PATRICK CHU, CONTI WONG LAWYERS LLP

Newsletter

Protection of third party dealing with company under common law and the Companies Ordinance

The author intends to examine the recent case of Zhang Kan (張侃) and SPH (Hong Kong) International Trading Co Ltd (尚品滙(香港)國際貿易有限公司) [2022] HKDC 731 Court of Appeal [2023] HKCA 996 (the "**Zhang Kan case**") in order to explore the application of both the common law principle of Turquand's Rule and statutory safeguards pertaining to Section 117 of the Companies Ordinance (CAP 622) concerning third-party transactions with companies.

Fact

The plaintiff claimed US$100,000 with interest from the defendant, as the outstanding amount owed pursuant to a loan agreement for US$300,000 (the "**Loan Agreement**") entered into by Chen on behalf of the defendant. Chen was a director of the defendant who had acted without any authorisation in entering into the Loan Agreement and causing the US $300,000 deposited in the defendant's account and in the next day, the loan was transferred out of the defendant's account to be dissipated for his own purposes, and subsequently US$200,000 to be repaid to plaintiff from the defendant's accounts. Chen had since disappeared. The plaintiff claimed that Chen had actual or apparent authority and further relies on the indoor management rule and section 117 of the Companies Ordinance (CAP 622) ("**Section 117**"). The plaintiff also claimed unjust enrichment.

Issues to decide

(1) Whether Chen had any actual authority to enter into the Loan Agreement;
(2) If not, whether Chen had any apparent authority to do so;
(3) If Chen had apparent authority to do so, whether it was irrational or reckless for the plaintiff to rely on the apparent authority;
(4) Whether the plaintiff can invoke the indoor management rule;
(5) Whether the plaintiff can invoke section 117 of the Companies Ordinance;
(6) Whether the defendant was unjustly enriched and has no defence;
(7) Whether the plaintiff was unjustly enriched in receiving the defendant's payment of US$200,000; and
(8) Whether the defendant has a claim against Chen for indemnification.

Turquand's Rule (Indoor Management Rule)

Turquand's Rule, originating from the ruling in Royal British Bank v Turquand (1856) 6 E &B 327, 119 ER 886, is a common law principle. It stipulates that a third party dealing in good faith with a company is not obligated to investigate the regularity of internal management acts and can assume that actions within the company's constitutional and authorized powers have been validly executed. For instance, the outsider is not required to undertake an inquiry to determine whether a particular person has authority to sign contracts on behalf of the company. However, this rule does not shield the outsider who was aware of the absence of authority of an individual claiming to act on behalf of the company. As Dawson J in Northside Developments Pty Ltd v Registrar-General (1989-1990) 170 CLR 146 at 198, cited with approval by Lord Neuberger NPJ in Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2), (2010) 13 HKCFAR 479, at §59 (the "**Thanakharn Case**"):

"[t]he rule is thus dependent upon the operation of normal agency principles; it operates only where on ordinary principles the person purporting to act on behalf of the company is acting within the scope of his actual or ostensible authority"

In order for the Indoor Management Rule to apply, the third party has to establish that the person he/she is dealing with is acting within his actual or ostensible authority.

Actual Authority

In Zhang Kan case, since there is no board resolution to borrow the loan or resolution to authorise Chen to do so, Chen does not have any actual authority even though the articles of association do allow directors to borrow money on the company's behalf.

Apparent/Ostensible Authority

The legal principles in respect of apparent authority were discussed in the Thanakharn Case at §§43-71 per Lord Neuberger NPJ and they are as follows:

(1) That a representation that the agent had authority to enter on behalf of the company into a contract of the kind sought to be enforced was made to the contractor (the third party in that case);
(2) That such representation was made by a person or persons who had "actual" authority to manage the business of the company either generally or in respect of those matters to which the contract relates, and in principle, such a person making such representation can be the agent himself although practically, this should be "very rare and unusual" and it is hard to conceive any such circumstances;
(3) That the contractor was induced by such representation to enter into the contract, that is, that he in fact relied upon it; and
(4) That under its memorandum or articles of association the company was not deprived of the capacity either to enter into a contract of the kind sought to be enforced or to delegate authority to enter into a contract of that kind to the agent.

Lord Neuberger in the Thanakharn Case at §71 specifically set out two conditions for such "very rare and unusual" circumstances in respect of (2) above:

(1) That the principal had given the alleged agent the authority (actual or apparent) to make the representation in question; and
(2) That the representation must be clear and unequivocal, judged by reference to the practical realities of the particular case.

In Zhang Kan case, does the company (the principal) make a representation that the alleged agent, Chen, is authorised to sign the Loan Agreement? The Loan Agreement utilized both the company chop and the defendant's Authorized Signature Chop. However, it was determined that the mere utilization of the company chop alone did not inherently signify any representation for the purpose of apparent authority. The authorization to use the chop serves as a consideration but is not conclusive; it is merely one factor to be weighed. Regarding the stamp of the defendant's Authorized Signature Chop, there is no documented evidence indicating that the defendant was granted permission to employ it. Given the substantial nature of the borrowing, its departure from the usual course of business, and being the first transaction between the plaintiff and defendant, such a chop was deemed insufficient.

In both Zhang Kan Case and Thanakharn Case, there were tell-tale signs that indicated that there was no apparent authority and the third party has constructive notice of the lack of authority of the director's authority:

- Significant or unusual size of the transaction without a director's resolution approving the transaction nor did it ask for any legal advice;
- Transaction not in the usual course of business without a director's resolution approving the transaction;
- The company would be receiving no benefit from the transaction whatsoever and there is no commercial reason for entering into the transaction and the minutes of the company do not disclose that the loan would be used for the benefit of third party with no benefit to the company;
- When the third party is provided with an articles of association from the company which states that a director who had an interest in a transaction that the company intended to enter into could not participate in any vote in respect of that transaction but the minutes of meeting provided to the third party did not mention that the director has a conflict of interest or that he did not vote at the meeting.

Section 117

Section 117 provides that: … in favour of a person dealing with a company in good faith, the power of the company's directors to bind the company, or authorize others to do so, is to be regarded as free of any limitation under any relevant document of the company."

In defining relevant documents, Section 117 provides a narrower definition compared to Turquand's Rule, specifying the company's articles, resolutions, and agreements among its members. It does not encompass limitations on a director's authority originating from sources other than these specified documents.

The difference between Turquand's Rule and Section 117 is that the former does not apply to forged documents (see Ruben v Great Fingall Consolidated [1906] AC 439).

The Turquand's rule also does not apply if the outsider has actual or constructive notice of the lack of the director's authority. However, unlike Turquand's Rule, a person dealing with a company is not to be regarded under Section 117 as acting in bad faith (Section 117 requires the person dealing with the company in good faith) by reason only of the person's knowing that an act is beyond the directors' powers under any relevant document of the company (Section 117(2)(c)).

In addition, unlike Turquand's Rule, Section 117 does not extend to charitable companies, as section 119 of the Companies Ordinance (CAP 622) exempts them from its application, particularly companies granted a licence to exclude "Ltd" from their name under Section 103 of the Companies Ordinance and classified as tax-exempt charities under Section 88 of the Inland Revenue Ordinance (CAP 112). Nonetheless, a third party dealing with such a company can invoke Section 117 if they were unaware of the company's exempted status at the time of the act, or if the company received full consideration for the act, and the third party was unaware that the act exceeded the director's powers or was not permitted by any relevant company document.

Despite minor differences in application, Section 117 may still be viewed as a statutory representation of Turquand's Rule. §5 of the Annex to the Report of the Bills Committee on Companies Bill of the Legislative Council (LC Paper No CB(1) 222111-12) suggested that Section 117 was "in addition to the common law indoor management rule, which may still have application in some circumstances". Since the indoor management rule relies on common law agency principles, the Legislative Council understood that Section 117 was not intended to override any common law requirements for directors to have actual or apparent authority.

Besides, the Zhang Kan case also establishes that Section 117 does not apply to the actions of a sole director. First, the language used is "the power of the company's directors," not "the power of the company's directors or a director thereof" or similar wording. Second, the court must balance protecting outsiders dealing with the company in good faith and protecting the company from directors acting outside their authority. If Section 117 applied to a single director, it would bind the company to transactions entered into by that director, effectively leaving the company with no defence against the outsider's claim.

Is there any difference when the power is exercised by more than one director to bind the company? As Judge Gary Lam in Zhang Kan pointed out, the difference is that it is generally more difficult for multiple directors to act together irregularly or outside their powers compared to just one director. This serves as an internal check-and-balance. Each director has duties to the company and must consider their own personal situation before joining another in such actions, weighing potential benefits against possible losses and the risk of the other director becoming a whistle-blower.

Applying Section 117 to directors of a company would not place an undue burden on outsiders dealing with the company. Outsiders can simply obtain proper evidence of authority, such as a board resolution, or at least seek confirmation from another director. Additionally, outsiders dealing with a single director are still protected by common law agency principles, such as apparent authority.

NB: The Zhang Kan case, notably the appeal, extensively addresses unjust enrichment and restitution; however, this topic falls beyond the purview of this newsletter.

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