Bills Committee on Companies Bill

Part 10 and Part 11 of the Companies Bill

PURPOSE

This paper outlines the major proposals and policy issues in Part 10 (Directors and Company Secretaries) and Part 11 (Fair Dealing by Directors) of the Companies Bill. It also covers relevant overseas experience and public views received during earlier public consultation on the major proposals and our responses.

DETAILS

2. Details for each Part are contained in the Annexes -

Annex A - Part 10 (Directors and Company Secretaries)

Annex B - Part 11 (Fair Dealing by Directors)

ADVICE SOUGHT

3. Members are invited to note the contents of the paper and provide their views.

Financial Services and the Treasury Bureau
Companies Registry
17 May 2011

Annex A

Bills Committee on Companies Bill

Part 10 – Directors and Company Secretaries

INTRODUCTION

Part 10 (Directors and Company Secretaries) of the Companies Bill ("CB") contains provisions relating to directors and company secretaries.

POLICY OBJECTIVES AND MAJOR PROPOSALS

2. Part 10 contains initiatives that aim at enhancing corporate governance, improving regulation and modernizing the law. The initiatives that aim at enhancing corporate governance include –

(a) restricting corporate directorship in private companies (paragraphs 6 to 13 below);

(b) clarifying the standard of directors' duty of care, skill and diligence (paragraphs 14 to 23 below); and

(c) requiring ratification of conduct of directors by disinterested members' approval (paragraphs 24 to 28 below).

3. The initiatives that aim at improving regulation and modernizing the law include –

(a) enabling the Registrar of Companies ("Registrar") to give directions to a company relating to the appointment of directors and company secretaries (paragraphs 29 to 32 below); and

(b) setting out rules on indemnification of directors against liabilities to third parties (paragraphs 33 to 38 below).

4. Apart from the above major proposals, this Part also restates a miscellany of provisions in the Companies Ordinance ("CO") concerning directors and company secretaries, including directors' vicarious liability for the acts of their alternates, the avoidance of acts done by a person in a dual capacity as director and company secretary, prohibition of undischarged bankrupt from acting as director and the keeping of minutes of proceedings at directors' meetings.

5. The details of the major proposals in Part 10 are set out in paragraphs 6 to 38 below

Restricting corporate directorship in private companies (clause 448)

Current position

6. Currently, the CO prohibits all public companies and private companies which are members of a group of companies of which a listed company is a member from appointing a body corporate as their director. There is no restriction for other private companies.

Proposal and key provisions in the Bill

7. We propose that corporate directorship should continue to be prohibited for public companies and private companies which are members of a group of companies of which a listed company is a member. As for other private companies, they should be required to have at least one director who is a natural person to enhance transparency and accountability.

8. **Clause 448** restricts corporate directorship by requiring a private company (other than one within the same group of a listed company) to have at least one director who is a natural person. Companies would be given a grace period of six months from the commencement of that clause to comply with the requirement (**clause 83 of Schedule 10**).

Overseas experience

9. The proposal is in line with section 155 of the United Kingdom Companies Act 2006 ("UKCA 2006").

Public consultation

10. In April 2008, we consulted the public on whether corporate directorship should be abolished altogether in Hong Kong or should be restricted by requiring every company to have at least one natural person as its director. The respondents' views were diverse. In view of the equally strong opinions on the need to enhance corporate governance and transparency and the legitimate commercial need for flexibility, we propose to restrict corporate directorship as mentioned above. It will also address to a large extent the anti-money laundering concern of the Financial Action Task Force[1].

11. During the consultation on the draft CB in 2009-10, there were concerns that the proposal would increase the cost of operating business and drive businesses away from Hong Kong. It was considered that exemption should be granted to trust companies as well as dormant and small companies. There was a suggestion that the grace period should be lengthened to two years from the enactment of the CB to allow companies to find and appoint individual directors. There were also suggestions that the individual director must be an accountant, lawyer or company secretary, and that the individual director should be a local resident.

12. Having considered the comments received, we have included in the CB an exemption for existing dormant companies (section 83(3) of Schedule 10), but they will need to comply with the requirements when they cease to be dormant. Regarding trust companies and small companies, we consider that it would be inappropriate to grant exemptions as it would be against the principles laid down and recommendations made by the Financial Action Task Force for combating money laundering. Granting exemptions to small companies would also

[1] See the Consultation Conclusions on Company Names, Directors' Duties, Corporate Directorship and registration of Charges (December 2008), available at http://www.fstb.gov.hk/fsb/co_rewrite .

lead to complexities in implementation as their status as small companies may change over time.

13. Regarding the grace period, we envisage that the new CO will come into force at least 18 months after enactment of the CB. After the new CO comes into force, a grace period of six months will be given. We believe that companies will have sufficient time to find and appoint individual directors. As for requirements on the individual director, we consider it too rigid to require that the director must be a professional or must be a local resident. It may adversely affect business operations in Hong Kong and we do not intend to introduce such requirement at the moment.

Clarifying the standard of directors' duty of care, skill and diligence (clauses 456 and 457)

Current position

14. There is no provision on directors' duty of care, skill and diligence in the current CO and the common law position in Hong Kong is not entirely clear. The standard in old case law which focuses on the knowledge and experience which a particular director possesses (which is generally called the subjective test[2]), is considered to be too lenient nowadays.[3] We observe that there is a judicial trend in other comparable jurisdictions towards the use of a mixed objective/ subjective test[4] in the determination of the standard of care, skill and diligence

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[2] The old case law culminated in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 where Romer J reviewed and summarised the general principles for the traditional standard at common law which was generally known to have been applied in Hong Kong (see paragraph 6.05 of the Consultation Paper on proposals made in Phase I of the Corporate Governance Review by the Standing Committee on Company Law Reform (July 2001)).

[3] In the Court of Appeal case of *Law Wai Duen v Boldwin Construction Co Ltd* [2001] 3 HKLRD 430 (at paragraph 10), the Hon Rogers VP stated that "Perhaps the classic exposition of the duty of care required of a director was given by Romer J in the case of In *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407. The standard which he described as being required of a director is, if anything, open to review in present day circumstances as, perhaps, being too low."

[4] In determining whether a director has fulfilled his/her duty of care, the court will consider whether he/she has exercised the care, skill and diligence that would be exercised by a reasonable person in the same circumstances having both (a) the knowledge, skill and experience that may reasonably be expected of a person in the same position as the director and (b) the knowledge, skill and experience which he/she has.

expected of directors. The adoption of a mixed objective/subjective test in overseas jurisdictions has occurred through both the decisions of the courts on the common law[5] and through confirmation of that test under statute. In light of overseas developments in the common law, it is likely that Hong Kong courts would also adopt the mixed objective/subjective test. However, there remains some uncertainty because of the absence of a clear case authority in Hong Kong.

Proposal and key provisions in the Bill

15. We consider it appropriate to clarify the standard of directors' duty of care, skill and diligence by introducing a statutory statement in the CB to provide appropriate guidance to directors.

16. **Clause 456** provides that a director must exercise reasonable care, skill and diligence, at the standard that would be exercised by a reasonably diligent person with

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

(b) the general knowledge, skill and experience that the director has.

Paragraph (a) provides an objective test whereas paragraph (b) a subjective test. A director has to meet the standard in both tests.

17. Clause 456(4) further provides that the said duty has effect in place of the corresponding common law rules and equitable principles. Clause 456(5) provides that the duty applies to a shadow director[6]. We consider that it is appropriate to subject shadow directors to the same duty as a duly appointed director, because anyone who interferes in the affairs

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5 England: *Re D'Jan of London* [1994] 1 BCLC 561; Australia: *Daniels v Anderson* (1995) 16 ACSR 607; Singapore: *Lim Wing Kee v PP* [2002] 4 SLR 327.

6 A shadow director is defined in clause 2 to mean, in relation to a body corporate, a person in accordance with whose directions or instructions (excluding advice given in a professional capacity) the directors, or a majority of the directors, of the body corporate are accustomed to act.

of a company to the extent that makes him fall within the definition of a shadow director must take on the same responsibilities and duties as those of a director.

18. **Clause 457** preserves the existing civil consequences of breach (or threatened breach) of the said duty. The remedies for breach of the duty will be exactly the same as those that are currently available following a breach of the common law rules and equitable principles that the said duty replaces.

Overseas experience

19. In the United Kingdom ("UK"), the general duties of directors (including fiduciary duties and duty of care, skill and diligence) have been comprehensively codified. The statutory statement proposed in the CB follows section 174 of UKCA 2006 albeit with a narrower scope (i.e. excluding fiduciary duties). This would allow us to benefit from precedent cases in the UK. Australia (section 180(1) of the Australia Companies Act 2001) and Singapore (section 157(1) of Singapore Companies Act) have both adopted the objective test in the statute, which are judicially interpreted to incorporate subjective elements[7].

Public consultation

20. In the consultation conducted in April 2008, we consulted the public on whether directors' general duties (including fiduciary duties and duty of care, skill and diligence) should be codified. Responses were highly divided. We concluded that it would be premature to go down the route of comprehensive codification at this stage but we saw merits in clarifying in statute the duty of care, skill and diligence to give guidance to directors.

21. During the public consultation on the draft CB held in 2009-10, we received some comments from chambers of commerce, several professional organisations as well as some listed companies on the current proposal to clarify the standard of directors' duty of care, skill and

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[7] Australia : *Daniels v Anderson* (1995) 16 ACSR 607 at 668; *ASIC v Rich* (2009) 75 ACSR 1 at [7202], [7205]; *Morley v ASIC* (2010) 274 ALR 205 at [819]. Singapore : *Lim Wing Kee v PP* [2002] 4 SLR 327.

diligence. While most of the respondents supported the proposal in principle, there was some concern that the subjective test would set an even higher standard for those directors having special knowledge or experience. Some queried whether the objective element would raise the current standard of directors' duty for non-executive directors requiring them to use the same care, skill and diligence of executive directors. Some suggested that a "safe harbour" should be developed to define the circumstances where the directors would be protected from liability and some suggested adopting a "business judgment rule" similar to that in jurisdictions like Australia to protect directors from liability for bona fide business decisions which subsequently turn out to be mistaken.

22. We have carefully considered the public views received. On the query whether the objective element raises the standard expected of non-executive directors to that of executive directors, it would not be the case. Clause 456(2)(a) makes it clear that the court must also take into account the functions carried out by the relevant director in relation to the company. This means that the court should consider the different functions of executive and non-executive directors when determining whether a particular director has exercised reasonable care, skill and diligence. As to the subjective element in clause 456(2)(b) raising the standard expected of directors who have special knowledge, skills or experience, we note that this largely reflects the position under the common law[8].

23. On the proposal to introduce a "safe harbour", we consider that there is no obvious need to do so given that clauses 891 and 892 already provide that the court may relieve an officer of a company from liability for any misconduct if he has acted honestly and reasonably and ought fairly to be excused having regard to all the circumstances. As regards the proposed introduction of a statutory "business judgment rule", the Standing Committee on Company Law Reform had considered the proposal and was of the view that there was already similar protection under the common law, and that the existing common law position was sound. There is no need for a statutory formulation of the "business judgment rule".

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[8] *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; *Re D'Jan of London* [1994] 1 BCLC 561; *Lim Wing Kee v PP* [2002] 4 SLR 327.

Requiring ratification of conduct of directors by disinterested members' approval (clause 464)

Current position

24. At present, the ratification of acts or omissions of directors is subject to common law rules, which generally require members' approval in a general meeting to release the directors from their fiduciary duties. Ratification would have the effect of barring the company from bringing actions against the director for damages it suffered as a result of the ratified act or omission, albeit it might not prevent dissenting minorities from pursuing unfair prejudice claims or statutory derivative claims. Under the current regime, conflict of interest may arise in situations where the majority shareholders are directors or are connected with the directors.

Proposal and key provisions in the Bill

25. We propose to introduce a disinterested shareholders' approval requirement for ratification of directors' conduct. **Clause 464** provides that any ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company must be approved by resolution of the members of the company disregarding the votes in favour of the resolution by the director, any entity connected with him/her and any person holding shares of the company in trust for him/her or for the connected entity.

Overseas experience

26. Our proposal is in line with section 239 of the UKCA 2006.

Public consultation

27. During the public consultation on the draft CB in 2009-10, there were concerns that the proposal was too wide in scope in relation to ratification of wrongs done to the company by the director. It was

going too far to require a simple breach of duty to be ratified by shareholders. On the other hand, it was suggested that certain breach of duties by the directors should not be ratifiable by the shareholders like misappropriation of assets of the company and fraud on minority shareholders. As ratification might prejudice creditors, it should be valid only if the company was solvent as at the date of the passing of the resolution ratifying the act. There was also a concern that the disinterested shareholders' approval requirement might be too restrictive in the context of Hong Kong, as there might be cases where nobody could vote in a family-owned company.

28. It is a basic principle of the law relating to fiduciaries that those to whom the duties are owed may release those who owe the duties from their legal obligations. Clause 464 does not alter the common law in relation to the types of breaches which can be ratified by the shareholders. Clause 464(7) preserves existing common law rules which restrict ratification, so there is no need to provide expressly that ratification is valid only if the company is solvent as at the date of the passing of the resolution ratifying the act, or that certain breaches are not ratifiable. As for the concern regarding family-owned business, clause 464(6) provides that nothing in clause 464 affects the validity of a decision taken by unanimous consent of the company's members, so the restrictions imposed by clause 464 will not apply when every member approves the ratification.

Enabling the Registrar to give directions to a company relating to the appointment of directors and company secretaries (clauses 449 and 467)

Current position

29. At present, the CO requires a private company to have at least one director and a public company at least two directors. In the event of contravention, the company and every officer in default are liable to a fine. In addition, every company should appoint a company secretary though there is no offence provision for failure to appoint one.

Proposal and key provisions in the Bill

30. We consider that provisions empowering the Registrar to give directions to the company to appoint directors (**clause 449**) and company secretaries (**clause 467**) would be useful for better enforcement of the statutory requirements. Non-compliance with the direction is an offence. The company and every responsible person of the company will be liable to a fine.

Overseas experience

31. The proposal is in line with sections 156 and 272 of the UKCA 2006.

Public consultation

32. There were no substantive comments raised on this proposal.

Clarifying the rules on indemnification of directors against liabilities to third parties (clauses 458 and 460 to 463)

Current position

33. The law regulating a director's right to be indemnified against liabilities to third parties is currently found in case law, which is fairly difficult for lay directors to understand. In particular, the scope of the right of directors to be indemnified against liabilities to third parties is not clear. The uncertainty over the right to be indemnified against liabilities to third parties may deter competent persons from accepting directorships.

Proposal and key provisions in the Bill

34. To remove such uncertainty, we propose to clarify the rules on indemnification of directors against liabilities to third parties.

35. **Clause 460** permits a company to indemnify a director against

liability incurred by a director to a third party if the specified conditions are met. Certain liabilities and costs must not be covered by the indemnity, such as criminal fines, penalties imposed by regulatory bodies, the defence costs of criminal proceedings where the director is found guilty and the defence costs of civil proceedings brought against the director by the company or an associated company in which judgment is given against the director. To enhance transparency, a company which provides any permitted indemnity to its or its associated company's directors must disclose the indemnity provision in the directors' report (**clause 461**) and make it available for inspection by any member on request (**clauses 462 and 463**).

Overseas experience

36. The approach is similar to that of the UK (see sections 234 and 236 to 238 of the UKCA 2006).

Public consultation

37. We received some comments during the public consultation on the draft CB that the indemnity in favour of the director should be required to be recorded in writing, duly authorised and executed by the company giving it. The liabilities and costs that could not be covered by indemnity should be expanded to cover any civil proceedings brought by a shareholder in a derivative or similar action in which judgment was given against the director. On the other hand, it was noted that under clause 460(2)(a)(ii), any penalty payable in respect of non-compliance with any regulatory requirement was excluded from the scope of a permitted indemnity. It was suggested that an exemption should be provided for a regulatory requirement that was a purely routine administrative matter and had inconsequential impact on the shareholders.

38. On the comment that the indemnity must be in writing, we believe that a written memorandum setting out the terms of the indemnity provisions as required in clause 462 should be sufficient for the purpose of disclosure even if the provision is not in writing. Regarding the comments on the liabilities and costs that could not be covered by

indemnity, we agree that the scope of prohibition should be expanded to cover any civil proceedings brought by or on behalf of the company or an associated company, in which judgment is given against the director. The change has been incorporated in the CB (clause 460(2)(b)(iii)). However, we do not agree that any exemption should be provided for any regulatory requirement. It is still a director's duty to ensure that the company complies with all regulatory requirements regardless of their nature.

PUBLIC COMMENTS

39. We have consulted the public on the draft CB in two phases of public consultation held from December 2009 to March 2010 and May to August 2010 respectively. Part 10 was covered in the first phase public consultation. The comments on our major proposals and our response are discussed above.

40. Other significant comments on Part 10 received and our response are as follows –

Major Comments	Administration's Response
Validity of Acts of Directors	
Clause 452 is too wide in scope in protecting the interests of third parties dealing with the company. It will cause a lot of harm to the company concerned in case a person is actually unqualified to act as a director or the person has ceased to hold office as a director. Such clause may cause a lot of trouble and unnecessary disputes or civil litigation between the company and the third party.	Clause 452 restates with modifications part of section 157 of the CO. The effect of the clause is that, as between the company and persons having no notice to the contrary, directors in fact are as good as directors in law. Pursuant to existing case law, a person seeking to rely on such validation provisions must have acted in good faith and in particular, the defect must not have been known at the time of the appointment. It does not

Major Comments	Administration's Response
	seem that the clause will cause unnecessary disputes or civil litigation as the case law in construing these types of provisions is long established.
Minutes of directors' meetings and written record of decision of sole director of private company	
In case a company does not keep the records of its directors' meetings as required in clause 472 or of decision of the sole director as required in clause 474, the liability should rest on the officers in default instead of the company itself.	We consider that the prosecution should be given the flexibility to prosecute the company and / or officers in default, given the fact that it is sometimes difficult to prosecute officers. In fact, the majority of Hong Kong companies are management owned, and the persons in default would often be the persons who suffer from the default if the companies are penalised.

41. Other comments on Part 10 and the Administration's response are set out in Appendix III to the consultation conclusions issued on 27 August 2010[9].

Financial Services and Treasury Bureau
Companies Registry
17 May 2011

[9] Available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccfp_conclusion_e.pdf .

Annex B

Bills Committee on Companies Bill

Part 11 – Fair Dealing by Directors

INTRODUCTION

Part 11 (Fair Dealing by Directors) of the Companies Bill ("CB") contains provisions relating to fair dealing by directors, particularly in situations in which a director is perceived to have a conflict of interest. It governs transactions involving directors or their connected entities which require members' approval (namely loans and similar transactions, payments for loss of office and directors' long-term employment), and covers disclosure by directors of material interests in transactions, arrangements or contracts.

POLICY OBJECTIVES AND MAJOR PROPOSALS

2. Part 11 contains initiatives that aim at enhancing corporate governance, facilitating business and modernizing the law. The initiatives that aim at enhancing corporate governance include –

(a) expanding the prohibitions on loans and similar transactions to cover a wider category of persons connected with a director (paragraphs 5 to 9 below);

(b) requiring disinterested members' approval for various prohibited transactions (paragraphs 10 to 15 below);

(c) expanding the prohibitions on payments for loss of office (paragraphs 16 to 20 below);

(d) requiring members' approval for directors' employment exceeding three years (paragraphs 21 to 24 below); and

(e) widening the ambit of disclosure currently required under section 162 of the Companies Ordinance ("CO") (paragraphs

25 to 29 below).

3. The initiatives that aim at facilitating business and modernizing the law include –

(a) introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities (paragraphs 30 to 38 below).

(b) modifying the scope of private companies that are subject to more stringent restrictions similar to a public company (paragraphs 39 to 44 below); and

(c) removing the criminal sanction for breach of the provisions on prohibition of loans and similar transactions in favour of directors and connected entities (paragraphs 45 to 48 below).

4. The details of the major proposals in Part 11 are set out in paragraphs 5 to 48 below.

Expanding the prohibitions on loans and similar transactions to cover a wider category of persons connected with a director (clauses 477 to 479)

Current position

5. At present, to avoid potential conflict of interests between a company and its directors, section 157H of the CO prohibits a company from entering into loans or other similar transactions with a director or persons connected with the director. In respect of a listed company or a private company that is within the same group as a listed company, section 157H(8) and (9) extends the references to "director" to a spouse, child and step-child (including illegitimate child) under the age of 18, and specified categories of trustees and partners; and section 157H(2)(c), (3)(c) and (4)(c) extends the prohibitions to a company in which a director (or the above categories of persons) holds a controlling interest. We consider that the current references are not sufficient to cover all

parties who are closely associated with directors.

Proposal and key provisions in the Bill

6. We propose to expand the prohibition to cover a wider category of persons connected with a director. In Part 11, clauses 493 and 494 prohibit a specified company from making a loan, quasi-loan, etc. to, or enter into credit transaction etc. as creditor for an entity connected with a director without prescribed approval of members. **Clauses 477 to 479** provide for the coverage of an entity connected with a director. It covers, on top of those in the existing CO –

(a) an adult child, adult step-child, an adult illegitimate child or an adopted child of any age;

(b) a parent;

(c) a cohabitee;

(d) a minor child, minor step-child, minor illegitimate child or minor adopted child of the cohabitee who lives with the director;

(e) an associated body corporate[1];

(f) a trustee of a trust which includes the director's minor adopted child; and

(g) a business partner of the director's minor adopted child.

Overseas experience

7. In formulating the proposal, we have made reference to relevant provisions of the United Kingdom Companies Act 2006 ("UKCA 2006") (sections 252 to 255), with suitable modifications to cater for local circumstances.

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[1] See clause 479. The voting powers of the director, his/her spouse, his/her minor child, minor step-child, minor illegitimate child or minor adopted child, and the trustee of a trust of which the beneficiaries include the above persons are taken into account in considering whether the director is associated with or controls a body corporate.

Public consultation

8. During our earlier public consultation, some respondents considered that due regard should be given to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong ("Listing Rules") in formulating the requirements in the CB. We have suitably modified the proposals and believe that the CB is generally in line with the relevant requirements in the Listing Rules.

9. There was also a concern during the public consultation about the possible implications of the expansion of the scope of entities connected with a director to cover parents and adult children. While we note the concern, we are of the view that parents and children (including adult children) seem very much to be the type of persons where questions of commonality of interest can arise. We therefore consider it necessary to expand the scope as currently proposed.

Requiring disinterested members' approval for various prohibited transactions (clauses 486, 506, 509 and 523)

Current position

10. Currently, 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 CO restricting members' rights to vote or requiring members to abstain from voting in relation to transactions in which they have an interest.

Proposal and key provisions in the Bill

11. The Standing Committee on Company Law Reform had considered and recommended amending the CO to incorporate the requirement for disinterested members' voting for connected transactions. The requirement will be applicable to public companies for various prohibited transactions, and to a private company or company limited by

[2] Sections 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 CO.

guarantee that is a subsidiary of a public company for loans and similar transactions.

12. **Various clauses in Divisions 2 to 4,** which set out the requirements for members' approval for the three types of prohibited transactions covered by Part 11[3], have incorporated the disinterested members' voting requirement for public companies. For loans, quasi-loans and credit transactions, the disinterested members' approval requirement is extended to a private company or company limited by guarantee that is a subsidiary of a public company (**clauses 482, 486(2)(b)(ii) and 506(1)(b)(ii)**). If a company is subject to the disinterested members' approval requirement, the resolution at a general meeting of such a company is passed only if every vote in favour of the resolution by the interested members is disregarded (**clauses 486(2)(b)(ii) and (5), 506(1)(b)(ii) and (4), 509(2)(b)(ii), (4) and (5) and 523(2)(b)(ii) and (4)**).

13. In general, the members whose voting rights may be restricted include the relevant directors or former directors, relevant connected entities and any person who holds any shares in the company in trust for these persons/entities. The votes of other persons are restricted in the following circumstances –

(a) in the case of a resolution for affirming a contravening loan or similar transaction (i.e. where the company elects to adopt the transaction despite the contravention), any other director who authorised the contravening transaction;

(b) in the case of a payment for loss of office, the proposed recipient of the payment for loss of office, if he is not the relevant director or former director;

(c) in the case of a payment for loss of office which is made in connection with a share transfer resulting from a takeover offer, person who makes the takeover offer and his associates; and

(d) any person who holds any shares in the company concerned in trust for the above categories of person.

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[3] The three types of transactions are (a) loans, quasi-loans and credit transactions; (b) payments for loss of office; and (c) directors' long-term employment.

Overseas experience

14. The proposal is recommended by the Standing Committee on Company Law Reform having taken into account local circumstances.

Public consultation

15. There were no substantive comments raised on this proposal.

Expanding the application of the prohibitions on payments for loss of office (clauses 507 to 520)

Current position

16. It is unlawful under sections 163 to 163D of the CO to make payments to directors or former directors of a company, as compensation for loss of office or as consideration for retirement from office, without the company's prior approval. There are potential loopholes under the current provisions –

(a) Payments may be made indirectly via other parties;

(b) The restriction on payment for loss of office to a director in connection with a transfer of a company's undertaking or property, or in connection with certain types of transfer of shares (sections 163A and 163B) do not cover transfers in respect of a subsidiary's undertaking or shares in the subsidiary. The coverage may not be wide enough.

Proposal and key provisions in the Bill

17. To plug any potential loophole, the loss of office payment provisions are extended by **clause 507(3)** to include −

(a) payment to an entity connected with the director; and

(b) payment to a person made at the direction of, or for the benefit

of the director or his connected entity.

18. Further, **clause 512(2)** extends the prohibition to include payment by a company to a director or former director of its holding company. **Clause 513(2)** extends the provisions to include the payment made in connection with a transfer of the undertaking or property of the company's subsidiary. By virtue of **clause 507(1)** (definition of "takeover offer") and **clause 514(1)**, the prohibitions in connection with a share transfer are extended to include all transfers of shares in the company or in its subsidiary resulting from a takeover offer.

Overseas experience

19. In formulating the proposal, we have made reference to sections 215 to 222 of the UKCA 2006, with suitable modifications to cater for local circumstances.

Public consultation

20. There were no substantive comments raised on this proposal.

Requiring members' approval for directors' employment exceeding three years (clauses 521 to 526)

Current position

21. At present, there is no provision in the CO requiring members' approval for long-term employment of a director. There is a risk that a director may arrange for himself long-term employment with his company which entrenches him in office or makes it too expensive for the company to remove him from office before his contract expires (as the director might be entitled to damages for the company's breach of contract arising from the early termination).

Proposal and key provisions in the Bill

22. We propose that members' approval should be required for

directors' long-term employment. **Clause 525** requires the approval of the members of a company for any contracts under which the guaranteed term of employment of a director with the company exceeds or may exceed three years.

Overseas experience

23. In formulating the proposal, we have made reference to section 188 of the UKCA 2006 with suitable modifications to cater for local circumstances.

Public consultation

24. As mentioned in paragraph 8, we have ensured that the CB is generally in line with the relevant requirements in the Listing Rules.

Widening the ambit of disclosure currently under section 162 of the CO (clauses 527 to 532)

Current position

25. Section 162 of the CO requires a director, who has a material interest, directly or indirectly, in a contract or proposed contract with the company which is of significance to the company's business, to disclose to the board of directors the nature of such interest at the earliest meeting of directors that is practicable. The current application of the section is relatively narrow and there is a need to widen the ambit.

Proposal and key provisions in the Bill

26. **Division 5 (clauses 527 to 532)** restates the provisions of section 162 of the CO with modifications to keep in line with the relevant provisions of other common law jurisdictions such as the UK, and to widen the ambit of the section as follows −

(a) the ambit of disclosure is widened to cover "transactions" and "arrangements" instead of just "contracts" (**clause 527(1) and**

(2));

(b) for a public company, the ambit of disclosure is widened to include disclosure by a director of any material interest of entities connected with him (**clause 527(2)**);[4]

(c) a director is required to disclose the "nature and extent" of the interest instead of just disclosing the "nature" of the interest (**clause 527(1) and (2)**); and

(d) the disclosure requirements are extended to shadow directors (**clause 531**).

Overseas experience

27. The proposal is in line with the relevant provisions in the UKCA 2006 (sections 177 and 182 to 187), with certain modifications to cater for local circumstances (e.g. the proposal under paragraph 26(b) above).

Public consultation

28. There was a suggestion during earlier public consultation that two further exceptions could be added to the requirement to declare material interests under clause 527, as in the case under section 177(6) of the UKCA 2006 –

(a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest; and

(b) the other directors are already aware of the interest.

29. In this regard, our intention is that the triggering threshold should be the existing threshold under section 162 of the CO i.e. a direct or indirect material interest in connected transactions which is significant to a company's business instead of the threshold implied in section 177(6)(a) of UKCA 2006 (i.e. it can reasonably be regarded as likely to

[4] Clause 527(4)(a) of the Bill contains an exception providing that a director is not required to declare an interest if he is not aware of the interest or the transaction in question.

give rise to a conflict of interest). We also consider that the exemption in section 177(6)(b) of the UKCA 2006 (i.e. the other directors are already aware of the interest) may lead to abuse and should not be adopted.

Introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities (clauses 491 to 495, 496, 498 and 499)

Current position

30. The decision whether to make a loan is normally taken by the directors. Section 157H of the CO prohibits, subject to certain exceptions, a company from entering into any direct or indirect loan transactions in favour of its directors, directors of its holding company or any of their connected persons. These rules are intended to protect shareholders and creditors. There are exemptions from prohibitions under section 157HA of the CO which apply to all companies. In addition, a private company which is not a member of a group which includes a listed company is exempted from the prohibitions if the loan transaction is approved by members in general meeting.[5]

31. Members' approval is a simple method of ensuring compliance but is currently applicable only to private companies which are not within the same group as a listed company. The narrow application of the members' approval exception is arguably too restrictive.

Proposal and key provisions in the Bill

32. To facilitate business operation, we propose to extend the members' approval exception to all companies. Nevertheless, this new exception contains appropriate safeguards for minority shareholders. In the case of a public company and a private company or company limited by guarantee that is a subsidiary of a public company, the transactions must be approved by disinterested members.

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[5] Section 157HA(2) of the CO.

33. **Clauses 491 to 495** provide generally that a company must not make loans, quasi-loans or enter into credit transactions in favour of a director of the company or of its holding company unless with the prescribed approval of members.[6] The prohibitions are extended to entities connected with a director of the company if the company is a public company or a private company or company limited by guarantee that is a subsidiary of a public company.

34. Two new exceptions to the prohibitions on loans and similar transactions have been introduced −

(a) exception for loan, quasi-loan and credit transaction of value not exceeding 5% of total assets or called-up share capital (**clause 496**);

(b) exception for funds to meet expenditure, incurred or to be incurred by a director, on defending proceedings or in connection with an investigation or regulatory action (**clauses 498 and 499**).

35. Modifications have been made to the existing exceptions in section 157HA of the CO –

(a) in the case of the exception for expenditure on company business, the conditions concerning company's approval and discharge of liability set out in section 157HA(4) as well as the financial limit with reference to 5% of the company's net assets are removed;

(b) in the case of the exception for home loan, the financial limit of not exceeding 80% of the value of the premises has been removed and the financial limit with reference to 5% of the company's net assets has been relaxed;

(c) in the case of the exception for leasing goods and land etc., the financial limit with reference to 5% of the company's net assets has been relaxed; and

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[6] The requirements for "prescribed approval of members" are set out in clause 486 of the Bill.

(d) in the case of the exception for transaction in ordinary course of business, the financial limit of $750,000 and the further financial limit with reference to 5% of the company's net assets have been removed.

Overseas experience

36. In formulating the proposal, we have made reference to relevant provisions in the UKCA 2006 (sections 204 to 209), with suitable modifications to cater for local circumstances.

Public consultation

37. A respondent noted that, in addition to the approval of its members before making any quasi-loans or entering into a credit transaction in favour of a director of its holding company, a public company must also seek the approval of its holding company's members under clauses 492(2) and 494(2). It was also noted that, this additional requirement would not apply if the holding company was incorporated offshore, rendering the additional requirement largely superfluous. In this regard, we are of the view that requiring all public companies to seek the approval of its holding company before making any quasi-loans to or entering into a credit transaction with a director of the holding company can better protect the interests of the members of the holding company. However, we note the impracticalities of applying the requirement to foreign holding companies and thus the requirement will not be applied if the holding company is incorporated offshore.

38. As mentioned in paragraph 8, some respondents considered that due regard should be given to the Listing Rules in formulating the requirements in the CB. We have taken it into account in finalising the CB.

Modifying the scope of private companies that are subject to more stringent restrictions similar to a public company (clauses 482, 492 to 495)

Current position

39. Currently, a private company that is a member of a group of companies which includes a listed company ("relevant private company"[7]) is in essence treated in the same manner as a public or listed company in the CO in respect of prohibitions on loans, quasi-loans and credit transactions in favour of a director of the company or of its holding company, or another company controlled by one or more of its directors. Under the CO, public companies and relevant private companies are subject to more stringent restrictions than other private companies in the following aspects −

(a) they are subject to additional prohibitions relating to quasi-loans and credit transactions[8];

(b) the prohibitions are extended to making loans or quasi-loans to or entering into credit transactions with persons connected with a director[9]; and

(c) they are not eligible for the members' approval exception in section 157HA(2) under which other private companies may be exempted from the prohibitions on making loans to a director if the transaction is approved by members at a general meeting.

40. A relevant private company under the CO may be a subsidiary, holding company or fellow subsidiary of a listed company.

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7 See section 157H(10) of the CO.

8 Section 157H(3) and (4) of the CO prohibits public companies and relevant private companies from making quasi-loans or entering into credit transactions in favour of their directors or other persons specified in the section.

9 Examples of connected persons are the spouse, minor child and minor step-child of a director. The additional prohibitions do not apply to a non-listed public company unless it is a member of a group of companies which includes a listed company, see section 157H(8) of the CO.

Public consultation

41. In the public consultation of the draft CB, we proposed relaxing the prohibitions on public companies in respect of loans and similar transactions by extending the members' approval exception to all companies including public companies (see paragraphs 32 and 33 above). As a safeguard for minority shareholders, we proposed the requirement of disinterested members' approval in the case of public companies. Private companies will generally continue to be subject to less stringent regulations. We asked the public whether "relevant private companies" should be subject to more stringent restrictions similar to a public company.

42. More respondents preferred confining "relevant private companies" only to those private companies which are subsidiaries of a public company, whether listed or non-listed. We agree with the view, which would avoid casting the net too wide. Other types of private companies in a group, such as those whose holding company is a private company but which is also a majority shareholder of a listed company, can be excluded from the concept of relevant private company. It seems that such private companies need not be subject to tighter restrictions since the public investors of the listed companies concerned generally have no interests in such private companies.

Proposal and key provisions in the Bill

43. The categories of companies that are subject to more stringent restrictions in respect of loans and similar transactions are now set out in the definition of "specified company" in **clause 482**. The expression "specified company" means a public company or a private company or company limited by guarantee that is a subsidiary of a public company. Therefore, a private company and a company limited by guarantee will only be subject to the tighter restrictions if they are subsidiaries of a public company, whether listed or non-listed. The more stringent restrictions relating to loans to entities connected with directors and quasi-loans and credit transactions in favour of directors or connected entities now in **clauses 492 to 495** only apply to specified companies.

Overseas experience

44. Under the UKCA 2006, private companies associated with a public company are subject to tighter regulation (sections 198(1), 200(1) and 201(1)). The concept is similar to that of "relevant private companies" in the CO, except that references are made to public companies in the UKCA 2006 instead of listed companies as in the CO. Taking into account the reasons stated above, we propose to modify the scope in the CB.

Removing the criminal sanction for breach of the provisions on prohibition of loans and similar transactions in favour of directors and connected entities

Current position

45. Section 157J of the CO provides for criminal sanction where there is a breach of section 157H (prohibition of loans, etc., to directors and other persons) and imposes the penalty of a fine and imprisonment. The liability extends to the company and directors who wilfully permitted or authorised the transaction and other persons who knowingly procured the company to enter into the transaction.

Proposal and key provisions in the Bill

46. We are of the view that the civil consequences under **clause 504** for contravention of the provisions on loans and similar transactions are sufficient. The criminal sanction provisions in section 157J of the CO are therefore repealed.

Overseas experience

47. In the UK, the UKCA 2006 decriminalised the provisions which restrict loans and similar transactions in favour of directors and connected persons (sections 197 to 214). The criminal sanction was therefore abolished. The rationale is that there is a danger of over-deterrence if criminal sanctions are attached to general directors' duties of loyalty

rather than closely defined wrongdoing, and that enforcement of such duties should be a civil matter for the companies.[10]

Public consultation

48. There were no substantive comments raised on this proposal.

PUBLIC COMMENTS

49. We have consulted the public on the draft Bill in two phases of public consultation held from December 2009 to March 2010 and May to August 2010 respectively. Part 11 was covered in the first phase public consultation. The comments on our major proposals and our response are discussed above.

50. Other significant comments on Part 11 received and our response are as follows –

Major Comments	Administration's Response
Service Contract	
Given that the standard term of office for a director of a listed company is on the basis of a three yearly rotation (and annual general meetings do not necessarily occur on exactly the same date in each year), the effect of the proposed clause 522 could be to require the terms of appointment of significant numbers of independent non-executive directors to be	Since the directors' appointments need to be made by the members, it does not seem to be too burdensome for the companies to also seek approval of the period of appointment at the same time. In any event, if the companies do not wish to require members' approval for the period of the appointment of non-executive directors, it is quite straightforward for the

[10] UK Company Law Review Steering Group, *Modern Company Law: Completing the Structure* (November 2000), paragraphs 13.4 and 13.36.

Major Comments	Administration's Response
subject to members' approval and to be held in the public domain.	terms of appointment to expressly state that the rotation period or fixed period is subject to the company's right to terminate under the articles (if any) or under the statute. Under the case law, this should be sufficient to mean that removal from office by the members will not lead to a breach of contract, and so there is no guaranteed term of employment under the contract.

51. Other comments on Part 11 and the Administration's response are set out in Appendix III to the consultation conclusions issued on 27 August 2010.[11]

Financial Services and the Treasury Bureau
Companies Registry
17 May 2011

[11] Available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccfp_conclusion_e.pdf .