1 Limitation of liability

The fourth clause of the memorandum of a limited company states that the liability of the members is limite and where the company is limited by guarantee this clause may contain the terms of the guarantee, though this may appear in the articles of association.[1]

5.2 Limitation by shares

The ability of a company to pay it's debts is unlimited in the sense that it must pay all debts due from it so long as it's assets are suffient to meet them.

It should be noted that limitation of liability refers to the members and not to the company itself. The liability of the discharge it's liabilities so long has it's assets to do so.

Limitation of liability may occur on formation, ie th company is registered as such[2]. This means the liability of each member to contribute to the capital is limited to the

nominal value of the shares that he has agreed to take up. Once the member has paid the company for his share his liability is discharged completely and he cannot be responsible for making up the dficiences of the company or of other share holders[3].

Further more, he has no liability whatever in respect of unissued shares. However in small companies which are private, the advantages of limited liability tend to be illusory since those who give the company credit facilities will in practice require guarantee from it's directors and major share holders[4].

5.3. Limited by guarantee

Company limited by guarantee maybe registered with or without a share capital. Where there is no share capital the members have no liability unless and until the company goes into liquidation. When this happens those who are members at the time are required to contribute towards the payment of the company's debts and liabilities and the cost of winding up in accordance with the guarantee. The amount guaranteed will be what over sum is state in the memorandum.

5.4 Minimum Share Capital

The fifth clause of the memorandum of a company which is limited by share or guarantee must state the amount of the company's share capital and it's division into a fixed amount. This is called the nominal capital or authorised capital, this is what the company is authorised to raise by the amount of shares. The amount of such capital will be determined by business considerations, and there is no fixed maximum's but, in Zambia the minimum is K100,000 but this is not provided for the Act it is just the amount you must raise as capital before the registrar can consider registering your company.

3.6 Abuses of limited Liability and minimum share Capital

The abuses caused are firstly that it is much too cheap and far too easy to form a limited company and this has led to an irresponsible multiplication of companies, particularly of one man companies, often to take over the assets of very small and under-capitalized business.

When these fails, as they frequently do the creditors have been left without a remedy against the proprietor and the company's assets have been insufficient to satisfy their claims. This is because of the principle of limited liability of the members.

The incorporation of small business can be traced back to the epoch making decision of the house of lords in Salomon V Salomon and co Ltd[6] recognising the validity of Mr Salomon's claim as a preferential creditor against his own one man company and the words of lord Davy at page 54 are often over looked but are much important. "it is possible and (I think) probable that the conclusion to which I feel constrained to come to in this case, may not have been contemplated by the legislature and maybe due to some defect in the machinery of the Act". He goes on to say that "this was true because the Act than and the administrative machinery do not sufficiently protect us against the economic damage caused by under capitalised limited liability companies"

There are two theories to under capitalised business' are argument is that, under capitalised business lead to over extended credit and increased prices. While on the other hand it is argued that limited liability encourages industrial and commercial enterprises[7].

The truth of the two theories is a matter of fact if under capitalised companies lead to over extend credit and increased prices then it should be discouraged.

In Zambia for instance the minimum share capital should be raised to reflect the economic realities because K100,000 is too little and it will definitely lead to heavy borrowing to raise the necessary capital to start a decent business concern which leads us to the point of over extended credit which seem to be true and it such a company folds up then the creditor lose out, because the capital of K100,00 cannot cover the debts of the company. Mean while the people who formed the company prosper at the expense of the creditors.

The other argument is that a company will be better run if the management have a larger stake in it themselves ie if they pump in a lot of money because it if folds up they also stand to lose.

And if limited liability does encourage industrialization it balance between the two must be strict so as to come up with the best alternative and the following alternatives are available.

(i) The government should set up a companies commission and which can carry out investigations into suspicious cases and would facilitate prosecution of offenders. It should be comprised of a member from the anti corruption commission, an accountants, a lawyer, a police officer, and somebody form the office

of the Registrar of companies office. This commission would fill the gap between the registry and the courts and would act as a watch dog for the two organisations and people could report this commission for irregularities in companies.

(ii) private companies which do not submit their accounts should do so to the commission. So too should public companies for scrutiny.

(iii) creditor protection must be linked to limited hability and not to the size of the company for example in Malayia if it is found that the capital is below the minimum the company forfeits it's limited liability or is wind up or declared a nullity leaving the members personality liable.

(iv) The value of the assets contributed in payment for shares must be guaranteed by the share holder and liability passes with the shares subject to a right of recourse against the transferor.

With this degree of morality imposed on a person by the law the private business man will not be so unscrupulous.

But, if you were to ask any small business man today why he decided to incorporate his business he will tell you it is to take advantage of their consequences of a limited liability company, but the truth of the matter is that they are afraid of being squeezed out of business and to protect his family because he forsees the risk of financial problems in the future and he would like the creditors to carry the risk that is why the minimum share capital should be raised to reduce an inscruplous people forming limited liabity companys so that they can hid behind the veil of incorporation and pass the risk to the creditors. It is down right moral to allow mini companies to risk money int the way they do.

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CHAPTER SIX

LIFTING THE CORPORATE VEIL

6.0 LIFTING THE CORPORATE VEIL

It is true that the Act is full of sections intended to prevent reckless trading but in practice those sections do not amount to a row of beans. That is why, in england, roads have been made by state for the veil of corporate personality to be lifted.

6.1 STATUTORY PIERCING OF THE CORPORATE VEIL

The first example of a case where the veil is lifted by statute is where a company carries on a business for more than six months with less than the statutory minimum number of members i.e two in a private company and seven in a public company, in which event every person who is a member during any part of the time that the business is so carried on after the end of 6 months and who knows that the business is so carried on after the end of six months is jointly and severally liable for all the companies debts contracted during such time and maybe severally sued there of[1]. This section intends to ensure that the number of members does not fall below the statutory minimum. This is exceptional because the general rule is that the debts of

the company can not be enforced against the members.

Section 87[2] provides that the failure of a company to publish its name it imposes liability on a company which fails to fix name in the manner prescribed by the Act and imposes personal liability on any manger or director who knowly or willfully allows the defect. This section was elaborated in the case of S.J. Patel Zambia V Gunamon[3].

This was an appeal by the plaintiff agaist the decision of the registrar in which he granted un-conditional leave to defend the plantiff claim brought in respect of three dishonored cheques. The plantiff supplied goods to longacres stores limited and three cheques were drawn in their favour signed by the defendant in his capacity as managing director of the company over a rubber stamp bearing the inscription, longacres store. Without the word limited appearing on the cheques. Subsequent to the issue of these cheques, the company went into voluntary liquidation and on presentation of the cheques they were dishonoured. The issue was as to whether the defendant had a statutory liability for the amount claimed by the plantiff was considered.

It was held under the companies ordinance that it requires that the company name in full be engraved on it's seal and mentioned in documents to be signed by or on

behalf of the company and that the last word of the company should end with the word limited failure to comply with the provision makes the person who signs the document personally liable if the company fails to pay[4].

And that if the failure to comply with the statutory provision the defendant is rendered himself liable to the plantiffs for the amount payable in respect of the three cheques..

Under section 218 of the companies Act, if in the course of winding up a company it appears that the affairs of the company have been carried out with the intention to defraud the creditors. The courts may on the application of the official receive or liquidator, creditor or contributor if it feels that any person who knownly was a party to the carrying on of the business with the intention to defraud the creditors shall be personally liable for all or part of the debt so as the court may direct.

For obvious reasons this paper is not intended to deal with statutory piercing but it was mainly intended t illustrate the provisions in the Act that provide protection to creditors.

6.3 UNDER JUDICIAL INTERPRETATION

Efforts by the judges to lift the veil have, in general been hum strung by the Salomon case, which finally destroyed the possibility of regarding a `one-man company' as a mere ahas of, or agent for, the principle shareholder. Third parties, who are so ill advised as to forget this and to regard the shareholders as the company, will not only have no rights against the numbers but many, in some circumstances mean incure liability to the company. Neverthel there have been exceptional cases in which the courts have felt themselves bound able to ignore the corporate entity and to treat the individual shareholders as liable for it's acts or entitled to it's property, or to regard the various companies of the group as one entity.

3.4 AGENCY:

If a company is acting expressly as the agent of it's controller then clearly the transaction will be binding on the controllers as principals. The problem arises in cases of implicit agency ie where the courts implies from the facts of a case that a company is a mere agent.

In Re F. G films[5] a United Kingdom Company; with it's sole place of business being a registered office with no employees and completely dominated by an American Company

apparently made a film. The problem was whether this was really a United Kingdom Company on which made the film and there for entitled to British subsidies it was held that the United Kingdom Company was merely acting as a nominee of the American company and therefore the film was not a British film.

6.2.1 `SHAM' COMPANIES:

The Salomon doctrine can be set aside if a company is a mere `Sham' - The problem is that a company cannot be a mere sham merely because advantages are gained by it being a company, because that is the very purpose of a company. In fern Brand V Pearl[6], a director of a company used his fiduciary position to get the company to lend money to two other companies which he wholly owned and controlled. The directors then used this money to pay off a debt which he owed on his shares in the first company. It was held by the court that the director was not allowed to perpetrate a fraud by setting up separate identies of his two companies and himself.

6.2.2 GROUP ENTERPRISES:

There is no doubt that the courts are more ready to set aside the Salomon doctrine and refuse to treat a subsidiary company as a separate legal entity where there

is an economic group with complete control. It must be remembered, however, that there are cases often cited where the issue is conceded by counsel and this naturally detracts from their being good authority..

<u>Re: Roberta</u>[7] certain chargo in a ship was damaged by neglect and the plantiff, who was the owner of the cargo, sued the first defended, who was the ship owner and the second defendant, who was a charterer. The issue was whether the second defendant, which was a Dutch subsidiary of another company was also liable.

In cross examination the parties admitted that the parent company and the subsidiary were an economic group and were separate companies in name only.

These are not the only situations in which the courts can lift the veil of incorporation, but this was only an example of judicial lifting of the veil and how the courts provide protection to persons delaingwith the company. i.e in addition to the statutory protection although these protections are not enough that is why further protections have been recommended in this paper.

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CHAPTER SEVEN

CONCLUSION AND RECOMMENDATIONS

7.0 CONCLUSION AND RECOMMENDATIONS

7.1 Companies Commission

Although there are statutory protections for persons dealing with a company and also judicial protection there are very few cases in Zambia which reach the courts. I am not personally aware of any case other than the S. J. Patel case) in which the veil of incorporation has been pierced.

This might be due to two factors, one is that the people are ignorant of their rights against companies or they are afraid of litigation being too expensive, this is where the companies commission would come in to investigate an behalf of the complaint and if he feels litigation is too expensive the commission can bring the action on his behalf and claim a certain percentage after the case has been won say 10% of the judgment award. This of course would be done with the other functions outlined above like checking the company records and accounts etc.

7.1.1 DIRECTORS

At present the law does not provide for standard of skill for directors, it is here submitted that the law should be amended so as to state the standard of skill required from directors so that companies can be ran more efficiently.

A section should be included obliging directors to disclose any interest they have in contracts they are to engage into on behalf of the company and if a next of kin or member of the family as a material interest in the contract.

There should be greater disclosure of matters relating to directors in that they should publish a directors report on which all directors are to be held liable for the accuracy of the report the idea is to insure that share holders are kept more fully informed of the company' activities.

The directors should not dispose of any company property without the approval of the board. The Act should also provide for summary procedure to deal with directors in default against third parties other than on winding up ie those who for example have been negligent. The Act

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The directors should not dispose of any company property without the approval of the board. The Act should also provide for summary procedure to deal with directors in default against third parties other than on winding up ie those who for example have been negligent. The Act

should also provide sufficient deterrents to directors who are dissuade in running the business or those who deliberately engage in fraud on third parties.

7.1.3 OBJECTIVES AND ULTRA VIRES DOCTRINE

The ultra vires doctrine should be abolished because it has outlived it's usefulness and all it does it create hardships for people who deal with the company and is being used by unscrupulous business men to their advantage at the expense of an innocent third party. But, the objects clause can operate between the would be share holders of a company or investors know what business the company they want to invest in is engaged in but, should however, not apply to third parties dealing with the company and it should be given the full rights of a natural person.

7.1.4 CONSTRUCTIVE NOTICE

The constructive notice principle should also be abolished because, if the objects clause and ultra vires doctrine do not apply to a third party then the constructive notice won't save any purpose. And secondly because this is a fallacy which does not exist in reality due to inadequacies in the filing system at the company registry as highlighted above.

7.1.5 LIMITED LIABILITY AND SHARE CAPITAL

The share capital should be increased so as to reflect the economic realities, so that, not every Jim and Jack can form a company only for the sake of passing the risk to creditors. But, to such an economic value so as to leave only the serious investors to form companies.

The value of assets contributed in payment for shares must be guaranteed by the shareholder and liability passes with the share subject to a right of recourse agaist the transferor. laws should be passed to defer small business just for the taking advantage of credit facilities allowed to companies and other incentives in such companies limited liability should not be limited but should attach to the shareholders upon the company winding up if there is fradulent trading.

7.1.6 LIFTING THE CORPORATE VEIL

The courts should have a wider discretion in lifting the corporate veil and not be restricted to those in the statute and those already set by earlier precedents because those were adequate for that period but are no longer adequate for this period because people have found ways around them.

The courts should have wider powers to lift the veil of incorporation when ever they feel it is in the interest of justice.

This paper was not intended to the review of all the company law because it does not even scratch the surface of all the short comings in the Act it was only to deal simply with a few selected principles and problems of incorporation and suggest a few resolutions to the loopholes in the present outdated Act.

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