Hong Kong Bar Association's comments on
Rewrite of the Companies Ordinance -

Consultation Paper on Draft Companies Bill (Second Phase Consultation)

Question 1

1. The Hong Kong Bar Association ("**Bar**") does not support the abolition of the financial assistance restrictions for private companies. The Bar believes that (a) the general prohibition still serves a useful purpose in protecting creditors; (b) if there is a genuine and legitimate need for allowing a prospective shareholder to acquire the company's shares at a low value, the same can be achieved with the introduction of the "no par" system; and (c) there is much to be said for providing a clearer definition of "financial assistance".

2. The Bar acknowledges that the current statutory rules governing financial assistance are complex and difficult to understand, and may be said to be "a trap for the unwary". However, the Bar is of the view that:-

   (1) The retention or otherwise of these rules must depend on whether they continue to serve a useful purpose – if so, there will be a case of making them easier to understand and apply, as opposed to abolishing them merely for the sake of simplicity and leaving the aggrieved parties to explore other recourse under the Companies Ordinance (Cap.32).

   (2) It may not be appropriate to assume that private companies are necessarily less well placed (in terms of ability and resources) to understand and handle statutory restrictions. There is a large spectrum of private companies in Hong Kong, many of which are very substantial. In principle, all active private companies have to prepare annual audited accounts and thus should have access to professional advice where required. If it is thought that the rules are complex and may be difficult (and expensive) to understand, the proper response would be to simplify them, as opposed to abolishing them for private companies and leaving the public companies to cruise the labyrinth.

3. First and foremost, the Bar is of the view that the prohibition of financial assistance continues to serve a useful purpose.

(1) The purpose of the prohibition is essentially to protect creditors. In the *Report of the Company Law Amendment Committee 1925-1926* (the Greene Committee) §30, which marked the genesis of the prohibition, financial assistance was said to offend against the spirit if not the letter of the law which prohibits a company from purchasing its own shares, a rule rooted in creditor protection: see Trevor v Whitworth (1887) 12 App Cas 409 at 415, 423-424, 433; also Re VGM Holdings [1942] Ch 235 at 239.

(2) Although the legal capital of the company may not be adversely affected in financial assistance situations, there can be a general depletion of the company's funds and assets, as the company may advance a loan or provide other benefits in kind, or may waive or reduce a liability otherwise due from the purchaser.

(3) In this regard, one starts from the position that the company's funds and assets should only be applied for a proper purpose of the company. In the general run of the cases, there is no reason to believe that the substitution of one shareholder for another, or the introduction of a new shareholder, can constitute a proper purpose of the company or should be regarded as beneficial to the company – the provision of financial assistance for the benefit of the incoming shareholder would appear to be the antithesis of the company's proper purpose.

(4) Further, the depletion of the company's funds and assets may prejudice the interests of the creditors. A typical situation is the company advances a loan to the prospective shareholder to acquire a controlling shareholding from an existing shareholder. While on one view of the matter the company's assets may not be depleted as the reduction in cash balance is offset by a corresponding increase in the receivables, whether the company is worse off financially necessarily depends on the ability of the debtor to repay. This can also provide an avenue for existing shareholders to siphon off assets of the

company – he can engineer a sale to a purchaser of little credit-worthiness, procure the company to advance a loan to such purchaser and receives the same by way of share consideration, leaving the company with an empty cause of action against the purchaser. In these scenarios, the creditors are very likely to be worse off, as valuable assets of the company have been channelled away, and the company is (at most) left with a chose in action of questionable value.

(5) It seems to us that this is particularly significant when one takes into account the creditors' nil or limited access to financial information of the company, and their inability to monitor how the funds of the company are being applied. Of course, creditors do not normally have any control over the way in which the company applies its funds, but hitherto they have been protected by the prohibition, so that the company's funds cannot be drained in this manner. If the prohibition is removed, the creditors will become more vulnerable.

(6) We also believe that the prohibition can protect the interests of minority shareholders, who do not accept the offer to acquire their shares or to whom the offer is not made (see Chaston v SWP Group plc [2003] 1 BCLC 675 at §31), from the application of the company's funds solely for the benefit of a particular group of shareholders.

4. Second, insofar as there is a genuine and legitimate reason for the company to allow the prospective shareholder to take up shares at a small or negligible consideration (e.g. in corporate rescue situations where the prospective shareholder is only prepared to inject funds into the company by way of secured loans and not capital injection), the same can be achieved under the new "no par" regime to be introduced. The practical result will be the same – the prospective shareholder will obtain control of the company, albeit by a different route, namely allotment of shares for a negligible sum (subject to shareholders' approval).

5. Third, given there is a proper purpose to be served, the Bar believes there is much to be said for maintaining a clear general prohibition. The converse situation, namely no prohibition and the aggrieved shareholders and creditors are to see redress through derivative actions, unfair prejudice petitions and insolvency legislation on a case-by-

case basis, is not desirable, not least because often the improper application of company funds may be difficult to detect or prove by minority shareholders with no management control and outsiders.

6. The Bar therefore takes the view that the general prohibition should be maintained and clarified.

(1) Under the current legislation there is no exhaustive definition of "financial assistance". Instead "financial assistance" is defined inclusively – there are 3 defined types which are prohibited regardless of whether there is diminution in net assets (s.47B(1)(a)-(c)), and "any other financial assistance" under s.47B(1)(d) which will only be prohibited if the company has no net asset or its net assets will be reduced to a material extent. While there is obvious benefit to an inclusive definition, it creates uncertainty, and a common complaint against the current regime is that it is often very difficult to determine whether a transaction (which may be far removed from the paradigm of loan or gift) amounts to "financial assistance", especially when one has to apply the test of commercial substance and reality of the transaction (Charterhouse Investment Trust Ltd v Tempest Diesels Ltd [1986] BCLC 1 at 10f-g). This is unsatisfactory, especially when non-compliance attracts criminal sanction. There is much to be said for providing a clearer definition of the concept of "financial assistance".

(2) Further, in part due to the manner in which the relevant provisions evolved over the years, there are many exceptions to the general prohibition. First there are defined transactions under s.47C(3) which although carried out for the purpose of an acquisition of shares and have financial implications do not constitute financial assistance for purpose of s.47A. Second there are financial assistance which are taken outside the general prohibition by the principal purpose defences in ss.47C(1) and (2). Third there are transactions exempted by s.47C(4). While the Bar accepts that the first and third types of exceptions (ss.47C(3) and (4)) should properly be excluded from the scope of financial assistance, the Bar has reservations as to the scope of the current "principal purpose" defences (and their interpretation in Brady v Brady [1989] 1 AC

775), which have bred much confusion. The Department of Trade and Industry of the UK had recommended a reversal of the Brady effect by introduction of a "predominant reason" test,[1] which recommendation was however not adopted. It appears to the Bar that the adoption of the "predominant reason" test would be an improvement over the current "principal purpose" test.

7. The Bar notes that the Administration has proposed to (a) retain the financial assistance prohibition and (b) expand the scope of its exception (or rather, provides 3 methods through which financial assistance can be authorized or sanctioned subject to solvency of the company). It will be apparent from the above that the Bar (i) does not believe there is a need further to expand (as oppose to clarify) the scope of the exceptions, and (ii) it is concerned that these further exceptions will only make the current rules even more confusing and unmanageable, in particular when there is no clarification to the fundamental question whether a transaction amounts to "financial assistance". Companies will still have to grapple with this difficult concept before they know whether they require authorization.

Question 2

8. The Bar has commented on the proposals concerning directors' remuneration report in the 2007 consultation. In brief, the Bar:-

(1) supports the proposal to give statutory backing to the disclosure requirement for listed companies, currently catered for in paragraph 24 of Appendix 16 of the Listing Rules (Main Board); and

(2) in the case of unlisted companies, the Bar believes that (a) companies which adopt Table A as their articles are already required to make full disclosure of the director's remuneration package to the members in general meeting for the purpose of determining directors' remuneration, and should accordingly be

[1] *Company Law Reform: Financial Assistance by a Company for the Acquisition of its own Shares – Outcome of the November 1996 Consultation*, DTI (April 1997).

excepted from preparing separate directors' remuneration reports so as not to duplicate costs; and (b) the threshold for members' request should be increased from 5% of the members to a higher percentage of members who are not recipients of or otherwise interested in the remuneration in question.

9. Insofar as listed companies are concerned, the Bar has no difficulty with the suggestion that there should be no separate disclosure requirement under the Companies Ordinance, for the same is already provided under the Listing Rules. The Bar wishes to point out, however, that it sees no reason why the disclosure requirements in Regulations under the Companies Ordinance and the Listing Rules cannot be framed in such a way as to tally with each other. At present the Listing Rules provide a specific list of items which a listed company must disclose in its financial statements. Those requirements can be adopted in the Companies Ordinance, and if a view is taken that additions should be made to that list, the same can also be incorporated into the Listing Rules to ensure consistency.

10. As for unlisted companies, the Bar supports the Administration's proposal to expand the scope of s.161 in lieu of requiring separate directors' remuneration reports to be prepared.

Question 3

11. On the proposed enhancement of the investigatory powers of the inspector:-

(1) The Bar supports the proposal in Clause 19.9(1)(b) and (4) to give the inspector a power to require a person to preserve records or documents before production. At present this power can only be found in s.152D, which imposes criminal sanction for concealment, destruction, mutilation or falsification of books or papers which may be relevant for the purpose of s.152A (i.e. s.142 inspections only). The Bar notes that the proposal is to provide a general power which is available in all types of inspection, while retaining the current s.152D in Clause 19.53 (also made to be applicable in all types of inspection). The Bar supports this approach.

(2) The Bar supports the proposal in Clause 19.11(2) and (3) to give the inspector a power to require the person to verify his explanation or information provided by statutory declaration. This tallies with the approach currently adopted in s.179 of the Securities and Futures Ordinance.

(3) The Bar supports the proposal in Clause 19.26 to impose criminal sanction for non-compliance with production/inspection requests made by the inspection, which at present is only punishable as a contempt of court under s.145.

(4) The Bar has doubts as to the utility of Clause 19.27. Non-compliance with any requirement imposed under Subsection 4 already gives rise to criminal liability. It is questionable what added value would the proposed procedure give.

12. The Bar supports the proposal in Clause 19.2 to extend the categories of companies that may be subject to investigation.

13. The Bar supports the proposal in Clauses 19.43-19.45 and 19.47-19.48.

14. The Bar supports the proposals set out under "Other Charges" in Part 19 of the Consultation Paper save that the proposed Clause 19.25 refers to "civil proceedings" whereas the current s.149 refers to "any legal proceedings" and is wider in scope, and the Bar queries whether the reduction in scope is deliberate, and if so the justification therefor.

Question 4

15. The Bar has reservations on whether there is sufficient justification for extending wide powers on provision of documents and records, and information and explanation concerning the same, buttressed by criminal sanction for non-compliance, to the Companies Registrar.

16. These powers (or powers substantially similar to them) are currently available in the following instances:-

(1) to the SFC, pursuant to s.179 of the Securities and Futures Ordinance (Cap. 571), in connection with various types of suspected market misconduct;

(2) to the Financial Reporting Council, pursuant to ss.25 to 28 of the Financial Reporting Council Ordinance (Cap.588), in connection with suspected auditing and reporting irregularities in listed entities, which findings and conclusions would then be referred to the HKICPA, SEHK or SFC (as may be appropriate) for follow-up; and

(3) to the Financial Secretary where an application has been made to appoint an inspector and there appears to be good reason to do so (s.152A of the Companies Ordinance), or an inspector appointed by the Financial Secretary pursuant to ss.142 and 143 of the Companies Ordinance (in the latter case sanction for non-compliance is contempt of court).

17. These wide powers are only conferred where there are suspected misconduct or irregularities in or concerning companies (listed and unlisted), and they are clearly necessary to help the regulators discharge their function of investigating into the company's affairs to unearth misconduct and mismanagement.

18. It is questionable whether the Companies Registrar stand in the same position as these regulators, and whether the purpose for which these powers are proposed to be conferred are of a sufficiently similar nature as misconduct and mismanagement as to warrant the grant of these wide powers. While one can readily see that consequences, sometimes even serious ones, may flow from the Registrar deregistering a company on the basis of false or misleading information or being provided with information which is false or misleading (ss.291AA and 349 of the Companies Ordinance), we do not believe they can be compared to the evils which are the target of the production provisions in the Securities and Futures Ordinance, the Financial Reporting Council Ordinance or in connection with inspectors appointed by the Financial Secretary. The Bar is concerned that the proposed conferral of power may be a disproportionate

response to the need to uphold the integrity of the Companies Registry or assist in the enforcement of the sanctions contained in ss.291AA and 349.

Question 5

19. The Bar supports the suggestion that a company should be required to give reasons explaining its refusal to register a transfer of shares upon request along the lines of s.69(1A) of the Companies Ordinance (concerning transmission of shares).

20. It appears the rationale for the rule that the directors need not provide reasons for refusal to register a transfer of shares is that of possible inhibition of the proper exercise of the directors' power, in that provision of reasons may lead to challenge to the decision and litigation: see Re Gresham Life Assurance Society ex p Penney (1872) LR 8 Ch App 446 at 452. Since the directors' power to refuse to register is a discretionary power which must be exercised bona fide in what the directors consider to be in the interest of the company, it is believed that sufficient protection is provided for by the Court's intervention in cases where a misuse of such discretionary power can be shown: see Re Smith and Fawcett Ltd [1942] Ch 304. If the directors' decision is one which a reasonable board could consider to be in the interests of the company then the court presumes that they acted bona fide and had good grounds for their decision: see Tett v Phoenix Property and Investment Co Ltd [1984] BCLC 599 at 621.

21. The rigour of the current rule is such that an applicant seeking to challenge the directors' decision cannot even administer interrogatories on the directors on their grounds of refusal: see Duke of Sutherland v British Dominions Land Settlement Corp Ltd [1926] 1 Ch 746. However, the burden is on the applicant to adduce evidence over and above any failure to provide reasons to show that the power was exercised in mala fides: see Smith and Fawcett 308; Re Coalport China Company [1895] 2 Ch 404. Where the directors choose not to place their reasons for refusal before the court, it will often be difficult for the applicant to point to other evidence to support his contention of mala fide exercise of power.

22. While it is accepted that the directors should be free to exercise their power to refuse to register, there is also a case for requiring the directors to provide their reasons for refusal in the interest of enhancing transparency and accountability. The latter is in fact recognized in the Companies Ordinance, for s.69(1A) expressly obligates directors to provide reasons for refusal, if so requested, in the case of transmission of shares. There does not appear to be a real qualitative difference between transmission and transfer cases – in either scenario the original shareholder is to be replaced by a new shareholder.

23. As a matter of principle, since the directors' power to refuse to register is a discretionary power which must be exercised bona fide in what the directors consider to be in the interest of the company, the Bar considers that the proper exercise of such discretion should be subject to the control of the Court, but such control cannot readily be undertaken unless the reasons for the exercise of the discretion are known.

24. Further, the presumption is that directors exercise their power properly, in good faith and in the interest of the company, so it should not be an onerous task for the directors to articulate their reasons.

25. The Bar recognizes, however, that if reasons are required to be provided in every case, there may well be instances where this will have the effect of "inviting" challenge. A balance needs to be struck to ensure that the directors will not be unduly harassed. Accordingly, the Bar takes the view an approach similar to that in s.69(1A) should be adopted, so that the directors will only be required to furnish reasons in cases where the aggrieved party is sufficiently concerned as to make a request for the same.

Dated this 21st day of October 2010.

Hong Kong Bar Association