

LS/B/15/01-02

Secretary for Financial Services
and the Treasury
Financial Services and the Treasury Bureau
(Attn: Mr Esmond LEE
PAS (Companies))
18/F, Tower 1
Admiralty Centre
18 Harcourt Road
Hong Kong

By Fax (2528 3345) and By Post

1 November 2002

Dear Mr LEE

Companies (Amendment) Bill 2002

Further to my letter of 1 November 2002, I have the following observations on your reply to my queries on clause 66:

- (a) The existing S165 of the Company Ordinance (Cap. 32) ("CO") provides that an exemption or indemnity given by a company to its officers and auditor against any liabilities attached to them in respect of any negligence, default, breach of duty or breach of trust of which they may be guilty in relation to company shall be void.
- (b) The Standing Committee on Company Law Reform ("SC") has distinguished two types of indemnity given by a company to its officers and auditor, namely:
 - (i) indemnity against their liabilities to the company; and
 - (ii) indemnity against their liabilities to others.
- (c) The SC recommends that the CO should confirm that indemnities may be given to directors for liability incurred by them to others in the course of performing their duties and that the permissible scope of such indemnities should be studied further (Recommendation 75).

- (d) The new S165 of the Bill only covers liability of a company's officers and auditor to the company or a related company. It provides that an exemption or indemnity granted by a company to its officers and auditor against any liability to the company or a related company attached to them in respect of any negligence, default, breach of duty or breach of trust of which they may be guilty in relation to the company or related company shall be void.

- (e) As the new S165 is silent on the exemption and indemnity granted by a company to its directors and auditor in relation to their liabilities to others, please confirm whether the policy is that the company's exemption and indemnity given to its officers and auditor in respect of their liabilities to others will no longer be void when the existing S165 is repealed?

It will be appreciated if your reply, in both Chinese and English, could reach us by noon, 4 November 2002.

Yours sincerely

(Monna LAI)
Assistant Legal Adviser

c.c. DoJ (Attn: Mr Jeffrey GUNTER)

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1 November 2002

Dear Mr LEE

Companies (Amendment) Bill 2002

I refer to your letter of 21 October 2002 and have the following observations on your comments:

Clause 38

- (a) You have confirmed that the public can easily ascertain the number of members of a company upon inspection of the company's register of members. Please explain the policy reasons for imposing an additional requirement on the company to enter a statement in the company's register of member to show that the company has only one member or has ceased to have only one member ("the Statement").
- (b) The Statement is required to be entered in the company's register of members upon occurrence of the event that the company has only one member or has ceased to have only one member. Does this mean that the Statement has to be entered on the very date on which such event occurs instead of as soon as practicable thereafter, failing which the company and every officer of the company who is in default is liable for penalty set out in S95A(3)?

Clause 58

General Observations on new sections 157H, 157HA, 157HI and 157J

The Standing Committee on Company Law Reform ("SC") is of the view that the definition of "loan" is inadequate to cover modern forms of credit and has recommended that the definition be suitably extended to embrace in generic terms the provision of financial assistance (Recommendation 65).

The UK has amended its laws and extended the prohibition to quasi-loans and credit transactions. The Administration has confirmed that clause 58 is drafted on the basis of relevant provisions in the UK legislation. However, it appears that the prohibition against quasi-loans and credit transactions introduced under the Bill is wider than that provided in the UK Companies Act 1985 ("CA"). The prohibition in the UK does not apply to a private company which does not belong to a group of companies comprising a public company. The prohibition introduced in the Bill covers private companies as well as non-private companies. Please account for the policy reasons for setting the scope of the prohibition as wide as proposed and the level of sanctions as set in the Bill.

Prohibited transactions

A comparison of the scope of the prohibition in the UK and the Bill is set out as follow:

The CA

- (a) A relevant company is prohibited from:
 - (i) making a quasi-loan to its director or a director of its holding company;
 - (ii) entering into a credit transaction as a creditor for its director or a director of its holding company; and
 - (iii) entering into a guarantee or providing security in connection with the quasi-loan or credit transaction.
- (b) A relevant company is defined to mean a company which -
 - (i) is a public company, or
 - (ii) is a subsidiary of a public company, or

- (iii) is a subsidiary of a company which has as another subsidiary a public company, or
 - (iv) has a subsidiary which is a public company.
- (c) Therefore, the prohibition against quasi-loans and credit transactions does not apply to private company which does not belong to a group of companies comprising a public company.
- (d) S741 provides that a body corporate is not to be treated as shadow director of any of its subsidiary companies by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions. No such exception has been provided in the Bill and the Administration have agreed to review this issue.

The Bill

- (a) The new S157H(1), (2) and (4) of the Bill extends the prohibition provided in the existing S157H of Companies Ordinance (Cap. 32) ("CO"). A company is prohibited from making a quasi-loan and entering into a credit transaction with its director and a director of its holding company and entering into a guarantee or providing security in connection with the quasi-loan and credit transaction.
- (b) "Company" is defined to mean:
- (i) a company formed and registered under the CO or an existing company; and
 - (ii) any other body corporate incorporated in Hong Kong and in the cases of which shares are listed on the Unified Exchange.
- but does not include an authorized financial institution.
- (c) Thus, the scope of clause 58 **covers private companies** as well as non-private companies.

Permissible transactions

Several exceptions to the prohibition have been provided to allow a company to enter into permissible transactions. The scope of the permissible

transactions in Hong Kong is wider than that provided in the UK.

Exceptions to the prohibition have been provided in the CA for a relevant company to enter into a guarantee or provide security in connection with a loan or quasi-loan. However, a company can only enter into a guarantee or provide security in connection with a credit transaction made by any other person if the credit transaction is for its holding company.

In the Bill, the exceptions which allow a company to enter into a guarantee or provide security in connection with a credit transaction extends beyond credit transaction for its holding company and covers the several situation described in the new S157HA.

Criminal sanction

In UK, criminal penalty only applies to a breach of the prohibition by a "relevant company". Criminal penalty does not apply to a private company which does not belong to a group of companies comprising a public company. Such company is only subject to civil sanctions.

Under the Bill, private companies and non-private companies will be subject to the criminal penalties prescribed under the new S157J if they contravene the new S157H.

Civil consequences of contravention

Please clarify the following ambiguities:

- (a) The new S157I(4)(b) provides that "a director of a company that has entered into a transaction or arrangement in contravention of S157H(1), (2) or (4) shall be liable jointly and severally with any other director liable under this subsection".

Does "a director of a company that has entered into a contravening transaction" include a director who is not a party to the transaction but has authorized or permitted the transaction? Who is "any other director liable under this subsection" and what are his liabilities?

- (b) The new S157I(5) provides that S157H(1), (2) and (4) shall not of itself invalidate transaction or arrangement entered into in contravention of that section.

Regarding the goods or land which falls within the definition of "credit transaction" as provided in S157H(7) and contravenes S157H(1), (2) and (4), please confirm whether the title or interest in such goods and land will be effected? Whether the rights required by subsequent purchasers of such goods or land will be affected?

- (c) S157I(2) provides that a guarantee entered into or any security provided by a company in contravention of S157H(1), (2) or (4) shall be unenforceable against the company.

As the new S157I(5) is provided to be without prejudice to S157I(2), does that mean that notwithstanding S157I(5), the guarantee or security in contravention of S157H(1), (2) and (4) will be unenforceable against the company?

- (d) The new S157I(3)(a) provides for an exception to S157I(2) in that the guarantee or security in contravention of S157H(1), (2) and (4) can be enforceable against the company if it is shown that the person in favour of whom the guarantee or security is provided for did not know the relevant circumstances at the time when the guarantee was entered into or the security provided.

The new S157I(3)(b) further provides that S157I(2) shall not affect an interest in any property that has been passed by the company to any person by way of security provided in connection with any transaction or arrangement. Please confirm whether the new S157I(3)(b) is also subject to the condition that the person in favour of whom the guarantee or security is provided for did not know the relevant circumstances at the time when the guarantee was entered into or the security provided.

- (e) The new S157H(1), (2) and (4) prohibits a company from selling land to its director or a director of its holding company under a "conditional sales agreement". "Conditional sales agreement" is not defined in the Bill. Doubt could arise as to whether it covers the usual agreement for sale and purchase of property currently used in Hong Kong. If the answer is in the affirmative, the new S157H will prohibit the sale of property by a company to its director or a director of its holding company. Please confirm the scope of such prohibition and consider the need for a definition for conditional sales agreement.
- (f) An exception is provided in the new S157HA(6) that a company which sells property in the ordinary course of business can sell property to its director or a director of its holding company if the amount of the transaction does not exceed \$500,000. Please account for level set for

this threshold.

New Section 157H(4)(b)

The new S157H(4)(b) provides that a company must not take part in an arrangement by or under which -

- (a) another person enters into a transaction or arrangement that would have contravened subsection (1) or (2) if the company had entered into it; and
- (b) the other person has obtained or is to obtain a benefit from the company or its holding company or a subsidiary of the company or its holding company.

The corresponding section for S157H(4)(b) in the CA restricts the "benefit" as follow:

"that other person, in pursuance of the arrangement, has obtained or is to obtain any benefit from the company or its holding company or a subsidiary of the company or its holding company."

Is the policy intent to make the scope under the new S157H(4)(b) wider than that of the UK provision?

Does "a benefit from the company or its holding company or a subsidiary of the company or its holding company" means any benefit obtained from these companies? Any bearing to the transaction or arrangement mentioned in the new S157H(4)(a)?

There may also be an ambiguity as to whether "the other person" refers to any other person, including one who does not enter into the transaction or arrangement mentioned in S157H(4)(a). On the other hand, the Chinese version of the new S157H(4)(b) appears to restrict "the other person" to "該另一人", i.e. that "另一人" referred to S157H(4)(a). Please clarify the inconsistency.

New Section 157H(1)(c)(ii)

In line with the drafting of the new S157H(1), should "such a director" be revised as "a director of the company or of its holding company"?

New Section 157H(2) and (4)

Chapter 10 of the Department of Justice's Drafting Manual states that "if the drafter is amending a body of existing law that uses "shall" the alternative "must" should not be introduced". As "shall" is used in S157H, should "must" be re-worded as "shall" for the sake of consistency?

The above mentioned issues will be discussed at the meeting on 6 November 2002. It will be appreciated if your reply, in both Chinese and English, could reach us by noon, 4 November 2002.

Yours sincerely

(Monna LAI)
Assistant Legal Adviser

c.c. DoJ (Attn: Mr Jeffrey GUNTER)