

New Companies Ordinance

Briefing Notes on Part 11

Fair Dealing by Directors

INTRODUCTION

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

POLICY OBJECTIVES AND MAJOR CHANGES

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

- (a) expanding the prohibitions on loans and similar transactions to cover a wider category of persons connected with a director (paragraphs 5 and 6 below);
- (b) requiring disinterested members’ approval for various prohibited transactions (paragraphs 7 to 10);
- (c) expanding the prohibitions on payments for loss of office (paragraphs 11 to 13);
- (d) requiring members’ approval for directors’ employment exceeding 3 years (paragraphs 14 and 15); and

- (e) widening the ambit of disclosure currently required under section 162 of the Companies Ordinance (Cap. 32) (“Cap. 32”) (paragraphs 16 and 17).
3. The initiatives that aim at facilitating business and modernising the law include –
- (a) introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities (paragraphs 18 to 23).
 - (b) modifying the scope of private companies that are subject to more stringent restrictions similar to a public company (paragraphs 24 to 27); and
 - (c) removing the criminal sanction for breach of the provisions on prohibition of loans and similar transactions in favour of directors and connected entities (paragraphs 28 and 29).
4. The details of the major changes in Part 11 are set out in paragraphs 5 to 29 below.

Expanding the prohibitions on loans and similar transactions to cover a wider category of persons connected with a director (Sections 486 to 488)

Position under Cap. 32

5. To avoid potential conflict of interests between a company and its directors, section 157H of Cap. 32 prohibits a company from entering into loans or other similar transactions with a director or persons connected with the director. In respect of a listed company or a private company that is within the same group as a listed company, section 157H(8) and (9) extends the references to “director” to a spouse, child and step-child (including illegitimate child) under the age of 18, and specified categories of trustees and partners; and section 157H(2)(c), (3)(c) and (4)(c) extends the prohibitions to a company in which a director (or the above categories of persons) holds a controlling interest. These Cap. 32 references are not sufficient to cover all parties who are closely associated with directors.

Position and key provisions in the new CO

6. The prohibition is expanded to cover a wider category of persons connected with a director. **Sections 502 and 503** prohibit a specified company from making a loan or quasi-loan to, or enter into credit transaction as creditor for an entity connected with a director without prescribed approval of members. **Sections 486 to 488** provide for the coverage of an entity connected with a director. It covers, on top of those in Cap. 32 –

- (a) an adult child, adult step-child, adult illegitimate child or adopted child of any age;
- (b) a parent;
- (c) a cohabitee;
- (d) a minor child, minor step-child, minor illegitimate child or minor adopted child of the cohabitee who lives with the director;
- (e) an associated body corporate as defined in section 488;
- (f) a trustee of a trust which includes the director's minor adopted child;
and
- (g) a business partner of the director's minor adopted child.

Requiring disinterested members' approval for various prohibited transactions (Sections 496, 515, 518 and 532)

Position under Cap. 32

7. Except for some specified transactions (most of which relate to purchase or redemption of a company's own shares), there is no provision in Cap. 32 restricting members' rights to vote or requiring members to abstain from voting in relation to transactions in which they have an interest.

Position and key provisions in the new CO

8. In the new CO, there is a new requirement for disinterested members' voting for connected transactions. The requirement will be applicable to public companies for various prohibited transactions, and to a private company or company limited by guarantee that is a subsidiary of a public company for loans and similar transactions.

9. **Various sections in Divisions 2 to 4 of Part 11**, which set out the requirements for members' approval for the three types of prohibited transactions covered by Part 11 (i.e. loans, quasi-loans and credit transactions; payments for loss of office; and directors' long-term employment), have incorporated the disinterested members' voting requirement for public companies. For loans, quasi-loans and credit transactions, the disinterested members' approval requirement is extended to a private company or company limited by guarantee that is a subsidiary of a public company (**sections 491, 496(2)(b)(ii) and 515(1)(b)(ii)**). If a company is subject to the disinterested members' approval requirement, the resolution at a general meeting of such a company is passed only if every vote in favour of the resolution by the interested members is disregarded (**sections 496(2)(b)(ii) and (5), 515(1)(b)(ii) and (4), 518(2)(b)(ii), (4) and (5) and 532(2)(b)(ii) and (4)**).

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

- (a) in the case of a resolution for affirming a contravening loan or similar transaction (i.e. where the company elects to adopt the transaction despite the contravention), any other director who authorised the contravening transaction;
- (b) in the case of a payment for loss of office, the proposed recipient of the payment for loss of office, if he is not the relevant director or former director;
- (c) in the case of a payment for loss of office which is made in connection with a share transfer resulting from a takeover offer, the person who makes the takeover offer and his associates; and

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

Expanding the prohibitions on payments for loss of office (Sections 516 to 529)

Position under Cap. 32

11. It is unlawful under sections 163 to 163D of Cap. 32 to make payments to directors or former directors of a company, as compensations for loss of office or as consideration for retirement from office, without the company's prior approval. There are potential loopholes under these provisions –

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

Position and key provisions in the new CO

12. To plug any potential loophole, the loss of office payment provisions are extended by **section 516(3)** to include –

- (a) payment to an entity connected with the director; and
- (b) payment to a person made at the direction of, or for the benefit of the director or an entity connected with the director.

13. Further, **section 521(2)** extends the prohibition to include payment by a company to a director or former director of its holding company. **Section 522(2)** extends the provisions to include the payment made in connection with a transfer of the undertaking or property of the company's subsidiary.

By virtue of **section 516(1)** (definition of “takeover offer”) and **section 523(1)**, the prohibitions in connection with a share transfer are extended to include all transfers of shares in the company or in its subsidiary resulting from a takeover offer.

Requiring members’ approval for directors’ employment exceeding 3 years (Sections 530 to 535)

Position under Cap. 32

14. There is no provision in Cap. 32 requiring members’ approval for long-term employment of a director. There is a risk that a director may arrange for himself long-term employment with his company which entrenches him in office or makes it too expensive for the company to remove him from office before his contract expires (as the director might be entitled to damages for the company’s breach of contract arising from the early termination).

Position and key provisions in the new CO

15. The new CO requires members’ approval for directors’ long-term employment. **Section 534** requires the approval of the members of a company for any contracts under which the guaranteed term of employment of a director with the company exceeds or may exceed 3 years.

Widening the ambit of disclosure as set out under section 162 of Cap. 32 (Sections 536 to 542)

Position under Cap. 32

16. Section 162 of Cap. 32 requires a director, who has a material interest, directly or indirectly, in a contract or proposed contract with the company which is of significance to the company’s business, to disclose to the board of directors the nature of such interest at the earliest meeting of directors that is practicable. The current application of the section is relatively narrow and there is a need to widen the ambit.

Position and key provisions in the new CO

17. **Division 5 of Part 11 (sections 536 to 542)** restates the provisions of section 162 of Cap. 32 with modifications to keep in line with the relevant provisions of other common law jurisdictions such as the United Kingdom, and to widen the ambit of the section as follows –

- (a) the ambit of disclosure is widened to cover “transactions” and “arrangements” instead of just “contracts” (**section 536(1) and (2)**);
- (b) for a public company, the ambit of disclosure is widened to include disclosure by a director of any material interest of entities connected with him, except that a director is not required to declare an interest if he is not aware of the interest or the transaction in question (**section 536(2) and (4)(a)**);
- (c) a director is required to disclose the “nature and extent” of the interest instead of just disclosing the “nature” of the interest (**section 536(1) and (2)**); and
- (d) the disclosure requirements are extended to shadow directors (**section 540**).

Introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities (Sections 500 to 504, 505, 507 and 508)

Position under Cap. 32

18. The decision whether to make a loan is normally taken by the directors. Section 157H of Cap. 32 prohibits, subject to certain exceptions, a company from entering into any direct or indirect loan transactions in favour of its directors, directors of its holding company or any of their connected persons. These rules are intended to protect shareholders and creditors. There are exemptions from prohibitions under section 157HA of Cap. 32 which apply to all companies. In addition, a private company which is not a member of a group which includes a listed company is exempted from the prohibitions if the loan transaction is approved by members in general meeting (section 157HA(2)).

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

Position and key provisions in the new CO

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

21. **Sections 500 to 504** provide generally that a company must not make loans, and a company which is a public company or a private company or company limited by guarantee that is a subsidiary of a public company must not make quasi-loans or enter into credit transactions, in favour of a director of the company or of its holding company unless with the prescribed approval of members. The requirements for "prescribed approval of members" are set out in **section 496**. The prohibitions on loans are extended to a body corporate controlled by a director of the company or of its holding company and the prohibitions on quasi-loans and credit transactions are extended to entities connected with a director of the company or of its holding company.

22. Two new exceptions to the prohibitions on loans and similar transactions have been introduced –

- (a) exception for loan, quasi-loan and credit transaction of value not exceeding 5% of net assets or called-up share capital (**section 505**);
- (b) exception for funds to meet expenditure, incurred or to be incurred by a director, on defending proceedings or in connection with an investigation or regulatory action (**sections 507 and 508**).

23. Modifications have been made to the existing exceptions in section 157HA of Cap. 32 –

- (a) in the case of the exception for expenditure on company business, the conditions concerning company's approval and discharge of liability set out in section 157HA(4) as well as the financial limit with reference to 5% of the company's net assets are removed;
- (b) in the case of the exception for home loan, the financial limit of not exceeding 80% of the value of the premises has been removed and the financial limit with reference to 5% of the company's net assets has been relaxed;
- (c) in the case of the exception for leasing goods and land etc., the financial limit with reference to 5% of the company's net assets has been relaxed; and
- (d) in the case of the exception for transaction in ordinary course of business, the financial limit of \$750,000 and the further financial limit with reference to 5% of the company's net assets have been removed.

Modifying the scope of private companies that are subject to more stringent restrictions similar to a public company (Sections 491, 501 to 504)

Position under Cap. 32

24. A private company that is a member of a group of companies which includes a listed company ("relevant private company") is in essence treated in the same manner as a public or listed company in Cap. 32 in respect of prohibitions on loans, quasi-loans and credit transactions in favour of a director of the company or of its holding company, or another company controlled by one or more of its directors. Under Cap. 32, public companies and relevant private companies are subject to more stringent restrictions than other private companies in the following aspects –

- (a) they are subject to additional prohibitions relating to quasi-loans and credit transactions (section 157H(3) and (4));
- (b) the prohibitions are extended to making loans or quasi-loans to or entering into credit transactions with persons connected with a director (section 157H(8)); and
- (c) they are not eligible for the members' approval exception in section 157HA(2) under which other private companies may be exempted from the prohibitions on making loans to a director if the transaction is approved by members at a general meeting.

25. A relevant private company under Cap. 32 may be a subsidiary, holding company or fellow subsidiary of a listed company.

Position and key provisions in the new CO

26. The new CO relaxes the prohibitions on public companies and companies limited by guarantee in respect of loans and similar transactions by extending the members' approval exception to all companies including public companies and companies limited by guarantee. As a safeguard for minority shareholders, specified companies (as defined in **section 491**) are subject to more stringent restrictions in respect of loans and similar transactions.

27. The expression "specified company" means a public company or a private company or company limited by guarantee that is a subsidiary of a public company. Therefore, a private company and a company limited by guarantee will only be subject to the tighter restrictions if they are subsidiaries of a public company, whether listed or non-listed. The more stringent restrictions relating to loans to entities connected with directors and quasi-loans and credit transactions in favour of directors or connected entities in **sections 501 to 504** of the new CO and the requirement of disinterested members' approval only apply to specified companies. Private companies will generally continue to be subject to less stringent regulations.

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

Position under Cap. 32

28. Section 157J of Cap. 32 provides for criminal sanction where there is a breach of section 157H (prohibition of loans, etc., to directors and other persons) and imposes the penalty of a fine and imprisonment. The liability extends to the company and directors who wilfully permitted or authorised the transaction and other persons who knowingly procured the company to enter into the transaction.

Position and key provisions in the new CO

29. The criminal sanction provisions in section 157J of Cap. 32 are repealed by the new CO as it is considered that the civil consequences under **section 513** for contravention of the provisions on loans and similar transactions are sufficient. The rationale is that there is a danger of over-deterrence if criminal sanctions are attached to general directors' duties of loyalty rather than closely defined wrongdoing, and that enforcement of such duties should be a civil matter for the companies.

TRANSITIONAL AND SAVING ARRANGEMENTS

30. Transitional and saving arrangements are set out in **sections 95 to 97 of Schedule 11** to the new CO. The transitional provisions in respect of the major changes are as follows –

- **Section 95 of Schedule 11 –**

If a company has dispensed with the holding of an annual general meeting in accordance with section 613 of the new CO, the condition specified in section 157HA(4)(b) of Cap. 32 in respect of a transaction described in section 157HA(3)(a) of Cap. 32, which is still outstanding on the commencement of Division 2 of Part 11 continues to apply as if it provided that –

- (a) the approval of the company is required on or before the last date on which the company would otherwise have been required to hold an annual general meeting; and
- (b) any liability falling on any person in connection with the transaction must be discharged within 6 months after that date if that approval is not forthcoming.

- **Section 96 of Schedule 11 –**

Sections 163, 163A, 163B, 163C and 163D of Cap. 32 continue to apply in relation to a loss of office or retirement specified in those sections that occurred before the commencement of Division 3 of Part 11. A loss of office or retirement occurred in the case of a directorship, when the person ceased to be a director, or in the case of any other office, when the person ceased to hold the office.

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