

**Bills Committee on
Companies (Amendment) Bill 2002**

**Follow-up actions arising from the discussion
at the meetings on 20 February and 23 January 2003**

Introduction

This paper sets out the outcome of the follow-up actions arising from the discussion at the meetings on 20 February and 23 January 2003.

(A) 20 February 2003

(a) Definition of “shadow director”

2. We do not consider it appropriate to amend the definition of “director” in section 2 of the Companies Ordinance to include “shadow director” unless otherwise specified. The existing approach of specifying in each of the relevant sections of the Ordinance that the term “director” should include “shadow director” appears to be preferable as it ensures that one who interprets these sections is alerted to the fact that the term “director” includes “shadow director”; otherwise, one may not realise the special meaning given to the term “director” in section 2 of the Ordinance.

(b) Disqualification order under section 168D(1)(a)

3. The existing section 168D(1) provides that in the circumstances specified in Part IVA of the Ordinance, a court may, and under section 168H shall, make against a person a disqualification order, that is to say an order that he shall not, without leave of the court –

- (a) be a director of a company;
- (b) be a liquidator of a company;
- (c) be a receiver or manager of a company’s property; or
- (d) in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company,

for a specified period beginning with the date of the order. The effect of this section is that a person who is subject to a disqualification order shall not, without leave of the court, do anything specified in items (a) to (d) above. Given the item (d), the person could not act as a shadow director of any company as he would be prohibited from being concerned or taking part in the management of a company in any way, whether directly or indirectly.

(c) Inviting views from the Hong Kong Bar Association etc on the draft specified form

4. The draft specified form has been sent to the Law Society of Hong Kong, Hong Kong Society of Accountants, Hong Kong Association of Banks, Hong Kong Institute of Company Secretaries and members of the Companies Registry's Customer Liaison Group comprising firms of solicitors, company incorporation agents etc at the initial consultation stage. As requested by Members, we will send the draft to the Hong Kong Bar Association for comments.

(B) 23 January 2003

(a) Enforceability of a guarantee entered into or any security provided by a company under section 157I

5. Section 157I sets out the civil consequences of transactions contravening section 157H, which prohibits loans to directors, etc. One of the civil consequences relates to the enforceability of a guarantee entered into or any security provided by a company in contravention of section 157H(2)¹ against the company. Such guarantee or security shall be unenforceable against the company (see section 157I(2)) unless the guarantee was entered into or the security provided in connection with a loan to a person who is not a director of the company or of its holding company; and the person to whom the guarantee was given or the security provided did not know the relevant circumstances at the time of the transaction (see section 157I(3)(a)). Moreover, section 157I(2) shall not

¹ Subject to this section (i.e. section 157H), a company shall not, directly or indirectly-

- (a) make a loan to a director of the company or of its holding company;
- (b) enter into any guarantee or provide any security in connection with a loan made by any person to such a director;
- (c) if any one or more of the directors of the company hold (jointly or severally or directly or indirectly) a controlling interest in another company, make a loan to that other company or enter into any guarantee or provide any security in connection with a loan made by any person to that other company.

affect an interest in any property which has been passed by the company to any person by way of security provided in connection with any loan (see section 157I(3)(b)).

6. The policy intent behind these provisions (included in the Companies Ordinance in 1984) is as follows. First, since a transaction contravening section 157H(2) is an illegal contract, we believe that the person who obtains a security from the company should not be able to enforce such security against the company. However, if the borrower is not a director of the company or of its holding company and the person to whom the security was provided did not know the relevant circumstances at the time of the transaction, the enforceability of the security will not be affected.

7. Second, although the transaction contravenes the law, we do not think that it should therefore be void. As the lender has provided consideration on the transaction (i.e. advanced money under the loan), it appears that to achieve a fair balance of the interests between the company and the lender, the passing of interest in any property under the security document should not be disturbed. Otherwise, the lender will be left with no security to cover against the risk of non-repayment by the director. We believe that the inability to enforce the security against the company is already a serious consequence that suffices to deter a person from lending money in contravention of section 157H.

8. Third, with regard to the position of an innocent third party, because interests in the property can successfully pass to the chargee, a third party can validly acquire an interest in the property from the chargee. However, as the chargee cannot enforce the security against the company, any third party who acquires an interest in the property from the chargee cannot similarly enforce the security against the company.

9. Under the UK Companies Act, section 330 provides for general restriction on loans etc to directors and persons connected with them, and section 341 provides for the civil remedies for breach of section 330. Section 341(1) provides that if a company enters into a transaction or arrangement in contravention of section 330, the transaction or arrangement is voidable at the instance of the company unless –

- (a) restitution of any money or any other asset which is the subject matter of the arrangement or transaction is no longer possible, or the company has been indemnified under section 341 for the loss or damage suffered by it; or

- (b) any rights acquired bona fide for value and without actual notice of the contravention by a person other than the person for whom the arrangement or transaction was made would be affected by its avoidance.

10. The effect of section 341 is that if a company has entered into a transaction or arrangement which is made in contravention of section 330, it has an option to either affirm or avoid the transaction or arrangement, unless certain exceptions apply. If a transaction or arrangement is avoided, the parties to the transaction or arrangement will be put in a position as if no transaction or arrangement has ever taken place². For example, money advanced will be returned.

11. It can be seen that section 157I of the Ordinance and section 341 of the UK Companies Act are premised on two different approaches. Broadly speaking, a transaction or arrangement in contravention of section 157I is valid but not enforceable. Interests purported to be passed by virtue of the security may pass but the chargee (and its subsequent assignees) is deprived of the opportunity to take the initiative to enforce its rights. On the other hand, the UK approach gives the company the right to either affirm or avoid the transaction/arrangement, unless certain exceptions apply.

12. Our legislation, which has been in place since 1984, has worked well and is up-to-date. Giving the company the right to affirm or

² Assuming that –

- (a) Bank A made a loan to a director of Company B;
- (b) Company B provided security (a property) for the loan in contravention of section 330 of the UK Companies Act;
- (c) Bank C acquired the debt due from the director and the security provided by Company B from Bank A for value and without actual notice of the contravention; and
- (d) the director failed to repay the loan to Bank C.

The provision of the security by Company B is a transaction in contravention of section 330 and therefore voidable at the instance of the company. However, Company B could not avoid the transaction as the rights of Bank C (which acquired the rights bona fide for value and without actual notice of the contravention) would be affected. In other words, Bank C would be able to enforce the security against Company B. As for Bank A, although it might have known that the transaction is in breach of section 330, it can successfully transfer the debt and security to Bank C for value.

If this scenario took place in Hong Kong, the security would not be enforceable, whether by Bank A or Bank C, against Company B; it was provided in connection with a loan to the director and thus the exception in section 157I(3) does not apply. Had the loan been made to a person other than a director of Company B or of Company B's holding company and Bank A had not known the relevant circumstances at the time the security was provided, the security would have been enforceable against Company B. Despite the unenforceability of the security, any interest in the property passed by Company B by way of security to Bank A (which had in turn been passed from Bank A to Bank C) would not be affected.

avoid the security or guarantee has serious implications, particularly as the company may not be entirely faultless in the circumstances. Accordingly, we are not inclined to change the legislation at this stage, particularly in the absence of consultation with the relevant stakeholders.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2003