Bills Committee on
Companies (Amendment) Bill 2002

Provision of Financial Assistance to Directors

Introduction

This paper sets out the Administration's responses to the concerns raised about clauses 58, 59 and 60 regarding "credit transaction" and "quasi-loan" by the Assistant Legal Adviser of the Legislative Council Secretariat at the meeting on 18 November 2002 and in her letters of 9 October 2002, 1 November 2002 and 14 November 2002 to the Administration.

Existing Regime

2. Section 157H of the Companies Ordinance prohibits a company (as defined in that section), whether it is a public or private one, from making loans or providing guarantee or security for loans to its directors or directors of its holding company or to another company controlled by one or more of its directors. However, such prohibition is subject to the following general exceptions -

(a) loans as between companies in the same group or the provision of guarantee or security in connection therewith;

(b) anything done by private companies (except those belonging to a group of companies of which a member is a listed company) if approved in general meeting;

(c) anything done to provide the directors with funds to meet expenses incurred or to be incurred for the purpose of the company or for enabling the directors to properly perform his duties, subject to certain conditions being met;

(d) loans (not exceeding 80% of the value) for the purchase of the only or main residence of a director of the company, subject to certain conditions being met; and

(e) loans or the provision of guarantee or security (up to amounts not exceeding $500,000) by companies the ordinary business of which includes the lending of money or the giving of guarantees /securities, subject to certain conditions being met.

Proposals

3. During the review of the Ordinance, the Standing Committee on Company Law Reform (SCCLR) considered that the existing regime (in paragraph 2 above) was fundamentally sound, though it was unduly restrictive in that only loans and guarantee/security for loans were covered. The term "loan" meant an advance of money to be repaid in future and was inadequate to cover modern forms of credit. The United Kingdom, for example, had amended its laws to cover credit transactions and quasi-loans. The SCCLR therefore recommended that the term "loan" should be extended to embrace in generic terms the provision of other forms of financial assistance to directors. To implement the SCCLR's recommendation, the Bill extends the provisions of the existing regime to cover "quasi-loan" and "credit transaction", using the concepts in the UK Companies Act.

4. The definition of the term "quasi-loan" in the new section 157H(7) aims to cover a transaction under which a company (as the creditor) agrees to pay for its director (as the borrower) or to reimburse expenditure incurred by a third party for the director on terms that the director will reimburse the company or in circumstances giving rise to a liability on the director to reimburse the company. For example, a company provides a credit card to its director, pays a bill for personal items initially and is reimbursed by the director afterwards.

5. The definition of the term "credit transaction" in the same section aims to cover a transaction between a company (as the creditor) and its director (as the borrower) under which the company –

(a) supplies goods or sells land to the borrower under a hire-purchase agreement[1] or a conditional sales agreement[2] ;

(b) leases or hires land or goods to the borrower in return for periodical payments; or

(c) otherwise disposes of land or supplies goods or services to the director on the understanding that payment (whether in a lump sum or instalments or by way of periodic payments or otherwise) is to be deferred.

6. Paragraph 5(a) above can include, for example, the provision of a car by a company to its director who would pay the price of the car by instalments and take ownership of the car when all the instalments are made (though the car is already in his possession). The terms "hire-purchase agreement" and "conditional sales agreement" are basically the same except that the purchaser in the former has an option to buy the goods/land in question while in the latter he would take ownership of the goods/land once the relevant conditions in the agreement are satisfied. Our policy intent is that these two terms would not cover the ordinary sale of property in Hong Kong, where the parties initially sign a provisional sales and purchase agreement and then sign a formal sales and purchase agreement about two weeks later. Such property transactions would not be covered by the terms "hire-purchase agreement" or "conditional sales agreement" because the purchaser is not given possession until the full price of the property is paid on the closing date of the transaction.

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[1] At common law, a hire-purchase agreement may be defined as a contract for the hiring of goods under which there is conferred on the hirer an option to buy the goods. The salient features of such an agreement are: that during the currency of the agreement the property in the goods remains in the owner, while the hirer is a mere bailee having no power to dispose of them; and secondly, the hirer has an option to buy the goods but not a binding obligation to do so. In practice, hire-purchase is a device used in order to give possession and the use of goods to an intending buyer over a period during which he pays the price, with interest, by instalments while the seller retains the title to the goods as security for the unpaid balance of the price. (*Benjamin's Sale of Goods*, para. 1-053) This term is defined in Order 84A of the Rules of the High Court to mean an agreement for the bailment of goods under which the bailee may buy the goods or under which the property in the goods will or may pass to the bailee.

[2] At common law, a conditional sales agreement is a contract of sale under which the transfer of the property in the goods is subject to some condition to be fulfilled after the making of the contract. In particular, it may be agreed that the property shall not pass to the buyer until the price had been paid in full; and the expression "conditional sale" is regularly used to described such a contract, at least in the common case where the price is payable by instalments. (*Benjamin's Sale of Goods*, para. 1-052). This term is defined in Order 84A of the Rules of the High Court to mean an agreement for the sale of goods under which the purchase price or part of it is payable by instalments, and the property in the goods is to remain in the seller (notwithstanding that the buyer is to be in possession of the goods) until such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled.

7. Paragraph 5(b) above can include, for example, the provision of a car by a company to its director in return for periodic payments but the director does not have an option to purchase the car. It can also include a tenancy agreement in respect of a property between a company and its director.

8. Paragraph 5(c) can include, for example, the scenario in which a company provides a car to its director in return for a payment, but whilst the director takes ownership of the car, the payment will not be due until sometime afterwards.

Differences between UK and Hong Kong Regimes

9. In the UK, the terms "quasi-loan" and "credit transaction" apply to a relevant company[3] only. We have not followed this approach in Hong Kong, having regard to the following -

(a) the existing regime as it applies to private companies is fundamentally sound; and

(b) unlike the UK regime, it does not prohibit a private company (other than one that is a member of a group of companies one of which is a listed company) from doing anything that has been approved by the company in general meeting. This should provide these companies with the necessary flexibility.

Specific issues

(a) New sections 157HA(8)

10. The new section 157HA(8) allows a company (where its ordinary business includes making loans etc) to make loans etc to any director of the company etc up to a limit of $500,000. This limit is a reinstatement of that in the existing section 157H(8) and is not subject to the new section 157HA(2). We are not in favour of increasing the limit as this would mean extra risk to be borne by a company.

(b) New sections 157I(2) and (3)(b)

11. The new section 157I(2) provides that a guarantee entered into

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[3] A relevant company is defined in section 331 of the UK Companies Act 1985 to mean (a) a public company; (b) a subsidiary of a public company; (c) a subsidiary of a company which has as another subsidiary a public company; or (d) has a subsidiary which is a public company.

or any security provided by a company in contravention of the new sections 157H(1), (2) or (4) shall be unenforceable against the company. However, the new section 157I(3)(b) provides that the new section 157I(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.

12. These two new sections are a reinstatement of the existing sections 157I(2) and 3(b) of the Ordinance. The policy intent is to strike a reasonable and fair balance between the company and the chargee (e.g. a bank) in case the director fails to repay the loan. As a general rule, any guarantee or security given by a company in breach of the new sections 157H (1), (2) or (4) to directors shall not be enforceable. In the event that the director fails to repay the loan, the chargee cannot sell the property (which is the subject of the guarantee or security). Nevertheless, it is unlikely for the company to sell the property to a third party as the interest of such party will be subject to the prior interest of the chargee. Thus, if the company wishes to sell the property, it has to obtain a release of the security or guarantee from the chargee by paying the outstanding amount due under the loan. The company could rely on the new section 157I(4), which is a reinstatement of the existing section 157I(4) to recover against any director who knowingly and wilfully authorized or permitted the transaction, etc for the loss that it has suffered.

(c) New Section 157I(4)

13. The new section 157I(4) provides that a director of a company that has entered into a transaction or arrangement in contravention of the new sections 157H (1), (2) or (4) shall be liable –

(a) to account to the company for any gain that he has made directly or indirectly by the transaction or arrangement; and

(b) jointly and severally with any other director liable under the subsection, to indemnify the company for any loss or damage resulting from that transaction or arrangement,

if -

(i) he knowingly and wilfully authorized or permitted the transaction or arrangement to be entered into;

(ii) the transaction or arrangement consists of the making of a loan or quasi-loan to, or the entering into of a credit transaction as creditor for, that director or a person connected with him; or

(iii) the transaction or arrangement consists in the giving of any guarantee or the provision of any security in connection with a loan or quasi-loan made by any person to, or a credit transaction entered into by any person as creditor for, that director or a person connected with him.

14. It is important to note that the expression "that has entered into a transaction or arrangement in contravention of sections 157H (1), (2) or (4)" in the new section 157I(4) qualifies the company rather than a director of the company.

(d) New Sections 157J(1) and (2)

15. The new section 157J(1) provides for criminal penalties for contravention of the new section 157H. In order to make out an offence under section 157J(1)(b), the prosecution must establish mens rea on the part of a director, i.e. that he wilfully authorised or permitted the transaction or arrangement. The new section 157J(2) provides that a person shall not be guilty of an offence under the new section 157J if he shows that at the time the transaction or arrangement was entered into, he did not know the relevant circumstances. Use of the word "show" is a strong indication that a defendant only has an evidential burden placed upon him. It is not a persuasive burden requiring a defendant to prove on the balance of probabilities a fact which is essential to his guilt or innocence. All the defendant is required to do is adduce evidence to raise the issue that he did not know the relevant circumstances of the transaction or arrangement. Once the matter is put in issue, the burden of proof remains on the prosecution to prove that the defendant wilfully authorised the transaction or arrangement, i.e. that the defendant either deliberately with knowledge of the possible consequences, or deliberately not caring what may be the possible consequences, authorised the transaction or arrangement.

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