6.2 Where the company has ratified the contract

4.051 **Enforcement action can be taken against company after ratification.** As the company ratifies the contract and thus becomes a party to the contract, the third party contractor is able to take enforcement action against the company if it fails to perform its obligations under the contract. The issue of the liability of the person who purported to contract for the company will arise where the company fails to perform for any reason.

4.052 **After ratification person who acted for company can only be held liable to extent that they would have been for breach of warranty of authority.** Section 122(4) provides that where the company has ratified the contract, the liability of the person who has purportedly entered into the contract in the name of or on behalf of the company "is not greater than the liability that the person would have incurred if the person had entered into the contract after the company's incorporation as an agent acting without the company's authority". The effect of this provision is that the person can be liable to the extent that he or she would have been on the basis of breach of warranty of authority. However, if the company's failure to perform was due to the company's insolvency, it seems that the third party would also be unable to obtain substantive damages from the person for the breach of warranty of authority.[93]

[93] See para.4.013 above.

Chapter 5

CORPORATE CONSTITUTION AND SHAREHOLDER AGREEMENTS

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Need for information about company and way company managed. Parties dealing with a company need information about the company to determine their rights and obligations resulting from such dealings. Incorporators and subsequent members need to have certainty on the manner in which the company is to be managed and the manner in which the relationship between the company and them is to be regulated. Information required by company insiders and outsiders relating to the above matters, before the commencement of the Companies Ordinance (Cap.622) on 3 March 2014 has been provided in the company's memorandum of association and articles of association respectively. Under Cap.622, the company's constitution is contained in a single document, namely the company's articles of association, and the memorandum of association is abolished. 5.001

Private company: constitution can be supplemented with shareholders' agreement. Where the company is a private company, there can be a need to supplement the company's constitution with a shareholders' agreement. The reasons why such an agreement might be necessary will be considered later in this chapter. 5.002

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1. Provisions on Information Required by Company Outsiders

1.1 Introduction

Memorandum of association abolished under Cap.622; and information to be included in articles. Before the enactment of Cap.622, the information required by outsiders was provided in the old style memorandum of association. This document contained information on, depending on the type of the company concerned, the name and objects of the company, the way in which members' liabilities are limited, the liability of members to contribute to the assets of the company, capital, and initial shareholders. Under Cap.622, these matters will be included in the company's articles of association.[1] Details of these provisions are discussed in Chapter 2. The conditions presently contained in the memorandum of existing companies will be deemed as being provisions in the articles.[2] 5.003

Memorandum abolished as diminished need with streamlined incorporation procedures. The decision to abolish the memorandum of association was made on the basis of the diminution of the need for such a document. The need for a memorandum of association is diminished because of the streamlined incorporation procedures that the Companies Registry introduced in 2008. Under these incorporation procedures, a person wishing to incorporate a company is required to deliver to the Registrar a duly completed incorporation form together with the memorandum of association and articles of association. The incorporation form includes much of the information that is required to be stated in the memorandum of association. Also, that information can be stated in the 5.004

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1 Cap.622 Pt.3, Div.2, Subdiv.3.

2 *Ibid.*, s.98.

one constitutional document (now comprised of just the articles of association under Cap.622) without the need for two separate documents. The abolition of the memorandum of association is consistent with the practice of some of the Commonwealth jurisdictions, notably Australia and New Zealand, of having a single constitutional document.[3]

5.005 **Objects clause and ultra vires doctrine.** The discussion below focuses on the objects clause in the company's constitution, and on the legislative reform and jurisprudence relating to the objects clause and the *ultra vires* doctrine. These matters can be important in the context of resolution of disputes between the company and parties dealing with the company.

1.2 Objects clause

1.2.1 *The purpose of the objects clause and the ultra vires doctrine*

5.006 **Historically aimed at protecting shareholders from uncontemplated business activities.** Under the common law, a company does not enjoy full legal capacity. The capacity of a company is defined by the objects clause in the company's constitution. The original requirement for an objects clause in the constitution was aimed at protecting company investors and creditors against unauthorised use of funds. A shareholder needs to assess the risks associated with the acquisition of shares in a particular company. It was assumed that that assessment could be accomplished through a careful perusal of the company's objects.[4] Inserting objects clauses in a company's constitution was thought to be an effective way of protecting shareholders from losses that might result from business activities that were never contemplated by the shareholders when they acquired their investments. In the 19th century, a company's assets were conceptualised as a trust fund "dedicated to the defined and limited objects which would, hopefully, generate fairly stable annual profits for the benefit of those who supplied the company's capital".[5] The objects clause would ensure that the company only engages in business activities the risks of which the shareholders could have assessed at the time of their acquisition of the shares.

5.007 **Aimed at protecting company's creditors who could ascertain scope of business.** An objects clause can also function to protect the interests of the company's creditors. It was thought that creditors would rely on the objects clause to ascertain the scope of business of the company and to use that information for assessing the creditworthiness of the company. Limiting the company's capacity to what is permitted by the objects clause would therefore ensure that the company does not depart from the basis on which creditors provided funds to the company.

[3] Eg, Corporations Act 2001 (Aust) s.136.

[4] Roman Tomasic, Stephen Bottomley and Rob McQueen, *Corporations Law in Australia* (2nd edn, the Federation Press, Sydney, 2002) 209.

[5] Robert Pennington, "Reform of the Ultra Vires Rule" (1987) 8 *Company Lawyer* 103, 104.

5.008 ***Ultra vires* doctrine: act not authorised by constitution ultra vires.** Under the *ultra vires* doctrine,[6] a company registered under the companies legislation only had the power to do acts authorised by the company's constitution. The classic version of the *ultra vires* doctrine was enunciated by the House of Lords in *Ashbury Railway Carriage and Iron Co Ltd v Riche* (1875) LR 7 HL 653. In that case, a company's contract to provide finance to another party for the construction of a railway was wholly ineffective, since provision of finance was not authorised by the company's memorandum of association.[7] It was held that an act done by the company unauthorised by its constitution was *ultra vires* the company and void. The act cannot be ratified by the members, even with the members' unanimous consent, since the act is something that the company is incapable of doing at all.

5.009 **Harsh effect of *ultra vires* doctrine.** The House of Lords soon realised the harsh effect of a strict application of the *ultra vires* rules it enunciated in *Ashbury*.[8] It stated in a subsequent case, *A-G v Great Easter Rly Co* (1880) 5 App Cas 473, that the *ultra vires* principle did not require that each type of transaction that the company was capable of entering into be particularised in its memorandum and the company had implied power to enter into transactions incidental or ancillary to the achievement of its stated objects.

1.3 Reform of the *ultra vires* doctrine in Hong Kong

1.3.1 *The need for reform*

5.010 **Commercial unreality of doctrine for those dealing with company.** The *Ashbury*[9] version of the *ultra vires* doctrine, even after having been relaxed in *A-G v Great Easter Rly Co* (1880) 5 App Cas 473, was still too draconian for the business community, especially from the perspective of those who deal with the company.[10] An example is *Re Jon Beauforte (London) Ltd* [1953] Ch 131. In that case, a sale of goods contract was held to be void because the goods delivered were for the purpose of the company's new line of business, which was outside the company objects. This can be harsh from the perspective of the party dealing with the company—the seller in the above case. While the *ultra vires* doctrine is premised on third parties having with knowledge of the restrictions in the objects clause when dealing with the company, this is unrealistic in practice. From the commercial perspective, it is often impractical for traders or others dealing with the company to inspect the company's constitution before contracting.

[6] Some care needs to be taken in the use of the term *ultra vires*. For the purpose of this chapter, *ultra vires* is used to refer to acts which are outside the "capacity" of a company. In other contexts, it might be said that an act of a company is *ultra vires* if the act is prohibited by statute or the general law. Even more widely, it is sometimes said that directors act *ultra vires* when they act outside the scope of their authority. However, to avoid confusion, it is preferable in the context of company law not to refer to the latter situation as *ultra vires* conduct, but only as conduct which is outside the directors' authority or which is in breach of the directors' duties.

[7] *Ashbury Railway Carriage and Iron Co Ltd v Riche* (1875) LR 7 HL 653.

[8] *Ibid.*

[9] *Ibid.*

[10] J H Farrar, *Farrar's Company Law* (3rd edn, Butterworths, London, 1991) 104.

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CHAPTER 16

FUND-RAISING BY PUBLIC ISSUE

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1. Introduction

Initial public offerings. As outlined in Chapter 13, public companies can raise funds through an offer of shares or debentures to the public. Although it is usual for the companies to be listed so that the shares or debentures can be publicly traded on the exchange, it is possible to offer shares or debentures to the public without listing on the stock exchange. When a company offers its shares to the public for the first time, the process is referred to as an initial public offering (IPO). The company is said to "go public". The procedure generally involves: 16.001

- appointment of a sponsor (such as an investment bank) to assist the company in the IPO (the sponsor also usually acts as lead underwriter[1]);
- appointment of professionals (legal advisers, reporting accountants);
- conducting of due diligence (to investigate the company's business, financial position, future prospects etc. to ensure that all necessary information about the company is ascertained for inclusion in the prospectus);
- drafting of the prospectus;
- application to the stock exchange for listing;[2]
- preparation of pre-deal research reports by analysts appointed by the sponsor or underwriters and engaging in marketing to institutional and professional investors (through various means, including provision of pre-deal research reports, conducting of management roadshows via promotion meetings or one-on-one meetings and distribution of the draft or "red-herring" prospectus[3]);
- book-building process, whereby the underwriters approach institutional investors to explore market interest and build a book of the demand of their clients (obtaining expressions of interest to acquire the securities in the offering at various prices)—this normally occurs a few weeks before the start of the public offering period and the issue price is fixed on the basis of the book-building;
- authorisation and registration of the prospectus;
- issue of the prospectus and application forms to the public and commencement of the offer period (the offer period usually only lasts three and a half days in Hong Kong);
- following the close of the offer (closing of subscription lists), shares are allocated and allotted to the subscribers;
- final approval for listing and commencement of trading on the stock exchange.

1 On underwriters, see also para.16.015 below.
2 See para.16.106 below.
3 "Red herring" prospectuses refer to a near-final draft of the prospectus with information such as pricing and related financial information omitted.

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16.002 **Public offerings regulated by Cap 32.** Part II of the Companies Ordinance (Cap.32) contains provisions regulating public offerings. The main provisions deal with the circumstances as to when a prospectus must be registered and issued, information that must be included in the prospectus, civil and criminal liabilities for misstatements contained in prospectuses, and restrictions on advertising activities of the company in the public fund-raising process. While the provisions in Pt.II of Cap.32 set out a statutory scheme regulating prospectuses and public offerings of shares or debentures, there are also some provisions of the Securities and Futures Ordinance (Cap.571) and principles of the common law that could be relevant (for example in relation to misstatements in prospectuses).

16.003 **Prospectus regime unchanged by new CO rewrite.** The reforms made under the new Companies Ordinance (Cap.622) do not touch on the prospectus provisions. For the time being, the prospectus regime will remain in the existing Companies Ordinance (Cap.32) (which will be renamed as the Companies (Winding Up and Miscellaneous Provisions Ordinance) (Cap.32) upon the commencement of Cap.622 (on 3 March 2014).

1.1 Historical development of regulation of prospectuses

16.004 **Regulation of prospectuses historically modelled on English law.** When promoters of joint stock companies in 19th century England sought to raise funds from public investors, they usually did so through the issue of a prospectus inviting persons to become shareholders in the company.[4] The prospectus contains information about the company and was used to attract potential investors. When the Joint Stock Companies Act 1844 was enacted in England, there was a requirement for registration of prospectuses as part of the scheme for provisional registration of companies, although the provision was not reproduced in the Companies Act 1856 when provisional registration was abolished, nor was it reproduced in the Companies Act 1862. Accordingly, in Hong Kong under the Companies Ordinance 1865, which was based on the UK 1862 Act, there were no requirements for registration of prospectuses. The provisions on registration, detailed contents requirements and civil liability for untrue statements in prospectuses were first introduced in Hong Kong in the Companies Ordinance 1911, modelled on provisions in the Companies Act 1900 (UK) and Directors' Liability Act 1890 (UK), which were consolidated in the Companies Act 1908 (UK). The provisions in the subsequent Companies Ordinance (of 1932) (Cap.32) were substantially amended in 1972 to implement reforms proposed in the First Report of the Companies Law Revision Committee on the Protection of Investors to bring the Hong Kong provisions up to date with the prospectus provisions contained in the Companies Act 1948 (UK).

[4] See J Ashton Cross, *Limited Liability Companies: The Law and Practice* (Simpkin Marshall Hamilton Kent & Co, London, 1912) 37–41; Henry Hurrell and Clarendon G Hyde, *The Law of Directors and Officers of Joint Stock Companies* (Waterlow and Sons, London, 1884) 34–44.

1.2 Recent developments

16.005 **Securities and Futures Commission conducting review of prospectus regime.** In the past decade, the Securities and Futures Commission (SFC) has been engaged in a three-part review of the prospectus regime.[5] Phase 1 of the review was completed in 2003, with the introduction of certain facilitative measures via guidelines and class exemptions within the existing framework. Phase 2 was completed in 2004 when a number of amendments were made to the Companies Ordinance (Cap.32) by the Companies (Amendment) Ordinance 2004. These amendments involved a number of "quick-fixes", providing for relatively straightforward and less controversial amendments in response to market demand. Phase 3 involves a comprehensive review of the entire prospectus regime. Public consultation was carried out in 2005, with the SFC proposing some major reforms to modernise the public offering regime for shares and debentures in Hong Kong.[6] Although some of the measures have been introduced in advance of the other Phase 3 initiatives, the bulk of the reforms are still to be implemented[7]

1.3 Disclosure philosophy

16.006 **Prospectus regime based on disclosure philosophy.** The prospectus regime under Cap.32, as is the case under Anglo-American models of securities regulation, is largely based on a disclosure philosophy. The core feature of a disclosure regime is that companies are required to disclose to the investing public material information about the company's operations and securities, and it is for investors to make up their own mind whether to invest in the company. Disclosure regulation can be contrasted with merit regulation and other substantive regulation. Merit regulation imposes controls on what investments can be offered to the public.[8] Substantive regulation sets out rules regulating corporate behaviour and enforcing required standards of conduct.[9] In the United States, federal regulation of securities laws is based on a disclosure philosophy, although some States in the United States provide for merit regulation through a requirement for registration of securities.[10] In Hong Kong, although the regulation of

[5] See SFC, *Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance* (August 2005) 4–5.

[6] SFC, *Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance* (August 2005), and *Consultation Conclusions* (September 2006).

[7] The carving out of structured products from the Cap.32 regime was implemented by the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance (8 of 2011); and see SFC, *Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance* (October 2009), and *Consultation Conclusions* (April 2010). At the time of writing, the SFC is also proposing to introduce amendments relating to regulation of sponsors: SFC, *Consultation Paper on the Regulation of Sponsors* (May 2012), and *Consultation Conclusions* (December 2012).

[8] See, e.g., Conrad G Goodkind, "Blue Sky Laws: Is there Merit in the Merit Requirements?" [1976] *Wisconsin Law Review* 79.

[9] Susanna K Ripken, "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation" [2006] *Baylor Law Review* 139.

[10] Referred to as "blue sky law": see Rick A Fleming, "100 Years of Securities Law: Examining a Foundation Laid in the Kansas Blue Sky" (2011) 50 *Washburn Law Journal* 583.

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