The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

FEBRUARY 2000

The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

FEBRUARY 2000

The Standing Committee on Company Law Reform was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances.

The members of the Committee for the period 1 May 1998 to 31 January 2000 were :-

Chairman	:	The Hon Justice Rogers, JA	
Members	:	Mr Roger T Best, JP	
		Mr John R Brewer	(up to 31 January 1999)
		Mr Moses Cheng Mo-chi, JP	
		Mr Henry Fan Hung-ling, JP	
		Ms Betty Ho May-foon	
		Mr Gerald Hopkinson	
		Mr Edwin Ing	(from 1 February 1999)
		Mr Robert G Kotewall, JP, SC	
		Mrs Angelina P L Lee, JP	
		Mr Winston Poon, SC	
		Mr David Shaw	(up to 4 May 1998)
		Mr Richard Thornhill	(from 1 February 1999)
		Mr Alvin Wong Tak-wai	
Ex-Officio Members	:	Mr Raymond Tang, Chief Counsel The Securities & Futures Commission	(up to 17 July 1999)
		Mrs Alexa Lam, Chief Counsel The Securities & Futures Commission	(from 11 September 1999)
		Mr Alec Tsui Yiu-wa, Chief Executive The Stock Exchange of Hong Kong Limited	
		Mr Charles Barr Department of Justice	
		Mr A R Hearder, JP The Official Receiver	(up to 27 December 1998)

Mr T E Berry, JP
The Official Receiver (from 4 January 1999 to 31 August 1999)

Mr E T O'Connell
The Official Receiver (Ag.) (from 1 September 1999)

Mr Gordon W E Jones, JP
The Registrar of Companies

Mr David T R Carse, JP
Deputy Chief Executive
The Hong Kong Monetary Authority

Mrs Rebecca Lai, JP
Deputy Secretary for Financial Services (up to 28 February 1999)

Miss AU King-chi, JP
Deputy Secretary for Financial Services (from 1 March 1999 to 4 July 1999)

Miss Susie HO Shuk-yee (from 5 July 1999)

Secretary : Mr D O Kitchell, JP (up to 30 November 1998)

Mr J S Bush (from 1 December 1998)

CONTENTS

NOTE

Unless otherwise stated or where the context otherwise requires, section numbers refer to sections of the Hong Kong Companies Ordinance Chapter 32 of the Laws of Hong Kong.

Chapter 1

Introduction

1.1 In the budget speech for 1994, the then Financial Secretary announced :-

> We have tried in the past to respond to developments in the corporate world through piecemeal amendment of the Companies Ordinance. I believe we have reached a stage when a thorough review has become essential. We now need an ordinance for the 21st century. I have therefore asked the Secretary for Financial Services to take this forward.

1.2 Subsequently, the Administration appointed consultants to undertake the review on 23 November 1994 and the Consultancy Report on the Review of the Hong Kong Companies Ordinance (the Report) was completed in March 1997.

1.3 In the introduction to their Report, the Consultants state that their Report "is the last step in the two year review of the Hong Kong Companies Ordinance but only the first step towards the preparation of new companies legislation for Hong Kong." The second step was the consultation exercise launched by the Secretary for Financial Services on 1 May 1997 at a press conference. By mid-1998, 28 written submissions on the Report had been received from individuals, firms of accountants and lawyers, and professional and trade institutions and associations. In parallel with this, the Standing Committee on Company Law Reform (the Committee) commenced a collective and general examination of each of the chapters of the Report and began to form initial views on the recommendations. The third step commenced in early 1999 when the Committee undertook further study on the subjects upon which the Consultants had made recommendations and the opinions given during the public consultation exercise as well as some topics upon which the Consultants had made no recommendations. As a result of this research and further consideration, the Committee has now produced this Report which it hopes will contribute to the "thorough review" of the Companies Ordinance launched by the

Financial Secretary in his budget speech in 1994. It goes without saying that this third step will be succeeded by many more before the legislative process has been completed.

1.4 As mentioned in the chapter on “Methodology”, Justice Holmes once remarked “The first requirement of a sound body of law is that it should correspond with the actual feelings and demands of the community, whether right or wrong.” The benefit to the Committee of the views of those members of the academic, professional and business community of Hong Kong who gave their comments on the Consultants’ Report has been immense. Some commentaries were restricted to certain recommendations only whereas others, mainly professional institutions and one large firm of solicitors, gave opinions on virtually all the recommendations. As a result, the Committee has had the benefit of the opinions of a wide section of the accounting, banking, company secretarial, legal and academic community of Hong Kong and, hopefully, has been able to gauge the “actual feelings and demands of the community whether right or wrong”.

1.5 The Committee decided in January 1999 to set up small task force groups to discuss papers submitted to it and make draft reports on specific topics and subject areas of the Consultants’ Report. The drafts were then submitted to the full Committee for consideration, amendment and adoption by all the members. The task of further research and the writing of the initial papers was undertaken by Ms Betty HO May-foon, a member of the Committee and a teaching member of the Faculty of Law at the University of Hong Kong. She researched the existing law and collated the recommendations of the Consultants, the initial views expressed by members of the Committee and those submitted during the public consultation exercise. Ms Ho produced all the papers, attended all the task force meetings and all but one of the full Committee meetings. The Chairman, Secretary and members of the Committee are totally indebted to her for volunteering to do this in the first place and for completing the work so competently and in such a timely manner as to enable this lengthy report to be issued in just over one year from its inception.

1.6 The Consultants’ Report has been a catalyst which has caused the Committee to focus attention on the overall structure and content of the Companies Ordinance. The process of examining the Consultants’ recommendations afforded us an opportunity to examine some of the fundamental principles underpinning Hong Kong Company Law. In addition, this exercise has enabled the Committee to identify more areas where reform is required than would be possible if analysis had proceeded on an incremental and piecemeal basis. In a number of areas where the Consultants' specific recommendations are rejected, the Committee did not reject the principles underlying those recommendations. Some of the Consultants' recommendations might become acceptable in future if and when circumstances warrant such changes. However, at present, the Committee has adopted views which it considers are in keeping with existing circumstances having regard to opinions which have been expressed. This Report contains 168 recommendations covering the 112 recommendations in the Consultants' Report. Having had the benefit of the views of the 28 written submissions, the Committee has, at this juncture, accepted 35 of the Consultants' recommendations. In the opinion of the Committee, many of the recommendations accepted can be taken forward quickly through amendment bills to the Companies Ordinance and the Committee accordingly so recommends to the Administration. Other recommendations involving further study or consultation and more structural changes to the Companies Ordinance will require more time. The Committee urges the Administration to accord priority to these in order to ensure that Hong Kong's company law continues to provide the Special Administrative Region with the commercial legal infrastructure commensurate with its status as a major international financial and commercial centre in the 21st century.

Chapter 2

Methodology

Introduction

2.1 The undertaking of the Consultants to conduct the first comprehensive review of Hong Kong's company law since 1973 was a major project for Hong Kong. Accordingly, we have given careful consideration to the Consultants' Report but are unable to support many of its major recommendations. The reasons for accepting or rejecting each of the Consultants' Recommendations will be given in the course of this Report. However, because of the importance of the project, we believe it would be desirable for us to set forth our views on the appropriate methodology for reviews of such a nature and to comment on the methodology adopted by the Consultants.

Analysis of and respect for existing law

2.2 Any reform effort must begin with a thorough study of the object of reform. In the present context, this means a thorough review of the provisions of the Companies Ordinance in the context of company case law as well as the general law, mores, needs and aspirations of Hong Kong society.

2.3 We consider that our role is to identify problems that can be addressed by law reform.

2.4 In this exercise, the reviewer should have both a healthy scepticism of and a healthy respect for the existing law. Scepticism may be more easily achieved as reformers are often pre-disposed to reform. Respect for the status quo may be more difficult as it may be considered old-fashioned. However, an old rule is not necessarily a bad rule. Longevity of a rule may be the result of inertia or the power of vested interests. On the other hand, it may also be evidence of the efficiency of the rule, in the sense of economic Darwinism. Our task is to distinguish the good from the bad.

2.5 Moreover, reform must be distinguished from initial legislation. In approaching reform the desirability of change or new concepts must be viewed in the light of cost and disruption to an existing system. The reformer does not have before him a green field.

2.6 The above approach to reform is in the tradition of the *Jenkins Report*, the last major report on English company law. We are aware that some may criticize such an approach as being unduly conservative. We note, however, that we are in the good company of the Company Law Review Steering Group (U.K.) and Professors Bernard Black and Reinier Kraakman, respectively of the Columbia and Harvard Law Schools. The U.K. Group is conducting a fundamental review of U.K. company law. It has made plain its determination to reform boldly, but it also noted that "the most efficient law will often derive from well tried practice" (para. 2.4). Professors Black and Kraakman were invited in 1993 to assist in the drafting of the Russian company law to replace existing regulations which were not suited to a market economy. They developed a model for emerging markets involving bold reforms, but even in such a context, they "[did] not, however, advocate wholesale change in existing laws. A company law that is already meeting a particular country's needs should enjoy deference because its success probably reflects adaptation to local institutions". If so in emerging markets, *a fortiori* in Hong Kong.

2.7 In sum, we agree with the former Chairman of the Law Commission for England and Wales when she said:

> In commercial law it is in general my view that there should be no reform just for reform's sake. This means that law reform has to be identified by users and others and should be on the basis of demonstrated purpose or need (Arden).

Proper use of comparative law

2.8 Being an international community, Hong Kong has been fully cognizant of the value of comparative studies. There is hardly a policy paper or reform proposal that does not refer to different solutions adopted in different jurisdictions. As an experienced borrower of foreign models, Hong Kong is also aware of the need to be cautious in such exercises.

2.9 One of the most significant comparative corporate studies in recent years is Professor Mark J. Roe's comparison between the Anglo-Saxon and Germanic systems. The Consultants cited one such paper in support of the proposition that "even corporations law regimes in jurisdictions as different in approach as the United States and continental Europe are learning from each other" (para. 66). All comparative scholars agree that different systems should learn from each other; that is the purpose of comparative studies. The difficult question is how. Professor Roberta Romano of Yale Law

School has warned readers to pay close attention to Professor Roe's paper. He did not, and readers should not, draw the easy implication that the German system should be emulated by American companies. Comparative law scholars are agreed on what comparative law study is *not* about: it is not about emulation of one system by another.

2.10 Professor Roe's most significant contribution in the comparative corporate law debate lies in a thesis presented in an earlier paper. He has demonstrated that the characteristics of American companies and corporate governance were the result of path dependence rather than economic selection. That is to say, a system is the way it is because it has reacted to and attempted to solve problems thrown in its path of development. As Professor Gilson has observed, each system solves the problem in the peculiar context of its own path dependent institutions. These insights make it difficult to argue that one system is inherently superior to another, as each has its own problems to solve in its own context. As Professor Barbara A. DeMott of the Duke University Law School stated at a conference at the Cambridge University Law Faculty Centre for Corporate and Commercial Law, "Only the most self-confident of aesthetes would categorically endorse a preference for [U.S.] over [U.K.]".

2.11 What, then, should we do by way of comparison and what "use" is it? Scholars have warned that in comparative legal studies, comparison of specific rules is not very significant. "Such seemingly narrow and technical doctrines of corporate law do not exist in isolation; they are inevitably linked to deeper assumptions of their legal cultures. Evaluation of legal approaches must take these links into account. The law should be illuminated by looking at the manner in which doctrines have been put to use over time and in the context of their legal cultures" (Scogin). The only sensible comparison is a comparison of legal cultures, not specific rules.

2.12 The purpose and "utility" of comparative law is to acquire a better understanding of our own. Comparative study "sharpens the eye for defects and weaknesses in one's national legal institutions. The comparatist can bring to bear on his home system a judgment which is more mature, thanks to his wider experience, and more critical, thanks to his deeper understanding of the matter" (Grossfeld). With this better understanding, the comparatist can then devise better solutions to problems in his own context.

The Committee's approach

2.13 In summary, we believe that the correct approach in conducting a review is to begin with a thorough and critical study of defects in the existing system. In devising solutions, the reviewer should seek inspiration from other jurisdictions, being careful always critically to examine foreign rules in their context. In both aspects of the study, the reviewer should explore both the concepts and details of the law. A litany of generalized aspirations would not be of assistance to policy makers.

The Consultants' Report

2.14 The Consultants' Report is divided into two parts. Part A takes up 41 pages and is part narrative and part summary of recommendations. The bulk comprises the background to the review, its major considerations and major trends in other jurisdictions. The existing legislative framework of the Companies Ordinance is outlined in four-and-a-half pages. Part B comprises the Recommendations divided into 12 Parts along the lines of the proposed new law. In each Part, each recommendation is set forth first, followed by a note of the existing provisions in the Companies Ordinance and a commentary on the recommendation. In addition, there are four background papers describing foreign models of share transfers, international business corporations, close corporations and family-controlled corporations in Asia and a fifth paper analyzing foreign companies in Hong Kong.

2.15 It appears that the Consultants considered the Companies Ordinance largely dysfunctional. According to them, this dysfunction is evidenced by the popularity of offshore jurisdictions such as the British Virgin Islands (para. 99). Practitioners pointed out, however, that the move offshore has been largely driven by tax (including stamp duty) and political factors. One respondent noted, "In early 1990s companies were incorporating at a rate of 50,000 to 60,000 per annum. The total number of companies on the Register in Hong Kong must be one of the highest per capita in any major economy. While a desire to take advantage of Hong Kong's dynamic economy may have been the driving force behind this activity, it would not of course have been necessary to incorporate in Hong Kong to do so. These figures do not suggest fundamental and debilitating problems with the current framework of company law. We consider, therefore, that a greater identification, and analysis, of specific concerns with the Company Ordinance would have been desirable". We agree.

2.16 The Consultants' proposal that directors' interested transactions be made subject to majority shareholders' approval (para. 6.21) is an inappropriate solution. In Hong Kong, interested directors are most likely to be controlling shareholders also. The proposed solution solves nothing.[1] Similarly, the Consultants' recommendations regarding codification and enabling legislation are wide of the mark. These will be discussed in the two Chapters following.

2.17 It appears that, in making their recommendations, the Consultants were largely influenced by the presence or absence of a similar statutory provision in North American models. For example, North America does not have disqualification of directors provisions and the Consultants recommended their removal. Similarly, compliance with accounting standards is not required under the *Model Business Corporations Act* (M.B.C.A.) and should therefore be waivable in Hong Kong. We have rejected these recommendations for reasons elaborated below (see paras. 10.82-10.87 below). Here, we would reiterate that comparative law is not a tabular comparison of statutory provisions.

2.18 At the minimum, a foreign statutory provision must be examined in the context of its case law. The Consultants recommended the abolition of the shadow director provisions in the Companies Ordinance. Simultaneously, they advocated the adoption of American jurisprudence. American company legislation does not contain any provisions regarding shadow directors, but in the case law, there is a stricter analogue developed by Judge Learned Hand. The Consultants' Recommendations simply cancel each other out. We have rejected the Consultants' recommendation to abolish the concept of shadow directors for reasons elaborated below (see paras. 6.112-6.119 below).

2.19 Moreover, examining company case law is only the first step. A foreign rule, be it decisional or statutory, must be examined in the context of its legal and regulatory system. The Consultants recommended the dispensation of audits by private companies. One respondent noted, "We are also concerned that the proposals are justified by reference to overseas legislation, but that adequate regard has not been paid to the other regulatory mechanisms operating in those environments, such as the public availability

[1] Our own research indicates that there is US case law holding that majority shareholders owe fiduciary obligations to the company or minority shareholders. However, although the Consultants advocated the import of US jurisprudence in general, they could not have had this rule in mind as there is no discussion of it.

of financial statements, regular inspections by collection agencies (e.g. PAYE/VAT) and rigorous procedures for tax audit. Such controls will often compensate for the relatively lax regulation through companies legislation. Within each regime, it is the environment created by the totality of legislation which will determine the effectiveness of regulation and it is essential that, in comparing the Hong Kong and overseas regimes, it is recognised that the Hong Kong environment does not provide for any such compensatory controls". We agree.

2.20 Further, a foreign rule should be assessed not only by its avowed aim, but also by its implementation and effect. No system can stand up to a comparison of its reality to the ideals of another system. The Consultants' tendency to focus on the idealized version of foreign rules is most marked in their recommendation of the appraisal remedy. We have rejected this recommendation for reasons elaborated below (see paras. 9.2-9.23 below). Here, we note again the lack of analysis of the operation of the foreign rule in its place of origin.

2.21 One respondent noted, "There also appears to be a tendency within the Report to have looked around the world and collected together a selection of topics which are significantly different from UK company law and practice and to hold these up as models to be followed. Company law has developed and grown over many years. It would be rash to discard that which is good simply to embrace novel ideas which might have a certain appeal but might have been developed in other jurisdictions to meet their specific requirements. It would be preferable if Hong Kong company law were to continue to meet the needs of Hong Kong". We agree.

2.22 One respondent noted, "Many of the Report's recommendations are conceptual and philosophical in nature or mere statements of intention. It is difficult to anticipate how they will operate in practice without more detailed commentary and draft legislation". We agree.

2.23 In summary, our different approach to the review may explain why many of the Consultants' Recommendations cannot be supported.

Consequential limitations of this Report

2.24 This Committee was formed to advise on amendments required to the Company Ordinance as and when experience has shown them to be necessary. As our resources are limited, we usually review business brought before us by the Administration or some interested member of the public rather than initiate business on our own. As regards the Consultants' Report, it was hoped that we would review the analyses and recommendations of the Consultants in the light of the public response and offer our own advice to the Administration on a blue-print for reform. It turned out that we had to and did conduct some limited research on our own. We have made a number of recommendations for immediate legislative action. However, even with additional research, this Report cannot offer a blue-print for comprehensive reform for three reasons.

2.25 First, given our limited resources, only limited research could be done. Thus, although we have identified certain problems or solutions not addressed by the Consultants' Report, we can only offer tentative views because of the need for further research. Time and financial resource limitations did not permit empirical research or extensive search for overseas experience which are needed in many cases.

2.26 Secondly, respondents expect further consultation. One respondent did not offer comments other than to reject codification, plainly expecting the Consultants' Report to be used as a resource document only and to be consulted as and when action is taken further. Another respondent stated, "We have not addressed each and every point covered by the commentary for the individual recommendations. This would necessitate a much longer response and we do not believe that this would serve a useful purpose at this stage in the review process. Clearly if any specific provisions are to be introduced or revised, a full consultation exercise should be undertaken." Judging from the contents of other responses, the above position is fairly representative.

2.27 Thirdly, the Committee would like the benefit of market opinion. Non-government appointees, although appointed on individual bases, in particular would like to know the views of their sector. In the past, reform proposals reached the Committee either on practitioners' initiative or only after they have had an airing in the market. We were able both to judge the intrinsic merits of the proposals and their acceptability in the market. Although we are mindful of the need to lead as well as to follow, we bear in mind also the admonition of Justice Holmes: "The first requirement of a sound body of law is, that it should correspond with the actual feelings and demands of the community, whether right or wrong." Thus, although our academic research may have exposed some problems and indicated some possible solutions, we hesitate to make reform proposals on the basis of academic research alone. Consultation is desirable before matters are taken further.

2.28 Accordingly, we would expect that, if the Administration agrees with the Committee that the areas identified in this Report require further investigation, it shall arrange such further investigation and consultation. We understand that the Administration is contemplating a project to improve corporate governance. Most of the issues raised in this Report can usefully be investigated as part of that programme. We would be pleased to offer our comment and advice on the result of any such investigation.

2.29 Finally, although this Report is lengthy and we have conducted some research of our own, it should not be thought that there is no need for improvement except as identified here. Resources did not permit investigations of incremental reforms that would be proposed in the usual course of events. We remain ready to consider such proposals as made. We would also add that it is important to review draft legislation with a view to confirming that it does reflect any proposal for reform that is sought to be implemented.

Chapter 3

American Codification

Introduction

3.1 The essence of the Consultants' Report is to replace the Companies Ordinance with a new statute built on the North American models of the *Revised Model Business Corporation Act* (R.M.B.C.A.) and the *Canada Business Corporations Act* (C.B.C.A.): Recommendation 1.02. Although the Consultants also referred to the American Law Institute's *Principles of Corporate Governance* and New Zealand's *Companies Act 1993* (para. 107), the latter materials are less evident in their recommendations. There are two intertwining strands to this proposal. One is that the statute should deal with all aspects of company law comprehensively, codifying wherever possible (see *Dickerson Report*). As a shorthand, we will refer to this aspect as the "comprehensive codification" proposal. The other is that this new code is to be built on a "modern, streamlined" North American model. We will refer to this aspect as "Americanization", and together the "American Codification" proposal, the merits of which are examined in this Chapter.

Benefits of Codification

Modernization

3.2 The Consultants cited the need to bring company law up-to-date in order to maintain Hong Kong's competitive advantage as a major international finance centre in support of their recommendation (para. 117).

3.3 We question whether such benefits would accrue from adopting the Consultants' recommendation. It is noted that the laws needed to maintain Hong Kong's status as an international finance centre are, by the Consultants' classification, securities regulations. They recommended that they be excised from company law (see paras. 4.33-4.47 below) and are omitted from their Review. Thus, the proposed code will not bring about the needed improvement. Furthermore, laws can be brought up-to-date in substance without comprehensive codification. Indeed, respondents have expressed concern that the process of comprehensive codification would delay the implementation of much urgently needed reforms.

Simplicity, clarity and accessibility

3.4 The Consultants commended the proposed model for its clarity (para. 116) and also advanced simplicity and accessibility as aims of company law (Recommendation 1.01). These features are often advanced as benefits of comprehensive codification.

3.5 Comprehensive codification has an intuitive appeal. Leaving aside the desirability of simplification as an end in itself, we question whether "simple" statutory language can necessarily achieve the objectives of clarity and accessibility. As the following example demonstrates, there is an insoluble dilemma between detailed drafting and drafting in general terms.

3.6 As will be discussed (see para. 10.126 below), the C.B.C.A. imposes liability on directors for wages in an effort to protect employees against undercapitalized businesses. Section 119 states:

> Directors of a corporation are jointly and severally liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.

Hong Kong does not have the same provision. The closest equivalent is the preferential payments provisions which contain (inter alia) the following :

> 265 (1) In a winding up there shall be paid in priority to all other debts--
> (a) …..
> (b)…..
> (c)…..
> (ca) any severance payment payable to an employee under the Employment Ordinance (Cap. 57), not exceeding in respect of each employee $6,000;
> (caa) any long service payment payable to an employee under the Employment Ordinance (Cap. 57), not exceeding in respect of each employee $8,000;
> (cb) any amount due in respect of compensation or liability for compensation under Employees' Compensation Ordinance (Cap. 282) accrued before the relevant date...
> (cc) any wages in lieu of notice payable to an employee under the Employment Ordinance (Cap. 57), not exceeding in respect of each employee one month's wages or $2,000 whichever is the lesser;

(cd) all accrued holiday remuneration becoming payable to any clerk, servant, workman or labour (or in the case of his death to any other person in his right) on the termination of his employment before or by the effect of the winding-up order or resolution.

(ce).….

………….

If the statutory provisions are compared on their own, it may be said that the C.B.C.A. is simpler, clearer and more accessible. Is this true in reality? What does the word "debts" mean? The British Columbia Court of Appeal has had to adjudicate on whether accrued vacation pay is included; the Manitoba Court of Appeal has had to adjudicate on contractual severance pay and "uncrystallized" vacation pay; the Ontario Court of Justice has had to adjudicate on statutory severance pay and the liability of former directors. None of the cases are clear or accessible to the layman and none of the cases would be required under the Hong Kong style of legislation. Which is clearer or more accessible?

3.7 As stated, the dilemma is over how much detail to include. On the one hand, to preserve the good parts of the existing law and to cover foreseeable eventualities, the temptation would be to include more detail. Such a provision will not be "clear" or "simple". On the other hand, if the provision is drafted in generalities both to prevent loss of any existing law and to have a code "look like a code", it would amount to "saying little more than that the court shall do what is just" (Reynolds). This result may be objectionable on other grounds, but the point here is simply that any clarity or accessibility is illusory.

3.8 We believe that the benefits of codification are limited.

Feasibility

3.9 The Consultants did not appear to mention the difficulties involved in and the overseas experience with codification, other than the C.B.C.A. In this section, we will consider some well-known cases and determine the difficulties involved.

3.10 The Consultants pointed to the success of the C.B.C.A. without detailing the road to success. Our research shows that many factors contributed to the success. First, the task was relatively simple. There were few "non-core" provisions in the old *Canada Corporations Act*. In fact, at the material time, the Act including an analogue of Table A had only 220 sections. If the Consultants' Recommendation is accepted, Hong Kong has not only has to codify "core" company law, but also to excise the "surplus" areas, put them in other instruments and rationalize them with the new code. In other words, the task proposed by the Consultants is immensely more complicated than the task accomplished in Canada.

Secondly, the adoption of the C.B.C.A. was a slowly maturing and natural process. Prior to the appointment of the Dickerson Committee (who eventually presented the draft) in 1967, a Select Committee had identified and discussed problems in corporate legislation. As a result of the work of this Committee and the work of many scholars and practitioners, the substantive issues of a "modern" corporate law had been thoroughly debated and a large measure of consensus reached. In substance, the Dickerson Report contained nothing new.

Thirdly, the legal and commercial conditions in Canada facilitated a smooth implementation. Also, conditions permitted a long transition of 10 years, from 1971 when the draft was completed, to 1975 when the Act was enacted, and to 1980 when the Act was fully implemented. It is unlikely that such long transitions would be tolerated today. As to the legal conditions then obtaining, Canadian law schools, being graduate schools, taught law at a high theoretical and policy level. As the professors were impetus for reforms, law students were educated in the substance of new laws long before their implementation. This provided a large population of young lawyers with a thorough knowledge of the old and new statutes when the new statutes were implemented. This is an important factor because it is extremely difficult for busy practitioners, not to speak of other members of the public who will be affected, to acquire, within a short time, sufficient mastery of a new code through continuous education seminars. The legal education system provided the needed continuity and stability through major legal changes in Canada.

Commercially speaking, although we do not have precise statistics, the number of old corporations requiring re-registration was probably insignificant. Authors writing in 1977 stated that there were then close to 300,000 corporations in Canada (Iacobucci) and that the federal government's "market share" in 1975 was 6.2 percent (Daniels). This meant that re-registration proceeded at the stately rate of 3,720 per year. It is not surprising that no disruptions were felt.

3.11 Turning to Hong Kong, the task proposed by the Consultants is much more difficult, the number of companies involved is much larger and our legal resources are much more limited. It would be difficult to duplicate Canada's success.

3.12 Indeed, successful comprehensive codification is the exception rather than the rule. There have been some spectacular failures in the recent past. Although the Consultants made no mention of these, we believe that the experience of the English project on contract, the American projects on company law and securities regulations are instructive.

3.13 The English Law Commission stated in its first report that it planned to codify the law of contract. Eight years later, in its eighth annual report (1972-73) it announced that it was suspending the project. At that time, it estimated that several more years of work were needed before a draft could be tabled (Kötz). The project may be revived in the future, but only because of a political need to meet European demands (Waddams).

3.14 In 1964, Professor Louis Loss of Harvard Law School, dean of securities regulations and the then Chairman of the Securities and Exchanges Commission (S.E.C.), Professor William L. Cary of Columbia, conceived the idea of codification of U.S. securities regulations. The project was blessed by the American Bar Association and commenced in 1969 under the aegis of the American Law Institute (A.L.I.) with Professor Loss acting as the Chief Reporter. There were six Tentative Drafts and one Proposed Official Draft before the final Official Draft of the Federal Securities Code was published in 1980.

The timing could not have been worse. The code was released when the deregulation philosophy was taking hold. It is "dead in the water" and is unlikely ever to be enacted.

3.15 In 1978, the Council of the A.L.I. authorized the Corporate Governance project. Its goal was to draft a restatement and recommendations for improvement in corporate structure and governance. A Tentative Draft No 1 was published in 1982. The reaction was swift, adverse and shockingly uncivilized. A decade later, the Proposed Final Draft 1992 was approved by the membership. Criticisms have not abated. The title of an article published in 1994 says it all: "The A.L.I. Principles of Corporate Governance: a Tainted Process and a Flawed Product". Despite the support that the project has had from a part of the legal community, the prestige of the A.L.I. may have been damaged by these projects.

3.16 Many have speculated about the causes of failure of the two A.L.I. projects. We believe that they illustrate two inherent difficulties involved in codification. The first involves the choice whether to reform or merely to re-state. Where an area of law is of sufficient importance to merit codification, there is bound to be room for improvement. In such cases, mere re-statement seems inappropriate. On the other hand, to combine re-statement with reform is itself difficult and creates further difficulties because of the delay involved. Secondly, even if one were to confine the project to re-statement, controversy cannot be avoided. As the late Professor Loss warned himself and others: "...anybody that ever tries to rewrite anything must realize in advance that he is going to create some new problems he never thought of". Any controversy will add to the delay.

3.17 Delay is the worst enemy of codification because society changes while the code is being drafted. People's views change over the long period that such a process inevitably takes so that any prior consensus is dissolved by the time the product emerges.

3.18 Given the inherent difficulties involved, we are doubtful that Hong Kong can succeed where so many have failed.

Costs of Comprehensive Codification

3.19 The Consultants made no mention of the costs involved. We believe it is imperative for policy makers to know the price of comprehensive codification before making a decision.

Transaction costs

3.20 The first item of costs is obvious: "transaction costs". It should be noted that, as respondents have pointed out, very little has been done to date. Even if all the Consultants' Recommendations were accepted, they might not add up to a new statute even in concept. This Report, with its limitations, has noted many outstanding issues, not to mention the questions that would be raised in the process of translating concepts into operational rules. In order for the project to have any chance of success, North American experts will have to be retained to complete the project. The complement of supporting legal professionals will have to include professional legal draftsmen from North America working with the Legal Department. These costs will be significant.

Uncertainty

3.21 Uncertainty is an inevitable price for comprehensive codification. In the great debate on codification of contract law in England, opponents, supporters and neutral observers all agreed that a price of codification is a long period of uncertainty. Uncertainty results both from the inherent difficulties of the task and from the habits of the profession.

3.22 As noted, most advocates of codification admire codes for their simplicity and aim for "simplicity" in their legislation. Commentators have warned that simple legislation may not work at all or, at best, they would increase uncertainty:

> Despite the raising of "simplicity" to the status of an objective in much of the literature, it is not an end in itself. An apparently simple legislative solution, where the underlying situation is complex, could create ambiguity and uncertainty and have the ultimate effect of increasing costs (Freedman).

Even if the draftsmen were content to re-state the law in detail, there would be a risk of disturbing settled law.

3.23 Habits of the profession also add to costs. Professor Kötz noted that for a long time after codification in Germany, lawyers and courts persisted in using pre-code cases as well as materials compiled by the drafting commissions. English experience is the same under the Sale of Goods Act, albeit on a smaller scale: a question of interpretation of the Act often involved first a dispute as to whether it is permissible to refer to old case law and second an inevitable reference to old case law. Furthermore, the Sale of Goods Act is considered one of the best examples of codification in terms of drafting skill and longevity of the legislation.

Opportunity costs

3.24 An even higher price is opportunity costs. It can hardly be disputed that a codification project will tie up highly qualified people for a long time. In the meantime, existing deficiencies cannot be rectified. Indeed, opportunity costs have already been paid. As the Consultants' Report is focussed on advocating comprehensive codification, certain issues have not been discussed. One respondent noted: "In broad terms we believe that the Report does not go into sufficient depth about the supposed problems with the current Company Ordinance, the advantages of the new system and the way in which the changes would fit in with and affect commercial life in Hong Kong". We agree.

3.25 Another respondent noted bluntly:

> We understand that the legislative process may take upwards of five years! Meanwhile what happens? Presumably, prior to any substantive amendments becoming effective the current idiosyncracies will remain in place.
> Seen from any perspective we believe that necessary amendments should be made as soon as possible rather than be delayed by any extra period required for the completion of an entirely new ordinance.

We agree and note that tending to substance is what Australia has decided to do, replacing the Australian Law Simplification Programme with the Corporate Law Economic Reform Programme.

Americanization

3.26 Assuming that codification is desirable, does it follow that the North American model should be imported? Besides "modernity" and "sophistication", the Consultants have advanced few reasons and have not made a detailed comparison of the two systems as a whole. As will be noted, the U.S. model is built on a managerial model for corporations with dispersed shareholding (see paras. 4.9-4.13 below). As is widely known, many Hong Kong's companies have majority shareholders. Canadian companies also have majority shareholdings and Dean Daniels objected to the import of the U.S. model to Canada. His words are apposite to Hong Kong:

> It is our belief that Canadian markets do possess distinctive characteristics, especially when compared to the United States, and that these characteristics have important implications for the nature of the optimal corporate and securities regime for Canada. Indeed, we argue that the failure to consider the distinctive features of Canadian markets may, especially when foreign approaches are emulated, result in statutory and judicial approaches to corporate regulation that only crudely fit the Canadian setting.

Conclusions

3.27 Given the limited benefits, the inherent difficulties and the high costs of codification, it is no wonder that commentators have referred to codification as a "luxury", affordable only by small countries or states of federations, unless compelled by a political need to unify divergent systems.

3.28 The overwhelming weight of opinion of respondents is against American Codification. Of those who did not object to the concept of codification, some objected to the North American model; others demanded further research and consultation. We agree that American Codification is not the appropriate reform at this stage of Hong Kong's development.

3.29 In saying this the Committee is in no way indicating that it does not appreciate that benefit could be derived from a re-organisation of the provisions of the existing legislation. But this is quite a different proposition and should be comparatively easy.

Recommendation 1: The Committee recommends that Recommendation 1.02 of the Consultants' Report be rejected.
Recommendation 2: The Committee recommends that Recommendation 1.10 of the Consultants' Report be rejected.

Chapter 4

Guiding Principles

4.1 In this Chapter, we set out our overall approach to company law and comment on certain recommendations of the Consultants in this regard.

Enabling or regulatory law

Introduction

4.2 The Consultants reiterated that the legislation they proposed is "highly enabling" as opposed to "regulatory" (para. 88). As we have rejected many of the Consultants' recommendations, we believe we should set out our views on the "enabling" issue even though it involves some dry corporate theory not usually of much interest to most practitioners or businessmen. In this section, we will trace the developing meaning of the term "enabling", consider how that term is used in the Consultants' Report, analyze the existing law and state our position on the appropriate approach to company law.

The developing meaning of enabling

4.3 Although the term "enabling" is much used in the Consultants' Report, it is not defined and its usage may not be entirely clear. This section will give a brief overview of the meaning of "enabling". As a Report of this nature is not the place for a detailed discussion of the legal theory of the corporation, we will be rather concise. The following historical account draws heavily on the works of Professors Bratton, Butler, Dillon, Parkinson and Phillips.

4.4 In the discussion of the theory of corporation, there are, inter alia, three pairs of opposing concepts that have appeared: entity and aggregate, fiction and reality, concession and contract. These appeared at different times in different associations for different purposes, e.g. concession and fictional entity, contract and aggregate, real entity, contract and aggregate again, appeared in succession. For simplicity, the historical account can be divided into five periods.

4.5 In the first part of the nineteenth century, the dominant theory was the concession theory which holds that the corporation owes its existence to an exercise of state power. Historically, corporate status was first a privilege, often granted for the performance of public as well as private functions. “The importance of the concession theory is that it establishes a theoretical framework sympathetic to state intervention; the company is a creature of the state, existing to promote the public welfare, and as such the state has the right to interfere in its internal affairs and need not confine itself to external, general-law regulation” (Parkinson).

4.6 Associated with the concession theory is the entity theory. This theory considers the corporation as an artificial entity with its own existence which is the result of the exercise of state power.

4.7 Privileged incorporation gave way to general incorporation as of right. This made the concession theory difficult to sustain. During the latter part of the nineteenth century, the partnership analogy was used to explain the corporation. The concession theory was discarded in favour of the contract theory. This theory holds that “the individuals’ freedom of contract implies a right to do business as a corporation without state intervention” (Bratton). Associated with this theory is the aggregate theory, which treats the company as an aggregation of its individual members.

4.8 In this era, the term “enabling” served to underline the right to incorporate.

4.9 By 1900, the early aggregate and contract theory had disappeared. This was due to the rise of large corporations and the appearance of the managerial class. Beginning in the 1890s, the States of New Jersey and Delaware engaged in a contest to attract large businesses (called management corporations because they were effectively managed by professional salaried managers rather than suppliers of capital) to incorporate in their states. Thus, they offered pro-management corporate law. The theory that prevailed in this period was the “real” or “natural” entity theory. This theory holds that a corporation is more than the sum of its human aggregates; it is “a real thing”.

4.10 The natural entity theory holds that corporations are the result of private initiative rather than state power. Thus, it is anti-concessionary and has an anti-regulatory strain. During this period, “enabling” meant more than the right to incorporate. It suggested some deregulation, although the regulatory content of the law was much higher than that of the law today.

4.11 A significant implication of the natural entity theory concerns the position of management. It was during this period that legal doctrine placed managerial powers in the law. Thus, directors' powers became original rather than on delegation from shareholders; directors' powers were co-extensive with those of the corporation. Management dominated corporations and corporate law of this era.

4.12 This era ended by 1930 when scholars, the most prominent of whom was John Dewey, refused to resolve practical legal questions by deducing solutions from some theory of the corporation. Instead, they grappled with the policy of management accountability.

4.13 The Model Business Corporation Act was born in this era. It was developed in 1946, first published in 1950, revised in 1969 and rewritten, becoming the Revised Model Business Corporation Act in 1984.

4.14 In the 1970s, a new contractual theory germinated. Legal theorists picked up the theory in the 1980s. This theory states that the corporation is "simply one form of legal fiction which serves as a nexus for [notional] contracting relationships", e.g. among investors, managers, employees, suppliers and customers. The ideal company law is a set of default rules that save transaction costs but yet allow parties to write their own ticket.

4.15 Under the "enabling" theory, management acts as agent to shareholder principals.

4.16 The new contractual theory has always had prominent critics who advocate some degree of control over the corporate contract necessitated by the unreality of consent and market failures. Since the excesses of the 1980s, there has been a retreat, at least from the full rigors of the contractual theory. Corporate law has entered the "post-contractual" stage! (Bratton).

4.17 Despite critics or recent reverses, the liberal contractarian or enabling school has exerted enormous influence over the discourse on corporate theory. Their language is often adopted by opponents to disprove their theory. The contemporary (and loose) meaning of "enabling" is essentially their meaning: deregulation.

4.18 Three observations on the contemporary meaning of "enabling" should be made here. First, the entire debate revolved around large economic enterprises and publicly-held corporations. The new enabling view in particular is premised on an efficient capital market. As to private companies, some believe that because ownership and management coincide, there is no problem to be studied. Others believe that shareholders of private companies face unique risks of exploitation, and have no means of escape. The most eloquent advocates of the new enabling school believe that there are different agency problems in the two types of companies, public and private. Company law in both cases should be enabling.

4.19 Secondly, the term “corporate law” in this debate embraces issues that the Consultants would classify as securities regulations. Indeed, the debate began with a challenge of traditional prospectus disclosure laws. The classic book of this school covers, inter alia, takeovers, prospectus disclosures and insider trading (Easterbrook and Fischel). To this school, there is no difference between corporate law and securities regulations, both should be “enabling”.

4.20 Thirdly, whatever the merits of the new contractual theory may be, it has no rival in a new concession theory. “A half-century has elapsed since advocates of government regulations of corporation emphasized concession theory” (Bratton).

The Consultants’ Report

4.21 The Consultants reiterated that the legislation they proposed is “highly enabling” as opposed to “regulatory” (para. 88). Their specific Recommendations on this point included:

> 1.01 The proper aims and objectives of companies law in Hong Kong should be:
>
> ...
> - to be enabling rather than regulating and prohibitive;
>
> ...

They elaborated:

> Modern companies law should be primarily facilitative or enabling in nature; it should permit commercial enterprises to function in the most effective and efficient way possible. True companies law should be less concerned with public purposes than with the ordering of private interests (p. 59).

Despite such ringing espousal of the “enabling” model, the reader may still be unclear as to what the Consultants meant by “enabling”. There is no other exposition than a long citation from a noted American work published in 1946:

> The primary purpose of corporation laws is not regulatory. They are enabling acts, to authorize businessmen to organize and to operate their business, large or small, with the advantages of the corporate mechanism. They are drawn with a view to facilitate efficient management of business and adjustment to the needs of change. They provide the legal force and financial structure of the intricate corporate device by which business can be carried on and in which the combined energies and the capital of the managers and of many investors may work together. They deal with the internal affairs of the organization, the content of the articles of incorporation, the rights of the shareholders, the powers and liabilities of directors, the authorized number and variety of the shares, the holding of meetings, restrictions on corporate finance, such as the withdrawal of funds by way of dividends and share purchases, the corporate records, the authorization of organic changes such as amendments, sale of entire assets, merger and consolidation, and dissolution and winding up. Some of these provisions are regulatory, seeking to prevent abuses of management and also of the majority and to protect minority shareholders and creditors (Ballatine).

The same passage was cited in the opening paragraphs of the *Dickerson Report* on which the Consultants placed much reliance.

4.22 The language used and the materials cited and relied on would indicate that the Consultants were using the term “enabling” in the pre-1970s sense. This is confirmed by the Consultants’ insistence that the “enabling” legislation they proposed is for the private rather than the publicly-held company (p. 62) and that corporate law should be “enabling” whereas securities regulations should be regulatory (pp. 59-60). As noted above, the new “enabling” school is primarily concerned with publicly-held companies and it is the capital market which renders regulation unnecessary. Furthermore, both corporate and securities laws should be enabling. It is clear, therefore, that the Consultants were harking back to the 1960s.

4.23 Further evidence that the Consultants were using the term in the pre-1970s sense comes from their advocacy of the R.M.B.C.A and the

A.L.I. *Principles of Corporate Governance* as "representing the expression of modern and sophisticated thinking in companies law" (para. 107). However meritorious these models are, they have been under bitter attack by the "enabling" school. These projects were initiated in a regulatory era in reaction against corporate abuses and emerged when deregulation was in full swing.

4.24 The reliance by the Consultants on a legal theory of corporation propounded at the latest in 1946 and on the substantive provisions in the C.B.C.A. and the R.M.B.C.A. (pre-1970s products) coupled with the employment of terms reinvented in the 1980s may lead to confusion. For example, the contents of the ideal company law set out in the long passage cited above would be viewed as regulatory by contemporary standards. This disjunction between the label attached and the substance of the recommendations, which has not escaped the notice of respondents, will be highlighted in the next section.

4.25 In addition, the Consultants appeared to have attached a unique meaning to the concessionary model and enabling model. This is most apparent in two recommendations. First, in recommending changing the method of incorporation to a "one-step" procedure, the Consultants denigrated the contractual model of incorporation as an "evolutionary relic" and promoted the "concessionary model" as a "natural progression" from the contractual model (pp. 38, 82). We have rejected the recommendation for reasons elaborated below (see paras. 12.20-12.27 below). Here, we note that, in the development of companies and corporate theory, concession is the relic.

Secondly, in recommending a statutory grant of powers to directors, the Consultants stated:

> ...the statutory division of powers model views the corporate statute as an enabling device; it confers limited liability on individuals who fulfil the requisite formalities, grants the corporation legal personality, and creates a division of powers within the corporation (p. 114).

We have rejected the recommendation for reasons elaborated below (see paras. 6.2-6.9 below). Here, we make some general observations. First, the description of the concessionary model advocated by the Consultants as "enabling" is novel. The contrast has always been one of contract versus concession, with contract being the enabling model. Secondly, whatever merits a management-centred corporate structure may have, original authority from the state for managers is not part of the contemporary enabling model; instead, it is part of the "real entity" theory current at the beginning of this century in the U.S.

4.26 We will turn to an analysis of existing law in the next section. Here, we point out that the Consultants have employed the term "enabling" in an unusual manner and that rejection of their recommendations is not a rejection of modernity.

Analysis of existing law

4.27 It is a little curious that the Consultants should have made so much of the "enabling" issue. Measured against an "enabling index" invented by Professors Black and Kraakman, Hong Kong company law rates high. This is hardly surprising as corporate scholars do not distinguish between American and British company law on this score: they are equally "enabling".

4.28 The most "enabling" feature of Hong Kong company law is the provision for wide-ranging articles of association. Professor DeMott observed, "Corporation statutes in the U.S. contain mandatory rules defining fundamental structures for corporate governance on points that the U.K. statute leaves to resolution in each corporation's articles". Yet the Consultants would displace the articles (Recommendations 3.01, pp. 82-83 and 10.06 pp. 182-184). Under existing law, directors and shareholders can regulate their own proceedings. Yet the Consultants would take these provisions out of the private domain and put them into the statute (Recommendations 5.07 and 5.08). Under existing law, the company has freedom to structure its capital in any manner it sees fit. Yet the Consultants would fix the structure in the law and prohibit partly-paid shares (Recommendations 4.03 and 4.05). As for directors' powers, under existing law, shareholders are free to determine the scope of such powers. Yet the Consultants proposed to take away that freedom, insert directors' powers in the statute and then insert another provision in the statute allowing shareholders to opt to take powers away from the directors (Recommendations 6.03 and 10.06). We have rejected all these recommendations for reasons elaborated below.

The Committee's approach

4.29 Hong Kong law comprises a mixture of mostly default rules with some mandatory rules. This is as it should be. A law consisting solely of default rules is not appropriate for Hong Kong. Mandatory rules are needed for the protection of creditors who have no control over the corporate contract and who often lack the bargaining power to require certain standards of corporate behaviour. We have in mind, in particular, the small and medium creditors. Mandatory rules are also needed for the protection of minority shareholders, particularly in the case of public companies (controlled by majority shareholders) where it is doubtful whether investors truly consent to the corporate contract or behaviour.

4.30 We are naturally concerned with the cost of regulation. Thus, reform may involve deregulation, but, to borrow the words of the U.K. Company Law Review Steering Group, "it is not restricted to deregulation; the objective is to suit the law to the needs of all participants...rather than to reduce regulatory safeguards" (para. 2.3). This means a critical examination of existing rules to determine their continued suitability.

4.31 The weight of opinion of respondents is in favour of a balanced regulatory regime. A respondent noted, "a balance between regulation and flexibility needs to be found, yet the Report begs the important question of whether there is a difference between Hong Kong and the jurisdictions used as models, as to where that balance should be struck". We agree.

4.32 We believe the following guiding principles should be followed in assessing the law. An existing permissive rule should be retained unless there is evidence of abuse. If so, adjustments should be devised. An existing regulatory rule should be examined to determine whether its costs outweigh its benefits. If so, appropriate deregulatory measures should be devised.

Recommendation 3: The Committee recommends that Hong Kong company law should strive for a balanced mix of default and mandatory rules.

Corporate or securities law

Introduction

4.33 The Consultants devoted considerable coverage to the necessity and desirability of separating company law from securities regulations (Recommendation 1.04). In specific terms, they recommended the removal of only two provisions from the Companies Ordinance: prospectuses and disqualification of directors. (These specific proposals are examined in later Chapters.) However, this discussion has influence over two other aspects of company law: regulatory content (above) and jurisdiction. For this reason, this section examines the feasibility and desirability of separate consideration of company and securities issues.

Foci of company law and securities regulations

4.34 One reason advanced by the Consultants for segregating the core of company law from securities regulations is that they have different foci: company law should be enabling in nature, whereas securities regulations should be regulatory in nature (pp. 59-60).

4.35 This perception is rooted in the 1960s when, in North America, a sharp distinction was drawn between the two. As noted above, today, the regulatory approach to both is the same. That is, one must strike a balance between flexibility and protection. An incantation of enabling corporate law versus regulatory securities law merely impedes the search for the right balance in both areas.

4.36 This is not to say that for drafting and administrative purposes, "corporate matters" should not be placed in one instrument and "securities matters" in another. Different statutory instruments for company law and securities regulations are not objectionable as such. What is objectionable is the elevation of a North American historical idiosyncracy and an administration matter to doctrinal status in the making of policy.

4.37 In formulating the substance and policy of the law, there should be only one consideration, namely, what is needed to achieve the objectives of business efficiency, investor protection and healthy market development. In this exercise, it seems strange to consider the core company law in isolation from securities regulations. This is the reaction of most respondents: "the Core cannot be considered except in relation to the entire package of regulatory Ordinances which have to be enacted after the removal of 'non-core' provisions. One can have a non-interventionist Core side-by-side with heavily interventionist regulatory Ordinances. No conclusion as to the interventionist or non-interventionist nature of companies legislation (comprehensively understood) can be drawn by reference only to the Core Ordinance". If conclusions are drawn in isolation, there is risk that the appropriate level of overall regulation is not attained.

Functions of company law and securities regulations

4.38 The other reason advanced by the Consultants for separating company law from securities regulations is that the two have different functions: “Company law looks primarily to the internal relationships within a company. Securities regulation looks primarily at investor protection and the capital market activities of companies” (p. 59).

4.39 The above characterization of functions is a typical portrait of the scene in North America before the 1970s. The sharp distinction drawn in North America was drawn as a result of constitutional necessity and history.

4.40 The sharp division between corporate and securities law previously drawn in North America was not drawn because of functional necessity but because of constitutional necessity. In the U.S., states have jurisdiction over corporate and securities matters, while the federal government has jurisdiction over interstate securities activities. In Canada, the provinces have jurisdiction over corporate and securities matters while the federal government has jurisdiction over corporations incorporated under federal laws. The characterization of an issue as a corporate issue or securities issue is often compelled by the desire to claim and justify jurisdiction. Such characterization is often arbitrary.

4.41 Functional distinctions are difficult to draw. Take insider trading regulations as an example. They may be viewed as regulating the relationship among management, controlling shareholders and minority shareholders. Anyone who acquires shares in a company acquires with the rights, the trading restrictions and other burdens which the incorporating state places on them. From this perspective, it is a corporate matter and in the case of Canada, within the jurisdiction of the incorporating state. From another perspective, insider trading regulation is a market regulation. From this point of view, it is a securities matter and the state operating the market has jurisdiction and entrants to that market must abide by its rules. Two other examples concern takeovers and proxy solicitations. Thus, corporate and securities law represents two intersecting circles and in a considerable area the issues are naturally intertwined.

4.42 Because of constitutional necessity, North America has had to assign certain matters to the corporate arena and other matters to the securities arena. This distribution is path dependent and is not considered ideal in itself. In the initial stages of the development of “securities” regulations, the focus was on disclosure on flotation and broker-dealer activities. The Consultants’ characterization of the function of corporate law as looking to internal relationships and that of securities regulation as looking to market activities is a typical portrait of the scene in the 1960s. The different functions ascribed to corporate and securities law are now considered artificial and undesirable.

4.43 On the one hand, it is agreed that corporate governance is a proper concern of securities regulations as it does not make sense only to regulate the vendor and the vending of securities and to allow the value of securities so sold to decline through misconduct of the issuer. On the other hand, much has changed in the area of disclosure which traditionally belonged to "securities regulations". The Consultants' recommendations to remove prospectus requirements out of the Companies Ordinance reflects this view and the structure of the Securities Act 1933 (U.S.). Under that system, disclosures are made and prospectuses registered on the distribution of individual batches of securities. Thus, prospectus requirements are securities-based and classified as securities regulations. Since that time, securities regulators have learnt two lessons. First, company-based continuous disclosure is far more important than disclosure on issuance. Secondly, vetting prospectuses on the issuance of each batch of securities takes time and may cause the issuer to lose market opportunities. Therefore, they have devised a system of shelf registrations for eligible companies under which registered companies may issue securities with minimum formalities. Securities disclosure has become company-based. Thus, securities regulations must deal with "corporate" matters and the regulation of companies involves regulating their securities. The functions of the two overlap.

4.44 Given the interrelationship between the two areas, a complete separation is not possible. One respondent noted in particular that securities regulations may need back-up from, and must remain in tandem with, corporate law. For example, since entities other than companies may issue securities, it may be convenient to remove prospectus requirements from the Companies Ordinance and place them in securities regulations. However, as noted above, care must be taken to orient them as company-based disclosures and to integrate them with corporate disclosure requirements in the company law. The only feasible aim is to avoid duplication.

Jurisdiction

4.45 There is a jurisdictional question arising from the division of corporate and securities regulations: the major thrust of the Consultants' Recommendation 1.04 to leave securities regulations to the remit of the

Securities and Futures Commission (S.F.C.) and the Stock Exchange of Hong Kong Limited (S.E.H.K.).

4.46 Considerable nervousness was expressed fairly strongly by respondents. Specifically, there is fear that any new securities regulations will not mesh with a gutted companies ordinance. Secondly, there are doubts about relying totally on securities' regulators. In short, there is fear of inappropriate securities regulations being improperly enforced.

Conclusions

4.47 We believe that the legitimate concerns of respondents highlight once again the inappropriateness of separating company law and securities regulations at the policy and law-making level. At this level, both must be considered together. Substantive provisions resulting from this deliberation may be assigned to different instruments and different administrators. To write a company law in isolation from securities regulations is a dangerous exercise.

Recommendation 4: The Committee recommends that, insofar as Recommendation of 1.04 of the Consultants' Report suggests that securities regulations should be given to the S.F.C. alone, it be rejected.

Other matters

4.48 This section examines the remaining recommendations made in the Consultants' Report in relation to the "core" company concept and aims and objectives of company law.

Insolvency

4.49 The Consultants recommended that only solvent dissolution and liquidation should be dealt with in the Companies Ordinance (Recommendations 1.05 and 9.01).

4.50 There is merit in maintaining solvent liquidations in the Companies Ordinance and removing insolvent liquidations from it. This would lead to better development of insolvency law. Naturally, connections between the two regimes are needed because "what appears to be a solvent company can, in the course of being wound-up, turn out to be insolvent". The weight of opinion of respondents is in favour of these recommendations. We agree also.

Recommendation 5: The Committee recommends that Recommendations 1.05 and 9.01 of the Consultants' Report be accepted.

Charges

4.51 The Consultants recommended that a separate, comprehensive regime governing personal property security interests be introduced and that pending the introduction of such a regime, the Companies Ordinance should continue its administration of Part III of the Ordinance (Recommendations 1.06, 2.03 and 5.11).

4.52 There is general agreement over the need to study and the maintenance of the status quo in the interim. Some respondents expressed disappointment in the failure of the Consultants to make specific proposals.

4.53 The Committee referred the matter to the Law Reform Commission in January 1998.

Recommendation 6: The Committee recommends that Recommendations 1.06, 2.03 and 5.11 of the Consultants' Report be accepted.

Financial institutions

4.54 The Consultants recommended that provisions in the Companies Ordinance imposing additional regulations on financial institutions or exempting them from certain provisions be removed to specialized statutes governing these institutions (Recommendation 1.07).

4.55 The recommendation is not objectionable in principle provided care is exercised in the migration and that general corporate standards are not compromised. Insofar as financial institutions are companies, they should conform to general corporate standards. Few respondents commented, but all who did agreed. We agree also.

Recommendation 7: The Committee recommends that Recommendation 1.07 of the Consultants' Report be accepted.

Not-for-profit enterprises

4.56 The Consultants recommended that the Companies Ordinance should not be applicable to not-for-profit enterprises. Instead, a new Not-for-profit Corporations Ordinance should be enacted (Recommendations 1.08 and 1.09)

4.57 The reason advanced by the Consultants was that this is the case in North America. It is not surprising that a majority of respondents opposed the recommendation. One respondent in particular noted the lack of analysis. It pointed out that the "not-for-profit" description can be a misnomer and that many of these entities generate substantial surpluses. They may be responsible for a large number of employees and may have a number of creditors. Consequently, they should be subject to an appropriate level of scrutiny. We agree.

Recommendation 8: The Committee recommends that Recommendations 1.08 and 1.09 of the Consultants' Report be rejected.

Aims and objectives

4.58 We have already set out our basic approach to company law above. Here, we comment on the remaining items recommended by the Consultants under 1.01: aims and objectives.

4.59 The Consultants recommended that the proper aims and objectives of company law should be "to provide a simple, efficient and cost effective method of incorporation and ongoing corporate maintenance". We have already cautioned against elevating simplicity to being an end in itself. The proper aim is to eliminate unnecessary complication.

Recommendation 9: The Committee recommends that company law should provide an efficient and cost effective method of incorporation and maintenance.

4.60 The Consultants recommended that company law should be "enabling". A few lines later, they recommended that company law should "strike a balance between the interests of management or majority shareholders on the one hand and shareholders or minority shareholders on the other hand". We note that an "enabling" law freely allows the parties to strike the balance for themselves. A law that attempts to strike the balance itself is not "enabling" as such. Our position on this issue has been set forth above (see paras. 4.29-4.32 above).

4.61 The Consultants recommended that company law should be self-enforcing. We agree and have made original recommendations to further this aim (see paras. 12.15-12.17 below).

Recommendation 10: The Committee recommends that company law should be self-enforcing.

4.62 The Consultants recommended that company law "should be written in clear, concise language so as to be accessible to business people as well as lawyers and accountants". We have already pointed out the dangers of simplicity and conciseness as ends in themselves (see paras. 3.5-3.7 and 3.22). We agree that the law should be written in plain language, but would caution that a degree of complication is unavoidable.

Recommendation 11 : The Committee recommends that the law should be written in plain language.
Recommendation 12: The Committee recommends that company law should aim to eliminate unnecessary complication.

4.63 The Consultants recommended that company law should "promote continuity, stability and certainty in commercial dealing". We agree. Our objection to Codification and our original recommendations in this Report have been made to further these aims.

Recommendation 13: The Committee recommends that company law should promote continuity, stability and certainty in commercial dealing.

4.64 The Consultants recommended that company law should "refrain from being a vehicle for implementation of industrial relations, tax, social or monetary policy". We agree in broad terms, but to the extent that it implies that the Companies Ordinance now contravenes this aim, we reject it. Furthermore, company law should not contravene accepted standards and morality of society.

Recommendation 14: The Committee recommends that company law should not be a vehicle for implementation of industrial relations, tax, social or monetary policy.

4.65 The Consultants recommended that company law should "take account of and meet international expectations". We agree. We believe the existing regime meets these aims, although there is room for improvement.

Recommendation 15: The Committee recommends that company law should take account of and meet international expectations.
Recommendation 16: The Committee recommends that Recommendation 1.01 of the Consultants' Report as to aims and objectives be replaced by the guiding principles stated in this Chapter.

Chapter 5

Public versus Private Companies

Introduction

5.1 The Consultants took an emphatic stance on the question of the public and private divide in company law. As this question underlies the Consultants' Report, this Chapter first sets out and comments on the Consultants' recommendations in general terms before proceeding to a discussion of specific issues afresh.

5.2 The Companies Ordinance defines private companies and listed companies. A private company is one which by its articles restricts the right to transfer its shares, limits the number of shareholders to 50 and prohibits any invitation to the public to subscribe for any shares or debentures: (s. 29). A listed company is one which has any of its shares listed on the Unified Exchange: (s. 2 (1)). A public company is, by default, a company that is not a private company, i.e. it may be a company limited by guarantee, an unlimited company as well as a publicly-held but not listed company. This is not the sense in which the term "public companies" is used in the debate on the public and private divide. In such a debate, a public company is a company limited by shares which are publicly-held, i.e. with over 50 shareholders, which may or may not be listed on an exchange. It is in this sense that the term "public company" is used in this paper.

5.3 Issuing shares to the public and listing on the Unified Exchange are two different matters. The law does not require a company issuing shares to the public to list on any exchange. Investors in a publicly-held but not listed company need as much protection as investors in a listed company. Indeed, they need more because they do not have the supervision of the S.E.H.K. Therefore, the Companies Ordinance should ensure that investors should have no less protection than those of listed companies. The consequences of such redefinition are noted in the final part of this chapter.

General comments

The Consultants' recommendations

5.4 The following is an attempt to summarize the Consultants' observations and recommendations which appear in different parts of their report.

First, The Consultants stated that the new Ordinance recommended in the Report "has the private company at the fore". This is said to have been done by recharacterizing and removing investor protection provisions from the Ordinance (pp. 30, 176).

Secondly, it follows that "comprehensive new provisions in respect of the regulation of listed and other public companies" must be enacted, although the Report did not make detailed recommendations in that regard (p. 62).

Thirdly, private companies/closely held corporations should be able to eliminate certain corporate formalities and otherwise derogate from standard statutory regimes (Recommendation 10.06).

Fourthly, a separate part of the new Ordinance should contain an optional regime applicable to private companies/closely held corporations which opt into the regime with the freedom of opting out of parts of the regime (Recommendation 10.05).

General critique

5.5 The first comment on the recommendations is that they are difficult to follow. In the words of one respondent, "[t]he Report alternates between the terms 'private company' and 'closely-held corporation' as if they were synonymous...The Report appears, therefore, to be proposing that a less stringent regulatory regime should be applicable to all private companies, as currently defined, that by unanimous shareholder agreement opt to dispense with the board of directors...the problem with this interpretation is that it is then not only part of the definition but also, and perhaps more appropriately, one of the possible consequences of fulfilling the definitions of being a private company. Under recommendation 10.06, the ability to dispense with the board is one of the concessions that it is proposed should be available to private/closely-held companies. If this is so then there appears to be an element of circularity in the proposal".

5.6 Secondly, if a closely-held company is a private company whose members choose to abolish the distinction between ownership and management, "what is the status of companies that would currently be considered a private company but whose shareholders have not abolished the distinction between ownership and management"? The net effect of the recommendations may be at least three categories of companies and four sets of company law provisions: one general "neutral" company law and three sets of additional provisions: one for public companies; one for private companies and one for closely-held companies. If so, "this should be made clear".

5.7 Thirdly, one respondent was unable to understand the need for a separate part in the new ordinance for private companies and stated "since the Report recommends the removal of all provisions applicable only to public companies (both listed and otherwise) to other securities related ordinances, we do not see any necessity of having a separate part for private companies".

5.8 Fourthly, while two respondents see merit in the idea of incorporated partnerships, it is also noted that this principle "has not been sufficiently worked-through into concrete proposals". This comment is applicable to other recommendations in this part which provide only "a brief outline of the 'opt out' provisions and additional flexibilities which, it is proposed, should be made available to private/closely-held companies. Some of these ideas merit further consideration and exploration. However, the Report confines itself only to listing the various items".

5.9 In this state of affairs, the Committee did not feel able to accept any of the recommendations without carrying out its own investigations.

The case for "incorporated partnerships"

The arguments

Definitions

5.10 Before proceeding, we propose the following definitions for purposes of advancing the discussion.

"Incorporated partnerships" is a shorthand reference to the concept that close corporations should be allowed to operate with no formal requirements, like partnerships, but with limited liability.

The term “close corporation” is used to indicate corporations with these characteristics: “(1) a small number of shareholders; (2) lack of a public trading market for the corporations’ stock; (3) a close relation between management and at least the principal shareholders; (4) a personal relationship among all or some of the shareholders; (5) shareholder knowledge about the corporation; (6) shareholder desire to exert some control over the corporate voting process, and (7) an informality in day-to-day management of the corporation” (Norton).

The term “private companies” is used to indicate companies with fewer than 50 shareholders, and otherwise as defined under the Companies Ordinance.

Arguments for preferential treatment of close corporations

5.11 The central idea of the recommendations of the Consultants is that close corporations should be allowed to operate without formal requirements in order to relieve them of “the undue burdens of compliance with the general companies law which, in its 19th Century origins, developed as a vehicle for public investment” (p. 174). They did not go beyond this argument which is commonly asserted and has been described as a “strong intuitive case” (Freedman).

5.12 The Consultants appear to have equated close corporations with small businesses. This is clearly not necessarily true. Furthermore, the tenor of the Report attributed the administrative and compliance costs of businesses to corporate formalities. Respondents pointed out that the question of costs of corporate formalities should be considered in the overall business setting; there are many administrative and compliance costs that are not dependent on the corporate form. In other words, the elimination of corporate formalities may not bring much benefit.

5.13 Assuming that the corporate form imposes significant costs, further consideration is required before they can be labelled an “undue burden”. It is true that in most cases the owners and operators of a close corporation act as if they were partners. It is also true that incorporation is a matter of choice. The question is raised: why do the owners incorporate? If they remain a sole proprietorship or partnership, they are free from governance structures and publicity. There must then be advantages in incorporation. These include: perpetual succession, the transferability of shares and limited liability. Of these, it is limited liability which is the cause of the burdens and costs. Thus, the crux of the question is: should incorporators be able to enjoy limited liability without complying with mandatory rules prescribed for the protection of others?

Rationale of limited liability

5.14 Limited liability has been considered a privilege. Law and economics scholars have pointed out that it is only a term of the corporate contract and that it is irrelevant to business relationships as parties can always contract around it. Nevertheless, the fact that limited liability is a default rule is still an advantage conferred by law since removing it requires bargaining power and effort. The rationale for this advantage is that it is the most efficient regime for encouraging investment in public companies. In the absence of such a regime, investors would have to monitor the managers and each other and the resultant uncertainty in the valuation of securities would threaten the existence of organized securities markets. This rationale is not universally accepted even as to public companies. It obviously has no application to the close corporation. Some argue that not only are there no social benefits in the regime of limited liability for close corporations, there are "incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors...". Therefore, "an unlimited liability regime for this class of enterprise...would be the most efficient regime" (Halpern et al).

5.15 Accordingly, in principle, the argument for offering limited liability to close corporations with no regulations is, at the least, very weak.

The experience overseas

The U.S.

5.16 In 1955, North Carolina enacted the first set of provisions for close corporations. In 1967, Delaware followed. At that time, the enactments were thought to be necessary because U.S. general company law was very strict and "did not sanction departures from the principles of majority rule and did not authorize variations on the grant of exclusive managerial control to the board of directors" (Cheffins). Also, Delaware general company law did not provide for applications for winding-up by a minority shareholder, nor for unfair prejudice remedies. The close corporation law improved the lot of the minority by expanding the scope for the appointment by the court of a custodian or a provisional director. Commentators conclude that with the current flexible general company law and advice by competent professionals on incorporation, most types of problems arising from the application of the general incorporation law to close corporations can be solved.

5.17 Empirical data support this assessment. The close corporations law of the U.S. is rarely used. While supporters try to find a benign reason for this surprising result, the more plausible explanation is that it is not very useful.

5.18 In addition to the close corporations law, there is a "limited liability company" regime. The Uniform Limited Liability Company Act has 86 sections; a standard form of limited liability company agreement has 65 defined terms and is divided into 16 parts governing: formation; nature of business; accounting and records; names and addresses of members and member-managers; rights and duties of members; managers; contributions and capital accounts; allocations and distributions; taxes; disposition of membership interests; dissociation of a member; admission of assignees and additional members; dissolution and winding up; amendment and miscellaneous provisions. Professional advice is needed and expected for the establishment of a Limited Liability Company (L.L.C.) under the Uniform Limited Liability Company Act.

5.19 The history and recent success of the L.L.C. may be instructive. The first L.L.C. statute was enacted by Wyoming in 1977 and the second in Florida in 1982. It then "languished" until 1988 when the Inland Revenue Service issued a ruling classifying a L.L.C. as a partnership, with pass-through tax advantages. This prompted two states to enact L.L.C. legislation in 1990. By 1994, only four states did not have L.L.C. legislation. There is no doubt why the L.L.C.s have become so popular. They allow a business to obtain the benefits of partnership status for tax purposes while retaining the benefits of limited liability for investors - benefits that traditionally have gone with the corporate form. Commentators are now wrestling with questions of the economic efficiency of the L.L.C. as a form of business organization, the application of securities regulations to L.L.C.s, fiduciary duties of controller members to minority members, and piercing the veil of a L.L.C. etc. This history indicates that corporate formalities are not the determining factor in the choice of business vehicles, nor can they be avoided.

The United Kingdom

5.20 The United Kingdom has agonized over the question of small companies for the last 30 years at least. The Board of Trade submitted to the Jenkins Committee evidence of the "irresponsible multiplication of companies" and "the dangers of abuse through the incorporation with limited liability of very small, under-capitalised businesses". The Committee concluded that the "proliferation of very small companies can and does lead to abuse and gives rise to ever-increasing administrative difficulties, and should, if possible, be checked without making it unduly difficult for genuine small businesses to incorporate with limited liability" (para. 20).

5.21 Shortly after the publication of the Jenkins Report, Professor Gower, a member of the Committee, drafted an incorporated partnerships law for Ghana. In 1981, the Department of Trade and Industry (D.T.I.) published proposals by Gower for a new form of incorporation for small firms. Nothing came of these efforts. The D.T.I. set to work again on simplifying the law for private companies in 1993. Since then, academics have proposed, on the basis of empirical studies sponsored by the Chartered Association of Certified Accountants, that the law offer a corporate form with unlimited liability to accommodate the needs of the close corporation. Others have found in empirical studies that "the majority of small firm owners [were] not particularly interested in the question of legal form" (Freedman). They concluded that small firms which find incorporation burdensome are those which are unable to reap the benefits of incorporation. The solution is not to allow them to retain the corporate form and relieve them of the duties but to create barriers to incorporation and provide disincorporation relief for those incorporated in error.

5.22 The U.K. Company Law Review Steering Group acknowledges the existence of the above facts and views, but appears to have taken the opposite position at the commencement of its review. It has taken the position that smaller companies should be relieved of "the opaque, unwieldy, unnecessarily complex and burdensome" law and is consulting on that basis (para. 5.2.13).

5.23 Further, the D.T.I. has proposed an additional choice of vehicles: the limited liability partnerships (L.L.P.s). The Limited Liability Partnerships Bill aims to provide certain eligible types of partnerships with limited liability whilst allowing them to have the organizational flexibility of a partnership. One major principle is that limited liability partnerships are to be subject to equivalent external requirements as limited liability companies. The Bill itself has only 17 sections, but the Regulations proposed under the Bill are spread out over 75 pages. Of these, 54 pages set out the section numbers of the Companies Act, the Insolvency Act and other statutes which apply to the incorporated partnership with modification. The

Bill may have its uses and merits, particularly for large professional partnerships, but it is questionable whether it is an improvement over "the opaque, unwieldy, unnecessarily complex and burdensome" (if true) company law. Such complexity arises directly from the basic principle, namely, that limited liability comes with strings attached. It is noteworthy that while the professions supported the L.L.P., "the majority of clients/regulators did not comment on the need for an L.L.P. vehicle -- where they did, support for and against was evenly split" (para. 2.2).

Other jurisdictions

5.24 A Canadian commentator noted that at the time the close corporations law was being considered in the U.S., "U.S. general incorporation legislation was rigid and restrictive in comparison with, for example, the permissive, enabling approach of the English Companies Act" (Cheffins). Canadian legislation then (and now) provided flexible rules applicable to all corporations; the just and equitable winding-up and the unfair prejudice remedies have long been available. While improvements can be made in savings in transaction costs for close corporations, the U.S. close corporations law is a model that Canada should not follow. The same sentiments have been expressed in New Zealand and Australia. Australia attempted but failed, to no-one's regret, to enact a close corporations statute.

5.25 The Consultants referred to the "notably successful experiment with a separate close corporations statute" in South Africa (p. 174). Our research suggests that this success is questionable. Although the number of close corporations incorporated between 1985 and 1993 outnumbered private companies incorporated during the same period (288,020 to 61,559), this was brought about in part by tax advantages. Once tax incentives were removed in 1989, new registrations of close corporations began to fall. Furthermore, the private company refused to die as planned and large enterprises were using the close corporation, not as planned. English reformers were urged to be cautious in following South Africa's example (Freedman).

The Consultants' Recommendations

5.26 The Consultants advanced three reasons for the incorporated partnership regime: (1) nearly 99 per cent of Hong Kong companies are private; (2) company law imposes unsuitable costly burdens on these companies; (This is the reason why the British Virgin Islands is the jurisdiction of choice. Reform will re-attract incorporation in Hong Kong.);

(3) the separate close corporations statute of South Africa is a notable success.

5.27 We note that there is a lack of empirical support for the second reason. No studies have been made as to why businesses incorporate overseas and the precise nature of their discontent. Respondents have pointed out that in their experience overseas incorporation is driven by tax and political factors rather than corporate formalities. We also note that the South African success has to be qualified and regarded with caution.

5.28 The Consultants also stated that limited liability should not "prove a stumbling block" to their recommendation "provided third parties are given adequate protection" (p. 177). However, we need to give due concern to outsiders trading with the company. Indeed, one respondent noted that the Consultants' Report tended "to focus on maintaining the protection of limited liability for the benefit of the *company*", ignoring "the equally (if not more) important question [of] the protection of third parties dealing with the company" (emphasis in original). There is no better illustration of this approach than the Consultants' observations on some characteristics of the small and medium sized enterprises of Hong Kong which find the costs of corporate formalities burdensome. The Consultants noted that "[t]he companies were generally under-capitalized and, unlike other jurisdictions, the tax benefits of incorporation were minimal" (p. 176). Given these characteristics, it must be questioned why the Consultants recommended the conferral of limited liability without regulations.

The way forward

5.29 Given the legitimate concern of the law with the effect of limited liability on others besides shareholders, and the experience of close corporation legislation overseas, there is no case for creating a regime to allow close corporations to enjoy limited liability without any of the burdens of incorporation. This is not to say that the law should not be concerned with costs savings for close corporations, but that the premise of unconditional limited liability is unsound. In the following part, specific items of relief listed in the Consultants' Report are considered with the view to saving unnecessary costs and the way forward is proposed.

Recommendation 17: The Committee recommends that Recommendation 10.01 of the Consultants' Report as to a single regime be accepted.
Recommendation 18: The Committee recommends that the part of

Recommendation 1.03 of the Consultants' Report dealing with a single regime be accepted.
Recommendation 19: The Committee recommends that Recommendation 10.02 of the Consultants' Report as to incorporated partnerships be rejected.

Some specific relief for close corporations

One-person companies

5.30 The Consultants recommended that the law permit "one person/one director incorporation" (Recommendation 3.02).

5.31 One person companies have been allowed in fact ever since *Salomon v. A. Salomon and Co. Ltd.* There appears to be no reason why they should not be recognized at law.

5.32 The Consultants suggested that one person companies require the abolition of the memorandum and articles of association as it is a contract and two parties are required to form a contract (p. 83). It is accepted that the title of the document, "memorandum and articles of association", will be less appropriate for a one-person company. However, the substance of the document, namely a contract among shareholders and between shareholders and the company, is unaffected. The shareholder and the company constitute two parties, the minimum needed to form a contract. By the nature of things, the contract is open to "accession" by further shareholders. Thus, it is not necessary to abolish the Memorandum and Articles of Association (M.A.A.) to accommodate the one-person company, but it may be appropriate to re-title the document as the "Constitution". There should be no requirement for existing companies to rename their M.A.A., since this would simply be a change in name without any real effect. The expense involved would be unjustifiable.

5.33 The weight of opinion of respondents favour one-person companies. We agree.

Recommendation 20: The Committee recommends that the part of Recommendation 3.02 of the Consultants' Report as to one-person companies be accepted.
Recommendation 21: The Committee recommends that the Memorandum and Articles of Association be retitled the Constitution.

Single director

5.34 The Consultants recommended that private companies should be permitted to have a minimum of one director (Recommendation 6.07).

5.35 If one-person companies are allowed, it follows that one-director companies should be allowed. This would be a recognition of reality.

5.36 The overwhelming weight of opinion is in favour of this recommendation. We agree.

Recommendation 22: The Committee recommends that Recommendation 6.07 of the Consultants' Report be accepted.

Preservation of limited liability despite default

5.37 Under Recommendation 10.05 the Consultants recommended that limited liability be preserved for shareholders despite any failure to observe corporate formalities.

5.38 Under case law, disregard of corporate formalities may lead to the loss of limited liability for the shareholders, whether on the ground that the corporate vehicle is a facade or an agent for the shareholder. The decision rests with the court and no reason has been advanced for statutory intervention. The only statutory provision that removes limited liability is the requirement for two shareholders. As the Committee has recommended the abolition of this requirement, the Consultants' Recommendation has no application.

Recommendation 23: The Committee recommends that the part of Recommendation 10.05 of the Consultants' Report as to preservation of limited liability despite failure to observe corporation formalities be rejected.

No need to have separate bylaws/articles

5.39 Under Recommendation 10.06, the Consultants recommended that there should not be any need to have bylaws or articles of association if the constitution and statute were sufficient.

5.40 Articles of association are part of the constitution. If the articles and the constitution are different, as we believe they are, it is not obvious that the dispensation of articles reduces costs or complexity when it is conditional on a "sufficient" constitution, unless it is clear what amounts to sufficiency. If the reference to the statute is an indication of a preference for mandatory provisions in the statute (as has been suggested by some academics), this is in direct contradiction to the "enabling" approach. Thus, a description and justification of the proposed mandatory rules are required, but none were offered.

Recommendation 24: The Committee recommends that the part of Recommendation 10.06 of the Consultants' Report as to dispensation with bylaws or articles be rejected.

Optional limited corporate life

5.41 Under Recommendation 10.06, the Consultants recommended that corporations may limit their life.

5.42 Given the general concept of perpetual succession of companies, the existence of companies with limited life may be a trap for the unwary. However, given the efforts to facilitate the liquidation of solvent companies, there is no reason why incorporators should not be required to take steps to terminate the life of the companies themselves. We deal separately, below at paras. 5.63-5.64 with liquidation on the occurrence of a specified event.

Recommendation 25: The Committee recommends that the part of Recommendation 10.06 of the Consultants' Report as to optional limited corporate life be rejected.

Elimination of the board of directors

5.43 The Consultants recommended that the private/close corporation should be allowed to eliminate the board of directors (Recommendations 6.02 and 10.06). The reason given was that the law should "reflect the reality of private companies/close held corporations where there may not be a separation of ownership and management".

5.44 It is not clear what is meant to be achieved by this proposal. The formalities required and the office of the director have a number of advantages. Paper work and formality impose discipline and assist in the management of the business. This is of value to insiders and outsiders alike.

Various rules imposing liability on directors, such as fraudulent trading, or the proposed insolvent trading provisions, are of value to outsiders.

5.45 The Consultants' proposal is not meant to relieve the shareholder of liability qua director which would have been unacceptable and contrary to overseas models. It is noted that the Delaware General Corporation Law provides that in such a case, "the stockholders of the corporation shall be subject to all liabilities of directors" (s. 351 (3)). In the Uniform Limited Liability Company Act, a manager owes a duty of care and loyalty to the company and its members (s. 409 (h), (2)). The U.K. Limited Liability Partnerships Bill incorporates parts of the Companies Act 1985 and the Insolvency Act 1986 and provides that "references to a shadow director shall include references to a shadow member; references to a director of a company or to an officer of a company shall include references to a member of a limited liability partnership" (s. 6.1 (g), (h)). The Consultants also proposed that directors' obligations are to be imposed on shareholders and that those shareholders may even be informally called directors (p. 113). It seems strange first to eliminate the board and then to re-impose the same obligations on shareholders. At the minimum, the proposal increases the complexity of the legislation.

5.46 If the proposal is meant to reduce costs, it is questionable whether it is achievable. One respondent noted that the elimination of the board may mean the elimination of the formality and record of directors' decisions. But what is to be done with the shareholders' decisions in their place? Clearly, it would be unacceptable if the company were to function without records. If the shareholders' decisions are required to be recorded, there would be no costs savings. If costs savings are the concern, the better approach is to examine which of the duties of directors are unjustifiable cost items and to eliminate them.

5.47 The weight of opinion of respondents is against the recommendation. We agree.

Recommendation 26: The Committee recommends that Recommendation 6.02 of the Consultants' Report and the part of Recommendation 10.06 dealing with elimination of the board be rejected.

Unanimous shareholders' agreement

5.48 The Consultants recommended that "all companies should be able to make use of unanimous shareholder agreements to regulate (1) the exercise of corporate powers and management and (2) the relationship among shareholders" (Recommendation 7.06).

5.49 The Consultants advanced three reasons: (1) such an agreement may go much further than standard memoranda or articles of association in terms of redistributing the decision making powers within a company; (2) there is privacy in that the agreement is not registered; (3) it need not be entered into at the time of incorporation and thus facilitate speedy incorporation.

The first reason starts from the premise of the North American model which places the powers of directors and officers in the statute. Under the existing law in Hong Kong, incorporators are free to distribute the decision making powers within the company.

As to the second reason, where the parties deviate from the norm, for instance, by stripping the managing director of all his powers, it is not obvious that privacy is an advantage. One respondent stated: "we believe that if the use of unanimous shareholders' agreements is to be expanded in this way and statutory backing given to them, then the more substantial agreements, including those of a constitutional nature, should be required to be filed".

As to the third reason, it is not desirable for small businesses to incorporate speedily without reflection or advice on the consequences of incorporation.

5.50 The concept of an unanimous shareholders' agreement is a North American one. The recommendations may have given the impression that shareholders' agreements are not possible under Hong Kong law. Our understanding of the unanimous shareholders' agreement is set out in the following paragraphs.

5.51 In a close corporation (see paras. 5.10 above and 5.53-5.54 below), shareholders often enter into a shareholders' agreement setting out rules for the conduct of business and agreeing to exercise their votes to implement those rules. Under Hong Kong law, the contents of those agreements can as well be placed in the articles. One advantage and perhaps motivation for such agreements is privacy. The price paid for this privacy is insecurity. Although a shareholders' agreement is valid and enforceable among the parties thereto, namely the shareholders, it is not binding on the company (*Russell v. Northern Bank*). Thus, acts of a party to the shareholders' agreement (usually the majority shareholder) in breach of the agreement may still be valid and binding on the company, even if the contract-breaker remains liable in damages. Academics believe the impact of this defect is now diminished because the court may grant injunctions to restrain corporate action in breach of the shareholders' agreement. Nevertheless, the risk of a breach being lawfully implemented remains significant.

To overcome the difficulty, the C.B.C.A. introduced the concept of an unanimous shareholders' agreement and validated it (s. 146). Thus, the company, future shareholders and directors whose discretion may be fettered (see paras. 5.10 and 5.53-5.54 below) are bound by it.

5.52 Notwithstanding the insecurity of the existing regime of shareholders' agreements, practitioners do not seem to have found problems in this area. That is, despite the inability to bind the company and directors, the existing regime functions well. The weight of opinion of respondents is against the statutory unanimous shareholders' agreement. We agree.

Recommendation 27: The Committee recommends that Recommendation 7.06 of the Consultants' Report as to unanimous shareholders' agreements be rejected.

Restriction of discretion or powers of board

5.53 Under Recommendation 10.06, the Consultants recommended that private/close corporations be permitted to restrict the discretion or powers of the board.

5.54 Under the existing law, the powers of the board derive from shareholders who may prescribe the powers of the board in the articles. This is in contrast to the U.S. model proposed by the Consultants in which the powers of directors are granted by statute. In such a case, statutory authority is indeed necessary to withdraw part of these powers. The Committee has rejected the introduction of statutory powers for directors (see paras. 6.6-6.9 below); we take the view that there is no need for this provision.

As for the restriction of discretion, if it is meant that the discretion of directors may be restricted, even in the exercise of powers delegated to them, this is a departure from the law. At common law, directors may not act as puppets or fetter their discretion. In a close corporation, shareholders often enter into agreements that set out corporate policies and personnel arrangements. To the extent that the agreement restricts directors' discretion, it does not bind them.

To overcome these difficulties, shareholders may place as much as possible in the articles. For instance, they can provide in the articles that the exercise of certain powers by the board is subject to shareholder approval. As to the matters that the shareholders are unable or unwilling to place in the articles, there is a risk of breach. Again, the C.B.C.A. removed this risk via the statutory unanimous shareholders' agreement. The recommendation therefore stands and falls with the statutory unanimous shareholders' agreement.

Recommendation 28: The Committee recommends that the part of Recommendation 10.06 of the Consultants' Report as to the restriction of discretion or powers of the board be rejected.

Standard buy-sell agreement

5.55 The Consultants recommended that the optional regime include standard buy-sell and buy back provisions to permit shareholders to leave (Recommendation 10.05). The Consultants did not elaborate but merely reasoned that such a regime would permit "incorporation with minimal drafting effort".

5.56 The buy-sell or buy-back agreement, sometimes called colloquially "shot-gun provisions", requires a shareholder on notice or the occurrence of other "triggering" events to buy the shares offered or to sell his own shares to the offeror. As the colloquial title indicates, these provisions can be used opportunistically by other shareholders and can back-fire. Prudent lawyers do not include these provisions in shareholders' agreements as a matter of course without thorough discussions with the client on his circumstances and the implications of the clause. To insert these provisions on a "one-size-fits-all" basis in the law, with a view to expediting incorporations by small businesses "with minimal drafting effort" is bad policy.

Recommendation 29: The Committee recommends that the part of Recommendation 10.05 of the Consultants' Report as to standard buy-sell agreement be rejected.

Arbitration

5.57 Under Recommendation 10.05, the Consultants recommended the inclusion of optional provisions for mediation or arbitration. In the Introduction of the Report, it is stated: “a great many disputes centre around the succession process which determines the control and future direction of the family controlled company. There is greater reluctance to resort to judicial intervention and a greater premium placed on privacy. Contractual dispute resolution mechanisms such as are found in partnership agreements, statutory appraisals and buy-out remedies which permit exit without judicial intervention, and alternative dispute resolution are more acceptable than litigation” (para. 129). Thus, Asian reluctance to litigate appears to be the reason for prescribing arbitration.

5.58 As there is nothing to prevent shareholders from agreeing at any time, before or after a dispute has arisen, to agree to submit disputes to arbitration, it is difficult to see what purpose the article would serve.

5.59 In England, the Law Commission proposed including arbitration provisions in Table A. The majority of practising lawyers opposed the measure. The reasons given included: disagreement over triggering events; disagreement over nomination of arbitrator; inability to protect third party rights; risk of opportunistic shareholder action and lack of legal aid. In the end, the Law Commission withdrew its proposal (para. 5.35).

5.60 The overwhelming weight of opinion of respondents is against the recommendation. We agree.

Recommendation 30: The Committee recommends that the part of Recommendation 10.05 of the Consultants’ Report dealing with arbitration be rejected.

Appointment of receiver

5.61 Under Recommendation 10.05, the Consultants recommended that provisions be made to allow the possibility of applying to court for the appointment of a rehabilitative receiver in the event of deadlock etc.

5.62 Shareholders of private companies already have remedies under the just and equitable winding-up and unfair prejudice provisions.

Recommendation 31: The Committee recommends that the part of Recommendation 10.05 of the Consultants’ Report dealing with the appointment of a receiver be rejected.

Shareholders' option to liquidate

5.63 Under Recommendation 10.06, the Consultants recommended that provisions be made to allow liquidation at the request of a shareholder or upon the occurrence of a specified event.

5.64 This is already possible under Hong Kong law.

Standard share transfer

5.65 Under Recommendation 10.05, the Consultants recommended that provisions be made for "standard share transfer restrictions and exceptions (e.g. transfer to trustee in bankruptcy, by operation of law).

5.66 There are such provisions in the Ordinance already.

The way forward

5.67 Rejection of the Consultants' Recommendations does not mean that the Committee is not concerned with efficiency of the law. It proposes a way forward on two fronts. First, following the completion of this review, as part of its ongoing tasks, existing mandatory rules not already examined in this review should be examined to determine whether the costs each poses can be justified.

Secondly, the door to new forms of business organizations should be open. However, the proper approach to devising new forms is not to remove corporate formalities and confer the shell of limited liability. This approach of the Consultants both over-estimates the costs of corporate formalities and overlooks the problems of limited liability. The Committee welcomes proposals by businesses which are best placed to assess the overall costs of doing business. If a new form of limited liability vehicle is proposed, for instance, for tax purposes, company law should be concerned to facilitate such a vehicle, provided that the prevailing rules of conduct devised to maintain the balance between operators and others are suitably replicated in the new form.

Single versus dual regimes

The Consultants' recommendations

5.68 As noted above, in addition to a separate statute for non-profit corporations, the Consultants recommended four sets of statutory provisions: general, public, private, and close. It was proposed that the general company law and private and close company provisions be placed in one instrument, but in separate sections, and that public company provisions be removed to another instrument (pp. 62, 174). Even if the separate close corporation regime is rejected, there remains the question of public versus private company law.

5.69 Although the Consultants wrote at length about the separation of public companies/securities related issues, their specific recommendations were few. The following are of relevance:

Item	**Remove as public companies /securities related issues**	**Retain in /recommended for Companies Ordinance**	**Unclear**
prospectus	X		
financial disclosure			X
inspection			X
scripless securities		X	
electronic data processing		X	
disqualification of directors	X		
shareholder proposal		X	

5.70 The paucity of specific recommendations makes it difficult to respond to the Consultants' recommendations. The following examines the assumptions underlying the general recommendation to separate out public company/securities related issues and the options available. If it is decided to separate out public company/securities related provisions, then the Companies Ordinance should be reviewed to determine whether there are other provisions beside the seven identified above.

5.71 The options for dealing with the public and private divide are:

(1) retain public companies provisions in the Companies Ordinance,

> (a) organized around issues (retain status quo);
> (b) reorganized internally to make it easier to locate provisions concerning a type of company;

(2) remove public companies provisions from the Companies Ordinance, and

> (a) place them in another instrument, perhaps with other securities matters (the "one and a half company law option");
> (b) place them in another instrument dealing comprehensively with public companies (the "two company law option");
> (c) place them in another instrument dealing comprehensively with public companies and securities (the "two company law and one securities regulation option").

Judging from the Consultants' recommendation of a "core company law" applicable to both public and private companies (Recommendation 1.03), the Consultants' recommendation is 2(a): there should be one full company law applicable to all companies and one-half company law applicable only to public companies. This recommendation assumes that public company provisions can be separated satisfactorily from private company provisions and company provisions from securities provisions.

Separating public company provisions from private company provisions

5.72 The first question raised by the proposal to excise public company provisions from the Ordinance is whether it can be done satisfactorily. One respondent cited Professor Sealy who, when commenting about separating out private company provisions, stated:

> There can be little merit in such an exercise. The task of "unteasing" one Act into two would involve some rather arbitrary decisions, and there would no doubt have to be savings provisions, as regards

existing private companies, allowing reference to be made to the old Act in cases of doubt.[1]

5.73 The point about arbitrariness is well illustrated in the Consultants' Report. For instance, on the one hand, the Consultants proposed to remove the provisions relating to disqualification of directors from the Ordinance on the ground, inter alia, that they pertain to capital markets (Recommendation 6.18). However, both in theory and in practice, these provisions for the protection of creditors are applicable to private companies as well as public companies (see paras. 10.69-10.79 below). On the other hand, the Consultants made recommendations in relation to shareholder proposals (Recommendation 7.02), scripless securities (Recommendation 5.10) and electronic records (Recommendation 5.12) which are primarily of concern to companies with numerous shareholders. If one were to separate out public company provisions, it is at least arguable that the above recommendations should be reversed.

5.74 Another example of arbitrariness is illustrated by the Consultants' treatment of inspections. In a long passage concerning the distinction between corporate and securities law, the Consultants identified inspection provisions in the Companies Ordinance as statutory provisions applicable to public companies (p. 61). It should follow from the stated approach of removing public company law provisions that inspection provisions should be removed. Yet, in the section specifically dealing with inspections, the recommendation is to maintain investigatory and inspection powers (Recommendation 2.06). The reason is clear: although investigatory powers are more often invoked in relation to public companies, it may be necessary or desirable to hold them in reserve for private companies as well. However, although such powers may need to be held in reserve for private companies, it may be that they need not be as elaborate or far reaching as for public companies. So, are they private company provisions or public company provisions? In the end, the Consultants recommended the retention of the existing problematic provisions for public or private companies (see paras. 12.15-12.17 below). The Consultants' treatment of financial disclosures fall into the same category.

5.75 Professor Sealy's second point about incompleteness is also conveniently illustrated by the Consultants' recommendations noted above. Take shareholder proposal as an example. The underlying principle of

[1] It should be noted that Professor Sealy is in favour of separating out legislation on prospectuses, insider dealing and other public company provisions from company law, although the point made here is that the same criticisms of arbitrariness and incompleteness should apply in reverse.

shareholder democracy is common to both public and private companies. The shareholder proposal regime is, however, only relevant to public companies where shareholders can be dispersed and numerous. Without such a regime, a shareholder may not be able to table his views before other shareholders. If one were to take the shareholder proposal provisions out of the Companies Ordinance, two further questions arise. First, although shareholders of close corporations do not need the machinery of shareholder proposals, one must consider whether it is necessary to replace the shareholder proposal provisions with an affirmation of the right of shareholders to place items on the agenda of shareholders' meetings. Secondly, and more seriously, it is questioned whether the shareholder proposal provisions should stand alone in the new public company law or whether all provisions concerning shareholder proceedings should be placed in the new law, even if they are duplicates of the existing general companies law. The dangers of the new law containing only specific provisions are that they may be or become out of step with the shareholder proceedings in the general law.

5.76 The above arguments would weigh against the one and a half company law option.

Separating company law from securities regulations

5.77 We have already referred to the difficulties of separating company law from securities regulations (see paras. 4.41-4.43 above). As the prospectus provisions are discrete and as entities other than companies may issue securities, it may be convenient to remove prospectus requirements from the Companies Ordinance and place them in securities regulations. However, as noted above, care must be taken to orient them as company-based disclosures and to integrate them with corporate disclosure requirements in the company law. The only feasible aim is to avoid duplication.

Conclusions

5.78 We have compared the various options and believe that, in order to minimize risks of unintended gaps and to ensure integral development of the law, with the exception of prospectus provisions, all "public company/ securities" provisions now in the Companies Ordinance should be retained. The Ordinance could with benefit be reorganized.

5.79 A consequence of our proposals is that there will be four categories of companies:

(1) private: companies limited by shares and privately-held. There is no reason to change the existing definition;

(2) public: companies limited by shares and not privately-held. In principle, all existing provisions regulating listed companies should apply to public companies;

(3) guarantee: companies limited by guarantee. In principle, they should be treated in the same manner as public companies (with appropriate modifications);

(4) unlimited: there is no reason to make any changes.

5.80 We note the existence of a few companies limited by guarantee with share capital and believe that this category serves little purpose and should be abolished prospectively.

Recommendation 32: The Committee recommends that Recommendation 10.03 of the Consultants' Report that there be a definition of private companies be accepted.
Recommendation 33: The Committee recommends that Recommendation 10.04 of the Consultants' Report as to the definition of private companies be accepted.
Recommendation 34: The Committee recommends that Public Companies be defined in the Ordinance to mean companies limited by shares that are not private companies.
Recommendation 35: The Committee recommends that provisions in the Ordinance applicable to Listed Companies be made applicable to Public Companies.
Recommendation 36: The Committee recommends that companies limited by guarantee be referred to as "Guarantee Companies".
Recommendation 37: The Committee recommends that the part of Recommendation 1.03 of the Consultants' Report dealing with an optional regime for private/close corporations be rejected.
Recommendation 38: The Committee recommends that provisions regulating prospectuses be removed from the Companies Ordinance.

Recommendation 39: The Committee recommends that, with the exception of recommendations dealing with prospectuses, Recommendation 1.04 of the Consultants' Report be rejected.
Recommendation 40: The Committee recommends that it should not be possible to incorporate a company limited by guarantee with share capital in the future.

Chapter 6

Directors and Officers

6.1 This Chapter examines the duties of directors and officers and their relationship to shareholders.

Nature of relationship between directors and shareholders

Analysis of existing law

6.2 The Companies Ordinance contains numerous provisions reserving various areas for shareholder approval. Directors' powers are scarcely mentioned; these are largely found in the articles of association, the shareholders' contract with each other and the company. Under the model articles of association, Table A, directors are given general management powers and other specific powers. The source of the directors' powers is the shareholders.

6.3 The shareholders are also the repository of residual powers, i.e. powers not specifically allocated or allocated by the general management clause to directors and in cases where there is deadlock in the board.

6.4 Although directors' powers are delegated by shareholders, directors are not the shareholders' delegate in the usual sense. The "principal-agent" relationship between shareholders and directors is one possessing at least three special features imposed by law. First, ever since 1932, shareholders have no choice but to appoint at least two directors (s. 153). Secondly, once appointed, directors have certain duties imposed by law. Thirdly, the duties of directors are owed to the company, and not to their appointors.

6.5 Each of the above features will be discussed in detail in later parts of this report. Here, the question is: what are the merits of the structure of this relationship? Are there any defects in this structure? As this relationship is built on contract and it acknowledges the sovereignty of shareholders (see paras. 6.141-6.150 below), it accords with the liberal contractual view of company law (see para. 4.15 above). At the same time, the special features of the "agency" relationship imposed by law provide external constraints on both shareholders and directors. The details of these constraints may require improvement, but the structure is fundamentally sound.

The Consultants' Recommendations

6.6 The Consultants recommended that the board of directors be given a direct grant of statutory power to manage, or supervise the management of, the company, subject to any unanimous shareholder agreement (Recommendation 6.03).

6.7 The Consultants advanced three reasons for their recommendation:

(1) this model reflects the concept of the corporation as a creature of the state;
(2) this model accommodates easily the one-person corporation;
(3) as directors' powers are original and not derivative from shareholders, shareholders may not forgive directors for having breached their statutory duties. This serves to "attenuate the situation which arose in *North-West Transportation Co. v. Beatty*" (p. 114).

6.8 The first reason is not valid. As previously discussed, the view of the corporation as a creature of the state is an out-moded one (see paras. 4.20, 5.30-5.33 above).

The second reason is not valid. As previously discussed, the one-person corporation can be accommodated easily under the existing conceptual and practical framework (see paras. 5.30-5.33 above).

The third reason is an overkill. The *Beatty* case represents a deficiency in the law on majority/minority relations. To cure this defect, it is not necessary to take away the power of shareholders to forgive directors entirely.

6.9 The weight of opinion of respondents is against the recommendation. All opponents pointed to the conceptual change entailed and the possible introduction of the stakeholder theory to Hong Kong company law. We agree.

Recommendation 41: The Committee recommends that Recommendation 6.03 of the Consultants' Report be rejected.

Directors' management powers

Analysis of existing law

6.10 In practice, all companies confer general management powers on the directors through the articles of association. Regulation 82 of Table A provides as follows:

> The business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and registering the company, and may exercise all such powers of the company as are not, by the Ordinance or by these regulations, required to be exercised by the company in general meeting, subject, nevertheless, to any of these regulations, to the provisions of the Ordinance *and to such regulations, being not inconsistent with the aforesaid regulations or provisions, as may be prescribed by the company in general meeting*; but no regulation made by the company in general meeting shall invalidate any prior act of the directors which would have been valid if that regulation had not been made. (emphasis added)

6.11 Although the term "management" is indeterminate, case law has established the boundaries of this power satisfactorily. There is, however, one defect in Regulation 82 on which action is required. The italicized portion above highlights the controversy over directorial autonomy.

6.12 Since the decision of the English Court of Appeal in *Automatic Self-Cleansing Filter Syndicate Company Limited v. Cuninghame*, it has been thought that directors enjoy full autonomy in the exercise of their management powers. "The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors..." (*Shaw v. Shaw*).

6.13 This rule has been criticized on two fronts. First, it is argued that it is incorrect as it renders the clause "subject nevertheless to any regulations prescribed by the company in general meeting" meaningless. Secondly, it is said that there is no reason why shareholders should not be able to overrule directors on specific occasions. In the U.K., Table A has been amended to abolish the directorial autonomy rule. In Hong Kong, the Court of Appeal has left the issue open, with two members of the court indicating an inclination to abolish the directorial autonomy rule (*Tang Kam-yip v. Yau Kung School*). The directorial autonomy rule is difficult to reconcile with the wording of Regulation 82. Thus, it is highly arguable that it is wrong in law.

6.14 The existing uncertainty is undesirable and Regulation 82 should be clarified.

The Consultants' Recommendations

6.15 The Consultants did not discuss this issue.

Recommendation 42: The Committee recommends that Regulation 82 of Table A be amended in line with the intention expressed in the U.K. Table A in order to remove the directorial autonomy rule.

Composition of the board

Qualifications

Analysis of existing law

6.16 The Companies Ordinance prescribes very few qualification requirements for directors: minimum age (s. 157C), natural persons for listed companies and their subsidiaries (s. 154A) and solvency (s. 156). In addition, a person subject to a disqualification order acting in contravention of the order is guilty of an offence (s. 168M). The articles may impose obligations to hold qualifying shares and usually provide for the vacation of office when a person is of unsound mind or has been absent for more than 6 months from meetings without leave (Table A, Reg. 90).

6.17 Two points are worth exploring. First, should the requirements be raised? Although the requirements may be "too low", it is difficult to see how the law could provide otherwise. There being no generally accepted institution for testing the aptitude for directorship, the law can hardly prescribe any "tests" for the post. It would be more productive for the law to ensure that shareholders have the opportunity to make informed choices of directors.

6.18 Secondly, should private companies be exempted from the prohibition on corporate directors? Corporate directors were permitted at common law. The Jenkins Committee, quoting from the *Report of the*

Patton Committee on Company Law Amendment in North Ireland objected to the practice:

> In our view the responsibility of directors for wrongful acts contemplated by the Companies Act has been the responsibility of natural persons and this has been lost sight of...
> It is important that it should be known who is responsible for the conduct of a company...A corporation cannot officiate as a director except by delegating its duty to some of its directors or some officer or servant. The person to whom these duties are delegated may change from day to day. Except by examining the minutes there is no means of finding out who at any particular time is exercising the functions of directors when a corporation is director of a company (para. 84).

The Companies Law Revision Committee agreed with the above and recommended a prohibition on corporate directors (para. 7.6). However, the resulting legislation made an exemption for private companies which still exists.

6.19 In principle, corporate directorships should be prohibited. Under a corporate directorship regime, an individual may be identified as the author of the impugned act or omission, but it is not easy to attach liabilities to him. One feature of corporate directorship is that the delegate may change from time to time, if not day to day. As such, he would not personally qualify as a "shadow director" (see paras. 6.114-6.115 below). As he is not personally a director, his duties are not owed to the company, but to his own employer. As such, it would be difficult to attach liability to him for acts or omissions prejudicial to the company. We believe that in the interest of improved corporate governance, which stresses a high degree of disclosure and transparency, that it is essential to be able to identify and hold an individual responsible for corporate acts.

6.20 Practitioners pointed out that professional secretarial services are often provided by a corporation and that reforms concerning directors should not affect secretaries. We agree.

The Consultants' Recommendations

6.21 The Consultants substantially repeated the existing requirements in their Recommendation 6.06. The only change recommended is that corporate directorships should be prohibited.

6.22 The weight of opinion of respondents is in favour of the recommendation. We agree. However, a reasonable grace period, say, two years, should be provided.

Recommendation 43: The Committee recommends that Recommendation 6.06 of the Consultants' Report be accepted, subject to a reasonable grace period of two years.

Unitary board

Analysis of existing law

6.23 Companies in Hong Kong have unitary boards selected by shareholders without cumulative voting. This means that the board is entirely elected by controllers.

6.24 Since 1993, the S.E.H.K. has introduced a requirement for listed companies to have independent non-executive directors. Now every listed company must have at least two independent non-executive directors on its board (Listing Rules 3.15).

6.25 The institution of independent directors has been hotly debated in England and the U.S.. It is one of the central planks of reform advocated by the A.L.I. to improve corporate governance.

The Consultants' Recommendations

6.26 The Consultants recommended that the unitary board be retained (Recommendation 6.01).

6.27 The reasons advanced by the Consultants were: "it is a structure that is well understood and accepted in Hong Kong and is the model for the Commonwealth jurisdictions which Hong Kong follows". We note that the Consultants had not discussed the law in the U.K. or North America nor the merits of the institution of independent directors.

6.28 All respondents who commented suggested that, for public companies, consideration should be given to optional two-tier boards or to committees of independent directors. We agree.

Recommendation 44: The Committee recommends that Recommendation 6.01 of the Consultants' Report be accepted.
Recommendation 45: The Committee recommends that further study be made of the appropriate board structure for public companies as part of the program to improve corporate governance.

Appointment of directors

Analysis of existing law

6.29 As stated above, rather than stipulating statutory qualifications for directors, it is preferable to ensure informed choices of directors by shareholders. By its nature, this topic is concerned more with public rather than private companies.

6.30 Commentators have pointed out that shareholder choice in public companies can easily be manipulated. The control over the appointment of directors illustrates this point.

First, as to nomination, the practice is that nominations are under the absolute control of controllers (management or controlling shareholders). It is recognized that this is not desirable and some rights of nomination are provided. However, they are provided under terms which render them practically inoperable. Regulation 95 of Table A requires a shareholder who proposes to nominate a director not recommended by the board to give notice to the company not less than 3 nor more than 21 days before the meeting. This time stipulation means that the shareholders' nomination cannot accompany the notice of the annual general meeting. Nor is there any obligation on the part of the company to circulate the notice for the nominator.

Secondly, there is no requirement to provide biographical details in respect of nominees. If the nominee is a retiring director, information is available from past annual reports and the Companies Registry. Such information, however, would at best enable the candidate to be identified.

Thirdly, with only controllers having the right to nominate, the number of nominees will be equal to the number of vacancies. If public shareholders do not like a nominee, they have a choice not to vote for him. Any resulting vacancies will then be filled by directors.

The Consultants' Recommendations

6.31 The Consultants did not discuss this issue.

Conclusions

6.32 It is desirable for shareholders to have a meaningful right to nominate, but it is not feasible for the Committee to recommend specific recommendations at this time. The matter is not urgent and will be kept under review.

Recommendation 46: The Committee recommends that the question of appointment of directors be reviewed.

Removal of directors

Analysis of existing law

6.33 At common law, an enabling provision in the articles of association is needed if shareholders wish to remove a director before the expiry of his term of office. Directors can thus be entrenched by negative or positive provisions in the articles. To remove them, shareholders must first amend the articles to give themselves such a right or to delete positive entrenchment provisions.

6.34 In the U.K., this defect was cured in the Companies Act 1948, which provided for removal by an ordinary resolution. At the time of consideration by the Companies Law Revision Committee, there was considerable opposition and it recommended the adoption of a compromise provision under which directors may be removed by a special resolution. Section 157B encapsulating this change came into force in 1984.

6.35 The introduction of section 157B was not much of an improvement. The rationale for the U.K. provision is that shareholders should have an overriding right to remove directors which is not given to them under the articles or which is contrary to the articles. In introducing a statutory provision at all, Hong Kong accepts the validity of that rationale. But by requiring a special resolution, the law merely returns the shareholders to square one. Even without that provision, shareholders capable of passing a special resolution can dismiss directors, even if they have to amend the articles first.

The Consultants' Recommendations

6.36 The Consultants recommended that shareholders should be able to remove directors by ordinary resolution, subject to class voting rights and the company constitution (Recommendation 6.10).

6.37 The reason given by the Consultants was that the shareholders are the owners of the company and the recommendation to reduce the level of shareholder approval is to be welcomed. However, making the right subject to the company constitution is meaningless. The purpose of such provision is to override the constitution. Making the right subject to class voting rights is also meaningless, as there are no "class" directors.

6.38 The response to this recommendation was split and some respondents were concerned that a right of removal might result in much antagonism. However, we believe that if over 50% of the shareholders wish to remove a director but cannot, there would be just as much if not more antagonism and frustration. Others were concerned with minority protection. As to minority protection, this envisages a scenario where the minority is protected by a director whom a simple majority wishes to remove. This is an unlikely scenario. In any event, it would be better to improve minority protection directly in adjusting the majority/minority relations than to risk allowing an entrenched management to trump the minority as well as the majority. We believe entrenchment of directors is undesirable.

Recommendation 47: The Committee recommends that Recommendation 6.10 of the Consultants' Report be rejected.
Recommendation 48: The Committee recommends that the law provide for the removal of directors by ordinary resolution, notwithstanding any provision in the company's constitution.

Proceedings of directors

Analysis of existing law

6.39 The Companies Ordinance does not contain provisions regulating the proceedings of directors. This has been left to the articles of association and courts. Accordingly, the "law" has easily kept up with the times. Telephone meetings where all participants can hear and be heard have been validated without the need of statutory authority. Written resolutions are provided for in the model articles. A quorum means the requisite number of disinterested directors. Reasonable notice is required.

The Consultants' Recommendations

6.40 The Consultants first recommended that provisions relating to directors' proceedings be set out in the Ordinance. They then recommended that meetings of directors should be permitted by means of electronic communications, unless otherwise specified in the company constitution, and that directors should be able to act unanimously by written resolution without a meeting (Recommendations 5.07, 6.11 and 6.12).

6.41 Placing regulation of proceedings in the main body of the legislation detracts from flexibility and impedes development. The present model which allows directors to be masters of their own proceedings is best able to keep up with the times.

6.42 As telephonic meetings and written resolutions are already either permitted by law or provided in the model articles, and as there is nothing that prevents companies from adopting any provision they wish, it is difficult to understand the purpose of the Consultants' Recommendations. The reasons given by the Consultants appear to be recitations from the M.B.C.A. on the merits of electronic communications etc.

6.43 Most respondents who commented accepted electronic communications without commenting on the locus of such provisions.

6.44 We consider it undesirable to include in the Ordinance matters pertaining to directors' proceedings, particularly matters which are subject to rapid changes. Considering that most respondents are in favour of electronic communications and written resolutions, we believe that enabling provisions should be inserted in Table A although they are not strictly necessary.

Recommendation 49 The Committee recommends that Recommendation 5.07 of the Consultants' Report be rejected.
Recommendation 50: The Committee recommends that Recommendation 6.11 of the Consultants' Report be rejected.
Recommendation 51: The Committee recommends that Recommendation

6.12 of the Consultants' Report be rejected.
Recommendation 52: The Committee recommends that enabling provisions be inserted in Table A to permit electronic communications.

Duties of performance

Delegation by board

Analysis of existing law

6.45 The board of directors cannot delegate its powers without authority. The model articles do grant the board authority to delegate to attorneys, managing directors and committees (Regs. 83, 111, 104). Delegation of authority does not mean relief of liability and the courts have been vigilant in scrutinizing delegation that may be injurious to shareholders (*Guinness plc. v. Saunders*). The existing law is sound and there is general satisfaction with it.

The Consultants' Recommendations

6.46 The Consultants recommended:

> The board of directors should be permitted to delegate all those powers which it is not required to exercise itself (Recommendation 6.04).
>
> Certain functions of the board of directors should not be subject to delegation, for example:
> - submission to shareholders of any question requiring their approval
> - filling an interim vacancy among directors, in the office of auditor, appointing or removing the chief executive officers
> - in most circumstances, issuing securities
> - declaring dividends
> - purchasing, redeeming or otherwise acquiring shares issued by the company
> - approving financial statements
> - adopting, amending, repealing any constitution documents (Recommendation 6.05).

6.47 The only reason for the Consultants making these recommendations is that the M.B.C.A. has these provisions.

6.48 We reiterate that the fact that a foreign statute has or does not have a particular provision is not itself a valid reason for change. We note further that Recommendation 6.05 in particular runs counter to the contractual concept of the company and the right of shareholders and management to arrange their internal affairs. As delegation of authority does not mean relief of liability, there is no need for regulation for the protection of the minority beyond that already exercised by the courts.

6.49 The overwhelming weight of opinion of respondents is firmly against the recommendation. We agree.

Recommendation 53: The Committee recommends that Recommendation 6.04 of the Consultants' Report be rejected.
Recommendation 54: The Committee recommends that Recommendation 6.05 of the Consultants' Report be rejected.

Delegation by individual directors

Analysis of existing law

6.50 Individual directors may not delegate without authority. In Hong Kong, many articles provide for the appointment of alternate directors whose function is to attend meetings. A director is not responsible for his alternate's acts (*Brown v. Byers*).

6.51 In relation to private companies, shareholder approval in the form of the articles should be respected.

6.52 In the case of public companies, the practice is questionable and arguments on the ground of shareholder consent are less compelling. However, practitioners and businessmen have pointed out practical difficulties with eliminating the institution. The institution is often employed where majority shareholders have an agreement as to the number of directors that would represent each of them on the board. When a designate cannot attend, the shareholder-appointer will lose his vote on the board unless alternates are permitted. It has been further pointed out that the reason that the designate cannot attend is not necessarily due to excessive directorships but because each directorship carries many committee memberships and businessmen have to travel frequently.

The Consultants' Recommendations

6.53 The Consultants recommended eliminating alternate directors (Recommendation 6.08).

6.54 Three reasons were advanced:

(1) as the conduct of meetings will be made easier, alternate directors will not be necessary;
(2) as to public companies, directors should not have so many other commitments that they cannot attend meetings;
(3) as to public companies, the use of board directorships as honorific positions is undesirable.

6.55 The weight of opinion of respondents is against the recommendation.

6.56 We believe that, as a matter of principle, a director should be vicariously responsible for his alternate. However, given the practical difficulties and the prevailing thinking it is not appropriate to abolish the institution at this time. As a measure to improve corporate governance incrementally, it is desirable to make it a default rule that a director should be responsible for the acts and omissions of his alternate.

Recommendation 55: The Committee recommends that the part of Recommendation 6.08 of the Consultants' Report as to alternate directors be rejected.
Recommendation 56: The Committee recommends that there should be a statutory provision to provide that, subject to contrary provision in the articles, a director is vicariously liable for the acts and omissions of his alternate.

Duty of care

Analysis of existing law

6.57 The most cited statement of the duty of care owed by directors is Romer J.'s judgment in *Re City Equitable Fire Insurance Company Limited.* The standard set there has been perceived to be too low. However, recent decisions in England, Australia and the U.S. appear to have raised the standard required.

6.58 There has been some dispute whether *City Equitable* established an objective or subjective standard. English courts have now held that the standard of care expected is the higher of an objective and the subjective standard.

6.59 Stipulating an objective standard does not by itself raise the standard. In *City Equitable,* it was held that a director need not give continuous attention to the affairs of his company. However, a recent Australian decision, citing in turn a New Jersey decision, has set this standard:

> As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. Directors are under a continuing obligation to keep informed about the activities of the corporation...Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies (*Daniels v. Anderson*).

6.60 Despite the rhetoric, it remains the case that few directors have been held liable for mere negligence untainted by conflict of interests. This is not necessarily bad. A low standard of care is justifiable on at least three grounds. First, directors are expected to take risks and it is too easy to be wise after the fact. Secondly, in the case of a slow decline, it is difficult to prove that a single director could have saved the company. Thirdly, too onerous a burden would simply scare off good managers. In the U.S., for example, in reaction to *Smith v. Van Gorkom* and the subsequent insurance crisis, the Delaware Corporations Law had to permit companies to opt out of the duty of care altogether and more than half of the States followed suit in less than a year.

6.61 Accordingly, it is arguable that, even if the current standard of care required of directors is low, the law is not defective.

The Consultants' Recommendations

6.62 The Consultants recommended:

(1) providing a statutory duty to exercise the care, diligence and skill that a reasonably prudent person would;
(2) providing a statutory right to rely on officers and advisers (Recommendations 6.13 and 6.14).

6.63 Three reasons were advanced:

(1) a statutory duty will be clear;
(2) the common law duty is too low and should be raised from a "gross negligence" standard to an objective standard of care;
(3) the M.B.C.A. has a provision concerning reliance on officers and advisers.

6.64 The first reason relates to the merits or otherwise of codification and we believe that a statutory duty will not necessarily be clearer (see paras. 3.4-3.8 above).

As to the second reason, as discussed above, the common law has "corrected" itself and the standard of care has been raised.

The third reason is not valid in itself.

6.65 Respondents were evenly split over the question of a statutory duty of care, but there was little support for including a statutory right of reliance. It was pointed out that this is a function of the standard of care and a separate provision is not necessary.

6.66 Given the difficulties of codification, its limited effect and the press of other business, codification should not be undertaken now.

Duty of loyalty

General

Analysis of existing law

6.67 According to Gower, in applying the general equity principle to company directors four separate rules have emerged:

(1) directors must act in good faith in what they believe to be the best interest of the company;

(2) they must not exercise the powers conferred upon them for purposes different from those for which they were conferred;
(3) they must not fetter their discretion as to how they shall act;
(4) without the informed consent of the company, they must not place themselves in a position in which their personal interests or duties to other persons are liable to conflict with their duties to their company (p. 601).

The Consultants' Recommendations

6.68 The Consultants recommended:

(1) providing a statutory duty to act honestly and in the best interests of the company;
(2) "care should be taken not to import the 'proper purpose' test" (Recommendation 6.13).

6.69 Two reasons were advanced:

(1) a statutory duty will be clear;
(2) New Zealand decided against including the proper purpose test in its statutory duty.

6.70 As to the first reason, the contrast between Gower's summary and the test recommended, as well as the recommendation regarding the proper purpose test put the case in doubt. Far from clarifying the law, a statutory duty may raise as many questions as it solves. An earlier attempt by the Committee to codify this duty failed in 1991.

6.71 The second reason is not valid by itself.

6.72 As noted, the reception was evenly split. For the same reasons given above, this is not the appropriate time for codification.

Recommendation 57: The Committee recommends that Recommendation 6.13 of the Consultants' Report be rejected.
Recommendation 58: The Committee recommends that Recommendation 6.14 of the Consultants' Report be rejected.
Recommendation 59: The Committee recommends that the question of a statutory statement of directors' duties and reliance on reports be kept under

review in the light of international developments.

Self-dealing

Analysis of existing law

6.73 Self-dealing refers to a transaction where a person who participates in decisionmaking on one side of the transaction also has an interest on the other side. The risk that such a person may favour his personal interest over the group interest is obvious. However, the common law recognizes that a well-connected director may bring more profits to a company than a loyal drudge. Therefore, the law permits self-dealing under certain conditions. This is probably sound. However, in delineating permissible and impermissible self-dealings, the law has not been effective.

6.74 It is an "inflexible" rule of equity that trustees and persons in a fiduciary position may not engage in self-dealing, unless the informed consent of the beneficiary has been obtained. These rules have been applied in the corporate context. A transaction in which a director is interested requires the informed consent of shareholders. If the interested party is an officer, only directors' approval is required. Interest is defined broadly to include legal or beneficial interest in the shares of the company on the other side of the transaction. In addition, the transaction must be fair.

6.75 However, these common law rules have long been robbed of any meaning. Quite early on, incorporators wrote into the articles of association permissive provisions, substituting board approval for shareholder approval and eliminating the fairness requirement. The courts have upheld these provisions on the grounds of freedom of contract.

6.76 In 1928, the legislature intervened in the U.K. to provide for disclosure to the board, currently section 162 of the Companies Ordinance. The model articles, currently Table A, Reg. 86, repeated the disclosure requirement and added that an interested director may not vote or be counted in the quorum. Four exceptions are provided where the interested director may vote and be counted in the quorum. Of these, the most notable is the exception for transactions where the director "is interested only as a director or an officer of the company or as holder of shares or other securities". Further, shareholders in general meeting may suspend or relax the prohibition to any extent either generally or in respect of any particular transaction.

6.77 In addition to the above requirements, the Companies Ordinance requires disclosures of interested contracts in the company's annual report (s.129D (3) (j)).

6.78 These provisions may look formidable but are seriously defective from the perspective of shareholder protection. Four major defects are outlined below.

6.79 First, to exclude transactions where the director "is interested only as a director or an officer of the company or as holder of shares or other securities" is to exclude almost all interested transactions. Given that most businesses employ the corporate form of organization, the only interested transaction that is not excluded is probably the director's service contract.

6.80 Secondly, the statutory disclosure requirement introduced in 1928 has always been a curiosity. Obviously, the legislature thought there was a mischief to be cured. Yet it only required a disclosure to the board, crystallizing the then existing practice. Indeed, an additional general notice option (s. 162 (2)) went further and made a mockery of the original requirement. As Gower puts it delicately, "it is possible to be sceptical about the protective value for shareholders of disclosure, even full disclosure, to fellow directors, who may be inclined to take a more lenient view of conflicts of interest than would the shareholders. This is especially likely where the other directors entertain hopes of similarly lenient treatment should they themselves have to disclose a conflict in the future" (p. 629).

6.81 Thirdly, although breach of the statutory duty of disclosure attracts a penalty of $150,000 and 6 months imprisonment, the civil consequences of breach are unclear. Lord Goff, citing Lords Wilberforce and Pearson, holds that a breach has no effect on the contract. Lord Templeman takes the opposing view, but commentators take Lord Goff's view (see *Guinness plc. v. Saunders*).

6.82 Fourthly, the second curiosity about the 1928 Act was that it did not prohibit contracting out of the law. Thus, model articles continued to contain the provisions outlined above exempting directors of their common law duty. In the Companies Act 1948, a provision was introduced (currently section 165 of the Companies Ordinance) invalidating any provision in the articles which exempted directors from any liability that would otherwise attach by law. There has been considerable debate about the validity of Reg. 86 of Table A in view of section 165. In *Movitex Ltd. v. Bulfield,* Vinelott J.

upheld the equivalent of Reg. 86 of Table A on the grounds that it did not exempt directors' duties but merely removed some disability placed on directors by the common law. This decision opened the way for controllers to remove other disabilities.

6.83 The net result of the above is that there are no effective sanctions for a breach of the existing lax requirements and controllers may write further exemptions into the articles. In the case of public companies, this state of affairs is unacceptable.

The Consultants' Recommendations

6.84 The Consultants made three recommendations:

(a) that consideration be given to placing directors and officers under a duty of fair dealing (Recommendation 6.19).

The reasons advanced were:

(1) at common law, "interested transactions were voidable at the option of the company and the director was accountable for any profit derived from the transaction". This is derived from trust law and is "inappropriate and impractical for corporate directors";
(2) a fair dealing obligation means fair (disinterested) decisionmaking and a fair price. This is a clear commercial standard, distinguished from stricter fiduciary duties;
(3) the Ordinance, articles and the case law are in an unsatisfactory state.

(b) that interested transactions should be upheld if (i) directors disclose to the board their material interest in the transaction; (ii) do not vote as a director on any resolution to approve the transaction; and (iii) the transaction was reasonable and fair to the corporation at the time it was approved. In the alternative, such transactions could also be approved by unanimous shareholders consent (Recommendation 6.20).

The reasons advanced by the Consultants were:

(1) the C.B.C.A so provides, and it is not substantially different from the M.B.C.A..

(c) that shareholders should be able to uphold a transaction by special resolution in certain circumstances (Recommendation 6.21).

The reasons advanced by the Consultants were:

(1) an alternative mechanism to uphold an interested transaction is desirable;
(2) the C.B.C.A, O.B.C.A., A.B.C.A. have similar provisions.

6.85 The first observation is that the three recommendations and arguments are difficult to understand. There is no substantial difference between Recommendations 6.19 and 6.20 except as to the inclusion of officers. It is not clear why there were two recommendations instead of one. Recommendation 6.21 purports to offer shareholder approval as an alternative mechanism. It seems superfluous under the Consultants' Recommendations since Recommendation 6.20 already provides for shareholder approval. There appears little point to require unanimous approval under Recommendation 6.20 and give an option for majority approval under Recommendation 6.21.

6.86 The first two reasons given for Recommendation 6.19 mistate the common law. The first reason only states the first part of the common law rule and not the proviso. The proviso is: unless the informed consent of the beneficiary is obtained and the transaction is fair. Thus, the common law position is precisely one of fair procedure and fair price as recommended.

6.87 The third reason under Recommendation 6.19 is inadequate. Other than the erroneous statement of the case law under the first reason, there is no supporting analysis. In particular, there is no discussion of why the Ordinance and the articles are in an unsatisfactory state.

6.88 The reasons given for Recommendations 6.20 and 6.21 are invalid by themselves.

6.89 There is no support for the recommendation.

6.90 We believe that the current law is not entirely satisfactory. Nevertheless, the Consultants' Recommendations 6.19, 6.20 and 6.21 are unacceptable because they do not address existing problems. As the issue is an important and sensitive one, further studies and consultations are required.

Recommendation 60: The Committee recommends that Recommendation 6.19 of the Consultants' Report be rejected.
Recommendation 61: The Committee recommends that Recommendation 6.20 of the Consultants' Report be rejected.
Recommendation 62: The Committee recommends that Recommendation 6.21 of the Consultants' Report be rejected.
Recommendation 63: The Committee recommends that the question of self-dealing be further studied.

Financial assistance by company

Analysis of existing law

6.91 While an argument can be made for self-dealing in general, there is little justification for financial assistance. A well-connected director may bring business and profits to the company. Self-dealing can thus be beneficial. However, the company has little to gain from lending to a director who cannot obtain needed financing in the market on commercial terms on his own credit. Section 157H (2) of the Companies Ordinance therefore prohibits a company from making loans to or providing security for loans to directors. Limited exceptions are available and the prohibition is extended to associates of directors of a listed company.

6.92 While the law is fundamentally sound, it is unduly restrictive in that only loans and security for loans are covered. Anglo-Hong Kong law has defined "loan" narrowly to mean an advance of money to be repaid in the future. This is inadequate to cover modern forms of credit. The U.K. has amended its laws and extended the prohibition to credit-transactions and quasi-loans.

The Consultants' Recommendations

6.93 The Consultants recommended maintaining the status quo (Recommendation 6.22).

6.94 The weight of opinion of respondents is in favour of the recommendation. It was pointed out that the provisions can be easily circumvented and are complex.

6.95 We agree that the current provisions can be easily circumvented and that the definition of loan should be suitably extended to embrace in generic terms the provision of financial assistance. The current provisions are complex due to the many exceptions and the style of drafting. We believe that, without sacrificing the exceptions, there is a need to improve and simplify the drafting of these provisions.

Recommendation 64: The Committee recommends that Recommendation 6.22 of the Consultants' Report be rejected.
Recommendation 65: The Committee recommends that the statutory provision be extended to cover in generic terms the provision of financial assistance to directors.
Recommendation 66: The Committee recommends that the drafting of the provisions regarding financial assistance to directors be simplified.

Corporate opportunities

Analysis of existing law

6.96 When one is employed to act on another's behalf, whether one is a trustee or not, one should not take the other's opportunities and property for oneself. This is an elementary principle of commercial morality and law. In the case of directors of a company, a complete prohibition on exploitation of business opportunities by directors for personal benefit is considered too stifling. Therefore, the case law slowly developed to distinguish between proper use of opportunities from usurpation of corporate opportunities by directors. Given the multifarious ways in which the question may arise, this has not been an easy task.

6.97 The leading Canadian case which has found its way into authoritative English treatises and courts is *Canadian Aero Service Ltd. v O'Malley*. In a much cited passage, Laskin J. (as he then was) rejected the traditional conflict of interests test and the profiting by one's position test as being exclusive tests. He stated:

> As in other cases in this developing branch of the law, the particular facts may determine the shape of the principle of decision without setting fixed limits to it. So it is in the present case...
> The general standards of loyalty, good faith and avoidance of a conflict of duty and self-interest to which the conduct of a director or senior officer must conform, must be tested in each case by many

factors which it would be reckless to attempt to enumerate exhaustively. Among them are the factor of position or office held, the nature of the corporate opportunity, its ripeness, its specificness and the directors or managerial officer's relation to it, the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or indeed, even private, the factor of time in the continuation of fiduciary duty where the alleged breach occurs after determination of the relationship with the company, and the circumstances under which the relationship was terminated, that is whether by retirement or resignation or discharge (p. 391).

6.98 Out of the cases, two factors emerged:

(1) good faith of the alleged "usurper" is not a defence as such. However, in Laskin J.'s formulation, it is one factor considered;
(2) the courts are sceptical of any alleged inability on the part of the company to exploit the opportunity, but if the company firmly rejected an opportunity acting on full information, the director is free to pursue it for himself.

6.99 The caution and scepticisms of the courts are well justified, as another Canadian case, *Peso Silver Mines (NPL) v. Cropper*, illustrates. The facts of the case were: the company concerned, a mining company, usually received two or three offers of mining claims a week. In March 1962, a consultant geologist brought a claim to the board which was rejected. In May (less than two months), the geologist, the managing director and two founding directors formed a company to exploit the claim. The trial judge found that the board's decision was honest and informed, made in good faith in the best interests of the corporation. This finding of fact was relied on by the superior courts in affirming the decision. There has always been a suggestion that evidence had been overlooked by the trial judge and that the finding of fact was not justified (Beck).

6.100 We believe that the case law has developed satisfactorily and the current position is fundamentally sound.

The Consultants' Recommendations

6.101 The Consultants recommended that directors and officers should not disclose or use for their benefit a corporate opportunity or information that they obtain by reason of their position or employment except (i) with consent of disinterested board members, (ii) where disclosure is required by law or otherwise, or (iii) where it is reasonable to assume that the disclosure or use of the information or opportunity will not be likely to prejudice the corporation (Recommendation 6.23).

6.102 The reasons advanced by the Consultants were:

(1) the strict rule in *Regal (Hastings)* is derived from trust standards and is less suitable than the rule in *Peso Silver Mines*;
(2) Australia and New Zealand have such provisions.

6.103 As to the first reason, it is noted that in *Regal* there was no shareholder approval and Lord Russell suggested that the directors could have protected themselves with a shareholders' resolution. Furthermore, the strictness of *Regal* if once true has been corrected.

6.104 The second reason is not valid by itself.

6.105 There is no support for this recommendation. As there are no defects in the law, we agree that change is not necessary.

Recommendation 67: The Committee recommends that Recommendation 6.23 of the Consultants' Report be rejected.

Review of management decisions

Analysis of existing law

6.106 At English common law, the courts have deferred to directors on questions of management. "….they accept that it would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, on such a question, if *bona fide* arrived at. There is no appeal on merits from management decisions to courts of law" (*Howard Smith Ltd. v. Ampol Petroleum*).

6.107 This is similar to positions reached in other jurisdictions. In the U.S. this practice of judicial restraint has been elevated to doctrinal status: the "business judgment rule".

6.108 The law is sound and not in need of reform.

The Consultants' Recommendations

6.109 The Consultants recommended that there is no need for a statutory formulation of the "business judgment rule" (Recommendation 6.15).

6.110 The reasons advanced were that it is a "jurisprudence rule" and "none of the U.S. states have attempted to codify it, leaving its formulation up to the courts".

6.111 All respondents that commented agreed. We also agree.

Recommendation 68: The Committee recommends that Recommendation 6.15 of the Consultants' Report be accepted.

Anti-avoidance

Analysis of the existing law

6.112 The law on directors can be easily evaded if it only applies to duly appointed directors. Therefore, the definition of a director includes "a person occupying the position of director by whatever name called" (s. 2 (1)). Thus, de facto directors are brought under the law. De facto directors act openly, if without authority. There is another class of person who remain in the shadow. These so-called "shadow directors" are brought in by specific reference in certain provisions, e.g., ss. 168C to 168T.

6.113 A shadow director is not defined in the general interpretation section. The court has held that it means a person in accordance with whose directions or instructions the directors of a company have been accustomed to act (*Re Wheelock Maritime*). In addition to shadowy figures pulling strings in the shadows, bankers or corporate consultants risk falling into this category.

6.114 The concept of shadow directors admittedly brings a degree of uncertainty to the law. But without such a concept, liability may only attach to the puppet director who may be a man of straw. This uncertainty is then a necessary evil. Nor is the concept unique. In the U.S., Judge Learned Hand invented the deputization theory which was confirmed by the U.S. Supreme Court (*Blau v. Lehman*). Under this theory, a person who deputizes another to take up the post of director is considered a director. The deputization theory goes further than the shadow director concept in that a shadow director has to be able to sway the entire board before he is treated as a director. Under the deputization theory, a person only has to sway one director to attract the responsibilities of a director, in relation to the deputy's acts and omissions.

6.115 While the concept of shadow directors is sound, there are a number of defects. First, there is no definition. Secondly, the requirement that a person must be able to sway all the directors before he is caught as a shadow director is too high. The threshold should be lowered to include someone who can influence less than the whole board.

The Consultants' Recommendations

6.116 The Consultants recommended the elimination of the "troublesome" concept of shadow directors (Recommendation 6.08).

6.117 The Consultants advanced two reasons:

(1) with the removal of the artificial distinction of directors/shareholders from private companies/closely-held corporations, the concept is unnecessary;
(2) with respect to public companies, "the concept, in its vagueness, is troublesome and unenforceable" (p. 119).

6.118 The first reason has been dealt with in the chapter on private companies/closely-held corporations (paras. 5.43-5.47 above).

The second reason indicates a preference for linguistic elegance over reality. In the words of respondents, "A shadow director is not an invention of the statutes". The law merely "recognise[s] the existence of outside influence over the board of directors". Without such a law, "the principle of ultimate responsibility of the board and those who run it will be undermined".

We note that the concept has a vague analogue in the deputization theory in U.S. jurisprudence. If it is removed from the statute, it will be reimported via U.S. case law on the recommendations of the Consultants (p. 57).

6.119 The overwhelming weight of opinion of respondents is against the recommendation. We agree.

Recommendation 69: The Committee recommends that the part of Recommendation 6.08 of the Consultants' Report as to shadow directors be

rejected.
Recommendation 70: The Committee recommends that a statutory definition of shadow directors be provided.
Recommendation 71: The Committee recommends that a shadow director be defined to include someone who can influence less than the whole board of directors.

Executives

Analysis of existing law

6.120 Before examining the law, a clarification of terminology is required. The Consultants have used throughout their Report the term "officers" or "executive officers" in the North American sense which is different from its meaning under Anglo-Hong Kong law. As this term has given rise to misunderstandings evident in the response received, a few words on terminology are in order.

6.121 North American law accords with the common management structure of large companies. At the apex of management is the board of directors. They do not, however, manage. They at most direct the management of the company which is done by a professional corps of executives. These executives, one tier below the board, are called "officers" and are recognized in the law. For example, the O.B.C.A. defines an officer as a person designated under section 133 and includes the president, a vice-president, the secretary, the treasurer etc. Section 133 provides that subject to the articles, the directors may designate the offices of the corporation and appoint officers. As regards duties to the company, officers are placed on the same level with directors, viz "Every director and officer of a corporation...shall (a) act honestly and in good faith with a view to the best interests of the corporation...".

6.122 In contrast, although the term "officer" is used in the Companies Ordinance, Anglo-Hong Kong law does not recognize the North American officer as such, except for the secretary. "Officer" is defined as including "a director, manager or secretary" (s. 2 (1)). The term "manager" may mean one with responsibility for the company or a department.

6.123 The company secretary is an officer recognized under both North American and Anglo-Hong Kong laws. Indeed, Hong Kong law requires every company to have a secretary who must be resident in Hong Kong (s. 154). The Listing Rules prescribe clear and high qualification requirements for this post. This is a valuable means of improving corporate governance.

6.124 A weakness in the existing law is that the definition of “officer” is unsatisfactory in that the term “manager” is now meaningless. It should mean a rank of executives immediately below and reporting to the board, but can now mean any rank.

The Consultants’ Recommendations

6.125 The Consultants recommended the abolition of the requirement for a company secretary (Recommendation 6.09).

6.126 Three reasons were advanced:

(1) for private companies/closely-held corporations, an informal structure is proposed;
(2) for public companies, the necessity should be left to the S.E.H.K.;
(3) North America does not require it.

6.127 The first reason has been dealt with in the chapter on private companies (see para. 5.29 above).

The second reason is invalid in that public companies are a legitimate concern of the law. It is not proper that all regulation of public companies be delegated to the S.E.H.K (see paras. 4.45-4.46 above).

The third reason is invalid in itself.

6.128 The overwhelming weight of opinion of respondents rejects the recommendation altogether. It is pointed out that for private companies, as no qualifications are stipulated, the post of secretary does not necessarily entail additional costs. We agree.

Recommendation 72: The Committee recommends that Recommendation 6.09 of the Consultants’ Report be rejected.
Recommendation 73: The Committee recommends that the definition of manager be clarified to indicate a rank immediately below and reporting to the board.

Indemnity of directors

Analysis of existing law

6.129 A director may incur liabilities to others in the course of performing his duties. The law regulating his indemnity is not found in the Companies Ordinance but in case law. By the common law of agency, directors have a right to be fully indemnified against all such losses and liabilities, subject to the law on illegality. However, an agent who has breached his duties may forfeit his remuneration and his right to indemnity. While breaches of the duty of care would not in all cases result in forfeiture; forfeiture may result if the breach is sufficiently serious. On the other hand, even a breach of duty of loyalty may not result in forfeiture if the act has been beneficial to the company.

As to liability for penalties or criminal liability, at common law, a contract to indemnify a person against criminal liability is illegal if the crime is one which can only be, or in fact is, committed with guilty intent. The courts will allow a person to recover an indemnity against criminal liability if they are satisfied that he is wholly (morally) innocent. A contract to indemnify a person against civil liability may be illegal if the wrong is intentionally and knowingly committed, but is perfectly valid if the liability was incurred innocently or negligently (Treitel).

6.130 A director may also incur liability to the company for breach of duty. Here, to allow blanket indemnity conferred by the controllers of the company would make a mockery of the law imposing the duty in the first place. Thus, the law imposes the following controls:

(1) Any provision in the articles or any contract exempting any officer (or auditor) from or indemnifying him against liability for breach of duty is void (s. 165).
(2) The court may relieve a director (or auditor) of liability for breach of duty if he has acted honestly and reasonably and the court thinks it just (s. 358).
(3) Where the director succeeds in actions brought or in obtaining relief from court, the company may indemnify him against costs (s. 165, proviso (c)). Table A includes an indemnity in such circumstances (Reg. 137).

6.131 We have been informed that the omission of statutory indemnities to directors against liability incurred to others in the course of performing their duties has occasioned concern to directors. The uncertainty over the right to indemnity may deter competent persons from accepting directorships and is thus undesirable.

The Consultants' Recommendations

6.132 The Consultants recommended that companies should be permitted to indemnify directors and officers in specific circumstances; and should be required to indemnify directors and officers in specific circumstances (Recommendations 6.16).

In the comments, the Consultants elaborated:

> The indemnification provisions should be broadened. Indemnification should be permissible where 1) the liability was reasonably incurred in a proceeding in which the manager was involved by virtue of his position, 2) the manager was not in breach of his fiduciary duty to the company and 3) where there is a monetary penalty, reasonably believed his conduct to be lawful. While the company itself is the plaintiff in the proceeding, different considerations prevail; judicial approval may be required. Indemnification should be mandatory where the manager has been substantially successful on the merits of a defence.

6.133 The reasons advanced were
"Indemnification should be permissible where it furthers 'sound corporate policies' and should be prohibited where it would 'protect or encourage wrongful or improper conduct', according to the M.B.C.A."

6.134 It is difficult to decipher from this recommendation what is proposed and how it is to be related to the existing law. Part of the problem is that the Consultants did not separate the two types of indemnity in their recommendations.

6.135 As to indemnity against liability to the company, it appears from the comments (although not clear in the recommendation) that the Consultants did not propose any change.

6.136 As to indemnity against liability to others, the second condition in the comments seems to limit forfeiture to and simultaneously mandates forfeiture in cases of breach of fiduciary duties. It is not clear whether this difference is a result of copying section 124 of the C.B.C.A. or a conscious proposal to change the law. No reasons were advanced to support any such change.

The third condition of the Consultants' proposal is directed to the range of permissible indemnities at common law. No reasons were given as to whether it was intended to change the common law or why.

6.137 No reasons were given as to why the law should mandate indemnity. The proposal is contrary to the "enabling" spirit.

6.138 There is no support for the recommendation. Some respondents objected and others sought clarification. While there is no reason to support the changes recommended by the Consultants, in view of the concerns of practitioners, statutory provisions confirming the ability of companies to provide indemnity for liability incurred by directors to others in the course of performing their duties should be added. The permissible scope of such indemnities should be studied further.

Recommendation 74: The Committee recommends that Recommendation 6.16 of the Consultants' Report be rejected.
Recommendation 75: The Committee recommends that the Ordinance should confirm that indemnities may be given to directors for liability incurred by them to others in the course of performing their duties and that the permissible scope of such indemnities should be studied further.

Insurance

6.139 The Consultants recommended that companies should be permitted to insure directors and officers except for a failure to act honestly and in good faith with a view to the best interests of the company (Recommendation 6.17).

6.140 This has been accepted by all. We had recommended this in 1993. Again, in 1998, we recommended that a company should be allowed to obtain insurance for directors' liabilities save for fraud, but that insurance cover could include the costs of litigation, irrespective of the outcome of such litigation and even if such litigation involved an allegation of fraud of a director.

Recommendation 76: The Committee recommends that action be taken promptly to implement the earlier recommendation of the Committee and

Recommendation 6.17 of the Consultants' Report.

Object of director duties

Analysis of existing law

6.141 The directors' duties are owed to the company, which means the interest of shareholders, present and future, as a whole. Traditionally, creditors have no standing to complain of directors' misdeeds, even in violation of the law intended for their protection (see para. 10.129 below). There must not be "cakes and ale" for employees beyond what are required to boost production and profits. Reasonable charitable donations are acceptable if they serve the company. In sum, "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end" (*Dodge v. Ford Motor Co.*).

6.142 Recently, however, other interests have been recognized in other jurisdictions. As to employees, the U.K. provides that in the performance of their duties directors shall consider the interests of employees as well as shareholders. However, this duty to consider employees is owed to and enforceable by the company only. In addition, directors may make provisions for employees on cessation or transfer of business, regardless of the benefit to the company.

6.143 As to creditors, English and Australian courts have spoken in terms of a duty to creditors, present and future, but the U.S. has adhered to the traditional position. The English position has been severely criticized.

6.144 Where takeovers are involved, Canadian and English courts have upheld the acts of directors accused of considering the consequences of the takeover to the community. The U.S. position appears to be the same. But the courts have not gone further than this, in allowing directors to consider societal interests.

6.145 The theory that supports the right, indeed the obligation, of directors to consider interests other than shareholder interests is the stakeholder theory.

The Consultants' Recommendations

6.146 The Consultants made no direct recommendations on the issue, but there are some recommendations with stakeholder implications:

(1) that the “concession” model of corporation be adopted (Recommendation 3.01);
(2) that directors be given a direct grant of statutory power (Recommendation 6.03);
(3) that the unfair prejudicial remedy be extended to directors and holders of “securities” (Recommendation 7.09).

6.147 The Consultants have not outlined the arguments for the stakeholder theory.

6.148 The usual argument for the stakeholder theory is that, by their enormous economic powers, large enterprises affect the lives of many other groups besides shareholders. Those subject to the power of the corporation should have a say in the exercise of that power.

6.149 Two powerful arguments against the stakeholder theory have never been met satisfactorily. One is the question of political legitimacy. The balancing of interests of various groups is essentially a political function. Why should it be performed by private citizens pursuing private gain? The other is the question of corporate governance. A board that is responsible to different interest groups is a board accountable to no-one.

6.150 We believe that any restraints on enterprises in the interests of society at large should be imposed by law rather than by directors. We reject the stakeholder theory.

Recommendation 77: The Committee rejects the stakeholder theory.

Chapter 7

Shareholders' Rights and Majority Rule

7.1 This Chapter examines the rights of shareholders and majority rule.

7.2 The Consultants recommended that a separate part of the new Ordinance should be dedicated to matters dealing with shareholders, their rights and remedies (Recommendation 7.01). There is support for this recommendation. We agree that the Companies Ordinance should be reorganized to gather all shareholders' rights and remedies provisions in one section.

Recommendation 78: The Committee recommends that Recommendation 7.01 of the Consultants' Report be accepted.

Shareholder proceedings

Introduction

7.3 The Companies Ordinance contains elaborate provisions on shareholder proceedings. These are generally satisfactory and this section will only touch on six issues: locus, disclosure, agenda, identity of conferees, proxies and C.C.A.S.S.

Locus of regulations

Analysis of existing law

7.4 Under the current scheme, regulations are generally included in Table A. It sets out what the law considers to be desirable, but allows parties to adopt other provisions. To prevent overreaching, the Ordinance prescribes the outer limits for contracting out. This structure may be complicated but it permits maximum freedom with certain minimal protection.

The Consultants' Recommendation

7.5 The Consultants recommended that the formalities associated with routine shareholders' meetings be set out in the Ordinance (Recommendation 5.08).

7.6 The Consultants appeared to be recommending that the majority of the formalities associated with shareholders meetings be included in the body of the ordinance.

7.7 There is little support for this recommendation. As the existing system provides the maximum freedom with protection, we do not believe that reform is needed.

Recommendation 79: The Committee recommends that Recommendation 5.08 of the Consultants' Report be rejected.

Disclosure

Analysis of existing law

7.8 The contents of notices are very important for shareholders in determining not only how to vote, but also whether to attend. The Ordinance and case law now contain a multitude of requirements other than the expected ones as to time and place.

First, the notice calling an annual general meeting need not specify the "usual business" to be transacted, but must specify the meeting as an annual general meeting (s. 111 (1)). Presumably, recipients would know the usual business: appointment of directors and auditors, approval of financial statements and declaration of dividends. The notable omission here is information on persons to be nominated as directors.

Secondly, the "general nature" of special business proposed to be transacted must be disclosed (Table A, Reg. 52).

Thirdly, "the intention to propose [a] resolution as a special resolution" must be disclosed (s. 116 (1)).

Fourthly, "full particulars" as to severance pay for directors must be disclosed in a notice of a meeting called to approve the payment (s.163D (4) (a)).

Fifthly, "adequate explanation" must be provided for a proposal to amend the articles in relation to emoluments for a director (s.116A (1) (a)).

Sixthly, where a company gives notice of the intention to move a resolution, there must be included a statement: (a) containing such information and explanation as is reasonably necessary to indicate the purpose of a proposed resolution, and (b) disclosing any material interests of any director (s. 155B (1)).

The court has imposed stricter requirements, particularly as regards conflict of interests.

7.9 The above provisions raise two questions. First, why should there be different criteria of disclosure for different action proposed? The *Jenkins Report* found this state of the law to be unsatisfactory (paras. 465-466). Secondly, at best, only the "purpose and effect" of the transaction are required to be disclosed. Is this enough? In principle, there should be one uniform requirement to provide a full explanation (including conflict of interests) of the proposed transaction sufficient to enable the shareholders to form a judgment.

The Consultants' Recommendation

7.10 The Consultants did not discuss this issue.

Recommendation 80: The Committee recommends that dispersed notice provisions be consolidated into one general criterion: the notice must provide a full explanation (including conflict of interests) of a proposed transaction to enable shareholders to form a judgment.

Agenda

Analysis of existing law

7.11 The shareholder proposal is an important topic in the debate on corporate governance. Section 115A of the Companies Ordinance provides that on request by holders of not less than one-twentieth of the voting rights or 100 shareholders holding shares on which there has been paid up an average sum of not less than $2,000 per person, the company must circulate the requisitionists' proposals to shareholders entitled to notice of general meetings. There are time restrictions and notice requirements; the proposals may only be made at an annual general meeting and the circular must not exceed 1,000 words. Requisitionists must pay all the expenses of notification and circulation.

7.12 Compared to the U.S., the shareholder's rights are restricted. First, not any shareholder may make a proposal. The compensating advantage is that the company need not bear the costs of frivolous or unreasonable proposals. Secondly, proponents have to bear costs, but as the materials are included in the company's annual reports, costs are minimized. They serve as a guarantee of seriousness. Thirdly, proposals may only be tabled at an annual general meeting. The compensating advantage is that management may not object on the basis that the business could not properly be dealt with at the annual general meeting, thereby avoiding the disputes that have occurred in the U.S. over the proper subject matter of the shareholder proposal.

7.13 The existing regime may be less "liberal" than the U.S. one, but it has compensating advantages. We believe that it is sound, but that the threshold is high. Consistent with our action to reduce the threshold for requisitioning meetings, the threshold for shareholder proposals should be lowered to 2 1/2 percent of voting rights or 50 shareholders.

The Consultants' Recommendation

7.14 The Consultants recommended that any shareholder should be entitled to require the company to circulate his proposal, but that the board may refuse on various grounds. It is not stated, but implicit in the promotion of the North American model is a recommendation that the company pay all costs. An alternative recommendation is to lower the threshold to 2 l/2 per cent, but without any discretion on the part of the directors to reject (Recommendations 7.02).

7.15 The Consultants advanced three reasons:

(1) the opportunity to discuss corporate affairs at shareholders' meetings is a right and not a privilege;
(2) there is case law in North America to assist in determining whether directors may refuse to circulate the proposal;
(3) there is no evidence of overuse or abuse in the U.S.

7.16 As to the first reason, the opportunity to discuss corporate affairs at shareholders' meetings is indeed a right. However, what is at issue here is not the right to discuss, but the right to use corporate (ie other shareholders') resources so to do. Furthermore, if the exercise of corporate democratic rights need not be subject to any reasonable restraints, any shareholder should be able to requisition a meeting. Yet the Consultants' accept that a 5 per cent holdings requirement is needed to "prevent abuses of this right".

As to the second reason, first, it is uncertain whether it is a help or a hindrance to shareholders to have to resort to U.S. case law to determine their rights. Secondly, U.S. case law is built on rules promulgated by the Securities and Exchange Commission on the issue. It is difficult to import the case law without the rules. Thirdly, in view of the proposed amendment to Regulation 82 of Table A (see paras. 6.10-6.14 above), shareholders have greater rights under Hong Kong law to "interfere" with management and reliance on U.S. case law would be restrictive rather than expansive of their rights.

As to the third reason, without empirical data, it is difficult to know whether there has been abuse in the U.S. It is known that in the 1980s proposals numbered in the hundreds annually and a commentator made these observations:

> A number of interesting facts appear from an examination of the statistics on proposals submitted under the rule during the last eight proxy seasons. Most notable is the increase both in the number of proposals submitted and in the number of proposals on which votes were actually taken. Also noteworthy is the fact that a substantial number of "professional" proponents are responsible for a substantial majority of all submissions (Liebeler).

7.17 It is interesting to note that scholars of the "enabling" persuasion have called for the repeal of the U.S. rule.

7.18 The overwhelming weight of opinion is against the proposal. We agree.

Recommendation 81: The Committee recommends that Recommendation 7.02 of the Consultants' Report be rejected.
Recommendation 82: The Committee recommends that the threshold for shareholders' proposals be reduced to 2 1/2 percent of voting rights or 50 shareholders.

Requisition

7.19 The Consultants recommended lowering the threshold for requisitioning a meeting to 5 per cent of the shareholders holding the voting shares (Recommendation 7.03). Proposals regarding this have already been included in the Companies (Amendment) Bill 2000.

Recommendation 83: The Committee recommends that Recommendation 7.03 of the Consultants' Report be accepted.

Dispensation with meeting

7.20 The Consultants recommended providing for a shareholders' right to dispense with meetings (Recommendation 7.04). Proposals regarding this have already been included in the Companies (Amendment) Bill 2000.

Recommendation 84: The Committee recommends that Recommendation 7.04 of the Consultants' Report be accepted.

Identity of conferees

Analysis of existing law

7.21 A former executive director of the S.F.C. noted, from his investigation into the share ownership of a company, that, at an annual general meeting held during the period of investigation, resolutions were passed by shareholders who voted shares which, to their knowledge, had previously been sold. He considered it "most unsatisfactory". The people involved might have been in the wrong, but the culprit is the law: the law has not caught up with the times and does not clearly provide who is entitled to receive notice of meetings, attend meetings or vote.

7.22 The Companies Ordinance carefully stipulates periods of notice, e.g. 21 days' notice for annual general meetings. But who is entitled to this notice: shareholders on the register as at the date of meeting or as at the date of dispatch of notice? Obviously, the entitlement to notice cannot be determined by the date of the meeting. If the entitlement is determined by reference to the date of dispatch, those who become shareholders after that date cannot complain of lack of notice. But are they entitled to attend and vote? If not, there will be the phenomenon of former shareholders voting shares that they had sold.

7.23 The law currently solves these problems by providing for the closure of the register for up to 60 days (s. 99). During this period, of which advance notice is required, presumably the company can catch up on registration of transfers so that notices can be given to, votes accepted from and dividends distributed to those on the frozen register. It would then be for the registered shareholders to sort out their respective rights with their purchasers. The company can only and must accept votes from those on the register. It is for this reason that the "most unsatisfactory" practice observed is not unlawful. However, the law is unsatisfactory for a number of reasons.

7.24 First, the closure of the register impedes transactions.

Secondly, the current system allows persons who have no interests in the company to vote. Although that person may be liable to the beneficial owner, the injury that may be done is to the corporate body as well as to the beneficial owner. The corporate injury cannot be compensated for by the beneficial owner's cause of action.

Thirdly, it has been reported that in fact registers are not closed, no doubt because closure is an unbearable impediment. However, this means that the law and practice are divergent. As a consequence, the advance notice stipulated by the S.E.H.K. is not triggered and parties might not be given advance notice of the dates on which events affecting their rights may occur.

7.25 In North America, the closure of the register has been replaced by the designation of record dates. As the register is never closed, registrations of transfers can take place throughout the year. With the use of computers, it is easy to determine entitlements by reference to the state of the register as at the "record date". Directors are empowered to fix "record dates" for the payment of dividends and the issue of notices of meetings. Time limits are placed and advance notices of record dates are required. It is expressly provided that notice of meetings is not required to be given to one not on the register as of the record date for the issue of notices of meetings but that his right to vote is not prejudiced. To ensure that voters approximate those with interests in the company as closely as practicable, a separate provision governs the voters list. A voters' list is made up firstly from the list of shareholders entitled to receive notice. Transferees subsequent to that list can, on proof of ownership, demand to be placed on the voters' list up to a certain date before the meeting.

7.26 It is noted that the final part of the Canadian provisions relating to the voters' list is a departure from the rule of non-recognition of trusts. An alternative solution would be to require expeditious registration of transfers. The S.E.H.K. currently requires standard registrations to be completed in less than 10 business days and expedited registrations within three to six business days to be available on payment of additional fees (Listing Rules, App. 7A, para. 26).

The Consultants' Recommendations

7.27 The Consultants did not discuss this issue.

Conclusions

7.28 We believe that the law should reflect the needs and practice of today's market and recommend introducing the concept of "record dates" for the payment of dividends and the issue of notices of meetings. Further, a date before the date of the meeting should be declared the record date for voting purposes and a strict time-limit (10 business days) should be stipulated for the completion of transfers of shares of public companies.

Recommendation 85: The Committee recommends that provisions be made for the concept of "record dates" for the payment of dividends, issue of notices of meetings and voting purposes.
Recommendation 86: The Committee recommends that a strict time-limit (10 business days) should be stipulated for the completion of transfers of shares of public companies.

Proxies

Analysis of existing law

7.29 At common law, management has a right and duty to solicit proxies at the company's expense.

7.30 The Companies Ordinance requires management to issue proxies to all shareholders, if they are issued at all. The form must be a two-way form and must allow for instructions for each resolution pertaining to special business (s. 114C).

7.31 The law is neutral on proxy solicitations by shareholders. It does not assist or prohibit such solicitations.

7.32 From the perspective of management solicitation, the law is lax. For instance, it does not prescribe disclosure and there is no liability provision for any disclosure. From the perspectives of shareholder solicitation, the law again is lax in that it does not prescribe disclosure. At the same time, it impedes shareholder solicitation in that shareholders have no meaningful access to a shareholder list where the shares are registered in the name of Central Clearing and Settlement System (C.C.A.S.S.) or its nominee.

7.33 Liability provisions for proxy solicitations, whether by management or shareholder, are important because the common law of misrepresentation is ill-suited to penalize misleading proxy materials. To be actionable at common law, a misrepresentation must have been made by someone with a duty of care, the representee must have relied on it and thereby suffered loss. A shareholder may be able to establish a duty of care, but may not be able to establish reliance; a shareholder with the prescience to complain may not have been misled. Even if he himself had been misled, his complaint embraces more than his own reliance because his votes would not have been determinative of the outcome of the meeting. His complaint is principally that other shareholders had been misled. This complaint is not embraced by the law of misrepresentation. Thus, without statutory liability provisions, there would be little or no sanctions exercisable against misleading proxy solicitations. In addition, statutory remedies would be required for the same reason. Although the US courts have fashioned a remedy in damages, the Canadians opted for injunctions, rectifications, adjournments, fines and imprisonment as sanctions.

7.34 The underdevelopment of the law is no doubt due to the lack of demand. However, with the anticipated growth in pension funds, consideration should be given to formulating a proper proxy regime in company law. This will enable institutional investors effectively to exercise their collective voices which would be useful in improving corporate governance.

Consultants' Recommendations

7.35 The Consultants did not discuss this issue.

Recommendation 87: The Committee recommends that provisions for a proxy system be further considered.

The Central Clearing And Settlement System (C.C.A.S.S.)

7.36 The introduction of C.C.A.S.S. has disrupted all the provisions in the Companies Ordinance for corporate democracy. In view of the proposals to overhaul the market structure in the near future, however, it would not be useful to study the issue at this time which should be placed on the Committee’s agenda after the completion of the market restructuring.

Recommendation 88: The Committee recommends that the impact of the C.C.A.S.S. on corporate democracy be further considered after the completion of the market restructuring.

One share one vote

Analysis of existing law

7.37 Hong Kong company law provides for the most flexible capital structure possible: there are no prescriptions in the law. Incorporators may provide in their memorandum of association any capital structure they wish, including supra-voting rights for any class of shares and non-voting ordinary shares. The Companies Ordinance only stipulates that, unless the articles of the company otherwise provide, every shareholder shall have one vote in respect of each share or each $100 of stock (s. 114A (1) (e)) and that non-voting ordinary shares should be labelled as such (s. 57A (1)).

The Consultants’ Recommendation

7.38 The Consultants recommended that unless otherwise provided by the constitution, one share should be entitled to one vote (Recommendation 7.05).

7.39 No reasons were given.

7.40 We note that no changes are proposed.

Recommendation 89: The Committee recommends that Recommendation 7.05 be accepted.

Restraints on controlling shareholders' voting

Analysis of existing law

7.41 First, the state of the law is confusing. For example, the case law still contains the following propositions without clear guidance as to which is applicable to what, when or why:

(1) When a shareholder is voting for or against a particular resolution he is voting as a person owing no fiduciary duty to the company and who is exercising his own right of property, to vote as he thinks fit (*Northern Counties Securities v. Jackson*).

(2) Plainly there must be some limit to the power of the majority to pass resolutions which they believe to be in the best interests of the company and yet remain immune from interference by the courts (*Estmanco v. Greater London Council*).

(3) But their Lordships do not think that there is any real difficulty in combining the principle that while usually a holder of shares or debentures may vote as his interests direct, he is subject to the further principle that where his vote is conferred on him as a member of a class he must conform to the interest of the class itself when seeking to exercise the power conferred on him in his capacity of being a member (*British American Nickel v. O'Brien*).

7.42 Secondly, the law leaves the minority extremely vulnerable. The following examines voting in three contexts.

Dealing with corporate assets

7.43 The state of the law can be revealed in three representative cases: *North-West Transportation Company v. Beatty*, *Menier v. Hooper's Telegraph Works* and *Alexander v. Automatic Telephone Company.*

In *Beatty*, minority shareholders sued in respect of a sale by a director/shareholder of his vessel to the company. The sale was approved by a majority of shareholders by 306 to 289. The majority was secured principally by the votes of the vendor director and his associates voting as shareholders. Their right to vote and bind the minority was upheld.

In *Menier v. Hooper's Telegraph*, minority action was allowed to pursue a charge that interested majority shareholders voted to settle an action by the company on terms favourable to themselves. The more well-known case in this line is *Cook v. Deeks* in which directors while acting as such negotiated a contract with Canadian Pacific Railway Company for the construction of a new line. On the successful conclusion of negotiations, they claimed the contract for themselves and voted as shareholders to abandon the company's claims to it. Minority action was allowed and successful.

In *Alexander*, minority action was allowed against directors who allotted and issued shares to themselves without requiring any payment, whilst requiring payment from other shareholders. The directors also had control of the majority of the votes of the shareholders.

7.44 Why did the controlling shareholder's vote count in the first case but not in the next two cases? Gower finds the distinction in "expropriation of corporate property with actual dishonesty". To allow the controlling shareholder to vote in such cases to approve or to forgive is to perpetuate a fraud on the minority. Thus, to protect the minority, the majority is deprived of the power to take the decision. This distinction is borne out by the cases. For instance, in the major cases applying *Beatty*, *Menier* was distinguished as a misappropriation of corporate assets case. In *Cook v. Deeks*, *Beatty* and its line of cases were distinguished as contracting with the company cases: the company had no prior right to the property concerned and must accept the terms on which they were sold to them or not at all. They could not retain the property and recover part of the price. *Alexander* can be considered a taking of corporate assets case. In other words, the controlling shareholder may vote in favour of a self-dealing but not in favour of an expropriation.

7.45 It must be questioned whether such a distinction is tenable today. Is there not an expropriation element in every unfair self-dealing? Why should the controlling shareholder's ability to vote depend upon his ingenuity in casting the transaction in the appropriate form? Even English courts do not consistently adhere to such distinctions without a difference. They have held that a purchase by the company from the majority at overvalue and a sale of corporate assets to the majority at gross undervalue cannot be approved by the majority.

7.46 An alternative distinction may be bona fides. If the director receives payment bona fide paid as remuneration, he, as a shareholder, may vote as he pleases to approve the payment. The court will not intervene. However, more recently, the court has held:

> Plainly there must be some limit to the power of the majority to pass resolutions which they believe to be in the best interests of the company and yet remain immune from interference by the court (*Estmanco*).

7.47 Thus, the controlling shareholder is under some constraints under certain circumstances. However, it is not clear what those circumstances are and what those constraints are. All depends on a finding of "abuse" by the court.

Dealing with minority's property

7.48 If there is a pre-existing right in shareholders to take certain actions in relation to the rights of shareholders, then controlling shareholders may vote selfishly. Thus, where the company's articles gave powers to shareholders to require any shareholder to sell his shares at a price fixed by a special resolution, the shareholder so required cannot complain of the price or mala fides; the others were merely exercising their contractual rights.

7.49 If there is no pre-existing right, the voting of controlling shareholders is subject to some restraint. Even though there are cases that appear to prohibit the majority from expropriating the property of the minority, Gower's conclusion is that there is no prohibition, but the decision of the majority is subject to judicial review "and it is in fact unclear how far the majority must here consider the interests of the company" (p. 709). The following are some representative cases.

7.50 In *Allen v. Gold Reefs of West Africa Limited,* the company altered its articles to create liens on fully-paid shares at a time when there was only one shareholder who had fully-paid shares and who was feared to be insolvent. By a majority of two to one, the English Court of Appeal upheld the alteration on the ground that "the shareholders were acting in the truest and best interests of the company".

In *Sidebottom v. Kershaw Leese and Company Limited*, the company had issued 7,620 shares of which 4,396 were held by the directors and 711 by the plaintiff. The directors as shareholders secured an amendment to the articles of association giving themselves powers to require any shareholder who carried on a competing business to transfer his shares at a fair value to such person(s) as the directors may direct. The plaintiff objected to the validity of the resolution. The secretary denied that the alteration was directed against the plaintiff, but admitted that it was directed against another shareholder holding 70 shares. The English Court of Appeal upheld the alteration on the grounds that it was bona fide for the benefit of the company.

In *Greenhalgh v. Arderne Cinemas Ltd.* the company's articles had a pre-emption provision requiring an outgoing shareholder first to offer his shares to the other shareholders. The controlling shareholders secured an alteration exempting any shareholder whose transfer is approved by an ordinary resolution. The English Court of Appeal upheld the alteration on the grounds that there was no expropriation by the controlling shareholder and the resolution was passed bona fide for the benefit of the company.

7.51 It has been pointed out that relief in cases such as *Greenhalgh* could now be obtained under the unfair prejudice remedy. Again, all depends on a finding of "abuse" by the court.

Transactional relief of directors' duties or liabilities

7.52 Controlling shareholders may freely vote to relieve themselves of liability as directors for negligence and of liability for breach of fiduciary duties. They may not ratify dishonesty or expropriation of corporate assets, but self-dealing is not expropriation.

The way forward

The need for reform

7.53 Some may argue that there is no need for reform because, firstly, as noted, some of the above cases can be cured by the unfair prejudice remedy. Secondly, although the law is confusing, there is a concept of "abuse" of majority voting rights which can be employed to give relief by way of derivative action.

7.54 These arguments are not valid because firstly, the unfair prejudice remedy is, as a practical matter, often not available in fact to shareholders of public companies. Their only remedy is the derivative action. It will be seen that the law of derivative action is unsatisfactory both to the majority because of its costliness and to the minority because of its ineffectiveness. As long ago as 1957, Lord Wedderburn had noted that the question of the *Foss v. Harbottle* rule is really a question of the limits of majority rule. Until the case law maps out clear and predictable boundaries of majority rule, grievances must continue to be litigated on an individual, ad hoc and protracted basis. Remedies will continue to be expensive and unattainable. Thus, reform is needed.

Clear restraints on controlling shareholders' vote

7.55 The principled way forward is to require the controlling shareholder to abstain from voting on transactions in which he is interested.

7.56 There are at least three reasons why such a rule is desirable as to public companies. First, to allow an interested director to vote qua shareholder is an aberration of the law and is objectionable even in England and the U.S. where shareholdings are dispersed. Professor Parkinson writing on English law stated:

> But the result of counting the votes of the interested directors is to render the consent process useless in those cases in which the directors are able to affect the outcome. It becomes a pointless formality, inevitably producing the same result as the original board decision. Instead of the directors being required to satisfy an independent body within the company that the transaction is fair, the onus is thrown back onto an objecting shareholder to demonstrate to the court that it is unfair, the problems associated with which the fiduciary principle is expressly designed to avoid (p. 216).

In the U.S., these conflicts are solved by imposing on controlling shareholders fiduciary obligations in certain circumstances, because any other law would render the duties imposed on directors meaningless:

> Ordinarily the director speaks for and determines the policy of the corporation. When the majority of stockholders do this, they are, for the moment, the corporation. Unless the majority in such case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds (*Greene v. Dunhill*).

The case is much more compelling in Hong Kong. Given the capital structure of our public companies, the lack of effective restraints over controlling shareholders reflects adversely on the law on directors' duties and the whole debate on corporate governance.

7.57 Secondly, an abstention rule is relatively clear and easy to enforce as compared to the current concept of abuse. Thus, it would reduce both the incidence of litigation and litigation costs. It would reduce the incidence of litigation because it would be relatively clear whether the controlling shareholder had complied with the law. Clearly, given the disposition of the law and the community towards majority rule, if a disinterested majority of the minority approves of transactions in which the controlling shareholder is interested, the minority of that minority has no cause for complaint and would know it. Where litigation occurs, it would probably occur over questions of disclosure and the interests of controlling shareholder, but it need not deal with the additional difficult question of "abuse" of voting powers by the controlling shareholder.

7.58 Thirdly, an abstention rule appeals to the ordinary sense of fairness that one should not be the judge in one's own cause. It is the standard already adopted in the Listing Rules, the non-legal codes administered by the S.F.C. and sporadically in the Companies Ordinance (e.g. s. 163D (4) (c)).

7.59 Accordingly, it is submitted that as a matter of principle, the controlling shareholder should abstain from voting on a transaction in which he has an interest different from that of other shareholders.

7.60 Is there any reason why this principle should not be applied in Hong Kong? Arguments may be founded on practicalities. It must be acknowledged that Hong Kong is very small and controlling shareholders have many business interests so that self-dealing is frequent and even inevitable. Putting these transactions to a vote by disinterested minority shareholders would increase costs and may abort the transaction. The fear of abortion is overstated. There is no reason to assume that minority shareholders would irrationally reject a fair deal for the company in order to spite the controlling shareholders. Costs, monetary and time, are a concern. To accommodate these concerns, it is not necessary to reject the principle of abstention. All that is needed is to ensure that adequate exceptions are available, such as exceptions for immaterial transactions, transactions in the ordinary course of business on arm's-length terms etc.

7.61 It should be noted that it is not suggested that the Listing Rules should be the blue-print for the law. Rather, the law should set out the principle and exceptions in broad terms and provide that compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law.

7.62 As for private companies, costs of meetings are less of a problem, but there may be resistance on the ground that the "junior partner" knows that the "senior partner" has outside interests and accepts self-dealing on his part. If the consent is real, there is no reason for the law to interfere. One way to ensure that consent is real is to make minority shareholder approval the default rule which may be altered by shareholder agreement.

7.63 In summary, transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting; adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's-length terms; compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law; private companies may include exemptions in their articles.

The Consultants' Recommendations

7.64 The Consultants did not discuss any of the above issues.

Conclusion

7.65 As the issue is important and sensitive, and has not been presented for consultation, further study and consultation are required.

Recommendation 90: The Committee recommends that the following principles should be subject to further study : transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting; adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's-length terms; compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law; private companies may include exemptions in their articles.

Access to records

Analysis of existing law

7.66 A shareholder is entitled to inspect the following records free of charge or on payment of relatively small sums: memorandum and articles of association and resolutions required to be registered (s. 26), register of directors (s. 158 (7)), register of shareholders (s. 98 (1), (2)) and minutes of shareholder proceedings (s. 120 (1), (2)). All of these except minutes of shareholders' meetings are open to the public for inspection also. In other words, a shareholder has very few rights to inspect the records of his company. This state of the law sits oddly with the concept of shareholder supremacy.

7.67 An argument against giving shareholders unlimited access is that, in the case of public companies, shareholder access may be harmful in disrupting the management and exposing commercial secrets. However, that argument can only support limiting but not denying access.

7.68 In the U.S., records are divided into two categories. One category is available on notice with no questions asked. This category is similar to records available to shareholders under Hong Kong law. The other category which includes minutes of directors' meetings and accounting records and the record of shareholders are available to a shareholder if:

(a) his demand is made in good faith and for a proper purpose;
(b) he describes his purpose and the records he desires to inspect, and
(c) the records are directly connected with his purpose (R.M.B.C.A, s. 16.02).

In Japan, shareholders holding more than 10 per cent of the company's stock can examine and copy the company's books and records (Lu).

7.69 In Hong Kong, access to corporate records by institutional shareholders would have a sobering effect on corporate controllers and is desirable from that point of view. However, as this issue has not been much debated, further study and consultation are needed.

Recommendation 91: The Committee recommends that the issue of access to corporate records be studied.

Personal rights of shareholders

7.70 Reform of the constraints of the controlling shareholder's right to vote on interested transactions will go a long way towards resolving the question of exceptions to the *Foss v. Harbottle* rule. However, there remains the question of personal rights and their actionability by a shareholder. It is proposed to examine this question under two headings: procedural rights and financial rights.

Procedural rights

Analysis of existing law

7.71 As will be noted in the next chapter, whether a shareholder may complain of procedural irregularities is a matter of uncertainty (see para. 8.35 below). On the one hand, there is an abundance of cases in which shareholders were allowed to proceed with their actions for irregularities, largely without comment on the *Foss v. Harbottle* rule. On the other hand, there are cases denying them such a right. Of these, two merit closer investigation.

7.72 In *Browne v. La Trinidad*, a meeting of directors summoned on short notice resolved to convene an extraordinary meeting to remove B from the office of director. B sued for an injunction to restrain the holding of the meeting and failed. Lindley L.J. stated:

> ...it is most important that the Court should hold fast to the rule upon which it has always acted, not to interfere for the purpose of forcing companies to conduct their business according to the strictest rules, where the irregularity complained of can be set right at any moment (p. 7).

7.73 In *MacDougall v. Gardiner*, shareholders sued in these circumstances. A meeting was convened on the requisition of the plaintiffs for the purpose of requesting one G (the Chairman of the Board) to resign his directorship. The plaintiffs held proxies of 15,000 shares, while the defendant directors held less than half of that number. However, the defendants had more persons attending so that on a show of hands, the plaintiffs would have been defeated. G was absent and one H chaired the meeting; he urged an adjournment of the meeting which was passed by a show of hands. The plaintiffs demanded a poll which was refused by the chairman who then left. The plaintiffs continued with the meeting and secured the passing of resolutions removing G as director and appointing another in his place. The plaintiffs then learnt that the directors were about to enter into an injurious transaction. They alleged that there was no time to convene another meeting and that the defendants would sabotage the second meeting by an enforced adjournment. They sought: (a) a declaration that the adjournment approved on a show of hands was illegal; (b) an injunction to restrain the directors from proceeding with the disputed transaction without shareholder approval; (c) a declaration that G had ceased to be a director, and (d) that a meeting of shareholders be summoned to consider the plaintiffs' proposals. They failed.

7.74 Considering the facts of the case, the decision is supportable today. As to the injunction restraining the directors from proceeding with a certain transaction, Baggallay J.A. was sceptical of the injury complained of and pointed out that the directors had full powers to manage; there was no basis for shareholder intervention. This was the spirit that germinated the directorial autonomy rule which constituted the substantive law for a long time and the court could not be faulted for the ruling. As to the declaration that G had ceased to be a director, the plaintiffs were in the wrong. Assuming that the adjournment was improper, the plaintiffs' conduct after the departure was also improper. Seeing that the notice of the meeting called for a resolution requesting the chairman to resign, the meeting had no power to dismiss him. Therefore, whether the adjournment by the chairman was proper was academic. As to the convening of a new meeting, the court should not convene meetings where it is within the power of the shareholders themselves to convene one. As to the urgency, the time lag between the filing of the petition and the hearing of the action was considerable, certainly long enough for the convening of a meeting.

7.75 Unfortunately, only Bagglay, J.A. examined the facts in any detail. Both Mellish L.J. and James L.J. spoke in generalities. Mellish L.J. stated:

> Looking to the nature of these companies, looking at the way in which their articles are formed, and that they are not all lawyers who attend these meetings, nothing can be more likely than that there should be something more or less irregular done at them--some directors may have been irregularly appointed, some directors as irregularly turned out, or something or other may have been done which ought not to have been done according to the proper construction of the articles. Now, if that gives a right to every member of the company to file a bill to have the question decided, then if there happens to be one cantankerous member, or one member who loves litigation, everything of this kind will be litigated; whereas, if the bill must be filed in the names of the company, then, unless there is a majority who really wish for litigation, the litigation will not go on. Therefore, holding that such suits must be brought in the name of the company does certainly greatly tend to stop litigation. In my opinion, if the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the

> company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having a litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes (p. 25).

7.76 It is the above speech that has spawned the procedural irregularity line of cases which has plagued the derivative action. Although the rhetoric of Mellish L.J. and James L.J. was not necessary for the decision in *MacDougall*, their sentiments obviously had resonance. Were they right? Their disregard of procedural irregularities was based on a certain view of shareholder democracy:

> I cannot conceive that there is any equity on the part of a shareholder, on behalf of himself and the minority, to say, "True it is that the majority have a right to determine everything connected with the management of the company, but then we have a right--and every individual has a right--to have a meeting held in strict form in accordance with the articles." Has a particular individual the right to have it for the purpose of using his power of eloquence to induce the others to listen to him and to take his view? That is an equity which I have never yet heard of in this Court, and I have never known it insisted upon before; that is to say, that this Court is to entertain a bill for the purpose of enabling one particular member of the company to have an opportunity of expressing his opinions *viva voce* at a meeting of the shareholders. If so, I do not know why we should not go further, and say, not only must the meeting be held, but the shareholders must stay there to listen to him and to be convinced by him (p. 23).

7.77 Twenty-three years later, a differently constituted Court of Appeal expressed different views. Lindley, M.R., citing Lord Eldon in *Const v. Harris*, stated:

> For a majority of partners to say, we do not care what one partner may say, we being the majority, will do what we please, is, I apprehend, what this Court will not allow.

The result is two lines of irreconcilable cases.

The way forward

7.78 The Law Commission (England) decided against making any recommendations in relation to personal actions, being of the view that "no hardship" was being caused by any difficulty in identifying actionable irregularities (para. 7.8). The decision has been roundly criticized.

7.79 The first step towards reform would be to choose between the two versions of shareholder democracy. There is little doubt that today, James L.J.'s views have little appeal. The picture painted there is not one of majority rule, but majority dictatorship. The principle of majority rule requires a forum at which the wishes of the majority can be properly ascertained. A shareholder submits to the majority on such a basis and must have the right to have proceedings conducted according to the company's constitution and the law. Thus, the propositions of Professor Sealy and Lord Wedderburn should be the starting premise: "it ought to be the law that any unconstitutional or illegal action on the part of the controllers of a company is a breach of the membership contract, and thus a wrong to every member, quite as much a wrong to the company"; "each member has a prima facie right to enforce by injunction and declaration 'in aid of his legal right', *every* provision of the contract in the articles".

7.80 Would such a principle subvert the principle of majority rule or open the proverbial floodgates?

7.81 The personal right itself is subject to majority rule provided in the constitution. So, e.g. if the notice of an extraordinary general meeting is short of the 14 days' (or longer) notice, any shareholder has a right to object, unless short notice has been approved by 95 per cent of the shares. Therefore, majority rule is not threatened.

7.82 Fears of liability or floodgates are unfounded. This is because of the limitation on remedies. In most cases, the plaintiff would be confined to declarations and injunctions. If he obtains damages, it would only be damages for his personal loss which may be insignificant. Given the costs of litigation and the liability for costs, it is unlikely that multitudes of shareholders would commence frivolous actions.

7.83 Finally, recognizing a personal right to enforce the constitution does not preclude the sensible results of *Browne v. La Trinidad* and *MacDougall v. Gardiner.* The futility of a court order in *MacDougall v. Gardiner* has been noted. In *Browne v. La Trinidad*, the matter at issue was the shareholders' vote to remove directors. Here, the majority is clearly not and should not be under any constraints. If an injunction were granted, the determined majority can simply convene another meeting to remove the plaintiff. The breaches in both cases were of no consequence; remedies would similarly be inconsequential. The principle that equity does nothing in vain is enough to dispose of those cases.

Financial rights

7.84 As to the financial rights of a shareholder, standing has not been a problem. He has been allowed to litigate on the merits (see para. 8.36 below). That being the case, the reforms proposed earlier to restrain the controlling shareholder and improve the system of judicial review where required should be adequate.

Conclusions

7.85 We believe that every shareholder should have a personal right to have the constitution observed.

Recommendation 92: The Committee recommends that the law should be amended to give every shareholder a personal right to sue to enforce the terms of the Memorandum and Articles of Association.

Chapter 8

Shareholder Remedies

8.1 This Chapter examines the remedies available to shareholders in the event of violation of their rights or the rights of the company. The remedies are essentially, though not exclusively, about minority shareholder protection.

Just and equitable winding-up

Analysis of existing law

8.2 Section 177 (1) (f) of the Companies Ordinance provides that the company or a shareholder may apply to the court to wind up the company on the ground that it is "just and equitable" so to do. The just and equitable winding-up remedy can be traced to the Companies Act 1862. The leading case, *Ebrahimi v Westbourne Galleries Ltd* established that the court may consider the rights, expectations and obligations of the parties that exist over and above their legal rights as shareholders. The remedy often applies where one or probably more of the following elements are present:

> (i) an association formed or continued on the basis of a personal relationship, involving mutual confidence - this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all, or some (for there may be "sleeping" members), of the shareholders shall participate in the conduct of the business; (iii) restriction upon the transfer of the members' interests in the company - so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.

Applications have succeeded on these grounds: loss of substratum of the company, exclusion from management, a break-down of a quasi-partnership relationship not caused by the misconduct of the petitioner himself and a justifiable loss of confidence in the management.

8.3 It should be clear from the above that the remedy is mainly for private companies. Not only would it be difficult for shareholders of a public company to establish any understanding about the conduct of business of the company, there is an additional bar in that there is a market at which they can sell, at a reasonable price, without the assistance of the court.

8.4 For public companies, the winding-up remedy is available on application by the S.F.C. when it finds it expedient in the public interest so to do (Securities and Futures Commission Ordinance, s. 45 which incidentally applies to all companies).

The Consultants' Recommendations

8.5 The Consultants recommended retaining the remedy, but that the court should be given the option of making any other order it sees fit, and the remedy should be dissociated from consequences of insolvency procedures such as the freezing of bank accounts (Recommendation 7.11).

8.6 The Consultants advanced two reasons: (1) the remedy is entrenched and should be retained; (2) the court needs discretion to grant other remedies to discourage opportunistic shareholders from using the remedy as blackmail.

8.7 We believe the law is sound and there is no need for alternative remedies as the court has jurisdiction under other provisions. Respondents further pointed out that "the freezing of bank accounts is important for the protection of shareholders and creditors, especially when there is an allegation of dishonesty, misfeasance or misappropriation of funds". All agreed to the retention of the remedy.

Recommendation 93: The Committee recommends that the changes recommended in Recommendation 7.11 of the Consultants' Report be rejected.

Unfair prejudice (private companies)

8.8 Although by its terms the unfair prejudicial remedy is not limited to private companies, there are inherent difficulties in its application to public companies. This will be dealt with in a separate section below.

Analysis of existing law

The remedy

8.9 The most important remedy for minority shareholder protection is the unfair prejudice remedy. It can be traced to section 210 of the Companies Act 1948 which provided a remedy, short of liquidation, for oppression.

The stringent requirements for an oppression remedy diminished its utility and the Jenkins Committee recommended changing it to the present form.

8.10 Section 168A provides that if -

> ...on any petition under this section the court is of opinion that the company's affairs are being or have been conducted in a manner unfairly prejudicial to the interests of the members generally or of some part of the members, whether or not such conduct consists of an isolated act or a series of acts, the court may, with a view to bringing to an end the matters complained of, [make certain orders].

The remedies are: injunctions, derivative actions, receiverships, buy-outs and other orders as the court thinks fit.

8.11 In determining whether there has been unfair prejudice, the court considers not only the shareholder's legal rights but also his interests or legitimate expectations. In England, a want of probity is not necessary though relevant.

English proposals

8.12 The Law Commission (England) believes that unfair prejudice proceedings are "costly and cumbersome. Unfair prejudice cases which go to trial often last weeks rather than days, and the costs of the litigation can be substantial" (*Shareholder Remedies*). The Commission conducted a consultation on the introduction of a simpler action for smaller companies. Respondents who objected to a new remedy pointed to the duplication and complication that would result. In the end, the Commission recommended retaining the unfair prejudice remedy subject to two statutory presumptions applicable to private companies: (1) where a shareholder has been excluded from participation in the management of the company, the conduct will be presumed to be unfairly prejudicial by reason of the exclusion; and (2) if the presumption is not rebutted and the court is satisfied that it ought to order a buy-out of the petitioner's shares, it should do so on a *pro rata* basis (paras. 3.30, 3.53 above).

The Consultants' Recommendations

8.13 The Consultants recommended the retention of the remedy, but to extend the scope of persons protected to include (a) beneficial owners, former owners (legal and beneficial) of securities of the company or any of its affiliates; (b) any director or officer or former director or executive officer; (c) the Financial Secretary. The scope of conduct should be broadened to include “conduct that is oppressive, unfairly prejudicial to or that unfairly disregards the interests of any security holder, director or officer” (Recommendation 7.09).

8.14 The reasons advanced consisted of a description of the history of the remedy and its expansion in Canada.

8.15 The weight of opinion of respondents is against the recommendation. To give the remedy to beneficial shareholders would violate the principle that the company does not recognize trusts. Incidentally, the term “security holders” indicate a wider scope - debt security holders would be included. This would violate the principle that debt holders have contractual rights and no more. To give the remedy to directors and others would change the concept of a company and bring in the stakeholder theory. Finally, “the fact that little abuse has been observed under the Canadian system...does not mean that scope for abuse does not exist”.

8.16 As the law is fundamentally sound, there is no reason to adopt the recommendation. Naturally, there will be continued watch to improve the remedy incrementally.

Recommendation 94: The Committee recommends that Recommendation 7.09 of the Consultants’ Report be rejected.

Appraisals

The Consultants’ Recommendations

8.17 As will be discussed in detail in the next chapter, the Consultants recommended introducing an extended appraisal remedy applicable to all companies (Recommendation 7.12).

The Consultants further recommended that for private companies there should be introduced as optional items:

(a) a standard form buy-sell and buy-back provision to permit shareholders to leave;
(b) recourse to mediation or arbitration to resolve disputes (Recommendation 10.05).

8.18 The Consultants offered these reasons:

(1) these corporations could benefit from streamlined constitutional documents that permitted minimal drafting efforts (and which could provide ready-made minority protections and dispute resolution mechanisms).

8.19 As will be noted, the appraisal remedy is not necessarily cheap and problem-free. Where the remedy is invoked on the grounds of some fault on the part of the controllers, it does not add much to the unfair prejudice remedy.

8.20 The questions whether company law should facilitate no-fault exit at will on the part of one shareholder against the will of the other(s), and whether a standard form buy-sell and buy-back provision is desirable has been examined in the chapter on the public versus private companies and been rejected (see paras. 5.55-5.56 above). The concept of arbitration has also been examined and rejected (see paras. 5.57-5.60 above).

Unfair prejudice (public companies)

Analysis of the law

Shareholder as complainant

8.21 Notwithstanding the recommendation of the Cohen Committee, the oppression remedy was not and now the unfair prejudice remedy is not limited by its terms to private companies. However, by its nature the remedy cannot be readily applied to public companies for at least two reasons: the conduct complained of is not sufficient and the complainant has alternative remedies.

8.22 The conduct complained of may not be sufficient to support an unfair prejudice claim. As noted above, the court considers the legitimate expectations and interests of the shareholders beyond their legal rights. Legitimate expectations arise out of understandings as to the affairs of the company which are not put in contractual form. The most common one is the expectation to participate in management. It is rare that a public shareholder could establish any expectations beyond his legal rights as shareholder, as *prima facie*, the position of all shareholders is the same. Even if he could, the expectations would be illegitimate: “there is in these circumstances no room for any legitimate expectations founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the [market]" (*Re Blue Arrow plc.*). Therefore, the only conduct the shareholder can complain of is a violation of rights.

8.23 Can unlawful conduct alone support an unfair prejudice proceeding? There is some uncertainty. One view holds that although unlawful conduct may be relied on, it is not the essential factor in unfair prejudice proceedings and, if there is nothing more than unlawful conduct, it would not be right for the shareholder to outflank the *Foss v. Harbottle* rule (see para. 8.31 below) by proceeding in unfair prejudice instead. Given the existence of such a view, we cannot place too much reliance on the unfair proceeding remedy in the design of shareholder remedies for public companies.

8.24 The shareholder may perhaps be able to complain of a personal wrong. In this case, as there is no question of circumventing the *Foss v. Harbottle* rule, there is no policy reason against allowing the shareholder to proceed in unfair prejudice.

8.25 Overall, while there are rare instances of successful claims, it would be extremely difficult for a shareholder to succeed in establishing qualifying conduct for an unfair prejudice remedy.

8.26 Even if the complaining public investor can establish offending conduct, his power to sell on the public market may be a bar to success. Again, there can be exceptions particularly if the wrong has already been occasioned.

S.F.C. as complainant

8.27 Since July 1994 the S.F.C. may bring an application for relief if it appears that the affairs of a listed company are being or have been conducted in a manner unfairly prejudicial to the interests of its members generally or of some part of the members (Securities and Futures Commission Ordinance, s. 37A). Conduct prior to July 1994 may constitute unfair prejudice. The position of the public shareholder is improved by this provision in that the problem of collective action is overcome and the intervention of the S.F.C. may persuade the court that there is no exit for shareholders. However, there is no extension of the scope of conduct that may be complained of. That is to say, if the S.F.C. can only complain of unlawful conduct, it may not be sufficient to found unfair prejudice.

8.28 In summary, the unfair prejudice remedy is of little utility to the public investor.

The Consultants' Recommendations

8.29 The Consultants did not discuss the issue.

Conclusions

8.30 We do not recommend that any change to the unfair prejudicial remedy be made in relation to public companies as such. However, its inutility must be borne in mind in examining other remedies, in particular the derivative action.

Derivative actions

Analysis of existing law

The Foss v. Harbottle *rule*

8.31 The *Foss v. Harbottle* case stands for the proposition that for an injury done to a company, the company is the proper plaintiff. This rule is unexceptional. However, there must be some exceptions to the rule. Otherwise, if the wrong is done by the controllers of the company who would not allow the company to sue themselves, minority shareholders will be left without any remedy.

8.32 Under the exception, a minority shareholder commences an action in his own name (since he does not have the authority to use the corporate name) on behalf of himself and all shareholders other than the defendants. If he is suing for a corporate injury, this is a derivative action. A shareholder may well sue for personal injuries and may join with other shareholders in this suit. He then sues on behalf of himself and all shareholders other than the defendants. This is a personal action, but in form it is indistinguishable from the derivative action. The cases have not distinguished the two actions until recently. First, because of their similarity and secondly because it took, in the words of Professor Gower, "an inordinate time" before the real nature of derivative actions was recognized in the U.K. This has further confused the scope of the *Foss v. Harbottle* rule.

8.33 What then is the scope of the rule and its exceptions? One formulation of the rule states:

> First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is *prima facie* the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then *cadit quaestio*. No wrong had been done to the company or association and there is nothing in respect of which anyone can sue. If, on the other hand, a simple majority of members of the company or association is against what had been done, then there is no valid reason why the company or association itself should not sue (*Edwards v. Halliwell*).

8.34 The central question then is: is this conduct capable of ratification by the majority? As Lord Wedderburn states: "the limits of [the *Foss v. Harbottle*] Rule lie along the boundaries of majority rule" (p. 198). The courts' efforts in drawing these boundaries have not been satisfactory in that the boundaries are unclear and shareholders are inevitably "sent away with no answer, as often as not with a rebuke for troubling the court with his problem" (Sealy, Problems of Standing, Pleading and Proof in corporate litigation p. 2). The following is an account of the exceptions to the Rule and procedural problems of the action.

"Exception": Personal actions

8.35 Because until recently the courts have not distinguished personal actions and derivative actions, we have on the one hand successful actions without reasons and unsuccessful actions with "unreasoned assertion[s] that the only wrong done was a wrong to the corporation" (Sealy, p. 8). For instance, actions have been allowed to restrain the holding of a meeting or to challenge the validity of resolutions passed where the notice of meeting was defective; or to challenge the chairman's decisions as to votes and adjournments etc. On the other hand, there is the famous *MacDougall v. Gardiner* which has been interpreted as denying a shareholder's right to complain of procedural irregularities. Given that the memorandum and articles of association constitute a contract among the shareholders themselves and between the shareholders and the company, any such rule would be extraordinary. It prompted uncharacteristically strong words from

Professor Sealy. As long ago as 1957 Lord Wedderburn had suggested confining these to decided cases (p. 214).

8.36 In addition to procedural irregularities, a shareholder may complain of violation of his financial entitlements. Here, there is uncertainty despite the existence of cases holding that the majority cannot expropriate dividends or shares of the minority; there are other cases placing a lien on fully-paid shares, compelling a sale of shares, removing a right of pre-emption discriminately. These were justified on the basis that the majority when voting for these actions were acting bona fide for the benefit of the company.

Exception: ultra vires

8.37 An often cited exception to the *Foss v. Harbottle* rule is the *ultra vires* exception. It was not until 1986 that Knox J. clarified the nature of this "exception". Where a shareholder sues to restrain an *ultra vires* action, he is enforcing personal contractual rights to have the memorandum and articles of association observed. This is a personal action to which *Foss v. Harbottle* is not applicable. If he sues for damages for loss caused by the *ultra vires* act, this is a derivative action, since the loss is suffered by the company. In this case, if the action is allowed, it is allowed as an exception to the *Foss v. Harbottle* rule (*Smith v. Croft (No. 2)*).

Exception: special majority

8.38 The third exception stated in the English Court of Appeal is that the *Foss v. Harbottle* rule does not prevent an individual member from suing if the matter in respect of which he was suing was one which could validly be done or sanctioned only by some special majority. This again demonstrates confused thinking. It cannot be that whenever some act requires special majority approval, a shareholder may sue. It can only mean that the shareholder may sue if some act requires special majority approval and it was not given. This is a breach of procedural requirements and should be treated as any other procedural requirements.

Exception: justice

8.39 The *Foss v. Harbottle* case itself established an exception on the ground of justice:

> If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private character, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that the principle so forcibly laid down by Lord Cottenham in *Wallworth v. Holt* and other cases would apply, and the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue (p. 492).

However, the English Court of Appeal has rejected the exception as not "practical" (*Newman*). Professor Sealy has severely criticized this ruling and the judicial hostility it exemplified.

Exception: fraud on minority

8.40 The most important and only true exception to the *Foss v. Harbottle* rule is left to the last because it is the most complicated. It is said that "where what has been done amounts to what is generally called in these cases a fraud on the minority and the wrongdoers are themselves in control of the company" (*Edwards v. Halliwell*), the rule is relaxed to allow an action by the minority.

8.41 The very title of the exception is wrong and misleading. First, fraud does not mean fraud. Secondly, the "fraud" is not on the minority (which would have been a personal wrong) but on the company, and the minority is suing to protect the company.

8.42 Confusion over nomenclature carried through to confusion over substance. The state of the law can be revealed in three representative cases: *North-West Transportation Company v. Beatty*, *Menier v. Hooper's Telegraph Works*and *Alexander v. Automatic Telephone Company*, already examined in chapter 7. Lord Wedderburn found this "jangle of discordant cases" irreconcilable (p. 105). Professor Sealy referred to the well known difficulties of the "familiar but slippery expression, 'fraud on the minority' which have created "real confusion" nonpareil "encouraged and shared by the courts" (p. 10). These are strong words of condemnation from leading scholars.

Termination of action properly brought

8.43 Before *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)*, it was not thought possible that an action brought on a non-ratifiable wrong could be terminated. There, the English Court of Appeal held that the court should try as a preliminary issue whether the action should continue over the objections of the controlling persons. In making this decision, the court should consider not only the "exceptions" to the Rule but also whether, assuming a non-ratifiable wrong had been committed, it is in the interest of the company to pursue the matter. In *Prudential*, the court contrasted the loss caused by the directors' fraud (L45,000) with the costs of litigation (L750,000) and wondered whether there was not something to be said after all for the old fashion rule in *Foss v. Harbottle*.

8.44 But if a "properly brought" action can be prematurely terminated on the grounds that it does not pay, who has the power to decide? In *Prudential*, the English Court of Appeal reproved the trial judge for allowing the case to proceed because the board, "of which all the directors save one were disinterested, with the benefit of the Schroder-Harman report, had reached the conclusion before that of the action that the prosecution of the action was likely to do more harm than good" (p. 221). The only evidence of independence of directors that can be gleaned from the report is: only one of the two defendants was on the board at the commencement of the action and he did not take part in the decision to discontinue; there had been changes in the board membership between the time of the acts complained of and the action. There was no investigation or proof of "independence". Indeed, the Court of Appeal appeared to have placed the burden on the plaintiff to challenge the claim of disinterestedness. It is also noted that the report that the disinterested directors relied on was of so little importance to the court that nothing of its contents was mentioned in the judgment.

8.45 In *Smith v. Croft (No. 2)*, minority shareholders sued some directors, claiming that they had paid themselves excessive remuneration. The plaintiff held 11.86 per cent of the shares; the defendant held 62.54 per cent. The other significant shareholder, W. Ltd., held 19.66 per cent and was not under the control of either the plaintiff or the defendant. After preliminary hearings lasting 17 days, the court held that the action was within the exceptions to the *Foss v. Harbottle* rule, but that it was proper to have regard to the views of the independent shareholders. Since the independent shareholders, including W. Ltd., had voted to discontinue the action, the court struck out the statement of claim. The plaintiff challenged the "independence" of W. Ltd., but the court accepted its vote:

> Mr. Potts relied on evidence that showed that Wren Trust has been described as an associate of the executive directors. I accept that there is evidence that Wren Trust sided with the executive directors in the board room tussle that resulted in Mr. Garrett's resignation as a director of the company and could properly be described as associates in that context, and that there is evidence that Gresham Trust itself was involved in the share transactions leading up to Mr. Garrett's resignation. I nevertheless remain firmly of the view that there is no sufficient evidence that in relation to the present question whether these proceedings should continue Wren Trust has reached its conclusion on any grounds other than reasons genuinely thought to advance the company's interests. It is not for me to say whether the decision itself is right or wrong. It is for me to say whether the process by which it was reached can be impugned and I hold that it cannot. Nor do I consider that in the circumstances there is shown to have been a substantial risk of Wren Trust's vote having been cast in order to support the defendants as opposed to securing the benefit of the company (p. 189).

8.46 Gower observed that *Smith v. Croft (No. 2)* would have a "destructive impact" upon the derivative action (p. 674). Professor Sealy observed that company had been brought to this level of absurdity by the ill-considered decision in *Prudential*. Professor Prentice thought that time had probably come for legislative intervention.

Costs

8.47 Assuming a minority shareholder surmounts all obstacles and is allowed to proceed with a derivative action, he is faced with the problem of costs. In proceeding he takes the risk of being liable for his own and the defendant's costs in the event of failure. Legal aid is not available. His only comfort is that at the end he may claim an indemnity from the company if he has acted in good faith and on reasonable grounds and it would have been reasonable for an independent board of directors to bring the action. However, the end may be many years away. Attempts to secure interim payment have not had a sympathetic hearing.

Public officer as complainant

8.48 It has been seen that the unfair prejudice remedy by its nature is rarely applicable to public shareholders. This leaves derivative actions as the only remedy available to them. The above account of the action would indicate that the derivative action cannot easily be invoked. The plight of the public shareholders has been recognized by the legislature, but a very strange remedy has been devised in the form of section 37A of the Securities and Futures Commission Ordinance.

8.49 Under section 37A, the S.F.C. may bring an application for relief if it appears that the affairs of a listed company are being or have been conducted in a manner unfairly prejudicial to the interests of its members generally or of some part of the members. The difficulties in proving unfair prejudice, even where the complainant is the S.F.C., have been mentioned (see paras. 8.21-8.27 above). Here, the focus is on the remedies available, particularly the relationship between unfair prejudice and the derivative action. One of the remedies available is authority to commence a derivative action (s. 168A (2) (b)). The obvious question is why does the legislature require the complainant to litigate twice. A commentator has suggested that an order authorizing derivative actions would be justified when a prima facie case of wrong has been established and there is no satisfactory explanation from the respondent (Stapledon). However desirable such a solution is, it is not supportable by the statutory language. Section 168A only gives the court power to order remedies when it is of the opinion that there has been unfair prejudice and the power is to be exercised with a view to bringing to an end the matters complained of. A prima facie case cannot support a remedy. Thus, the S.F.C., as well as any shareholder, must take two full sets of proceedings.

8.50 In addition, the Financial Secretary has power to bring derivative actions following an investigation if he believes public interest so warrants (s. 147 (3)).

Concluding comments

8.51 Few dispute that the law is defective and reforms are needed. The only question is how. The following sections consider reforms and proposed reforms in Canada, New Zealand and England before proposing a way forward.

Canada : the Consultants' Recommendations

The recommendation

8.52 Recommendation 7.08 reads as follows: "there should be a statutory derivative action in the new Ordinance".

8.53 Despite this, the Consultants did not define "a statutory derivative action". One can gather from the contrasts between the statutory derivative action and the common law made by the Consultants that a statutory derivative action is one which is authorized under statute. They did not propose any particular form of statutory derivative action, nor gave any explanation why and how such a statutory derivative action would cure the defects in Hong Kong law. Both in the Report and in the Working Paper, the Consultants referred to and described some features of the statutory derivative action in the U.S., Canada and New Zealand.

8.54 The reference to a statutory derivative action in the U.S. is puzzling. The derivative action in the U.S., as in England, was developed in equity. The U.S. has its own version of *Foss v. Harbottle*, as the following statement from the U.S. Supreme Court shows:

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment; and, as a rule, only after application to the stockholders, unless it appears that there was no opportunity for such application, that such application would be futile (as where the wrongdoers control the corporation), or that the delay involved would defeat recovery (*United Copper Securities v. Amalgamated Copper*).

The difference between the U.S. and England is that the U.S. has only the general exception for justice and not the various strict classifications in England (Clark).

The hospitable environment for derivative suits in the U.S. led to abusive "strike suits", suits commenced and maintained for their nuisance value. This in turn led to restrictions on the derivative action. The relationship between case law and statute has been thus described:

> Equity developed the derivative action so that the shareholder "derivatively" or "secondarily" could enforce a corporate right against insiders or outsiders, where those in control of the corporation

> refused to have the corporation sue directly, and thereby protect the whole community of corporate interests--creditors and shareholders, including plaintiff-shareholder's own investment in the corporation...While the derivative action serves a useful purpose, it is susceptible to abuse by "strike suits" when brought by small shareholders and their attorneys to gain private settlement and self-enrichment. Misuses of the derivative remedy led to various restrictions being placed upon it by statutes, rules of practice...(Henn & Alexander).

Thus, far from enabling derivative actions to be brought, U.S. statutes are prohibitory and restrictive. The R.M.B.C.A sets out ownership and "demand on director" requirements and sets out mandatory termination requirements, but itself neither confers a right to derivative action, nor defines the circumstances in which a derivative action is appropriate. That is left to case law.

8.55 In the absence of any explanation by the Consultants of the statutory derivative action that is recommended, it is assumed that the Consultants recommended a version of section 239 of the C.B.C.A.. This provides as follows:

(1) A complainant must apply to the court for leave to bring a derivative action. (The provisions embrace also the right to intervene in actions or bring actions of the company against outsiders, but for simplicity these other rights are omitted.)
(2) The applicant must satisfy the court that :
    (a) reasonable notice had been given to the directors;
    (b) he is acting in good faith, and
    (c) it appears to be in the interests of the company that the action be brought.
(3) Shareholder approval of the act complained of is a factor which may be taken into account by the court but is not decisive.

Merits and reception of the Consultants' Recommendation

8.56 The reasons advanced by the Consultants were:

(1) the current law is "completely ineffective" (p. 149);
(2) despite its infrequent use, the Canadian provision is useful: "John Howard (an original member of the Dickerson Committee [then a

corporate counsel]) maintains that the statutory derivative action has had a clear prophylactic effect" (p. 149);

(3) "a statutory derivative action eliminates the noisome case law spawned by the 1843 case of *Foss v. Harbottle*", "minority shareholders in Canada and New Zealand are no longer obliged to struggle with the complexities and uncertainties of the exception to the rule in *Foss v. Harbottle*" (p. 150).

8.57 It is agreed that the current law is ineffective. However, before any effective cure can be devised, the nature and causes of the defects should be examined. The Report did not offer any analysis in this regard. The reasons advanced add up to one: the Canadian statutory derivative action provides effective minority protection.

8.58 We have doubts on this proposition. There were certainly great expectations for this new remedy. However, observers have been surprised and disappointed. The Consultants admitted that the derivative action is rarely used. The reason given by the draftsman of the C.B.C.A is that its very existence is a deterrent. It is implied that therefore corporate controllers are better behaved. Hence, less law suits. The statistics give a less benign reason for the dearth of derivative actions. On one count, for the period after 1975, there were 160 cases of oppression but only 50 cases involving derivative actions and of the 50 some were mixed actions. For the year 1995 to 1996, one set of law reports listed 18 oppression remedy decisions and one involving leave for derivative action. The reason for the small number of derivative actions is, then, not better behaviour, but a preference for other remedies. This is the reason given by Canadian scholars: "the advantages of the oppression remedy have considerably lessened the importance of the statutory derivative action" (Cheffins). Thus, the second reason advanced by the Consultants is not valid.

8.59 As for the *Foss v. Harbottle* rule, some such rule must exist to confirm majority rule; it exists in the U.S.; it is acknowledged by the Canadian provisions themselves since without such a majority rule, there would not be any need for a "statutory derivative action". Thus, the Rule is not a nuisance and should not be buried. The continued implicit existence of the Rule means that one part of the *Foss v. Harbottle* case law cannot be ignored: the distinction between personal actions and corporate actions. "Canadian courts, in numerous cases heard after the enactment of the statutory derivative action, have cited *Foss v. Harbottle* as authority for the proposition that a corporation, and the corporation alone, is the proper party to sue for wrongs committed against it". "In numerous instances, defendants have successfully invoked *Foss v. Harbottle* and 'the proper plaintiff' principle" (Cheffins). Thus, the third reason even if valid in theory has proven false in reality.

8.60 More importantly, the dissatisfaction with the *Foss v. Harbottle* Rule arises from the state of the law as to exceptions. The question is: do the Canadian provisions provide better exceptions? Under the Canadian provisions, the action may proceed if, *inter alia*, the court is satisfied that it appears to be in the interests of the company. This vests "extraordinarily wide discretion" in the court. Why was that discretion given and how is it to be exercised? On both counts, what actually happened was different from what was expected.

8.61 The purpose of requiring the leave of court was to give the court power to block actions to recover small amounts and also to block strike suits. Furthermore, commentators expect an assessment of the costs and benefits of an action, assuming the existence of a valid claim.

8.62 It was not proposed that each judge might act as he pleased. The court must be guided by standards and the implicit premise of the Dickerson proposal was that "dominant shareholders who are in a position to control management, owe a fiduciary duty to minority shareholders comparable to the duty that directors and officers owe to the corporation...this approach has long been commonplace in U.S. courts, both state and federal" (para. 487). Thus, if the new provision permits the court to ignore the "fraud on minority" cases, it requires the court to consider the more abundant U.S. case law on fiduciary obligations of dominant shareholders.

8.63 If the court proceeded as expected, the statutory derivative action would have been a restrictive rather than an expansive force. As noted by Professor Sealy, where a judge is required to make decisions at too early a stage, the applicant is placed at a disadvantage. He is left with "little or no evidence and without the orderly and detailed pleadings, discovery and so on which normally smooth the way" (p. 4). What the court had done at one time was to grant leave liberally: "if I come to the conclusion that the applicant is acting in good faith, has complied with the requirements of [the section], that the action does not appear to be frivolous or vexatious and could reasonably succeed...then leave to bring the action should be granted" (*Armstrong v. Gardner*). The criteria had been the likelihood of success at trial. Specifically, the court has not considered the expense and inconvenience of litigation, although some commentators detect a more restrictive trend after the first decade (Maloney).

8.64 There was no support for a Canadian-style statutory derivative action.

Recommendation 95: The Committee recommends that insofar as the Consultants recommended the adoption of a Canadian-style statutory derivative action, Recommendation 7.08 be rejected.

New Zealand

8.65 In 1993, New Zealand adopted a statutory derivative action in its major overhaul of company law. The principal feature is a requirement for leave of court to bring the action. In contrast to the Canadian provisions, the statute sets out the factors to be considered by the court as follows:

(a) the likelihood of the proceedings succeeding;
(b) the costs of the proceedings in relation to the relief likely to be obtained;
(c) any action already taken by the company or related company to obtain relief;
(d) the interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be.

After considering these factors, the court may grant leave if it is satisfied that

(a) the company or related company does not intend to bring, diligently continue or defend, or discontinue the proceedings, as the case may be; or
(b) it is in the interests of the company or related company that the conduct of the proceedings should not be left to the directors or to the determination of the shareholders as a whole.

8.66 The informational hurdle that Professor Sealy noted appears to have been overcome. There is apparently a right of discovery before commencement of proceedings (*Hetherington v. Carpenter*).

8.67 The first case, *Vrij v. Boyle,* was brought one year after the statute came into force on 1 July 1994. In it, the court cited and applied a test from *Smith v. Croft.* Although leave was granted, commentators thought it was of little significance for these reasons. The company was essentially an incorporated partnership of three and the application was unopposed. The court noted minimal costs would be involved since the parties were already embroiled in litigation. The plaintiff, holding 45 per cent of the shares, had access to information and would obtain substantial benefit from the action. None of the above factors would be present in the case of a public shareholder suing directors of a public company (Fitzsimmons).

8.68 In the two cases which followed, the applicant failed and the overall assessment is that the statutory derivative action "may be of less value than hoped, and may provide a shareholder with little more than is already available with the oppression remedy" (Fitzsimmons).

English proposal

The proposal

8.69 The Law Commission (England) found the law relating to the ability of a shareholder to bring proceedings on behalf of his company to be "obscure and complex". It is "inaccessible except to lawyers specialising in this field because, to obtain a proper understanding of it, it is necessary to examine numerous reported cases decided over a period of 150 years" (para. 1.4). The Commission proposed to replace the rule in *Foss v. Harbottle* with "a simpler and modern procedure if a satisfactory procedure could be devised". Further, "the court must have all necessary powers to streamline minority shareholder litigation so that it is less costly and complicated" (para. 1.11, 1.21).

8.70 After consultation, the Commission proposed two measures to deal with the operation of the rule in *Foss v. Harbottle* which the vast majority of respondents found unsatisfactory. One of the measures is to improve case management. This is a matter for the judiciary. The other measure is to introduce "a new derivative procedure with modern, flexible and accessible criteria for determining whether a shareholder can pursue the action" (para. 6.15). This action should entirely replace the existing common law right to bring a derivative action (para. 6.51).

8.71 The Report included draft legislation as follows. There shall be added to the Companies Act the following:

458A - (1) A derivative action is an action by a member of a company where the cause of action is vested in the company and relief is sought on its behalf.

(2) A derivative action may be brought if and only if the cause of action arises as a result of an actual or proposed act or omission involving -

(a) negligence, default, breach of duty or breach of trust by a director of the company, or

(b) a director putting himself in a position where his personal interests conflict with his duties to the company.

(3) The cause of action may be against the director or another person (or both).

Proposals to amend the civil procedure rules were also made. First, a derivative claimant must serve notice on the company before commencing action. Once commenced, the court must fix a case management conference and the claimant must apply to the court for leave to continue the derivative claim. In considering the application, the court must take all relevant matters into account, including the following:

(a) whether the plaintiff is acting in good faith in bringing the derivative claim;
(b) whether the derivative claim is in the interests of the company, taking account of the views of the company's directors on commercial matters;
(c) whether the director's activity as a result of which the cause of action is alleged to arise may be approved by the company in general meeting and (if it may be) whether it has been;
(d) whether the company in general meeting has resolved not to pursue the cause of action;
(e) the opinion (if any) of an independent organ that for commercial reasons the derivative claim should or (as the case may be) should not be pursued;
(f) whether a remedy is available as an alternative to the derivative claim (App. B, s. 50.7).

The court must strike out the claim if it is satisfied that there has been ratification by the company (App B, s. 50.8 (4)).

Analysis

8.72 The proposed derivative action introduced at least two major new concepts.

8.73 First, the derivative action is available for negligence of directors, overruling *Pavlides v. Jensen.* Those who disagreed with the Commission pointed out that a shareholder should take risks of mistakes untainted by impropriety; this is a business risk. There was concern also of increased litigation frightening competent people away from directorships. The Commission thought those concerns were overstated and in any event, the action would be tightly controlled by the court (para. 6.39 above). This proposal has drawn rare praise from commentators. However, the express inclusion of negligence in the statutory derivative action is not only contrary to the common law, but contrary to current developments in the U.S.. Since 1986, over half of the states have enacted legislation to shield directors from liability for breach of the duty of care (see para. 6.60 above).

8.74 Secondly, court approval is required for settlement or discontinuance. This is to prevent collusive settlements, with the directors buying off the plaintiff in disregard of the rights of the company and its members (para. 6.107 above).

8.75 Compared with the Canadian provisions, the English provisions are more favourable to the minority shareholder in that he does not have to establish positively that the action would be in the interest of the company. The Commission recognized that such a requirement would have the effect of laying down additional hurdles and lengthening the leave stage and adding to the costs. However, if the court is satisfied that it is not in the interest of the company to allow the action to proceed, the court must refuse leave (para. 6.79 above).

8.76 The Commission's Report has not been well-received. While sympathetic to the Commission in its "complex and delicate relationship" with the Department of Trade and Industry, and while unstinting praise is given for the summaries of the law in the Commission's Consultation Paper and the Report, there is general disappointment with the scope of the review and the recommendations. Commentators faulted the questions posed; this will be discussed below. Here, assuming the validity of the task posed by the Commissioners for themselves, the question is asked: do the proposals fit the bill? Will the new derivative action be an improvement over the old in providing "modern, flexible and *accessible* criteria for determining whether a shareholder can pursue the action"? Commentators thought not. One example will suffice: it is noted that the third factor to be considered by the court is whether the wrong is one which *may be approved* by shareholders and that the court must strike out the claim if there has been "effective" ratification by the company. These are precisely the questions which muddled the old case law and no answer is given in the new procedures. It is still up to the court to decide. Whether the court decides by reference to the old case law or by formulating new standards, the law would not be "accessible".

The way forward

8.77 As noted, the law on derivative action is unsatisfactory and the statutory models in Canada, New Zealand and England each has its own drawbacks. This section attempts to identify the common conceptual weaknesses in them in order to determine the way forward for Hong Kong.

Wide discretion in the court

8.78 Despite some differences, all three models have one common theme and that is reliance on wide discretion in the court. Is this the right approach? Certainly, the adoption of this approach without debate looks odd: "if the courts, as well as the lawyers, are part of the problem, then it may seem odd to cast the courts as the solution" (Sugarman). Presumably, the attractions of a "statutory" derivative action are that standards are set out in statutes. There are at least three disadvantages in having an open-ended "statutory" remedy.

8.79 First, commentators fear that the court would simply refer to old case law under the new statute and the New Zealand courts have proven them right (see para. 8.67 above). Worse still, as has happened under the Sale of Goods Ordinance, there may first be a dispute as to whether it is permissible to refer to old case law, followed by an inevitable reference to both the old and new case law. Whether or not the exercise will achieve better equity, the law will not be "clear or accessible".

8.80 Secondly, the very requirement for leave of court to proceed means an increase of both the incidence and duration of litigation. Further, open-endedness means uncertainty and uncertainty means costs. This has been noted by those who commented on the English proposals (Sugarman).

8.81 Thirdly, there is already an effective open-ended remedy, namely the unfair prejudice remedy. It would be duplicitous to have another. Given the procedural and remedial flexibilities of the unfair prejudice remedy, shareholders will be likely to prefer the unfair prejudice remedy, and the Canadian experience is living proof. The statutory derivative action is useful only when the only complaint is a legal wrong. In that event, it may be better, as one respondent suggested, to restructure the derivative action as a remedy with public companies in mind. For purposes of economy, this remedy should be sharply defined. It would make for a better complement of remedies.

Of shareholder rights

8.82 Commentator after commentator has criticized the Law Commission's Report (England) for its narrow scope and resulting incoherence. It has been pointed out that the Commission drew "an extremely artificial distinction between shareholder rights, considered to be outside the scope of the review, and remedies, considered to fall within its scope" (Poole and Roberts). Other commentators remarked that "the reform of remedies in isolation from the effect of the changes being proposed on other related areas of company law is unlikely to produce satisfactory law reform and may actually accentuate the complexity and incoherence of the law" (Sugarman). This incoherence is squarely demonstrated in the Commission's neglect to deal with the issue of ratification, an issue involving rights, leaving its proposals meaningless (Lowry). The Law Commission is not alone. The Canadian and New Zealand models similarly referred to the likely success of the action and the relevance of ratification without addressing the question of the nature and effect of ratification, a question of rights. As long ago as 1957, Lord Wedderburn pointed out the way forward:

> ...the problem of "fraud" would best be approached by the court posing for itself two questions: (i) which "frauds", or breaches of fiduciary duty, are open to majority ratification?; and (ii) are there cases where the majority can *ratify*, but the minority can sue, so as to constitute *real* exceptions to the Rule? Only when those questions are answered will we know the extent of the Rule in *Foss v. Harbottle* (p. 106).

Until the questions posed are answered, the law will remain confused and incoherent, whether it is statutory or otherwise. Once they are answered, the discretion of the court will be reduced and the remedy can be sharply drawn. Thus, one way forward would be to clarify, rationalize and reform if necessary the voting and personal rights of shareholders. We have attempted to do this in the previous chapter and have reached tentative conclusions in that regard.

Even brighter-line rules

8.83 Bright-line rules have the advantage of clarity, certainty and reduction in costs. The law of Germany provides an even brighter-line rule. There, shareholders representing 10 per cent of the corporate capital or more may compel the corporation to bring actions against defaulting managers even though the shareholders' meeting has decided against it. If the action is in respect of a wrong uncovered during an investigation, the necessary minority is reduced to 5 per cent. On application, the court may appoint a special guardian for the corporation to bring the action (Falkenhausen and Steefel). There is support from English commentators, some predating the Law Commission's Report (Boyle, Lowry), for a percentage of shareholder test, at least for institutional investors. In Hong Kong, knowledgeable institutional investors may provide much needed discipline for public companies controlled by entrepreneurial owner-managers.

Enforcement by public officer

8.84 Another alternative way forward is to vest powers in the S.F.C. to bring derivative actions on behalf of a public company against their directors and officers for breaches of duty. Such a provision will probably solve most of the problems. One may assume that if the S.F.C. takes action it has considered both the claims of majority rule and the "worthiness" of the suit so that no further hurdles should be placed before it. Such a provision will not be alien to the spirit of the law since the S.F.C. is already empowered to take unfair prejudice proceedings, the inadequacy of which has already been noted. Further, it is not reasonable to require the S.F.C. fully to litigate twice before bringing a defaulting director to book. In Australia, the Australian Securities Commission has power to enforce corporate rights and duties and is seen to be in a superior position so to do. Naturally, this power should not be exclusive and there should not be over-reliance on a public body subject to budgetary and other constraints. It is nevertheless a power which is necessary and desirable (Ramsay).

8.85 The countervailing consideration is the nervousness of the community in extending the powers of the S.F.C. (see para. 4.46 above).

Conclusions

8.86 We believe that the *Foss v. Harbottle* rule itself is correct in confirming majority rule for the governance of companies, but recognize that the state of the law is unsatisfactory. Having considered the defects in the law and the solutions adopted elsewhere, we believe that statutory reforms should be made along the following lines:

1. the derivative action be made simple and accessible to minority shareholders. To that end,

   (a) it would not be desirable to require preliminary hearings on the plaintiff's standing or to vest in the court discretion to approve the commencement or maintenance of an action. Where a cause of action, being a wrong done to a company by directors not capable of ratification by the majority, is stated, the plaintiff should be allowed to proceed to trial on the merits, and

   (b) the right of the majority to "ratify" (approve or forgive) wrongs of directors against the company should be clarified, rationalized and reformed in the manner set out in chapter 7;

2. a plaintiff who seeks interim payments on account of the company's indemnity as to costs be required to prove that he has acted in good faith and on reasonable grounds. When considering such applications, the court may seek and consider the views of independent organs of the company as to the desirability of the action;

3. the personal rights of shareholders not subject to deprivation by majority rule be clarified, rationalized and reformed in the manner set out in Chapter 7;

4. the securities regulator be given the power to bring derivative actions against directors of a public company for breaches of duty as if it were a shareholder, except that (a) the regulator shall exercise its power in the public interest as well as in the interest of the company, and (b) it shall not be entitled to indemnities as to costs from the company.

Recommendation 96: The Committee recommends that a statutory right of derivative action as outlined in this Report be provided.

Compliance and restraining order

Analysis of the law

8.87 At common law, despite the confusion surrounding *Foss v. Harbottle*, a shareholder has a right to secure the observance of the memorandum and articles of association (see paras. 8.35-8.37 above). Section 5B of the Companies Ordinance clearly provides a right to shareholders to restrain acts in contravention of the objects and powers of the company. Similarly, section 155A provides a right to shareholders to restrain the directors from entering into a transaction for the disposal of fixed assets of the company in contravention of the limits stipulated. The court may make an order restraining unfairly prejudicial conduct (s. 168A).

Thus, by virtue of the statutory contract, shareholders already have a right to sue for compliance or restraining orders. As noted in chapter 7, the personal rights of shareholders require clarification, rationalization and reform.

The Consultants' Recommendations

8.88 The Consultants' recommended that a shareholder or director should have the standing to apply to court for a statutory compliance and restraining order (Recommendation 7.10).

8.89 The reasons advanced were

(1) they help protect shareholders' personal rights of action against the directors and the company wherever duties are imposed by the corporate constitution for their benefit;
(2) the Listing Division of the S.E.H.K. has suggested broadening the class of applicants to include directors, creditors and employees, but this suggestion is not supported with respect to creditors and employees. No reasons were given for S.E.H.K.'s suggestion or the Consultants' partial support.

8.90 As to the first reason, a statutory remedy would not add to the shareholders' existing contractual rights, once properly clarified and reformed as discussed.

As to the second reason, the addition of directors would involve a fundamental change in the concept of shareholder supremacy.

8.91 There was little support for the recommendation and we see little need to add a statutory right to apply for compliance orders.

Recommendation 97: The Committee recommends that Recommendation 7.10 of the Consultants' Report be rejected.

Chapter 9

Fundamental Changes

9.1 The Consultants' central recommendation is to introduce the appraisal remedy. This chapter will first examine the appraisal remedy. As will be seen, we have rejected the remedy and examined the existing regime to determine the necessity for and extent of reform. In view of this, our analysis is more detailed and conclusions more tentative than policy makers may have expected.

The appraisal remedy

Introduction

9.2 Most jurisdictions employ one of two alternative means for externally reviewing fundamental changes. Hong Kong, following England, employs prior judicial or expert review of the transaction. The U.S. employs the appraisal remedy and in 1975 Canada changed from the English to the American system.

9.3 The Consultants recommended the introduction of the appraisal remedy (Recommendation 8.02). Although they recommended also the removal of "court intervention" in amalgamations (Recommendation 8.04), they did not clearly propose to replace the current system of prior judicial review entirely with the appraisal remedy. However, given that the two systems are often cast as alternatives, this Chapter will consider them as alternative systems.

The remedy's operation and problems in the US

9.4 Every American jurisdiction provides an appraisal remedy of some sort. "Unfortunately, it is not easy to draw conclusions from the ways in which the various state statutes make appraisal available to shareholders. There are almost as many varieties of appraisal statutes as jurisdictions" (Kanda and Levmore). The following is an account of the provisions under the R.M.B.C.A..

9.5 The events which trigger the remedy are widely cast: mergers, sale or exchange of all or substantially all of the assets of the company, changes in rights as shareholders. Once triggered, there is a mechanism for the parties to agree on a value. If the dissenting shareholder is dissatisfied with the controller's offer, he may invoke judicial appraisal. The court may then appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers have the power described in the order of appointment, as amended from time to time. The dissentients are entitled to the same discovery rights as parties in other civil proceedings. To encourage settlement, as an exception to the general rule, the court may make orders as to costs against parties as may be equitable. At the end of the process, the court issues a judgment as to the amount to which the dissentients are entitled (ss. 13.02, 13.20-13.31).

9.6 It should not be surprising that this remedy is extremely expensive to operate.

9.7 It should be noted that, in this context, despite the common nomenclature, no fault is required. Indeed, the proper title for this "remedy" is "dissenting shareholders' right".

9.8 There are at least four areas of contention: what events should trigger the remedy; whether the remedy should be available to holders of publicly traded shares; what are proper valuation principles; and whether the remedy should be exclusive.

9.9 As to triggering events, the "logic" of the various lists has been subject to considerable criticism and remains a matter of debate. As to the availability of the remedy to public investors, many states exclude them and the draftsmen of the R.M.B.C.A. changed their minds twice: a stock market exception was introduced into the M.B.C.A. in 1969 and removed in the late 1970s. As to exclusivity, 16 states provide in their statutes for exclusivity, subject to certain exceptions (Seligman). However, it is said that the statutes "mask a long-standing ambiguity about the extent to which breach of fiduciary duty is included" and that courts outside of Delaware are inclined to resolve this ambiguity in favour of exclusivity (Madill). These three problems reveal and result from difficulties in articulating a rational rationale for the remedy.

9.10 The question of valuation shows operational as well as theoretical difficulties. English and Commonwealth courts involved in the valuation of shares in other contexts have experienced the same problems. The first problem is the meaning of value. Generally, the fair value to which the dissentient is entitled is equated to the market value. However, the market value obviously cannot be applied where the remedy is available to a holder of publicly traded shares. In such cases, he is entitled to "intrinsic value" and litigation is needed to determine its meaning. Similarly, litigation is required to resolve questions of the appropriate valuation methodology: the underlying asset value, on an ongoing basis or a break-up basis, the earnings approach or a combination of the above; the reference dates of valuation and the relevance of the disputed event; discounts or premia. Disagreement over these issues, particularly the question of discounts and premia, signify also conflicting views of the remedy.

The origin, rationales and merits of the appraisal remedy

9.11 The original and conventional rationale of the remedy was as follows. In the beginning, the corporate contract in the U.S. could not be changed in a fundamental way without the approval of every shareholder. This protected the dissenting shareholder, but allowed him to frustrate the bona fide wishes of even an overwhelming majority for development. The appraisal remedy was invented to give the dissenting shareholder a right to be bought out on the occurrence of certain fundamental changes. As will be seen, the above traditional review of the appraisal remedy has come under challenge and is largely repudiated.

9.12 The remedy has been dogged by controversy from the beginning. Two doubters deserve special mention because the Consultants relied heavily on them for the central recommendation to introduce the North American code. In California, Professor Ballantine expressed reservations on its introduction into Californian law. In 1962, Professor Manning, the dean of the enabling school, made the most famous denunciation of the remedy:

> The appraisal remedy is of virtually no economic advantage to the usual shareholder except in highly specialized situations. The remedy is, or can be, a substantial nuisance to the remaining shareholders and to the enterprises as a whole. Enterprises should not be required to stay liquid to stave off appraisal claims (p. 260).

Even supporters such as Professor Eisenberg conceded that for shareholders of public companies, the remedy can only be regarded as a remedy of the last resort.

9.13 In the 1980s, a second round of commentators affirmed the utility of the remedy by re-rationalizing it. It is no longer considered as an exit for a dissenting minority in a no-fault situation. Instead, it is a means of monitoring and constraining overreaching by controllers (Fischel). Yet, in the 1990s, scholars were still searching for the role of the appraisal remedy in corporate law. Of these, Professor Thompson provided important empirical data. He found that in the period 1983[1] to 1993, there were 103 reported appellate decisions involving appraisal and more than 80 per cent of these involved the freezing out of the minority; less than one in 10 of the litigated cases illustrated the liquidity/fundamental change concern of the classic appraisal remedy (pp. 25-26). Thus, the role of appraisal is a remedy against opportunistic behaviour by majority shareholders in mergers.

9.14 Thompson's findings pose at least two questions. For the U.S., where the remedy is entrenched, the question is whether rules carried over from an earlier period when appraisal served a different purpose were appropriate. Attention is now paid to reform of procedural and valuation rules. For foreigners contemplating the U.S. model, the question is whether appraisal is the appropriate tool to restrain overreaching by controllers. After all, the remedy carries a risk that a minute minority can hold both the majority and the majority of the minority to ransom. Prudence dictates that such a risk should not be assumed without reason. In that regard, it should be noted that commentators find two substitutes for the remedy: a high vote requirement (including a class vote) (Folk) and judicial or regulatory approval (Black and Kraakman).

The Consultants' Recommendations

9.15 The Consultants recommended the adoption of the appraisal remedy twice: once in Chapter 8 on Fundamental Changes and once in Chapter 7 on Shareholder Rights and Remedies. Although this chapter is only concerned with fundamental changes, both recommendations are examined here as their juxtaposition demonstrates the incoherence of the remedy.

9.16 In Chapter 8, the Consultants recommended an appraisal remedy for shareholders where there is any change in the nature of the shareholder's investment or where a fundamental change is proposed (Recommendation 8.02). The reasons given in the Report consisted of a statement of the conventional rationale for the remedy and a lengthy quotation from the Dickerson Report to the same effect.

In Chapter 7 the Consultants recommended also an appraisal remedy which does not necessitate judicial intervention. The reasons advanced were:

[1] 1983 is significant because the Delaware Supreme Court's decision in *Weinberger v UOP*, 457 A 2d 701 (Del 1983) is considered a peak in the revitalization of the remedy.

(1) it is relatively cheap;

(2) the automatic nature of the buy-out remedy reduces uncertainty for shareholders seeking relief;

(3) "The main advantage of the statutory buy-out remedy in its Canadian...formulation, is that it is designed, at optimum use, to avoid recourse to the courts. It can operate without court or administrative intervention." (p. 158).

(4) even in the U.S., "between 1972 and 1981 there were only 20 or so reported cases on the appraisal remedy (J. Seligman, 'Reappraising the Appraisal Remedy' (1986) 28 Corporate Practice Commentator 2 at 2)". One reason for the low incidence of litigation in a "most litigious jurisdiction" is that the remedy works (p. 159).

9.17 The first observation on the two recommendations is that they demonstrate clearly the incoherence of the "remedy". In the context of fundamental changes, the remedy originated as a no-fault remedy. In the context of shareholder remedies, fault is implied. As noted above, some have observed a change in the nature of the remedy in the U.S.. Furthermore, procedural and valuation rules should be different in the two contexts: "very simply, the measure of value and the procedures that one would install if the minority were choosing to get out are often the reverse of what would be adopted if the majority were expelling the minority at a price fixed by the majority" (Thompson). Take, for instance, the question whether disputed or subsequent events should be taken into account in valuation. If it is simply a difference of opinion over the direction of the company, then since the minority will not join with the majority, neither depreciation nor appreciation caused by the disputed event should be factored into the value. However, if the minority is complaining that the proposed fundamental change is not the most advantageous for the company, or that he is not getting a fair share, it would be unfair to restrict the dissenting shareholder to the pre-restructured state of business (Brudney and Chirelstein).

9.18 As to the first reason, the Consultants did not explain why the remedy is relatively cheap. In a background paper dated May 1996 describing the remedy, citing from a Canadian source, it is said that since the remedy is only concerned with quantum and not liability, the remedy is relatively cheap even if litigation is involved. However, one of the most contentious issues in valuation is the propriety of discounts. It has been held that if the minority has behaved in such a manner as to deserve its fate, a discount may be appropriate (*Re Bird Precision Bellowes Ltd*). Thus, liability issues cannot be avoided and U.S. commentators have remarked upon the expensiveness of the remedy.

9.19 As to the second reason, the automatic nature of the buy-out remedy does reduce the uncertainty for shareholders seeking relief. But it increases the uncertainty and insecurity for the remaining shareholders and is not necessarily fair, particularly in a no-fault situation.

9.20 The third reason is difficult to understand. Under the C.B.C.A., the appraisal is initiated by the dissenting shareholder sending a notice to the corporation. The corporation is required to make an offer which lapses if not accepted within 30 days. If the parties fail to reach agreement or if the corporation fails to make an offer, either party has the right to apply to the court to fix a fair value (s. 190). In real life, even without an appraisal remedy, parties who have differences will try to reach a negotiated buy-out. Only if they fail do they resort to the court. In an appraisal regime, the absolute entitlement of one party may make it more, not less difficult, to reach agreement. In any event, it is difficult to see how the appraisal can work without the backing of a right of recourse to the court.

9.21 As to the fourth reason, there are two observations. First, the statistics cited were accurately cited. The appraisal remedy was not much litigated in the 1970s. However, as noted above, there has been a revival and sharp increase in reported decisions in the 1980s. Secondly, and more seriously, the above citations were taken from the second introductory paragraph of Professor's Seligman's paper setting out certain facts. The paper itself was an attempt to find reasons for the phenomenon. Immediately following the passage cited, Professor Seligman speculated on some "benign" reasons, such as the remedy works (this was accurately referred to by the Consultants) and only appellate decisions are reported. That is to say, there may be many more cases of judicial intervention than reported. (The Consultants made no reference to this second reason). The professor then continued:

> But, along with these benign reasons for the low frequency of reported opinions are other factors that suggest substantial defects in the ability of corporate law to ensure dissenting shareholders the fair value of their shares...Viewed empirically, the costs, risks, and time delays of an appraisal usually dissuade all but the wealthiest of plaintiffs from demanding a valuation. Collectively, these disadvantages of an appraisal-valuation proceeding have inspired an

> impressive number of attempts to circumvent the appraisal remedy...(pp. 3-4).

Thus, contrary to the impression given by the Consultants' Report, while Professor Seligman supports the remedy in principle, he is critical of its operation in the U.S..

9.22 The overwhelming opinion of respondents is against the recommendation.

9.23 As discussed below, the present system of prior judicial review has advantages over the system of appraisal which has been mired in controversy and confusion. Although there are problems in the operation of the system of prior judicial review, we have suggested some improvements and do not believe that the present regime should be replaced by the appraisal remedy.

Recommendation 98: The Committee recommends that Recommendation 7.12 of the Consultants' Report be rejected.
Recommendation 99: The Committee recommends that Recommendation 8.02 of the Consultants' Report be rejected.

Distinguishing between fundamental changes

9.24 The Consultants did not distinguish between fundamental changes, but proposed the same level of shareholder protection for all. For example, changing the scope of the business of the company and restructuring the share capital would both require a special resolution and entitle any dissenting shareholder to be "bought out". The merits of the appraisal remedy have already been examined. Here, the question is whether any distinction should be drawn between the two transactions.

9.25 We believe that applying different requirements to different fundamental changes grouped by substance is more appropriate. This is because the risk of abuse may be different. Uniform treatment of all fundamental changes may result in regulations that are either too strict or too lax or both.

9.26 Consistent with their approach to substantive regulation, the Consultants recommended that all amendments to the company's constitution that may be effected by special resolution of shareholders be regrouped into one section (Recommendation 8.01).

9.27 Due to the accretion of discrete amendments made over the years, the Companies Ordinance is poorly organized. That is why the Consultants' Recommendation was generally welcomed. The advantage of the proposed organization is administrative convenience for the company secretary. It would be easy for him to determine whether a special resolution is required for a proposed action. This convenience is, however, bought at the price of neglect of substantive issues: events of vastly different significance, such as changing the registered address and changing the capital structure of the company are lumped together. These two changes belong to different types and arguably should be subject to two different regimes of shareholder protection. Although the common denominator may be that a special resolution is required, they should be examined and dealt with separately lest some substantive matters be overlooked.

9.28 At the policy-making level, the organizing principle should be to group provisions according to the economic nature of the transaction and the overall level of shareholder protection required. This is the principle adopted in the remaining parts of this Chapter. As the current disorganization is more of a result of piecemeal amendments made over time than of confused thinking, the Law Draftsman can be trusted to adopt the most appropriate organizing principle. All that the Committee need to do is to state the need for reorganization.

Recommendation 100: The Committee recommends that Recommendation 8.01 of the Consultants' Report be rejected.
Recommendation 101: The Committee recommends that the Law Draftsman be asked to improve the organization of the restructuring provisions employing the most appropriate organizing principle as he sees fit.

Fundamental business changes

Change of objects

9.29 With the abolition of the *ultra vires* doctrine, amendments of objects clauses will become increasingly rare. Nevertheless, when a company's constitution contains an objects clause, before it can expand or change the scope of its business, it must examine the clause to determine whether any change is necessary. Since most objects clauses cover every conceivable type of business, changes are generally not necessary. Where they are necessary, an elaborate procedure is provided for in the Companies Ordinance. In addition to requiring a special resolution, holders of not less than 5 per cent in the nominal value of the company's issued share capital or any class thereof may apply to the court. The court may confirm the alteration in whole or in part or not at all and on such terms and conditions as it thinks fit, including the purchase of the interests of the dissentients (s. 8).

9.30 The existing provision permits a minority to impede fundamental business decisions made on business grounds. It originates from the days of *ultra vires* and the immutability of the memorandum of association. The right of holders of 5 per cent to appeal to the court was given in exchange for the majority's right to change the corporate contract. It must be questioned whether this level of "shareholder protection" is necessary today. If a transaction is tainted with improprieties or self-dealing, it can and should be dealt with by other provisions of the law with a focus on such improprieties. As to public companies, in the absence of improprieties, the dissenting shareholder can always sell his stake in the company.

9.31 Accordingly, we believe that the right of dissenting shareholders in public companies to resort to the court should be repealed.

Recommendation 102: The Committee recommends that the right to resort to the court under section 8 of the Companies Ordinance be repealed as regards public companies.

Sale of substantial assets

The law

9.32 At common law, so long as the memorandum and articles of association authorized the sale of part of the company's undertakings, the directors had the power to sell even a large part. Given the breadth of objects clauses, this meant that a company may change its principal business without shareholder approval.

9.33 In 1984, section 155A was introduced to require prior shareholder approval for a disposal of fixed assets exceeding a certain level. This level is set by reference to the amount or value of the consideration received or to be received, including in aggregate any amount for disposals, in any four months immediately preceding the proposed disposal. The aggregate level of such consideration is set at 33 per cent of the value of the company's fixed assets as shown in the latest balance sheet laid before the shareholders. The section applies only to listed companies and companies which are members of a group in which there is a listed company (s. 155A).

Analysis

9.34 The memorandum accompanying the Companies (Amendment) Bill 1983 introducing section 155A did not provide any explanation. Judging from its contents, it is not directed against improprieties. It is believed that the premise of this provision is that such disposals represent a change of directions in the company and requires shareholder approval. From this perspective, there are three defects in the existing law. First, it is not logical to confine the section to the disposal of fixed assets. Secondly, it only applies to listed companies. Given that this provision is premised on a general division of power between management and shareholders, there is no reason to limit this to listed companies. Thirdly, transfers between parents and wholly-owned subsidiaries and between wholly-owned subsidiaries do not affect the position of shareholders and the approval requirement is cumbersome.

9.35 Given that the provision concerns a division of power between management and shareholders and is not directed against improprieties, it is overly restrictive to place it in the Ordinance. Consistent with the approach to facilitate the carrying on of business, this provision should be made a default rather than mandatory provision.

Conclusions

9.36 Section 155A should be repealed and its contents removed to Table A with the following amendments: the requirement for approval should be triggered by disposals of the same percentage of net assets of the company, the provision should apply to all companies, provided that transactions between parents and wholly-owned subsidiaries and between wholly-owned subsidiaries of the same holding company shall be exempted.

Recommendation 103: The Committee recommends that section 155A be repealed and its contents moved to Table A with the following amendments: the requirement for approval should be triggered by disposals of the same percentage of net assets of the company; the provision should apply to all companies, provided that transactions between parents and wholly-owned subsidiaries and between wholly-owned subsidiaries of the same holding company shall be exempted.

Restructuring requiring shareholder approval only

Introduction

9.37 The position of a shareholder in his company can be changed in a myriad of ways, subject to a variety of regulations. Relatively straightforward changes are made subject to shareholder approval and more complicated changes are subject to shareholder approval and judicial or regulatory approval. This section examines the first category.

Pre-emption rights

Analysis of existing law

9.38 At common law, in the absence of any limitations in the articles, the allotment and issue of shares is a management function vested in directors under the management clause. Controllers were not content and usually inserted express provisions in the articles. While directors are subject to fiduciary duties in exercising such a power, they need not offer shares to existing shareholders on a pro-rata or any other basis before offering them to any person. The Jenkins Committee believed and the Companies Law Revision Committee agreed that equity issues for cash ought always first to be offered pro-rata to the existing shareholders unless they have agreed to some other form of disposal of them (para. 3.37 above).

9.39 Following the recommendation of the Companies Law Revision Committee, section 57B was introduced into the Companies Ordinance to provide that the power to allot shares is vested in shareholders subject to two exceptions. First, shareholder approval is not required if the shares are offered pro-rata to existing shareholders. Secondly, shareholders may give advance approval to directors to exercise the power of allotment generally by way of a resolution at each annual general meeting.

9.40 Pre-emption rights pose the usual choice between equity and efficiency. While pre-emption rights protect shareholders against dilution, they also prevent the issuance of shares at the most favourable market terms, thus raising the cost of capital. Section 57B strikes a happy compromise. It protects shareholders against the "whims" of directors, but allows the shareholders as a body to approve other issues. However, the annual mandate can quickly develop into a formality in the case of a public company. The Stock Exchange sensibly imposes restrictions on listed companies.

The Consultants' Recommendations

9.41 The Consultants recommended that pre-emption rights for existing shareholders should be optional; they may be provided for in the corporate constitution (Recommendation 4.06).

9.42 We have some difficulty with this recommendation. First, the Consultants did not mention section 57B at all and did not state whether their recommendation was to replace it. However, no reasons were given for any such replacement. Secondly, under the existing framework, shareholders are already free to provide for pre-emption rights and shareholders of private companies often do. It is difficult to see what purpose the recommendation is intended to achieve.

9.43 The reasons given are not particularly clear. The Consultants noted that, while statutorily imposed pre-emption rights protect shareholders, they raise the cost of capital. They also noted that the concept is more appropriate in the context of private companies where the dilution of shareholders' interests is more critical and that pre-emption rights for listed companies is not a matter for company law. One would then have expected a recommendation for statutory pre-emption rights for private companies. However, the recommendation is, as stated above, optional rights.

9.44 We believe the existing regime is satisfactory and no change is required.

Recommendation 104: The Committee recommends that Recommendation 4.06 of the Consultants' Report be rejected.

Variation of class rights

Analysis of existing law

9.45 The Companies Ordinance has three provisions which are of relevance in this context. First, where the articles so provide, a company may increase its share capital by new shares of such amount as it thinks expedient (s. 53 (1) (a)). Only an ordinary resolution is required.

Secondly, where the articles so provide, a company may consolidate and divide all or any of its share capital into shares of larger amount than its existing shares or subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum (s. 53 (1) (b)). Again, approval by ordinary resolution is sufficient.

Thirdly, there is an elaborate structure for the variation of special rights attached to any class of shares (s. 63A).

9.46 The reason for the low approval threshold stipulated for issuance, consolidation and subdivision must be that since no capital is flowing out of the company and the shares remaining in the hands of each existing shareholder remain unchanged, no special protection is needed. The premise of the law is fortified in that selective issuance, consolidation and subdivision is authorized by the statute and in such cases, special protection is needed but not provided.

9.47 The reason for the elaborate structure for the variation of class rights must be that disturbance of vested interests require special protection. However, the intention of providing special protection is not achieved because of the uncertainty over the meaning of class rights and the narrow construction of the meaning of variation.

9.48 The lethal combination of the three provisions can be seen in the following cases. In *Greenhalgh v. Arderne Cinemas Ltd* the plaintiff lent money to the company and as a condition obtained shares giving him more than one-third of the voting rights. Two years later, while the loan was still outstanding, the company proposed to subdivide all the shares held by the other shareholders. The result of the subdivision would divest the plaintiff of all negative control. As subdivision itself only required approval by an ordinary resolution, the plaintiff claimed a right to a class vote. He failed. The court held there was no variation of his class rights:

> Of course, if it had been attempted to reduce that voting right, e.g., by providing or attempting to provide that there should be one vote for every five of such shares, that would have been an interference with the voting rights attached to that class of shares. But nothing of the kind has been done; the right to have one vote per share is left undisturbed...If an attempt had been made, without subdividing the

> [other] shares, to give them five votes per share, it may very well be that the rights attached to the [plaintiff's] shares would have been varied...But this is not what has been done (p. 516).

9.49 In *White v. Bristol Aeroplane Co Ld* the plaintiff held preference shares in the company at the time when it had only two classes of shares: L1 preference and 10s ordinary shares. The preference shares carried the right to a fixed cumulative preferential dividend and a preference in winding up to repayment of capital and all arrears of dividends. The company proposed to create further preference shares ranking pari passu with the plaintiff's shares, pay for them out of company funds, and to distribute them to existing ordinary shareholders. The plaintiff, representing himself and other preference shareholders, claimed the right to vote as a class on the ground that the resolution directly affected their rights or privileges as a class. This was rejected by the court who clearly saw the effect of the proposal, but drew a distinction between rights and enjoyment of rights:

> The question then is...are the rights which I have already summarized "affected" by what is proposed...No, they are not; they remain exactly as they were before; each one of the manifestations of the preference stockholders' privileges may be repeated without any change whatever after, as before, the proposed distribution. It is no doubt true that the enjoyment of, and the capacity to make effective, those rights is in a measure affected...the existing preference stockholders will be in a less advantageous position...But there is to my mind a distinction, and a sensible distinction, between an affecting of the rights and an affecting of the enjoyment of the rights or of the stockholders' capacity to turn them to account (p. 74).

9.50 In *Adelaide Electric Supply Company Limited v. Prudential Assurance Company* a change of place of payment of dividends resulting in a change in the currency of obligation and a currency loss was held not to be a variation of class rights.

9.51 Gower describes these cases as "extraordinarily narrow construction" of the variation of class rights provisions (p. 724). They do not appear fair to the parties concerned and are out of line with contemporary expectations.

9.52 On the other hand, the court appears to be more liberal over the definition of class rights. Specific rights given to certain shareholders in their capacity as shareholders are class rights (*Cumbrian Newspapers*). While these recent cases have been welcomed, the effectiveness of section

63A remains in question as long as the narrow construction of "variation" applies.

9.53 Action has been taken in some private quarters both to clarify the meaning of class rights and variation and to rectify the unfairness of the above cases. For instance, a reported decision reveals that "deemed class rights" clauses have been inserted in articles and are honoured (*Re Northern Engineering*). The New York Stock Exchange provides for voting rights for non-voting shares where, inter alia, there is creation of a pari-passu or senior class of shares. The Hong Kong Stock Exchange requires "adequate" voting rights for non-voting shares in "appropriate" circumstances.

The Consultants' Recommendation

9.54 The Consultants recommended:

> In certain circumstances, a class vote should be held where a proposed amendment to the constitution would affect, directly or indirectly, the rights of that class of shares (Recommendation 8.03).

The reason given was that a provision of this nature safeguards the interests of minority shareholders while providing the necessary flexibility to controllers. The Consultants noted the existence of section 63A but did not examine any of the existing problems. There was no indication whether the Recommendation was intended to replace section 63A. It did not address existing problems.

9.55 Respondents agreed with the concept of class voting but questioned the meaning of the recommendation, i.e. in what circumstances would a class vote be required.

9.56 In view of the above considerations, we believe that further studies are required.

Recommendation 105: The Committee recommends that Recommendation 8.03 of the Consultants' Report be rejected.
Recommendation 106: The Committee recommends that the question of class rights and variation be further studied.

Restructuring subject to shareholder approval and judicial approval

The existing law

9.57 The two main forms of restructuring that are subject to shareholder approval and judicial approval are reduction of share capital and a scheme of arrangement. In addition, freeze-outs following a successful takeover are subject to judicial scrutiny.

Reduction of share capital

9.58 Section 58 of the Companies Ordinance provides that, if authorized by its articles and subject to confirmation by the court, a company may reduce its share capital in any way. Originally, it was thought that capital could only be reduced where it had been lost or where it was excessive. If so, reduction would merely be an issue for the external relations of the company. However, it has since been held that a company may reduce its capital in any circumstances, for any purpose. Thus, reduction of capital has often been employed to redistribute corporate wealth among shareholders.

9.59 Perhaps because of the narrow scope of the transaction originally perceived, the statute does not contain any provision for shareholder protection. The statutory procedure laid down is for the protection of creditors. Shareholder protection has largely been created by the court exercising its power to confirm the reduction. The court has laid down two criteria for confirmation: disclosure and fairness.

9.60 Although the court has required disclosure, the standards prescribed varied. For instance, while the cause of the reduction must be disclosed, directors need not disclose their shareholdings and financial information is not required even where reduction is but a step in a merger.

9.61 As to fairness, the central question is what protection is required where there is uneven distribution of the burden of reduction. Despite judicial statements on the importance of equal or fair treatment, the present case law yields the following. First, as the statute did not mandate class voting, class voting is not a pre-requisite for the jurisdiction of the court to approve. Secondly, non-rateable reduction can be and has been confirmed over the objection of the minority. Thirdly, in a non-rateable reduction, the court would scrutinize the scheme to ensure that it would not work unjustly or inequitably. Fourthly, perhaps the controlling shareholders may vote to impose a disproportionate burden on the others.

Scheme of arrangement

9.62 Section 166 is a catch-all provision for reorganization under which "compromises" or "arrangements" between a company and its creditors or between a company and its shareholders or any of them may be effected. The term "arrangements" is not defined and the court has intentionally left it vague. All types of restructuring can be and have been effected under this section: increase and reduction of capital, variation of rights, take-overs, spin-off with take-overs, amalgamations and privatizations.

9.63 On the application of the company, the court orders meetings of creditors or shareholders or any class of them to be held. If the scheme is approved by three-fourths present and voting at each of the meetings, the company returns to the court for confirmation. The most often cited criteria for confirmation were laid down by Lindley L.J.:

> What the Court has to do is to see, first of all, that the provisions of that statute have been complied with; and secondly, that the majority has been acting bona fide. The Court also has to see that the minority is not being overridden by a majority having interests of its own clashing with those of the minority whom they seek to coerce. Further than that, the Court has to look at the scheme and see whether it is one as to which persons acting honestly, and viewing the scheme laid before them in the interests of those whom they represent, take a view which can be reasonably taken by businessmen (*Re Alabama New Orleans Texas and Pacific Junction Railway Company*).

The requirements are: disclosure, class voting and fairness.

9.64 The Ordinance requires that shareholders be given with the notice of meeting a statement explaining the effect of the scheme and in particular the interests of the directors. The court has held that the circular must be "perfectly fair, and as far as possible, give all the information reasonably necessary to enable the recipients to determine how to vote" (*Re Dorman Long & Co.*).

9.65 The requirement for class meetings is imposed by statute and meetings are ordered by the court, but "it is the responsibility of the petitioners to see that the class meetings are properly constituted, and if they fail then the necessary agreement is not obtained and the court has no jurisdiction to sanction the agreement" (*Re Hellenic Trust*). The requirement is clear, but what constitutes a class is not. This will be examined further below.

9.66 Although the court's self-imposed criteria include an independent assessment of fairness, courts seldom refused to confirm on this ground.

Freeze-out following successful takeover

9.67 Section 168 of the Companies Ordinance provides that, where a company (the "bidder") makes an offer for all the shares of another company (the "target") or all the shares of a class of shares of the target not already held by it, and achieves acceptance by not less than nine-tenths in value of the shares for which the offer is made, it may require the remaining shareholders to sell to it. On principle, the dissentient should receive no less favourable treatment than an approving shareholder. The dissentient has a further opportunity to object if he makes application to the court within two months from the date on which the notice is given. The court has power to order that the bidder shall not be entitled or bound to acquire the shares or specify different terms and conditions for the acquisition.

9.68 As what is involved is private expropriation, the court takes a strict view of the section. However, the fact that 90 per cent accepted the bid weighs heavily:

> ...prima facie the court ought to regard the scheme as a fair one inasmuch as it seems to me impossible to suppose that the court, in the absence of very strong grounds, is to be entitled to set up its own view of the fairness of the scheme in opposition to so very large a majority of the shareholders who are concerned (*Re Hoare & Co.*).

In the past, courts were not sympathetic to dissentients. Today, courts are aware of the herd instinct problem and are more sympathetic. Non-compliance with disclosure requirements of the voluntary City Code is a reason for denying the freeze-out. Costs are not ordered against an unsuccessful applicant because "his application was not obviously unsustainable or impossible" (*Re Britoil plc.*). Nevertheless the chance of success is slim.

Analysis

9.69 The restructuring provisions are arguably one of the least satisfactory areas of company law. This section will examine three issues: suitability of judicial control, multiplicity of provisions and class voting.

Suitability of judicial control

9.70 As noted above, the appraisal remedy and prior judicial control are alternative systems. It was argued that if the prior judicial system is functional, there is no reason to import the appraisal system. Here, we examine the effectiveness of judicial control.

9.71 The court's record has been criticized. Reductions are rarely disapproved. As Gower once said, "this cannot be explained on the ground that all reduction schemes have been scrupulously fair" (4th ed., p.709). And although the statute and the court take schemes of arrangement more seriously, "when they [the court] are unhappy about a scheme there is the same tendency to try to find that there has been some flaw in the procedure rather than to exercise the discretionary power to refuse to sanction on the ground that the scheme is unfair" (p. 765). This state of affairs is not confined to the U.K. but is observed in the Commonwealth. A Canadian commentator has attributed it to the institutional limitations of courts in general (MacIntosh). First, these applications are mostly unopposed. The court is thus deprived of the benefit of any opposing views. In such circumstances, courts are justifiably unable or unwilling to challenge the management and its financial advisers. Secondly, even where there is opposition, the opponent is unlikely to be supported by expert financial advice.

9.72 With these criticisms, the retention of the prior judicial review system hinges on two issues: what are the advantages of this system and can the structural weaknesses be cured.

9.73 The principal advantage of the prior judicial review system over the appraisal system is certainty. Controllers implementing an approved scheme know that it cannot be unravelled and that they are unlikely to be held liable for losses resulting from the scheme. On the other hand, controllers in the appraisal system take the risk that large numbers of dissentients would exercise the right of appraisal after the scheme had been agreed. Such costs are less predictable than court costs and may place unbearable strains on the finances of the company.

9.74 The principal advantage of the appraisal is that the minority may get a better deal. First, the fear of large numbers of appraisals gives incentives to the controllers to make a better offer in the first place. Secondly, the minority gets a second chance if the offer is still not good enough. Compared with the prior judicial review system, this is a decided advantage. On the other hand, if schemes pass through the court easily, there are less incentives for the controllers to formulate fair schemes.

9.75 This leads to the second question: are the structural weaknesses of the prior judicial review scheme curable? Is it worth a try? We believe that there are advantages to retaining the existing system and an effort should be made to restore the court to its primary function of adjudication rather than investigation. For public companies, *amicus* briefs from securities regulators would be helpful. For private companies, the court should be empowered and encouraged to seek *amicus* briefs.

Multiplicity of provisions

9.76 Even the abbreviated account of the different forms of restructuring shows that the same result is achievable under different forms with different levels of shareholder protection. For instance, if an existing shareholder wishes to privatize, it can bid for the shares of the other shareholders and if it achieves 90 per cent approval, it may freeze out the remainder. Alternatively, he may freeze them out under a section 166 scheme with 75 per cent approval and the court's sanction. Further, he may proceed under the reduction of capital provision with even less statutory safeguards for minorities (*Nicron Resources v. Catto*).

9.77 Some courts are troubled by this and demand a very high standard of proof of fairness (*Re Hellenic Trust*). They also urge controllers to be good and proceed under section 166 where one part of a class of shareholders has been treated differently (*Re Robert Stephen Holdings Ltd.*). Nevertheless, applicants have complete freedom of choice of provisions. This is partly due to the court's faith in its ability to check unfairness and partly due to the fact that the statute does provide these various provisions without limitation. The present patchwork of restructuring provisions was not planned but simply happened over time.

9.78 As Hong Kong's provisions are derived from the U.K. which have been copied in the Commonwealth and have given rise to the cases cited above, there is a possibility of misuse. Given the concerns expressed in those cases, we believe that the issue of multiplicity should be studied.

Class votes

9.79 As noted earlier, vesting decisions in shareholders is inadequate for minority protection because of the presence of the controlling shareholder. This is recognized by law in that section 166 explicitly requires class meetings. The question is what constitutes a class. The undisputed authority is Bowen L.J.'s definition:

> The word "class" is vague, and to find out what is meant by it we must look at the scope of the section, which is a section enabling the Court to order a meeting of a class of creditors to be called. It seems plain that we must give such a meaning to the term "class" as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest (*Sovereign Life Assurance v. Dodd*).

9.80 There are two lines of cases, both citing Bowen L.J. as authority. One line, predominantly Australian, takes the position that only holders of different rights are entitled to a separate meeting. This line was followed by the High Court in *Re Industrial Equity (Pacific) Ltd.*

9.81 The other line holds that shareholders with the same rights but different interests should vote separately. The High Court has rejected this concept on the grounds that identifying different interests would raise "virtually insuperable difficulties". It is admittedly difficult to identify all the different interests that could possibly exist. But the different interests that emerge in these cases are clearly and easily identifiable. In the leading case, *Re Hellenic & General Trust Ltd*, 53 per cent of the company was held by M Ltd which was a wholly-owned subsidiary of H Ltd. A scheme was proposed for the takeover of the company by H Ltd. It was held that M Ltd had other considerations and should be separated from the other ordinary shareholders.

9.82 The common expectations now are that controllers and their associates who have a material interest in the transaction which is different from the others should abstain from voting. *Re Hellenic* and its line of cases are more in tune with the times. The earlier discussion as to restraints on interested controllers is applicable (see paras. 7.55-7.65 above).

Conclusions

9.83 We believe that the current law is not entirely satisfactory. However, because the issue is an important and sensitive one, further study should be made of the existing provisions.

Recommendation 107: The Committee recommends that the suitability of judicial control, multiplicity of provisions and class votes be further studied.

Takeovers

9.84 Takeovers and repurchases are subject to shareholder approval and approval by the S.F.C. It is not proposed to examine the contents of these "regulations" as they involve a larger question of the nonlegal status of corporate and securities regulations in Hong Kong. However, one provision in the Companies Ordinance needs to be dealt with in this connection: section 47A of the Companies Ordinance which prohibits a company from giving financial assistance in connection with the purchase of its securities.

9.85 We believe that takeovers can be beneficial where they allow assets to be put to the most economic use and thus should be facilitated. However, it is also true that some takeovers are driven by fraud or misconduct, so that some regulations are required. As a regulatory tool, section 47A has been unsatisfactory. There is no dispute that reform is needed. This section examines the existing law and suggests directions for further study.

Analysis of existing law

Its origin and rationale

9.86 The origin of section 47A can be traced to section 16 of the Companies Act 1928 introduced on the recommendation of the Greene Committee. The Greene Committee's rationale that the financing of acquisitions of a company's own shares contravened the spirit of *Trevor v Whitworth* was rejected by the Jenkins Committee. The Jenkins Committee also noted that the provision of such financial assistance does not reduce the company's capital but merely substitutes one asset for another. Thus, the purpose of the provision is not the maintenance of capital (para. 173).

9.87 Professor Hadden traced the origin of the provision and discovered its rationale in curbing "asset stripping":

> It was originally introduced in 1928 in an attempt to curb a particularly prevalent form of “asset stripping”. The essence of this practice consists in obtaining control of a company whose shares are undervalued by making an attractive offer to existing shareholders and then selling off the company’s assets; the balance between the price paid for the shares and the money realized from the assets is pure profit for the asset stripper. If the operations of this kind can be financed by using the company’s own resources, there is obviously no need for the organizer to raise any money at all on this own account. It is arguable that there is no harm in the end result, in so far as the company’s assets may not have been profitably employed by the company. But the Greene Committee considered that there was a risk to minority shareholders where asset strippers gained control *without buying up all the shares*, and that allowing the company’s own assets to be used to pay for the purchase increased the opportunities for abuse (p. 350, emphasis added).

9.88 Interestingly enough, beginning in the 1940s, a series of cases developed in the U.S. along the same lines: the anti-looting cases. They held that controlling shareholders owe certain duties when disposing of their control shares:

> Those who control a corporation, either through majority stock ownership, ownership of large blocks of stock less a majority, officeholding, management contracts, or otherwise, owe some duty to the corporation in respect of the transfer of the control to outsiders...it may be said that the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard----unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result (*Insuranshares Corporation*).

The use of corporate funds to finance the purchase of the company’s shares is a fact which might arouse suspicion. Although the cases are not numerous, the duty to investigate if there are suspicions that the buyer would loot the company has been affirmed as late as 1990 (*Harris v. Carter*). Thus, the same mischief is addressed in the U.K. by statute and in the U.S. by case law.

9.89 Admittedly, laws are ineffective in preventing near-fraudulent looting. However, the Jenkins Committee indicated another policy reason for the prohibition. Even if the acquirer is bona fide and intends to pay for the shares, his need for financing by the company means that he is speculating at the expense of the company. He can only gain but not lose; the company has little to gain and everything to lose. It should be emphasized that the provisions do not prohibit a bidder from financing his bid on his own credit. Thus, not all leveraged takeovers are prohibited. They only prohibit the use of the financial strength of the target company for the bidder's benefit. The analogy is to a director who cannot borrow in the market on his credit and borrows from the company instead. This is the basic impropriety and risk to shareholders.

Existing defects

9.90 There is no doubt that the existing provisions are unsatisfactory. Three chief complaints have been made: the provisions are cumbersome, difficult to apply and result in unnecessary costs; they sometimes result in the non-completion of transactions which would be economically beneficial; and parties determined to circumvent the current prohibitions can succeed in so doing. The Jenkins Committee endorsed the policy behind the provisions but noted that they were "an occasional embarrassment to the honest without being a serious inconvenience to the unscrupulous" (para. 176). Thus, reforms were proposed and introduced in the U.K. in 1981 and in Hong Kong in 1991. It is generally agreed that the reforms have not worked.

9.91 The principal cause of the problem is confusion over the purpose of the provisions. This has two consequences: (1) an inappropriate definition of the wrongful conduct which creates both uncertainty and costs and which results in ineffectuality because truly harmful conduct may escape the provisions; (2) mistaken identification of the intended beneficiary of the provisions resulting in the absence of exemptions for public companies.

9.92 As noted above, the rationale of the provisions is to prevent looting of a company by bidders. The primary concern is for minority shareholders who remain in the company after a successful takeover. Companies that are targets of such bids are usually rich in liquid assets; creditor concerns are generally subsidiary. One solution which is consistent with the de-regulation trend would be to subject such transactions to the approval of those shareholders, with the existing controlling shareholders barred from voting.

The Consultants' Recommendations

9.93 The Consultants recommended the repeal of the provision (Recommendation 4.08).

9.94 The Consultants advanced these reasons:
(1) the provision no longer serves its original purpose of capital maintenance;
(2) if the purpose is to prevent leveraged buy-outs, this is wrong as "leveraged buyouts are a fact of modern corporate life" (p. 97);
(3) there is no equivalent in the U.S.

9.95 As to the first reason, it is questionable whether the original purpose of the provision was capital maintenance. It is agreed, however, that the current provisions cannot be justified on that basis.

9.96 As to the second reason, two comments are in order. First, as noted above, section 47A does not prohibit all leveraged takeovers, only a particular kind of leveraged takeover. Secondly, leveraged buy-outs were a fact of life in the US in the 1980s, but there is a considerable body of opinion which holds that the takeovers of the 1980s were excessive and that uninhibited takeovers are not desirable.

9.97 As to the third reason, it is true that U.S. statutes do not contain a provision similar to section 47A. However, there are at least four types of substitutes. First, there is the fiduciary duty of controlling shareholders and the line of anti-looting cases which would hold them responsible for injury to the company made possible by the takeover. Secondly, "management has not only the right but the duty to resist by all lawful means, persons whose attempt to win control of the corporation, if successful, would harm the corporate enterprise" (*Heit v. Baird*). Thirdly, in response to leveraged buy-outs, management have inserted in the company's constitution all types of colourful defences: greenmail, poison pills, sale of crown jewels, shark repellents and scorched earth. Fourthly, even during the height of leveraged buy-outs, states were busily enacting anti-takeover statutes. By the end of 1986, there were 22 states with some form of second-generation statute upheld by the U.S. Supreme Court as constitutional. State statutes continued to grow thereafter. These substitutes reduced and kept down the number of leveraged buy-outs.

9.98 The fourth substitute deserves further comment. Of the variety of anti-takeover legislation two are of particular interest. The Indiana version in effect sterilizes the bidder's shares by denying them voting rights without the approval of the majority of the remaining shareholders. The New York and Delaware versions prohibit a long list of transactions for a period of five years unless approved by target shareholders before the takeover. Among the transactions prohibited are: "any receipt by such [bidder and associate] of the benefit, directly or indirectly...of any loans...other financial assistance...provided by or through such resident domestic corporation" (see Booth).

9.99 The weight of opinion of respondents is against repeal of the provision. Reform is supported.

Conclusions

9. 100 Unfortunately, the Consultants only proposed repeal of section 47A and did not propose any alternatives. While we believe reforms are clearly needed, we cannot accept an immediate elimination of section 47A without any substitutes. The issues are far from simple and further study and consultation are required.

Recommendation 108: The Committee recommends that Recommendation 4.08 of the Consultants' Report be rejected.
Recommendation 109: The Committee recommends that reform of section 47A be further studied.

The remaining Recommendations in Chapter 8 of the Consultants' Report

Amalgamation

The Consultants' Recommendation

9.101 The Consultants recommended that "simple procedures should be made available to provide for corporate restructuring such as by way of amalgamation without the necessity for court intervention or liquidation" (Recommendation 8.04).

9.102 In their comments, the Consultants contemplated that provisions for creditors and appraisal remedy would be available to ensure that “minority shareholders and creditors are not prejudiced”. Thus, this recommendation does not add to Recommendation 8.02 and no reasons were given for singling out amalgamations for special treatment.

9.103 We speculate that Recommendation 8.04 was triggered by a feature of Hong Kong law which looked strange to North American eyes. In North America, two corporations can merge or consolidate by setting forth in an agreement the terms of the merger or consolidation. Statutory formalities are approval of the merger or consolidation by the respective boards and shareholders of the original corporations. On completion of the procedures, the succeeding corporation succeeds to all the rights and liabilities of the original corporations by universal succession. Original shareholders would participate in the succeeding corporation in the manner set out in the agreement or opt out for appraisal rights.

9.104 England never developed this form. Amalgamations proceeded by way of liquidation, friendly takeovers or schemes of arrangements. Originally, the amalgamation by liquidation mode required actual conveyances of assets which were cumbersome, costly and incomplete. This accounted for the infrequent use of this form of restructuring. However, section 167 was developed to facilitate amalgamations by way of schemes of arrangements. Under this section, actual transfers of assets and liabilities are obviated by the court order confirming the scheme. Thus, although the form of Hong Kong amalgamations may look strange to North American eyes, the practical difficulty has been overcome.

9.105 The substantive difference between Hong Kong amalgamations and North American ones lies in the external review system. Here, there is nothing to add to earlier discussion.

9.106 No respondents objected to “simple procedures”, but all insisted on the involvement of the courts which is needed for the protection of creditors as well as minority shareholders. As there is no need for an American-style amalgamation, we agree.

Recommendation 110: The Committee recommends that Recommendation 8.04 of the Consultants’ Report be rejected.

Restructuring of related companies

The Consultants’ Recommendation

9.107 The Consultants recommended that "restructuring of related companies and wholly-owned subsidiaries should be facilitated" (Recommendation 8.05). This recommendation is fleshed out in the comments as follows:

> Simplified procedures for the amalgamation of a parent with a wholly-owned subsidiary or among wholly-owned subsidiary would not require shareholder approval (for the obvious reason) or court approval. The amalgamation would be approved by directors' resolution. No amalgamation agreement would be necessary. Creditors should be adequately protected by their own contractual arrangements, the solvency tests and certification [of non prejudice to creditors].

9.108 It is difficult to understand why shareholder approval should be dispensed with. The Consultants may mean the ultimate shareholders, whose approval for obvious reasons would not be required in the case of an amalgamation of a second or third tier subsidiary under the current system. But that is not reason enough to dispense with second tier approval for third tier amalgamations etc. It is also difficult to understand why an amalgamation agreement should be dispensed with. For proper record and accounting purposes, there must be some document, however simplified, setting forth the terms of the amalgamation.

9.109 As to the dispensation of court approval, this can be viewed from two perspectives. From the perspectives of shareholders, if the amalgamation is between parent and wholly-owned subsidiaries or among wholly-owned subsidiaries, indeed court approval is not necessary as the position of the ultimate shareholders is not prejudiced. Under the current system, this can be done quite easily by way of a "friendly takeover", but a North American amalgamation agreement would not be objectionable. However, related companies are included in the Recommendation (but not the Comments) and they present a different set of problems. Minority shareholders could be prejudiced and court approval is needed.

9.110 Whether the subsidiaries are wholly-owned or related, the position of creditors may be adversely affected. In this regard, respondents' insistence on court involvement is noteworthy. The weight of opinion is against the recommendation.

9.111 We believe that while minority shareholder protection is not needed for the amalgamation of two wholly-owned subsidiaries, creditor protection is still required and court approval should be retained.

Recommendation 111: The Committee recommends that Recommendation 8.05 of the Consultants' Report be rejected.

Other restructuring

9.112 The Consultants recommended that provision should be made for court ordered arrangements for solvent companies where it is impracticable to restructure under other provisions of the legislation (Recommendation 8.07).

9.113 The contents of the recommendation are not objectionable, but unless the existing system is replaced by the appraisal system, there is no need for such a provision.

Recommendation 112: The Committee recommends that Recommendation 8.07 of the Consultants' Report be rejected.

Chapter 10

Creditor Protection

10.1 This Chapter examines the protection provided to creditors under company law.

Existing law and its rationale

Existing law and its original rationales

10.2 Ever since *Salomon v. A Salomon and Company Limited*, it has been trite law that incorporation not only means the creation of an entity separate and apart from its members, it means also that members are not liable for the company's debts. This feature of Hong Kong law is one of the attractions of the corporate form of business organization. It is also one of the pitfalls for outsiders dealing with the company.

10.3 Hong Kong company law has always included provisions for the protection of creditors of a company. These fall into two categories: capital requirements and disclosure requirements. As to capital requirements, there are nine provisions, statutory or decisional, falling into three categories:

(1) capital contribution: minimum start-up capital (s. 42); issue at discount (*Ooregum Gold Mining*), and consideration in kind (s. 45);
(2) maintenance of capital: current distributions (ss. 79A-79P); formal reduction of share capital (ss. 58-63), and redemption and repurchase of shares (ss. 49-49S), and
(3) deterrence of undercapitalization: lifting the corporate veil; fraudulent trading (s. 275), and disqualification of directors (ss. 168G, 168H).

10.4 As to disclosure, there are six main provisions requiring disclosure of the company's state of capital and finance: returns as to allotments (s. 45); returns as to commissions and discounts (s. 46 (1) (a)); returns as to formal reduction of share capital (s. 61); returns as to redemption or repurchase of shares (s. 49G); audited annual financial statements (ss. 122, 141, 141D, 109 (3)), and annual returns (ss. 107, 109 (3)).

10.5 Most of the existing provisions have existed in one form or another since 1932. A few, notably provisions regarding dividends, redemption and repurchase of shares and disqualification of directors, were substantially amended in the 1990s, following the U.K., to provide greater protection to creditors. In spirit, all provisions can be traced to the first statute conferring limited liability. Their rationales can be sought in the original campaign for limited liability.

10.6 Limited liability is so common now that it is easy to forget that limited liability is not an inevitable component of capitalism: it was not adopted in England until more than 100 years after the commencement of the industrial revolution. Limited liability was not the impetus for incorporation either; it was the transferability of shares as well as perpetual succession that propelled the demand for incorporation as of right. Incorporation as of right was won in the Joint Stock Companies Act 1844. Limited liability was only won amidst deep division of opinion in 1855. The controversy still rages among lawyers and economists today.

10.7 The Limited Liability Act 1855 conferred the privilege of limited liability on the following conditions. To obtain a certificate of registration,

(1) the shares of the company must have a minimum nominal value of L10;
(2) the company must have not less than 25 members, holding shares paid up to 20 per cent. Payment must be endorsed on the Deed of Settlement and verified by declaration;
(3) not less than three-fourths of the authorized capital must have been subscribed;
(4) the word "limited" must be added to the company's name, and
(5) the company must complete and file all other forms required under the 1844 Act.

Subsequent to the issuance of the certificate,
(6) the company's auditors must be approved by the Board of Trade, and
(7) the company must be wound-up if it loses three-fourths of its capital.

10.8 The scheme and purpose of the 1855 Act are simple and obvious. Limited liability is a privilege and some protection must be provided to outsiders dealing with the company. This protection consisted in requiring a company to start with a minimum capital which must be maintained to a certain extent during its life and to disclose all to the public. It is then for the outsiders to take care of themselves.

Validity of rationales today

10.9 Is the scheme valid today? As to minimum start-up capital, there are three arguments against stipulating such requirements. First, it is difficult to determine one uniform level which is "right" for all companies. Stipulating different levels for different companies would be an administrative nightmare and inoperable. Secondly, it raises the threshold for starting up a business and dampens the entrepreneurial spirit. Thirdly, minimum capitalization requirements are ineffective if the company takes on excessive risks. If regulation is to be meaningful, it should regulate debt levels also. Again, this level of regulation for all types of business would be inoperable and stifling.

10.10 As to maintenance of the capital contributed to the company, it does not follow from the abolition of minimum start-up capital requirements that members should be allowed to withdraw the amount of the investment said to have been made. There is in principle very little argument against this type of requirement.

10.11 As to disclosure, the arguments against the law mandating disclosure are that it is costly and that the outsider should take care of himself by demanding such information as he needs for decision. These arguments raged in the area of securities regulations in the 1960s. Opponents of regulation claimed that the securities market itself would induce companies voluntarily to make reliable disclosure. These arguments proved inconclusive and even those generally disposed to deregulation favour the retention of the mandatory disclosure system for public companies (Easterbrook and Fischel). In relation to private companies, on the one hand, the argument for mandatory disclosure is even stronger as there are no external market forces to induce voluntary disclosure. The disclosures available to an outsider dealing with the private company are only commensurate with his own bargaining power. Mandatory disclosure corrects some of such imbalances. On the other hand, there may be a justified desire for privacy on the part of the company.

10.12 Accordingly, two at least of the original conditions for limited liability retain some validity: members of a company should not withdraw their contributed capital from their company, and, subject to legitimate privacy concerns of private companies, the financial state of a company should be disclosed. The law should be examined in this light.

Concept of share capital

Analysis of existing law

10.13 Much of the complexity of and dissatisfaction with the existing law stems from the concept of share capital and in particular, the par value. The issue of “par value” has been much debated and this section examines that concept in the historical and current contexts.

10.14 Section 5 (4) of the Companies Ordinance requires the memorandum of association of a company limited by shares to state the amount of share capital with which the company proposed to be registered and the division thereof into shares of a fixed amount. This amount obviously has no relationship to investments in the company; it is only the amount of shares authorized to be issued. Only issued and paid-up share capital have some relationship to the amount invested. This relationship may, however, be misleading because of the concept of par value, i.e. the nominal value of a share.

10.15 The nominal value of shares served a useful purpose in 1855 when the law stipulated minimum par value, subscribed capital and paid-up capital. The entire structure gave an assurance of minimum capitalization. The stated issued or paid-up capital was then a good indicator of the original investment in the company. Share capital in the legal sense and capital in the economic sense was not far apart.

10.16 However, when the minimum capitalization requirement was removed, the remaining structure of par-value shares became first a nuisance and then an irrelevance. Par-value shares became a nuisance because the prohibition on issuance at a discount, of the par-value, meant that companies in need of capital could not raise capital at all or without taking (then) difficult proceedings to reduce the par-value. Businessmen soon found a way around this obstacle by creating shares with low or even trivial par value. Later, amending the memorandum of association was made easier. The resulting low par-value meant that shares would be issued at a premium. Thus, a statement of the paid-up capital of the company, comprising the number of shares issued multiplied by their par-value, does not remotely indicate the amount originally invested. Still less does it indicate the current worth of that investment. Par-value shares thus became and are now an irrelevance.

10.17 There is no doubt that the concept of par-value is an anachronism. This has long been recognized. After a thorough consideration of the various English reports on the issue, the Companies Law Revision Committee recommended that no-par value shares be permitted (para. 3.29). However, no doubt partly due to the lack of demand as noted by the Companies Law Revision Committee, this recommendation has not been implemented.

10.18 Two strong arguments have been made against the concept of par-value. The first is that in a par value system, a statement of share capital is misleading as to the amount invested in the company and as to the current worth of the investment. However, investors in Hong Kong are sophisticated enough not to be misled. In any event, this defect can be cured by disclosure.

10.19 The second argument is that par-value impedes the raising of further capital. As stated above, this difficulty has long been solved by practitioners through the device of low par-value. However, there may still be some older companies with par values higher than their trading value. We propose a simple solution to address this problem below (see para. 10.64 below).

10.20 Although there are no fundamental difficulties in retaining the current par-value system and the response of institutions to the Consultants' Report indicates that there is not much demand for no-par shares, we recognize that some changes are required since the international trend is to move toward a no-par system. Accordingly, we believe that incorporators should be given a choice to adopt no-par shares.

10.21 We note, however, that the current system offers certain practical benefits to incorporators. For instance, the current system minimizes the capital duty payable on incorporation by imposing duty by reference to the par value. All such benefits and flexibility should be preserved to the maximum extent in the new system including the share premium account which can be utilized in various circumstances.

The Consultants' Recommendations

10.22 The Consultants recommended that par-value shares should be prohibited (Recommendation 4.02).

10.23 Citing from the *Dickerson Report*, the Consultants advanced four reasons:

(1) par-value shares no longer serve their originally intended purpose;
(2) par-value shares are misleading;
(3) difficulties associated with issuing shares at a discount would fall away with abolition of the concept, and
(4) statutory provisions relating to capital structure and the accounting problems associated with par value would be simplified.

10.24 We agree that par-value shares do not serve their originally intended purpose. However, the second condition does not exist in Hong Kong in the 1990s. The third reason may apply to a small number of companies, but the solution proposed below should obviate further action. The fourth reason is not a valid reason as it posits simplification of statutory provisions as an end in itself. As we will demonstrate below, the existing provisions relating to maintenance of capital serve a useful purpose and should not be "simplified". Furthermore, par-value itself does not pose accounting problems.

10.25 Converting the share capital of existing companies to no-par shares entails expenses. In addition to re-stating and re-registering the constitution, accounts of the company would require revision and reconciliation. We do not have complete information on the financial cost involved in making such a change. However, we do not believe that companies should be compelled to incur such expenses which they may consider unnecessary. We note that although principal U.S. jurisdictions such as Delaware and New York had introduced no-par shares in the early 1900s, they still permit par-value shares today.

Conclusions

10.26 There is little support for the recommendation. We agree there is no case for abolition of par-value shares.

10.27 We believe that company law should offer no-par shares as an option for existing and future companies. This should be acceptable even to those who wish to retain par-value shares as they may do so. We recognize that our recommendation will add complexity to the law. However, this is a price that must be paid if we wish both to provide the maximum flexibility to companies and to avoid unjustified criticisms for not following international trends.

Recommendation 113: The Committee recommends that Recommendation 4.02 of the Consultants' Report be rejected.
Recommendation 114: The Committee recommends that company law should permit no-par shares for all companies on an optional basis.

Capital contribution

Analysis of existing law

10.28 As noted above, there are three provisions concerned with capital contribution: minimum capital requirements, issues at a discount and consideration in kind.

Minimum capital requirements.

10.29 Section 42 of the Companies Ordinance provides that, in the case of a public offer, if the prospectus states that a certain minimum amount is required to complete certain proposed transactions, no allotment may be made unless that amount is subscribed and paid, at least by cheque, to the company.

10.30 As argued above, stipulating minimum capital requirements is meaningless. Section 42 is doubly so in that it bites only if the company states in its prospectus that a minimum amount of capital is required and, except for companies destined for the Growth Enterprise Market, such a statement of minimum amount of capital is not required where a general purpose of the public issue is clearly stated and the issue is fully underwritten (Third Sch, Part 1, s. 7, proviso). However, section 42 does not itself impose any particular minimum capital against the wishes of the promoters. Thus, it is innocuous as a stipulation of minimum capital requirement. Its function is to guard against the failure of a public issue. No action is needed in relation to this provision.

Issue at a discount.

10.31 The prohibition on issuance of shares at a discount of par value is a common law prohibition confirmed by the House of Lords in 1892 (*Ooregum Gold Mining*). The Companies Ordinance created two exceptions: section 50 permits issuance at a discount subject to, *inter alia*, court approval; section 46 permits the payment of commissions up to certain limits as consideration for securing subscriptions for the company's shares. With the introduction of no-par shares, some consequential amendments would be required.

10.32 Although the prohibition would not be needed for no-par shares, it is worth noting its deficiency. As a protection against dilution by issuing shares at too low a price, the prohibition is ineffective as it merely prohibits discounts from the par value. If the worth of the shares is higher than par value, it is no comfort to existing shareholders and creditors that the directors issue the shares at par value, but at a discount from market value. However, the courts have held that in general there is no obligation to issue shares above par value because they are salable at a premium in the market.

Consideration in kind.

10.33 Shares may be issued for consideration in kind provided that appropriate documentation is filed with the Registrar (s. 45). However, section 45 does not require any reasonable value to be given for the shares. All that is required is that a price be placed on the consideration given and this price is not at a discount to the par value of the shares. The court will not examine the value of the consideration so long as it is not illusory.

10.34 It can be seen from the above that the provisions concerning issuance of shares at a discount or for consideration in kind are not useful in ensuring that the company receive reasonable value for shares. In the case of consideration in kind received from controllers or their associates, the potential for abuse is enormous. As the mispricing of shares may be easily excused as good faith mistakes, the directors' fiduciary duty may not be an adequate restraint against this type of abuse. Reforms have been undertaken in other jurisdictions.

10.35 In the U.K., provisions were introduced in 1985 to require, in relation to public companies, independent valuation of the consideration by valuers qualified to be appointed as an auditor of the company. Gower referred to this approach as being a "long overdue tightening up" (p. 239), but Farrar criticized it as being overly complicated and easily evaded (pp. 179-181).

10.36 In Canada, a separate duty fairly to value the consideration received is imposed on directors who are made liable for the difference between the consideration received and "the fair equivalent of the money that the corporation would have received if the share had been issued for money on the date of the [directors'] resolution" (s. 118 (1) C.B.C.A.)

The Consultants' Recommendations

10.37 No recommendations are made beyond the abolition of par value. There is no discussion of issuance of shares at a discount to real value.

Conclusion

10.38 The existing rules do not provide much external restraint on the issuance of shares to controllers or their associates for consideration in kind. We believe that further study is needed to determine whether, and if so what, external restraints are required to prevent abuse.

Recommendation 115: The Committee recommends that further study be made of restraints on issuance of shares for consideration in kind.

Maintenance of capital

Analysis of existing law

10.39 As noted above, there are three provisions concerned with the maintenance of capital: current distributions, formal reduction of capital, and redemption and repurchase of shares.

Current distributions

10.40 The primary concern of creditors is that the company retains adequate assets to meet existing claims due or payable in the future. Prior to 1991 in Hong Kong (1981 in the U.K.) current distributions were regulated by case law. Due to the obfuscation of par value and the lack of understanding of business and accounts on the part of the courts, the concept of maintenance of capital was meaningless. Despite the court's declaration that "dividends must not be paid out of capital" or "dividends must only be paid out of profits", the courts did permit dividends to be paid out of capital, including the share premium account, without a formal reduction of capital as long as there was a surplus in the relevant fiscal year. In 1991 the Companies Ordinance was amended by adding amendments first introduced in the U.K. in 1981 and later consolidated in Part VIII of the 1985 Act. The principal amendments were:

(1) A company may not pay dividends out of profits of the current year without first "making up" for losses of previous years.
(2) A company may not pay dividends out of unrealized gains.
(3) Unrealized gains may not be used to pay up amounts unpaid on issued shares.

Listed companies are subject to the following additional requirements under section 79C:

(4) At the time of the distribution, the amount of the company's net assets is not less than the aggregate of its called up share capital and undistributable reserves.
(5) After the proposed distribution, the amount of the company's net assets would not be less than the aggregate of its called up share capital and undistributable reserves.

10.41 The purpose of amendments applicable to all companies is to ensure that distributions are only made from accumulated realized gains less accumulated losses. The purpose of the additional requirements for listed companies is to ensure that the capital and undistributable reserves are not merely historical entries but are represented by real assets.

10.42 The difference between regulations for private companies and listed companies highlights a deficiency of the existing rules in relation to private companies. That is, dividends may be paid notwithstanding any devaluation of assets in the hands of the company. Thus, for private companies, the maintenance of capital may be no more than maintenance of historical entries not represented by assets.

10.43 As the principle of capital maintenance and creditor protection apply to both public and private companies, it is arguable that section 79C should be extended to private companies, remedying this deficiency. However, since many private companies are members of a group of companies, an extension may have adverse implications for the listed corporate parent. Further study of the issue is desirable.

Formal reduction of share capital

10.44 There are three principal motivations for a formal reduction of share capital:

(1) voluntarily to reduce the scope of future business;
(2) to match the balance sheet with reality when capital has been lost, and
(3) to reorganize the capital structure of the company.

10.45 There are two aspects to a formal reduction of share capital. One is to ensure fair distribution of the burden of a reduction among shareholders and the other is to ensure protection of creditors. Although this Chapter is concerned with creditors only, the shareholder perspective must be borne in mind as any resolution must operate well in both respects.

10.46 The required procedure is shareholder approval followed by court approval. Where the reduction involves return of paid-up capital or where the court thinks fit, the court may fix a date for determining creditors with claims against the company. The court shall then fix a list of creditors entitled to object and ascertain the nature and amount of their claims. If the consent of these creditors is not obtained then full provision must be made by the company, unless dispensed with by the court (s. 59). Although the statute does not give creditors the right to object when reduction is proposed on the ground of loss of capital, if reduction is proposed on such a ground, the loss must be permanent loss. If the loss is not permanent, reduction will not be permitted unless the company undertakes to place all subsequent recoveries in a permanent capital reserve account.

10.47 The above applies to a reduction of the share premium account in the same manner (s. 48B (1)).

10.48 If a creditor is overlooked in the settlement of the list of creditors, and the company is unable to pay him subsequently, the shareholders as at the date of registration of the court order confirming the reduction, are liable to contribute for payment of the debt as if the company had commenced to be wound up on the day before such date (s. 62 (1)).

10.49 The objective of capital maintenance is a valid objective and is achieved by the above provisions. There is, however, one defect: the above provisions are cumbersome where the only reduction involved is a redesignation of the par value to a lower amount. If there is no distribution out of the company and shareholders are treated equally and fairly, there is really no need for court approval. Accordingly, where the proposed reduction consists of a redesignation of par value to a lower amount, court approval should not be required if

(1) the company has only one class of shares,
(2) all issued shares are fully paid-up,
(3) the reduction is distributed equally to all shares, and
(4) the reduction is credited to the share premium account.

Redemption and repurchase of shares

10.50 Redemption of shares is permitted if the shares are fully paid and if they had been made redeemable on issuance (s. 49).

10.51 Repurchases of shares are permitted subject to shareholder approval (s. 49BA) and, in the case of a public company in Hong Kong, the approval of an Executive Director of the S.F.C. (Share Repurchase Code, Rule 2).

10.52 The protection of creditors lies mostly in the regulation of the amount payable on redemption and repurchases. This is achieved in two principal ways. First, the maximum amount that may be paid is stipulated as the amount of distributable profits or the proceeds of a new issue. Secondly, capital is preserved for future purposes. The face value of shares repurchased is cancelled (as share capital) and entered in the capital redemption reserve account (s. 49A). These provisions are relaxed for private companies (ss. 49I to 49O).

10.53 The objective of capital maintenance is a valid objective and is achieved by the above provisions.

The Consultants' Recommendations

The Recommendations

10.54 The Consultants recommended that the existing provisions be replaced by a solvency test. Companies may make current distributions, redeem or repurchase their own shares or reduce their share capital if they pass a solvency test which combines an asset test and a liquidity test (Recommendation 4.07).

10.55 It appears to be part of the Consultants' Recommendations that court approval (see Recommendations 8.01 and 8.02) be dispensed with, although this is not explicitly stated.

10.56 The Consultants advanced three reasons for their recommendations:

(1) the capital maintenance rules are founded in notions of minimum capital requirements and par value;
(2) the existing provisions are extremely detailed and complex, whereas the recommended provision is "elegant and starkly simple", and
(3) the U.S. has done so.

Their merits

10.57 The first reason advanced by the Consultants is not valid. Capital maintenance is not necessarily tied to minimum capital requirements. Even if the law does not stipulate any minimum start-up capital, it may still be legitimate to require members not to withdraw their investment from the company, whatever the amount may be. The current rules are indeed based on par value. If the concept of par value is abolished, the rules would need to be re-written. That is all. As long as the concept of capital maintenance is valid, there would need to be rules of a similar nature.

10.58 The second reason confuses simplicity and efficiency in operation with simplicity in statutory language. If the Consultants' Recommendations introduce a simple and more efficient means of delivering the same level of creditor protection than the existing provisions, clearly they are to be commended. However, efficient creditor protection is not necessarily demonstrated by linguistic elegance and simplicity. As to the relative efficiency between existing provisions and the Recommended approach, the existing provisions provide greater protection to creditors at less cost.

10.59 The third reason advanced by the Consultants is not valid in itself.

10.60 The Consultants' solvency test has two prongs. As to the first, the ability to pay debts as they fall due, it is to a certain extent provided for at common law and the wrongful trading provision recommended below. As to the second, the excess of assets over liabilities, this will allow companies that adopt "mark-to-market" accounting to make distributions out of unrealized gains, resulting in erosion of capital where the anticipated gains do not materialize. Thus, the existing rules provide greater protection to creditors.

10.61 On the other hand, the Consultants' approach may be more costly. In this connection, two points can be raised. First, this approach overlooks the potential uses and abuses of redemptions and repurchases of shares or of reductions of capital. In Hong Kong, these corporate activities may be conducted as a way of redistributing corporate wealth among existing shareholders. Potential abuses include: selective repurchases, overpayment or underpayment for shares, acquisition of control (surreptitious), selective reduction and inequitable distribution of the burden of reduction. The solvency test can at best provide creditor protection. For shareholder protection, shareholder and court approvals are needed. Thus, the recommended approach would not result in reduction of those costs.

Secondly, even as regards creditor protection, it is questionable whether the Consultants' approach would reduce costs. From the point of view of costs, under the existing provisions, the company would certainly need the assistance of accountants to calculate the various reserves to arrive at the amount of permissible distributions and payments. Under the Consultants' approach, there will not be any need to make these calculations. However, accounting costs are still unavoidable. The Consultants' approach would require in practice an opinion from accountants that the company is solvent and would be solvent after the proposed transaction (Welling).

Their reception

10.62 There is little support for the Consultants' Recommendations on dividends and repurchases, while the recommendation on dispensing with court approvals on reduction of capital was overwhelmingly rejected.

Conclusions

10.63 As the objectives of the existing provisions are valid and have been achieved, whereas they are unachievable under the Consultants' system, we believe the Consultants' Recommendation 4.07 should be rejected.

10.64 To facilitate the redesignation of par-value to a lower amount, we believe that a provision be added to allow reduction of capital without court approval if the following conditions are satisfied:

- (a) the company has only one class of shares;
- (b) all issued shares are fully paid-up;
- (c) the reduction is distributed equally to all shares; and
- (d) the reduction is credited to the share premium account.

10.65 As there appears to be one deficiency in the existing rules for the maintenance of capital for private companies, we should study further the issue whether section 79C should be extended to all private companies.

Recommendation 116: The Committee recommends that Recommendation 4.07 of the Consultants' Report be rejected.
Recommendation 117: The Committee recommends that court approval for reduction of capital should not be required for the redesignation of par-value to a lower amount provided that the company has only one class of shares; all issued shares are fully paid-up; the reduction is distributed equally to all shares; and the reduction is credited to the share premium account.

Recommendation 118: The Committee recommends that the application of section 79C to private companies should be further studied.

Deterrence of undercapitalization

Analysis of existing law

10.66 As noted above, there are three types of provisions that may deter undercapitalization:

Lifting the corporate veil

10.67 Anglo-Hong Kong law affords very narrow grounds for lifting the corporate veil. The *Salomon v Salomon* principle is generally adhered to only except in the case of sham. Specifically, gross undercapitalization has not resulted in the lifting of the corporate veil. Piercing the corporate veil, then, is not an effective deterrent against undercapitalization.

Fraudulent trading

10.68 Section 275 (1) of the Companies Ordinance imposes personal liability on a person who is party to carrying on business of a company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose. The requirement for a subjective wrongful intent reduces the utility of this provision for purposes of deterrence of undercapitalization. In the U.K., the mental requirement has been reduced to an objectively tested reasonable appreciation of insolvency. As a result, the section has been utilized more frequently. The Law Reform Commission of Hong Kong has recommended a like change.

Disqualification of directors

10.69 A person guilty of fraudulent trading (whether or not convicted under section 275) may be subject to a disqualification order for up to 15 years (s. 168H). A director or former director of an insolvent company may be found by a court to be unfit to be involved in the management of a company. In such an event, he may be disqualified for a minimum period of one year and a maximum period of 15 years (s 168H). English cases have shown that undercapitalization during the tenure of the person is a factor taken into consideration.

10.70 These more rigorous disqualification provisions were adopted in Hong Kong in 1994. While there has been usage of the disqualification provisions on the general ground of unfitness, mainly for not keeping proper books of account and not supplying statements of affairs, we are not aware of any case in which undercapitalization constituted a major consideration.

The Consultants' Recommendations

10.71 The Consultants recommended removing Part V of the Companies Ordinance (which contains the fraudulent trading provision) and the disqualification of directors provisions from the Companies Ordinance (Recommendations 1.05 and 6.18).

10.72 The reasons advanced for both recommendations is that the provisions do not pertain to "core" company law. The treatment of these provisions reveals the central weakness of the approach of the Report in discussing only "core" company matters. First, this approach invites a sterile debate over what constitutes core company law. More seriously, even if for drafting and administrative reasons, certain provisions may be more conveniently placed in another statutory instrument, in formulating principle and policy, all provisions must be considered together as they impact on one another. In the present case, fraudulent trading is a prime tool for deterring undercapitalization. If it is working effectively, the law may be less demanding on capital or disclosure requirements. On the other hand, if it is not yet working effectively, then the law on capital or disclosure requirements may need tightening up. It is disappointing that the Consultants did not offer any assistance here.

10.73 As to the disqualification of directors, the Consultants questioned the merits of the provisions and advanced the following additional reasons for their removal:

(1) citing from an article published in 1988, the Consultants stated that disqualification has not been very useful in the U.K.;
(2) the C.B.C.A. does not contain any such provision; the M.B.C.A. provides for judicial removal of an erring director from his office. "Disqualification can thus be seen to be an exceptional recourse" (p. 129).
(3) the shareholders' remedies recommended "should provide the means of removing rogue directors without recourse to specific disqualification provisions" (p. 129).

10.74 The first reason is invalid because the article there cited first studied the period from the Second World War to the mid-1980s and reached the conclusion cited by the Consultants. The purpose of the article was to critique the reforms introduced in the Company Directors Disqualification Act 1986. Following the passage cited by the Consultants, the author offered eight recommendations for further reform and ended the article expressing a belief in "the potential usefulness of disqualification" (p. 48). Since the date of the article, a rigorous enforcement program has been pursued under the new Act and there has been a sea change in disqualification of directors in the U.K.. The Sixth Edition of Gower published in 1997 noted that "for many years the disqualification provisions of the successive Companies Acts seemed to make little impact... The combination of the substantive reforms recommended by the Cork Committee and of acceptance by Government that the promotion of small, and not-so-small, businesses needed to be accompanied by action to raise the standards of directors' behaviour and to protect the public from the scheming and the incompetent, has at last brought the disqualification provisions to the fore" (p. 690). Indeed, while there are still voices demanding further reforms, there has been a dramatic increase in the number of disqualification proceedings since 1988.

10.75 The second reason is not valid in itself.

10.76 The third reason overlooks the purpose of the disqualification provisions. Assuming that shareholders' remedies may be effective in removing rogue directors, any such removal is limited to the existing office. An aggrieved shareholder can at best remove the rogue director from his company. Such a director may immediately form or join another company. The disqualification provisions have a much broader remit than shareholder remedies. They remove an unfit director from circulation. They are a preventive rather than a punitive measure and make it difficult for unfit persons to trade on limited liability.

10.77 There is general consensus that insolvency provisions be removed from the Companies Ordinance. It is interesting to note that one respondent noted that the proposed codification of company law would delay much needed reform, such as in the area of fraudulent trading. It was proposed that the U.K. concept of "wrongful trading" be adapted to Hong Kong as soon as possible.

10.78 A number of respondents would not object to the removal of disqualification provisions from the Companies Ordinance, while almost an equal number thought that some disqualification provisions should be retained in the Ordinance. All saw merits in the substance of the provisions and objected to their removal from Hong Kong law (as opposed to removal from the Companies Ordinance). One urged the government to "ensure that there is active and efficient enforcement to protect public interest".

Conclusions

10.79 We agree insolvency provisions may be removed but urge prompt action on the reform of fraudulent trading which can be undertaken independently of larger reforms. There is merit in the disqualification provisions which should be retained.

Recommendation 119: The Committee recommends that prompt action be taken on the reform of fraudulent trading.
Recommendation 120: The Committee recommends that Recommendation 6.18 of the Consultants' Report be rejected.

Disclosure

10.80 Given the current emphasis on disclosure and transparency in Hong Kong, it is not proposed to discuss the provisions relating to returns as to allotments, commissions and discounts, formal reduction of share capital, redemption or repurchase of shares. It is assumed that there is little purpose in removing the current disclosure requirements. Incremental improvements that may be required will be dealt with in the ordinary course of business of the Committee. This Report will focus on five controversial aspects of disclosure: waiver of compliance with Generally Accepted Accounting Principles (G.A.A.P.) by private companies; waiver of mandatory audit for private companies; simplified financial statements for private companies; mandatory publication of financial statements of private companies, and general contents and standards requirements relating to financial statements.

10.81 In assessing the law on disclosure, it should be borne in mind that the law on capital requirements is minimal. Thus, it is arguable that disclosure requirements should be strict as severely undercapitalized businesses are allowed to trade with limited liability.

Waiver of G.A.A.P. by private companies

Analysis of existing law

10.82 The financial statements of all companies must present a "true and fair view" of their state of affairs or operations, as the case may be (s. 123).

10.83 The meaning of a "true and fair view" is not defined in the statute and has been a matter of argument. Originally, there had been a view that a "true and fair view" meant no more than that all the specific legal requirements have been followed, thus subordinating the "true and fair view" requirement to the specific requirements. In the U.K., statutory amendments have been made to make it clear that a "true and fair view" is the overriding requirement. Hong Kong has not done so.

10.84 Despite the lack of decisional law, there is a measure of consensus on the meaning of a "true and fair view". Prominent counsel who are now on the Bench had opined that departure from accounting principles is prima facie evidence that the financial statements do not present a true and fair view (see Bird).

The Consultants' Recommendations

10.85 The Consultants recommended that consideration should be given as to whether private companies should be able to dispense with the requirement to comply with G.A.A.P. by means of unanimous shareholder agreement (Recommendation 5.03).

10.86 The Consultants advanced two reasons: (1) the US does not require G.A.A.P. of small companies, and (2) compliance is costly.

10.87 It is noted that the overwhelming weight of opinion is against the recommendation. We agree.

Recommendation 121: The Committee recommends that Recommendation 5.03 of the Consultants' Report be rejected.

Waiver of mandatory audit for private companies

Analysis of existing law

10.88 All companies, public and private, are required to present to shareholders audited annual financial statements within certain time limits after the year end (ss. 122, 141).

The Consultants' Recommendations

10.89 The Consultants recommended that shareholders should be able to dispense with an audit by unanimous agreement (Recommendation 5.06).

10.90 The reasons advanced by the Consultants were:

(1) where there is a sufficient identity of ownership and management, an audit is of little use to shareholders;
(2) individual creditors who require audited financial statements can request them as a condition of doing business;
(3) audits are costly, and
(4) popular offshore jurisdictions do not require them and Hong Kong incorporated businesses find themselves at a competitive disadvantage in this respect.

10.91 The first reason of the Consultants indicates a rather narrow and legalistic view of the function of audited financial statements. In reality, there are many outside users of these documents.

10.92 The second reason ignores the plight of the small trader. Certainly, an important creditor such as the Inland Revenue Department (I.R.D.) may be able to demand and get audited statements if it wishes. However, creditors with less bargaining power who may be given audited financial statements if they are already available will have no means of getting an audit in the absence of a legal requirement. Such a trader is usually, but not necessarily, small: bankers are known to have waived prudential requirements in a borrower's market. It is noted that one of the three primary conditions for the privilege of limited liability is disclosure. The removal of the mandatory audit, coupled with the absence of minimum capital requirements, would leave the creditor with practically no protection.

10.93 The third reason considers the costs of audits in isolation. Naturally, there will be a savings of audit fees if the audit requirement is removed, although it has been pointed out that the savings will not be significant. If financial statements must comply with G.A.A.P. (see above), accountants will be needed to assist in their preparation. The incremental cost of audit is not significant. More seriously, it is not right to leap from the fact of savings of some audit fees to the conclusion that there will be a net reduction in the cost of doing business. The following costs may be incurred in the system proposed by the Consultants:

(a) as companies go back and forth from the audit system, the absence of a history of audit increases the costs of audit in the years when it is required;
(b) similarly, the absence of a history of audit increases the costs of audit when the company needs to raise capital,
(c) the enforcement costs of I.R.D. will be raised if it has to compensate for the audit.

Thus, savings in audit fees may at best be a zero-sum game.

10.94 The popular jurisdictions referred to in the fourth reason are known tax havens. Hong Kong should not join in a race to the bottom and tarnish its reputation in the process.

10.95 Many respondents pointed out that jurisdictions such as England, Canada, New Zealand and Australia which allow private companies to waive audits to various extents have other systems in place to impose a certain measure of discipline on management. In the U.S., the litigious citizen acting as the private attorney-general also exerts pressure on management. It is not legitimate to make comparisons of statutory provisions in isolation without reference to the environment in which they operate.

10.96 The overwhelming weight of opinion is against the recommendation. We agree.

Recommendation 122: The Committee recommends that Recommendation 5.06 of the Consultants' Report be rejected.

Simplification of financial statements for private companies

Analysis of existing law

10.97 A private company other than a company which is a member of a corporate group; a banking, insurance, shipping or airline company; a securities dealer, or a lending company may, with the agreement of all shareholders in writing, prepare simplified financial statements.

Specifically, there is no obligation to prepare financial statements showing a "true and fair view" and a shorter schedule of specified items of disclosure (the Eleventh Schedule) is stipulated in place of the Tenth Schedule. An auditor's opinion on the "true and correct view" of the statements is necessary (s. 141D). The Hong Kong Society of Accountants (H.K.S.A.) states that as the meaning of "true and correct" as opposed to "true and fair" has never been clear, the auditing profession "has necessarily applied the same standards of accounting and auditing to all companies despite the accounts disclosure exemptions". It is desirable that the statute be amended expressly to provide for a "true and fair" view.

The Consultants' Recommendations

10.98 Although the Consultants recommended waiver of G.A.A.P. and auditing requirements for private companies, they did not propose deletion of section 141D as being superfluous.

10.99 Respondents pointed out that the Consultants' concerns about costs for private companies might be addressed, not by waiver of G.A.A.P. or auditing requirements, but by modification and extension of section 141D. In brief, the idea is to reduce the quantity but not the quality of disclosures for companies below a certain size.

Recommendation 123: The Committee recommends that section 141D of the Companies Ordinance be amended to refer to a "true and fair" view.
Recommendation 124: The Committee recommends that a study be undertaken as to whether, and if so to what extent, section 141D should be modified and extended.

Mandatory publication of financial statements by private companies

Analysis of existing law

10.100 The audited financial statements of private companies are not required to be filed with the Registrar (s. 109 (3)).

10.101 This exemption which dates back to the Companies Act 1929 has an interesting history. In the U.K., the Companies Act 1967 repealed the exemption on the recommendations of the Jenkins Committee. The issue was considered by the Companies Law Revision Committee. Of the formal representations received, four favoured the retention of the exemption, as against three who opposed. However, informal representations were overwhelmingly in favour of the exemption.

10.102 The arguments against the exemption which found favour with the Jenkins Committee were:

(1) many private companies were not "small";
(2) fears of embarrassment or inconvenience of publication were exaggerated. The Jenkins Committee proposed limited exemptions for companies under certain sizes;
(3) protection of creditors required publication (paras. 55-63).

10.103 The Companies Law Revision Committee favoured the retention of the exemptions for these reasons:

(1) many private companies were formed with the intention of operating outside Hong Kong and publication would embarrass them without compensating benefits for the local community;
(2) Chinese businessmen have "the most rooted aversion" to disclosure and mandatory publication would cause them to abandon the corporate form of business organization and revert to the Chinese partnerships.

10.104 It may be questioned whether the reasons which found favour with the Companies Law Revision Committee are still valid. Considering again the negligible capital requirements placed on companies, it is perhaps time to reconsider the exemption.

The Consultants' Recommendations

10.105 The Consultants recommended exemptions from publication of financial statements for private companies (Recommendation 5.05).

10.106 The reasons advanced by the Consultants were:

(1) any such information would be stale;
(2) creditors should look to negotiated contractual or other statutory protections,
(3) partnerships and sole proprietorships are not required to publish financial statements.

10.107 The first reason is not a reason to eliminate publication. If timeliness is a problem, the cure is to require more frequent or timely publications. In any event, the availability of last year's statements would provide a more convenient starting point for investigations and a means of verification of information otherwise obtained.

The second reason ignores the disparity in bargaining power that exists. Also, it overlooks the Consultants' own observations that Hong Kong lacks private sources of credit information (p. 21).

The third reason ignores a crucial difference between a company and a sole proprietorship, namely, limited liability. It is interesting to note that in the U.K. proposal for limited liability partnerships, one theme stands out clearly: limited liability is offered to partnerships on condition that they be subjected to equivalent external requirements. Thus, limited liability partnerships will be required to file audited accounts (ch. 3).

10.108 The Consultants' Report did not make clear that the recommendation was to maintain the status quo rather than to introduce something new. Interestingly enough, looking at the issue afresh, the weight of respondents' opinion is against the exemption without qualification or further study.

Conclusions

10.109 We believe that the issue deserves further study and consultation.

Recommendation 125: The Committee recommends that Recommendation 5.05 of the Consultants' Report be rejected.
Recommendation 126: The Committee recommends that further study and consultation be conducted on exempting private companies from publication of financial statements.

General contents and standards requirements

Analysis of existing law

10.110 The relevant provisions are as follows:

Section 123 (1) Every balance sheet of a company shall give a true and fair view of the state of the affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.

(2) A company's balance sheet and profit and loss account shall comply with the requirements of the Tenth Schedule, so far as applicable thereto.

(3) Save as expressly provided in the following provisions of this section or in Part III of the Tenth Schedule, the requirements of subsection (2) and the said Schedule shall be without prejudice either to the general requirements of subsection (1) or to any other requirements of this Ordinance.

10.111 The provisions are set out in full to illustrate a drafting problem. It had been argued that the above provisions subordinated the "true and fair view" requirement to the special contents requirements. The Jenkins Committee thought otherwise (para. 332), but the point was too important to be left in doubt. The U.K. has amended its provisions to make certain that the "true and fair view" is the overriding requirement (s. 226). Hong Kong has not done so.

10.112 The Tenth Schedule is a recognizable copy of the Eighth Schedule of the Companies Act 1948. It is agreed by all that it is antiquated. The only question for reformers is how to reform and how to ensure that statutory requirements, if any, are kept up-to-date.

The Consultants' Recommendations

10.113 The Consultants made two recommendations in this regard. The first can be disposed of quite shortly. Recommendation 5.01 states:

> Companies should be required to prepare accounts that give a true and fair view of the state of affairs of the company. Details as to the form and content, to the extent required to be specified, should appear in subsidiary legislation; the Tenth Schedule of the Companies Ordinance (Accounts) should be eliminated.

10.114 There is no quarrel to be had with the first sentence, although the Consultants do not appear to have recognised the problem referred to in the preceding section and the need for reform. The second sentence indicates that the Consultants believed that the Tenth Schedule constituted primary legislation and for that reason should be eliminated. This mistates the law. Although appearing as a schedule to the Ordinance, the Tenth Schedule is subsidiary, not primary, legislation in the sense that it may be amended by the Chief Executive in Council instead of the Legislative Council (s. 360 (1)).

10.115 The second and principal recommendation of the Consultants is that instead of stipulating requirements by legislation, primary or subsidiary, the law should simply mandate compliance with G.A.A.P. to be established by "an independent standards body or by a H.K.S.A. process that would involve a wider representation of interested parties" (Recommendation 5.02).

10.116 In substance, Recommendation 5.02 should be an alternative recommendation to 5.01, but it was not clearly stated. Indeed, the comments of the respondents show some confusion and inconsistencies possibly due to the manner of presentation of Recommendations 5.01 and 5.02.

10.117 The reasons advanced by the Consultants for Recommendation 5.02 were:

(1) this eliminates possible conflicts between legislative standards and accounting practices;
(2) Canada and Australia have done so.

10.118 The second reason is not valid in itself.

The first reason is premised on a misapprehension of the law. As noted above, the law respects accounting practices and requires explanations from those who depart from G.A.A.P.. There is no conflict. If it is suggested that various items in the Tenth Schedule conflict with accounting practices, this was not demonstrated. In any event, as the Tenth Schedule stipulates items of information required, and not accounting principles and practices, cases of "conflicts" must be rare. Further, conflicts can be resolved by amendment rather than elimination.

10.119 Although the proposal is momentous, no consideration has been given to alternative reform adopted elsewhere.

10.120 This only leaves for consideration the very detailed and closely-reasoned arguments of the H.K.S.A. against giving legal effect to G.A.A.P.. Briefly, their views are as follows:

(1) the Tenth Schedule is intended to provide in law for the principal disclosures that should form the backbone of the accounts rather than the optimal accounting disclosures that are required to show a true and fair view as prescribed in Statements of Standard Accounting Practice (S.S.A.P.). There is therefore no inherent conflict;
(2) the Tenth Schedule is out-of-date and the H.K.S.A. would assist in updating efforts;
(3) “statufication” of standards will impede development of the profession;
(4) the question of legitimacy of a private body making law may mean the creation of additional oversight bureaucracies;
(5) accounting standards may be politicized, and
(6) no information has been provided as to the operation of the law in Canada, Australia and New Zealand.

10.121 Although the H.K.S.A. may be considered an interested party, the reasons advanced by them have merit.

Recommendation 127: The Committee recommends that Recommendation 5.01 of the Consultants’ Report be rejected.
Recommendation 128: The Committee recommends that Recommendation 5.02 of the Consultants’ Report be rejected.
Recommendation 129: The Committee recommends that the Tenth Schedule be updated and that the H.K.S.A.’s offer of assistance in this respect be accepted.

Involuntary creditors

Analysis of existing law

10.122 While the requirement for minimum capitalization is no longer generally accepted, it is also generally recognized that limited liability operates harshly on involuntary creditors for whom disclosure is not adequate. This is recognized even by proponents of deregulation, leading to proposals by Professor Posner (now chief judge of the U.S. Court of Appeals, Seventh Circuit) for mandatory insurance for companies engaged in dangerous trades. Another significant group of vulnerable involuntary creditors is employees. It is arguable that the privilege of limited liability should not be conferred on owners of the business at the employees’ expense.

10.123 Hong Kong law recognizes that some provisions must be made for employees. It has opted to create a fund (the "Fund") for the protection of wages on the insolvency of employers under the Protection of Wages on Insolvency Ordinance. The plight of the employees can be seen from the following statistics. In 1997-1998, 503 (30.7%) petitions for liquidations were presented by the Director of Legal Aid. According to the Law Reform Commission, these petitions are mostly triggered by unpaid employees. This is borne out by the number of applications for payment under the Fund. In 1997-1998, 8,987 applications for arrears of wages owed by insolvent employers were approved and 8,376 applications recovered the maximum amount payable. In 1996-1997, $180 million was paid out of the Fund.

10.124 The above statistics indicate that companies are undercapitalized to a serious extent. Although the plight of employees is alleviated under the above scheme, it is worthwhile to ask whether company law can offer amelioration. The current scheme is unsatisfactory in that despite the statutory set-up, payments out of the fund are *ex gratia* and are subject to limits stipulated in the Protection of Wages on Insolvency Ordinance (s. 16 (2)). The principal source of income for the Fund is a levy payable on registration of businesses and their annual renewal (Business Registration Ordinance, s. 21). This means that on the one hand, employees understandably seek to raise these payment limits periodically. On the other hand, because these payments are perceived as handouts and solvent businesses are made to subsidize undercapitalized concerns, the requests are strenuously resisted. This makes for unhappy relations.

10.125 The Fund is fast diminishing. While the Fund had run on a surplus in the past, in 1997/1998, the Fund had a deficit of $25 million and expects a deficit of $90 million for 1998/1999 (Financial Services Bureau (F.S.B.)). While the Fund stood at a healthy $748 million as at December 1998, it is expected to drop to $471 million by March 2001. Furthermore, the Fund may become subject to further strains. The Law Reform Commission has recommended removing the existing preferential status of employee claims in the insolvency of the employer (para. 15.8). If adopted, these proposals may place increased burdens on the Fund.

10.126 The F.S.B. has asked, who is to pay the employees? New York and Canadian corporate law may offer a solution. The New York Business Corporation Law provides that the ten largest shareholders of every company shall be jointly and severally liable for all debts, wages or salaries due to employees for services rendered (s. 630). Canada modified this in two respects: liability is imposed on directors and is limited to six months (s.

119). There are benefits in imposing on controlling shareholders liability for six months' wages in addition to the existing scheme. In this manner, the employee will have a better chance of full recovery. At the same time, the Fund's subrogation rights will serve also to relieve the burden on innocent employers.

The Consultants' Recommendations

10.127 The Consultants did not discuss this issue.

Conclusion

10.128 The issue of liability of controllers of companies for employees' wages should be referred to the F.S.B. and the Education and Manpower Bureau (E.M.B.) for further study.

Recommendation 130: The Committee recommends that the issue of liability of controllers of companies for employees' wages be referred to the F.S.B. and E.M.B. for further consideration.

Enforcement by creditors

10.129 Although company law has always had provisions for the protection of creditors, the courts have consistently refused creditors the right directly to enforce those provisions. Thus, a creditor has no standing to restrain any proposed ultra vires act of his corporate debtor. In case of an unlawful distribution, a creditor has no standing to sue unless his collateral would be injured by the distribution. He has no standing to complain of any breach by directors of their duties to the company. The question of enforcement by creditors is allied to the question of the proper constituencies of the company. As discussed in Chapter 6, no changes to the law are warranted.

Chapter 11

Foreign Companies

11.1 This Chapter examines provisions in the Companies Ordinance concerning foreign companies, i.e. companies incorporated outside Hong Kong.

Company/securities law

The Consultants' recommendations

11.2 The Consultants recommended that the Companies Ordinance should respect the "traditional common law conflict of laws rule" and "should not contain provisions having an extraterritorial effect": Recommendations 11.01 and 11.02.

11.3 In the commentary, the Consultants noted some existing provisions which apply to companies incorporated outside Hong Kong. In their view, these provisions should be removed from the Companies Ordinance and placed in other legislation or repealed altogether. The reasons advanced were:

(1) The rule that the law of the place of incorporation governs "internal affairs" and the law of the market governs "securities" is "quite simple and, in a complex area such as conflict of laws, provide certainty and predictability": (p. 188).
(2) Certain existing provisions (concerning securities, personal property security interests, insolvency, creditor protection etc.) in the Companies Ordinance are the result of mischaracterization and assertion of jurisdiction under these sections by Hong Kong would not be recognized overseas because they are not properly "company" matters: (pp. 188, 191-194).
(3) These provisions are, in any event, ineffective: (pp. 192, 194).

Analysis

11.4 We observe, first, that the Consultants' recommendations were coloured by their view that the relevant provisions were "extraterritorial" and overreaching in nature. We believe, however, that Hong Kong jurisdiction can be justified by the strictest standards of international law and practice because the relevant actors are in Hong Kong and their acts and their effect are in Hong Kong. One respondent commented angrily: “The suggestion that the provisions [...] have extraterritorial effect is ridiculous”.

11.5 Secondly, the Consultants thought that the problem of overreaching would be solved if only we would re-characterize and relocate the offending provisions as securities/insolvency/etc. regulations. This is based on a number of fallacies about characterization of issues in the conflict of laws arena. They asserted that characterization was “simple” and would bring “certainty”. Our examination of the difficulties in distinguishing corporate and securities matters (see paras. 4.41-4.44 above) should indicate that it is by no means simple. *Dicey and Morris* observed, “The problem of characterisation has given rise to a voluminous literature, much of it highly theoretical. The consequence is that there are almost as many theories as writers and the theories are for the most part so abstract that, when applied to a given case, they can produce almost any result” (p. 35). Fortunately, the courts do not pay much attention, but they then compound the problem by a preliminary dispute as to which system of law should apply to characterization. Simplicity and certainty are far from assured.

11.6 Thirdly, characterization is not controlled by reviewers or by legislators, but by courts. Nothing in the Consultants’ Report can control the outcome of any characterization issue in the future.

11.7 Fourthly, on the international front, characterization is in the hands of the foreign forum. A foreign forum is not precluded from characterizing the issue before it and denying Hong Kong’s jurisdiction simply because a Hong Kong provision is placed in a statute entitled “Securities Act”. One respondent noted, “The Report also suggests that certain provisions of the Companies Ordinance should be removed in order to cause proper characterization of such issues. We contend that, when characterising an issue, the court will pay no attention at all to where that issue is addressed in the legislation. The location of relevant provisions is therefore relevant only as a matter of practicality”. We agree.

11.8 While some respondents accepted the statements in the Consultants’ Recommendations 11.01 and 11.02, which are themselves unexceptional, without commenting on the commentary, others object strongly to the suggestion that existing provisions are offensive. The weight of opinion is against the repeal of the provisions identified by the Consultants, although some would not object to their removal to other legislation.

11.9 We note that no action is called for under Recommendation 11.01; the law should be respected. We find Recommendation 11.02 of the Consultants' Report to remove existing "extraterritorial" provisions from the Companies Ordinance unsound.

11.10 We considered at some length whether, in addition to the existing winding-up provisions, provisions equivalent to section 168A should be applicable in respect of foreign companies.

11.11 We note that, ever since *Re Irish Shipping Ltd*, Hong Kong courts have consistently allowed winding-up petitions to be presented in respect of foreign companies even though they are unregistered in Hong Kong. As noted above, we do not believe that this law should be changed.

11.12 We further note that, in respect of domestic companies, the undesirable use of winding-up proceedings where the petitioning party desires to redress a grievance rather than secure the winding-up of a company has been alleviated by the introduction of section 168A. The practical desirability of extending section 168A to foreign companies, from the point of view of dissatisfied shareholders, is at once apparent. Indeed, to all concerned, an alternative remedy may be preferable to the more drastic remedy of winding-up which is now available.

11.13 However, we also considered that considerable care was needed not to create disincentives for public companies to list in Hong Kong or for companies to carry on business in Hong Kong. Indeed, to put the matter on a simple footing, if provisions such as section 168A or its equivalent were to be applicable to foreign companies, the dividing line between applicable and inapplicable provisions would be blurred.

11.14 Foreign companies which have chosen to be listed in Hong Kong might be said to have chosen Hong Kong as a jurisdiction in which shareholders exist who might legitimately expect to be protected. However, provisions similar to section 168A would not, except in the most exceptional circumstances, be likely to be relied upon by shareholders of public companies.

11.15 In respect of private companies, the choice of the shareholder to become a shareholder of a foreign company would, on the face of the matter, be apparent. On a theoretical level at least, it could be said that there is less justification for imposing upon companies where the shareholders have elected to become shareholders of foreign companies, provisions of Hong Kong law and, in particular, section 168A.

11.16 Until a clearer solution to the problem can be derived, we consider that it is best that the existing law remain unchanged.

Recommendation 131: The Committee recommends that, in so far as Recommendation 11.01 of the Consultants' Report suggests that the existing law is defective, it be rejected.
Recommendation 132: The Committee recommends that, in so far as Recommendation 11.02 of the Consultants' Report suggests that the existing law is "overreaching", it be rejected.

Registration of foreign companies

The Consultants' Recommendations

11.17 The Consultants recommended that foreign companies be required to register in Hong Kong but that the threshold test should be changed. In addition, there should be an inclusionary and exclusionary list of what is or is not carrying on business: Recommendations 11.03 and 11.04.

11.18 The overwhelming weight of opinion of respondents is in favour of lowering the threshold. We have considered the issue periodically since 1993 and, at one point, reached a consensus that an alternative threshold of "carrying on business" should be added. It was thought that the existing threshold "established place of business" was too easily avoidable and less relevant to a service industry. However, we have not been able to reach a decision on the definition of "carrying on business".

11.19 Research by the Companies Registry has shown that Singapore, Australia and New Zealand employ the "carrying on business" threshold. They have a short inclusive definition of "carrying on business" and a list of activities not regarded as "carrying on business". At first sight there seems to be merit in adopting this approach for the following reasons:

(1) the short inclusive definition would allow reconciliation with the Business Registration Ordinance and further judicial development;
(2) the list of negatives would provide comfort and certainty to those engaged in the enumerated excluded activities;

(3) Hong Kong will not be placed at a competitive disadvantage vis-a-vis others in the region.

11.20 However, on inquiry, the Singaporean Registrar of Companies and Businesses replied to our Registrar of Companies as follows:

> It is interesting that you should raise this issue with us at this time. We have received feedback from the private sector in Singapore that we should be following the Hong Kong model in this area of foreign company registration. They have advised us that in certain situations the "carrying on business" requirement has resulted in the need for dual registrations e.g. where a foreign company effects through a related subsidiary. They have also expressed the opinion (quite rightly so) that there is no certainty in the "carrying on business" test as compared with the "place of business" test. Very often, solicitors advise their clients to register just to be on the safe side.
>
> I am therefore curious to find out why Hong Kong is thinking of reverting to the "carrying on business" test. Perhaps you can share with me your concerns or the background.

11.21 Apart from the style of its drafting, there have been no complaints about the current definition which appears to have worked reasonably well.

11.22 In the circumstances and particularly in the light of the comments of the Singaporean Registrar of Companies and Businesses, we do not now think that there are any compelling reasons to change the threshold test for registration. The definition could be redrafted to avoid the double negative in the proviso excluding a representative office at which a company does not transact its principal business.

Recommendation 133: The Committee recommends that Recommendation 11.03 of the Consultants' Report be rejected.
Recommendation 134: The Committee recommends that Recommendation 11.04 of the Consultants' Report be rejected.
Recommendation 135: The Committee recommends that section 341 be redrafted to address criticisms of its proviso.

Registration requirements

The Consultants' Recommendations

11.23 The Consultants recommended that registration requirements be simplified and coordinated with the Business Registration Ordinance: Recommendations 11.05 and 11.08.

11.24 The overwhelming weight of opinion of respondents favoured coordination and simplification of registration requirements, but there was disagreement over the contents.

11.25 These are matters which would, in any event, be under the scrutiny of the Registrar of Companies as part of the program of incremental and continuous improvement. Indeed, the Registrar has made periodic recommendations to streamline and simplify registration requirements and procedures. In this respect, a further instalment of reforms will be submitted for our consideration.

Recommendation 136: The Committee recommends that Recommendation 11.05 of the Consultants' Report be referred to the Registrar without endorsement as to its specific contents for action, if necessary, in the ordinary course of business.
Recommendation 137: The Committee recommends that Recommendation 11.08 of the Consultants' Report be referred to the Registrar without endorsement as to its specific contents for action, if necessary, in the ordinary course of business.

Service of process

The Consultants' Recommendation

11.26 Recommendation 11.06 reads as follows:

> An agent for service of process within Hong Kong should be required; alternative methods of service of process should be stipulated in default of an agent.

11.27 The weight of opinion of respondents is in favour of the requirement for an agent for service and alternative methods of service of process. However, it has been pointed out that existing provisions are available. The Consultants seemed to have been unaware of alternative provisions in the Rules of the Supreme Court.

11.28 We believe that the existing law is satisfactory.

Recommendation 138: The Committee recommends that Recommendation 11.06 of the Consultants' Report be accepted.

Disclosure

11.29 The Consultants recommended retention of the current disclosure provisions: Recommendation 11.07.

11.30 The overwhelming weight of opinion of respondents is in favour of the recommendation. We agree.

Recommendation 139: The Committee recommends that Recommendation 11.07 of the Consultants' Report be accepted.

International business companies

11.31 After a lengthy discussion, the Consultants recommended that the Companies Ordinance should not address the use of international business companies, but did not mention whether there ought to be a separate international business companies statute: Recommendation 11.09.

11.32 Most respondents noted that the Consultants had not made any recommendations regarding international business companies.

11.33 We do not believe a case has been made for the introduction of a separate international business companies statute.

Recommendation 140: The Committee recommends that Recommendation 11.09 of the Consultants' Report be accepted.

Export and import of companies

The Consultants' Recommendation

11.34 The Consultants' Recommendation 8.06 reads as follows:

> "Import" and "Export" of companies into and out of Hong Kong should be permitted. Foreign companies should be able to re-incorporate in Hong Kong under the new Ordinance without the necessity of liquidation and the resulting disruption and interruption of corporate existence; Hong Kong incorporated companies should be able to continue under the laws of incorporation of another jurisdiction in the same manner.

11.35 The Consultants noted that there are no provisions in the Companies Ordinance which allow the "import" and "export" of companies. The reasons advanced for the recommendation are that the volume of international transactions makes it desirable to offer "convenient" and "cost effective" import and export provisions.

11.36 We observe, first, that although there are no explicit provisions in the Companies Ordinance dealing with import and export, Hong Kong law does permit the movement of companies. Under existing law, companies can export themselves out of Hong Kong by a scheme of arrangement and import themselves by incorporation or private legislation.

11.37 Secondly, an export out of the C.B.C.A. triggers the appraisal remedy (s. 190 (1) (d)) and is not obviously cheaper than proceeding under a scheme of arrangement in Hong Kong.

11.38 Thirdly, whether foreign companies could re-register in Hong Kong "without liquidation" and whether Hong Kong companies could "continue" overseas are matters governed by foreign laws beyond the control of Hong Kong. We note that no difficulties have been encountered in moving companies within jurisdictions with a common law tradition. Any required judicial or legislative scrutiny is proper for purposes of investor and creditor protection.

11.39 There is no support for this recommendation. Some respondents pointed out that the proposal lacked specificity and that research on the desirability of such provisions is required.

11.40 We do not believe there is any need for any change to the law.

Recommendation 141: The Committee recommends that Recommendation 8.06 of the Consultants' Report be rejected.

Chapter 12

Miscellaneous

12.1 This Chapter collects all the recommendations of the Consultants not otherwise dealt with in preceding Chapters. Although some issues addressed here are of lesser significance, this is not true of all issues. Some are of great importance; they are dealt with in this Chapter because, as will be seen, only summary responses are possible in the circumstances. The headings of this Chapter follow the headings in the Consultants' Report.

Administration of the Ordinance

Consolidation and updating

The Consultants' Recommendations

12.2 The Consultants' Recommendation 2.01 reads as follows:

> The provisions of Part VII of the existing Ordinance, General Provisions as to Registration, should be consolidated, and if necessary, updated in this Part. In particular, provision for the electronic keeping and filing of notices and other documents should be made.

Analysis

12.3 We note that provision for electronic keeping of documents has already been made (s. 348D, and see para. 12.72 below). No one would object to consolidation and updating, if necessary. Thus, many respondents agreed with the recommendation, but some noted that further details are necessary. We agree.

Recommendation 142: The Committee recommends that Recommendation 2.01 of the Consultants' Report be accepted.

Role of Registrar

12.4 The Consultants recommended that the role of the Registrar should continue to be primarily an administrative and policy advisory one (Recommendation 2.02).

12.5 The consensus is that the Registrar's role should not be changed.

12.6 We note that Recommendation 2.02 of the Consultants' Report has not recommended any reform.

Recommendation 143: The Committee recommends that Recommendation 2.02 of the Consultants' Report be accepted.

Subsidiary legislation

The Consultants' Recommendations

12.7 The Consultants' Recommendation 2.04 reads as follows:

> Subsidiary legislation and standard forms should be used extensively to deal with technical filing requirements, fees etc. in order to facilitate timely updating and amendment.

Analysis

12.8 Again, most respondents agreed with the statement, but it is unclear what the Consultants actually proposed. Respondents noted that "the Companies (Amendment) Ordinance 1997 has already deregulated the forms required to be filed to make them more 'user friendly' and 'computer compatible'". If the Consultants recommended the extension of the Registrar's powers "to allow him to make any changes to forms which would require additional information of any substance or materiality to be filed", then this would be unacceptable.

12.9 We do not believe that any reforms are necessary for the time being.

Recommendation 144: The Committee recommends that Recommendation 2.04 of the Consultants' Report be accepted.

Offences

The Consultants' Recommendations

12.10 The Consultants' Recommendation 2.05 reads as follows:

> With respect to offences, the Twelfth Schedule should be eliminated; such offences which are to be retained or created should be regrouped in more generic categories in this Part of the Ordinance and accorded appropriate sanctions.

Analysis

12.11 Few commented and fewer agreed. No one would object to improving organization or ensuring that the punishment fits the crime. However, respondents pointed out that "details should be provided on which offences are to be 'regrouped in more generic categories'" and that "there must be adequate mechanisms in place to counter actual and potential abuses".

12.12 We believe that the issue is of great importance but that the materials put forward in the Consultants' Report are not adequate for a decision. The matter requires further study.

Recommendation 145: The Committee recommends that the question of offences and punishment raised in Recommendation 2.05 of the Consultants' Report be further studied.

Enforcement

The Consultants' Recommendations

12.13 The Consultants' Recommendation 2.06 read as follows:

> To the extent possible, companies legislation should be self-enforcing and self-executing; investigation and inspection by a government body should essentially be a residual remedy, available in the event that private civil resources are inadequate or ineffective. Powers comparable to the existing investigation and inspection powers would be maintained.

12.14 In the commentary, the Consultants stated:

(1) "As a function of the shift to a highly enabling companies law regime...companies law should be, to the greatest extent possible, self-enforcing and self-executing".

(2) "In this particular area, investigation and offences, care should be taken not to uncritically emulate U.K. provisions". This statement was followed by a description of the "messiness" of the U.K. regime.
(3) There is no need for a "public body specifically concerned with the corporate conduct of companies".

Analysis

12.15 Again, no quarrel can be had with the statement as to the desirability of self-enforcement. However, respondents noted that the Report failed to discuss the problems and difficulties of self-enforcement and failed to put forward any real solutions. Further, it is noted that there are inconsistencies among the investigation provisions of different Ordinances. However, the Consultants were content with describing the "messy compromise" in the U.K. and noting that in-house investigatory capacity is a "problem in need of consideration".

12.16 We believe that self-enforcement is desirable and many of our recommendations made in preceding Chapters, including recommendations as to standards of disclosure to shareholders, shareholder voting process, proxies, restraints on majority voting, personal rights of shareholders, derivative actions and approval of restructuring were intended to promote self-enforcement.

12.17 As to investigation, we note the problems raised by respondents, but in view of the market reforms proposed in 1999, believe that this matter should be studied after the completion of the reforms.

Recommendation 146: The Committee recommends that the investigation provisions of the Companies Ordinance mentioned in Recommendation 2.06 of the Consultants' Report be further studied.

Financial Secretary

12.18 The Consultants recommended that the Financial Secretary should continue to have residual enforcement powers (Recommendation 2.07).

12.19 No one objected. We note that no reforms are required.

Recommendation 147: The Committee recommends that Recommendation 2.07 of the Consultants' Report be accepted.

Incorporation; capacity and powers

Incorporation

The Consultants' Recommendations

12.20 The Consultants' Recommendation 3.01 reads as follows:

> The new Ordinance would provide one-step incorporation by filing a simple application for incorporation.

Analysis

12.21 The reasons advanced by the Consultants were:

(1) The method proposed is based on the concessionary or status concept of corporations. The existing method of registering a memorandum and articles of association is based on the contractual concept of corporations. The former is the modern concept and the latter is an "evolutionary relic" in the development of the corporate form (p. 82).
(2) The method proposed is faster and cheaper.
(3) The method proposed requires minimum information and facilitates self-incorporation.
(4) The method proposed is highly conducive to computerization.

12.22 As to the first reason, it has been pointed out (see para. 4.20 above) that in the evolution of corporate theory, the concession theory is the relic. The contractual theory is espoused by the "enabling" school. The existing regime of Table A and the M.A.A. are the most enabling aspect of company law. As the Consultants claimed to have sponsored an "enabling" law, it is puzzling why they would advocate the abolition of the M.A.A..

12.23 The second and third reasons emphasized speed and self-incorporation. In a later section recommending the unanimous shareholders' agreement, the Consultants claimed, as an advantage, the ability to incorporate first and negotiate the shareholders' agreement later (p. 145). Together with the elimination of Table A, the proposed method of incorporation will leave incorporators with inadequate means to regulate their relationship; the minority shareholder may lose whatever he had by way of bargaining chips in the subsequent negotiation of the shareholders' agreement. Respondents noted that externally, the minimum information recommended would be insufficient for the protection of outsiders dealing with the company. Speedy incorporation in the manner proposed would also reduce the sense of responsibility which should accompany incorporation. Thus, speed in such circumstances is far from being an advantage. The economy thus realized may be off-set by costs of subsequent disputes. The Consultants' Reasons (2) and (3) are not valid.

12.24 As to the fourth reason, the Companies Registry has already made enormous progress in computerization and a new form of incorporation is unnecessary for that purpose.

12.25 While we believe there is no justification for abolishing the existing scheme in the name of speed, it is worthwhile to point out that in reality the proposed method is not "simpler". Take the case of incorporating under the C.B.C.A.: an incorporator has to file three forms: Form 1, Articles of Incorporation; Form 3, Notice of Registered Office and Form 6, Notice of Directors (ss. 7, 19, 106). Incorporators in Hong Kong are required to file four forms: the memorandum and articles of incorporation, statutory declaration of compliance, particulars of first directors and secretary, consent of directors to act. Despite the additional form required under the existing regime in Hong Kong, it is misleading to dub the North American method a "one-step" and the Hong Kong method a "two-plus-step" incorporation, with all that those titles imply.

12.26 The crucial difference between the existing regime and the proposed method is that the North American method does not require the submission of by-laws (the equivalent of articles of association) at the time of incorporation. It is noted that strictly speaking, articles of association are not required under Hong Kong law either. Further, in the absence of articles, Hong Kong companies are operable because of the existence of Table A, whereas the North American company will find it more difficult to operate without by-laws. Thus, the difference boils down to formulating the articles before incorporation and formulating the by-laws after incorporation. As noted, incorporating first and agreeing later is not desirable.

12.27 The weight of opinion is in favour of the principle of simplification, but objected to the recommendation. We agree.

Recommendation 148: We recommend that Recommendation 3.01 of the Consultants' Report be rejected.

Numbered companies

The Consultants' Recommendation

12.28 The Consultants' Recommendation 3.03 reads as follows:

> Provision should be made for numbered companies, and use of the company name.

Analysis

12.29 The reasons advanced by the Consultants for numbered companies were:

(1) the system should reduce the need for shelf incorporations by permitting incorporation virtually on the spot.

12.30 This recommendation was made against a Canadian background not explained, so that one respondent noted, "we do not understand why this recommendation is necessary. The use of numbered companies is not prohibited under the provisions of the Ordinance".

12.31 Numbered companies were introduced by the Dickerson Committee at a time when the Director of Corporations was required to approve a name before incorporation. This led to substantial delays, particularly when searches had to be done across Canada before computerization. The problems of name searches apparently still remain. The numbered companies system meant that a company may be incorporated with a designated number instead of a descriptive name. After incorporation, the company may change its name at leisure. Numbers under this system are assigned on a roster basis. In fact, "all corporations are assigned a number upon incorporation. The number is stated on the certificate of incorporation; if no other corporate name is requested, the number name is assigned by default" (Welling).

12.32 We consider that the above system is unnecessary and undesirable for Hong Kong. The use of descriptive names does not involve substantial delays in Hong Kong: incorporations are completed in six days in the normal course of events. Given the sensitivity of the community to lucky and unlucky numbers, a system of assigned numbers on a roster basis would create much unhappiness. To allow incorporators to choose numbers on the roster is to complicate the process involving both delays and the possibility of corruption.

12.33 While some respondents agreed that numbered companies should be allowed, it was not generally appreciated that there is nothing in Hong Kong law that prohibits numbered names and that the system proposed was one of involuntary numbers.

12.34 We see no need for any change to the law.

Recommendation 149: The Committee recommends that Recommendation 3.03 of the Consultants' Report be rejected.

Pre-incorporation contracts

The Consultants' Recommendations

12.35 The Consultants' Recommendation 3.04 and commentary in its entirety reads as follows:

> Provisions for the adoption by the company of pre-incorporation contracts should be simplified.
> Speedy incorporation should reduce the extent of resort to pre-incorporation contracts. However, such provisions could continue to be useful in a number of circumstances and a modern statutory formulation of the ability of the company to adopt pre-incorporation contracts (and providing for the allocation of liability to the promoter) should be retained.

Analysis

12.36 Respondents noted that the recommendation was to simplify the existing provisions, whereas the commentary suggested that they be retained. More seriously, the recommendation suggested that the existing provisions are defective, but we note that section 32A is one of the shortest and simplest provisions in the Ordinance. It is in fact shorter than the equivalent C.B.C.A. provisions.

12.37 While some respondents agreed in principle to simplification, others objected to the recommendation: "the current provisions of section 32A of the Companies Ordinance with regard to pre-incorporation contracts appear to be sufficient and it is not clear that there is a need to simplify them". We agree.

Recommendation 150 : The Committee recommends that Recommendation 3.04 of the Consultants' Report be rejected.

Ultra vires

12.38 The Consultants' recommended the abolition of the doctrines of ultra vires and constructive notice (Recommendations 3.05 and 3.06). In the event, this was achieved by provisions in the Companies (Amendment) Ordinance 1997 which was enacted and implemented at the time when the Consultants' Report was being finalized.

Recommendation 151: The Committee notes that Recommendations 3.05 and 3.06 of the Consultants' Report have been previously accepted and enacted into law.

Indoor management rule

The Consultants' Recommendations

12.39 The Consultants' Recommendation 3.07 reads as follows:

> A statutory formulation should be given to the indoor management rule (the so-called rule in Turquand's case).

Analysis

12.40 The Consultants referred to other jurisdictions that have adopted a statutory rule, but did not otherwise give any reason why it is necessary.

12.41 The response is split. Some respondents opposed for the same reason they opposed codification. Others thought that a statutory rule seemed "sensible" and would "promote speed and certainty in commercial transactions" and suggested adopting the U.K. versions. However, Gower thought that the U.K. statutory provisions were of limited utility. In the end, "we have to turn to the basic common law principles of agency as refined in relation to companies by the Rule in *Royal British Bank v. Turquand*" (p. 221). This suggests that codification of the Turquand rule by itself is also of limited utility and may be misleading without a codification of the agency rules which it refines. We agree. We note further the complication that has arisen due to the abolition of the doctrine of constructive notice.

Recommendation 152: The Committee recommends that Recommendation 3.07 of the Consultants' Report be rejected.

Capital structure

Modern capital structure

The Consultants' Recommendations

12.42 The Consultants' Recommendation 4.01 reads as follows:

> A new Business Corporations Ordinance should provide for a modern, flexible capital structure.

Analysis

12.43 The reasons advanced were that the "rapid developments in modern corporate finance and accounting have long overtaken the 19th century assumptions of Part II of the current Ordinance" (p. 88). The commentary suggested that the Consultants mostly objected to the maintenance of capital already discussed (see paras. 10.39-10.65).

12.44 Almost all respondents agreed with this recommendation. Of those who agreed, almost all did so with qualifications, objecting to specific proposals in the chapter or to "the lack of sufficient details" to support the Consultants' specific proposals.

12.45 It should be pointed out that the existing regime provides the most flexible capital structure possible in that incorporators may provide for any "innovative capital and financing raising techniques" desired in their memorandum and articles of association. The mandatory rules in Part II largely apply to preserve capital raised, not to prohibit or regulate fund-raising techniques. We believe that the law should and does permit a modern, flexible capital structure. In so far as the Consultants' Recommendation 4.01 suggests that the existing law is not flexible, we reject it.

Recommendation 153: The Committee recommends that Recommendation 4.01 of the Consultants' Report be rejected.

Classes and rights of shares

The Consultants' Recommendations

12.46 The Consultants' Recommendation 4.03 reads as follows:

> The corporate constitution should prescribe the classes of shares (if more than one) and the number of shares of each class that the company is authorized to issue if there is a limit (which there need not be). If there is only one class of shares, that class must have three fundamental rights of shareownership: the right to vote, the right to receive dividends when declared; and the right to receive the net assets of the company upon dissolution. Where there is more than one class of shares, the rights, preferences, etc. should be stated in the corporate constitution, the three fundamental rights of shareownership should be attached to at least one class of shares although not all rights need be attached to any one class. For statutory purposes, the traditional distinction between common or ordinary shares and preference shares should be eliminated.

Analysis

12.47 The reasons advanced by the Consultants were:

(1) the three fundamental rights are normally associated with "common or ordinary shares";
(2) for statutory purposes only, the abolition of the distinction between common and preferred shares, would permit the use of "hybrid" securities and other "modern techniques of corporate finance".

12.48 It is difficult to understand why the Recommendation is made, given the desire to provide a "modern, flexible capital structure". The Consultants' Recommendations do not compare favourably with the existing law as to flexibility.

12.49 The Consultants' Recommendation requires that classes of shares be prescribed in the constitution and that the rights and preferences of each class be stated in the constitution.

Under the existing law, classes of shares may be created by or in the memorandum and articles of association or by resolution pursuant to authority in the M.A.A.. In the latter case, the rights and preferences would be found in the resolution and not the M.A.A..

The existing law is more flexible.

12.50 The Consultants' Recommendation requires that three fundamental rights be ("must be") attached to a sole class of shares.

Under the existing law, the company is free to attach any rights to any shares (Table A, Reg. 2). There is nothing to prevent a company with only one class of shares from attaching dividends to a class of debt securities instead. This is the nature of the "hybrid" securities.

The existing law is more flexible.

12.51 The Consultants' Recommendation then requires, for statutory purposes, that the distinction between ordinary and preferred shares be abolished to permit "hybrid" securities.

For statutory purposes, there is no distinction between ordinary and preference shares and the company is free to create any hybrid (Table A, Reg. 2).

12.52 Again, some respondents agreed, but others did not understand the proposal and some objected, pointing out that "it is already possible to structure the capital of a Hong Kong company with many of the class rights noted in the report".

Recommendation 154: The Committee recommends that Recommendation 4.03 of the Consultants' Report be rejected.

Series

The Consultants' Recommendations

12.53 The Consultants' Recommendation 4.04 reads as follows:

> Statutory provisions with respect to the use of series within classes of shares are unnecessary.

Analysis

12.54 The reasons advanced by the Consultants consisted of a description of the difference in the U.S. between a class and series in the class: the attributes of a class are found in the constitution, determined by shareholders and the attributes of a series are found in directors' resolutions. This distinction is, according to the M.B.C.A., artificial and should be eliminated.

12.55 The distinction has no meaning in Hong Kong which provides for maximum flexibility in that the attributes of each "class" can be determined by the authorizing resolution, with shareholder oversight. Few commented specifically. It is noted that if it is merely proposed not to provide for series, there is no change to the law. There is no reason to prohibit them either.

12.56 We note that this recommendation has no application to Hong Kong law.

Recommendation 155: The Committee recommends that Recommendation 4.04 of the Consultants' Report be accepted.

Partly-paid shares

The Consultants' Recommendations

12.57 The Consultants' Recommendation 4.05 reads as follows:

> Partly-paid shares should be prohibited.

Analysis

12.58 The reasons advanced by the Consultants were:

(1) partly-paid shares add "considerable complexity to capital structure with little, if any, benefit"; they are "unnecessary" with a "modern, flexible capital structure";

(2) partly-paid shares were prohibited in Canada over 20 years ago.

12.59 This recommendation is puzzling. Whether or not the assertion that partly-paid shares have little benefit is true, in the "enabling" spirit, is a question which should be decided by the company. Even in the "regulatory" spirit, something should not be prohibited without any identifiable mischief. The fact that Canada has abolished it is not in itself a valid reason. It is noted that Delaware (s. 156) and New York (cf. s. 504 (h) permit partly-paid shares.

12.60 The weight of opinion is against the recommendation. We agree.

Recommendation 156: The Committee recommends that Recommendation 4.05 of the Consultants' Report be rejected.

Management and administration

Minimum financial information

The Consultants' Recommendations

12.61 The Consultants' Recommendation 5.04 and the commentary in its entirety reads as follows:

> As an aid to small companies in particular, the minimum financial information to be delivered to shareholders, unless they agree otherwise, should be stipulated in the legislation, or subsidiary legislation.
> Most jurisdictions stipulate at a minimum the financial information which must be delivered annually to shareholders: a balance sheet, an income statement or profit and loss account and, variously, a statement of retained earnings and statement of changes in financial position or changes in shareholders equity.

Analysis

12.62 The law already stipulates certain financial reports but, if it is inadequate, the Consultants did not specify any deficiency. It may be that the Consultants intended to introduce a waiver of financial reporting by the clause "unless they agree otherwise". If so, this places minority shareholders at the complete mercy of the controllers and deserves more prominence and a thorough discussion. As noted, the Consultants offered no elaboration or reasons for their recommendation.

12.63 While a number of respondents agreed with the contents of the reporting requirements, the few who specifically commented on the proposal to allow shareholders to waive the minimum reporting, objected. We agree.

Recommendation 157: The Committee recommends that Recommendation 5.04 of the Consultants' Report be rejected.

Negotiable instruments

The Consultants' Recommendations

12.64 The Consultants' Recommendation 5.09 reads as follows:

> Securities certificates should be statutorily recognised as negotiable instruments.

Analysis

12.65 The reasons given by the Consultants consisted of a description of the change of Canadian law from the U.K. system to the U.S. system. The Report stated that the British system is defective for "uncertainty". In the background paper on share transfers, the inadequacies of the British model were illustrated in one paragraph by reference to one Ontario decision in which the bona fide purchaser for value won, though not on the ground of negotiability. The rest of the paper described the system under the U.S. Uniform Commercial Code.

12.66 The response was overwhelmingly negative. A number thought that it meant the end of the private company and objected. In reports of such a nature, given the momentous change proposed, the burden is on the reporter to establish first there is a problem and second that the remedy proposed is appropriate. This the Consultants failed to do.

12.67 It is noted that Hong Kong Securities Clearing Company Limited (H.K.S.C.C.) is supportive of the recommendation. H.K.S.C.C. guarantees good title and finds that the current law is to its detriment. It believes that "new rules which enhance the finality in the exchange of scrip are beneficial to the clearing and settlement system provided by C.C.A.S.S.".

12.68 In view of the fact that market reforms have been proposed by the Administration in 1999, we believe that study of this issue should be deferred to the completion of market reforms.

Recommendation 158: The Committee recommends that the issue of the status of shares as negotiable instruments raised in Recommendation 5.09 of the Consultants' Report be studied following the completion of the market reforms proposed by the Administration.

Modernised security certificates system

The Consultants' Recommendations

12.69 The Consultants' recommendation 5.10 reads as follows:

> Provisions with respect to security certificates, their form, content, registration and transfer should be modernised to provide for the optional use of "scripless" (book entry or "uncertificated") securities and, to the extent not dealt with under other legislation, the mechanics of their transfer (including the use of clearing agencies).

The Consultants noted in their commentary that "it was too early to make concrete proposals".

Analysis

12.70 Scripless securities would only be useful for public companies and should be developed in close co-operation with H.K.S.C.C.. Since the introduction of market reforms in March 1999, it is indeed untimely to make proposals now.

Recommendation 159: The Committee recommends that the issue of scripless securities raised in Recommendation 5.10 of the Consultants' Report be studied after the completion of market reforms.

Modern record keeping

The Consultants' Recommendations

12.71 The Consultants' Recommendation 5.12 reads as follows:

> Provision should be made for modern record keeping, including electronic data processing. An obligation should be imposed to ensure the accurate preservation of data and its accessibility in written form to those entitled to it within a reasonable period of time.

Analysis

12.72 As expected, the few institutions that commented agreed to modern record keeping. However, the Companies Ordinance already makes provisions not only for electronic registers (s. 95 (2)) but also for electronic records in general. Section 348C provides:

> (1) Any register, index, minute book or book of account required by this Ordinance to be kept by a company may be kept by either by making entries in bound books or by recording the matters in question in any other manner.
> (2) The power conferred on a company by subsection (1) includes power to keep the register or other record by recording the matters in question otherwise than in a legible form so long as the recording is capable of being reproduced in a legible form.

12.73 We note that Recommendation 5.12 states the existing law.

Recommendation 160: The Committee recommends that Recommendation 5.12 of the Consultants' Report be accepted.

Company records

The Consultants' Recommendations

12.74 The Consultants' Recommendation 5.13 reads as follows:

> The new Ordinance should contain a clear and concise statement of the records which must be kept by the company, their location and who has access to them (and in what circumstances and to what purposes).

In the commentary, the Consultants listed records that should be kept and their accessibility. They rejected the maintenance of a register of directors' interests. They also stated that accessibility to records "should be broadened for companies with public shareholders".

Analysis

12.75 No one can quarrel with the recommendation as such and most respondents agreed that clear statements are good. However, the Companies Ordinance already has provisions as to the maintenance of records and accessibility (ss. 74A, 88, 89, 95, 120, 158A). The records mentioned in the Consultants' commentary are already provided for. Therefore, one does not know whether the Consultants were recommending drafting amendments or substantive amendments; if the latter, what further types of records should be provided for whom?

12.76 The Consultants were clearer on two other issues which were unfortunately asserted in the commentary without elaboration or reason. First, the Consultants referred to New Zealand's register of "directors' interest" and stated that it was "not recommended for Hong Kong". The Consultants did not discuss the pros and cons or why it was not recommended for Hong Kong. One Respondent thought this was an important point for corporate governance and "merits further consideration". Second, the Consultants stated cryptically that accessibility to records "should be broadened for companies with public shareholders". It is not clear whether they meant more people, and if so whom, should be given access, or whether shareholders should be given access to more records, and if so what. This is another point which merits consideration.

12.77 We find Recommendation 5.13 of the Consultants' Report unhelpful and believe that the issues of directors' interest be studied in the corporate governance program. We have already made recommendations as to access to records (see paras. 7.66-7.69 above).

Recommendation 161: The Committee recommends that Recommendation 5.13 of the Consultants' Report be rejected.
Recommendation 162: The Committee recommends that the concept of a register of directors' interest be studied further.

Corporate Seal

The Consultants' Recommendation

12.78 The Consultants' Recommendation 5.14 reads as follows:

> Use of a corporate seal should be voluntary and no agreement should be invalid merely because a corporate seal is not affixed to it.

Analysis

12.79 The reason advanced by the Consultants was that the Recommendation would facilitate international transactions where use of a corporate seal is not required of foreign corporations.

12.80 The Companies Ordinance only governs the maintenance of a seal by its company and control over the seal within the corporate entity. The circumstances in which a corporate seal is required to be used and the effect of non-compliance are matters for general law, outside the purview of the Companies Ordinance.

12.81 If the Consultants intended to recommend abolition of section 93 (1) (b) of the Companies Ordinance (requiring the maintenance of a corporate seal), there are at least four reasons against the recommendation.

First, given the state of the general law as to the use of seals, it is a meaningless gesture since most companies will want to maintain seals.

Secondly, given the law of contract recognizing the ability to make promises under seal without the need for consideration, the Companies Ordinance will have to provide some substitute in order for companies to continue to benefit from the law.

Thirdly, in the words of one respondent, "the company seal is a very important element of a company's internal control procedures".

Fourthly, also in the words of a respondent, "in a place where the chop is ubiquitous it is almost going against local culture to abolish the company seal".

12.82 If the Consultants intended merely to recommend saving documents not under seal, this is a matter beyond the jurisdiction of company law. As to foreign companies without seals, the problem has long been tackled. The *Law Amendment and Reform (Consolidation) Ordinance* validates deeds executed by attorneys on behalf of foreign corporations even where the appointments are not made under seal, provided that the appointment is valid under the laws of the incorporating state.

12.83 While some agree that *use* of the seal should be optional, no one referred to the abolition of section 93 (1) (b) and one objected strongly. It was also pointed out that the general law is involved.

12.84 We do not believe that any reform is necessary in relation to the corporate seal.

Recommendation 163: The Committee recommends that Recommendation 5.14 of the Consultants' Report be rejected.

Solvent dissolutions

Simplification of winding-up

12.85 The Consultants made various recommendations for the simplification of winding up (Recommendations 9.02 to 9.05). While there is general agreement that simplification is needed, particularly for defunct, solvent private companies, the proposed procedure under which dissolution preceded liquidation attracted considerable criticism. In the event, we have already taken action to introduce a simplified, streamlined statutory procedure to deregister defunct, solvent private companies in the Companies (Amendment) Ordinance 1999 which was implemented on 11 November 1999.

Recommendation 164: The Committee recommends that Recommendations 9.02 to 9.05 of the Consultants' Report be rejected.

12.86 The Consultants recommended that the Registrar of Companies should be able to commence an administrative dissolution in limited circumstances (Recommendation 9.06). We agree that the Registrar should have such enforcement power which currently exists in the form of the striking-off provisions in the Companies Ordinance. However, it should not provide an alternative to winding-up a company under the existing statutory procedure and, with the provision of the new statutory deregistration procedure mentioned in para. 12.85, companies have a variety of means to terminate their existence depending on their circumstances.

Recommendation 165: The Committee recommends that Recommendation 9.06 of the Consultants' Report be accepted.

Court liquidations

12.87 The Consultants recommended that the court should be given broad discretion to dissolve a company (Recommendation 9.07).

12.88 Few commented and one registered surprise: "We fail to see why such a recommendation is necessary. There are already provisions in the Ordinance".

12.89 We note that no reforms are required.

Recommendation 166: The Committee recommends that Recommendation 9.07 of the Consultants' Report be accepted.

Transitional Provisions

12.90 The Consultants recommended that a new ordinance should include a requirement of mandatory continuance for companies created under the old legislation over a transitional period of three to five years (Recommendation 12.01) and that there should be a simple reregistration procedure (Recommendation 12.02). As we do not recommend the enactment of a new ordinance, there is no need for the transitional arrangements recommended.

Recommendation 167: The Committee recommends that Recommendation 12.01 of the Consultants' Report be rejected.
Recommendation 168: The Committee recommends that Recommendation 12.02 of the Consultants' Report be rejected.

Appendix 1

The Consultants' Recommendations		The Committee's Recommendations	
1.01	**Aims and Objectives.** The proper aims and objectives of companies law in Hong Kong should be: • to provide a simple, efficient and cost effective method of incorporation and ongoing corporate maintenance; • to be enabling and permissive rather than regulating and prohibitive; • to the extent possible, to be self-enforcing so as to avoid intervention of public authorities and to limit the necessity of recourse to the judicial system; • to be written in clear, concise language so as to be accessible to business people as well as lawyers and accountants; • to focus on "core company law", the birth, life and death of the enterprise; • to strike a balance between the interests of management or majority shareholders on the one hand and shareholders or minority shareholders on the other hand, in keeping with modern commercial practices; • to promote continuity, stability and certainty in commercial dealing; • to refrain from being a vehicle for implementation of industrial relations, tax, social or monetary policy; • to take account of and to meet international expectations with respect to the incorporation, operation and administration of modern companies.	Rejected	Ch.4 R.16
1.02	**Business Corporations Ordinance.** Hong Kong should implement a modern, streamlined Business Corporations Ordinance drawing on the most appropriate aspects of existing North American and Commonwealth models. Continued primary reliance on the U.K. model of companies law is not advised.	Rejected	Ch.3 R.1
1.03	**Single Regime.** With respect to core company law matters, the same regime should be applicable to both public and private companies. In addition, the new Ordinance should provide a basic optional regime for private companies that would facilitate their operation in an informal and consensual manner.	Pt Accepted Pt Rejected	Ch.5 R.18 & Ch.5 R.37

1.04	**Securities Regulation.** The new Ordinance should not regulate the capital markets activities of companies nor the protection, in the largest sense, of public investors; this should be left to the SFC and the SEHK. With the removal from companies legislation of securities regulation, the SFC should consider the need to re-enact existing, updated or comprehensive new provisions in securities legislation. In the process of extracting the securities law aspects from companies legislation, careful consideration needs to be given to the dangers of creating regulatory gaps as well as the need to address any inadequacies in existing statutory regulation.	Rejected	Ch.4 R.4 & Ch.5 R.39
1.05	**Insolvency.** The new Ordinance should not apply to insolvent winding up; matters pertaining to insolvency should be left to a comprehensive Insolvency Ordinance.	Accepted	Ch.4 R.5
1.06	**Charges.** A study should be undertaken with a view to introducing a separate, comprehensive regime governing security interests in personal property (such as recommended by the U.K. Diamond Report). It would permit the elimination of Part III of the Ordinance, Charges. Until such time, Part III would continue in effect in conjunction with the new Ordinance.	Accepted	Ch.4 R.6
1.07	**Financial Institutions.** The new Ordinance would continue to serve as the basic legislation governing the "core company law" aspects of regulated financial institutions in Hong Kong, essentially incorporation and its incidents; the regulatory aspects would be determined by the Hong Kong Monetary Authority and the Insurance Authority, as appropriate and would preferably appear in their related legislation.	Accepted	Ch.4 R.7
1.08	**Not-for-profit Enterprises.** The new Ordinance would not be applicable to not-for-profit enterprises, currently formed as companies limited by guarantee; the current Ordinance would continue to apply to such entities until such time as consideration is given to their separate treatment.	Rejected	Ch.4 R.8
1.09	**A new Not-for-profit Corporations Ordinance.** Serious consideration should be given to implementation of an Ordinance governing incorporated not-for-profit organizations.	Rejected	Ch.4 R.8
1.10	**Structure of a New Ordinance.** The following structure is proposed for the organization of a new Ordinance.	Rejected	Ch.3 R.2

OUTLINE FOR A BUSINESS CORPORATIONS ORDINANCE

Part 1 : Interpretation

Part 2 : Administration of the Ordinance

Part 3	:	Incorporation; Capacity and Powers
Part 4	:	Capital Structure
Part 5	:	Management and Administration
Part 6	:	Directors and Executive Officers
Part 7	:	Shareholders' Rights and Remedies
Part 8	:	Fundamental Changes
Part 9	:	Solvent Dissolution and Liquidation
Part 10	:	Private Companies/Closely Held Corporations
Part 11	:	Foreign Corporations/Oversea Companies
Part 12	:	Transitional Provisions
Part 13	:	General

2.01	**Consolidation and Updating Part VII.** The provisions of Part VII of the existing Ordinance, General Provisions as to Registration, should be consolidated, and if necessary, updated in this Part. In particular, provision for the electronic keeping and filing of notices and other documents should be made.	Accepted	Ch.12 R.142
2.02	**Role of Registrar.** The role of the Registrar should continue to be primarily an administrative and policy advisory one.	Accepted	Ch.12 R.143
2.03	**Charges.** Pending reconsideration of the legislative treatment of "Charges", the Companies Registry would continue its administration of Part III of the current Ordinance.	Accepted	Ch.4 R.6
2.04	**Subsidiary legislation.** Subsidiary legislation and standard forms should be used extensively to deal with technical filing requirements, fees, etc. in order to facilitate timely updating and amendment.	Accepted	Ch.12 R.144
2.05	**Offences.** With respect to offences, the Twelfth Schedule should be eliminated; such offences which are to be retained or created should be regrouped in more generic categories in this Part of the Ordinance and accorded appropriate sanctions.	Further Study	Ch.12 R.145
2.06	**Enforcement.** To the extent possible, companies legislation should be self-enforcing and self-executing; investigation and inspection by a government body should essentially be a residual remedy, available in the event that private civil recourses are inadequate or ineffective. Powers comparable to the existing investigation and inspection powers	Further Study	Ch.12 R.146

would be maintained.

2.07	**Role of the Financial Secretary.** The Financial Secretary should continue to have residual discretion to act in the public interest in certain circumstances (such as investigation).	Accepted	Ch.12 R.147
3.01	**One-step incorporation.** The new Ordinance would provide one-step incorporation by filing a simple application for incorporation.	Rejected	Ch.12 R.148
3.02	**One person companies.** The new Ordinance would permit one person/one director incorporation.	Accepted	Ch.5 R.20
3.03	**Numbered companies.** Provision should be made for numbered companies, and use of the company name.	Rejected	Ch.12 R.149
3.04	**Pre-incorporation contracts.** Provisions for the adoption by the company of pre-incorporation contracts should be simplified.	Rejected	Ch.12 R.150
3.05	**Capacity, powers and privileges of natural person.** A corporation should be given the capacity, powers and privileges of a natural person. Restrictions may be placed on the activities of a corporation in its constitution but the rights of third parties should be preserved in the event a corporation acts in contravention of its articles or the Ordinance.	Accepted	Ch.12 R.151
3.06	**Constructive notice.** The constructive notice doctrine should be eliminated except, temporarily, with respect to charges.	Accepted	Ch.12 R.151
3.07	**Indoor Management rule.** A statutory formulation should be given to the indoor management rule (the so-called rule in Turquand's case).	Rejected	Ch.12 R.152
4.01	**Modern capital structure.** A New Business Corporations Ordinance should provide for a modern, flexible capital structure.	Rejected	Ch.12 R.153
4.02	**No par value shares.** Par value shares should be prohibited**.**	Rejected	Ch.10 R.113
4.03	**Classes and rights of shares.** The corporate constitution should prescribe the classes of shares (if more than one) and the number of shares of each class that the company is authorised to issue if there is a limit (which there need not be). If there is only one class of shares, that class must have three fundamental rights of share ownership: the right to vote, the right to receive dividends when declared; and the right to receive the net assets of the company upon dissolution. Where there is more than one class of shares, the rights, preferences, etc. should be stated in the corporate constitution; the three fundamental rights of share ownership should be attached to at least one class of shares although not all rights need be attached to any one class. For statutory purposes, the traditional distinction between common or ordinary shares and preference shares should be eliminated.	Rejected	Ch.12 R.154

4.04	**Series.** Statutory provisions with respect to the use of series within classes of shares are unnecessary.	Accepted	Ch.12 R.155
4.05	**Partly paid shares.** Partly paid shares should be prohibited.	Rejected	Ch.12 R.156
4.06	**Optional pre-emptive rights.** Pre-emptive rights for existing shareholders should be optional; they may be provided for in the corporate constitution.	Rejected	Ch.9 R.104
4.07	**Solvency test.** The concept of impairment of capital should be replaced by a solvency test to be used to determine the ability of the company to engage in a variety of activities: repurchase of its own shares (by way of redemptive provisions in the corporate constitution or otherwise), payment of dividends and other activities in the nature of a transfer of corporate assets to the possible detriment of creditors. No "distribution" (widely defined) of company assets should be permitted if, after giving effect to it: (1) the company would not be able to pay its debts as they become due in the usual course of business; or (2) the company's total assets would be less than the sum of its total liabilities plus (unless the constitution provides otherwise) the amount that would be needed, if the company were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.	Rejected	Ch.10 R.116
4.08	**Financial Assistance.** Provisions with respect to "financial assistance" for the purchase of company shares should be eliminated.	Rejected	Ch.9 R.108
5.01	**Companies' accounts.** Companies should be required to prepare accounts that give a true and fair view of the state of affairs of the company. Details as to the form and content of accounts, to the extent required to be specified, should appear in subsidiary legislation; the Tenth Schedule of the Companies Ordinance (Accounts) should be eliminated.	Rejected	Ch.10 R.127
5.02	**Generally accepted accounting principles.** Rather than detailing line item by line item the information to be contained in accounts, reference should be made to preparation of accounts in accordance with generally accepted accounting principles (GAAP). GAAP would be embodied in standards set by an independent accounting standards body or by a Hong Kong Society of Accountants process that would involve a wider representation of interested parties.	Rejected	Ch.10 R.128
5.03	**Waiver of generally accepted accounting principles.** All companies should prepare their accounts in accordance with generally accepted	Rejected	Ch.10 R.121

	accounting standards; consideration should be given as to whether private companies should be able to dispense with this requirement by means of unanimous shareholder agreement (unless required for other purposes.)		
5.04	**Minimum financial information.** As an aid to small companies in particular, the minimum financial information to be delivered to shareholders, unless they agree otherwise, should be stipulated in the legislation, or subsidiary legislation.	Rejected	Ch.12 R.157
5.05	**Filing of accounts.** Unless required by other legislation (as should be the case for public and listed companies), companies would not be required to file accounts.	Rejected	Ch.10 R.125
5.06	**No mandatory audit.** Company accounts should continue to be audited but shareholders should be able to dispense with an audit by unanimous agreement.	Rejected	Ch.10 R.122
5.07	**Formalities associated with directors' meetings.** The formalities associated with routine directors' meetings such as notice, quorum, attendance, dissent, etc. should be set out in Part V, Management and Administration of the new Ordinance.	Rejected	Ch.6 R.49
5.08	**Formalities associated with shareholders' meetings.** The formalities associated with routine shareholders' meetings such as notice, quorum, attendance, proxies, record date, etc. should be set out in Part V, Management and Administration of the new Ordinance.	Rejected	Ch.7 R.79
5.09	**Negotiable instruments.** Securities certificates should be statutorily recognised as negotiable instruments.	Further Study	Ch.12 R.158
5.10	**Modernised security certificates system.** Provisions with respect to security certificates, their form, content, registration and transfer should be modernised to provide for the optional use of "scripless" (book entry or "uncertificated") securities and, to the extent not dealt with under other legislation, the mechanics of their transfer (including the use of clearing agencies).	Further Study	Ch.12 R.159
5.11	**Part III retained.** Pending consideration of the creation of a separate regime for the granting of security interests in personal property, Part III of the current Ordinance, Registration of Charges would continue to apply.	Accepted	Ch.4 R.6
5.12	**Modern record keeping.** Provision should be made for modern record keeping, including electronic data processing. An obligation should be imposed to ensure the accurate preservation of data and its accessibility in written form to those entitled to it within a reasonable period of time.	Accepted	Ch.12 R.160
5.13	**Company records.** The new Ordinance should contain a clear and	Rejected	Ch.12 R.161

	concise statement of the records which must be kept by the company, their location and who has access to them (and in what circumstances and to what purposes.)		
5.14	**Corporate seal.** Use of a corporate seal should be voluntary and no agreement should be invalid merely because a corporate seal is not affixed to it.	Rejected	Ch.12 R.163
6.01	**Unitary board structure retained.** The traditional unitary board structure should be retained.	Accepted	Ch.6 R.44
6.02	**Board of directors.** In private companies/closely-held corporations, a single decision making body should be an option; the responsibilities of the directors would be assumed by the shareholders.	Rejected	Ch.5 R.26
6.03	**Statutory power of directors.** The board of directors should be given a direct grant of statutory power to manage, or supervise the management of, the company. This power should be made subject to any unanimous shareholder agreement.	Rejected	Ch.6 R.41
6.04	**Delegation of powers.** The board of directors should be permitted to delegate all those powers which it is not required to exercise itself.	Rejected	Ch.6 R.53
6.05	**Functions not subject to delegation.** Certain functions of the board of directors should not be subject to delegation, for example : • submission to shareholders of any question requiring their approval • filling an interim vacancy among directors, in the office of auditor, appointing or removing the chief executive officers • in most circumstances, issuing securities • declaring dividends • purchasing, redeeming or otherwise acquiring shares issued by the company • approving financial statements • adopting, amending, repealing any constitutional documents.	Rejected	Ch.6 R.54
6.06	**Directors' minimum qualifications.** Directors should meet certain minimum qualifications : • age of majority • mental capacity (i.e. not found legally incapable) • only individuals (no corporate directors) • no one who has the status of an undischarged bankrupt unless permitted by court order • no one who has been disqualified from acting as a director.	Accepted	Ch.6 R.43
6.07	**One director.** Private companies should be permitted to have a	Accepted	Ch.5 R.22

minimum of one director.

6.08	**Shadow and alternate directors.** The troublesome concepts of shadow and alternate directors should be eliminated.	Rejected	Ch.6 RR.55 & 69
6.09	**Company officers.** There should be no requirement for the appointment of any particular company officer such as a company secretary.	Rejected	Ch.6 R.72
6.10	**Removal of directors by shareholders.** Shareholders should be able to remove directors by ordinary resolution, subject to class voting rights and the company constitution.	Rejected	Ch.6 R.47
6.11	**Meetings of directors.** Meetings of directors should be permitted by means of electronic communications, unless otherwise specified in the company constitution.	Rejected	Ch.6 R.50
6.12	**Unanimous action.** Directors should be able to act unanimously by written resolution without a meeting.	Rejected	Ch.6 R.51
6.13	**Statutory statement of directors' duties.** There should be a statutory statement of directors' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would. These duties should also be made applicable to those corporate officers appointed by the board.	Rejected	Ch.6 R.57
6.14	**Reliance on reports.** Directors and executive officers should be able to rely in good faith on financial statements and other reports prepared by officers and employees as well as the professional advice of lawyers, accountants, etc.	Rejected	Ch.6 R.58
6.15	**Business judgment rule.** There should be no need of a statutory formulation of the 'business judgment rule'.	Accepted	Ch.6 R.68
6.16	**Indemnifying directors.** Companies should be permitted to indemnify directors and officers in specific circumstances; companies should be required to indemnify directors and officers in specific circumstances.	Rejected	Ch.6 R.74
6.17	**Insuring directors.** Companies should be permitted to insure directors and officers except for a failure to act honestly and in good faith with a view to the best interests of the company.	Accepted	Ch.6 R.75
6.18	**Disqualification of directors.** Disqualification of directors provisions should be eliminated for company law purposes. Those existing provisions relating to securities, insolvency or criminal activity should be reenacted in appropriate legislation.	Rejected	Ch.10 R.120

6.19	**Conflicts of interest.** Consideration should be given to placing directors and executive officers (i.e. those appointed directly by the board) under a duty of fair dealing with respect to transactions they enter into with the company.	Rejected	Ch.6 R.60
6.20	**Qualification of interested transactions.** Interested transactions should be upheld if (i) directors disclose to the board their material interest in the transaction; (ii) do not vote as a director on any resolution to approve the transaction; and (iii) the transaction was reasonable and fair to the corporation at the time it was approved. In the alternative, such transactions could also be approved by unanimous shareholder consent.	Rejected	Ch.6 R.61
6.21	**Shareholder approval of interested transactions.** Shareholders should be able to vote to uphold a transaction by special resolution in certain circumstances.	Rejected	Ch.6 R.62
6.22	**Loans to directors.** Transactions involving loans to directors should continue to be prohibited subject to certain exceptions.	Rejected	Ch.6 R.64
6.23	**Use of Corporate Information and Opportunity.** Directors and officers should not disclose or use for their benefit a corporate opportunity or information that they obtain by reason of their position or employment except (i) with consent of disinterested board members, (ii) where disclosure is required by law or otherwise or (iii) where it is reasonable to assume that the disclosure or use of the information or opportunity will not be likely to prejudice the corporation.	Rejected	Ch.6 R.67
7.01	**Shareholders' rights and remedies.** A separate part of the new Ordinance should be dedicated to matters dealing with shareholders, their rights and remedies.	Accepted	Ch.7 R.78
7.02	**Proposal at annual meeting.** Any shareholder entitled to vote at an annual meeting should be able to submit a proposal to the company to be raised at the annual meeting and circulated prior to the meeting. The board of directors could refuse to circulate proposals in certain circumstances such as proposals designed to redress personal grievances or espousing political or other causes. In addition or in the alternative, a proposal put forward by a minimum number or percentage of shareholders (e.g. the lesser of 25 shareholders or those holding 2½% of the voting shares) could not be refused by the board of directors.	Rejected	Ch.7 R.81
7.03	**Requisition to call meeting.** Shareholders holding 5% of the voting shares should be able to requisition the directors to call a meeting of shareholders or, if the directors fail to act, a shareholder should be able to call a meeting itself. The time delay in which the directors may act	Accepted	Ch.7 R.83

	should be fairly short, 21 days for example. The requisitioners should be reimbursed their expenses unless the meeting otherwise resolves.		
7.04	**Shareholders' rights to dispense with meeting.** A resolution in writing signed by all shareholders entitled to vote should be sufficient to preclude the necessity of a meeting. A meeting should be required, however, in the event of the resignation or removal of a director or auditor who wishes to explain or contest the action. Shareholders should be able to dispense with the requirement for an annual general meeting (or other meetings) by unanimous shareholder agreement.	Accepted	Ch.7 R.84
7.05	**One share entitled to one vote.** Unless otherwise provided by the company constitution, one share should be entitled to one vote. "Circular holdings" should be prohibited from voting.	Accepted	Ch.7 R.89
7.06	**Unanimous shareholder agreement.** All companies should be able to make use of unanimous shareholder agreements to regulate (1) the exercise of corporate powers and management and (2) the relationship among shareholders.	Rejected	Ch.5 R.27
7.07	**Statutory remedies**. There should be made available to shareholders a variety of statutory remedies designed to induce accountability of management and achieve the desired balance between flexibility in management powers and protection of shareholders, especially minority shareholders' interests. These statutory remedies should include the following : - Statutory Derivative Action - Oppression or Unfairly Prejudicial Action - Buy-Out or Appraisal Remedy - Compliance and Restraining Orders - Just and Equitable Winding-up	-	-
7.08	**Statutory derivative action.** There should be a statutory derivative action in the new Ordinance.	Rejected	Ch.8 R.95
7.09	**Unfairly prejudicial remedy.** The current unfairly prejudicial or oppression remedy should be broadened. The remedy should be available to a broader class of persons, to include - any registered holder or beneficial owner, and any former registered holder or beneficial owner, of a security of the company or any of its affiliates; - any director or officer or former director or executive officer; and - the Financial Secretary. The scope of the conduct that may be complained of would also be broadened to include conduct that is oppressive, unfairly prejudicial to or that unfairly disregards the interests of any security holder, director	Rejected	Ch.8 R.94

	or officer.		
7.10	**Statutory compliance and restraining order.** A shareholder or director should have the standing to apply to court for a statutory compliance and restraining order.	Rejected	Ch.8 R.97
7.11	**Just and equitable winding-up.** The traditional "just and equitable" winding-up remedy should be retained, but the court should be given the option of making any other order it sees fit. The remedy should be dissociated from the more undesirable consequences of winding-up procedures in insolvency (such as the freezing of bank accounts).	Rejected	Ch.8 R.93
7.12	**Appraisal or "buy-out" remedy.** A form of appraisal or "buy-out" remedy which does not necessitate judicial intervention should be adopted; the statutory buy-out remedy gives shareholders the right to have the company buy their shares upon the occurrence of a limited number of fundamental changes while permitting the company to proceed unimpeded with its proposed action. In the alternative, consideration should be given to introducing such a procedure but excluding its application to listed companies.	Rejected	Ch.9 R.98
8.01	**Amendments by special resolution.** There should be regrouped in one section, all amendments to the company constitution that may be effected by special resolution of the shareholders. A special resolution should require a "super-majority" vote, i.e. 75%.	Rejected	Ch.9 R.100
8.02	**Dissenting shareholder entitled to be "bought-out".** Where an amendment to the constitution would (1) affect substantially the nature of a shareholder's investment (e.g. remove or change any restriction on the nature of the business of the company or change the characteristics of its shares) or (2) where the company proposes a fundamental change such as an amalgamation, continuance in another jurisdiction (see recommendation with respect to continuance), or sale of substantially all of its property, a dissenting shareholder should be entitled to be bought out of the company at a "fair" price.	Rejected	Ch.9 R.99
8.03	**Class vote.** In certain circumstances, a class vote should be held where a proposed amendment to the constitution would affect, directly or indirectly, the rights of that class of shares.	Rejected	Ch.9 R.105
8.04	**Corporate restructuring procedures.** Simple procedures should be made available to provide for corporate restructuring such as by way of amalgamation without the necessity for court intervention or liquidation.	Rejected	Ch.9 R.110
8.05	**Restructuring of related companies.** Restructuring of related companies and wholly-owned subsidiaries should be facilitated.	Rejected	Ch.9 R.111
8.06	**"Import" and "export" of companies.** "Import" and "export" of	Rejected	Ch.9 R.141

	companies into and out of Hong Kong should be permitted. Foreign companies should be able to re-incorporate in Hong Kong under the new Ordinance without the necessity of liquidation and the resulting disruption and interruption of corporate existence; Hong Kong incorporated companies should be able to continue under the laws of incorporation of another jurisdiction in the same manner.		
8.07	**Court ordered arrangements.** Provision should be made for court ordered arrangements for solvent companies where it is impracticable to restructure under other provisions of the legislation.	Rejected	Ch.9 R.112
9.01	**Solvent dissolution and liquidation.** Only solvent dissolution and liquidation should be dealt with in the new Ordinance.	Accepted	Ch.4 R.5
9.02	**Voluntary dissolution by simple filing.** Voluntary dissolution should be effected by a simple filing (depending on the nature of the dissolution sought) and should take effect upon filing; the corporate existence would then be continued only for the purpose of winding up and liquidating the business and affairs of the entity.	Rejected	Ch.12 R.163
9.03	**Circumstances for simple filing.** Voluntary dissolution by way of simple filing should be available in two instances; (1) before the company has commenced business and (2) where initiated by directors and shareholders.	Rejected	Ch.12 R.164
9.04	**Revocation of dissolution.** Within a limited period of time a company should be able to revoke dissolution essentially in the same manner as it has been initiated.	Rejected	Ch.12 R.164
9.05	**Claims of creditors.** Provision should be made for the claims of known and unknown creditors.	Rejected	Ch.12 R.164
9.06	**Administrative dissolution.** The Registrar should be able to commence an administrative dissolution in limited circumstances, primarily where a company has failed to comply with its filing obligations under the new Ordinance.	Accepted	Ch.12 R.165
9.07	**Dissolution by the court.** A court should be given broad discretion, both in terms of the grounds and the procedures adopted, to dissolve a company upon the application of the Financial Secretary or a delegated authority, a shareholder or a creditor.	Accepted	Ch.12 R.166
10.01	**No separate ordinance.** There should not be a separate specialised ordinance pertaining only to private companies/closely held corporations.	Accepted	Ch.5 R.17
10.02	**Purpose of legislative provisions.** The purpose of legislative provisions specifically applicable to private companies/closely held corporations should be to facilitate the creation of incorporated entities	Rejected	Ch.5 R.19

that, for internal purposes, function like partnerships or sole proprietorships.

10.03	**Statutory definition.** There should be a statutory definition of or conditions to be met for private companies/closely held corporations.	Accepted	Ch.5 R.32
10.04	**Definition of "private company".** The traditional definition of "private company" should be retained. A private company has restricted the right to transfer its shares, has limited the number of shareholders to 50 and prohibits any invitation to the public to subscribe for its securities. In addition, a company which by means of a unanimous shareholder agreement abolishes the distinction between ownership and management, irrespective of number of shareholders, should also fall within the definition.	Accepted	Ch.5 R.33
10.05	**Optional regime.** A separate part of the new Ordinance should contain an optional regime applicable to private companies/closely held corporations. The regime could be varied in the corporate constitution or by unanimous shareholder agreement. It should contain the following provisions: • Standard share transfer restrictions and exceptions (e.g. transfer to trustee in bankruptcy, by operation of law); • Preservation of limited liability despite failure to observe corporate formalities; • No mandatory audit; • Standard form buy-sell and buy back provisions to permit shareholders to leave; • Recourse to mediation or arbitration to resolve shareholder disputes; • Possibility of applying to court for the appointment of a rehabilitative receiver in the event of deadlock, etc.	Rejected	Ch.5 RR.23, 29, 30 & 31
10.6	**Possibility of Eliminating Corporate Formalities.** Private companies/closely held corporations should be able, by unanimous shareholders agreement or in their constitution, to eliminate certain corporate formalities and otherwise derogate from standard statutory provisions: • no need to have an annual meeting of shareholders unless requested by a shareholder; • no need to have separate bylaws/articles of association if constitution and statute sufficient; • ability to choose limited corporate life if desired; • possibility of dissolution at the request of a shareholder (or certain % of shareholders) or upon the occurrence of a specified event; • elimination of board of directors; • restriction of discretion or powers of the board or weighted voting rights; • operation of enterprise as if a partnership among	Rejected	Ch.5 RR.24, 25, 26 & 28

shareholders;
- creation of relationship among shareholders that would otherwise be only appropriate among partners.

11.01	**Conflict of laws rule.** For purposes of the new Ordinance, the traditional common law conflict of laws rule applicable to companies, i.e. that their creation, internal affairs, and termination are governed by the law of their place of incorporation, should be respected.	Rejected	Ch.11 R.131
11.02	**No extraterritorial effect.** As a general principle, the new Ordinance should not contain provisions having an extraterritorial effect.	Rejected	Ch.11 R.132
11.03	**Threshold of registration.** Registration of foreign incorporated companies should be required in Hong Kong but the threshold test should be changed.	Rejected	Ch.11 R.133
11.04	**Threshold test.** The threshold test of "carrying on business" in the jurisdiction, including both an inclusionary and exclusionary list of what is or is not considered carrying on business, should be adopted for purposes of the new Ordinance.	Rejected	Ch.11 R.134
11.05	**Filing requirements simplified.** The filing requirements for registration as a foreign company should be simplified. It should not be necessary to file the company constitution or accounts.	Accepted	Ch.11 R.136
11.06	**Service of process.** An agent for service of process within Hong Kong should be required; alternative methods of service of process should be stipulated in default of an agent.	Accepted	Ch.11 R.138
11.07	**Disclosure of foreign status retained.** Current requirements with respect to the obligation to disclose the foreign status of the company (on letterhead, at the place of business, etc.) should be retained.	Accepted	Ch.11 R.139
11.08	**Filing requirements.** The filing requirements applicable to foreign companies under the new Ordinance should be coordinated with those of the Business Registration Ordinance; registration under the new Ordinance should be deemed to satisfy requirements of the Business Registration Ordinance.	Accepted	Ch.11 R.137
11.09	**International business companies.** There appears to be no need to address the use of international business companies in a new Ordinance or otherwise.	Accepted	Ch.11 R.140
12.01	**Mandatory continuance for companies.** A new Ordinance should include a requirement of mandatory continuance for companies created under the old legislation over a transitional period of three to five years.	Rejected	Ch.12 R.167
12.02	**Simple reregistration procedure.** Continuation under the new Ordinance should be effected through a simple reregistration	Rejected	Ch.12 R.168

procedure which should involve only minimally more effort and expense than the current annual filing and audit requirements.

Appendix 2

The Committee's Recommendations

Recommendation 86: The Committee recommends that a strict time-limit (10 business days) should be stipulated for the completion of transfers of shares of public companies. 101

Recommendation 87: The Committee recommends that provisions for a proxy system be further considered. 102

Recommendation 88: The Committee recommends that the impact of the Central Clearing and Settlement System on corporate democracy be further considered after the completion of the market restructuring. 103

Recommendation 89: The Committee recommends that Recommendation 7.05 be accepted. 103

Recommendation 90: The Committee recommends that the following principles should be subject to further study : transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting; adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's-length terms; compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law; private companies may include exemptions in their articles. 110

Recommendation 91: The Committee recommends that the issue of access to corporate records be studied. 111

Recommendation 92: The Committee recommends that the law should be amended to give every shareholder a personal right to sue to enforce the terms of the Memorandum and Articles of Association. 116

Recommendation 93: The Committee recommends that the changes recommended in Recommendation 7.11 of the Consultants' Report be rejected. 118

Recommendation 94: The Committee recommends that Recommendation 7.09 of the Consultants' Report be rejected. 120

Appendix 3

Additional References

I. CASES

Abbey Glen Property Corp. v. Stumborg (1975) 65 D.L.R. 235

Adelaide Electric Supply Company Limited v. Prudential Assurance Company [1934] A.C. 122

Alabama New Orleans Texas and Pacific Junction Railway Company, Re [1891] 1 Ch. 213

Alexander v. Automatic Telephone Company [1900] 2 Ch. 56

Allam & Co. Ltd. v. Europa Poster Services Ltd. [1968] 1 All E.R. 826

Allen v. Gold Reefs of West Africa Limited [1900] 1 Ch. 656

Amanda Acquisition Corporation v. Universal Foods Corporation, 877 F. 2d 496 (7th Cir. 1989)

American General Corporation v. Camp, 190 A. 225

Anglo-Eastern (1985) Ltd. v. Knutz [1987] 3 H.K.C. 80

Anglo-French Exploration Company, Re [1902] 2 Ch. 845

Armstrong v. Gardner (1978) 2 O.R. 648

Ashington Piggeries Ltd. v. Christopher Hill Ltd. [1972] A.C. 441

Atco Ltd., Re [1980] O.S.C.B. 412

Austinsuite Furniture Ltd., Re [1992] B.C.L.C. 1047

Automatic Self-cleansing Filter Syndicates Co. Ltd. v. Cuninghame [1906] 2 Ch. 34

Avon Chambers Ltd., Re [1978] 2 N.Z.L.R. 638

Balston Limited v. Headline Filters Limited [1990] F.S.R. 385

Banco de Bilbo v. Sancha [1938] 3 K.B. 176

Benson v. Heatborn (1842) 1 Y. & C.C.C. 326

Bird Precision Bellows Ltd., Re [1984] Ch. 419

Blau v. Lehman, 368 U.S. 403 (US 1962)

Blue Arrow plc., Re [1987] B.C.L.C. 585

Blue Metal Industries Ltd v. R W Dilley [1970] A.C. 827

Bomac Batten Ltd. v. Pozhke (1983) 1 D.L.R. 435

Bonanza Creek Gold Mining Company Limited v. Rex [1916] A.C. 566

Bond v. Barrow Haematite Steel Company [1902] 1 Ch. 353

Boston Deep Sea Fishing and Ice Co. v. Ansell (1888) 39 Ch. D. 339

Brady v. Brady [1988] 2 W.L.R. 1308

Brant Investments Ltd v. KeepRite Inc. (1991) 80 D.L.R. 161

British America Nickel Corporation Limited v. M.J. O'Brien Ltd. [1927] A.C. 369

British and American Trustee and Finance Corporation Limited and Reduced v. Couper [1894] A.C. 399

British Building Stone Company Limited, Re [1908] 2 Ch. 450

British Columbia Electric Co. Ltd., Re (1965) 47 D.L.R., Re 754

Britoil plc., Re [1990] B.C.C. 70

Brown v. Shearer, 1995 ACWSJ LEXIS 3170

Brown v. British Abrasive Wheel Company Limited [1919] 1 Ch. 290

Brown v. Byers (1847) 16 M. & W. 252

Brown v. Duby (1980) 111 D.L.R. 418

Browne v. La Trinidad (1887) 37 Ch. D. 1

Buckingham v. Francis [1986] 2 All E.R. 738

Bulawayo Market and Offices Company Limited, Re [1907] 2 Ch. 458

Burks v. Lasker, 44 U.S. 471 (U.S.S.C. 1979)

Burland v. Earle [1902] A.C. 83

Byng v. London Life Association Ltd [1990] 1 Ch. 170

Campbell v. Rofe [1933] A.C. 91

Canadian Aero Service Ltd. v. O'Malley (1973) 40 D.L.R. 371

Carlton Holdings Ltd., Re [1971] 1 W.L.R. 918

Carruth v. Imperial Chemical Industries Limited [1937] A.C. 707

Castlereagh Securities Ltd., Re [1973] 1 N.S.W.L.R. 624

Charnley Davies Ltd., Re [1990] B.C.C. 605

Chevron (Sydney) Ltd., Re [1963] V.R. 249

Chez Nico (Restaurants) Ltd., Re [1991] B.C.C. 736

Chicago Corp v. Munds, 172 A. 452

Chow Yoong Hong v. Choong Fah Rubber Manufactory [1962] A.C. 209

City Equitable Fire Insurance Company Ltd., Re [1925] 1 Ch. 407

Clinch v. Financial Corporation (1868) L.R. 5 Eq. 450

Company, A, Re (No 996 of 1979) [1980] 1 Ch. 138

Company, A, Re (No. 005009 of 1987) [1989] B.C.L.C. 13

Company, A, Re (No. 005134 of 1986), ex parte Harries [1989] B.C.L.C. 383

Concorde Construction Co. Ltd. v. Colgan Co. Ltd. [1984] H.K.C. 253

Consolidated South Rand Mines Deep Limited, Re [1909] 1 Ch. 491

Const v. Harris (1824) T. & R. 496

Cook v. Deeks [1916] A.C. 554

County Palatine Loan and Discount Company, Re Cartmell's Case (1874) 9 Ch. App. 691

Credit Assurance and Guarantee Corporation Limited [1902] 2 Ch. 601

Crichton's Oil Company, Re [1902] 2 Ch. 86

Cross v. Imperial Continental Gas Assn. [1923] 2 Ch. 553

CTS Corporation v. Dynamics Corporation of America, 107 S. Ct. 1637 (U.S.S.C. 1987)

Cumberland Holdings Ltd. v. Washington H Saul Pattinson & Co. Ltd. (1976-1977) 13 A.L.R. 561

Cumbrian Newspapers Group Ltd v. Cumberland & Westmorland Herald Newspaper & Printing Co [1987] 1 Ch. 1

D'Jan of London Ltd. [1993] B.C.C. 646

Daimler Company Limited v. Continental Tyre and Rubber Company (Great Britian) Limited [1916] 2 A.C. 307

Daniels v. Anderson (1995) 16 A.C.S.R 607

Daniels v. Daniels [1978] 1 Ch. 406

David J. Greene & Co. v. Dunhill International Inc., 249 A. 2d. 417

Dean v. Prince [1954] 1 Ch. 409

Diligenti v. RWMD Operations Kelowa Ltd. (1977) 4 B.C.L.R. 134

Dimbula Valley (Ceylon) Tea Co. Ltd. v. Laurie [1961] 1 Ch. 353

Dodge v. Ford Motor Co., 170 N.W. 668

Domglas Inc v. Jarislowsky (1983) 138 D.L.R. 521

Dorman Long and Company Limited, Re [1934] 1 Ch. 635

Duomatic Ltd., Re [1969] 2 Ch. 365

Ebrahimi v. Westbourne Galleries Ltd. [1973] A.C. 360

Edwards v. Halliwell [1950] 2 All E.R. 1064

Harris v. A. Harris Limited 1936 S.C. 183

Harrods (Buenos Aires) Ltd., Re [1992] Ch. 72

Haven Gold Mining Company, Re (1882) 20 Ch. D. 151

Heit v. Baird, 567 F. 2d 1157

Hellenic & General Trust Ltd., Re [1976] 1 W.L.R. 123

Henry Browne & Son Ltd v. Smith [1964] 2 Ll. L. Rep. 476

Hetherington Ltd. v. Carpenter [1997] 1 N.Z.L.R. 699

Hilder v. Dexter [1902] A.C. 474

Hoare & Co. Ltd., Re [1933] All E.R. 105

Hogg v. Cramphorn [1967] 1 Ch. 254

Homer District Consolidated Gold Mines, Re Ex p. Smith (1888) 39 Ch. D. 546

Hooper v. California, 155 U.S. 648 (U.S.S.C. 1895)

Howard Smith Ltd. v. Ampol Petroleum Ltd. [1974] A.C. 821

Hutton v. West Cork Railway Co. (1883) 23 Ch. D. 654

Imperial Chemical Industries Limited, Re [1936] Ch. 587

Imperial Hydropathic Hotel Co, Blackpool v. Hampson (1882) 23 Ch. D. 1

Imperial Mercantile Credit Association v. Coleman (1870-1871) L.R. 6 Ch. App. 558

Industrial Equity (Pacific) Ltd., Re [1991] 2 H.K.C. 364

Insuranshares Corporation of Delaware v. Northern Fiscal Corporation Limited, 35 F. Supp. 22

Irish Shipping Ltd. Re [1985] H.K.L.R. 437

Island Export Finance Ltd. v. Umunna [1986] B.C.L.C. 460

Isle of Wight Railway Company v. Tahourdin (1883) 25 Ch. D. 320

J.I. Case Company v. Borak, 377 U.S. 426 at 427 (U.S.S.C. 1964)

James Shaw & Sons (Salford) Limited v. Shaw [1935] 2 K.B. 113

Jax Marine Pty Ltd., Re (1966) 85 W.N. (N.S.W.) (Pt. 1) 130

Jepson v. The Canadian Salt Co [1979] 4 W.W.R. 35

Joint Stock Discount Company v. Brown (1869) L.R. 8 Eq. 381

Jupiter House Investments (Cambridge) Ltd., Re [1985] 1 W.L.R. 975

Karak Rubber Co Ltd v. Burden (No. 2) [1972] 1 W.L.R. 602

Katz v. Oak Industries Inc., 508 A. 2d 873 (Del. Ch. 1986)

Kornblum Furnishings Ltd., Re (1981-1982) 6 A.C.L.R. 456

Lawrence v. West Somerset Mineral Railway [1918] 2 Ch. 250

Leeds Banking Company, Howard's Case (1866) L.R. 1 Ch. App. 561

Loch v. John Blackwood Limited [1924] A.C. 783

London School of Electronics Ltd, Re [1986] 1 Ch. 211

M/S Aswan Engineering Establishment Co. v. Lupdine Ltd. [1987] 1 W.L.R. 1

Mac Dougall v. Gardiner (1875-1876) 1 Ch. 13

Magnacrete v. Robert Douglas-Hill (1988) 15 A.C.L.R. 325

Manfield Coatings Co Ltd v. Springfield Coatings Co [1995] 1 H.K.C. 74

Mason v. Harris (1879) 11 Ch. D. 97

Mason v. Intercity Properties Ltd. (1987) 37 B.L.R. 6

Menier v. Hooper's Telegraph Works (1874) 9 Ch. App. 350

Meux's Brewery Company Limited, Re [1919] 1 Ch. 28

Mills v. Electric Auto-Lite Company, 396 U.S. 375 (U.S.S.C. 1970)

Mills v. Northern Railway of Buenos Ayres Company (1870) 5 Ch. App. 621

Montrotier Asphalte Company (Perry's Case), Re (1876) 34 L.T. 716

Morgan v. Gray [1953] 1 Ch. 83

Movitex Ltd. v. Bulfield [1988] B.C.L.C. 104

Multiple Access Ltd. v. McCutcheon (1982) 138 D.L.R. 1

Mutual Life Insurance Co of New York v. The Rank Organisation Ltd [1985] B.C.L.C. 11

Mysore West Gold Mining Company, Re (1889) 42 Ch. D. 535

National Bank Ltd., Re [1966] 1 W.L.R. 819

National Bank of Greece and Athens S.A. v. Metliss [1958] A.C. 509

National Dairy Association of New Zealand Ltd., Re [1987] 2 N.Z.L.R. 607

National Dwellings Society v. Sykes [1894] 3 Ch. 159

National Grocers, Re [1938] 3 D.L.R. 106

Neale v. City of Birmingham Tramways Company [1910] 2 Ch. 464

Nicron Resources Ltd v. Catto 1992 NSW LEXIS 1086

Norman v. Theodore Goddard [1991] B.C.L.C. 1028

North Eastern Insurance Co. Ltd., Re [1919] 1 Ch. 198

North-West Transportation Company v. Beatty (1887) 12 A.C. 589

Northern Counties Securities Ltd v. Jackson & Steeple Ltd [1974] 1 W.L.R. 1133

Northern Engineering Industries plc., Re [1993] B.C.C. 267

O.C. (Transport) Services Ltd., Re [1984] B.C.L.C. 251

Ong Kim Yim Mary v. Sheecon Trading Company Limited, Unrep. M.P. No. 780 of 1995

Ooregum Gold Mining Company of India Limited v. Roper [1892] A.C. 125

Palmer and Carling O'Keefe Breweries of Canada, Re (1989) 56 D.L.R. 128

Pavlides v. Jensen [1956] 1 Ch. 565

Peel v. London and North Western Railway Company [1907] 1 Ch. 5

Pender v. Lushington (1877) 6 Ch. D. 70

Peso Silver Mines (NPL) v. Cropper (1966) 58 D.L.R. 1

Phillips v. Manufacturers' Securities Ltd. (1917) 86 L.J. Ch. 305

Piccadilly Radio plc., Re (1989) 5 B.C.C. 692

Pisani v. Attorney General for Gibraltar (1874) L.R. 5 P.C. 516

Poole v. National Bank of China Limited [1907] A.C. 229

Portuguese Consolidated Copper Mines Limited, Re (1889) 42 Ch. D. 160

Posgate & Denby (Agencies) Ltd., Re [1987] B.C.L.C. 8

Press Caps Ltd., Re [1949] 1 Ch. 434

Produce Marketing Consortium Ltd., Re [1989] 1 W.L.R. 745

Prudential Assurance Co. Ltd. v. Chatterley-Whitfield Collieries Ltd. [1949] A.C. 512

Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2) [1982] 1 Ch. 204

Queensland Mines Ltd v. Hudson (1978) 52 A.L.J.R. 399

R.A. Noble & Sons (Clothing) Ltd., Re [1983] B.C.L.C. 273

Racal Communications Ltd., Re [1981] A.C. 374

Rathie v. Montreal Trust Co [1953] 4 D.L.R. 289

Ratners Group plc., Re (1988) 4 B.C.C. 293

Rattner v. Lehman, 193 F. 2d 564

Regal (Hastings) Ltd. v. Gulliver [1967] 2 A.C. 134

Registrar of Restrictive Trading Agreements v. W.H. Smith & Son Ltd. [1969] 1 W.L.R. 1460

Residues Treatment & Trading Co. Ltd. v. Southern Resources Ltd. (No. 2) (1989) 7 A.C.L.C. 1130

Robert Stephen Holdings Ltd., Re [1968] 1 W.L.R. 522

Roessler v. Security Savings & Loan Co, 72 N.E. 2d 259 (Ohio 1947)

Rogers v. Guaranty Trust Co, 288 U.S. 122 (U.S.S.C. 1932)

Rogers v. Parish (Scarborough) Ltd. [1987] Q.B. 933

Royal Bank of Canada v. Amatilla Holdings Ltd, 1995 ACWSJ LEXIS 1045 (21 February, 1995)

Russell v. Northern Bank Development Corporation Ltd. [1992] 1 W.L.R. 588

Salomon v. A Salomon and Company Limited [1897] A.C. 22

Sam Weller & Sons Ltd., Re [1990] 1 Ch. 682

Saul D. Harrison & Sons plc., Re [1995] 1 B.C.L.C. 14

Savoy Hotel Ltd., Re [1981] Ch. 351

Scottish Insurance Corporation Limited v. Wilsons & Clyde Coal Company Limited [1949] A.C. 462

Securities and Futures Commission v. Manadarin Resources Corp. Ltd. [1997] 1 H.K.C. 214

Selangor United Rubber Estates Ltd v. Cradock (No 3) [1968] 1 W.L.R. 1555

Shaw v. Thompson (1876) 3 Ch. D. 233

Shaw v. Shaw 193 Z K.B. 113

Sheldon, Re (1987) 3 N.Z.C.L.C. 100

Sidebottom v. Kershaw Leese and Company Limited [1920] 1 Ch. 154

Smith v. Croft (No. 2) [1988] 1 Ch. 114

Smith v. Croft [1986] 1 W.L.R. 580

Smith v. Van Gorkom, 488 A. 2d 854

Sohland v. Baker, 141 A. 277

Southdown Inc v. McGinnis, 510 P. 2d 636

Southern Pacific Co. v. Bogert, 250 U.S. 483

Sovereign Life Assurance Company v. Dodd [1892] 2 Q.B. 573

Sparling v. La Caisse de depot et Placement du Quebec [1988] 2 S.C.R. 1015

Spokes v. The Grosvenor and West End Railway Terminus Hotel Company Limited [1897] 2 Q.B. 124

Springbok Agricultural Estates Limited, Re [1920] 1 Ch. 563

Standard Manufacturing Co and Baird, Re (1984) 5 D.L.R. 697

sub nom Carruth v. Imperial Chemical Industries Limited [1937] A.C. 707

Sussex Brick Co Ltd., Re [1961] 1 Ch. 289

Tan Eng Guan v. Southland Co. Ltd. [1996] 2 H.K.C. 100

Tang Kam-yip v. Yau Kung School [1986] H.K.L.R. 448

Tasbian (No. 3), Re [1991] B.C.L.C. 792

Teck Corporation Ltd. v. Millar (1973) 33 D.L.R. 288

Theatrical Trust Limited, Re Chapman's Case [1895] 1 Ch. 771

Todd v. Robinson (1884) 14 Q.B.D. 739

Tottenham Hotspur plc., Re [1994] 1 B.C.L.C. 655

Transvaal Lands Company v. New Belgium (Transvaal) Land and Development Company [1914] 2 Ch. 488

Travis v. Anthes Imperial Limited, 473 F. 2d. 515 (8th Cir. 1973)

Trevor v. Whitworth [1887] 12 A.C. 409

United Copper Securities Company v. Amalgamated Copper Company, 244 U.S. 261

Vopni v. Droenewald, 1991 Ont C.J. LEXIS 987

Vrij v. Boyle (1995) 7 N.Z.B.L.C. 260

W.J. Hall & Co. Limited, Re [1916] 2 Ch. 115

Walker v. Wimborne (1976-1977) 137 C.L.R. 1

Wall & Redekop Corporation, Re (1975) 50 D.L.R. 733

Wall v. London and Northern Assets Corporatpion [1898] 2 Ch. 469

Wallersteiner v. Moir [1974] 1 W.L.R. 991

Wallersteiner v. Moir (No. 2) [1975] 1 Q.B. 373

Weinberger v. UOP, 457 A 2d 701 (Del. 1983)

Welfab Engineers Ltd., Re [1990] B.C.L.C. 833

Westar Mining Ltd, 1996 ACWSJ LEXIS 78487

Western Finance Company Ltd v. Tasker Enterprises Ltd [1980] 1 W.W.R. 323 (Man. C.A.)

Westfair Foods Ltd v. Watt (1989) 106 A.R. 40

Westfair Foods Ltd., Re [1991] 4 W.W.R. 694

Wheelock Maritime International Limited, Unrep. Civ. App. No. 24, 25, 36, 37 and 104 of 1994

White v. Bristol Aeroplane Co. Ltd. [1953] 1 Ch. 65

Wincham Shipbuilding Boiler and Salt Company, Re Poole Jackson and Whyte's Case (1878) 9 Ch. D. 322

Winkworth v. Edward Baron Development Co. Ltd. [1986] 1 W.L.R. 1512

Wondoflex Textiles (Pty) Ltd. Re [1951] Vict. L. Rev. 458

Wood v. Odessa Waterworks Company (1889) 42 Ch. D. 636

Woodhouse v. Walsall Metropolitan Borough Council [1994] 1 B.C.L.C. 435

Woolfson v. Strathclyde Regional Council [1978] S.L.R. 159

Worcester Corsetry Limited v. Witting [1936] 1 Ch. 640

Yan Kwok Kin Julian v. Yan Kwok Kee Gay [1997] 3 H.K.C. 235

Yenidje Tobacco Company Limited, Re [1916] 2 Ch. 426

Young v. Ladies, Imperial Club Limited [1920] 2 K.B. 523

Zanda Investment Ltd. v. Bank of American National Trust and Savings Association [1994] 2 H.K.C. 409

II. BOOKS AND ARTICLES

Akehurst, Michael, "Jurisdiction in International Law" (1974) 46 Brit. Y. B. Int'l. Law 145

Alchian, Armen A. and Harold Demsetz, "Production, Information Costs, and Economic Organization" (1974) 62 American Economic Review 777

Anisman, Philip, "The Commission as Protector of Minority Shareholders" in Law Society of Upper Canada, 1989 Special Lectures (Ontario)

Arden, Dame Mary, "Company Law Reform" (1997) 2 CfiLR 159

Bainbridge, Stephen M, "Independent Directors and the ALI Corporate Governance Project" (1993) 61 Geo. Wash. L. Rev. 1034

Ballatine, H.W., Ballatine on Corporations, Callaghan and Company, Chicago, 1946

Ballatine, Henry W. "Questions of Policy in Drafting a Modern Corporation Law" (1931) 19 Calif. L. Rev. 465

Baxter, Colin, "The Role of the Judge in Enforcing Shreholder Rights" [1983] C.L.J. 96

Bebchuk, Lucian A., "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments" (189) 102 Harv. L. Rev. 1820

Beck, Stanley M., "The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered" (1971) 49 Can. Bar Rev. 80

Benston, George J, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934" (1973) 63 American Economic Review 132

Berle, A.A., Jr, "For Whom Corporate Managers Are Trustees: A Note" (1932) 45 Harv. L. Rev. 1365

Bird, Peter, "What is 'A True and Fair View'?" [1984] J.B.L. 480

Black, Bernard and Reinier Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 Harv. L. Rev. 1911

Blumberg, Phillip I, "Limited Liability and Corporate Groups" [1986] J. Corp. Law. 573

Booth, Richard A., "The Limited Liability Company and the Search for a Bright Line between Corporations and Partnerships" (1997) 32 Wake Forest L. Rev. 79

Booth, Richard A., "The Other Side of the Management Compensation Controversy" (1994) 22 Sec. Reg. L.J. 22

Booth, Richard A, “The Promise of State Takeover Statutes” (1986) 86 Mich. L. Rev. 1635

Boyle, A.J., “The new derivative action” (1997) 18 Co. Law. 256

Bratton, William W, Jr, “The Economic Structure of the Post-Contractual Corporation” (1992) 87 Nw. U. L. Rev 180

Bratton, William W., “The ‘Nexus of Contracts’ Corporation : A Critical Appraisal” (1989) 74 Cornell L. Rev. 407

Bratton, William W., “The New Economic Theory of the Firm: Critical Perspectives from History” (1989) 41 Stan. L. Rev. 1471

Bratton, William W. and Joseph A. McCahery, “An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition” (1997) 54 Wash. & Lee L. Rev. 629

Brownlee, Hunter J., “Comment: The Shareholders’ Agreement: A Contractual Alternative to Oppression as a Ground for Dissolution” (1994) 24 Stetson L. Rev. 267

Brudney, Victor and Marvin A. Chirelstein, “Fair Shares in Corporate Mergers and Takeovers” (1974) 88 Harv. L. Rev. 297

Brudney, Victor, “Corporate Governance, Agency Costs, and the Rhetoric of Contract” (1985) 85 Colum. L. Rev. 1403

Burke, Karen C., “The Uncertain Future of Limited Liability Companies” (1995) 12 Am. J. Tax Pol’y 13

Butler, Henry N, “The Contractual Theory of the Corporation” (1989) 11 Geo. Mason U. L. Rev. 99

Buxbum, Richard M., “Corporate Legitimacy, Economic Theory and Legal Doctrine” (1984) 45 Ohio St. L. J. 515

Carney, William J., “Controlling Management Opportunism in the Market for Corporate Control : an Agency Cost Model” [1998] Wis. L. Rev. 385

Cheffins, Brian R., “Reforming the Derivative Action: The Canadian Experience and British Prospects” [1997] CfiLR 227

Cheffins, Brian, “The Oppression Remedy in Corporate Law: The Canadian Experience” (1988) 10 U. Pa. J. Int’l Bus. L. 305

Cheffins, Brian R., “U.S. Close Corporation Legislation: A Model Canada Should Not Follow” (1989) 35 McGill L.J. 160

Clark, Robert Charles, “Agency Costs Versus Fiduciary Duties” in Principals and Agents: The Structure of Business (J. Pratt & R. Zeckhauger eds. 1985)

Coffee, John C., Jr., “No Exit? Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies” (1988) 53 Brooklyn L. Rev. 919

Coffee, John C., Jr., “Re-engineering Corporate Disclosure: The Coming Debate Over Company Registration” (1995) 52 Wash. & Lee L. Rev. 1143

Cohen-Whelan Debra, “Individual Responsibility in the Wake of Limited Liability” (1988) 32 U.S.F.L. Rev. 335

Cooper, Karen, “Laws urged to back bailouts; Accountants call for provisional supervision”, South China Morning Post (12 February 1999) B3

Daniels, Ronald J, “Should Provinces Compete? The Case for a Competitive Corporate Law Market” (1991) 36 McGill L.J. 130

Daniels, Ronald J. and Jeffry G. MacIntosh, “Toward a Distinctive Canadian Corporate Law Regime” (1991) 29 Osgoode Hall L.J. 861

DeMott, Deborah A., “Beyond Metaphor: An Analysis of Fiduciary Obligations” [1988] Duke L.J. 879

DeMott, Deborah A., “The Figure in the Landscape: A Comparative Sketch of Directors’ Self-Interested Transactions”, Presentation at Cambridge University Law Faculty Centre for Corporate and Commercial Law Conference, April 1999

Dent, George W Jr, “Dual Class Capitalization: A Reply to Professor Seligman” (1986) 54 Geo. Wash. L. Rev. 725

Dent, George W, Jr, “SEC Rule 14a-8: A Study in Regulatory Failure” (1985) 30 N.Y.L. Sch. L. Rev. 1

Dicey and Morris on The Conflict of Laws, (London: Sweet & Maxwell, 1993)

Dillon, David, “Theories of the Corporation” [1990] Duke LJ 201

Drake, Charles D., “Disqualification of Directors - The “Red Car” [1989] J.B.L. 474

Easterbrook, Frank H. and Daniel R. Fischel, “Close Corporations and Agency Costs (1985-1986) 38 Stan. L. Rev. 271

Easterbrook, Frank H. & Daniel R. Fischel, “Corporate Control Transactions” (1982) 91 Yale L.J.

Easterbrook, Frank H. and Daniel R Fischel, “Limited Liability and the Corporation” (1985) 52 U. Chi. L. Rev. 89

Easterbrook, Frank H. and Daniel R. Fischel, "The Corporate Contract" (1989) 89 Colum. L. Rev. 1416

Easterbrook, Frank H. and Daniel R Fischel, The Economic Structure of Corporate Law (Cambridge, Mass: Harvard University Press 1991)

Easterbrook, Frank H. & Daniel R. Fischel, "Voting in Corporate Law", (1983) 26 J. L. & Econ. 395

Eisenberg, Melvin Aaron, "The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking" (1969) 57 Calif. L. Rev. 1

Eisenberg, Melvin Aaron, "The Structure of Corporation Law" (1989) 89 Colum. L. Rev. 1461

Eisenberg, Melvin Aron, Corporations and Business Associations (Westbury, N.Y.: The Foundation Press Inc. 1995)

Elson, Alex and Michael L Shakman, "The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product" (1994) 49 Bus. Law. 1761

Falkenhausen, Bernard V. and Ernst C. Steefel, "Shareholders' Rights in German Corporations" (1961) 10 Am. J. Comp. L. 407

Fama, Eugene F. and Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 J.L. & Econ. 301

Fama, Eugene F. and Michael C. Jensen, "Agency Problems and Residual Claims" (1983) 26 J.L. & Econ. 327

Farrar FH, NE Furey and BM Hannigan, Farrar's Company Law 4th ed. (London: Butterworths 1998)

Fischel, Daniel R, "Organized Exchanges and the Regulation of Dual Class Common Stock" (1987) 54 U. Chi. L. Rev. 119

Fischel, Daniel R, "The Appraisal Remedy in Corporate Law" (1983) Am. B. Found. Res. J. 875

Fischel, Daniel R., "The Corporate Governance Movement" (1982) 35 Vand. L. Rev. 1259

Fitzsimmons, Peter, "Statutory Derivative Actions in New Zealand" (1996) 14 C. & S. L.J. 184

Fitzsimmons, Peter, "The Companies Act 1993: a new approach to shareholder litigation in New Zealand" (1997) 18 Co. Law. 306

Flocos, Peter N, “Towards a Liability Rule Approach to the ‘One Share One Vote’ Controversy: an Epitath for the SEC’s Rule 19c-4” (1990) 138 U. Pa. L. Rev. 1761

Folk III, Ernest L, “De Factor Mergers in Delaware: Hariton v Arco Electronics Inc” (1963) 49 Va. L. Rev. 1261

Fox, Merritt B., “Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis” (1984) 70 Va. L. Rev. 1005

Freedman, Judith, “Small Businesses and the Corporate Form: Burden or Privilege?” (1994) 57 Mod. L. Rev. 555

Friedman, Martin, with the assistance of Rose D. Friedman, Capitalism and Freedom (The U of Chicago Press 1962) 133-134

Gazur, Wayne M. and Neil M. Goff, “Assessing the Limited Liability Company” (1991) 41 Case W. Res. 387

Gilson, Ronald J., “Evaluating Dual Class Common Stock: The Relevance of Substitutes” (1987) 73 Va. L. Rev. 807, 808

Gilson, Ronald J, “Path Dependence and Comparative Corporate Governance: Corporate Governance and economic Efficiency: When Do Institutions Matter” (1996) 74 Wash. U. L. Q. 327

Goldberg, G.D., “Article 80 of Table A of the Companies Act 1948” (1970) 33 Mod. L. Rev. 177

Goldstein, Elliott, “The Revised Model Business Corporation Act: Comment and Observation: Revision of the Model Business Corporations Act” (1985) 63 Tex. L. Rev. 1471

Gordon, Jeffrey N, “Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice” (1988) 76 Calif. L. Rev. 1

Gordon, Jeffrey N., “The Mandatory Structure of Corporate Law” (1989) 89 Colum. L. Rev. 1549

Gower, LCB, “A Comment” (1967) 30 Mod. L. Rev. 259

Gower’s Principles of Modern Company Law, 4th ed (1979), 5th ed. (1992), 6th ed. (1997)

Grantham, Ross, “The Unanimous Consent Rule in Company Law” [1993] C.L.J. 245

Grossfeld, Bernhard, The Strengths and Weakness of Comparative Law, translated by Tony Weir (Oxford: Clarendon Press, 1990)

Grundfest, Joseph A, “The Limited Future of Unlimited Liability: A Capital Market’s Perspectives” (1992) 102 Yale J. on Reg. 387

Hadden, Tom, Company Law and Capitalism, 2d ed (London: Weidenfeld and Nicholson 1977)

Hahlo, HR, “Here Lies the Common Law: Rest in Peace” (1967) 30 Mod. L. Rev. 241

Hale, Christopher, “What’s Right with the Rule in Foss v. Harbottle” (1997) 2 CFiLRev. 219

Halpern, Paul, Michael Trebilcock and Stuart Turnbull, “An Economic Analysis of Limited Liability in Corporation Law” (1980) 30 U.T.L.R. 117

Hamilton, Robert W., “The State of State Corporation Law: 1986” (1986) 11 Del. J. Corp. L. 3

Hansmann, Henry and Reinier Kraakman, “Towards Unlimited Shareholder Liability for Corporate Torts” (1991) 100 Yale L.J. 1879

Harris, Mike, “Comment: Assessing the Utility of Wisconsin’s Close Corporation’s Statute :An Empirical Study” (1986) Wis. L. Rev. 811

Harvard Draft Convention on Jurisdiction With Respect to Crime (1935) 29 Am. J. Int’l L. 437

Hayton, David J., Underhill’s Law Relating to Trusts and Trustees 15th ed. (London: Butterworths, 1995)

Henn, Harry G. and John R. Alexander, Laws of Corporations, 3d (St. Paul, Minn.: West Publishing 1983)

Hetherington, JAC, “When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights” (1979) 8 Hofstra L. Rev. 183

Hicks, Andrew, “Corporate Form: Questioning the Unsung Hero” [1997] J.B.L. 306

Hicks, Andrew, “Directors’ Liability for Management Errors” (1994) 110 L.Q.R. 390

Hicks, Andrew, “Disqualification of Directors - Forty Years On” [1988] J.B.L. 27

Hill, Jennifer, “Close Corporations in Australia - The Close Corporations Bill 1988” (1989) 15 C.B.L.J. 43

Hoey, Amanda, “Disqualifying Delinquent Directors” (1997) 18 Co. Law. 130

Iacobucci, Frank, Marilyn L Pilkington and J Robert S Prichard, Canadian Business Corporations: An Analysis of Recent Legislative Developments (Toronto: Canada Law Book Ltd 1977)

Investment Responsibility Research Center, “More than Half of the States Offer Director Liability Protection”, 4 IRRC Corporate Governance Bulletin No. 5 (Sept./Oct. 1997)

Jensen, Michael C. and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 Journal of Financial Economics 305

Johnson, Lyman, “Individual and Collective Sovereignty in the Corporation Enterprise” (1992) 92 Colum. L. Rev. 2215

Kahn-Freund, O, “Some Reflections on Company Law” (1944) 7 Mod. L. Rev. 54

Kanda, Hidei and Saul Levmore, “The Appraisal Remedy and the Goals of Corporate Law” (1985) 32 U.C.L.A. L. Rev. 429

Karjala, Dennis S., “A Second Look at Special Close Corporation Legislation” (1980) 58 Texas L. Rev. 1207

Kraakman, Reinier H., “Corporate Liability Strategies and the Costs of Legal Controls” (1984) 93 Yale L.J. 857

Kötz, Hein, “Taking Civil Codes Less Seriously” (1987) 50 Mod. L. Rev. 1

Latty, Elvin R., “Pseudo-foreign corporations” (1955) 65 Yale L.J. 137

Leebron, David W., “Limited Liability, Tort Victims, and Creditors” (1991) 91 Colum. L. Rev. 1565

Letsou, Peter V., “The Role of Appraisal in Corporate Law” (1998) 39 B.C.L. Rev. 1121

Levine, Michael E and Charles R Plott, “Agenda Influecne and Its Implications” (1977) 63 Va. L. Rev. 561

Levy, Irving J, “Rights of Dissenting Shareholders to Appraisal and Payment” (1929-1930) 15 Cornell L.Q. 420

Liebeler, Susan W, “A Proposal to Rescind the Shareholder Proposal Rule” (1984) 18 Ga. L. Rev. 425

Lorsch, Jay W with Elizabeth MacIver, Pawns or Potentates: The Reality of America’s Corporate Boards (Boston: Harvard Business School Press 1989)

Loss, Louis and Joel Seligman, Fundamentals of Securities Regulation, 3d (Boston: Little Brown 1995)

Lowry, John, “Reconstructing shareholder actions: a response to the Law Commission’s Consultation Paper” (1997) 18 Co. Law. 247

Lu, Shen-shin, “Are the 1988 Amendments to Japanese Securities Regulation Law Effective Deterrent to Insider Trading?” (1991) 2 Col. Bus. Rev. 179

MacIntosh, Jeffrey G, “Minority Shareholder Rights in Canada and England: 1860-1987” (1989) 27 Osgoode L.J. 561

MacIntosh, J.G., “The Shareholders’ Appraisal Remedy in Canada: A Critical Reappraisal” (1988) 13 Canada-United States L.J. 299

MacKenzie, Judith-Anne, “Who Controls the Company: The Interpretation of Table A” (1983) 4 Co. Law. 99

Madill, George Alexander, “Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law” (1995) 84 Geo. L.J. 1

Maloney, M.A., “Whither the Statutory Derivative Action?” (1986) 64 Can. Bar. Rev. 309

Manning, Bayliss, “The Shareholders’ Appraisal Remedy: An Essay for Frank Coker” (1962) 72 Yale L.J. 223

Meiners, Roger E, James S Mofsky and Robert D Tollison, “Piercing the Veil of Limited Liability” (1979) 4 Del. J. Corp. Law. 351

McGinty, Park, “The Limited Liability Company: Opportunity for Selective Securities Law Deregulation” (1996) 64 U. Cin. L. Rev. 369

Miller, Sandra K., “What Remedies should be Available to the Dissatisfied Participant in a Limited Liability Company?” (1994) 44 Am. U. L. Rev. 465

Miller, Sandra K., “What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies” (1994) 68 St. John’s L. Rev. 21

Moran, Leslie J., “Missing links and missed opportunities” (1997) 18 Co. Law. 264

Norton, J.J., “Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas” (1985) 39 Southwestern L.J. 781

Oesterle, Dale A., “Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business” (1995) 66 U. Colo. L. Rev. 88

Oldfield, Stewart, “Supervision plan stirs collapse fear”, South China Morning Post (29 December 1998) B1

O’Neil, Timothy K, “Rule 19c-4: The SEC Goes Too Far in Adopting a One Share, One Vote Rule” (1989) 83 Nw. U. L. Rev. 1057

Ong, Kingsley T.W., “Disqualification of Directors : a Faulty Regime?” (1998) 19 Co. Law. 7

Orts, Eric W, “Shirking and Sharking: A Legal Theory of the Firm” (1998) 16 Yale Law & Pol’y Rev. 265

Parkinson, J.E., Corporate Power and Responsibility: Issues in the Theory of Company Law (Oxford: Clarendon Press 1993)

Payne, Jennifer, "Bigger and Better Guns for Minority Shareholders" [1998] C.L.J. 36

Pettet, Ben, "Towards a Competitive Company Law" (1998) 19 Co. Law. 134

Phillips, Michael J, "Reappraising the Real Entity Theory of the Corporation" (1994) 21 Fla. S. U. L. Rev. 1061

Poole Jill and Pauline Roberts, "Shareholder Remedies - Corporate Wrongs and the Derivative Action" [1999] J.B.L. 99

Poole, Jill and Pauline Roberts, "Shareholder Remedies - Efficient Litigation and the Unfair Prejudice Remedy" [1999] J.B.L. 38

Posner, Richard A, "The Rights of Creditors of Affiliated Corporations" (1976) 43 U. Chi. L. Rev. 499

Prentice, D.D. (1988) 104 L.Q.R. 341

Price Waterhouse, Corporate Governance Survey (Hong Kong 1995)

Ramsay, Ian M., "Enforcement of Corporate Rights and Duties by Shareholders and the Australian Securities Commission: Evidence and Analysis" (1995) 23 Aust. Bus. L. Rev. 174

Resnick, J., "Managerial Judges" (1982) 96 Harv. L. Rev. 374

Reynolds, FMB, "Contract: Codification Legislation and Judicial Development" (1995) 9 J. Contract L. 11

Ribstein, Larry E., "Form and substance in the Definition of a 'Security': The Case of Limited Liability Companies" (1994) 51 Wash. & Lee L. Rev. 897

Ribstein, Larry E., "Limited Liability Companies: Statutory Forms for Closely Held Firms: Theories and Evidence From LLCs" (1995) 73 Wash U. L. Q. 369

Riley, Christopher A., "Contracting Out of Company Law : Section 459 of the Companies Act 1985 and the Role of the Courts" (1992) 55 Mod L. Rev. 782

Riley, C.A., "The values behind the Law Commission's consultation paper" (1997) 18 Co. Law. 260

Roberts, Pauline and Jill Poole, "Shareholder Remedies - Efficient Litigation and the Unfair Prejudice Remedy" [1999] J.B.L. 38

Roe, Mark J., "A Political Theory of American Corporate Finance" (1991) 91 Colum L. Rev. 10

Roe, Mark J., "Political and Legal Restraints on Ownership and Control of Public Companies" (1991) 27 Journal of Financial Economics 7

Romano, Roberta, "A Cautionary Note on Drawing Lessons from Comparative Corporate Law" (1993) 102 Yale LJ

Romano, Roberta, "Empowering Investors: A Market Approach to Securities Regulations" (1998) 107 Yale L.J. 2359

Schwenk, Michael R, "Valuation Problems in the Appraisal Remedy" (1994) 16 Cardozo L. Rev. 649

Scogin, Hugh T, Jr, "Withdrawal and Expulsion in Germany: A Comparative Perspective on the 'Close Corporation Problem'" (1993) 15 Mich. J. Int'l L. 127

Sealy, L.S., "More Bleak News for the Minority Shareholders [1987] C.L.J. 398

Sealy, L.S., "Problems of Standing, Pleading and Proof in Corporate Litigation" in B.G. Pettet, Company Law in Change (London: Stevens & Son 1987)

Sealy Len, "Shareholders' Remedies in the Common Law World" (1997) 2 CfiLR 172

Seligman, Joel, "A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project" (1987) 55 Geo. Wash. L. Rev. 325

Seligman, Joel, "American Law Institute's Corporate Governance Project: Remedies: Reappraising the Appraisal Remedy" (1984) 52 Geo. Wash. L. Rev. 829

Siegel, Mary, "Back to the Future Appraisal Rights in the Twenty-first Century" (1995) 32 Harv. J. on Legis. 79

Stapledon, G.P., "Use of the Oppression Provision in Listed Companies in Australia and the U.K." (1993) 67 A.L.J. 575

Sugarman, D., "Reconceptualising company law: reflections on the Law Commission's consultation paper on shareholder remedies: Part 1" (1997) 18 Co. Law. 226; Part 2 (1997) 19 Co. Law. 274

Sullivan, G.R., "The Relationships between the Board of Directors and the General Meeting in Limited Co." (1977) 93 L.Q.R. 569

"The 'Nationality' of International Corporations Under Civil Law and Treaty" (1961) 74 Harv. L. Rev. 1429

Thompson, Robert B, "Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law" (1995) 84 Geo. L.J. 1

Topping, MP and JPM Vandanlinden, “Ibi renascit jus commune” (1970) 33 Mod. L. Rev. 170

Tyler, E.L.G. (1987) 17 H.K.L.J. 230

Waddams, SM, “Codification, Law Reform and Judicial Development” (1996) 9 J Contract L 192

Wecker, Andrew, “Note: O.R.C. Chapter 1705 - Ohio’s New Statute on Limited Liability Companies” (1995) 56 Ohio St. L.J. 951

Wedderburn, K.W., “Shareholders’ Rights and the Rule in Foss v. Harbottle (1957) 15 C.L.J. 194

Wedderburn, K.W., “Shareholders’ Rights and the Rule in Foss v. Harbottle [1958] C.L.J. 93

Welling, Bruce, Corporate Law in Canada: The Governing Principles, (Toronto: Butterworths 1991)

Wertheimer, Barry M, “The Purpose of the Shareholders’ Appraisal Remedy” (1998) 65 Tenn L Rev 1

III. REPORTS, PAPERS AND PROCEEDINGS

Great Britain, Company Law Amendment Committee 1925-1926 Report

Great Britain, Company Law Review Steering Group, Modern Company Law for a Competitive Economy, The Strategic Framework (1999)

Great Britain, Department of Trade and Industry, Limited Liability Partnerships Bill, Consultation Document (1998)

Great Britain, Law Commission, Consultation Paper No. 142, Shareholder Remedies

Great Britain, Law Commission, Shareholder Remedies, Cm 3769 (London : H.M.S.O. 1997)

Hong Kong, Financial Services Bureau, Consultation Paper on Corporate Rescue and the Protection of Wages on Insolvency Fund (Dec. 1998)

Hong Kong, Hongkew Holdings Limited Inspection Report

Hong Kong, Law Reform Commission, Consultation Paper on the Winding-up Provisions of the Companies Ordinance (April 1998)

Hong Kong, Law Reform Commission, Report on Corporate Rescue and Insolvent Trading (Hong Kong : Government Printer 1996)

Hong Kong, Official Receiver's Report 1996-1997, 1997-1998

Hong Kong, Secretary for Education and Manpower, Legislative Council Proceedings, 23 Sept. 1998

London Stock Exchange, Yellow Book

New York Stock Exchange, Listed Company Manual

Stock Exchange of Hong Kong Limited, Fact Book 1998

Appendix 4

List of Abbreviations

A.B.C.A.	Alberta Business Corporations Act
A.L.I.	American Law Institute
C.B.C.A.	Canadian Business Corporations Act
C.C.A.S.S.	Central Clearing and Settlement System (H.K.)
C.O.	Companies Ordinance (H.K.)
D.T.I.	Department of Trade and Industry (U.K.)
E.M.B.	Education and Manpower Bureau (H.K.)
F.S.B.	Financial Services Bureau (H.K.)
G.A.A.P.	Generally Accepted Accounting Principles
H.K.S.A.	Hong Kong Society of Accountants
H.K.S.C.C.	Hong Kong Securities Clearing Company Limited
I.R.D.	Inland Revenue Department (H.K.)
L.L.C.	Limited Liability Company incorporated under the Uniform Limited Liability Company Act (U.S.A.)
L.L.P.	Limited Liability Partnership
M.A.A.	Memorandum of Association and Articles of Association
M.B.C.A.	Model Business Corporations Act (U.S.A.)
O.B.C.A.	Ontario Business Corporations Act
P.A.Y.E.	Pay as you earn - a U.K. system of tax collection
R.M.B.C.A.	Revised Model Business Corporations Act (U.S.A.)
S.E.C.	Securities and Exchange Commission (U.S.A.)
S.E.H.K.	Stock Exchange of Hong Kong
S.F.C.	Securities and Futures Commission (H.K.)
S.S.A.P.	Statements of Standard Accounting Practice (H.K.)
Table A	Table of the First Schedule to the Companies Ordinance
V.A.T.	Value Added Tax (U.K.)