Bills Committee on Companies Bill

Follow-up actions for the meetings held on 2 and 9 December 2011 in relation to Part 11 of the Companies Bill

Purpose

This paper sets out the Administration's response to the issues raised by Members at the Bills Committee meetings on 2 and 9 December 2011 relating to Part 11 (Fair Dealing by Directors) of the Companies Bill ("CB").

Administration's response

Clause 477 (Connected entity)

2. Members noted that an entity connected with a director of a company covered a person other than the director's family with whom the director lived "as a couple in an enduring family relationship" (clause 477(1)(b)). Members asked the Administration to review the formulation after taking into account the relevant formulation in the Domestic and Cohabitation Relationships Violence Ordinance ("DCRVO") (Cap. 189).

3. We note that in the definition of "cohabitation relationship" in the DCRVO, the formulation of "as a couple in an intimate relationship" has been adopted after extensive deliberation. We consider that the formulation in the DCRVO reflects our intention. Having considered Members' views, we will introduce a Committee Stage Amendment ("CSA") to replace "as a couple in an enduring family relationship" with "as a couple in an intimate relationship".

Clause 482 (Interpretation)

4. As suggested by Members, we will align the wordings of clause 482(2) with those of similar provisions.

Clauses 486 (Prescribed approval of members) and 509 (Prescribed approval of members or affected members)

5. Members asked if the requirement for disinterested shareholders' approval should be extended to private companies. In this regard, the general principle of shareholders' rights to vote is that shareholders can vote in their own interests and have no personal obligation to vote in the interests of the company generally.[1] This applies even where the shareholder is a director of the company. Voting rights are considered as proprietary rights, and therefore should only be restricted with sound justifications.

6. Currently, the right to vote is subject to certain limitations under the common law, for example, doctrine of fraud on the minority. Except for some specified transactions (most of which relate to purchase or redemption of a company's own shares)[2], there is no provision in the Companies Ordinance ("CO") restricting members' rights to vote or requiring members to abstain from voting in relation to transactions in which they have an interest.

7. In the CB, the requirement for disinterested shareholders' approval will be applicable to public companies for various prohibited transactions, and also private companies and companies limited by guarantee that are subsidiaries of a public company for loans and similar transactions. We consider that the current proposal has struck a balance between corporate governance and shareholders' rights to vote, and therefore do not propose any change. However, individual private companies may include the requirement for disinterested shareholders' approval in their articles of association if it is considered necessary.

Subdivision 2 (Prohibitions) of Division 2 (Loan, Quasi-loan and Credit Transaction)

[1] This was established in *Pender v Lushington* (1877) 6 Ch 70.

[2] Section 49BA(1)(c) and (5), 49D(4) and (6), 49E(2) and (3), 49F(2) and (3), 49L(2) (purchase or redemption of a company's own shares) and 163D(4)(c) (payment to director for loss of office or retirement) of the Companies Ordinance.

8. Members expressed concerns about the potential loopholes in the provisions under Subdivision 2 of Division 2. Having reviewed the provisions and considered Members' views, we will introduce CSAs to –

(a) extend the prohibition from making a loan etc. to a director of the company under clause 491 to cover a body corporate with which the director is associated (see clause 479 which defines associated body corporate);

(b) extend the prohibition from making a loan, quasi-loan etc. to a director of the holding company of the specified company under clauses 491, 492, 494 and 495 to cover the connected entities of such a director.

9. Members also expressed concerns on clauses 491(3)(a), 492(3)(a), 494(3)(a) and 495(3)(a), which exempt a holding company, subsidiary or body corporate (as the case may be) from the requirement for members' approval in respect of a transaction to be entered into if the holding company, subsidiary or body corporate is incorporated outside Hong Kong. These provisions are modelled on sections 198(6)(a) and 217(4) and similar provisions in the United Kingdom Companies Act 2006 ("UKCA 2006").

10. As explained at the meeting, the CB mainly governs companies incorporated in Hong Kong. It is therefore appropriate to provide for the exemption under clauses 491(3)(a), 492(3)(a), 494(3)(a) and 495(3)(a).

<u>Clause 496 (Exception for loan, quasi-loan and credit transaction of value not exceeding 5% of total assets or called-up share capital)</u>

11. Members sought clarification on the reference to "the company's accounts prepared under section 122 of the predecessor Ordinance" in clause 496(2)(b). In this regard, section 122(1) of the CO mentions a "profit and loss account" and an "income and expenditure account" and section 122(2) mentions a "balance sheet". The expression "company's accounts prepared under section 122 of the predecessor Ordinance" is intended to refer to the "profit and loss account" or "income and expenditure account" and the "balance sheet" in section 122 of the CO.

Clauses 496 (Exception for loan, quasi-loan and credit transaction of value not exceeding 5% of total assets or called-up share capital), 500 (Exception for home loan) and 501 (Exception for leasing goods and land etc.)

12. Members noted that the financial limits for the exceptions under clauses 496, 500 and 501 would be calculated on the basis of the company's total assets, and were concerned if the financial limits would be unduly high, in particular for highly-geared companies.

13. Having considered Members' views, we will introduce a CSA to change the basis of calculations from the company's total assets to the company's net assets.

Clause 497 (Exception for expenditure on company business)

14. In response to Members' suggestion, we will review the drafting of the Chinese version of the provision.

Clauses 498 (Exception for expenditure on defending proceedings etc.) and 499 (Exception for expenditure in connection with investigation or regulatory action)

15. Members asked –

(a) what a company could do in case a director could not repay the funds to the company after the proceedings;

(b) whether judgment would be considered as given against the director if judgment was given against the director in the Court of First Instance but the case was subsequently settled in the course of appeal; and

(c) whether a director would be required to repay the funds if he was only convicted of some of the criminal charges against him.

16. Clauses 498 and 499 of the CB are modelled on sections 205 and 206 of the UKCA 2006. The clauses were considered necessary in the

UK in view of a shortage of suitable candidates for directorship due to, among others, the increase in legal actions against directors personally and the costs of lengthy court proceedings. We consider it useful to introduce clauses 498 and 499 in the CB.

17. As for the questions raised by Members –

(a) if a director fails to repay the funds or discharge the liability after the proceedings, the company may enforce against the director its claim for repayment under the funding arrangement as in the case of breach of contract;

(b) if judgment in civil proceedings has been given against a director in the Court of First Instance but the case is settled in the course of the appeal (while the judgment given in the Court of First Instance still stands), the judgment is to be regarded as given against the director;

(c) if a director is acquitted of some but not all the charges in criminal proceedings, we consider that the repayment or discharge of liability should be in respect of the costs fairly attributable to the relevant charges.

<u>Clauses 500 (Exception for home loan) and 501 (Exception for leasing goods and land etc.)</u>

18. Members asked the Administration review whether the exceptions under clauses 500 and 501 should cover a director of a holding company of the company.

19. Regarding the exception for home loan under clause 500, we will introduce a CSA that the exception applies to a director of the holding company of the company only if he is also an employee of the company.

20. As for the exception for leasing goods and land etc. under clause 501, we note that one of the conditions for the application of the exception is that the terms of the transaction in question are not more favourable than what is reasonable to expect the company to have offered, if the goods had been leased or hired, or the land had been leased, on the open market, to a

person unconnected with the company (clause 501(2)(b)). We consider that preventing a director of a holding company of the company from taking a lease or hire of goods or a lease of land from the company on open market terms simply because he happens to be a director of the holding company is unfair, especially when a director of the company is not similarly prevented. We therefore propose no change to clause 501.

Clause 505 (Affirmation of contravening transaction or arrangement)

21. Members asked whether clause 505(5) would imply that a transaction or arrangement could be affirmed even after a reasonable period had lapsed. In this regard, our intention is that affirmation must be within a reasonable period, otherwise the interests of a company's creditors may be prejudiced if the company enters into liquidation. We will introduce CSAs to clarify our intention.

Clause 507 (Interpretation)

22. Members asked whether the Chinese rendition of "takeover offer" should be "收購要約". In this regard, "要約" as the rendition of "offer" is consistently adopted in the laws of Hong Kong. In the English-Chinese Glossary of Securities, Futures and Financial Terms, the Chinese equivalent of "takeover offer" is also "收購要約".

Clause 513 (Person must not make payment for loss of office to director or former director in connection with transfer of company's undertaking or property)

23. In response to Members' suggestion, we will review the use of the "undertaking" in clauses 513 and other provisions in the CB with a view to avoiding confusion with "undertaking" as defined in clause 2(1).

Clause 516 (Exception for small payment)

24. In view of Members' suggestion, we propose to raise the limit from $20,000 to $100,000 so as to provide further flexibility to companies.

Clauses 518 (Civil consequences of contravention of section 512), 519 (Civil consequences of contravention of section 513) and 520 (Civil consequences of contravention of section 514)

25. Members noted that, if a payment was made by a company in contravention of the CB provisions, the payment would be held by the recipient in trust for the company. Members asked if a time limit should be introduced so as to provide certainty to the recipients.

26. In this regard, we consider that the matter is covered by equitable rules depending on the facts and circumstances of each case and it is undesirable for an enactment to impose a time limit for a fund held on a trust arising by operation of law. We therefore propose no change to the provision.

Clause 529 (Declaration to directors: procedures)

27. In response to Members' suggestion, we will propose CSAs to delete "effective" in clause 529(4)(a)(ii) and (b)(ii). The effectiveness of the general notice will be governed by clause 529(6).

28. On a related note, clause 529(6) is modelled on section 185(4) of the UKCA 2006. The interpretation of the phrase "takes all reasonable steps" is a matter of fact depending on all the relevant circumstances of the case. According to our research, there is no direct case authority on the interpretation of "the director takes all reasonable steps to secure that it is brought up and read at the next directors' meeting after it is given", whether under section 185(4) of the UKCA 2006 or its predecessor provision in section 317(4) of the United Kingdom Companies Act 1985. However, reference may be made to recent cases in the UK that discussed "reasonable endeavours", "all reasonable endeavours" and "best endeavours".

29. In *Rhodia International Holdings Ltd v Huntsman International LCC* [2007] 1 CLC 59 at 76 (paragraph 33), the court confirmed the established position that "best endeavours" was a more stringent obligation than "reasonable endeavours", and that "best endeavours" probably required a party to take all reasonable courses it could, "reasonable endeavours" probably meant an obligation for a party to take one

reasonable course. The court also stated that in that context, it might well be that an obligation to use all reasonable endeavours equated with using best endeavours.

30. In *Ryanair Ltd v SR Technics Ireland Ltd* [2007] EWHC 3089 (QB), the applicant airline claimed that the respondent company was in breach of a collateral contract and applied for injunctive relief. One of the issues was whether the respondent had used its best endeavours to obtain the consent of the Dublin Airport Authority to issue a hangar licence to the respondent for 15 years, or such lesser period as the Authority would consent to. The judge found (at paragraphs 163 to 166) that the respondent was in breach of its obligation to use its best endeavours to obtain the consent taking into account inter alia that the respondent delayed unduly in making the initial approach to the Authority for consent to the licence, thereafter failed to pursue the question with the diligence which was to be expected of it in all the circumstances, and the person acting for the respondent did nothing to press the Authority to agree to a 15 year licence and he went out of his way to facilitate a refusal.

Clause 535 (Contract with sole member who is also director)

31. In response to Members' suggestion, we will propose CSAs to provide that the company must ensure that the terms of the contract are set out in a written memorandum within 7 days after the contract is made. This restates the period as provided for in section 162B(1) of the CO.

Financial Services and the Treasury Bureau
Companies Registry
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