

# THE 'ULTRA VIRES' DOCTRINE IN SRI LANKAN CORPORATE LAW: A JUDICIAL SCHISM?

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**Abstract** - *Ultra Vires* (hereinafter "UV") is the doctrine which confines the capacity of companies to their objectives. Originated in English law, UV was believed to be applicable in its full rigor in Sri Lanka for more than a century, until it was said to be partially abolished through the Companies Act No.7 of 2007.

Be that as it may, the majority decision of the Supreme Court of Sri Lanka in People's Bank v. Yashodha Holdings (Pvt) Ltd. seriously calls in to question, the long-lived credence that UV was part of Sri Lankan corporate law, at least, as far as the Companies Act No.17 of 1982 is concerned. Focusing on this controversial decision, this paper examines whether the application of doctrine of UV in Sri Lanka remains a controversial watershed.

While the Companies Act No.7 of 2007 has partially abolished UV, the Yashodha Holdings decision has the potential of (mis)construing the legal position that courts in Sri Lanka have undermined the application of UV even under a legal regime which had not abolished it. This might constitute a call for the present courts to take the same approach. The main objective of this paper is to resolve this point. Through an extensive doctrinal research, the paper examines the status, scope and application of the doctrine of UV under the current Sri Lankan law while pointing out, with all due respect, that the reasoning of the majority decision in Yashodha Holdings is inexact and unsound.

**Keywords:** Ultra Vires, Corporate law, Object Clause, People's Bank v. Yashodha Holdings

## 1. Introduction

### 1.1. Introduction

*Ultra Vires* (hereinafter "UV") is the doctrine through which the capacity and the powers of companies are kept within the limits of their objectives. The current corporate law regime in Sri Lanka, which is the *Companies Act No.7 of 2007*, has partially abolished this doctrine.

It appears that while the 1st and 3rd subsections of section 17 of the Companies Act No. 7 of 2007 move for the establishment of the UV doctrine, the 2nd subsection is against the doctrine in terms of application for third parties. It is important in the study of these provisions to not misunderstand this to mean that the UV doctrine is both supported and contradicted. Therefore, although at a glance a vague nature would appear within the provisions in Section 17 of the 2007 Companies Act, in-depth analysis of the provisions reveals that it is competent and efficacious.

People's Bank v. Yashodha Holdings (Pvt) Ltd<sup>1</sup> is the most recent Supreme Court determination which has delved into the application of UV in the corporate law of Sri Lanka, although under the predecessor to the present Companies Act, i.e. *Companies Act No.17 of 1982*. However, as this paper points out, this decision is controversial. Moreover, the majority decision in this case appears to have the potential of giving rise to unnecessary issues, particularly in relation to misapprehension of section 4 of the Companies Act No. 17 of 1982, in the majority reasoning. The main objective of this paper is to resolve these unwarranted issues.

## 2. Methodology

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<sup>1</sup>[2009] Bar Association Law Report 176.

This paper is a result of a qualitative study. It adopts library research method which extensively examines all the available and relevant literature on the point, including legislation, judicial decisions, juristic writings and other writings. The decision of the Supreme Court in People's Bank v. Yashodha Holdings (Pvt) Ltd<sup>2</sup> is used as the focal point throughout this study.

### 3. The Doctrine of UV

The capacity of a company is limited through an object clause. If a company acts beyond its object clauses, that act will be considered *UV* and therefore could become void.

There are two purposes of including object clauses in the public documents<sup>3</sup> of a company, which are for shareholders to gain information on how their money was invested, and for creditors to understand how their money will be used. The latter is especially important for the creditors to understand the transactions for which their advancements could be legally employed by the company, since if the advancements have been employed in unlawful means, there are serious risks in terms of recovery of debts.

Ashbury Railway Carriage and Iron Co v Riche<sup>4</sup>, is the landmark case by which *UV* doctrine was established in company law. The company in question was incorporated under the English Companies Act of 1862. The object clause of the company stated that the company had been incorporated to "make, sell or lend railway carriages, wagons...". However, the company contracted with Riche and his brother to build a railway line. The company later repudiated the agreement, and Riche sued against the company<sup>5</sup>. The company brought the defence of *UV*, and the House of Lords held that;

- a) The contract was beyond the objects as defined in the object clauses of its Memorandum of Association, and therefore was void.

- b) The company had no capacity to ratify the contract.

The House of Lords held that the company had no power to make the contract and therefore the contract had no legal effect. This case presented the difficulty to third parties from the application of the defence of *UV*. Furthermore, the application of the *UV* doctrine meant the third parties faced hardships, since a company had the ability to escape liability by raising the defence of *UV* to prove the invalidity of the contract, and thereby leaving the third party at a loss.

#### 3.1. Principle of Constructive Notice

Prior to the introduction of the Constructive Notice Principle, third parties who contracted with a company which subsequently raised the defence of *UV* in court initially had a last resort opportunity to state a lack of knowledge of the object clauses of the company. However, this opportunity was removed by the introduction of the judicially-developed constructive notice principle.

Under this principle, an assumption was created that third parties who deal with a company had full knowledge and understanding of the object clauses, since the constitutional documents of a company are public documents, which are accessible by any person.

In the case of In Re Jon Beaufort (London) Ltd<sup>6</sup>, the company was authorized by its' memorandum to carry on the business of costumiers and gown makers. They started making veneered panels, which was undoubtedly *UV*. They contracted for Coke (as fuel) from merchants. By the application of the constructive notice doctrine the contract was held void. It is clear that constructive notice is therefore both a trap for third parties and an undue restriction.

It is clear that the *UV* doctrine along with the Constructive Notice principle created unnecessary hardships for persons dealing with companies. However, this hardship was somewhat mitigated by the introduction of the Indoor Management Rule.

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<sup>2</sup> Ibid.

<sup>3</sup> Memorandum of Association and Articles of Association.

<sup>4</sup> Ashbury Railway Carriage and Iron Co v Riche [1875] LR 7 HL 653.

<sup>5</sup> Ibid.

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<sup>6</sup> In Re Jon Beaufort (London) Ltd. [1953] 1 Ch. 131.

### 3.2. Principle of Indoor Management

During the examination of the aforementioned hardships, it is clear that the judiciary developed indoor management rule as a new and equitable approach to the *UV* doctrine.

*Royal British Bank v Turquand*<sup>7</sup> could be credited as the judgment which gave birth to the indoor management rule. It was held that people transacting with a company can assume that the company acts in compliance with its legal limitations, even if in reality it did not. This is aptly explained by Lord Hatherly; “outsiders are bound to know the external position of the company, but are not bound to know its indoor management”<sup>8</sup>.

A point worthy of note is that while the indoor management rule mitigated the harshness present in the *UV* doctrine, it did not manage to abolish it.

### 3.3. Evolution of the Application of *UV* Doctrine to Corporate Law in English Law

The judicially-developed Indoor Management Rule gained a statutory recognition within the European Communities Act of 1972. This act reduces the harshness of the *UV* doctrine by its declaration that a company has the capacity to perform an act which is conferred upon it by the company act, even if such act is not within the objects. It is clear that this Act could be credited for the recognition of indoor management rule within the UK Companies Act of 1985.

It is noteworthy that the UK Companies Act of 1985 provides for the capacity of a company not being limited by its memorandum. Although shareholders are capable of bringing derivative actions, the Companies Act declares that such actions are not grounds to deny performance of contractual obligations with third parties<sup>9</sup>.

The Sri Lankan legal system contains a parallel provision (discussed below) in its own Companies Act<sup>10</sup>, where protection is given to third parties from repudiation of *UV* contracts by ensuring that acts, contracts or obligations entered by a

company shall not be invalid by reason of *UV*<sup>11</sup>, whereas internal management-related issues can be invalidated. This will be addressed in detail below.

#### 3.3.1. English Companies Act of 2006

The Company Act of 2006 follows the direction of the Prentice reports, which were first legislated by the Companies Act of 1989, by the inclusion of provisions that unless a company restricts its objects of its own volition, the objects are unrestricted<sup>12</sup>. The idea of the aforementioned provision is to ensure freedom for companies to engage in commercial affairs without unnecessary limitations in the object clause. However, it must be noted that if a company opts to include objects clauses to limit its capacity, the *UV* doctrine remains applicable for internal matters (e.g. derivative actions against directors who exceed their powers<sup>13</sup>) rather than external matters. The rationale for this situation is that while the internal proceedings of a company are entirely of the company itself, this should not place third parties in hardships. Therefore, the effective capacity of companies is limited to some extent, and ***the doctrine of UV is only partially abolished within UK company law.***

#### 3.4. Status of *UV* in Sri Lankan Companies Act No. 7 of 2007

The aforementioned situation is declared in a similar manner within the 2007 Companies Act<sup>14</sup> of Sri Lanka. Upon a glance, a vague nature would appear within the provision on ‘Effects of Statements of Objects in Articles’<sup>15</sup>. However, with in-depth analysis of the provision it can be observed that it is competent and efficacious, in the following manner;

The Act explicitly states on the one hand that “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

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<sup>7</sup> Royal British Bank v Turquand [1856] 6 E&B 327.

<sup>8</sup> Ibid.

<sup>9</sup> Section 35, Companies Act 1985.

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<sup>10</sup> No.7 of 2007.

<sup>11</sup> Section 17(2).

<sup>12</sup> Section 31(1), Company Act 2006.

<sup>13</sup> Section 171, Company Act 2006.

<sup>14</sup> Companies Act No.7 of 2007, (as amended up to No.13 of 2014)

<sup>15</sup> Section 17, Companies Act No.7 of 2007.

any business or activity that is not within those objects, unless the articles expressly provide otherwise<sup>16</sup>". This subsection binds a company to its object clauses and therefore it ***favours the application of UV.***

In contrast the 2<sup>nd</sup> subsection declares as follows; "where the articles of the company provides 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 of such restriction***<sup>17</sup>".

***It is clear that the 2<sup>nd</sup> subsection is a rebuttal to the application of UV brought by companies,*** by protecting third parties from hardships faced due to the aforementioned application, whereas the 3<sup>rd</sup> subsection binds directors and shareholders, who are internal parties, by the following declaration; "(a) the ability of a shareholder or director of the company to make an application to court under **section 233**<sup>18</sup> 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**<sup>19</sup><sup>20</sup>".

Therefore, it can be surmised that the ***3<sup>rd</sup> subsection binds the internal parties of a company by the application of UV.***

It can be concluded that while the 1<sup>st</sup> and 3<sup>rd</sup> subsections move for the establishment of the *UV* doctrine, the 2<sup>nd</sup> subsection is against the doctrine in terms of application for third parties. It is important in the study of this provision to not misunderstand that the *UV* doctrine is both supported and contradicted. The truth of the situation is that the provision contains subsections which apply to the ***2 distinct situations of UV*** in a company; internal (directors and shareholders)

<sup>16</sup> Section 17(1) Companies Act No.7 of 2007

<sup>17</sup> Section 17(2), Companies Act No.7 of 2007.

<sup>18</sup> 'Restraining Order'.

<sup>19</sup> 'Directors to Comply with Act and Company's Articles'.

and external (with third parties). Thereby it can be understood that the ***Companies Act of 2007 conducts an effective partial abolishment of the UV doctrine.***

This provision deserves recognition for its establishment of the demarcation of the two situations, rather than applying in a blanket manner, and is therefore an effective and efficacious provision.

#### **4. Analysis of the Controversial Judgement in Peoples Bank v. Yashodha Holdings (Pvt) Ltd<sup>21</sup>.**

Due to the weaknesses in managerial decisions of Yashodha Holdings (Pvt) Ltd.<sup>22</sup>, regarding transactions with the People's Bank, there were a multitude of famous legal actions between them. This work shall discuss one such decision which involved a relatively controversial application of the *UV* doctrine. The judgement under analysis was decided on 25<sup>th</sup> July 2009<sup>23</sup>, in the time during which the Companies Act of 2007 was active (as of 23<sup>rd</sup> March 2007). However, the judicial proceeding began in the Commercial High Court in 1999. which was a time when company law was governed by the Companies Act of 1982<sup>24</sup>.

The facts of the case are such that Yashodha Holdings had been advanced money by the People's Bank in order to clear an import of sugar, In 1995. Due to the failure of the company to repay the amount as well as interest, the Bank instituted an action in 1999. In defence, the company raised the doctrine of *UV* by establishing that none of the objects in its Memorandum included the transaction which had been done, and was therefore void. ***This defence had been accepted*** by the Commercial High Court. Therefore, the Bank appealed to the Supreme Court.

##### **4.1. Analysis of The Judgement of Marsoof J.**

<sup>20</sup> Section 17(3), Companies Act No.7 of 2007.

<sup>21</sup> Peoples Bank v. Yashodha Holdings (Put) Ltd.,  
[2009] Bar Association Law Report 176.

<sup>22</sup> *Ibid.*

<sup>23</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd.  
[2009] Bar Association Law Report 176.

<sup>24</sup> Companies Act No. 17 of 1982.

In the analysis of the judgement of Marsoof J., acceptance was shown to *UV* in Sri Lankan Company Law, as far as the 1982 Companies Act is concerned.

It is visible that the Supreme Court was unanimously of the view that People's Bank would not be served justice if the application of doctrine of *UV* was not rebutted by the use of relevant legal provisions. It was identified that the "companies act of 1982 is an exhaustive enactment which contains a provision that may be regarded as expressly embodying the doctrine of *UV*<sup>25</sup>".

It must be noted that if section 17 of Companies Act of 2007 was applicable, the serving of justice could have been possible at a higher efficiency due to it containing a competent partial abolishment of *UV*. It was further identified by Marsoof J. that "Section 17(2) of the Companies Act of 2007 has no application to this case as the law that has to be applied is the law that was in force at the time of the institution of the action in July 1999<sup>26</sup>".

Meanwhile, the English Act gives the effect of restricting the application of *UV* to the internal management of a company, while simultaneously protecting the validity of contracts entered with third parties<sup>27</sup>. The path of application of the English Act can be achieved only through the use of section 3 of the Civil Law Ordinance<sup>28</sup>. Furthermore, the law requires the presence of a *casus omissus* as the qualification for application of Civil Law Ordinance<sup>29</sup>. However, it was established that due to the presence of provisions regarding *UV* in the Companies Act of 1982, the opportunity to use the English Act was lost (due to absence of *casus omissus*).

Next, Marsoof J. also examined the possibility of relief for the appellant through the principle of **Unjust Enrichment**. However, the general principle of unjust enrichment of requesting a minimum refund became an obstruction to application, due to the claim of maximum possible amount by the

appellant. Therefore, the remedy of unjust enrichment was also a failure.

Due to the failure of both English Law as well as the principle of Unjust Enrichment, the principle of **Estoppel was used to bypass the defence of UV**, which requires the company to pay the bank the due amounts. This was done by estopping the company from raising the defence of *UV*. The principle of estoppel, as established by *Whitney Arms Co. v Barlow*<sup>30</sup> was that a corporation cannot escape liability through the defence of *UV* when it has had the benefit of the performance of a contract in good faith by the third party. This attempt was successful, and the respondent was estopped from raising the defence of *UV*<sup>31</sup>.

Therefore, the judgment was given in favor of People's Bank by establishment of an approach against the *UV* doctrine.

#### 4.2. Analysis of the Judgement of Bandaranayake J.

This work will limit itself to the matter of '**Whether English Law would be applicable to this appeal**', as discussed by Shirani A. Bandaranayake J. in the majority judgement (agreed by N. G. Amararatunga J.).

While Marsoof J. identified that the *UV* doctrine is recognized by section 4 of the Companies Act 1982, this view was opposed by Bandaranayake J.<sup>32</sup>. However, Bandaranayake J. agreed on the need to avoid the injustice upon the appellant if the doctrine of *UV* was applied. Therefore, Bandaranayake J. attempted to use the English Companies Act of 1989, as enabled by the Civil Law Ordinance, in an identical approach to that used by Marsoof J. This judgment discussed the issue of whether the applicability of English Law to the dispute was in prejudice to existing laws was argued extensively by the counsels to both parties, for which many past decisions and domestic laws were applied. Among the decisions used to argue the above issue, *Boyd v. Staples*<sup>33</sup>, where "English

<sup>25</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 200.

<sup>26</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 97.

<sup>27</sup> Section 35(1), English Companies Act 1989.

<sup>28</sup> Civil Law Ordinance No. 5 of 1852.

<sup>29</sup> Section 3, Civil Law Ordinance.

<sup>30</sup> *Whitney Arms Co. v Barlow* [1875] 63 New York 62.

<sup>31</sup> People's Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 103.

<sup>32</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 182.

<sup>33</sup> *Boyd v. Staples* [1820-33] Ramanathan Report 21

judges...gradually they had sought to follow English precedents in considering matters concerned with Commercial Law<sup>34</sup>, as well as *Sivapooniam*<sup>35</sup> were In relevance to the choice between the domestic Roman Dutch Law and English Law.

The court expressed that the introduction of the Civil Law Ordinance was aimed at settling the clash between the application of aforesaid laws. "the learned President's Counsel for the respondent contended that...since the country became a republic after 1972 there was total severance from the British Government. Moreover "...laws enacted by the British Parliament after 1972 cannot be applicable in this country as the sole authority to enact laws is in the Parliament of Sri Lanka.<sup>36</sup>". In support of this argument, Bandaranayake J. highlights Article 76(1) of the 1978 Constitution which prevents the Parliament from delegating legislative power<sup>37</sup>.

Furthermore, Bandaranayake J. acknowledged the view of Dr. L.J.M. Cooray that the laws passed by Parliament will repeal all existing legal rules which are in conflict with relevant provisions<sup>38</sup>. Therefore, it can be said that the introduction of the Companies Act of 1982 significantly limited the applicability of English Law through section 3 of the Civil Law Ordinance, and that the necessity of section 3 is only in situations of a lacuna in the Companies Act of 1982<sup>39</sup>.

Be that as it may, Bandaranayake J. expressed that since there is no provision on *UV* in the 1982 Companies Act, section 35(1) of the English Act could be applied via the section 03 of the Civil Law Ordinance in order to fill the legal vacuum. This was the approach employed by Bandaranayake J. in her judgement in favor of the appellant.

## 5. Criticism

<sup>34</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 184.

<sup>35</sup> Sivapooniam [1820-33] Ramanathan Report 78

<sup>36</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 186.

<sup>37</sup> Article 76(1), Constitution 1978.

<sup>38</sup> Dr. L.J.M. Cooray, *An Introduction to the Legal System of Sri Lanka* (1972), pp 155.

<sup>39</sup> Peoples Bank v. Yashodha Holdings (Pvt) Ltd. [2009] Bar Association Law Report 176, p 188

It is visible that although Bandaranayake J. gave judgement on the basis that the 1982 Companies Act contains no provisions on *UV*, this work contends that this basis is erroneous. It is clear that section 4 of the Companies Act of 1982 contains an *UV* provision, as expressed accurately by Marsoof J. in his judgement, to which this work strongly agrees.

Therefore, this work argues with all respect that since the **foundation** upon which the reasoning of Bandaranayake J. was given was erroneous, the judgement itself is erroneous (therefore in reality English Law is not applicable since there is no *casus omissus* in the 1982 Companies Act).

On the other hand, although Marsoof J. had very accurately identified the *UV* provision in the 1982 Companies Act, the application of English law was impossible due to the absence of *casus omissus*. However, in the pursuit of justice for the appellant, Marsoof J. applied two other legal principles which were unjust enrichment and *estoppel* respectively (discussed in detail separately above). While unjust enrichment failed, the principle of *estoppel* was employed to rule against the *UV* doctrine, which brought justice to the appellant.

It has been established that the 2007 companies act contains provisions against *UV*. However, the Marsoof J was forced to employ the provisions of 1982 companies act, or in other words the reason for him being unable to employ the 2007 companies act, was due to the cause of action occurring at the time during which the 1982 act was active.

Therefore, this work finds that although all the learned judges ultimately brought justice to the appellant by ruling against the *UV* doctrine, the judgement of Marsoof J. was relatively more reasonable than that of Bandaranayake J. (and Amaratunga J.).

## 6. Conclusion

However, this work highlights that throughout the time from the argument of this dispute, up to the decision of it, the Companies Act No. 7 of 2007,



which became operational on 23<sup>rd</sup> March 2007, had been in force. Furthermore, section 17 of the Companies Act of 2007 is an effective and efficacious provision on UV (discussed above) in that it partially abolishes the doctrine by preserving application to internal matters of a company while protecting third parties from companies which escape liability by the defence of UV.

The case in consideration was argued and decided after 2007 (in 2009). This creates an ambiguity upon why such a competent legal provision (discussed above- section 17) was not applied.

The reason is that although the hearing for this case began in 2008, and the 2007 companies act was in force at that time, the cause of action occurred prior to 2007. Since the initial proceedings on this matter in the Commercial High Court concluded in 1999, it can be deduced that the cause of action occurred at least prior to 1999. Therefore, invariably only the 1982 Companies Act can be applied.

It is to be stressed that if the cause of action occurred after the 2007 companies act became active, justice to the people's bank would have been achieved with significantly lower effort.

This analytical work, related to the judgement in People's Bank v. Yashodha Holdings (Pvt) Ltd. case presented an issue as to whether section 17 is a contradictory provision, in which 17(1) and 17(3) support the presence of UV while 17(2) opposes it. However, upon close examination it is clear that since the subsections of section 17 apply themselves to the two distinct situations of UV in Company Law separately, there is in fact no such contradiction. Therefore, this work gives solution to the aforementioned question in law with the aim of becoming an aid to those who use the Companies Act No. 17 of 2007 in the years to come, in order to prevent misleading situations similar to that in People's Bank v. Yashodha Holdings (Pvt) Ltd. impairing the proper operation of law.

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