STANDING COMMITTEE ON COMPANY LAW REFORM

THIRD REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subjects considered by the Standing Committee during 1986

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1.1 The background to these subjects was explained in the Standing Committee's Report for 1985, pages 2 - 9. The last paragraph of the relevant section read as follows:

"We decided that before we reached any decisions on the subjects of Section 48 and purchase by a company of its own shares, we would have to have a decision on whether the Companies Ordinance should contain detailed provisions on distributable profits. The subject is a particularly technical one and it has to be remembered that the British legislation was drafted very much with the British tax system in mind. The Committee therefore appointed a Sub-Committee consisting of Mr. Connolly as Chairman, two co-opted members of the Law Society of Hong Kong and two co-opted members of the Hong Kong Society of Accountants to consider and report on it. The Sub-Committee has met on a number of occasions and we understand that they expect to be able to submit their recommendations in the first quarter of 1986. Once these are to hand, we shall resume our consideration of both Section 48 and the question of the purchase by a company of its own shares."

1.2 In fact, the Sub-Committee's Report was issued in May. It was a thorough document with an admirably clear explanation of the reasons for its recommendations, which were to the effect that the British legislation should be adopted subject to a number of amendments

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to make it suitable for Hong Kong's circumstances. It would not be practical to annex a copy of the Report to this Report because of its size, but anyone interested in the details can obtain a copy from the Secretary to the Standing Committee.

1.3 At the risk of over-simplifying the Sub-Committee's recommendations (the draft recommended legislation annexed to their Report covers eleven typewritten pages) the principles underlying it can be summarised as follows:

(1) The following basic rules regarding distribution of profit will apply to all companies -

(a) There may only be treated as distributable the unapplied excess of realised profit over realised losses (revenue and capital);

(b) Unrealised profit, of which the classic example is the revaluation surplus, will not be distributable; and

(c) Past revenue losses must be made good before current realised profits are distributable.

(2) The following additional restriction will apply to a listed company, namely, that it can make a distribution only to the extent that its net assets after the distribution are not less than the aggregate of its called-up share capital and its undistributable reserves. Undistributable reserves are:

(a) Share premium account;

(b) Capital redemption reserve;

(c) Unrealised profits not previously capitalised less unrealised losses not previously written-off in a capital reduction or reorganisation; and

(d) Any other reserve which the company is prohibited from distributing by any other Ordinance or by its own memorandum or articles.

In other words, an unlisted company can make a distribution provided that it has profits available for the purpose. However before it can make a distribution, a listed company must not only have profits available for the purpose, it must also provide for any existing unrealised losses.

1.4 Before reaching any decisions on the recommendations in the Sub-Committee's Report, the Standing Committee decided that they should obtain the comments of the professional and other organisations usually consulted on these matters. These organisations were duly written to at the end of June and the last of their comments were received on 1st December. Having carefully considered all the comments, we decided to accept the Sub-Committee's Report and the recommendations therein subject to deletion of a comparatively minor provision, Clause XIV(3), in the recommended draft legislation.

1.5 We therefore recommend the introduction of new legislation on the subject of distributable profits as recommended in the Sub-Committee's Report, subject to deletion of the proposed Clause XIV(3) in Appendices D & E to the Report. We would like to stress that the recommended legislation will only make law what is already good accounting practice.

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1.6 Having reached a decision on the recommendations regarding distributable profits we were able to return to the subjects of the purchase by a company of its own shares and of Section 48.

1.7 With regard to the purchase by a company of its own shares, the Standing Committee's Report for 1985 explained that the relevant provisions in Britain (formerly Sections 45 - 62 of the Companies Act 1981, now Sections 159 - 181 of the Companies Act 1985) allow both private and public companies to purchase their own shares. Rather oddly, in the opinion of the Standing Committee, the procedure for purchase by a public company is the simpler of the two. The provisions are fairly complicated, as one would expect, but basically they allow both private and public companies to buy their own shares out of distributable profits or the proceeds of a fresh issue of shares made for the purpose, subject to prior approval by a special resolution in the case of a private company and by an ordinary resolution in the case of a public company buying its listed shares. In addition, a private company can purchase its own shares out of capital if there are insufficient distributable profits and if there are insufficient proceeds from any fresh issue of shares (although there is no compulsion to make such an issue).

1.8 Members recalled that, prior to 1981, any suggestion that a company should be allowed to purchase its own shares would have been regarded as rank heresy in Britain. Indeed, the Companies Act 1980 had contained a specific prohibition of such purchase; the prohibition had previously depended on case law. Members noted that when the British Government gave notice of its intention to amend the law to allow a company to purchase its own shares, it had stated in its consultative document that this would have the following advantages:

(1) For private companies, the change would make investment and participation in such companies more attractive, by providing shareholders with a further means of disposing of their shares and by permitting the remaining members to maintain control and ownership of the business; and

(2) Public companies with surplus cash resources could find it useful to be able to buy their own shares and thus return surplus resources to shareholders, thereby removing the pressure on the companies to employ the surplus resources in uneconomic ways, and enabling shareholders to deploy the resources to better effect.

1.9 Part of the British Government's consultative document consisted of a paper by Professor L.C.B. Gower, author of "Principles of Modern Company Law" and Research Adviser on Company Law to the Department of Trade, which included the following elaboration of the claimed advantages of a company being able to purchase its own shares:

"11. The main advantages which have been claimed for allowing companies to buy their own shares are the following:

(a) It may enable the company to buy out a dissident shareholder.

(b) It facilitates the retention of family control.

(c) It provides a means whereby a shareholder, or the estate of a deceased shareholder, in a company whose shares are not listed can find a buyer.

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(d) It is particularly useful in relation to employee share schemes in enabling the shares of employees to be re-purchased on their ceasing to be employed by the company.

(e) It may help with the marketing of shares by enabling the company to give a subscriber an option to re-sell to the company.

(f) It enables companies to purchase their shares for use later in stock option plans or acquisition programmes.

(g) If redeemable shares are quoted at below the redemption price it enables the company to save money by buying up in advance of the redemption date (a practice which our companies can, and do, adopt in the case of debentures but cannot in the case of redeemable preference shares).

(h) It permits the evolution of the open-ended investment company or mutual fund instead of having to operate through the mechanism of a unit trust.

(i) It provides a company with surplus cash with a further means of using it advantageously.

(j) It can be used to support the market for the shares if this is thought to be unduly depressed, thus preserving for the shareholders the value of their shares as marketable securities.

(k) If the company not only buys its shares but trades in the treasury shares thus acquired it may make money thereby.

12. It is not suggested that all the above advantages are necessarily desirable; (j) in particular may be regarded as objectionable as leading to market-rigging and (k), trafficking in its own shares, is not self-evidently a desirable corporate activity. But some - particularly (b), (c) and (d) - clearly are valuable, especially in the case of closely-held companies and it is in relation to such companies that the power is mainly used in the U.S.A. Even in these cases, however, the power is clearly capable of abuse; for example by enabling the management to maintain its own control or to gain control and to use the company's money in doing so."

Professor Gower went on to explain why there was a case for consideration, at least, of an extension of the power of a private company to re-purchase its own shares. He then continued:

"16. The case for an extension in relation to public companies is of a different character. Advantages (a) to (d) are either of no or of lesser moment, (e) seems undesirable in the case of listed securities and (j) and (k) are probably actually or potentially objectionable. The only seemingly unobjectionable advantages appear to be (f) to (i). It is, however, doubtful how far use would be made of (f)(h) or (i). If public companies want to have shares available for stock options or acquisitions they seem to experience no difficulty in persuading their members to authorise the creation of further share capital for this purpose. If they want to reduce, rather than increase, capital they can do so under a formal reduction scheme which, in the case of larger companies, is a relatively simple and inexpensive operation. The argument that, if companies could spend surplus cash on informal reductions by buying their shares, they would do so rather than engage in possibly dangerous expansion and diversification seems distinctly dubious in view of the many surveys which have concluded that the main motivation of company managements is a desire to expand their empires. It is difficult to see how a power to purchase the company's own shares could be directly used to facilitate 'de-mergers'. At the most it might provide an outlet for surplus cash alternative to further take-overs and, when a company h d hived-off part of its undertaking by a sale, provide it with an alternative method of distributing the proceeds of sale to its shareholders. As for (h) (the possibility of operating through Mutual Fund companies rather than Unit Trusts) at the time of the Jenkins Committee the unit trust managers showed a marked lack of interest and enthusiasm for any such innovation. Whether that is still the view of the industry is questionable."

1.10 Members were of the opinion that there were not the same pressures to allow listed companies in Hong Kong to purchase their own shares because, unlike their counterparts in Britain, they could distribute reserves as dividends without incurring serious tax problems. We recognised, however, that some directors were reluctant to take advantage of this situation because they remembered uninformed public criticism of companies which had made large distributions of reserves as dividends in the past.

1.11 Members were concerned about the possibility of a power for listed companies to purchase their own shares being abused to manipulate the market prices of these shares. We noted that such companies already had the power in Britain and the United States and accepted the argument that since Hong Kong was moving towards international standards in the securities field, listed companies here should have the same power, provided that there were sufficient safeguards to prevent its abuse. We considered, however, that there would not be sufficient safeguards until there was satisfactory legislation in Hong Kong dealing with -

(a) Disclosure of Beneficial Ownership of Shareholdings

(b) Insider Dealing

(c) Distributable Profits

(d) Fiduciary Duties of Directors

1.12 It was accepted by all members that a power for private companies to purchase their own shares could be very useful in dealing with succession problems arising on the deaths of shareholders.

1.13 Various professional and business organisations had been consulted by the Standing Committee in 1985 when consideration of this subject started and Members were interested to note that two of the leading professional organisations had thought that there was no need to amend the existing law. One remarked:

"Generally we are concerned that the business environment in Hong Kong may not be the right one in which to introduce the concept of a company buying its own shares in the market or otherwise." However, a leading business organisation was in favour of introducing the new British legislation and stated: "Our members have experience of current difficulties that seem peculiar to Hong Kong when handling work for, for example, American companies. Their expectations regarding purchase by a company of its own shares is at variance with the present law. In general terms, the current prohibition seems to hinder rather than to assist economic development." Another thought that the power to allow companies to purchase their own shares would not be undesirable in principle provided that a number of basic requirements were followed including requirements that correct accounting entries and treatment of the transaction were properly prescribed and that any restrictions on the transaction would be subject to the proper supervision by the appropriate Government Departments.

1.14 After careful consideration of this controversial subject, we <u>recommend</u> with regard to the purchase by a company of its own shares -

(a) that <u>unlisted</u> companies only, be given power to purchase their own shares subject to the same conditions, and in accordance with the same procedures as apply in Britain, <u>mutatis mutandis</u>, but subject always to the prior or contemporaneous enactment of the Standing Committee's recommendations on distributable profits; and

(b) that the question of allowing listed companies to purchase their own shares be considered again after satisfactory legislation has been enacted dealing with -

(i) Disclosure of Beneficiary Ownership of Shareholdings

(ii) Insider Dealing

(iii) Distributable Profits

(iv) Fiduciary Duties of Directors.

1.15 <u>With regard to Section 48 of the Companies Ordinance</u>, the Standing Committee's Report for 1985 explained that this is based on a section in the British Companies Act of 1929 which had been replaced by an improved section in the Companies Act 1948, which in turn had been repealed and replaced by a completely new set of sections in the Companies Act 1981 (now Sections 151 - 158 of the Companies Act 1985). In short our section is very much out-of-date.

1.16 This state of affairs was recognised by the Companies Law Revision Committee who recommended extensive amendments to Section 48 in their Second Report (April 1973). These amendments were intended, basically, to bring our Section 48 into line with the then-current Section 54 of the Companies Act 1948 and, in addition, to implement a number of important amendments which the Jenkins Committee had recommended in respect of Section 54.

1.17 The Companies (Amendment) Bill which was published in 1980 as a White Paper contained a proposed new version of Section 48 of the Companies Ordinance which incorporated the recommendations made in the Second Report of the Companies Law Revision Committee. This proposed new version, however, attracted criticism from the Law Society of Hong Kong and the Hong Kong General Chamber of Commerce. The Law Society felt that the proposed new version gave rise to so many problems that the law should be left as it was, or a new Section 48 in the same terms as Section 54 of the Companies Act 1948 should be substituted. The General Chamber of Commerce also felt that Section 48 should be redrafted in the same form as Section 54 of the 1948 Act.

1.18 By the time an ad-hoc working group of UMELCO members came to consider the Law Society's and the General Chamber of Commerce's comments on the Bill in detail, new British legislation on the subject had arrived in the shape of Sections 42, 43 and 44 of the Companies Act 1981. However, this new legislation was not a straightforward implementation of the Jenkins Committee recommendations for amendments to Section 54 of the Companies Act 1948. Not only did it contain a complete prohibition, subject to certain technical exemptions, of provision of financial assistance by a public company, but the provisions allowing a private company to provide financial assistance were much more complicated and strict than those recommended by the Jenkins Committee. The prohibition of provision of financial assistance by a public company was necessitated by Article 23 of the Second EEC Directive on Company Law. The new legislation did, however, define what constituted provision of financial assistance more clearly and in a more realistic way.

1.19 The Standing Committee's views on the effect of, and special points about, the new provisions in the 1981 Act are set out in detail in paragraphs 2.10 and 2.11 of the Report for 1985, as follows:

"2.10 With regard to the new provisions in the 1981 Act, it seems to the Committee that, very briefly, their net effect is:

(1) they introduce clearer and more sensible criteria as to what constitutes the provision by a company of financial assistance for the purchase of its own shares;

(2) subject to certain exemptions of a technical nature, they prohibit a public company and its subsidiaries from giving anyone financial assistance, direct or indirect, for the purpose of acquiring shares in that company; but

(3) they do, however, allow a private company to give financial assistance for acquisition of shares in the company or its holding company (unless the holding company is itself a public company or there is an intermediary holding company which is a public company) provided:

(a) it has net assets which are not reduced by the giving of the assistance, or

(b) to the extent that those net assets are reduced, the financial assistance is given out of distributable profits;

(c) the giving of the financial assistance must be approved by a special resolution of the company in general meeting;

(d) where the financial assistance is for the acquisition of shares in the company's holding company, that holding company and any intermediary holding company must also give approval by special resolution in general meeting;

(e) before the general meeting to approve a special resolution for the giving of assistance, the directors of the company giving the financial assistance (and if the shares to be acquired are shares in the holding company, the directors of the holding company and of any intermediary holding company) must make a statutory declaration of solvency in respect of the company. The statutory declaration must have annexed to it a report by the auditors of the company that they have inquired into the state of affairs of the company and are not aware of anything to indicate that the opinions expressed by the directors in the statutory declaration are unreasonable.

2.11 We noted the following points about the new provisions:

(1) as already mentioned, the prohibition of a public company giving financial assistance goes against the recommendations of the Jenkins Committee;

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(2) the provisions allowing the provision of financial assistance by private companies are developments of those recommended by the Jenkins Committee with additions; the most important additions are those referred to in (3)(a) and (b) above;

(3) the detailed procedures for provision of financial assistance by a private company are so complicated and strict that it is unlikely that many private companies will in fact be able to use them in practice; and

(4) the concept of "distributable profits" forms a very important part of the provisions and there are detailed statutory provisions on what constitutes distributable profits in Part III of the Companies Act 1980, as amended (now Part VIII of the Companies Act 1985); however there are no provisions on the subject in the Companies Ordinance."

1.20 As mentioned previously, when consideration of the subject of purchase by a company of its own shares started in 1985, various professional and business organisations were consulted. They were also consulted regarding Section 48 at the same time. On this subject, only one of the professional organisations thought that no amendment was necessary. The other organisations thought that the section needed amendment but while the two business organisations had no specific objections to the new British legislation, the other professional organisation commented: "Simplicity is important and for this reason the provisions of Clause 24 of the draft Companies (Amendment) Bill 1980 (which contained the proposed new version of Section 48) are attractive and ought not to be disregarded. The

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provisions of Section 42 of the U.K. Companies Act 1981 are extremely complex and in some areas difficult to apply and for that reason there is much to be said for a more straightforward approach in Hong Kong."

1.21 The Members of the Standing Committee have no doubt that the existing Section 48 is seriously outdated and requires amendment. In particular we feel that the terms of the section may catch innocent transactions where the parties have no idea that they are commiting an offence. It is true that the fine for a breach of the section is a trivial $2000, but the civil consequences could be disastrous in some cases e.g. contracts could become unenforceable and the directors could be called upon to compensate the company.

1.22 However, the new British provisions do not seem to be entirely practical. No less an authority than Professor Pennington, the author of the standard text-book "Pennington's Company Law" has commented in an article in "The Company Lawyer":

"The conditions which a private company must fulfil in order to give financial assistance .... are likely to make it little used in practice". "The reluctance of auditors to give forecasts of the continuing solvency of companies in view of the recent sharpening of judicial views about their liability for negligence, makes it unlikely that even optimistic directors willing to face the prospect of prosecution if it turns out that their opinion about the company's solvency lacked a reasonable basis (s. 44(7)), will be able to make the necessary statutory declaration for the special exemption to apply. When the stringent timetable for the making of the declarations, the passing of the requisite special resolutions, and the giving of the financial assistance is also taken into account, together with the possibility that minority shareholders may apply to the court to prevent the financial assistance being given (ss. 43(9) and 44(1) - (5)), the special exemption for private companies is seen to provide a singularly unattractive route to follow."

1.23 In an effort to deal with the faults in Section 48 in a way which is less complicated than the new measures adopted in Britain and more suited to the practical needs of Hong Kong, we have instructed the Secretary:

(1) To draft proposals for new provisions which would allow unlisted companies only to provide financial assistance for the purchase of their own shares, based on the proposed new version of Section 48 which appeared in the Companies (Amendment) Bill which was published as a White Paper in 1980 but subject to -

(a) incorporating all the exemptions and clarifications in Section 42 of the Companies Act 1981,

(b) bringing the statutory declaration requirements into line with those in the 1981 Act,

(c) incorporating the net assets/distributable profits provisions in Section 43(2) of the 1981 Act, and

(d) imposing heavy monetary and custodial penalties for breach of the provisions.

However, the provisions in Section 43(8) of the 1981 Act regarding an auditor's report are not to be included;

(2) To send these proposals to the usual professional and business organisations for their views; and

(3) To inform the organisations at the same time that we will consider recommending that listed companies be allowed to provide financial assistance for the

purchase of their own shares in due course, after the four legislative safeguards referred to in paragraph above are in place.

1.24 We expect therefore to be able to put forward some substantive recommendations in the coming year or in our next report.

2. Section 79 of the Companies Ordinance (Payment of certain debts out of assets subject to floating charge in priority to claims under the charge) and Section 265 of the Companies Ordinance (Preferential payments)

2.1 The background to the problem which has arisen in connection with automatic crystallisation of a floating charge before the appointment of a receiver, was explained in the Standing Committee's Report for 1985, pages 11 - 13. The Report concluded by explaining that the Committee thought that it would be prudent to follow the Australian precedent and put the point beyond doubt by amending Section 79 of the Companies Ordinance in the same way as had been done in Australia, but that we would like to have the views of various professional and business organisations before reaching a final decision.

2.2 The views of these organisations were received early in 1986 and were, in principle, all in favour of amending Section 79 as proposed. The Standing Committee also noted that the section corresponding to our Section 79 in Britain, i.e. Section 196 of the Companies Act 1985, had, in the meantime, been amended by the Insolvency Act 1985 to deal with the problem. Although the wording adopted in Britain differed from that used in the Australian legislation,

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it was agreed that it would be preferable to follow the British precedent because Section 79 itself is based on the British precedent.

2.3 We therefore recommended that Section 79(1) of the Companies Ordinance be amended by inserting the words "a charge which, as created, was" after the words "secured by". Legislation along these lines has been introduced by the Companies (Amendment) Bill published on 12 December 1986.

3. Section 80(2)(c) & (e) of the Companies Ordinance (Registration of charges created by companies) Report of the Sub-Committee

3.1 Section 80 of the Companies Ordinance sets out a basic obligation to register certain types of charges created by companies and subsection (2) specifies the types of charges to which the obligation applies. Paragraphs (c) and (e) of subsection (2) apply to:

"(c) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale; and

(e) a charge on book debts of the company;"

3.2 The Report of the Standing Committee for 1984 mentioned, in paragraphs 1.26 and 1.27, that a number of professional organisations had asked Government to clarify the scope of paragraphs (c) & (e) of subsection 80(2) and that a Sub-Committee consisting of Mr. Wrangham as Chairman, Professor Willoughby, and two co-opted members, had been appointed to consider the subject.

3.3 The Sub-Committee has now submitted its Report to the Standing Committee and this has brought home to Members once again the complications which can be involved in what might at first sight appear to be relatively simple matters, such as paragraphs (c) and (e). Considerations of space prevent us from annexing a copy of the Sub-Committee's Report to this Report but anyone interested in its detailed discussions of the problems involved can obtain a copy of the Report from the Secretary to the Standing Committee.

3.4 Very briefly, the views and recommendations of the Sub-Committee can be summarised as follows:

(1) Paragraph (c) of subsection 80(2).

(i) To understand what class of charges is registrable under the existing provision, one has to go to the Bills of Sale Ordinance, Cap. 20, which itself is far from being a model of clarity as far as the ordinary businessman is concerned, and ascertain when an individual has to register a bill of sale.

(ii) The Sub-Committee have therefore recommended that the existing wording of the paragraph be deleted and the following substituted:

"(c) a charge on a personal chattel created or evidenced by an instrument".

A definition of 'personal chattel' is included in the recommendations.

(2) Paragraph (e) of subsection 80(2).

(i) The problem with this provision is that 'book debts' is a very vague term and there has been a good deal of case law on the subject, much of it

Victorian. The difficulties in interpreting the term are so great, and the exceptions from the term thrown up by the case law are so numerous that various legal authorities have recommended that this category of registrable charges be repealed.

(ii) At an early stage, the Sub-Committee thought that redrafting the paragraph along the lines of the corresponding Australian legislation would be helpful. Further consideration of this proposal, however, showed that because of certain differences in principle between the provisions on registration of charges in the Companies Ordinance and the Australian provisions, the Australian definition of book charges -

(a) would have to be extensively amended before it could start to be regarded as reasonably acceptable, and

(b) the amended version would be highly technical, complicated and, regrettably, as much subject to exceptions and as easily avoided by the sophisticated as the existing provisions.

(iii) The Sub-Committee have therefore recommended that paragraph (e) of subsection 80(2) be repealed.

(iv) However, if this recommendation for repeal is not acceptable to Government, the Sub-Committee have reached the conclusion that a considerable proportion of the problems which arise with paragraph (e) in practice could be dealt with by amending it to make it clear that it does not apply to charges on credit balances held by any person carrying on banking business or the business of taking deposits. A recommended form for such an amendment is included in the Report.

3.5 Having carefully considered the terms of the Sub-Committee Report, we recommend that amendment be made to Section 80(2)(c) & (e) of the Companies Ordinance in accordance with the recommendations in the Report.

3.6 The Sub-Committee also recommended that Section 80 be amended to make it apply to charges created by companies in favour of the Crown. We are still considering this recommendation.

4. Section 114C of the Companies Ordinance (Proxies) and Section 157A of the Companies Ordinance (Appointment of directors to be voted on individually)

4.1 Both of these sections were introduced by the Companies (Amendment) Ordinance 1984 and they provide an interesting illustration of how new legislation can sometimes produce unforeseen problems, no matter how much public consultation takes place before its introduction.

4.2 Both sections were introduced in implementation of recommendations in the Second Report of the Companies Law Revision Committee (April 1973).

4.3 Section 114C was in implementation of a recommendation in paragraph 5.39 of the Second Report. Prior to the enactment of Section 114C, there was no provision in the Companies Ordinance regarding proxies except

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for certain references to them in the model articles of association in Tables A and C in the First Schedule. The Second Report recommended that the then-existing provisions in Section 136 of the Companies Act 1948 in Britain be enacted here, subject to certain amendments which had been recommended by the Jenkins Committee but never actually implemented in Britain. One of these amendments was that the provisions of Section 136, which were expressly stated not to apply to companies not having a share capital, should be extended to such companies. Section 114C(1) therefore provides that any member of any company entitled to attend and vote at a meeting of a company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him, and a proxy so appointed shall also have the same right as the member to speak at the meeting.

4.4 Section 157A was in implementation of a recommendation in paragraph 7.18 of the Second Report. The Report noted the provisions of Section 183 of the Companies Act 1948 to the effect that, except in the case of a private company, a motion at a general meeting for the appointment of two or more persons as directors shall not be made by a single resolution, unless the meeting unanimously resolves that the motion be so made. The Report recommended that a similar section be included in the Companies Ordinance.

4.5 Both of the recommendations in the Second Report seemed to be uncontroversial and so it proved. Both sections, in their ultimately-enacted form, appeared in the White Paper of the Companies (Amendment) Bill which was published for public discussion in 1980 and again in the Companies (Amendment) Bill 1983. They attracted no adverse comment whatsoever and were duly enacted in 1984.

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4.6 In practice, however, it was soon discovered that the operation of the new sections in so far as they applied to companies limited by guarantee, was causing a good deal of concern. This unexpected problem arose from the fact that a great many, probably the majority, of private clubs in Hong Kong are companies limited by guarantee. Similarly, a number of professional and business organisations are also companies limited by guarantee.

4.7 In October 1985, a leading local solicitor wrote to the Standing Committee stating that a number of private clubs which were incorporated as companies limited by guarantee were finding it somewhat unpalatable to allow members to appoint non-members as proxies to attend, and to speak at, general meetings. Several members of the Committee were also aware from personal experience that the requirement for appointment of directors to be voted on individually was causing embarrassment for private clubs (A company limited by guarantee does <u>not</u> come within the definition of a 'private company' and Section 157A therefore does apply to such a company).

4.8 In November 1985, the Standing Committee wrote to a cross-section of fourteen of the better-known private clubs incorporated as companies limited by guarantee, asking whether they wished to comment on the operation of Sections 114C and 157A or of any other provision in the Companies Ordinance. The Committee also wrote in similar terms to three of the better-known professional and business organisations incorporated as companies limited by guarantee.

4.9 When the replies were received, members noted that, with one exception, all the organisations which had replied were strongly in favour of exempting clubs incorporated as companies limited by guarantee from the requirements of Section 114C, in the same way as they were exempted from Section 136 of the Companies Act 1948 (now Section 372 of the Companies Act 1985) in Britain or that, at least, the section should be amended to provide that only another member of the club could be appointed as a proxy. The almost universal reaction was that strangers should not be able to speak and vote at a general meeting of a private club.

4.10 The criticism of Section 157A was rather less strong and three of the organisations consulted felt that they could live with the section. However, most did feel that the section was an unnecessary complication which went against their existing rules and procedures and that there was no real justification for it.

4.11 With regard to Section 114C, Members recognised that the application of the section to all companies was in line with the recommendation of the Jenkins Committee. One Member, with considerable experience of these matters in Britain, thought that the situation there was very different as far as private clubs were concerned in that far fewer of them were incorporated as companies compared with Hong Kong where, for various reasons, a large number of clubs are incorporated as companies limited by guarantee. This meant that when the Jenkins Committee decided on their recommendations to extend Section 136 of the Companies Act 1948 to apply to all companies, they had not had to take into account the impact of such a change on a large number of clubs. Accordingly, even if the Jenkins Committee's recommendations had been implemented in Britain, this would not have meant that they would have constituted a good precedent for Hong Kong. It was also felt that when the Companies Law Revision Committee had agreed in

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1973 to adopt the Jenkins Committee's recommendation to include companies limited by guarantee within the scope of the proxies legislation, they had not foreseen the practical implications for clubs in Hong Kong. This was hardly surprising because the clubs themselves had overlooked the implications and had not raised the point at any time during the very lengthy period of public consultation over the two bills containing the proposed new Sections 114C and 157A.

4.12 Members considered whether there was any satisfactory method of distinguishing between companies limited by guarantee which were private clubs in the ordinarily-accepted sense of the term and those which were not and whether different provisions regarding proxies could be applied to each. It was suggested that one ground for distinguishing between them was that most established clubs had been granted certificates under Section 21 of the Companies Ordinance entitling them to dispense with the word "limited" in their names. It was pointed out, however, that before a company could get a licence under Section 21, it usually had to demonstrate, inter alia, an established history and financial stability. This meant that a number of new clubs which were perfectly bona fide, were not eligible for a Section 21 licence in their early years. In addition, many excellent clubs of long standing simply did not think it necessary to go to the considerable expense and administrative effort involved in getting a Section 21 licence. Members decided that, in the absence of a satisfactory method of categorising companies limited by guarantee, any amendment to Sections 114C and 157A should apply to all such companies.

4.13 After careful consideration, we reached the conclusion that, in the case of a company limited by guarantee, the basic principle should be that only members who are prepared to attend meetings should have a right to vote. We therefore recommend that section 114C be amended to bring into line with the corresponding Section 372 of the Companies Act 1985 in Britain i.e. by exempting all companies not having a share capital (which in practice covers all private clubs incorporated as companies limited by guarantee*). We would point out that, if this recommendation were implemented, the members of any particular company limited by guarantee who wished to have a right to appoint proxies would be able to do so by providing accordingly in their company's articles of association.

4.14 With regard to Section 157A, Members noted that the section already has its own "exemption" provision in subsection (1), which provides that a motion for the appointment of two or more directors by a single resolution cannot be made unless a resolution that it shall be so made has first been agreed to by the meeting without any vote being given against it. However, Members again thought that this provision was not appropriate for companies limited by guarantee. It was thought that the provision had been designed to prevent attempts to force through groups of directors of commercial companies and was an unnecessary complication in the running of companies limited by guarantee. We therefore recommend that Section 157A be amended by excluding companies not having a share capital from its provisions, in addition to the existing exclusion of private companies.

* The Companies Ordinance does contain provisions for the incorporation of companies limited by guarantee and having a share capital but these are extremely rare in practice; according to our researches, all the private clubs which have been incorporated under the Companies Ordinance have been incorporated as companies limited by guarantee and not having a share capital.

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5. Section 146 of the Companies Ordinance (Inspector's report) and Section 147 of the Companies Ordinance (Proceedings on inspector's report)

5.1 The Standing Committee's Report for 1985 contained recommendations for substantial amendments to Section 145 of the Companies Ordinance (Production of documents, and evidence, on investigation). Briefly, they recommended that the powers of an inspector appointed by the Financial Secretary to investigate the affairs of a company should be extended to allow him:

(i) to require anyone whom he considers is, or may be, in possession of any information concerning the company's affairs to produce any books or documents of the company in his possession;

(ii) to require directors (but not the banks concerned) to give information about certain bank accounts; and

(iii) to examine on oath anyone whom the inspector considers is, or may be, in possession of any information concerning the company's affairs.

5.2 In early 1986, the Standing Committee were again approached on a matter involving the inspection provisions in the Companies Ordinance.

5.3 Section 146(1) provides that an inspector may, and if so directed by the Financial Secretary, shall make interim reports to him and on the conclusion of the investigation shall make a final report to him. These reports must be written or printed, as the Financial Secretary directs. Under Section 146(3)(a)(i) the Financial Secretary must forward a copy of any report made by the inspector, to the company at its registered office. It is obvious that, if the inspector had evidence tending to show that an offence had been committed by the company or any of its officers, the submission of a formal written report to the Financial Secretary, which then had to be copied to the company, might seriously prejudice any subsequent action to be taken by the authorities. Accordingly, in implementation of a recommendation made by the Companies Law Revision Committee in its Second Report (April 1973) a new subsection 146(4) was introduced by the Companies (Amendment) Ordinance 1984 which provided that an inspector may at any time in the course of his investigation, without the necessity of making an interim report, inform the Financial Secretary of matters coming to his knowledge as a result of the investigation tending to show that an offence has been committed.

5.4 The new subsection (4) only dealt with the problem as far as criminal matters were concerned.

5.5 However, there are also provisions in the Companies Ordinance for civil proceedings to be taken as a result of an inspector's report. Section 147(2) provides that if it appears to the Financial Secretary from the report -

(a) that it is expedient in the public interest that the company should be wound up, he may present a petition for it to be wound up if the court thinks it just and equitable to do so, and

(b) that the business of the company is being conducted in a manner unfairly prejudicial to the interests of any part of its members, he may, in addition to or instead of, petitioning for winding up under (a),

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present a petition for an order under Section 168A (Alternative remedy to winding up in cases of unfair prejudice to the interests of minority shareholders).

In addition, under Section 147(3), if from any inspector's report it appears to the Financial Secretary that any civil proceedings ought in the public interest to be brought by any company, he may himself bring such proceedings in the name of and on behalf of the company. From the terms of Section 148(1)(b) it is clear that such proceedings include proceedings to recover property.

5.6 It was suggested to us by the Attorney General that the same argument which led to the introduction of subsection 146(4) in respect of criminal matters applied in respect of the civil matters covered by subsection 147(3) i.e. if an inspector learned in the course of his investigations, information which tended to show that civil proceedings ought to be commenced immediately by the Financial Secretary on behalf of the company against one or more of its officers for recovery of substantial sums of money, the chances of such proceedings ever being successful could be seriously prejudiced if the inspector had to set out the information in a formal written report to the Financial Secretary, which then had to be copied to the company. We accepted this argument, considering that it may be just as much in the public interest to facilitate the recovery of misappropriated property as it is to bring offenders to justice. We therefore suggested to the Attorney General:

(a) that Section 146(4) be amended by adding at the end after ".... offence had been committed":
"or that any civil proceedings ought in the public interest to be brought by any body corporate", and

(b) that Section 147(3) be amended by inserting after "If, from any report":

", or information supplied,"

Legislation along these lines has been introduced by the Companies (Amendment) Bill published on 12 December 1986.

6. (1) Section 157C of the Companies Ordinance (Minimum age limit for directors)

(2) Should there be a maximum age limit for directors?

6.1 Section 157C of the Companies Ordinance, which was introduced by the Companies (Amendment) Ordinance 1984, provides that no person shall be capable of being appointed a director of a company unless he has attained the age of 21 years.

6.2 The section was introduced in implementation of a recommendation in the Second Report (April 1973) of the Companies Law Revision Committee which read: "We think, however, that there should be a minimum age for appointment as director. The need for this is illustrated by a case in England which has been brought to our attention in which the three directors of a company were the wife and two sons, aged fourteen and seventeen, of an undischarged bankrupt. We therefore recommend that no person should be capable of being appointed a director of a company unless he has attained the age of twenty-one."

6.3 In June the Standing Committee were advised that the Law Reform Commission had recently issued a Report entitled "Young Persons - Effect of age in Civil Law" para. 16.9.1 of which read as follows:

"The age at which a person may become a director of a company should be lowered from 21 years to 18 years. The Companies Law Revision

Committee should be requested to reconsider generally the age restrictions on company directors as contained in section 157C of the Companies Ordinance (Cap. 32)."

6.4 Some Members of the Standing Committee questioned whether there was any need for a minimum age limit at all. They noted that there was none in the British Companies Legislation. The incident quoted in the Companies Law Revision Committee's Second Report had obviously not been thought serious enough by the British authorities to require legislation. These Members thought that there might be some argument for a minimum age limit for directors of public companies but could not see any at all for such a limit in respect of private family companies. Why shouldn't the owners of family companies be able to appoint their children as directors? This could be very useful in these days when the deaths of both husband and wife in a common accident are, unfortunately, not uncommon. In such circumstances, the surviving children who were directors could continue the management of the family company with a minimum of legal complications.

6.5 It was also pointed out that infant children can be members of a partnership. It was accepted, however, that this can, and does in practice, cause problems, resulting in a good deal of case law on the subject.

6.6 Members who supported the provisions of Section 157C thought that it was preferable that very young children could not be appointed as company directors. They considered that the need for continuity in the case of common accidents could be met efficiently by the appointment of corporate directors. They also pointed out that there had been no objections to the proposed Section 157C when it was included in the

Companies (Amendment) Bill which was published as a White Paper for discussion in 1980 and again in the Companies (Amendment) Bill 1983; nor was there any evidence of any objection by members of the public subsequent to the enactment of the section in 1984.

6.7 We agree that Section 157C should be retained but that it would be desirable to keep the minimum age limit for all purposes consistent, if possible, and accordingly we recommend that the age limit in Section 157C should be reduced to 18 years of age, provided Government accepts the other recommendations in the Law Reform Commission's Report.

6.8 Members also took the opportunity to consider the question of a maximum age limit for directors. The British legislation does contain such a limit, namely in Section 293 of the Companies Act 1985 (formerly Section 185 of the Companies Act 1948) which lays down a limit of 70 years of age. Perhaps it would be more accurate to say that it appears to lay down such a limit, because under one of the subsections a person of 70 years or over can still be appointed as a director by a general meeting of the shareholders of a company. When this subject was considered by the Companies Law Revision Committee in their Second Report, they said:

"Many public companies in Hong Kong are the creation of individuals or families, and generally speaking neither the directors nor the shareholders would wish that retirement should be forced upon any director who had founded or built up, or had for decades been associated with, the company. The same applies with even greater force to private companies .... Any company which wishes to do so is already free to set an age limit for its directors in its articles and we do not see that there is anything substantial to be gained by the adoption of the British sections ...."

We agree with these views and <u>do not recommend</u> the imposition of a maximum age limit for directors.

7. Section 157G of the Companies Ordinance (Prohibition of tax-free payments to directors)

7.1 Section 157G was introduced by the Companies (Amendment) Ordinance 1984 in implementation of a recommendation in the Second Report (April 1973) of the Companies Law Revision Committee, which read as follows:

"The Cohen Committee took the view that payment to directors of fees or salaries tax-free should be prohibited since this practice created a class of person who is immune from any increase in taxation. Giving effect to the Committee's recommendations, section 189 of the Companies Act, 1948, prohibits the payment of director's remuneration free of tax except under a contract in force on 18th July 1945 (which was the date of the publication of the Cohen Committee's Report). While there is perhaps no clamant need for such a section in Hong Kong as our tax laws stand at present, it seems to be sound in principle, and we recommend that a similar section should be included in our Ordinance."

7.2 One of our Members, Professor Willoughby, submitted to the Standing Committee that the Section should be repealed. Part of his argument was as follows:

"At first sight the section appears to be a sensible restriction on the remuneration of directors. On further reflection it is unnecessary, has nothing to do with tax avoidance and is at variance with the Inland Revenue Ordinance.

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The purpose of the section is apparently to prevent a director from gaining an advantage of Salaries Tax free remuneration. However, the section does not have this effect. If a company wishes a director to receive remuneration "tax free" this is only another way of saying that it wishes its director to receive a particular sum net after tax. There is nothing in any way improper in this. Indeed it is the normal practice with many United States and Japanese multinationals when sending staff to work abroad for overseas subsidiaries. If a director of a Hong Kong company is intended to receive a net salary after tax of, say, \$830,000 per annum the company, if properly advised, would agree to pay him \$1,000,000 gross. With tax at 17% he will have a net or "tax free" salary of \$830,000. If the shareholders think that this is excessive they can raise the matter at the appropriate AGM and refuse to pass the accounts. Section 157G is irrelevant and protects no-one.

Section 159G is not only unrealistic but at variance with the Inland Revenue Ordinance. This can be illustrated by two further examples. As the first example illustrates a "tax free" salary of \$830,000 can be achieved by paying the director \$1,000,000. If, however, the service contract provided that the company would pay the director \$1,000,000 free of tax section 157G(2) provides that this sum would have to be treated as a gross sum leading the director to pay \$170,000 in tax. If the company then paid the tax for the director, as often is the case, section 9(1) of the Inland Revenue Ordinance would apply and the director's income for Salaries Tax purposes would become \$1,170,000 and not \$1,000,000 with the result that the total tax payable would be increased to $198,900. This raises the question of whether section 157G is binding on the Commissioner of Inland Revenue. Plainly it is not: all the section does is to make unlawful for company law purposes a particular formula for calculating a director's remuneration.

One further example may be added to illustrate the confusion that can arise from section 157G. If a company agrees to pay a director $830,000 "free of tax", and to pay the tax thereon of $141,100, under the Inland Revenue Ordinance the director's income for Salaries Tax purposes would be $971,100 and not $830,000 as section 157G directs. The total tax payable under the Inland Revenue Ordinance would therefore be $165,087 and not $141,100. If the company paid the addition tax on tax further tax would be due and so it might go on ad infinitum. The problems are theoretically worse than this because the addition of tax on tax to income for Provisional Salaries Tax will compound the amount payable to refund tax year by year. Quite how section 157G(2) would operate in such circumstances is not clear.

In practice foreign multinationals with Hong Kong subsidiaries invariably ensure that their Hong Kong based directors are paid a tax inclusive gross salary that will yield the required "free of tax" remuneration and no problem occurs with the Inland Revenue Ordinance. However, my inquiries indicate that section 157G(2) is either ignored or misconstrued. The subsection is derived from section 189 of the Companies Act 1948 and correctly construed means that the "prohibited remuneration is to be construed as a provision for the payment of the stipulated sum to the director, leaving him to pay the ... tax in respect of it himself" (Pennington's Company Law 4th Edition at 517). It is apparent that the words "as a gross sum subject to tax" in section 157G(2) are in practice either ignored or construed to mean "as a grossed up sum subject to tax" ....

I have never seen a case argued for the need for the section or seen any statement of the "mischief" it seeks to prevent. In truth it is a misconceived provision, largely ignored in practice, avoided by the well advised, a confusing trap for the unsophisticated and of no interest to the Commission of Inland Revenue. I suggest it should be reconsidered and either amended to accord with the practice under the Inland Revenue Ordinance or repealed.

It may be added that section 157G only applies to directors and does not affect other employees whose Salaries Tax may be paid by the company and deducted for Profits Tax purposes as part of the total remuneration package (see IRO section 17(1)(g)). What is so special about directors in this regard?"

7.3 We ourselves can not see any basic flaw in Professor Willoughby's arguments and we therefore recommend that Section 157G be repealed.

8. Section 228A of the Companies Ordinance (Special procedure for voluntary winding up in case of inability to continue its business)

8.1 The Standing Committee's Report for 1985 mentioned briefly, in paragraph 10.1, that consideration was being given to amendments in respect of inter alia, the above section.

8.2 Section 228A was introduced by the Companies (Amendment) Ordinance 1984. It was in implementation of a recommendation in paragraph 8.22 of the Second Report of the Companies Law Revision Committee (April 1973) which read as follows:

"At paragraph 503 of their Report the Jenkins Committee recommended:-

"(r) in order to speed the appointment of a liquidator in case of emergency, the directors should have power to deliver to the Registrar of Companies a declaration that the company cannot by reason of its liabilities continue its business and that meetings of the company and of its creditors will be summoned for a date not more than twenty-eight days after the date of the declaration. After delivering such a declaration the directors should be required to appoint forthwith a provisional liquidator to remain in office for twenty-eight days or such extended period as the Board of Trade may allow, or until the earlier appointment of a liquidator. The declaration and notice of the appointment of the provisional liquidator should be required to be advertised, and such notice to be delivered to the Registrar for registration. The date of the delivery

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of the declaration should be treated as the commencement of the winding up. The provisional liquidator should be protected by statute in relation to all acts properly done by him and should be entitled, out of the company's funds, to adequate remuneration and to reimbursement of all expenses properly incurred;

(s) if the proposals outlined in (r) above are adopted, provision for voluntary winding up by extraordinary resolution (as opposed to special resolution) will, in our view, no longer be necessary as the power of providing immediate interim protection by the appointment of the provisional liquidator will more than offset any disadvantage there might otherwise be in the additional week's notice required for a special resolution. Accordingly no exception need be provided to our general recommendation, made elsewhere in this Report, that extraordinary resolutions should be abolished. However section 133(3) which, inter alia, permits a meeting to consider a special resolution to be called by shorter notice than twenty-one days should be amended to preclude, in any circumstances other than a members' voluntary winding up, the calling of a meeting to consider a special resolution pursuant to section 278(1)(b) by notice of less than seven days;".

We agree, and recommend accordingly."

8.3 The Jenkins Committee's recommendations have never been implemented in Britain and the procedure set out in Section 228A is therefore completely new.

8.4 The Standing Committee were approached in the first instance by the Registrar General in his capacity as Official Receiver, who suggested that experience with operation of the new procedure had shown that some amendments were necessary. The Committee then consulted the Law Society of Hong Kong and the Hong Kong Society of Accountants for their views and were also grateful for the views of a well-known firm of solicitors which were submitted for consideration.

8.5 As a result of these consultations we recommend the following amendments to Section 228A for the reasons stated:

(1) Subsection 228A(1)(b). Delete entirely and substitute:

"(b) the directors consider that it is necessary that the company be wound up and that there are good and sufficient reasons for such winding up to be commenced under this section; and"

Reason:

There are doubts in the professions as to the meaning of the existing provision which states that the directors must make a statutory declaration that, inter alia, "it is necessary that the company be wound up and that such winding up be commenced under this section". The question is, in what circumstances can it be said that it is "necessary" for the winding up to be commenced under Section 228A? It is understood that the professions generally are taking the view that this means that the circumstances are such that, if this step is not taken, there is a real prospect of the assets of the company being in jeopardy or some other threat of material prejudice to the company's creditors. In practice, the position is not always so clear-cut and while it may be possible to put forward good reasons for saying that winding up is highly desirable in a particular situation, it may be difficult to say that it is strictly "necessary". This is particularly so in a situation where the company concerned, perhaps a listed company, is wholly or partly a holding company, and it is of practical importance that someone takes control of the group without delay and yet there may be doubt as to whether the directors can be advised that it is "necessary" - an absolute test. The recommended wording of paragraph (b) makes the test more subjective and wider.

(2) <u>Subsection 228A(3)</u>. Delete entirely and substitute:

"(a) The directors, at the meeting where the statutory declaration is made under subsection (1), shall appoint as provisional liquidator a qualified person who has consented so to act, the appointment to be effective as at the commencement of the winding up;

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(b) For the purposes of (a), a qualified person is a person who is either -

(i) a solicitor qualified to act as such under the Legal Practitioners Ordinance or

(ii) a professional accountant who holds a practising certificate under the Professional Accountants Ordinance;

(c) The statutory declaration must be filed with the Registrar of Companies forthwith and, in any event, not later than 7 days after the day on which it is made, failing which it will cease to be capable of being used for the purposes of this section;

(d) The winding up of the company shall commence on the day of delivery of the statutory declaration to the Registrar of Companies;

(e) The directors shall cause a meeting of the company and of the creditors of the company to be summoned for a date not later than 28 days after the delivery of such declaration."

Reason:

It is thought that there are too many loopholes in the existing subsection (3). For example, under the existing provisions, the directors of a company could make the statutory declaration under subsection (1) and not take any action on it for an indefinite period, perhaps not delivering it to the Registrar for a year. The Section 228A procedure was meant for use in emergency situations and we think that the recommended amendments make this clearer. The recommendation in the paragraph (b), that a provisional liquidator must be qualified is thought to be necessary in order to prevent the appointment of "cowboy" liquidators by unscrupulous directors. There are, of course, no specific requirements for a liquidator appointed under the other winding up provisions in the Companies Ordinance to possess any qualifications. However, there are sufficient safeguards to prevent an obviously unsuitable person being appointed. For example, Section 193 of the Ordinance, which deals with the appointment of an 'ordinary' provisional liquidator (i.e. other than one appointed under Section 228A) provides that he shall be appointed by the court and that "either the Official Receiver or any other <u>fit person</u> may be appointed". (Our emphasis) There are no such safeguards in the existing provisions of Section 228A and we feel that, having regard to the circumstances in which the Section is likely to be used in practice, the recommended amendment is necessary. Some people feel that there should be a requirement for <u>all</u> liquidators to possess certain qualifications, as is now the case in, for example, Britain. This is something we intend to look at in due course but we feel that Section 228A should be amended as recommended as soon as possible, in the meantime. The recommendations in (d) and (e) repeat the provisions of the existing paragraphs (a) and (c).

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(3) Subsection 228A(4)

Add a new subsection (4A):

"(4A)(1) The provisional liquidator shall, within 14 days after his appointment, deliver to the Registrar for registration a notice of his appointment.

(2) If the provisional liquidator fails to comply with the requirement of this subsection he shall be liable to a fine of $200 for every day during which the default continues."

Reason:

Section 253 of the Companies Ordinance requires a liquidator in an "ordinary" voluntary winding up to register with the Registrar of Companies a notice of his appointment. It is considered that a similar requirement should be included in Section 228A for the benefit of any person making a search of the public file of the company in the Companies Registry.

(4) Subsection 228A(6)(a)

Amend by deleting "as the Official Receiver may allow" and substituting new provisions for the extension of time to be granted either by a meeting of the creditors summoned under the section or, failing this, by the court on application by the provisional liquidator. The subsection should also be amended to make it clear that more than one extension of the provisional liquidator's appointment can be granted by the creditors' meeting or the court, as appropriate.

Reason:

The existing subsection provides that a provisional liquidator appointed under Section 228A shall, unless a full liquidator is appointed under the ordinary provisions of the Ordinance, hold office for 28 days or such longer period as the Official Receiver may allow. In practice, however, the Official Receiver may have difficulties in knowing whether or not it would be reasonable, in all the circumstances of a case, to grant an extension of the appointment of the provisional liquidator. He simply may not have enough information available to allow him to reach a decision. It is considered that the grant of any extension would best be left to a meeting of creditors who will either grant the extension or appoint a liquidator. Failing a grant of an extension by a meeting of creditors, there should be a residual power for the court to grant the extension on an application being made by the provisional liquidator.

(5) Subsection 228A(6)(b)

Amend as follows:

(i) Insert immediately after "to be entitled" in subsection (6)(b):

"but without power of sale except of perishable property or as may be necessary in the ordinary course of carrying on business under subsection (5)(a);".

(ii) As a consequential amendment, insert in subsection (7), line 2, immediately after "appointment":

"and subject to subsection (6)(b)".

Reason

It is considered that the present powers of a provisional liquidator appointed under Section 228A, which are the same as those of a liquidator in a creditors' winding up, are too wide. It is thought that, to deal with the possibility of the provisional liquidator being to some extent subject to the influence of the directors who appointed him, he should not have power of sale except of perishable property or as may be necessary in the ordinary course of carrying on business. It is also thought that the restriction of the powers of sale as proposed would be a good discipline in moving the company along to a normal creditors' voluntary liquidation.

(6) Subsection 228A(6)(c)

Amend as follows:

(i) Delete "adequate remuneration and" in lines 1 and 2;

(ii) In line 3, immediately after "him" insert "and remuneration to be fixed in accordance with the provisions of Section 244(1) or by the court".

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Reason:

The meaning of "adequate remuneration" can be open to considerable debate. It is thought that the proposed amendment will bring more certainty. Section 244(1) provides that the remuneration of a liquidator shall be fixed by the committee of inspection, or if there is no such committee, by the creditors. In view of the unusual aspects of the Section 228A procedure, it is thought that there should be the alternative of applying to the court to fix the amount of the remuneration.

8.6 We would also mention that it was put to us during our consultations that it is not clear whether the procedure under Section 228A is a voluntary winding up or a special type of winding up. We accepted the Registrar General's view that the procedure was intended to be grafted onto the provisions of the Companies Ordinance relating to a creditors' winding up. We are not clear, however, as to whether the terms of Section 230, which provides that a voluntary winding up shall be deemed to commence at the time of the passing of the resolution for voluntary winding up, shall be amended to take account of the provision in Section 228A that it commences on the date of delivery of the statutory declaration to the Registrar of Companies. We feel that this is a technical drafting point which we should leave to the Law Draftsman to decide.

9. Directors' duty regarding information to shareholders

9.1 The Standing Committee's Report for 1985 mentioned briefly, in paragraph 10.1, that the subject of the directors' duty regarding information to shareholders was being considered.

9.2 The history of this matter is that it was considered at some length in the Second Report (April 1973) of the Companies Law Revision Committee. Paragraph 7.16 of the Second Report reads as follows:

"Although there have as far as we know been no such cases in Hong Kong, there have been cases in Britain in which companies which have been disturbed over the stock market rating of the company's shares have held private meetings with representatives of institutional shareholders at which information about the progress, plans and prospects of the company has apparently been given. Although no doubt the object of these meetings has been to show the merits of the company and so enhance the share price for the benefit of the general body of shareholders, we think that it is wrong that a company should give to selected shareholders, in their capacity as such, information which it does not simultaneously give to the remaining shareholders either by circular or public announcement through the press. We accordingly recommend that it should be made an offence to do so."

9.3 The Companies (Amendment) Bill which appeared as a White Paper in 1980 contained a proposed new Section 155D(2) which attempted to implement the recommendations in paragraph 7.16, in the following terms:

"No company shall make available or disclose to any part of the members of the company at any time any information relating to the affairs, plans or prospects of the company unless that information

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is made available or disclosed, whether by circular or public announcement, to the other members at the same time; and if any company makes default in complying with this subsection, the company and every officer of the company who is in default shall be liable to a default fine of $500."

9.4 There were many criticisms of the draft clause, particularly as to the wide scope of the information covered and as to the lack of exemptions in respect of information supplied to such persons as auditors.

9.5 A revised version of the proposed Section 155D appeared in the Companies (Amendment) Bill 1983 but, again, there was criticism and Government decided that the clause should be deleted and the matter referred to the Standing Committee for consideration. The revised form of the proposed Section 155D in the 1983 Bill was as follows:

> "(1) Subject to subsection (3), no company shall make available or disclose to any person at any time any information to which this section applies unless that information is made available or disclosed at the same time, whether by circular or public announcement, to all the members of the company; and if any company makes default in complying with this subsection, the company and every officer of the company who is in default shall be liable to a default fine of $500.
>
> (2) This section applies to information which, as respects a company -
>
> (a) relates to specific matters relating or of concern (directly or indirectly) to that

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company, that is to say, is not of a general nature relating or of concern to that company; and

(b) is not generally known to those persons who are accustomed or would be likely to deal in any securities of the company but which would, if it were generally known to them, be likely materially to affect the price of those securities.

(3) Nothing in this section shall require a company to make available or disclose any information to the members of the company where that information is made available or disclosed by the company to any of the following -

(a) a director or other officer of the company, whether or not such director or other officer is also a member;

(b) an employee of the company;

(c) a person acting as auditor of the company;

(d) the company's bankers;

(e) a person acting in a professional capacity as adviser to the company;

(f) a person participating with the company in a business venture;

(g) a person requiring such information in connextion with negotiations between him and the company for the purchase of the whole or any part of the undertaking or property of the company."

9.6 When the Standing Committee considered this proposed section in late 1985, two of the ex-officio Members commented on it. Mr. Gleeson, Registrar General, in his capacity as Registrar of Companies, thought that if legislation along the lines of the proposed section, and incorporating all the amendments recommended by members of the public who had commented on it, was enacted, there would be no practical way for him to enforce it strictly. For example, he would have great difficulty in deciding what information was price-sensitive in particular circumstances.

9.7 Mr. Astin, Commissioner for Securities, supported the principle behind the proposed Section 155D but thought that the clause itself had been too restrictive. He thought that the Securities Commission's then-draft Stock Exchange Listing Rules, which were scheduled to go into operation in early 1986, would go a long way towards meeting the need for prompt disclosures of price-sensitive information.

9.8 It was agreed that Members should at least have an opportunity to see the finalised form of the Securities Commission's Stock Exchange Listing Rules before reaching any decision on this matter.

9.9 Consideration was therefore resumed in early 1986 after the Securities (Stock Exchange Listing) Rules 1986 came into operation on 1st February 1986.

9.10 The Standing Committee noted that, in the context of information to shareholders, the important part of the Rules is the Undertaking in the Schedule which sets out the information which listed companies are required to supply to, <u>inter alios</u>, their shareholders. Paragraph 2 of the Undertaking contains a general obligation to supply information. It appeared to Members that, in comparing this with the requirements of the proposed Section 155D in the 1983 Bill, the main differences were:

(a) the time limits; under the proposed Section 155D, a company would have to supply the information to shareholders at the same time as it gave it to third parties, whereas under the Rules it has to supply it "as soon as reasonably practicable"; and

(b) the penalties; under the proposed Section 155D, there would be a default fine on the company and every officer of the company in default, of $500 per day, whereas under the Rules the penalty is suspension/cancellation of an offending company's listing.

9.11 The Standing Committee also noted that, for most practical purposes, the notifiable transactions set out in paragraphs 6 - 9 of the Undertaking in the Rules are the equivalent of the concept of price-sensitive information contained in the proposed Section 155D. Paragraph 6 of the Rules requires disclosure of notifiable transactions to the whole world, not just shareholders, "as soon as reasonably practicable" after agreement in principle has been reached for a notifiable transaction.

9.12 Having regard to the widespread opposition to the proposed Section 155D in both 1980 and 1983 and to the reservations which some Members of the Standing Committee had regarding the practical problems involved in implementation of such a provision, it appeared to the Standing Committee that the question which Members had to ask themselves was: Were they satisfied that the requirements in the new Rules were good enough or did they think that something stronger was required?

9.13 It was generally agreed that the Undertaking required by the Listing Rules was a long step, albeit in the right direction, and that it would be sensible to make sure that it had been firmly taken before considering whether to go further. The Committee decided to resume consideration of this question in due course.

10. Insider Dealing

10.1 The Standing Committee's Report for 1984 dealt with a recommendation to extend the provisions of Section 157E of the Companies Ordinance (Power to restrain fraudulent persons from managing companies) to cover a person named as a culpable insider dealer by an Insider Dealer Tribunal. The Report stated that: "It was thought also that the whole subject of insider dealing might usefully be reconsidered after the Inspector's reports on the investigations into the Carrian Group and the Eda Group and the Tribunal's report on the trading in International City Holdings Ltd shares have been made available."

10.2 The Report of the Tribunal on trading in International City Holdings Ltd's shares (The Clough Tribunal Report) was issued on 27th March 1986. It named a number of very well-known Hong Kong businessmen as culpable insider dealers who applied for a judicial review of the Tribunal's findings. In a judgement dated 20th October 1986, The Honourable Mr. Justice Kempster upheld all of those findings.

10.3 The Clough Tribunal Report contained a number of suggestions for amendments to the legislation dealing with insider dealing.

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10.4 In July, the Financial Secretary asked the Standing Committee for our views on certain aspects of the existing legislation and we decided that it would be appropriate to start our review of the whole subject of insider dealing mentioned in our Report for 1984. The Inspectors' reports on the investigations into the Carrian Group and the Eda Group were still not available to us but we decided that, as there was no reliable estimate as to when they would become available and as the subject of insider dealing had been attracting increasing attention, we should start our consideration of the subject without the benefit of the reports.

10.5 We have considered voluminous material on insider dealing at our subsequent meetings during 1986, except at our November meeting when we considered and approved the draft Bill implementing our recommendations made at the end of December 1985 regarding disclosure of beneficial ownership of shareholdings in listed companies - a subject which is closely related to insider dealing. We have not yet reached a decision on what recommendations we should make but hope to do so early in 1987.

11. Insolvency Law and Practice

The Insolvency Acts 1985 & 86

11.1 The Standing Committee's Report for 1984 mentioned at paragraph 5.1 that the Committee had considered two aspects of The Cork Report on Insolvency Law & Practice, namely, Wrongful Trading and The Ten Per Cent Fund. It was also noted that the Registrar General in his capacity as Official Receiver was considering the proposals in the Report regarding Administration Orders. It was stated that further

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discussion was being deferred pending expected legislation in the near future in Britain.

11.2 Since then there have been enacted in Britain the Insolvency Act 1985 and the Insolvency Act 1986. The latter has consolidated the law on the subject but has not repealed all of the 1985 Act.

11.3 The Standing Committee has considered the new legislation on Wrongful Trading and Administration Orders on a number of occasions (The proposals for a Ten Per Cent Fund in The Cork Report have not been implemented and since, as was indicated in the Standing Committee's Report for 1984, the Committee's initial reaction to the proposals was also unfavourable, the subject has not been pursued further).

11.4 With regard to Wrongful Trading, the Standing Committee were concerned to note that the relevent new provisions in Section 15 of the 1985 Act (new Section 214 of the 1986 Act) were regarded with considerable caution, not to say scepticism, by some experts in Britain. For example, in an article in the November/December 1985 issue of "Insolvency Law & Practice", Mr. Peter Farmery, Head of Company Law, Company and Environmental Affair at the Confederation of British Industry said:

> "The criminal offence of fraudulent trading will no doubt be familiar to you; wrongful trading is based on similar principles but by virtue of being a civil offence will require a less onerous burden of proof, ergo it is hoped that more culprits will be caught by its provisions. Wrongful trading has been described variously as being too indiscriminate, not tough enough, confusing and unworkable. Each of these comments is true. The idea of introducing such a penalty evolved

out of the Cork Committee's deliberations and it is true to say without risk of contradiction, that none of those taking a close interest in the Act opposed the general principles underlying such an offence. Where, however, Government and others came adrift was on questions of definition and wording. The general but considered view of the business community was and is that the provision is too vaguely cast. It is not abundantly clear on the face of the Section when, in practical terms, the proposal would begin to bite. This is worrying, as the Act will be used for guidance by non-lawyers whose decisions will affect the livelihoods of many."

11.5 Members noted that the Cork Committee in its Report laid out the principles by which wrongful trading could be identified and went so far as to propose a draft clause for this purpose. This draft, however, was not followed in Section 15 of the 1985 Act. The Cork Committee proposed that a company would be trading wrongfully if, being insolvent or unable to pay its debts as they fall due, it incurs liabilities to other persons without a reasonable prospect of meeting them in full; and that a person who was party to the carrying on of the company's trading may be made personally liable if he knew or, as an officer, ought to have known that the trading was wrongful. Attractive though this definition is in the context of Hong Kong, where directors often permit their companies to continue trading long after they have, and are known to have, gone beyond the point of no return, Members felt that this concept of wrongful trading and the liability therefore still suffers from an undesirable degree of uncertainty. For instance: when is a company unable to pay its debts as they fall due? It may have the asset value but not the cash. It may be able to pay all its debts tomorrow but not to-day. When is there no reasonable prospect of the company meeting its liabilities? When ought an officer of the company to have known that the trading was wrongful?

11.6 Members felt that the draft clause suggested by the Cork Committee was very complicated, suffered from a degree of uncertainty and, at sub-clause (6), would involve the court in taking decisions regarding the day-to-day operations of companies which, by definition, were already in serious financial difficulties. Of course, the Cork Committee stressed that their clause was not intended to be definitive but even if it were reduced into proper legislation form, Members were worried that it would not be any better than Section 15 of the Insolvency Act 1985.

11.7 Having regard to the obvious problems in defining Wrongful Trading and to the forebodings of experts about the practicability of the provisions which have been enacted in Britain we have decided that the sensible approach is to defer a decision on the matter until there has been a reasonable opportunity to see how the British provisions work out in practice.

11.8 During the discussions on Wrongful Trading, the question was raised of whether non-executive directors should be subject to the same liabilities as their executive colleagues. This is a point with implications for many other sectors of company law and we have therefore

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dealt with it in its own section of this Report.

11.9 With regard to Administration Orders, Members were again concerned to note that, as with the provisions a Wrongful Trading, the provisions on this subject in Sections 27 - 44 of the Insolvency Act 1985 (now Sections 8 - 27 of the 1986 Act) were regarded with scepticism by the experts. For example, Mr. Farmery in the article already quoted, said with regard to the provisions on Administration Orders:

"In principle, the introduction of such a concept is to be welcomed, although there are very real worries as to whether these provisions will work. A number of general and technical objections have been raised in this respect. Suffice it to mention a few of these ...."

11.10 We agreed that before proceeding further with consideration of this subject it would be desirable to have the views of the various professional and business organisations whom we normally consult. The Secretary duly wrote to these organisations and we shall resume our deliberations when we have received the replies. It is to be hoped that, by then, there will also be some information available as to how the British provisions have operated in practice.

11.11 We also agreed that, in the meantime, we should learn more about the Chapter 11 procedure in the United States which some professionals have seen as a preferable alternative to Administration Orders.

11.12 It was therefore arranged for a representative of one of the leading firms of Wall Street attorneys which has an office in Hong Kong, to attend one of our meetings. He gave us a very informative address, was good enough to answer all questions and left us with a very useful written memorandum on the American provisions.

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11.13 It would not be appropriate to try to give a summary of the Chapter 11 proceedings, or to compare them with the Administration Order provisions, in this Report at this stage. Suffice it to say that the Standing Committee can see why a number of local practitioners find the American system attractive. It is designed to provide a company in serious financial trouble with a last alternative to liquidation. If the company files under Chapter 11 and can get the majority in number and value of its creditors to agree to its plans for dealing with its difficulties, no creditor can take any action against the company to enforce his rights. It is not, as some laymen think, an "easy option" because the stigma attached to the Chapter 11 proceedings will affect the company's future credit-worthiness and the valuation of its shares. There is no guarantee that the creditors will accept the company's proposals and they may insist on getting rid of the incumbent management as the price for acceptance.

11.14 For some practitioners, the greatest merit of the Chapter 11 procedure is that it stops a single small or minor creditor who refuses to agree to the plans of the majority creditors for rescuing a company in trouble, from going ahead and putting the company into liquidation. Apparently such a creditor is popularly known as a "rogue creditor".

11.15 The obvious weakness in the protection afforded to a company by the Chapter 11 procedure, and indeed any other similar procedure, is where the company has assets situated in other jurisdictions, the most obvious examples being a shipping company and an airline company. No matter what American law may do to restrict the rights of creditors in America, there is nothing to prevent, say, a Spanish creditor enforcing his rights against a ship or aircraft which docks or lands in Spain (although we noticed in recent newspaper reports of the Chapter 11 proceedings involving United States Lines, the shipping company, a statement that any action against the company's ships in a foreign port by a foreign company with a subsidiary operating in the United States, would constitute contempt of court by that subsidiary). So many Hong Kong companies have important assets abroad that this weakness might assume much greater importance than it has in the United States. However, the same weakness also exists in the British system of Administration Orders, so it is certainly not a reason for preferring the British system.

11.16 As already indicated, the Standing Committee would prefer to wait and see how the new Insolvency legislation works in practice in Britain before deciding on what amendments, if any, are required to the existing law in Hong Kong. There are obvious practical reasons for preferring to adopt British legislation on technical subjects such as this. The Companies Ordinance is based almost entirely on British legislation and it would be difficult to graft onto it a very substantial piece of technical legislation from another jurisdiction. Nevertheless it may utlimately prove the more suitable for this jurisdiction.

12. Non-executive directors

12.1 When the Standing Committee was considering the subject of the provisions on Wrongful Trading in the Insolvency Acts 1985 & 86, the question was raised of whether it was reasonable that the non-executive directors of a company should be subject to the same penalties for breach of this and other provisions in the companies legislation as their executive colleagues. It was pointed out that the provisions of Section 15 of the 1985 Act (now Section 214 of the 1986 Act) were very vague; in particular, the provision in Section 15(2)(a) that the wrongful trading provisions apply to a director who knew "or ought to have concluded" that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The consequences of being found responsible for wrongful trading were very serious indeed and this section could be applied even to non-executive directors who took no part in the day-to-day management of a company.

12.2 It was suggested that the legislative approach to directors in Britain and Hong Kong was wrong. The legislation was directed towards imposing ever-stricter obligations on directors and imposing severe penalties for default in compliance with them. This approach failed to recognise the need for distinguishing between executive and non-executive directors. It had been shown in Europe in particular, where non-executive directors are very common, that they perform an important function. However few people would be willing to act as non-executive directors if they knew that by so doing they might, for example, make themselves liable for a company's ordinary trading losses. The correct approach would be to provide for the two classes of directors, executive and non-executive, in companies legislation generally and then confer appropriate powers and impose appropriate duties, with appropriate penalties for failing to fulfil these duties.

12.3 The opposing view was that the introduction of a sort of "director (2nd class)" with different powers, responsibilities and obligations from "directors (1st class)" would tend to devalue or debase the status and credibility of directors generally. The majority of directors are directors in the real sense, i.e. they direct the affairs of the company, and it would be wrong to downgrade, blur or cause confusion in the role they play on the boards of their companies. If it is felt that a person can give some specialist advice to a company but he does not wish to assume the responsibilities of a director, then he can easily act as a consultant or adviser without taking a seat on the board. Indeed there is a case for saying that professional advice in particular should come, as it normally does, from a source independent of the board and the company.

12.4 The Committee would not like to encourage the practice, which is sometimes thought to occur, of inviting persons of distinction to joint the board of a company solely with a view to enhancing the status of that company in the eyes of the general public. It is thought equally undesirable that any person should join the board of a company intending to take no active part in its affairs but only in the hope of advancing his own personal reputation. Nevertheless it was felt that conscientious non-executive directors, particularly those with professional qualifications, can perform a useful function in the system and that there is a real danger that harsh penalties imposed upon all directors for failure to comply with statutory requirements, such as the filing of annual returns, in which a non-executive director cannot reasonably be exepcted to take an interest, might well discourage capable persons from accepting proper invitations. It is accepted that the nature of a particular director's position is something that a court would necessarily take into consideration when assessing the individual penalty. But even so it is thought that there may be a care for exempting non-executive directors for initial liability in some instances. The Committee will return to this question when it resumes discussion on the general and fiduciary duties of directors.

13. "One Man Private Companies"

13.1 In March a well-known solicitor wrote to the Standing Committee stating that he had been informed that Canadian company law had been amended to provide for the incorporation of a one man private company with both a sole director and a sole shareholder. Hong Kong's Companies Ordinance, on the other hand, requires at least two directors (Section 153(1)) and two shareholders (Section 4(1)). The solicitor submitted that the Hong Kong requirement merely causes unnecessary expense and administrative problems both for what are, in effect if not in legal terms, one man companies and wholly-owned subsidiaries and that they should be changed in the same way as the Canadian law had been.

13.2 We have written to the usual professional and business organisations whom we usually consult, asking for their views on this proposal and, when there have all been received,will resume consideration of it.

14. Ultra Vires

14.1 In the section of this Report dealing with "One man private companies" it was mentioned that the subject had been raised by a well-known solicitor. The same solicitor, at the same time, asked that the subject of ultra vires be considered by the Standing Committee.

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14.2 The subject was considered at some length in the Second Report (April 1973) of the Companies Law Revision Committee, as follows:

"2.4 The doctrine of ultra vires, which has been the subject of much criticism and on which a great deal of evidence was submitted to the Jenkins Committee, was thus described in paragraph 11 of the Cohen Committee's Report:-

> "The memorandum of a company defines its objects and a company's objects are limited to those expressly mentioned and such as are ancillary to the expressed objects. A contract made by the directors upon a matter not within the ambit of the company's objects is ultra vires the company, and, therefore, beyond the powers of the directors. This principle is intended to protect both those who deal with the company, and its shareholders.".

2.5 On this, the Cohen Committee proceeded in their paragraph 12 to comment as follows:-

> "Had memoranda of association of closely followed the forms in the First Schedule to the Act, this protection might have been real, but, partly with a view to obviating the necessity of applying to the Court for confirmation of an alteration of objects, a practice has grown up of drafting memoranda of association very widely and at great length so as to enable the company to engage in any form of activity in which it might conceivably at some later date wish to engage and so as to confer on it all ancillary powers which it might conceivably require in connection with such activities. In

consequence the doctrine of ultra vires is an illusory protection for the shareholders and yet may be a pitfall for third parties dealing with the company. For example, if a company which has not taken powers to carry on a taxi-cab service, nevertheless does so, third persons who have sold the tax-cabs to the company or who have been employed to drive them, may have no legal right to recover payment from the company. We consider that, as now applied to companies, the ultra vires doctrine serves no positive purpose but is, on the other hand, a cause of unnecessary prolixity and vexation. We think that every company, whether incorporated before or after the passing of a new Companies Act, should, notwithstanding anything omitted from its memorandum of association, have as regards third parties the same powers as an individual. Existing provisions in memoranda as regards the powers of companies and any like provisions introduced into memoranda in future should operate solely as a contract between a company and its shareholders as to the powers exercisable by the directors. In our view it would then be a sufficient safeguard if such provisions were alterable by special resolution without the necessity of obtaining the sanction of the Court, subject in cases where debentures have been issued before the coming into force of a new Act, to the consent of the debenture-holders by extraordinary resolution passed at a meeting held under the provisions contained in the trust deed or (in the absence of such provisions) convened by the Court.".

They accordingly recommended that section 5 of the Companies Act, 1929, (which provided that, subject to confirmation by the Court, a company might, by special resolution, alter the provisions of its memorandum with respect to its objects) should be repealed, and a new section inserted giving effect to their said views.

2.6 Although in section 5 of the Companies Act, 1948, (as to which see paragraph 2.11 below) effect was given in a modified form to the Cohen Committee's recommendation that objects should be alterable by special resolution without the sanction of the Court, the Act did not, because of serious difficulties foreseen by the Board of Trade, implement the Committee's recommendation that the ultra vires doctrine be abolished. The problems involved were restated by the Jenkins Committee in paragraph 39 of their Report as follows:-

"(i) Those who favour the abolition of the ultra vires principle seek to achieve their object by legislation to the effect that notwithstanding anything contained in or omitted from its memorandum of association every company is to have as regards third parties all the powers of a natural person.

(ii) But a company not being in fact a natural person can only act through directors or other agents exercising powers delegated to them by the company.

(iii) What, then, is the extent of the delegation to be? The company could (apart from legislation to the contrary) presumably adhere to the plan now usual of making by its articles an "omnibus" delegation of its powers to its directors.

(iv) The position then would be that the company would have all the powers of a natural person, and that these powers (with the usual statutory exceptions, which are not material for the present purpose) would be exercisable in their entirety by the directors.

(v) Would not this state of affairs place too much power in the hands of the directors? Present complaints regarding the state of company law are often to the effect that shareholders should be given greater and more effective control over the activities of directors. From this point of view the omnibus delegation to the directors of all the powers of a natural person conferred on the company by the proposed legislation would seem to us a retrograde step.

(vi) Moreover, would not investors and creditors and the public at large justifiably wish to know what activities the company was pursuing or presently intending to pursue within the ambit of its all-embracing powers of a natural person, and to have some particulars as to existing or proposed activities in some public document available for inspection?

(vii) Once it is accepted that some limit is to be set upon the extent of the powers delegated to the directors, how is it to be done? The Cohen

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Committee's plan was in effect to make the objects clause operate only as between the shareholders and the company, by way of definition of, or limitation upon, the powers of the company exercisable by the directors. If this were done, would not the third party be fixed with notice of the objects in their new guise, and of the limitations which they imposed, in accordance with the general rule that anyone dealing with a company is deemed to have notice of its public documents? Would not ultra vires third party be concerned to see that the directors on their part be concerned to see that the objects clause stated the scope of their delegated powers with the greatest possible width and particularity (incidentally leaving objects clauses as prolix as they are today)?

(viii) Thus the third party if fixed with constructive notice of the extent of the director's delegated powers would be little better off under the new law than he was under the old. If on the other hand the new law absolved him from notice, would the objects clause in its new guise afford any protection to the shareholders? We doubt if it would.

(ix) To give complete protection to the third party it would be necssary to absolve him not only from constructive, but also from express, notice of any limitation upon the directors' delegated powers. In other words he would have to be deemed not to know things which he actually did know - a legislative expedient which seems to us highly undesirable.".

2.7 In view of these difficulties the Jenkins Committee saw no sufficiently cogent reason for adopting the proposed attribution to companies of all the powers of a natural person. Instead, in paragraph 42 of their Report, they recommended that:-

"(a) a contract entered into between a company and another party (including a shareholder contracting otherwise than in his capacity as a shareholder) contracting with the company in good faith should not be held invalid as against the other party on the ground that it was beyond the powers of the company: he should not, however, be allowed to enforce the contract without submitting to perform his part of it so far as it is unperformed;

(b) in entering into any such contract the other party should be entitled to assume without investigation that the company is in fact possessed of the necessary power; and should not by reason of his omission so to investigate be deemed not to have acted in good faith, or be deprived of his right to enforce the contract on the ground that at the time of entering into it he had constructive notice of any limitations on the powers of the company, or on the powers of any director or other person to act on the company's behalf, imposed by its memorandum or articles of association;

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(c) the other party should not be deprived of his right to enforce the contract on the ground that he had actual knowledge of the contents of the memorandum and articles at the time of entering into the contract if he honestly and reasonably failed to appreciate that they had the effect of precluding the company (or any director or other person on its behalf) from entering into the contract in question;

(d) there should be no change in the position of a company in relation to ultra vires contracts entered into by it.".

2.8 No action was taken on this recommendation in the Companies Act 1967, but section 9(1) of the European Communities Act 1972 has since been enacted providing:-

> "In favour of a person dealing with a company in good faith, any transaction decided on by the directors shall be deemed to be one which it is within the capacity of the company to enter into, and the power of the directors to bind the company shall be deemed to be free of any limitation under the memorandum or articles of association; and a party to a transaction so decided on shall not be bound to enquire as to the capacity of the company to enter into it or as to any such limitation on the powers of the directors, and shall be presumed to have acted in good faith unless the contrary is proved.".

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2.9 We agree with the Jenkins Committee that there should be no general repeal of the ultra vires doctrine, and recommend that changes in the existing law of ultra vires in relation to companies should be limited to the enactment of a section similar to section 9(1) of the European Communities Act 1972."

14.3 When the Companies (Amendment) Bill was published as a White Paper in 1980 it contained a proposed new Section 6A implementing the Companies Law Revision Committee's recommendation, but in a considerably revised form, as follows:

"6A. (1) The validity of a transaction entered into by a company after the commencement of the Companies (Amendment) Ordinance 1980 shall not be impugned by the company by reason of the fact -

(a) that the transaction was not within the capacity of the company; or

(b) that the directors of the company have exceeded their powers under the memorandum or articles,

unless the other party to the transaction had actual notice of the existence of that fact.

(2) Where a party to such a transaction has actual notice of provisions of the company's memorandum or articles which give rise to any such fact as is mentioned in subsection (1) he shall nevertheless be treated for the purposes of that subsection as not having actual notice of the existence of that fact if he shows that he did not understand those

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provisions to give rise to that fact and that his failure to do so was in all the circumstances reasonable.

(3) The foregoing provisions of this section do not affect any liability to a company incurred by its directors by reason of their having caused the company to enter into a transaction which was not within its capacity or by reason of their having otherwise exceeded their powers.

(4) References in this section to a company's memorandum or articles include references to any document to which section 117 applies.

(5) The court may, on the application of any member or holder of debentures of a company, restrain such company from doing any act or thing which the company has no power to do.".

14.4 This proposed new section was criticised in principle and in detail by a number of professional and business organisations. For example, the Law Society of Hong Kong said <u>inter alia</u>:

".... we consider that the Bill should be amended to provide for a company to have all the powers of a natural person, for all of such powers to be exercisable by the Board (except for those specifically provided by statute to be exercisable only in some other way) and for the company's articles to be able to contain specific restrictions or limitations on the directors' powers (in addition to those imposed by statute) but for the breach of any such non-statutory restrictions or limitations only to give rise to a claim against the directors in question rather than invalidating the relevant dealing by the company.

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Such a statutory claim against the directors would, of course, be without prejudice to any other claim for breach of fiduciary duty or misfeasance. In certain cases some shareholders may also have a remedy under S. 168A."

14.5 In view of the widespread criticism of the proposal, Government withdrew the clause; it did not appear in the subsequent Companies (Amendment) Bill 1983 which was a revised version of the 1980 White Paper.

14.6 We decided that before reaching any conclusions on this subject we would like the up-to-date views of the professional and business organisations usually consulted on these matters. The Secretary of the Standing Committee wrote to them accordingly and when all the replies have been received we will consider them carefully.

14.7 We have also noted that, in Britain, the Report of Dr. Dan Prentice of Oxford University who was appointed in December 1985 "to conduct a study into the legal and commercial implication of the proposed abolition of the ultra vires rule as it applies to registered companies" has been published. We are sure that Dr. Prentice's proposals will also be of the greatest interest and help when me take up the subject again.

Appendix 1

Terms of Reference of
the Standing Committee
on Company Law Reform

(1) To advise the Financial Secretary on amendments to the Companies Ordinance as and when experience shows them to be necessary.

(2) To report annually through the Secretary for Monetary Affairs to the Governor in Council on those amendments to the Companies Ordinance that are under consideration from time to time by the Standing Committee.

(3) To advise the Financial Secretary on amendments required to the Securities Ordinance and the Protection of Investors Ordinance with the objective of providing support to the Securities Commission in its role of administering those Ordinances.

Appendix 2

Memership of the Standing Committee
as at 31st December 1986

Chairman:

The Hon. Mr. Justice Cons

Members:

Mr. D.E. Connolly, JP,

Mr. Kenneth Fang Hung,

Mr. Robert Fell, CB, CBE, JP,

Mr. Andrew Li Kwok-nang, JP,

Mr. Eric K.C. Lo,

Mr. P.J. Pearson,

Mr. Keith R. Whitson,

Mr. Charles H. Wilken,

Professor P.G. Willoughby, JP,

Mr. C.H. Wong, JP,

The Hon. Peter C. Wong, CBE, JP,

Mr. Charles Wrangham

Ex-officio Members:

Mr. Joseph C.K. Yam, JP, Deputy Secretary for Monetary Affairs, as representative of the Secretary for Monetary Affairs,

Mr. Noel M. Gleeson, OBE, JP, Registrar General,

Mr. Ray Astin, JP, Commissioner for Securities

Co-opted Members of Sub-Committee:

Sub-Committee on Section 80(2)(c) & (e) of the Companies Ordinance

Mr. Malcolm Barnett,

Miss Vanessa Stott.

Mr. Stephen J. Hood and Mr. A.N. Williams also attended a number of Meetings of the Sub-Committee as representatives of the Financial Law Sub-Committee of the Law Society of Hong Kong

Sub-Committee on Distributable Profits

Mr. Richard Hall,

Mr. K.G. Morrison,

Mr. David J. Shaw,

Mr. J.B. Wilkinson

Secretary:

Mr. P. Murphy, Registrar General's Department

Appendix 3

Meetings held during 1986

Eighteenth	Meeting	- 4th January
Nineteenth	"	- 1st February
Twentieth	"	- 1st March
Twenty-first	"	- 12th April
Twenty-second	"	- 2nd May
Twenty-third	"	- 7th June
Twenty-fourth	Meeting	- 5th July
Twenty-fifth	"	- 13th September
Twenty-sixth	"	- 4th October
Twenty-seventh	"	- 1st November
Twenty-eighth	"	- 6th December