REVIEW OF THE HONG KONG COMPANIES ORDINANCE

CONSULTANCY REPORT

MARCH 1997

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Mr. Donald Tsang, OBE, JP
Financial Secretary
Government of Hong Kong

Dear Sir,

Ermanno Pascutto was appointed on November 23, 1994 to conduct a review of the Hong Kong Companies Ordinance and to report to you. Cally Jordan, then an Associate Professor at the Faculty of Law, McGill University in Montreal, Canada was engaged on a full-time basis to research and prepare the reports associated with the review.

Cally Jordan prepared this Report with input from Ermanno Pascutto and with the assistance of those persons appearing in the Preface. Particular recognition should be given to the hard work and enthusiasm of the students at the Faculty of Law at McGill University who provided the research support to the review.

We now have the honour to submit this Report.

The Report recommends that Hong Kong replace the existing Companies Ordinance with a modern, streamlined Business Corporations Ordinance drawing on the most appropriate aspects of existing North American and Commonwealth models. The new legislation would focus on core company law.

The Report recommends an unbundling of non-core company law matters from company law, including securities regulation, insolvency, charges and not-for-profit companies. The regulation of the capital market activities of companies and, in particular, listed companies, would be left to securities regulation which is the responsibility of the Securities and Futures Commission and the Stock Exchange of Hong Kong. Implementation of a new Ordinance would need to be coordinated with this unbundling and, in particular, with updated securities and insolvency legislation.

Finally, the contribution of the members of the four Working Parties who donated their invaluable time and expertise to the process of the review should be acknowledged. Working Party members helped ensure that regard was had, among other things, to the particular and unique aspects of the corporate culture in Hong Kong.

Ermanno Pascutto *Cally Jordan*

Hong Kong
March 27, 1997

PREFACE

This Consultancy Report was prepared in the context of the ongoing, comprehensive review of the Hong Kong Companies Ordinance undertaken by Ermanno Pascutto.

Cally Jordan prepared the Report with input from Ermanno Pascutto and with the assistance of L.S. Sealy, John Howard, David Goddard, Vanessa Stott, Philip Smart, Yue Xiang, Wei Yao-Rong, Ian Ramsay, Bruce Welling, Walter Woon, Johan Henning, Jean DuPlessis, Gordon Walker, Eamonn O'Connell, Martin Chester, John Brewer, Susan Zimmerman, W. Brian Scholfield, Mary Saulig, Connie Crosby, the students at the Faculty of Law, McGill University (Jennifer Yang, Peter Nagy, Rod Elliott, Steve Wishart, Phil Duffy, Karen Cheong), Marianne Hald, Agnes Lee, Ruby Tsang, the Corporations Law Simplification Task Force (Australia), the Canada Business Corporations Act Directorate, the Corporate Governance Branch of Industry Canada, the Department of Trade and Industry (U.K.), and in particular, the Companies Registry (Hong Kong) and Working Party members.

The publication of this Consultancy Report does not imply that the views and recommendations contained in it are endorsed by the Hong Kong Government or the Standing Committee on Company Law Reform.

WORKING PARTY MEMBERS

Module 1 - Identification of Core Company Law

Mr. John Allen, Deputy Crown Solicitor, Attorney General's Chambers
Mr. John Brewer, Managing Director, East Asia Trust
Mr. Marvin Cheung, Senior Partner, KPMG Peat Marwick
Mr. Clifton Chiu, Executive Director, Harvester (Securities) Co., Ltd.
Mr. Gordon Jones, JP, Registrar of Companies, Companies Registry
Mr. David Little, Chief Counsel, Securities & Futures Commission
Dr. K.S. Lo, Deputy Chairman and Managing Director, Great Eagle Holdings Limited
Mr. Selwyn Mar, Managing Partner, Charles Mar Fan & Co.
Mr. Peter Pang, Executive Director (Banking Policy), Hong Kong Monetary Authority
Mr. Winston Poon, Q.C. (resigned)
Mr. David Shaw, Consultant, Johnson Stokes & Master

Module 2 - Corporate Formalities

Mr. John Allen, Deputy Crown Solicitor, Attorney General's Chambers
Mr. John Brewer, Managing Director, East Asia Trust (resigned)
Mr. Julian Chow, Ernst & Young
Mr. Robin Hearder, JP, Official Receiver, Official Receiver's Office
Mr. Philip Hilliard, Coopers & Lybrand
Mr. Gordon Jones, JP, Registrar of Companies, Companies Registry
Mr. Larry Kwok, Partner, Kwok & Yih in Association with Blake Dawson Waldron
Ms. Phyllis Kwong, Phyllis K Y Kwong & Leung
Ms. Vanessa Stott, Associate Professor, HK Polytechnic University
Mr. Stephen Taylor, Partner, Deloitte Touche Tohmatsu

Module 3/4 - Shareholders' Rights, Remedies and Communication/ Directors' Duties; Corporate Governance Issues

Mr. John Allen, Deputy Crown Solicitor, Attorney General's Chambers
Mr. Ashley Alder, Partner, Herbert Smith
Mr. Richard Bennett, Head of Legal and Compliance, The Hongkong and Shanghai Banking Corporation Limited
Mr. Moses Cheng, JP, Senior Partner, P.C. Woo & Co.
Mr. Paul Chow, Chief Executive, The Stock Exchange of Hong Kong
Mr. Henry Fan, Managing Director, CITIC Pacific Ltd.
Mr. David Fleming, Partner, Baker & McKenzie
Mr. Arvind H. Patel, Registry Solicitor, Companies Registry
Dr. K.S. Lo, Deputy Chairman and Managing Director, Great Eagle Holdings Limited
Mr. Gerard McMahon, Executive Director, Securities & Futures Commission
Mr. Robert Owen, Deputy Chairman, Nomura International (HK) Ltd.

Module 5 - Foreign/International Business Corporations

Mr. John Allen, Deputy Crown Solicitor, Attorney General's Chambers
Mr. Andrew Hedden, Coudert Brothers
Mr. Donald Hess, Pillsbury Madison & Sutro LLP
Mr. Barry Macdonald, Coopers & Lybrand
Mr. Kenneth Ng, The Hongkong & Shanghai Banking Corporation Ltd.
Mr. Arvind H. Patel, Registry Solicitor, Companies Registry
Professor Philip Smart, The University of Hong Kong
Mr. W. Anthony Stewart, Jones, Day, Reavis & Pogue
Mr. William Tam, Manager, Sun Hung Kai Properties Ltd.
Mr. Greg Terry, Jardine Matheson Limited

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HIGHLIGHTS OF THE RECOMMENDATIONS

Simplification of the Ordinance

- Streamlining and rationalisation of structure
- Simplification and modernisation of statutory language
- Adoption of a "core company law" approach
- Removal of provisions relating to securities regulation, charges, insolvency and not-for-profit organisations
- Facilitation of solvent corporate reorganisations and restructuring, especially among related companies
- Decriminalisation of companies law; greater reliance on self-enforcement

Incorporation

- Quick, single-step incorporation procedures
- One person, one director companies
- Facilitation of electronic filing and record keeping
- Import/export provisions to facilitate international operations

Private Companies

- Creation of an optional statutory regime for private companies
- Streamlining formalities
- Provisions permitting informal and consensual operation
- Permitting shareholders to eliminate the board of directors
- Non-litigious dispute resolution mechanisms

Accounts and Audits

- Elimination of the Tenth Schedule; reference instead to external generally accepted accounting principles
- Private companies would have the option of eliminating the mandatory audit

Capital Structure

- Facilitation of the creation of modern, flexible capital structures
- Prohibition of par value shares and partially paid shares
- Optional pre-emptive rights
- Replacement of the capital maintenance requirements by a solvency test
- Provisions for optional use of uncertificated or book-entry securities

Directors and Executive Officers

- Statutory formulation of directors' and executive officers' duties
- Provision for action being taken without the necessity of a meeting
- Facilitation of meetings using telecommunications
- Duty of fair dealing in interested transactions
- Safe harbour provisions for interested director transactions, based on disclosure, disinterested voting and fairness to the company

Shareholders

- Broadening of the current unfairly prejudicial and just and equitable winding up remedies
- Creation of new shareholder remedies:
  - statutory derivative action
  - an appraisal/buy-out remedy triggered by fundamental changes
  - statutory compliance and restraining order

- Statutory unanimous shareholder agreement

International Implications

- Creation of modern legislation meeting international expectations which provides an alternative to offshore incorporation for Hong Kong businesses
- Avoidance of provisions having an extraterritorial effect
- Introduction of a simple "carrying on business" test for registration by foreign companies

Transitional Measures

- Three to five year transitional period for implementation
- Mandatory continuance by simple re-registration procedures for existing companies

Other Matters

- Securities regulation would be addressed in separate legislation to be implemented contemporaneously with the new Ordinance
- Insolvency of companies left to a comprehensive Insolvency Ordinance
- Consideration should be given to a separate comprehensive regime governing security interests in personal property
- Regulatory aspects of financial institutions to appear in banking and insurance legislation
- Current Ordinance to apply until consideration given to separate treatment of not-for-profit enterprises

REVIEW OF THE HONG KONG COMPANIES ORDINANCE

TERMS OF REFERENCE

Having regard to:-

(a) The Government's policy of minimum interference in the market;
(b) the economic and legal systems in Hong Kong;
(c) Hong Kong's status as an international financial and business centre;
(d) the particular and unique aspects of the corporate culture in Hong Kong;
(e) recent developments in companies law and regulation in other comparable jurisdictions; and
(f) the existing framework of securities-related law and regulation in Hong Kong,

consider and make recommendations on the following matters:-

A. (a) The proper aims and objectives of the Companies Ordinance

(b) Whether private and public (and, in particular, listed) companies should continue to be subject to the same regulatory regime, under the Ordinance, in relation for example to requirements for accounts, or whether they should be the subject of distinct and separate regulation in the light of, inter alia,

(i) developments in the role and responsibilities of the Securities and Futures Commission since its establishment in 1989; and

(ii) the fact that 50% or more of the companies listed on the Hong Kong Stock Exchange are incorporated overseas,

and if the latter course of action is proposed, to make recommendations as to the nature of the respective regulatory regimes for private and public/listed companies.

B. The scope for and desirability of -

(a) rationalising and simplifying the Ordinance, including a greater use of subsidiary legislation and/or administrative arrangements;
(b) streamlining and simplifying the procedures prescribed under the Ordinance, including in relation to the incorporation of a company and the submission of returns;
(c) codifying duties and responsibilities and stipulating minimum qualifications and capacities for company directors;
(d) including more specific statutory assistance for minority shareholders, and other persons who deal with companies, who wish to forestall, or to seek redress against, misconduct or abuses by a company and/or its directors (including through easier access to the judicial process);
(e) extending financial and other disclosure requirements, having regard also to existing non-statutory rules in respect of listed companies;
(f) rationalising and making more effective the enforcement provisions and sanctions under the Ordinance;
(g) extending regulatory powers in relation to the investigation and inspection of a company's affairs; and
(h) providing alternative forms for the constitution of a company.

C. Whether Part XI of the Ordinance is sufficient to regulate the activities of companies incorporated overseas with a place of business in Hong Kong.

D. The relevance with respect to Hong Kong of the development of international business companies.

E. Such other related matters as the Secretary for Financial Services may from time to time specify.

November 23, 1994
Hong Kong

A. INTRODUCTION

A. INTRODUCTION

1. This Report is the last step in the two year Review of the Hong Kong Companies Ordinance but only the first step towards the preparation of new companies legislation for Hong Kong.

2. The Review of the Hong Kong Companies Ordinance marked the first comprehensive look at the legislation since 1973. The last twenty-five years have been a period of very rapid change, in Hong Kong as elsewhere in the world. Great efforts are being made to try to keep commercial legislation attuned to modern business. In Hong Kong, the Standing Committee on Company Law Reform was created in 1984 to ensure that the Companies Ordinance remained responsive to the day-to-day needs of the business sector and the community at large. Since 1984 the Standing Committee has been instrumental in the process of annual renewal of the Companies Ordinance.

3. It remains the case, however, that the Companies Ordinance has not had a major overhaul since the implementation, in 1984, of the recommendations of the last review which had reported in 1973. The recommendations of this Report owe a considerable amount to dominant trends and developments in other modern commercial jurisdictions. In the past, Hong Kong has looked primarily to U.K. legislation as its model but for a variety of reasons can no longer do so. U.K. companies law is in a period of transition and adaptation to European Commission directives and no longer provides a model which can be readily emulated, by Hong Kong or any other jurisdiction.

4. The recommendations in this Report are primarily based on modern companies legislation in the United States, Canada and New Zealand which all share common law roots. As new as some of the recommendations in this Report may seem, they do not represent a break for Hong Kong companies legislation so much as a natural progression. The overall organisation and structure of the current Ordinance is retained, with certain parts being consolidated and others subdivided into more balanced and coherent units.

5. Although guided by the Terms of Reference, great latitude was given to the Review in structuring the process by which recommendations were made. A key component in the process was the creation of four separate working parties; each working party had a different composition and focused on different issues. This Report is very much the product of the working party deliberations and is based in form and substance on the background materials prepared for the working parties. Several hundred pages of background materials were prepared (an index of which appears at the end of this Report). In the background papers, an analytical and comparative approach was adopted; legislative responses in several jurisdictions were canvassed on particular issues accompanied by an assessment of strengths and weaknesses.

6. The recommendations and commentary which form the body of this Report were presented in draft to working party members as a means of focusing discussions, which they did quite effectively. In some cases, a consensus emerged very quickly as to the appropriate road to take. In the case of other recommendations, there are still alternatives to be seriously explored. A summary of the recommendations themselves appears at the beginning of Part B of this Report.

7. The introduction which follows provides the background to the Review and describes the process involved in producing this Report. The introduction also outlines the major considerations underlying a review of companies law in Hong Kong and the international, regional and local context in which Hong Kong companies legislation operates. There is a discussion of major trends in other jurisdictions which may be supplemented by reference to the Comparative Survey of Companies Law in Selected Jurisdictions prepared in January 1996 and which is available at the Government Publication Centre. The existing legislative framework is described and the major thrust of the proposed reforms identified: the creation of a "core company law" through simplification, rationalisation and modernisation of the Companies Ordinance.

BACKGROUND TO THE REVIEW

Initiation of the Review

8. On November 23, 1994, the Hong Kong Government appointed Mr. Ermanno Pascutto, the former Deputy Chairman of the SFC, to lead the review of the Hong Kong Companies Ordinance (Cap. 32) (the Review). Cally Jordan, an Associate Professor at the Faculty of Law, McGill University in Montreal, Canada was engaged on a full-time basis to research and prepare the reports associated with the Review. She relocated to Hong Kong in order to do so.

9. In accordance with the terms of the mandate, an Inception Report outlining the objectives and scope of the Review, the proposed methodology for conducting the Review, the areas of substantive investigation and a tentative timeline, was submitted to the Financial Services Branch (FSB) in February 1995. In the Inception Report it was proposed that the Review begin with the preparation of two background reports, one an overview of the Ordinance, its legislative history and a brief analysis, and the other a comparative survey of companies law in a number of jurisdictions (the United Kingdom, Australia, New Zealand, Canada, South Africa, France, Germany, the European Union, the United States, Singapore and the People's Republic of China). An initial request for comments was sent to a wide variety of institutions and associations at the outset of the Review in December 1994. A list of the organisations and individuals who responded in writing to the initial request for comments appears as Annex B to the Report on Module 1 (February 1996).

Need for the Review

10. A combination of factors prompted the Government to "take stock" of the Ordinance: concerns were expressed about the redomiciling/overseas domicile phenomenon of listed companies; the Companies Registry raised a number of practical problems with regard to the enforcement of the Ordinance; issues pertaining to corporate governance were gaining prominence, in Hong Kong as elsewhere; questions were asked as to the desirability of separate regimes for private and listed companies; and changes to U.K. legislation resulting from harmonisation with European Union Company Law Directives raised the longstanding issue of the continued suitability of the United Kingdom as a model for Hong Kong companies law.

11. In 1984, the Standing Committee on Company Law Reform (SCCLR) was created to ensure that the Ordinance remained responsive to the day-to-day needs of the business sector and the community at large. Over the last few years, certain members of the SCCLR (although not all) "argued forcibly" for an overall review of the Hong Kong Ordinance. They cited the "growing size and complexity of company law", "the piecemeal nature of the amendments" made to the Ordinance, the lack of harmonisation of amending provisions with existing provisions, and the "explosion in the number of private companies". With respect to private companies, committee members questioned whether it was "right to subject that type of corporate vehicle to a regulatory regime which had evolved since the 19th century to deal with the needs of public companies" (see SCCLR, *The Tenth Annual Report* (1993/94) at 52-53).

12. An additional consideration underlying a review of the Ordinance at this time was the rapid internationalisation of trade and finance which had taken place in the last 15 years. Hong Kong is literally at the centre of this phenomenon. In important commercial areas such as companies, insolvency, securities and financial institutions, Hong Kong legislation does not exist in isolation. It operates in the international arena and is held up to international scrutiny as never before. With the increasing internationalisation of commerce in all of these areas (companies, insolvency, securities and financial institutions law), there is a convergence of thought and approach in different jurisdictions; commercial activity is raising problems for which existing legal regimes may no longer have an adequate response.

13. The Ordinance is one of the largest and most complex pieces of legislation in Hong Kong. In structure and approach, its 19th century origins are still very much apparent. Although amendments have been ongoing in an effort to adapt the Ordinance to changing times, it remains the case that the last major review of the Ordinance was implemented well over ten years ago (in 1984) based on a 1973 Report of the Companies Law Revision Committee; it was only then that the Ordinance was brought broadly into line with the U.K. Companies Act 1948.

14. ***Work of the SCCLR on Company Law Reform.*** One of the most oft-quoted statements in the 1962 Jenkins Report (U.K.) has been that finality in companies law cannot be expected (see Second Report at 4). Taking this observation into consideration, the Second Report, as its very last recommendation, suggested that "there should be a Standing Committee to advise on amendments required to the Ordinance as and when experience has shown them to be necessary" (*ibid.* at 53). The SCCLR was set up in early 1984 by the Hong Kong Government and continues its work today.

15. Professor E.L.G. Tyler of City University of Hong Kong, a former member of the SCCLR, has provided a succinct description of its composition and activities:

> The Standing Committee is chaired by a High Court judge and consists of approximately 20 members, including the ex-officio members who are currently the Registrar of Companies, the Official Receiver, the Commissioner of Banking [now the Monetary Authority] and a representative of the Financial Services division [now Financial Services Branch]. The non-official members represent the interests of the legal, accountancy and banking professions, company secretaries, the Securities and Futures Commission, the Monetary Authority, etc., academia, and business interests generally. There are several senior executives representing major businesses in Hong Kong on the Committee. There is a full-time legally qualified

> secretary. The Committee meets monthly or less frequently on a Saturday morning. It has never been the practice of the Committee to initiate business nor to seek to review the Companies Ordinance as a whole or basic principles of company law. Rather it is reactive to particular problems put to it, which may come from the Registrar of Companies or the Official Receiver or a Government Department or some interested member of the public. Usually the issues considered involve a fairly narrow and discrete point of law as can be seen from the Committee's Annual Reports (E.L.G. Tyler, "Hong Kong's Companies Legislation Review" (December 1994) [unpublished] at 25).

The SCCLR is very much an extension of the original Companies Law Revision Committee and continues its work of detailed, point by point consideration of the Ordinance, involving the fairly narrow and discrete points of law referred to by Professor Tyler. Its mandate is to ensure that the Ordinance remains responsive to the day-to-day needs of the business sector and the community at large.

16. In this respect, many of the recommendations of the SCCLR have been acted upon. The Committee closely monitors legislative developments and proposals in the United Kingdom in an attempt, as has been the practice in the past, to keep the Ordinance in line (literally, line by line) with the United Kingdom. The Companies (Amendment) Ordinance 1991 saw fairly significant charges: it implemented the current provisions concerning financial assistance, redeemable shares, purchase by a company of its own shares and distribution of profits and assets. With the exception of the financial assistance provisions (where they are applicable in Hong Kong to public companies, listed or not), the actual wording follows that of their equivalent sections in the U.K. Companies Act 1985.

17. Given the level of legislative activity and debate in the U.K. in the past 15 years, trying to keep abreast of developments in the U.K. is no mean feat. Between 1980 and 1989, for example, there were nearly a dozen pieces of major companies-related legislation in the U.K.: two major initiatives prompted by EC Directives, the Companies Act 1980 and the Companies Act 1981, as well as the Companies (Beneficial Interests) Act 1983; a partial consolidation in 1985, the Companies Act 1985 as well as the Companies Securities (Insider Dealing) Act 1985, Business Names Act 1985 and the Companies Consolidation (Consequential Provisions) Act 1985; the Company Directors Disqualification Act 1986; the Companies Act 1989 (consisting of 216 sections and 24 Schedules, again prompted by EC Directives); the Financial Services Act 1986 and the Insolvency Act 1986. In addition to the difficulty of adapting increasingly complex and divergent U.K. legislation to the Hong Kong environment, there is the added complication of a series of stalled or compromised initiatives in the U.K. which have left the SCCLR and Hong Kong legislators at an impasse.

18. Quite apart from the practical difficulties of attempting to stay abreast of a multitude of legislative developments in the U.K., there is the even more difficult question which has arisen in the SCCLR as to the appropriateness of following the U.K. model at all. This is not a new question and was raised in the very opening paragraphs of the Second Report in 1973. Increasingly, reference has been made in the SCCLR to legislative initiatives in other jurisdictions: Australia, South Africa, the United States and Canada.

19. The SCCLR has not confined its discussions to narrow technical issues. Especially given the increasing internationalisation of commercial activity and its significance to Hong Kong, the major debates and discussions in the area of company and commercial law

worldwide have come before the SCCLR. This fact, and the difficulties of continued reliance on U.K. legislation, are partly responsible for this Review. The SCCLR, already labouring under an increasingly heavy agenda, does not by its nature possess the resources to deal with issues arising from more fundamental developments and structural changes in the commercial world. For this reason the SCCLR recognised the need for a broad review to be conducted on a full-time and concentrated basis.

20. It is difficult to overestimate the importance of the work of the SCCLR over the last decade; it is equally difficult to appreciate fully the complexity and enormity of its task.

21. *Major Preoccupations of the SCCLR.* During each year of its existence the agenda of the SCCLR has grown longer. Although not intended to be exhaustive, the following discussion highlights certain recurring issues before the SCCLR over the last ten years, many of which have been carried over for consideration from year to year. Certain issues have found a resolution; others have only recently leapt to prominence.

22. *Charges.* Part III of the Ordinance, "Charges", has come before the SCCLR in virtually every year since the Committee began meeting. Charges represent an archaic and highly unsatisfactory area of the law in Hong Kong (as it does in other jurisdictions where it has not been modernised and rationalised). The situation with respect to charges is a prime example of the difficulty of following a U.K. model given the current legislative environment in the United Kingdom. In Hong Kong, legislation based on provisions in the U.K. Companies Act 1989 was being processed several years ago. However, due to a major reconsideration of the Act's provisions by the Department of Trade and Industry concerning the land registration system in the U.K., the proposed legislation did not proceed.

23. *Shareholders and Directors.* In the past decade, the duties, liabilities and conduct of directors have been the object of intense scrutiny around the world. It is no surprise, then, that the SCCLR has devoted a considerable part of its energies to looking at the legislative framework in which directors must act. In keeping with the recommendations of the Jenkins Report, and the situation in other jurisdictions, a statutory statement of directors' fiduciary duties was considered and legislation introduced but failed to be enacted. Primarily at the behest of the Law Society, the issue was passed on to the Institute of Directors which published "Guidelines for Directors 1995". The adequacy of shareholders remedies has also been a focus; the unfairly prejudicial remedy was broadened somewhat in the 1994 amendments to the Ordinance but difficulties associated with the 1843 rule in *Foss v. Harbottle* persist. Liability insurance for directors and the liability of non-executive directors were considered by the Committee as well as the grounds for disqualification of company directors (leading to enactment of Part IVA of the Ordinance). Issues involving shadow directors, nominee directors and corporate directors were also examined. Pending the implementation of a comprehensive directors index under section 158C of the current Ordinance, it was recommended that an index showing all the directorships held by the directors of listed companies should be introduced. This computerised index has been available for public search since 1994. The troublesome issues of the prohibition of financial assistance for the purchase of shares, the repurchase of a company's own shares, loans to directors and the distribution of profits, all closely related activities essentially controlled by directors, came up for examination year after year.

24. *Ultra Vires*. The unloved but remarkably tenacious doctrine of *ultra vires* came before the Committee on numerous occasions over the last ten years and has just recently met its justly deserved and long awaited demise. The Companies (Amendment) Ordinance 1997 abolishes the doctrine of *ultra vires*, modifies the doctrine of constructive notice and introduces the concept that a company has the powers and capacity of a natural person thus making objects clauses unnecessary. The provisions are drawn from the Business Corporations Act (Ontario) where they have successfully eradicated the doctrine of *ultra vires*.

25. *Financial Disclosure*. The availability and reliability of financial information are arguably the most important safeguards for shareholders. The form and content of the accounts required by the Ordinance are generally acknowledged to be out-of-date and seriously in need of revision. The form and content of accounts have been a recurring issue before the SCCLR. The debates have consistently argued for a complete revision of the Tenth Schedule (Accounts). The schedule was introduced in 1974 and raises continuing interpretation difficulties. Ancillary to the issue of the form and content of accounts is the issue of auditors' reports, another matter which has come before the SCCLR with great regularity.

26. *Securities Law*. Since 1987, with increasing frequency, issues related to listed companies have come before the SCCLR. The SEHK and, once it came into existence in 1989, the SFC, have increasingly participated in the SCCLR's work. The SCCLR has looked into prospectus vetting issues, insider dealing, coordination of listing rules with existing provisions of the current Ordinance, major and related party transactions, the Takeover Code and mandatory offers, disclosure of interest issues, proxies, clearing and settlement, and options trading, among other things. The SFC has prepared a draft Composite Securities and Futures Bill that would consolidate the numerous ordinances under its supervision. Subject to the recommendations of this Review, it is likely that all prospectus provisions in the current Ordinance will be incorporated into separate securities legislation. The question to be asked going forward is the extent to which it will be necessary to continue to bring securities law related matters before the SCCLR.

27. *Compliance: Balancing the Burden*. Concerns about compliance with the statutory regime have surfaced in various guises. On the one hand, there is the regulatory burden currently placed on small business and the consequential pressures which this places on the Companies Registry. There has been growing recognition of the need for a differentiation in the treatment of private companies and public / listed companies. The Companies (Amendment) Ordinance 1997 also tries to address the compliance burden, especially for small companies. The complexity and the length of the current forms have been identified as unduly onerous and a disincentive for small companies, in particular, to comply with the current Ordinance.

28. Concerns have also been expressed with respect to the proliferation of criminal and other offences in the current Ordinance. The SCCLR has recently looked at concerns raised by the Commercial Crime Bureau (CCB) in the investigation of serious commercial crime. It was noted by Committee members that the appropriate vehicle for overcoming the CCB's current problems should be through criminal legislation, not companies legislation. On the other hand, there have been serious demands for enforcement, if not creation, of regulatory

requirements in the interests of protection of the investing public and integrity of the capital markets.

29. *Financial Institutions.* Coincident with the rise in importance of Hong Kong as an international financial centre, the Commissioner of Banking, and more recently, its successor, the Hong Kong Monetary Authority, have participated in the deliberations of the SCCLR. In particular, the extent to which financial institutions generally, subject as they are to the oversight of a regulatory authority, should be exempt from certain provisions of the current Ordinance has been discussed. Financial disclosure requirements for financial institutions have been the main issue. More recently, in response to the much publicised liquidation of the Bank of Credit and Commerce in Hong Kong, mechanisms for protection of depositors were considered, including creation of an insurance fund. (The Companies (Amendment) Ordinance 1995 implemented instead a system of preferences for depositors).

30. *Oversea Companies.* Various factors, both political and economic, have focused attention on the inadequacy of provisions in the current Ordinance dealing with foreign incorporated companies. As the activities of the SEHK and the SFC have rapidly taken on greater importance, the gaps in the existing regulatory regimes, statutory and otherwise, applicable to overseas incorporated companies have become more apparent. Currently, nearly 70% of companies listed on the SEHK are incorporated elsewhere, primarily in Bermuda (50%), the Cayman Islands (approximately 3%) as well as the PRC (nearly 4%).

31. *Major Difficulties Encountered by the SCCLR.* It is obvious from the Annual Reports that the SCCLR has encountered several major difficulties over the brief period of its existence.

32. *Scope of its Mandate.* Modern commercial activity has become highly specialised, extremely complex and inextricably interconnected around the world. The Ordinance, as the repository of much of commercial law in Hong Kong, reflects these developments; it is one of the largest and most complex pieces of legislation in Hong Kong.

33. The SCCLR has had, in effect, to cover the entire commercial waterfront: banking, insolvency, securities, security interests, accounting, and white collar crime. This is a tremendous task. Originally envisaged in 1973 in the Second Report as a small committee (of no more than five members), it has mushroomed to over twenty members. This has been an inevitable development given the number of the various interests concerned and the need to deploy appropriate expertise to address the issues coming before it. As the agenda of the SCCLR has steadily lengthened and the size of the Committee increased, speedy resolution of complex issues has become more difficult.

34. *The Difficulties with the U.K. Model.* One of the main difficulties faced by the SCCLR over the last decade has been the growing complexity and questionable relevance for Hong Kong of the U.K. legislative model. Some of the reasons for this have already been discussed above.

35. Although the centre of intense commercial activity, both domestic and international, Hong Kong is a small jurisdiction with limited legal, legislative and judicial resources. The creation, implementation and maintenance of legal regimes is a time-consuming and costly

affair. Hong Kong should borrow and adapt. In the past this was a relatively straight-forward process, aided by the political, educational and professional integration with the U.K. This has ceased to be the case and the difficulties encountered by the SCCLR in dealing with the Ordinance are indicative of this new reality.

36. Not only have circumstances in Hong Kong changed; in the area of commercial and companies law, the U.K., for its own reasons, has experienced enormous difficulties recently in producing models worth emulating. The U.K. has been preoccupied with integration of its commercial law with that of continental Europe; this has not been an easy process and has absorbed considerable legislative energies that might otherwise have been devoted to modernisation and rationalisation of its legal regimes.

37. Companies law itself has been the object of successive and marginally successful waves of amendment over a short period of time, building in complexity and unwieldiness. By 1985, according to Professor Gower, U.K. "company legislation was in a worse state than at any time this century" (Gower's at 51). The U.K. Financial Services Act 1986, with its intricate regulatory structure, has been roundly criticised; Part V, originally intended to replace the provisions of Part III of the Companies Act 1985, was never enacted. Now both parts have been repealed to be replaced by the Public Offers of Securities Regulations implementing the EC Prospectus Directive. The U.K. Insolvency Act 1986 was a welcome arrival on the regulatory scene but, according to Professor Gower, the voluntary winding-up of *solvent* companies should have remained in the companies legislation. The Insolvency Act 1986, although in some respects adopting a radically different approach, was itself to a certain degree influenced by the well-known Chapter 11 protective provisions of the U.S. Bankruptcy Code (see J.L. Westbrook, "A Comparison of Bankruptcy Reorganisation in the U.S. with the Administration Procedure in the U.K." (1990) Insolvency Law & Practice 86). Moreover, despite the Diamond Report in 1989 which recommended the adoption of a North American-style personal property security interests regime in the U.K., legislative initiatives in this area appear to have stalled.

38. Even so eminent an authority as Professor Gower recommends looking elsewhere for inspiration in companies law matters:

> The major questions still unresolved, and likely to remain unresolved, can really be reduced to one: Has our system of Company Law (evolved in the 19th Century) adapted itself adequately to the needs of the 20th and the likely challenges of the 21st? To suggest that it has not, may seem churlish.... [O]ur system of Company Law was, until recently, the model widely followed in the Common Law countries. That leading role has now been taken over by the United States [influencing Canada, Australia and New Zealand] and we cannot hope to recover it (Gower's at 70).

New Zealand has already looked elsewhere as has South Africa; Australia may as well; Canada did so twenty-five years ago.

39. Given the rapidly changing and uncertain state of much of commercial law in the United Kingdom, the SCCLR has found itself unable to renew Hong Kong companies law by looking to its traditional sources.

40. *Interaction of a General Companies Regime with Specialised Regimes such as*

Banking, Securities and Insolvency. The last decade in Hong Kong has seen the emergence of specialised areas of regulation, in particular with respect to financial institutions and securities markets. These areas of specialised regulation now overlap with the older and more general provisions of the Ordinance. A comprehensive review of insolvency and bankruptcy legislation is currently underway which may lead to the creation of a separate insolvency regime. The result has been the increasing frequency of involvement by the SEHK, the SFC, the Monetary Authority and the Official Receiver in the work of the SCCLR. This has added to the complexity and sheer volume of matters coming before the Committee.

The Review Process

41. This Review picks up directly from the 1973 Second Report of the Companies Law Revision Committee on Company Law. In announcing the Review in his budget speech of March 2, 1994 the Financial Secretary announced the Government's intention to undertake a comprehensive review of the Ordinance:

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

In recommending a new framework law for companies in Hong Kong, this Report has looked to, and is a direct descendant of, the major companies law reform efforts which have preceded it: Professor Gower's 1961 Ghana Code, Canada's 1971 Dickerson Report, the United States' Model Business Corporations Act (1984) and New Zealand's 1989 Company Law Report No. 9, Company Law Reform and Restatement.

42. ***Background Reports.*** In accordance with the terms of the mandate, an Inception Report outlining the objectives and scope of the Review, the proposed methodology for conducting the Review, the areas of substantive investigation and a tentative timeline, was submitted to the FSB in February 1995. The Review began with the preparation of two background reports, one an overview of the current Ordinance (its legislative history and a brief analysis) and the other, a comparative survey of companies law in certain jurisdictions (the United Kingdom, Australia, New Zealand, Canada, South Africa, the United States, Singapore, the People's Republic of China, France, Germany, Bermuda and the European Union).

43. ***The Five Modules.*** As proposed in the Inception Report, the issues raised in the Terms of Reference were grouped into five broad areas or modules to be addressed sequentially. This approach was adopted primarily in order to discuss and determine the acceptability of the overall direction of the Review upon which much of the consideration of the substantive issues that ensued would depend. It was also hoped that this approach would accelerate the process of consideration and coordinated legislative action. Finally, regrouping the substantive areas of investigation in this manner permitted a more focused approach to the working party consultations and a better allocation of consultative resources. The five modules were:

Module 1: Identification of Core Company Law
Module 2: Corporate Formalities
Module 3: Shareholders' Rights, Remedies and Communications
Module 4: Directors' Duties; Corporate Governance Issues
Module 5: Foreign/International Business Corporations.

To this end, working parties were formed to advise on a module by module basis, drawing on various specialised expertise and ensuring channels of communication with the professional and business communities having the greatest interest in the Ordinance.

44. Members of various working parties included solicitors (qualified in several jurisdictions in addition to Hong Kong), barristers, in-house counsel, accountants, company secretaries, business people, academics, as well as the Registrar of Companies (and other representatives from the Companies Registry), the Official Receiver, representatives from the Attorney General's Chambers, the SFC, the Monetary Authority, and the SEHK. Several working party members were also members of the SCCLR. The presence on all working parties of John Allen from the Attorney General's Chambers and either Gordon Jones, Arvind Patel or Rita Ho from the Registry, ensured continuity from one working party to another. A complete list of working party members is found at the beginning of this Report.

45. ***Working Party Deliberations.*** Each working party met a number of times for a total of 23 meetings. Background information in the form of issue lists, briefing papers and background memoranda was supplied to each working party. A comparative and analytical approach was adopted; legislative responses in several jurisdictions were canvassed on particular issues accompanied by an assessment of strengths and weaknesses. The primary jurisdictions considered, for reasons discussed below, were the United Kingdom, the United States, Canada, Australia and New Zealand. As there was great interest in the legislative treatment of private companies, an additional paper on the close corporation/private company in Singapore, Malaysia, Taiwan and Japan was prepared. In order to focus deliberations as the working parties progressed, draft recommendations and commentary were prepared and tabled for discussion. On some issues consensus developed quickly; on others, none was reached.

46. *Working Party 1: Identification of Core Company Law.* Module 1: Identification of Core Company Law sought to address at the outset the major conceptual and structural issues which would determine the considerations that followed. In keeping with proposed and actual legislative developments in Hong Kong in other areas, a "core company law" approach was generally accepted by the working party. New company legislation in Hong Kong should narrow its focus to deal with the "birth, life and death" of companies. Regulation of the capital market activities of Hong Kong and foreign incorporated companies would be left to develop under the aegis of the SFC and the SEHK. Prospectus requirements and other securities aspects would be removed from the current Ordinance and incorporated into securities legislation. The need for a new statutory regime for public and listed companies was identified and recommendations made as to the general nature of a regime for such companies. Corporate insolvency matters would be left to the consideration of the Law Reform Commission, with a view to the preparation of a comprehensive Insolvency Ordinance. The regulatory aspects of supervision and oversight of financial institutions would be left to the Monetary Authority and the Commissioner of Insurance (although the

formalities of incorporation, in particular, would continue to be those of the companies legislation). There should be separate consideration given to Part III, Charges, with an eye to creation of a comprehensive regime applicable to all nature of personal property security interests. Finally, any new proposed legislation should be business enterprise legislation; not-for-profit entities, for the time being at least, would continue to be governed by the existing regime.

47. As a consequence of the narrowing of the focus of companies law in Hong Kong, working party members raised several cautionary flags. Over-regulation was to be avoided. It would be important in the new characterisation of companies law matters to avoid creating overlap or, conversely, regulatory gaps with other legislative initiatives proceeding apace in Hong Kong. In particular, given the significance for the economy in general, coordination of the reforms to companies law and securities legislation would have to be assured in the interests of investor protection and integrity of the capital markets. Working party deliberations concluded December 21, 1995 and a Report on Module 1 was prepared in February 1996 for limited circulation.

48. *Working Party 2: Corporate Formalities.* The working party for Module 2, Corporate Formalities, then turned to consider a new framework for companies law in Hong Kong, building upon the core companies law elements of the current Ordinance and drawing upon models in other jurisdictions. It was felt that the United Kingdom, given its convergence with European company law, would in general be a poor source, although in some specific areas it might provide useful guidance. In terms of scope, this working party covered the widest area with a considerable degree of consensus emerging as to the optimum approach.

49. Two "big picture" issues engendered considerable debate. Without a doubt the desirability of a separate legal regime for small or private companies (reference was often made to the South African Close Corporation Act 1984) was the most discussed issue. The decision to proceed on the basis of a single, flexible regime that would accommodate both public and private companies treating small, closely held companies as the norm did not leave all working party members convinced. A separate part of the new Ordinance (rather than a separate Ordinance) would contain provisions tailored to the private company.

50. A second major concern, raised primarily by the Registrar of Companies and the Deputy Crown Solicitor, was the balancing of formal enforcement mechanisms against "self-enforcement" in the form of civil remedies. Approbation was given to the creation of a self-enforcing corporate regime that would permit the "decriminalisation" of company law in Hong Kong. Investigatory powers would be left as a residual recourse in exceptional circumstances.

51. One step incorporation, with the possibility of one-person incorporation, was found to be desirable. Retention of an optional standard form corporate constitution was favoured. Abolition of the *ultra vires* doctrine was also looked upon with favour. There was little objection to making the capital structure requirements more flexible and the abolition of par value shares was generally supported as was the ability of private companies to dispense with a board of directors if shareholders were effectively performing the role themselves. The question of the use of a solvency test in corporate distributions such as dividends and share redemptions was discussed with interest.

52. With regard to share transfers, although it was generally felt that the current system was problematic, there was little in the way of clear consensus; it was suggested that as this was an evolving area of law, it would be best not to deal with it in the Ordinance. There was also a good deal of discussion of the use of uncertificated securities. European-inspired book entry shares, which are found in one Taiwanese corporate form, were discussed, although the issues of poor upkeep of the books and deliberate fraud were raised.

53. As to financial disclosure and audits, it was agreed that the Tenth Schedule to the current Ordinance should be eliminated. All companies should be required to prepare accounts giving a true and fair view of their affairs in accordance with generally accepted accounting principles in Hong Kong. The possibility of exempting small companies from this requirement was not generally accepted. With regard to audits, it was felt that they should be the "default position" although not mandatory for all companies.

54. Concerning fundamental changes to corporate form, the issue that was most discussed was that of so-called "import/export", or continuance, provisions: reservations about their possible abuse were raised. It was noted that such provisions were not only used to enable companies to be exported to "offshore" jurisdictions offering a laxer regulatory regime, but also to permit local companies to diversify and restructure their international operations.

55. *Working Party 3/4: Shareholders and Directors.* The closely related issues raised by shareholder rights and remedies and directors' duties were dealt with by a single working party. Although there was considerable consensus with respect to proposals concerning directors, the breadth and range of various shareholders remedies presented to the working party evoked debate.

56. With respect to directors, it was generally agreed that a two-tier board structure was not a desirable innovation in Hong Kong; that there should be a statutory statement of directors' duties; and that the rules governing directors' conflicts of interest should be more stringent.

57. As to shareholders remedies, at issue was the sanctity of majority rule. A range of remedies was discussed with the so-called appraisal remedy or buy-out remedy being greeted with a fair amount of dismay by some members. They felt that this remedy gave a disproportionate amount of power to minorities which could use it as a means of holding a company to ransom. The utility of a statutory derivative action was also met with a certain amount of scepticism. Considerable support was voiced for the strengthening of the unfairly prejudicial remedy, found at s.168A of the current Ordinance. Statutorily sanctioned unanimous shareholder agreements as a means of corporate governance in private companies were also queried. A constant thread running through the discussions on shareholders remedies was their effectiveness given the high cost of private litigation in Hong Kong, although their deterrent effect was acknowledged. The desirability of encouraging recourse to alternative dispute resolution, either in the form of contractual or arbitral mechanisms, was underlined. Shareholders remedies were also discussed in the context of Module 2, where new remedies were viewed more favourably.

58. *Working Party 5: International Aspects.* Consideration of the last Module, that dealing with the dual issues of the international business company and the regulation of

foreign incorporated companies operating in Hong Kong, raised the more theoretical issues of private international law. In recent years, foreign incorporated Hong Kong businesses have proliferated. Questions have arisen as to the extent to which substantive provisions of the Hong Kong Companies Ordinance should be made applicable to these entities on the basis that they are, in fact, Hong Kong businesses despite their foreign jurisdictions of incorporation. The practical consequences, however, in terms of recommendations for a new Ordinance, were minimal. There was general support for a new "carrying on business" test for oversea companies for registration purposes under the new Ordinance. Implementation in Hong Kong of an international business companies regime (such as found in offshore jurisdictions) was not supported.

59. The recharacterisation of insolvency and securities law matters, in particular, and their incorporation in separate legislation should address some of the thornier issues of the extraterritorial application of Hong Kong companies law. The SFC and the SEHK should be able to provide the regulatory oversight necessary in the public interest with respect to foreign incorporated companies raising capital in the Hong Kong markets. A modern, streamlined companies legislation in Hong Kong should also make Hong Kong incorporation more attractive, as it should be, to Hong Kong businesses.

60. In conclusion, the module approach did raise some difficulties of continuity; new working party members in the later modules arrived "cold" to issues that had received extensive consideration earlier in the process and were briefed on prior discussions and decisions. On the other hand, the Review did have the benefit of very diverse viewpoints and "fresh eyes" on an ongoing basis. Furthermore, working parties could be formed to include persons with particular interests or expertise.

61. ***Consultants.*** There was considerable interest expressed in the Review over its course by academics and law reform bodies around the world examining similar issues. Comments and assistance were provided, primarily over the Internet, by academics in Europe, the U.K., South Africa, Singapore, Australia, New Zealand, Canada and the United States as well as the PRC. In addition, former members of New Zealand's Law Commission, the Corporations Law Simplification Task Force (Australia), the Corporations Directorate of Industry Canada, the Department of Trade and Industry in the U.K. and the Company Law Committee of the U.K. Law Society, all provided valuable and timely information. Professor Vanessa Stott from Hong Kong Polytechnic University and Professor Philip Smart from the University of Hong Kong both assisted in preparation of background papers.

The Review engaged three outside consultants at various times. Mr. David Goddard, who had participated in the preparation of the New Zealand Law Commission's report on company law reforms which led to implementation of the New Zealand Companies Act 1993, provided the benefit of very recent law reform experiences in this area. Professor Len Sealy, the S.J. Berwin Professor of Corporate Law at Gonville and Caius College, Cambridge University, provided ongoing assistance and commentary at every stage of preparation of this Report. Mr. John Howard, one of the three original members of the Dickerson Committee responsible for the Canada Business Corporations Act, also provided assistance and commentary in the final stages of preparation.

MAJOR CONSIDERATIONS FOR THE REVIEW OF THE HONG KONG COMPANIES ORDINANCE

The International, Regional and Local Context of Hong Kong Companies Law

62. ***Hong Kong Companies Law in the International Arena.*** Hong Kong is a major international centre for trade and finance, out of all proportion to its size. A recent study of the competitiveness of the Hong Kong economy by Professor Michael Enright of the Harvard Business School identified Hong Kong's "unique set of strengths":

> Hong Kong's strong economic performance has been due to its location, its people and a distinct economic system. This system is characterized by unique balance and interaction between government and business, between local and overseas firms, between strategies of hustle and commitment, and between management and entrepreneurship. These combinations have allowed Hong Kong to emerge as an economic powerhouse with an influence in the global economy that goes far beyond what would be expected given its size. Hong Kong is far more than a passive bridge, gateway, or entrepot. Instead, Hong Kong and its firms are active packagers and integrators of activities for the local, regional, and global economy, matching demand and supply on an international basis.
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> ...
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> Hong Kong is home to a unique mix of thousands of local firms with transnational operations or sales and over eighteen hundred overseas firms with offices or operations in Hong Kong. The combination of entrepreneurial companies and managerial companies found in Hong Kong is distinctive in the Asian context. Hong Kong also has a unique mix of firms employing "commitment strategies" based on large scale investments in industries with relatively stable cash flows such as transportation, infrastructure, property, and utilities, and firms employing "hustle strategies" based on flexibility, rapid response, competitive pricing in industries such as garments, toys, electronics, and trading. It is the interaction of the components of each combination, rather than the presence of any one component, that has created advantage for Hong Kong. (M. Enright *et al. The Hong Kong Advantage: A Study of the Competitiveness of the Hong Kong Economy* (Hong Kong: Vision 2047, 1996) (Enright), Executive Summary at 1-2).

Hong Kong's place at the centre of rapid internationalisation of trade and finance has several important implications for its commercial law.

63. At the highest level, the existence of an internationally recognised body of commercial law in Hong Kong has undoubtedly been one of the attractions for international businesses basing their regional activities in Hong Kong. However, this has meant that Hong Kong legislation, in important commercial areas such as securities, companies, insolvency, finance, does not exist in isolation. It operates in the international arena and is held up to international scrutiny as never before.

64. Usually, company law serves primarily local interests, Delaware and the multitude of small offshore incorporation jurisdictions being the notable exceptions. Company law tends to have a local face. There are not the same international pressures towards uniform international standards which have manifested themselves, for example, in banking or financial markets regulation.

65. Nonetheless, there are identifiable trends in the structure of and regimes applicable to commercial entities in major trading jurisdictions which have produced international expectations, if not international standards. Hong Kong companies legislation should at the least meet these international expectations. Based as it now is on a 1948 U.K. statute, it does not. Foreign interests doing business here are often surprised at some of the more archaic aspects of Hong Kong companies legislation, for example, the requirement that a company have two shareholders.

66. The internationalisation of commerce has also provoked a convergence of thought and approach in different jurisdictions, where commercial activity is raising similar problems for which existing legal regimes may no longer have an adequate response. Even corporations law regimes in jurisdictions as different in approach as the United States and continental Europe are learning from each other (see M. Roe, "Some Differences in Corporate Structure in Germany, Japan and the United States" (1993) 102 Yale L.J. 1927). A more detailed discussion of this phenomenon is contained in the Comparative Survey.

67. The internationalisation of commerce is also sparking heightened competition among jurisdictions. Singapore, Shanghai, Taiwan, Sydney are all positioned as rivals to Hong Kong as regional centres for business in Asia. The Enright study notes that competitors are improving and trying to duplicate or surpass Hong Kong's strengths. Although he concludes that competitors are unlikely to "out Hong Kong" Hong Kong anytime soon they are narrowing the gap or the perceived gap (Enright at 4-5). Commercial infrastructure is identified as one of Hong Kong's advantages; commercial law is an important if intangible component of the commercial infrastructure. Enright exhorts Hong Kong to stay "ahead of the curve in infrastructure, education and training for the economy of the future" (Enright at 10).

68. A recent study by the HKSA sounded a similar note. Prevailing corporate governance practices in Hong Kong taken as a whole were "respectable by international standards and high by regional standards." The study goes on to flag the increasing competition in the region and the importance of continuous improvement in the business environment: "However, to maintain and enhance Hong Kong's image as an international financial and commercial centre amidst increasing competition, particularly those from the region, Hong Kong needs to continually improve its business environment, including its method of corporate governance to ensure investor confidence" (Hong Kong Society of Accountants, Second Report of the Corporate Governance Working Group, January 1997, at 3).

69. In terms of "staying ahead of the curve" in the legal infrastructure, the lead is coming from the financial markets in Hong Kong. This is an area of rapid specialisation, considerable technicality and a very high degree of international integration and interdependence. It is a major Hong Kong industry and one that must be regulated with great finesse. The SEHK and the SFC, as well as the Monetary Authority and the Futures Exchange, are all very much plugged into the international financial community and its regulatory structures. Regulation and commercial practices are responsive to and driven by international standards.

70. The emergence of Hong Kong as a major international financial centre has only served to highlight the inadequacies of outdated companies legislation. Old-fashioned Hong

Kong companies legislation is now out of step with the modern regulation and oversight of capital markets of which it is an essential part. It is not surprising then that the comments submitted to the Review by Mathew Harrison, Director, Research and Planning at the SEHK in November 1995 are to the following effect:

- [...] I see the need for a fundamental review as urgent. The total costs to the business community of poorly drafted legislation - in terms of management time, professional fees, and general uncertainty - are very great. Conversely, clear and simple business legislation is a major "national" asset.

- The proposal to unbundle the Companies Ordinance into a core company law and various pieces of specialist legislation seems a good one. If this effort is successful, Hong Kong's business statutes could overleap the burdensome process of modernisation in which the UK and other advanced countries are floundering and reach a "post-modern" era in one bound. (Letter of Matthew Harrison (Director, Research and Planning - SEHK) to Ermanno Pascutto (14 November 1995)).

The recommendations that follow attempt to fashion a companies law regime that will be contemporary and compatible with the directions taken in financial markets regulation.

71. ***Hong Kong Companies Law in the Asia Pacific Region.*** Hong Kong is very much a regional business centre as well as an international one.

> Hong Kong also is uniquely situated at the most important economic crossroads in the world today, between East and West, between East and East (intra-Asian trade and investment), between North and South, between industrialized and developing nations, between capitalist and reforming economies, and between China and everywhere else. Hong Kong is well situated in the center, both literally and figuratively, of the most dynamic economic region in the world today.
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> ...
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> Hong Kong also has emerged as the de facto capital of the overseas Chinese business community which is playing a powerful role in the growth of the economies of east and southeast Asia. This has increased Hong Kong's importance as a conduit between overseas Chinese and opportunities on the Mainland and elsewhere in Asia. It has enhanced Hong Kong's position as Asia's leading headquarters location for overseas firms and one of the world's principal sources of foreign direct investment (Enright, *supra*, at 3-4).

As such, Hong Kong's companies legislation operates primarily in the Asia Pacific region.

72. History has made of the Asia Pacific a region of great diversity, politically, economically and legally. As documented by Gordon Redding and others, a unifying thread in the commercial activities of the region has been the phenomenon of the overseas Chinese business empires, large and small. The overseas Chinese business community provides the common denominator for business structures and practices throughout the region. Although overseas Chinese comprise only six percent of the population of ASEAN nations, they exercise economic influence out of all proportion to their numbers. Notable characteristics of overseas Chinese businesses include an emphasis on informal networking, networking along ethnic/linguistic lines, and aversions to litigation and debt. The most notable characteristic is the use of the family controlled company by businesses both big and small (Review, *Family-Controlled Companies Background Memorandum*, at 1-3). The Second

Corporate Governance Study of the HKSA confirmed the "widespread view that the extent of control by one shareholder or one family group of shareholders in the shareholding of listed companies in Hong Kong is significant" (at 4). Almost 90% of all Hong Kong listed companies have one shareholder or one family group of shareholders owning 25% or more of their entire issued capital; 77% show one shareholder or family group owning 35% or more of the entire issued capital, and more than half have one shareholder or family group owning 50% or more. Business enterprise legislation in Hong Kong should be responsive to the needs of family controlled companies; some of the ways in which this may be accomplished are discussed in the Recommendations for Part 10 of a new Ordinance.

73. In terms of legal regimes, however, the source of greatest diversity in companies law throughout Asia is the mix of the two major Western legal traditions, the civil law and the common law, which overlay local and perhaps religious law which predate them. Each legal tradition takes a distinctive approach to business enterprise law (discussed in greater detail in the Comparative Survey), using different structural techniques and balancing different interests. Although some jurisdictions have successfully implanted elements from the different traditions into their business enterprise law, indiscriminately mixing and matching legal regimes can produce undesirable results. Malaysia, Singapore, Australia, New Zealand and Hong Kong originally aligned their legal regimes with the U.K. version of the common law tradition, whereas much of the rest of Asia has looked first to European civil law. This traditional alignment is breaking down, as North American influences make themselves felt in the commercial law area.

74. Adding to the diversity of approach to business enterprise law in the Asia Pacific region is the interaction of developed market economies, such as Hong Kong's and emerging market economies such as those of the PRC and Vietnam. Much of Hong Kong's phenomenal rise to prominence has been attributed to a wide open approach to doing business free of government intervention. The emerging market economies around it are, on the contrary, subject to highly interventionist policies and only at the very beginning of a long process of creating the legal infrastructure to support a significant level of market economy activity. The business enterprise legislation required to promote their objectives may need to be structured quite differently from that of a developed market.

75. It is for these reasons that companies law in Hong Kong will likely continue upon a different path of development from that in the People's Republic of China. Throughout the course of this Review the question has been asked as to the degree to which Hong Kong companies law should be aligned with that of the PRC (for a more detailed discussion of which, refer to the Comparative Survey). The answer is that Hong Kong companies law proceeds from a different starting point and will continue to be distinct from that of the PRC for the foreseeable future.

76. First of all, it is so stipulated in the Basic Law, which will serve as Hong Kong's constitution after June 30, 1997. Article 8 of the Basic Law maintains the existing common law legal system (that has been operative in Hong Kong for over 150 years) for the next 50 years. The Western legal tradition being gradually reintroduced in the PRC after a hiatus of several decades is primarily European civil law inspired (German law, by way of Japan and Taiwan). Although the PRC has been quite eclectic in its use of foreign models for its 1994 Companies Law, the predominant influence of the German model is quite discernible.

Structural concepts, such as dual boards and worker participation in management, have been astutely turned to socialist market economy purposes but would appear quite alien to the Hong Kong business community.

77. Secondly, the primary purpose of the new PRC Companies Law is "corporatisation" of state-owned enterprises in furtherance of the transition to a market economy. The PRC legislation is a first step, and a good one, towards creation of a more comprehensive companies law. It is essentially transitional in nature and somewhat incomplete pending the further development, among other things, of mature capital markets on the mainland. Hong Kong is a freewheeling market economy with developed capital markets. Over 98% of the companies in Hong Kong are private and virtually 100% are owned by the private sector (as opposed to the state).

78. The PRC has looked to sophisticated commercial legislation from many sources and it is quite possible it will also look to Hong Kong. As Hong Kong has taken a lead in the region in the development of its financial markets regulation, companies legislation setting the standard in the region would be a natural complement.

79. ***Hong Kong Companies Law in the Local Commercial Context.*** *General commercial dealings.* Companies are the prime actors in local business dealings and so considerations respecting third parties are pertinent to companies law reform. Much of the credit for the phenomenal economic success of Hong Kong has been attributed to the non interventionist, free market policies of the Hong Kong government. Balanced against the desirability of these policies, however, are concerns of fair dealing in the marketplace. These concerns have been acute with respect to the public capital markets with both the SEHK and the SFC determined to promote integrity in the market and the containment of commercial fraud. The SFC has spoken of the creation of a "culture of compliance" (SFC, Annual Report 95/96: *A Strategic Outlook for the Future*, at 15).

80. These concerns with commercial fraud are not confined to Hong Kong. The United Kingdom's introduction of the Serious Fraud Office, to combat financial fraud, is one example. However, with the prospect of the transition to a Special Administrative Region of the PRC, concern has been expressed with respect to the possibility of an increase in commercial fraud (See e.g., P. Stein and P.W. Tam, "Hong Kong Market Reform Isn't Fast Enough for Some" *Asian Wall Street Journal* (9 September 1996) at 1). The Commercial Crime Bureau in Hong Kong has jurisdiction with respect to commercial fraud and recently brought before the SCCLR various problems encountered in undertaking investigations into commercial fraud.

81. Although strictly speaking outside the purview of this Review, there are measures related to companies law which would promote a business environment of fair commercial dealing, primarily in the interests of third party trade and consumer creditors. Easily accessible public information with respect to company solvency and creditworthiness is the most important. In a comment letter from the Consumer Council, for example, more public information with respect to undischarged judgment debts was requested. The Consumer Council was also concerned that short of an action for fraudulent trading (which, like all allegations of fraud, is hard to prove), there was very little redress for consumer creditors with a grievance.

82. Very much related to issues of creditworthiness and solvency is the recommendation that a study be undertaken with respect to the creation of a comprehensive regime for personal property security interests. This issue is discussed at greater length in section 1.06 of the Recommendations and Commentary. Two separate issues are involved; implementing a modern regime for the systematic creation of security interests in a whole spectrum of personal property by any person or entity and providing for easy public access to such information. Part III of the current Ordinance, Charges, is inadequate for dealing with the complexity of modern commerce. Modern, sophisticated working models for personal property security interest regimes exist elsewhere. They have already been considered seriously for implementation in Hong Kong. It is time to look again at this, particularly in light of the recommendations being made here for a core company law approach along North American lines. Ideally, intelligent use of information technology could provide centralised access to the information most significant to trade and consumer creditors.

83. *The role of the Companies Registry*. The Registry has traditionally been the primary source of public information with respect to companies registered in Hong Kong and makes a considerable effort to ensure the credibility of the public record. In addition to its important role as a public record keeper, the Registry also acts as a policy advisor on companies law and related legislation. In 1993 it assumed "Trading Fund" status; it must now be financially self sufficient and commercially viable although the Secretary for Financial Services continues to have policy responsibilities for all aspects of the services provided by the Registry. The Registry aims:

- to provide facilities to allow the promoters of companies, limited partnerships and trust companies to incorporate their enterprises easily and to register all documentation required by the various Ordinances governing those enterprises.
- to provide the public with facilities to search for the information held by the Registry.
- to ensure compliance by enterprises and their officers with their obligations under relevant Ordinances.
- to advise the Government on policy and legislative issues regarding company law and related legislation.
- To achieve all the aims described above in an efficient and effective manner and to provide services within time frames and at prices which are acceptable to our customers.

(Companies Registry, *Annual Report* 1995-96 at 6).

This is an ambitious mandate and the Registry must stretch to meet it. In its primary function as a registry, the Registry is coping with the "paper crunch" generated by recent high levels of commercial activity and the major task of implementing the transition to computerised record keeping. In 1996, the number of documents filed with the Companies Registry was up 23%, while searches for the public increased by 0.4%. ("Businesses Boost Registrations In Hong Kong", *Asian Wall Street Journal*, (20 January 1997) at 4). As to its role as a policy advisor, the Registry provides the secretariat to the SCCLR and has been an important contributor to this Review. A difficult issue which has arisen over the course of

the last few years has been that of "enforcement" and the degree to which, if at all, investigatory powers, along the lines of those exercised by the U.K. Department of Trade and Industry, should be exercised in the public interest by the Registrar of Companies.

84. Several major developments have recently impacted on the primary role of the Registry. Needless to say, advances in computerised record keeping and access to public information are at the head of the list. Information technology provides the means of coordinating the availability and reliability of public information pertinent to commercial dealings. In Hong Kong, this is a particularly acute problem. Compared to other jurisdictions, working party members commented on the lack of private sources of credit information. With respect to public and listed companies, the major credit rating agencies are now setting up in Hong Kong and, welcome or not, will be bringing their considerable analytical resources to bear on the Hong Kong market.

85. The question is what information should be mandated for public access. Obviously, information technology permits the treatment and processing of huge amounts of information. With respect to mandatory disclosure of information by companies, however, the Review is recommending that less is more. Information which no longer serves a purpose should not be required, leaving that information which is useful more readily accessible. Disclosure of information by public and listed companies should fall to be determined by the SEHK and the SFC.

86. The other 98.5% of Hong Kong incorporated companies, private companies, should benefit from streamlined public disclosure. The working party members were of the view that while it is useful to make public the identity of directors, information as to the identity of all shareholders is not necessary. (It should be noted here that it is recommended that corporate directors not be permitted). The existing public shareholder registers fall quickly out of date and are not of particular use.

87. The availability of financial information (and the related issue of auditing of accounts) was discussed at some length in the working parties. There was some dispute as to the quality of audits in Hong Kong but none as to the view that the Tenth Schedule, Financial Information, is seriously outdated. With respect to public and listed companies, again, detailed requirements with respect to public financial information should be left to the SEHK and the SFC. The nature of this information will be driven by considerations of the public interest, requirements of the market and developments in international accounting standards. For purposes of the Ordinance (and the vast majority of private companies registered under it), there should be no requirement for public disclosure of accounts. The information is outdated by the time it is put on the register and commercial practices in negotiated transactions provide third parties with greater comfort.

88. The issue of "enforcing" company law is raised in the Terms of Reference; this issue is linked to the role of the Registry. There are in fact several very different issues raised here. The Registry must of course have sufficient authority and resources to administer the legislation it oversees; this is primarily a question of appropriate sanctions for administrative misdemeanours (the current role). As to the level of public intervention in internal company matters, the type of legislation being proposed is highly "enabling" as opposed to "regulatory"; the goal has been to propose legislation which is self-executing and self-

enforcing.

89. The primary purpose of this companies legislation is to facilitate the ordering of private interests. With respect to internal company matters, by providing a broad range of civil remedies, those most directly aggrieved should be able to seek redress, either through the judicial process or alternative dispute resolution mechanisms. The oversight of the public interest involved in banking, insurance, insolvency, financial markets regulation should be left to the Monetary Authority, the Insurance Commissioner, the Official Receiver, the SFC and the SEHK. Allegations of outright fraud should continue to be taken to the CCB. Attached as Appendix 3 is a chart of the current regulatory structure with respect to inspections and investigations in commercial matters in Hong Kong.

90. Currently, the Ordinance contains provisions regarding inspection powers in sections 142, 143 and 152A. Section 142 empowers the Financial Secretary to appoint an inspector upon an application by a minimum of 10% of a company's shareholders or members; section 143 empowers the Financial Secretary to appoint an inspector upon an order of the court; or upon a request made by special resolution of the company; or where there are circumstances suggesting fraud or corporate mismanagement; and section 152A empowers the Financial Secretary to direct a company to produce books and papers to a person authorised by the Financial Secretary. However, these powers are rarely used for various reasons including the costs involved or the staffing implications. In 1994, the SFC was given powers under the Securities and Futures Commission Ordinance, mirroring those in section 152A of the Companies Ordinance, where they are more appropriately invoked in securities laws matters.

> In Hong Kong, the Financial Secretary is the authority for appointing inspectors (under sections 142 and 143 of the Companies Ordinance) or appointing an 'Authorized person' (including a public officer) (under section 152A of the Ordinance) to undertake company investigations. There does not seem to be any merit in delegating the power of appointment any further given that such appointments can be and are made very quickly. Furthermore, the fact that no public officer is specified in the legislation gives the Government the flexibility to determine which public officer should be appointed. In practice, if the Government were to develop an in-house capability to undertake company investigations, this is more likely to be located in the Official Receiver's Office (ORO) rather than the CR and, in this context, it would not be appropriate to specify the Registrar as the public officer responsible for initiating company investigations (Letter of the Registrar of Companies to Cally Jordan (25 April 1996) Appendix 3 at 2-3).

The inspection powers should remain as a residual and exceptional recourse; as it is, they are used sparingly in the pure companies law context given the limited circumstances in which the public interest is invoked and the difficulty in justifying the considerable expenditure of public funds incurred.

91. *Hong Kong companies law through the transition.* One consideration important to any decision as to the future direction of Hong Kong companies law is the political transition of 1997. That there will be such a transition is certain; the extent of the ramifications for the legal system is not. Proposals for the reform of the Ordinance should provide for continuity and stability. Continuity and stability are not necessarily assured by retention of the status quo.

92. Continuity and stability in the companies law area may be better assured by modern, mainstream legislation which can draw on a larger body of law to assist in its interpretation and development over time. This is particularly important with respect to judicial interpretation of statutory provisions at a time when the judiciary and the administration in Hong Kong will be in a state of transition. It will also be important in term of fostering confidence among participants in the international commercial community that business practices in Hong Kong are supported and nourished by an internationally recognisable legal infrastructure.

93. It must be borne in mind that the recommendations in this Report are merely a first step towards a new companies law for Hong Kong. The process of reform will extend well beyond the political transition of 1997. Typically, law reform efforts in this area take a period of five to seven years from inception to full implementation. In this case, the Review is recommending a new Ordinance (rather than a consolidation or reform of the current Ordinance). The Review is also recommending a three to five year transitional period. During this period, all new incorporations would be effected under the new Ordinance and existing companies would continue under the new Ordinance by simple reregistration procedures. This transitional procedure has been used successfully in several jurisdictions.

94. Of course, the efforts at renewal of companies law in Hong Kong are not taking place in isolation. Major initiatives in insolvency and securities regulation are ongoing. Hong Kong's place as a major international financial centre will require rapid responses with respect to capital markets, monetary affairs, and accounting practices, all of which are also ongoing. Hong Kong companies law must also be formed by and responsive to these forces. It is imperative that companies law initiatives be coordinated with efforts in these other areas to avoid inadvertent overlap or omissions which would be highly detrimental to commercial activity.

95. *Proliferation of overseas incorporation by Hong Kong businesses.* A curious anomaly in some respects, given that Hong Kong has rapidly risen to prominence as a major international business centre, is the equally rapid rise of foreign incorporation of Hong Kong business. In some respects, this is a phenomenon sparked by the conjuncture of political, fiscal and commercial forces unique to Hong Kong. Although there is abundant speculation as to the implications of political risk for Hong Kong businesses, strictly financial and commercial factors emerged from working party discussions as primarily responsible for the wave of offshore private company incorporations.

96. The British Virgin Islands (BVI) is the jurisdiction of choice for private foreign incorporations of Hong Kong businesses. Although 1121 BVI companies were registered under Part XI of the Ordinance as of December 31 1996, the vast majority are not registered and their actual presence in Hong Kong is estimated to be over 100,000. Working party members pointed to professional advisors as the driving force behind the proliferation of these offshore incorporations. The speed and ease of incorporation and reduced costs of operation were cited. BVI incorporation has been found to be suitable for both small flat owning companies and as a building block in major commercial conglomerates. The enabling nature of BVI companies law, as well as the absence of stamp and capital duty, ongoing reporting formalities, and the mandatory audit ranked high in the decision to incorporate in the BVI.

97. As for listed company offshore incorporations, political considerations appear to have given way to competitive forces; Bermuda and the Cayman Islands, having been recognised as acceptable jurisdictions of incorporation for listing purposes in Hong Kong, now compete in a variety of ways to attract such incorporations. This does not constitute a "race to the bottom" since both jurisdictions must remain reputable for listing purposes in Hong Kong. In this way, the SEHK and the SFC continue to monitor the standards of corporate governance of these companies by serving as the gatekeepers to their entry into the public markets in Hong Kong. Both Bermuda and the Cayman Islands are promoting their responsive legislation and fine professional and back office services as primary attractions.

98. The recommendations in this Report are geared primarily to structural features either common to public and private companies or exclusively related to private companies. Public and listed companies will, by definition, be of a sufficient size and economic significance to engage sophisticated professional advisors to structure their affairs; such structuring may point to offshore incorporation. This should not be of undue concern given that oversight of their financial market activities in Hong Kong should be subject to the SFC and, in the case of listed companies, the SEHK as well. The core company law approach contemplates removal of securities law from the current Ordinance and anticipates enactment or reenactment in separate securities legislation.

99. With respect to private companies on the other hand, there are much stronger arguments for actively promoting local Hong Kong incorporations, shareholder protection and the maintenance of respectable standards of commercial dealing being among them. Small businesses should prefer Hong Kong incorporation; it should be in their best interest. The remarkably high incidence of foreign incorporation of private companies by Hong Kong businesses is very much at odds with the usual bias of such businesses in favour of the convenience and predictability of local incorporation. This fact alone speaks eloquently to the proposition that the current Ordinance "ain't broke"; if Hong Kong is not the jurisdiction of choice for the incorporation of private Hong Kong businesses, something is decidedly wrong.

100. It should be noted that much of the evidence with respect to foreign incorporation of private companies by Hong Kong businesses, while fairly reliable, is anecdotal. Many such companies would not, and would not be required to register under Part XI of the current Ordinance. It may be that Hong Kong incorporation is experiencing a renewed popularity; for example, there has been a significant increase in the number of Hong Kong incorporations from November 1996 to December 1996 (7,092 compared with 4,891), likely attributable to a sharp increase in property transactions. In any event, modern North American style companies legislation would provide many of the features of speedy, easy incorporation and cost efficient operation to rival the BVI, but with the added respectability of legislation designed to operate in reputable jurisdictions with a high level of commercial activity.

A Model for Hong Kong Companies Law

101. ***The Orphaning of Hong Kong Companies Law.*** Until recently, Hong Kong, like

other Commonwealth jurisdictions, looked exclusively to the United Kingdom in structuring its public institutions and formulating its legislation, for a variety of obvious reasons. Other small jurisdictions as different as Singapore and New Zealand have done the same, essentially importing legislation developed elsewhere, and relying on the judicial and other resources of that jurisdiction to "maintain" the local legislation. Professor Walter Woon of the National University of Singapore and others have spoken of "legislation by Xerox". In Hong Kong, the process has been an even more natural and integral one, Hong Kong being an extension of British territory.

102. There is still much merit in aligning Hong Kong legislation with that of another jurisdiction, perhaps even more so given the broad considerations mentioned above. The current difficulty resides in the fact that in this particular area of the law, the United Kingdom no longer provides a model that is easily emulated. The difficulties presented by U.K. companies law are canvassed in detail in the Overview and the Comparative Survey prepared for this Review. The last major review of Hong Kong companies law, as long ago as 1973, noted that it would no longer be possible to look as a matter of course to U.K. law as a model for Hong Kong companies law. Since then the difficulties of following a U.K. model have been exacerbated by successive waves of complex and marginally successful companies legislation in the United Kingdom. Hong Kong companies law has been orphaned.

103. In fact, Hong Kong companies law has been looking elsewhere for direction for quite some time now, as have, to a greater or lesser degree, other common law jurisdictions including South Africa, Singapore, New Zealand, Australia and Canada. Recent initiatives to abolish the noisome doctrine of *ultra vires* in Hong Kong have looked to the Ontario Business Corporations Act. This initiative, however, also serves to illustrate the potential pitfalls of incorporating isolated provisions taken from foreign legislation which proceeds from different assumptions and underlying concepts. The Ontario legislation is specialised business corporations legislation, by its terms not applicable to the broad range of different entities, such as not-for-profit enterprises, which may be created under the current Ordinance. The Ontario provisions, assuming as they did, applicability exclusively to commercial entities, could not be dropped, unaltered, into the Hong Kong legislation.

104. ***A New Model for Hong Kong Companies Law.*** It is primarily for this reason that this Report recommends a shift to a new, coherent model rather than cobbling bits and pieces of foreign legislation together with the current Ordinance. The piecemeal approach to legislative change in this area has been criticised both in the United Kingdom and in Hong Kong. A new model will provide a coherent legislative framework for commercial entities in Hong Kong, internally consistent, conceptually clear and well articulated. What is proposed is not the old "legislation by Xerox". The use of model legislation, as it has been developed of necessity in federal jurisdictions such as the United States and Canada, is much subtler and more flexible.

105. The model provides the basic principles and structure of the legislation which can then be adapted in detail to local circumstances. With its fifty state jurisdictions, the United States has been a consummate master in developing this technique. Model laws, such as the MBCA, are developed by bodies like the American Bar Association, drawing on the vast resources available to them among practioners and academics. A detailed official commentary is

provided section by section explaining the origins, purpose and intended operation of the model legislation. The legislation is then adopted voluntarily on a state by state basis, being tailored and adapted as each state wishes. Over time, the model itself is revised and updated.

106. In this way, the costs of developing and maintaining sophisticated and responsive legislation are spread across many states. Individual states are free to adapt the model legislation as they wish, but the basic principles of the model continue to inform local legislation. Reference can continue to be made to developments and evolution in both the model and judicial decisions in other jurisdictions using the model. This process has also been taking place, informally, among Commonwealth jurisdictions which share common roots; legislators and the judiciary in Commonwealth countries look increasingly to each other rather than back to the United Kingdom. Of course, given its wealth of sophisticated commercial legislation, everyone looks to the United States, if not to follow, then as a benchmark against which to act.

107. The recommendations which follow are drawn primarily from four interrelated sources: the U.S. MBCA (1984) (revised annually since then), the ALI Principles of Corporate Governance (1994), the CBCA (and its provincial variants) and the New Zealand Companies Act 1993. The MBCA and the ALI Principles of Corporate Governance represent the expression of modern and sophisticated thinking in companies law. The MBCA provides the structural and conceptual framework upon which to build new legislation, as it did for the Canadian and New Zealand legislation. These U.S. sources can also provide the ample annotation and a rich body of commentary to inform the legislation and guide practitioners and the judiciary alike.

108. The Canadian and New Zealand legislation impart Commonwealth sensibilities to the U.S. model; they share the same U.K. roots. In particular, the prevalence in both New Zealand and Canada of majority held, publicly-traded companies and family controlled businesses (characteristics shared with Hong Kong) argues for a different balancing of shareholder/management powers than in the United States. As well, unlike the United States, the Commonwealth jurisdictions tend to be considerably more litigation averse in commercial matters. Mediation and other alternative dispute resolution mechanisms should be highly appropriate to Hong Kong business and are now becoming firmly established in Canada in commercial matters (see e.g. J. McFarland, "Companies Move Away from Courtroom Battles" *The Globe and Mail* (22 November 1996) B-19). The New Zealand and Canadian legislation also provide the additional benefit of working legislative models; this is legislation which is operating in the real world, in the case of the Canadian legislation for over 20 years. In addition to an established body of case law and practice which can be drawn upon by the judiciary and practitioners, recourse can be had to administrative practices that make the legislation work.

109. Finally, the use of internationally recognisable models for companies law will enhance Hong Kong's role as a centre for international and regional business. The form of legislation proposed meets modern international expectations and should promote the use of Hong Kong incorporated entities for international business in the region. In addition, by developing modern companies legislation adapted to the Asian environment, the Hong Kong legislation could become the model and the benchmark for the region.

Major Areas of Reform

110. The overall objective of the following recommendations is the simplification, rationalisation and modernisation of Hong Kong companies law. Although the recommendations address every major aspect of companies law, there were six substantive areas in particular which commanded attention: the "core company law" approach, the private company, the family controlled company, minority shareholder rights and remedies, directors' duties and conflicts of interest.

111. ***Simplification, Rationalisation and Modernisation.*** Rationalisation, simplification, streamlining, codification, these are some of the key words of the Terms of Reference for the Review. In December 1993, Australia, which like Hong Kong had long been in the thrall of U.K.-style companies law, embarked on an ambitious Corporations Law Simplification Program. The objectives of the Australian initiative have a resonance for Hong Kong:

> Action to simplify the content will concentrate on those sections of the law where policies:
>
> - are unclear or uncertain or no longer relevant
> - do not cater for the needs of small business
> - place undue regulatory burdens on business
> - thwart the efficient operation of the law
> - do not achieve their objectives on technical grounds
>
> The objective is to streamline the law, procure consistency and coherence, strip away unnecessary complexities, maintain effective protection for investors, and bring significant cost benefits both to business in complying with the law and to relevant authorities in administering it (Australia, Corporations Law Simplification Program Task Force, Plan of Action (December 1993)).

The choice of a "core company law" approach, such as that adopted in New Zealand and Canada, has been primarily dictated by the Terms of Reference in this respect.

112. *Core Company Law Approach.* The recommendations in this Report propose to separate out from companies laws insolvency and securities regulation, in particular. This would leave companies law to concentrate on the "birth, life and death" of companies, or "core company law". The core company law approach, with its dissociation of securities regulation and insolvency matters from company law, is also highly consistent with the current direction being taken in these matters in Hong Kong. The SFC has recently published a consolidation bill (*A Draft for a Composite Securities and Futures Bill* (Hong Kong: SFC, 1996)) which proposes to rationalise and consolidate provisions in the existing 11 Ordinances that deal with securities law matters; this is a first step. The SFC has also published a three year plan (*Corporate Plan, 1996/97-1998/99* (Hong Kong: SFC, 1996)) designed to build a modern securities law regime for Hong Kong.

113. The Law Reform Commission of Hong Kong has also published several reports, the recommendations of which are now beginning to make their way into legislation, with a view

to establishing a comprehensive insolvency law regime in Hong Kong. Both insolvency and securities laws have developed into highly specialised and technical areas of the law in modern times. They have been developing outside the confines of the Companies Ordinance for some time now in Hong Kong. The recommendation to complete their separation is merely recognition of this fact.

114. *Simplification and rationalisation.* For future companies law in Hong Kong, however, the result of these developments is salutory and very much in keeping with the Terms of Reference. By removing these highly specialised and technical areas from companies law, it is possible, with one stroke, to greatly simplify and streamline the legislation. Removing the insolvency-related provisions alone from Part V, Winding Up, would reduce the bulk of the current Ordinance by approximately one-third.

115. As to the structure of the proposed new Ordinance, it is familiar terrain; the "core company law" parts of the current Ordinance have been retained but Part IV, Management and Administration, another mammoth chunk of the Ordinance, broken into its component parts: management and administration, directors and executive officers, shareholders, fundamental changes. Various miscellaneous parts that are of historic interest only have been eliminated; others of marginal utility have been rethought, eliminated or rolled into a larger part. The resulting proposed structure of the new Ordinance draws from the current Ordinance but is now more in line with modern corporate statutes.

116. *Drafting Style.* Simplification and modernisation does not stop at substance. A sample of model legislation appears at Appendix 10 to illustrate the clarity and conciseness which is possible in modern legislative drafting in this area. The process of amendment by accretion in the U.K. companies acts has resulted in legislation which is complex and archaic in many respects. This is not to say that legislation can always avoid the burden of complexity in highly technical areas (U.S. securities regulation springs to mind) but rather that in companies law it can be avoided. The CBCA, the U.S. MBCA and the New Zealand Companies Act 1993 are testimony to this assertion. Simplification of drafting style, and a move away from the Victorian (or earlier) language of the U.K. statutes is also under consideration generally in Hong Kong as ancillary to the preparation of bilingual legislation. Where there has been a transition to bilingual or multilingual legislation in other jurisdictions, the discipline of the process has instilled a belief in the virtues of simplicity and clarity. Modern legislative language which demonstrates these virtues will go far in easing the transition and avoiding unfortunate divergences of interpretation and opinion.

117. *Modernisation.* Modern language, modern ideas. The sample of model legislation exemplifies the language of a modern corporate statute. Substantively, the recommendations that follow draw from modern corporate legislation; they reflect current issues and current thinking. The goal is to bring Hong Kong companies law into line with international expectations and to take account of the predominant trends in other major trading jurisdictions.

118. ***Main Areas of Modernisation and Simplification.*** *Corporate Formalities.* Much of the work in Module 2: Corporate Formalities was undertaken with the goal of modernisation and simplification of the Ordinance. Simplified one-step incorporation techniques, elimination of unproductive filings and formalities, especially with respect to private companies, and the

elimination of a multiplicity of archaic company forms are means to this end.

119. *Modernisation and simplification of capital structure.* The recommendations replace rigid and archaic capital maintenance tests with the modern, fluid, solvency based tests. The goal is to provide great flexibility in structuring capitalisation, consistent with the vast array of modern financial instruments. With the elimination of the concept of capital maintenance, many of the conceptual concerns associated with share repurchases and other run-of-the-mill corporate reorganisations fall away.

120. *Simplification of accounting and audit requirements.* Concomitant with the great changes in corporate finance techniques have been enormous changes in accounting standards as well. Hong Kong is in the process of bringing its generally accepted accounting principles into line with internationally accepted accounting principles. This move is very much driven by the pace and intensity of international capital market activity. An example of this trend is the SFC's participation in the International Organisation of Securities Commissions' technical committee, most notably in the Working Party on Multinational Disclosure and Accounting, which has as its objective the creation by 1999 of a set of core accounting standards for use in international equity offerings (*SFC Annual Report 1995-1996, supra*, at 55). Accounting standards can not be frozen in the Tenth Schedule; it is outdated and impossible to keep current. The accountants on the working parties applauded the suggestion of removing accounting standards entirely from the companies legislation; reference would be made to external Hong Kong accounting standards as developed by the Hong Kong Society of Accountants or an independent accounting standards board such as exists elsewhere.

121. The recommendations also suggest removal of the mandatory audit requirement for private companies. Audits may be left to the pressures of commercial practice. The view was expressed that the Inland Revenue Department was placing too much reliance on the auditing requirement in the current Ordinance. Indications are that the Inland Revenue Department, in any event, is moving towards greater use of field audits and self assessment, following practices in the United States and Australia.

122. *Solvent restructuring, reorganisation and dissolution.* Removing insolvency considerations from the Ordinance does a good deal more than reduce the bulk of Part V. Various forms of solvent corporate reorganisation can be implemented with little formality and without recourse to judicial approval. Equally, confining the companies legislation to procedures for solvent dissolution and liquidation permits great simplification. The procedures proposed in these recommendations are drawn from the U.S. MBCA; they are simple, elegant and effective.

123. *Decriminalisation of the companies legislation.* One of the primary goals of the South African Close Corporation Act 1984 was the "decriminalisation' of old U.K.-style companies law. Modern corporate statutes contain very few "offences"; they are not criminal in nature. These statutes rely upon self-enforcement mechanisms and the availability of civil remedies for those aggrieved. In commercial matters generally there is greater reliance being placed on non-litigious dispute resolution techniques, with great success. The Twelfth Schedule of the current Ordinance, with its 167 offences, can be eliminated. Those offences which it is judged useful to retain can be consolidated into more generic categories and regrouped

elsewhere.

124. ***The Private Company, The Family Controlled Company, Minority Shareholder Rights, Directors duties and Conflicts of Interest.*** *The private company.* Nearly ninety-nine percent of Hong Kong companies are private. Of the 483,181 companies registered in Hong Kong as of 31 December 1996, 477,140 are private companies. One of the major criticisms directed against the current Ordinance is that it is based on 19th century legislation designed to accommodate the joint stock company, i.e. a commercial vehicle with public subscribers. The suggestion was made, at times forcefully, that modern companies legislation should be designed primarily to accommodate the most prevalent form of company, the private company, and not the public company.

(1) A separate regime for a close/proprietary/owner-managed companies is preferred, for the following reasons:-

- drafting a new set of legislation embodying new concepts and principles is easier and quicker than amending existing legislations with different assumptions and concepts
- users have a choice
- re-registration is not necessary, thus lesser hazards for the users
- where the new co-exists with the old, professional inertia and vested interests obstruction can be lessened
- in the unlikely event that the new regime does not work well, there is still the "old regime", with its back-up case laws, to fall back on, hence ensuring continuity and certainty of the Law (submission by SME Committee of the Hong Kong General Chamber of Commerce to the Review, 14 February 1996).

A subject of debate was the creation of a separate ordinance for the private company, along the lines of other specialised vehicles such as the South African close corporation or even the U.S. limited liability company (or one of its offshore variants).

125. The recommendations which follow do not advocate creation of a separate private company ordinance but do in fact propose a structure and regime that very much has the private company at the fore. The proposed framework for a new Ordinance draws heavily on North American models, which in fact, cater to the private company. Securities regulation in North America has a long history and has developed a regulatory framework for many of the activities of public companies that would have been found in a U.K. companies act a decade ago. The result in North America has been quite streamlined corporate statutes, largely devoid of the more complex technical regulatory mechanisms triggered by public investor protection concerns.

126. The framework legislation proposed would apply equally the "core company law" to all companies under the legislation. In addition, however, the recommendations go further in permitting the elimination of artificial and unnecessary formalities for private companies where there is no distinction between ownership and management. It should be possible to

dispense with the board of directors, for example.

127. *The family controlled company.* Closely related to the issues raised by the private company is the family controlled company. Many private companies are family controlled of course. In Hong Kong, as in many other jurisdictions, however, many public and listed companies are also family controlled. Recent statistics indicate that family controlled business accounts for 99% of Italian businesses, 70% of Portuguese, 75% of British, 80% of Spanish, 85-90% of Swiss, 90% of Swedish and 80% of Canadian. Even in the United States, noted for its widely held public corporations, 80 to 95% of businesses are family controlled. The ALI Principles of Corporate Governance note the prevalence of "second tier" public companies in the United States which have a majority shareholder or family holding.

128. The prevalence of family controlled companies, and the characteristic issues related to them, is very characteristic of but not unique to Hong Kong. Family controlled companies raise two related issues in particular,the treatment of minority shareholders and dispute resolution mechanisms. In family controlled companies, there may very well be a need for a wide variety of minority shareholder remedies which facilitate exit and compensation in the absence of a liquid market for the shares and without recourse to judicial action. Dispute resolution is also high on the agenda of family controlled companies.

129. Family controlled companies are not necessarily more prone to disputes than other business but the nature of the disputes are more predictable and have been documented extensively. Recent statistics support the adage that "wealth does not last more than three generations." A great many disputes centre around the succession process which determines the control and future direction of the family controlled company. There is greater reluctance to resort to judicial intervention and a greater premium placed on privacy. Contractual dispute resolution mechanisms such as are found in partnership agreements, statutory appraisal and buy-out remedies which permit exit without judicial intervention, and alternative dispute resolution are more acceptable than litigation.

130. *Shareholders remedies.* The move to a highly enabling regime of corporate law promotes

> ...a largely unqualified system of majoritarian control. The justifications for this system are both that it promotes economic efficiency by enabling the corporation to accept entrepreneurial risks that a minority might wish to veto and that alternative protections -such as class voting and the appraisal remedy - are sufficient to protect minority rights. Absent majority rule, the corporation might face considerable difficulty in expanding into new fields, might be hindered in its ability to meet new business conditions or opportunities, and might often be unable to effect a sale or other disposition of its assets (ALI Principles of Corporate Governance, vol. 2, at 291).

131. The balance to this "largely unqualified system of majoritarian control" is an array of shareholder remedies, primarily to the benefit of minority shareholders. "Yet, no single technique of accountability (including market and legal remedies) is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations, and, as a result, shareholders are best served by an overlapping system of protections" (*ibid.* at 5). These recommendations propose such an overlapping system of protections.

132. The statutory derivative action has long been discussed in Hong Kong and its introduction would put a well deserved nail in the coffin of that 1843 nuisance, *Foss* v. *Harbottle*. In the United States, in a highly litigious environment, the derivative action has not spawned a torrent of unproductive litigation. Only a minority of public companies ever experience such litigation and it invariably focuses on self-dealing rather than second guessing of third party business decisions. The existence of the remedy itself serves a useful deterrent function.

133. The other new statutory remedy of note, again derived from the United States by way of Canada, would be the appraisal/buy-out remedy. This remedy provides a minority shareholder with an exit from a company in a very limited set of circumstances, primarily where the nature of the shareholder's investment has been so substantially altered as to justify reconsideration of the investment. This remedy, which in most circumstances operates without recourse to the courts, is particularly valuable in situations where there is no public market for the securities or a very illiquid one. The beauty of the remedy is that it permits the company to proceed unimpeded with its course of action provided it buys out the unhappy shareholder.

134. *Directors' duties.* The recommendations propose a statutory statement of directors' duties. Directors should act honestly and in the best interests of the company and exercise the care, diligence and skill that a reasonably prudent person would. Again, this is an initiative which has been discussed at length in Hong Kong and its time has well and truly come.

135. *Conflicts of Interest.* The legislative treatment of conflicts of interest by directors is fraught with difficulty, in Hong Kong as elsewhere. It becomes a particularly acute problem in small jurisdictions such as New Zealand, Canada and Hong Kong because of the close relationships among businesses and the prevalence of interlocking directorships. Ultimately, it is a question of directors acting in accordance with their fiduciary duty to the company. There is really no completely satisfactory statutory response; the one recommended here is a fairly traditional one based on disclosure of the interest, disinterested voting and fairness to the company. The one novel suggestion, taken from the American Law Institute's Principles of Corporate Governance, is the creation of a statutory duty of fair dealing in situations of conflict of interest. This would permit a more commercially reasonable standard to be applied to these situations than that of the traditional strict trust standard.

MAJOR TRENDS IN OTHER JURISDICTIONS

136. By the Terms of Reference, the Review was requested to consider "recent developments in companies law and regulation in other comparable jurisdictions". A detailed comparative survey of companies law in selected jurisdictions was prepared. It deals with how companies and corporations are governed in other jurisdictions; how the major issues associated with corporate activity are dealt with elsewhere; what the major differences are in approach from one jurisdiction to another; and how different historical developments have affected current structures. The Comparative Survey was supplemented, at the request of working party members, with a background memorandum on the treatment of close corporations/private companies in Japan, Taiwan, Singapore and Malaysia, included in the background papers to this Review. The purpose of these papers was to provide a necessary backdrop against which important issues in Hong Kong could be assessed. For example, the one person company, also known as the single shareholder corporation, has long been available in many jurisdictions. Some jurisdictions have a separate legal regime for small or closely-held businesses. The thorny issue of the *ultra vires* doctrine has been eliminated with no adverse consequences in many parts of the world.

137. As well, the Comparative Survey and background reports give some indication of dominant trends worldwide with respect to company law. With the rapid internationalisation of financial and commercial activity in recent years, there has developed an increasing interdependence of domestic legal regimes. This interdependence has led to greater understanding and awareness in the major commercial jurisdictions of non-domestic legislative approaches and solutions. The result has been a greater willingness to consider the domestic application of what would otherwise have been considered unsuitable "foreign" notions. There has been a notable convergence in the legal approaches to commercial problems. The degree of convergence internationally varies from one area of commercial law to another. The domestic regulation of capital markets (securities regulation, for example) has been subjected to strong pressures to conform to international standards.

138. Companies law on the other hand, has not been subject to the same degree of pressure towards standardisation as securities law or the regulation of financial institutions. Nonetheless, the internationalisation of commercial activity has promoted the cross-fertilisation of company law concepts. Europe, for example, has looked to America's one-person corporation, while America has looked to European-style legal personality for partnerships. The People's Republic of China, it would seem, has looked everywhere.

139. The Comparative Survey considers both civil law and common law jurisdictions. Hong Kong has operated under English common law for over 150 years and the Basic Law (Hong Kong's de facto constitution after 1997), continues this legal tradition uninterrupted for another 50 years. European civil law is of great significance in the Asia-Pacific region and, through the imposition of European Commission Directives, now also determines the direction of U.K. companies law. The Survey looked to the major Commonwealth jurisdictions (the United Kingdom, Australia, Canada, New Zealand, South Africa), the United States, Continental Europe (France, Germany, European Union), Asia (Singapore and the People's Republic of China) and Bermuda.

140. Company law in the United Kingdom has been undergoing a difficult period of

transition and instability over the last 15 years. Nearly a dozen major statutory initiatives associated with companies law have been introduced or attempted in the United Kingdom, and in some instances, introduced, attempted and withdrawn. The prime motor for this high level of legislative activity has been the imposition of European Commission Directives which have their source in the civil law tradition. The difficulties that have ensued go beyond those involved in simply adapting civil law concepts to the very different legal tradition in the United Kingdom; there are profound divergences of political and social views, particularly with respect to the relationship between management and labour.

141. As Professor Gower sadly notes, U.K. companies legislation is no longer in a state to serve as a model to other jurisdictions. Jurisdictions, primarily those in the Commonwealth, which have traditionally relied heavily on the United Kingdom as the source of their company law have deliberately broken away or been orphaned. Canada made the break over twenty years ago; the resulting federal legislation looked to the U.S. MBCA as its starting point. Onto this American stalk was grafted the then most highly desirable aspects of U.K. companies law. The 1975 CBCA proved so successful that most Canadian provinces quickly harmonised their companies law to the new federal legislation. Although showing its age somewhat, and currently the subject of its first comprehensive review (primarily as a result of the shifting boundaries between companies law and securities regulation), the CBCA is still a highly regarded corporate law regime.

142. New Zealand, in implementing the Companies Act 1993, has openly turned to North American models, much as Canada did before it. The New Zealand legislation has suffered more compromises during the legislative process than did the Canadian legislation and has had a more difficult birth. Given the already well-established separation in New Zealand of securities law from company law (which occurred in 1978), there is little doubt as to the future direction of New Zealand companies law. Other commercial legislation in New Zealand will inevitably align itself with North American models. The use of North American judicial decisions to interpret the statute may be eased by the recent decision to consider eliminating appeals to the Privy Council from New Zealand courts.

143. Australia, for many reasons, began a major company law reform initiative in 1993, the Corporations Law Simplification Program, which has been proceeding apace. Despite its title, the "Corporations Law" (which would indicate a more focused North American approach), the Australian legislation retains the older monolithic U.K.-style approach, regrouping very separate areas of commercial law in one "umbrella" statute. This may well have more to do with constitutional issues at work in Australia's federal system than purely commercial considerations.

144. Form has determined substance in Australia; simplification of the form of the legislation has turned to consideration of the introduction of new concepts and substantive approaches. One step incorporation, one person companies, and reference to modern accounting standards are a few of the reforms. According to the Simplification Task Force, the jurisdictions considered to be of most direct relevance to the future direction of Australian corporate law are Canada and the United States.

145. Jurisdictions as different as Singapore, South Africa and the PRC have turned to solutions and approaches developed in other jurisdictions. South Africa, as a mixed civil

law/common law jurisdiction, is an interesting case in point. The North American influences on the South African Close Corporations Act of 1984 are quite obvious; the European civil law influences may be more subtle. The decision in South Africa to create a new separate regime for the close corporation (which exists side by side with the older U.K. style companies law) is very much European in inspiration.

146. In looking to Malaysia and Australia as its traditional sources of companies law, Singapore was in fact indirectly modelling its legislation on that of the United Kingdom. Over time, however, Singapore did not hesitate to look elsewhere for solutions to problem areas, and in doing so, adapting them to local circumstances. The result has been a rather eclectic and fairly indigenous mix, but with more pronounced North American overtones of late.

147. In structuring its 1994 Companies Law, the PRC has looked to the European civil law roots of its Western legal tradition. It has also looked to the United Kingdom and the United States. The PRC companies legislation is an astute combination of features from different legal regimes, but it remains very much a first step, a transitional measure designed to facilitate the "corporatisation" of state-owned enterprises.

148. In companies law, there is certainly an embarrassment of riches in terms of approach, even within the common law tradition. North America alone has over 60 different corporate law regimes, some of which are highly distinctive and quite idiosyncratic. All are related however and interact extensively so that it is not surprising that they show a good deal of similarity in structure and fundamentals. In North America, excellent use has been made of "model" corporations acts which provide the underlying unity in diversity. There is no doubt that North American corporate legislation now provides the benchmark for the world.

149. As the North American and the European experience has shown, the existence of a multiplicity of corporate law regimes in the same business community, region or country (usually the result of a particular political imperative) is not necessarily a bad thing. Much has been written in the United States about competition among state jurisdictions for incorporation business but the dire predictions of a "race to the bottom" have, in reality, not materialised. Although there are notable exceptions (Delaware and the many small off-shore incorporation jurisdictions), companies law serves primarily local interests. It has a local face.

150. This situation, a diversity of existing legal regimes and the absence of strong international pressures towards harmonisation, permits great latitude in crafting a companies law regime. Singapore and the PRC, for example, have shown fairly eclectic taste in fashioning their companies law, picking up on the best bits from other regimes. Bermuda's very specialised forms of incorporation have been tailored to suit local circumstances and foster the local economy. Despite a Memorandum of Understanding between Australia and New Zealand concerning harmonisation of commercial law, New Zealand did not feel overly compelled to coordinate its new approach in the Companies Act 1993 with the Corporations Law in Australia.

151. Although there are not compelling reasons leading to homogeneity in companies law throughout the world, nonetheless, there are identifiable trends creating international

expectations, if not international standards. Companies law regimes no longer operate in domestic isolation but are constantly the subject of comparison in international business transactions. Nowhere is this phenomenon more marked than in Hong Kong with its high level of international commercial activity.

152. A summary of the Comparative Survey is included in this Report as Appendix 2 and the full Survey is available at the Hong Kong Government Publication Centre.

THE LEGISLATIVE FRAMEWORK OF THE HONG KONG COMPANIES ORDINANCE

153. Like Topsy, the current Ordinance just grew! The Ordinance is comprised of 17 distinct parts and 15 schedules. The original 19th century outlines are still discernible but have been overgrown with amendments and adaptations to changing times.

154. Those members of the SCCLR arguing "forcibly" for the creation of this Review cited the "growing size and complexity of company law" and "the piecemeal nature of the amendments" as the reasons. Over 130 years, the Ordinance has lost its original structure and coherence. Certain parts are now of only historical significance; others are comprised of no more than a section or two; still others have been superseded by regulatory initiatives outside the purview of the Ordinance. The most significant provisions with respect to basic companies law are crammed into no more than three or four parts.

Core Company Law: The Formation, Operation and Termination of a Company

155. Core company law, the provisions dealing with the formation, operation and termination of companies in Hong Kong, appear in Parts I, II, IIA, IV, IVA and V of the current Ordinance. There are no separate parts dealing with shareholders and their rights, fundamental changes to the company structure, role of the Registrar of Companies, or remedies and offences (although Schedule 12, the result of an amendment in 1990, tabulates all of the offences and the penalties).

156. The manner of inclusion of Parts IIA and IVA, in 1991 and 1994 respectively, indicates the difficulties now encountered in adopting U.K. legislation and its incorporation into the Ordinance. Both Parts are virtually identical to provisions adopted in the United Kingdom, Part IIA being entitled "Distribution of Profits and Assets" and Part IVA "Disqualification of Directors". The provisions with respect to Distribution of Profits and Assets appear as Part VIII of the U.K. Companies Act 1985 but were in fact introduced somewhat earlier and influenced by the Second Company Law Directive of the European Commission (see Gower's at 244). Disqualification of Directors provisions were introduced in the United Kingdom by way of separate legislation, the Company Directors Disqualification Act 1986. "Greater use is now being made of these salutary provisions, which go some way to make up for the fact that no qualifications are required for appointment as a director, by weeding out those who have proved to be glaringly unfit" (*ibid.* at 146). On the other hand, these provisions have attracted criticism; they are not considered to be cost effective and the "big fish" swim free.

157. Parts IIA and IVA have been introduced to address perceived abuses of the corporate entity: impairment of capital and concerns over the integrity and suitability of directors. Given the divergence which has occurred between the statutory schemes in the U.K. and Hong Kong, however, it is no longer possible to integrate U.K. legislative changes in a coherent way. They must now be dropped in as satellites on their own. Sections 79A to 79P of Part IIA must be cross-referenced to Table A in Schedule 1 in the absence of clear statutory provisions with respect to the payment of dividends and other distributions. Part IVA does not enumerate all causes for disqualification of directors and must be read together with Table A of the First Schedule as well as the older s. 156 dealing with undischarged bankrupts.

158. Parts IV and V of the Ordinance, "Management and Administration" and "Winding Up", demonstrate a different difficulty with the Ordinance; both Parts are lengthy, complex and overburdened by decades of legislative accretion. Each tries to do too much in what has become an erratic fashion; and each, in its own way, is paradoxically incomplete. Part V, Winding Up, is comprised of over 130 sections, or roughly a third of the Ordinance. Very little of Part V deals with winding up of a company, strictly speaking; rather, the main thrust of Part V is the creation of a rudimentary insolvency regime. Part V is supplemented by Part X, "Winding Up of Unregistered Companies", which really deals with ringfencing assets found within the jurisdiction rather than with winding-up.

159. Part IV, "Management and Administration", is another mammoth chunk of the Ordinance, comprised of approximately 140 sections of which almost half have been wedged in by way of alphanumeric amendment. It truly represents core company law, dealing as it does with accounts, directors and shareholders meetings, as well as shareholder remedies (such as they are). Again, as extensive and unruly as Part IV is, it is not comprehensive and must be supplemented by reference to other parts of the Ordinance.

160. Part II of the Ordinance, "Share Capital and Debentures", despite attempts to modernise it by the inclusion of various provisions with respect to financial assistance, redeemable shares, repurchase by the company of its shares, and the creation of non-voting and disparate rights shares, is still outdated and inadequate to deal with the diversity and complexity of modern financial instruments.

161. Finally, to end with the beginning, Part I, "Incorporation of Companies and Matters Incidental Thereto", deals with filing formalities and has changed very little since its inception.

162. ***Formation of a Company.*** Part I of the Ordinance deals with "Incorporation of Companies and Matters Incidental Thereto". This Part prescribes the procedures involved in incorporation, the memorandum and articles of association, their statutory form and registration. "Private company" is defined, as is "member" or shareholder and the different forms of company (e.g., companies limited by guarantee). The treatment of pre-incorporation contracts and other formalities associated with contracting by a company are dealt with. Very little of real substance in this Part has changed since its original formulation.

163. The durability of Part I of the Ordinance, as indicated by the relatively few amendments over the years, is deceptive. Certainly, the registration machinery still works, and can still be made to work, as much 19th century machinery can. The real question is whether there is an easier and more cost effective way to achieve the same results, one which can profit from the advances in computerised technology and is more responsive to business needs of this century and the next.

164. Many of the procedures and filings associated with incorporation are relics of the 19th century which no longer serve a purpose, other than as a reminder of another time and place. The problem runs deeper, however. Continuance of these unnecessary but traditional formalities does put an unnecessary burden on the Companies Registry, especially in times of heightened commercial activity.

165. Equally troublesome is the fact that retaining these 19th century structures (which generate such a massive amount of filings) impedes the adoption of simplified incorporation techniques. For example, very few jurisdictions now would quibble with the desirability of permitting the one-person corporation; it is becoming a world standard. There is little utility in persisting in the view that companies are no more than registered partnerships with legal personality and limited liability. In evolutionary terms, in the mid-19th century, that was certainly the case. It is no longer.

166. Part I is a rockbed of fossilised forms, of interest only to the legal palaeontologist. This is the opportunity to weed the living from the dead.

167. ***Operation of a Company.*** Parts II, IIA, IV and IVA together form the "heart" of company law in Hong Kong, dealing with capitalisation, administration, meetings, accounts, directors and officers, reorganisation and shareholders' rights.

168. *Capitalisation.* Part II, "Share Capital and Debentures", and Part IIA, "Distribution of Profits and Assets", deal with corporate finance matters. Part II includes the original prospectus provisions, administration of which has now been transferred to the SFC (which in turn has transferred responsibility to the SEHK in the case of listed companies). Several sub-parts are of more recent origin dealing with the (controversial) financial assistance provisions; issuance, redemption and repurchase of shares by the company; provisions for the creation of different classes of shares (including non-voting shares); and provisions dealing with variation of class rights. Although an effort has been made to update these corporate finance provisions (for example, with respect to the ability of the company to repurchase its own shares and to create non-voting shares), it remains the case that the overall structure of this Part is still very much rooted in the 19th century and does not reflect the diversity and sophistication of modern financial instruments.

169. Part IIA, on the other hand, is of very recent vintage, dating from 1991, and introduces the concept of distributable profits and assets. The Part prohibits distribution of capital except in certain circumstances and upon meeting certain tests, essentially in the interests of creditors of the company.

170. Part IIA was introduced to keep the Ordinance in line with the Companies Act 1985, Part VIII. Prior to 1985, "[t]he common law was very largely content to leave the question of the determination of profits available for distribution to companies... Arguably the law was not in accordance with good commercial practice, particularly for example in not requiring the setting aside of profit to take account of depreciation in wasting assets and in permitting an unrealised increase in the value of fixed assets to constitute profit available for dividend" (A.J. Boyle & R. Sykes, *Gore-Browne on Companies*, 44th ed., loose-leaf (Bristol: Jordan Publishing Ltd., 1986) at Supplement 18, 13.043). The provisions of Part VIII of the Companies Act 1985 were themselves a response to a European Commission Directive.

171. Parts II and IIA, "Share Capital and Debentures" and "Distribution of Profits and Assets", are in need of rationalisation and modernisation. The emergence of sophisticated securities regulatory regimes, the innovations in corporate finance which have so marked the last decades, the complexity of corporate holdings and structures -- all these factors point to the need for a rethinking of these Parts. The prospectus provisions of Part II obviously

belong to the new world of securities regulation (as do the provisions of Part XII, applicable to overseas incorporated entities) and should be updated and re-enacted as securities regulation.

172. The mechanical aspects of transfer and registration should be clearly delineated from substantive issues relating to capital structure. Given developments in clearing and settlement, provision must be made for book-entry or uncertificated securities. The need for par value shares and the rigid categories of share capital and debentures are now seriously questioned.

173. *Management and Administration.* Part IV, "Management and Administration", is the most comprehensive part of the current Ordinance. It deals with a wide variety of matters, some of which have been fairly extensively updated. Routine matters such as requirements relating to publication of the name and registered office, the register of members, and the annual return appear in this Part. Certain protections for shareholders, some of more recent origin than others, have been added in this Part by way of adjustments to shareholder communication and voting and resolutions provisions in the context of meetings and proceedings. Rudimentary protection of minority shareholders has been provided in the form of the updated 1948 U.K. formulation of the unfairly prejudicial remedy and the mandatory offer following a share repurchase which results in acquisition of 90% or more of the shares of a company.

174. Reflecting the debates over the changing role and responsibilities of company directors and officers in recent years, the provisions of this Part dealing with directors have been amended in some significant respects. In 1984, amendments were made dealing primarily with situations of potential conflict of interest, such as loans or other payments to directors. A new part, Part IVA, of U.K. origin has been added to the Ordinance dealing exclusively with the disqualification of directors for fraud involving a company, conviction of indictable offences, company insolvency, persistent breaches of the Ordinance, and so on.

175. Corporate reorganisations, a complex and important part of modern corporate life, are dealt with in a most summary manner in four sections of a sub-part entitled "Arrangements and Reconstructions" with more detailed provisions appearing in the Ninth Schedule (Acquisition of minority shares after a successful take over offer). The section dealing with Accounts and Audits and the Tenth Schedule, Accounts, are quite dated and in need of complete rethinking.

176. Part IV, "Management and Administration", should be split into its component parts and regrouped in a systematic fashion. A separate Part should address issues pertaining to directors of a company as well as the officers appointed by them. Technicalities such as registered office and name and register of members are better dealt with in a separate part that also deals with the more mechanical aspects of transfer and registration of securities. Shareholders, their rights and their remedies, merit separate consideration.

177. Auditing and accounts, too, of such great importance to shareholders, should be dealt with in a separate part. With the development of sophisticated accounting standards, both domestically and internationally, it is time to defer to the professional bodies in the setting of standards. There is too much flux and dynamism in accounting standards for there to be

great utility in having them frozen in the Ordinance. And, finally, is it really necessary to require all private companies to have their accounts audited? Even the United Kingdom has relaxed its audit requirements, although not far enough to suit certain commentators.

178. With respect to investigation powers and procedures, those invoked by shareholders rightfully belong in the part dealing with shareholders; those invoked with coercive effect in the public interest might be better regrouped. The substance of the Twelfth Schedule, "Punishment of Offenses under this Ordinance", which runs on for 16 pages, should be distilled into more generalised categories of offences and penalties.

179. ***Termination of a Company's Existence.*** Extensive and detailed provisions exist in Parts V and X concerning winding-up, voluntary and involuntary, as well as the provisions of Part VI, Receivers and Managers. Much of these parts constitute, in fact, a corporate insolvency regime which goes beyond the simpler considerations of dissolution and termination of corporate existence. Stripped of those provisions relating to insolvency (ideally to form part of a new Insolvency Ordinance), very little would remain of Part V.

Non-Core Company Law Matters

180. The current Ordinance is the repository of several areas of commercial law which are ancillary to core companies law, such as registration of charges (Part III), prospectuses (Part II, ss.37-41A, Part XII), and insolvency (Part V, Part VI). In addition there is a miscellaneous assortment of provisions, some of historical interest, with respect to former ordinances (Part VIII), continuance from a former ordinance (Part IX), dormant companies (Part XIIA), offences and miscellaneous (Part XIII), evasion (Part XIIIA) and saving provisions (Part XIV). Parts VII and XIII both deal with various registration matters and the Registrar of Companies. Several parts govern certain aspects of the activities of unregistered companies and oversea incorporated companies (Part X, Part XI).

181. In the recommendations, many of these Parts will simply disappear, or their provisions be absorbed elsewhere. The prospectus and insolvency related provisions will migrate to other legislation. Provisions with respect to dormant companies will likely be unnecessary and it appears that Part IX applies uniquely to the Hong Kong and Shanghai Banking Corporation (which has no objection to Part IX being eliminated).

B. RECOMMENDATIONS

B. RECOMMENDATIONS

This Report is proposing a new approach to and framework for companies law in Hong Kong. The general recommendations contained in Part 1.00 are responsive to the Terms of Reference and determine the overall structure of a new Ordinance. The specific recommendations that follow are organised on a part by part basis, keyed to the proposed structure of the new Ordinance, the substantive provisions of which would be regrouped into 10 more balanced and logically coherent Parts.

A summary of the recommendations precedes their part by part consideration. An explanation and commentary is provided for each recommendation as well as a very brief synopsis of the current Ordinance. At the end of each commentary is an indication of the source or sources of the recommendation for further reference.

SUMMARY OF RECOMMENDATIONS

1.00 GENERAL RECOMMENDATIONS FOR A NEW BUSINESS CORPORATIONS ORDINANCE

1.01 Aims and Objectives. The proper aims and objectives of companies law in Hong Kong should be:

- to provide a simple, efficient and cost effective method of incorporation and ongoing corporate maintenance;
- to be enabling and permissive rather than regulating and prohibitive;
- to the extent possible, to be self-enforcing so as to avoid intervention of public authorities and to limit the necessity of recourse to the judicial system;
- to be written in clear, concise language so as to be accessible to business people as well as lawyers and accountants;
- to focus on "core company law", the birth, life and death of the enterprise;
- to strike a balance between the interests of management or majority shareholders on the one hand and shareholders or minority shareholders on the other hand, in keeping with modern commercial practices;
- to promote continuity, stability and certainty in commercial dealing;
- to refrain from being a vehicle for implementation of industrial relations, tax, social or monetary policy;
- to take account of and to meet international expectations with respect to the incorporation, operation and administration of modern companies.

1.02 Business Corporations Ordinance. Hong Kong should implement a modern, streamlined Business Corporations Ordinance drawing on the most appropriate aspects of existing North American and Commonwealth models. Continued primary reliance on the U.K. model of companies law is not advised.

1.03 Single Regime. With respect to core company law matters, the same regime should be applicable to both public and private companies. In addition, the new Ordinance should provide a basic optional regime for private companies that would facilitate their operation in an informal and consensual manner.

1.04 Securities Regulation. The new Ordinance should not regulate the capital markets activities of companies nor the protection, in the largest sense, of public investors; this should be left to the SFC and the SEHK. With the removal from companies legislation of securities regulation, the SFC should consider the need to re-enact existing, updated or comprehensive new provisions in securities legislation. In the process of extracting the securities law aspects from companies legislation, careful consideration needs to be given to the dangers of creating regulatory gaps as well as the need to address any inadequacies in existing statutory regulation.

1.05 Insolvency. The new Ordinance should not apply to insolvent winding up; matters pertaining to insolvency should be left to a comprehensive Insolvency Ordinance.

1.06 Charges. A study should be undertaken with a view to introducing a separate, comprehensive regime governing security interests in personal property (such as recommended by the U.K. Diamond Report).

It would permit the elimination of Part III of the Ordinance, Charges. Until such time, Part III would continue in effect in conjunction with the new Ordinance.

1.07 **Financial Institutions.** The new Ordinance would continue to serve as the basic legislation governing the "core company law" aspects of regulated financial institutions in Hong Kong, essentially incorporation and its incidents; the regulatory aspects would be determined by the Hong Kong Monetary Authority and the Insurance Authority, as appropriate, and would preferably appear in their related legislation.

1.08 **Not-for-profit Enterprises.** The new Ordinance would not be applicable to not-for-profit enterprises, currently formed as companies limited by guarantee; the current Ordinance would continue to apply to such entities until such time as consideration is given to their separate treatment.

1.09 **A new Not-for-profit Corporations Ordinance.** Serious consideration should be given to implementation of an Ordinance governing incorporated not-for-profit organisations.

1.10 **Structure of a New Ordinance.** The following structure is proposed for the organisation of a new Ordinance:

OUTLINE FOR A BUSINESS CORPORATIONS ORDINANCE

Part 1:	Interpretation
Part 2:	Administration of the Ordinance
Part 3:	Incorporation; Capacity and Powers
Part 4:	Capital Structure
Part 5:	Management and Administration
Part 6:	Directors and Executive Officers
Part 7:	Shareholders' Rights and Remedies
Part 8:	Fundamental Changes
Part 9:	Solvent Dissolution and Liquidation
Part 10:	Private Companies/Closely Held Corporations
Part 11:	Foreign Corporations/Oversea Companies
Part 12:	Transitional Provisions
Part 13:	General

2.00 ADMINISTRATION OF THE ORDINANCE

2.01 **Consolidation and Updating Part VII.** The provisions of Part VII of the existing Ordinance, General Provisions as to Registration, should be consolidated, and if necessary, updated in this Part. In particular, provision for the electronic keeping and filing of notices and other documents should be made.

2.02 **Role of Registrar.** The role of the Registrar should continue to be primarily an administrative and policy advisory one.

2.03 **Charges.** Pending reconsideration of the legislative treatment of "Charges", the Companies Registry would continue its administration of Part III of the current Ordinance.

2.04 **Subsidiary legislation.** Subsidiary legislation and standard forms should be used extensively to deal with technical filing requirements, fees, etc. in order to facilitate timely updating and amendment.

2.05 **Offences.** With respect to offences, the Twelfth Schedule should be eliminated; such offences which are to be retained or created should be regrouped in more generic categories in this Part of the Ordinance and accorded appropriate sanctions.

2.06 **Enforcement.** To the extent possible, companies legislation should be self-enforcing and self-executing; investigation and inspection by a government body should essentially be a residual remedy, available in the event that private civil recourses are inadequate or ineffective. Powers comparable to the existing investigation and inspection powers would be maintained.

2.07 **Role of the Financial Secretary.** The Financial Secretary should continue to have residual discretion to act in the public interest in certain circumstances (such as investigation).

3.00 INCORPORATION; CAPACITY AND POWERS

3.01 **One-step incorporation.** The new Ordinance would provide one-step incorporation by filing a simple application for incorporation.

3.02 **One person companies.** The new Ordinance would permit one person/one director incorporation.

3.03 **Numbered companies.** Provision should be made for numbered companies, and use of the company name.

3.04 **Pre-incorporation contracts.** Provisions for the adoption by the company of pre-incorporation contracts should be simplified.

3.05 **Capacity, powers and privileges of natural person.** A corporation should be given the capacity, powers and privileges of a natural person. Restrictions may be placed on the activities of a corporation in its constitution but the rights of third parties should be preserved in the event that a corporation acts in contravention of its articles or the Ordinance.

3.06 **Constructive notice.** The constructive notice doctrine should be eliminated except, temporarily, with respect to charges.

3.07 **Indoor Management rule.** A statutory formulation should be given to the indoor management rule (the so-called rule in Turquand's case).

4.00 CAPITAL STRUCTURE

4.01 **Modern capital structure.** A new Business Corporations Ordinance should provide for a modern, flexible capital structure.

4.02 **No par value shares.** Par value shares should be prohibited.

4.03 **Classes and rights of shares.** The corporate constitution should prescribe the classes of shares (if

more than one) and the number of shares of each class that the company is authorised to issue if there is a limit (which there need not be). If there is only one class of shares, that class must have three fundamental rights of share ownership: the right to vote, the right to receive dividends when declared and the right to receive the net assets of the company upon dissolution. Where there is more than one class of shares, the rights, preferences, etc. should be stated in the corporate constitution; the three fundamental rights of share ownership should be attached to at least one class of shares although not all rights need be attached to any one class. For statutory purposes, the traditional distinction between common or ordinary shares and preference shares should be eliminated.

4.04 **Series.** Statutory provisions with respect to the use of series within classes of shares are unnecessary.

4.05 **Partly paid shares.** Partly paid shares should be prohibited.

4.06 **Optional pre-emptive rights.** Pre-emptive rights for existing shareholders should be optional; they may be provided for in the corporate constitution.

4.07 **Solvency test.** The concept of impairment of capital should be replaced by a solvency test to be used to determine the ability of the company to engage in a variety of activities: repurchase of its own shares (by way of redemptive provisions in the corporate constitution or otherwise), payment of dividends and other activities in the nature of a transfer of corporate assets to the possible detriment of creditors.

No "distribution" (widely defined) of company assets should be permitted if, after giving effect to it:

(1) the company would not be able to pay its debts as they become due in the usual course of business; or

(2) the company's total assets would be less than the sum of its total liabilities plus (unless the constitution provides otherwise) the amount that would be needed, if the company were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

4.08 **Financial assistance.** Provisions with respect to "financial assistance" for the purchase of company shares should be eliminated.

5.00 MANAGEMENT AND ADMINISTRATION

5.01 **Companies' accounts.** Companies should be required to prepare accounts that give a true and fair view of the state of affairs of the company. Details as to the form and content of accounts, to the extent required to be specified, should appear in subsidiary legislation; the Tenth Schedule of the Companies Ordinance (Accounts) should be eliminated.

5.02 **Generally accepted accounting principles.** Rather than detailing line item by line item the information to be contained in accounts, reference should be made to preparation of accounts in accordance with generally accepted accounting principles (GAAP). GAAP would be embodied in standards set by an independent accounting standards body or by a Hong Kong Society of Accountants process that would involve a wider representation of interested parties.

5.03 **Waiver of generally accepted accounting principles.** All companies should prepare their accounts in accordance with generally accepted accounting standards; consideration should be given as to whether private companies should be able to dispense with this requirement by means of unanimous shareholder agreement (unless required for other purposes).

5.04 **Minimum financial information.** As an aid to small companies in particular, the minimum financial information to be delivered to shareholders, unless they agree otherwise, should be stipulated in the legislation, or subsidiary legislation.

5.05 **Filing of accounts.** Unless required by other legislation (as should be the case for public and listed companies), companies would not be required to file accounts.

5.06 **No mandatory audit.** Company accounts should continue to be audited but shareholders should be able to dispense with an audit by unanimous agreement.

5.07 **Formalities associated with directors' meetings.** The formalities associated with routine directors' meetings such as notice, quorum, attendance, dissent, etc. should be set out in Part V, Management and Administration of the new Ordinance.

5.08 **Formalities associated with shareholders' meetings.** The formalities associated with routine shareholders' meetings such as notice, quorum, attendance, proxies, record date, etc. should be set out in Part V, Management and Administration of the new Ordinance.

5.09 **Negotiable instruments.** Securities certificates should be statutorily recognised as negotiable instruments.

5.10 **Modernised security certificates system.** Provisions with respect to security certificates, their form, content, registration and transfer should be modernised to provide for the optional use of "scripless" (book entry or "uncertificated") securities and, to the extent not dealt with under other legislation, the mechanics of their transfer (including the use of clearing agencies).

5.11 **Part III retained.** Pending consideration of the creation of a separate regime for the granting of security interests in personal property, Part III of the current Ordinance, Registration of Charges would continue to apply.

5.12 **Modern record keeping.** Provision should be made for modern record keeping, including electronic data processing. An obligation should be imposed to ensure the accurate preservation of data and its accessibility in written form to those entitled to it within a reasonable period of time.

5.13 **Company records.** The new Ordinance should contain a clear and concise statement of the records which must be kept by the company, their location and who has access to them (and in what circumstances and to what purposes.)

5.14 **Corporate seal.** Use of a corporate seal should be voluntary and no agreement should be invalid merely because a corporate seal is not affixed to it.

6.00 DIRECTORS AND EXECUTIVE OFFICERS

6.01 **Unitary board structure retained.** The traditional unitary board structure should be retained.

6.02 **Board of directors.** In private companies/closely-held corporations, a single decision making body should be an option; the responsibilities of the directors would be assumed by the shareholders.

6.03 **Statutory power of directors.** The board of directors should be given a direct grant of statutory power to manage, or supervise the management of, the company. This power should be made subject to any unanimous shareholder agreement.

6.04 **Delegation of powers.** The board of directors should be permitted to delegate all those powers which it is not required to exercise itself.

6.05 **Functions not subject to delegation.** Certain functions of the board of directors should not be subject to delegation, for example:

- submission to shareholders of any question requiring their approval
- filling an interim vacancy among directors, in the office of auditor, appointing or removing the chief executive officers
- in most circumstances, issuing securities
- declaring dividends
- purchasing, redeeming or otherwise acquiring shares issued by the company
- approving financial statements
- adopting, amending, repealing any constitutional documents

6.06 **Directors' minimum qualifications.** Directors should meet certain minimum qualifications:

- age of majority
- mental capacity (i.e. not found legally incapable)
- only individuals (no corporate directors)
- no one who has the status of an undischarged bankrupt unless permitted by court order
- no one who has been disqualified from acting as a director

6.07 **One director.** Private companies should be permitted to have a minimum of one director.

6.08 **Shadow and alternate directors.** The troublesome concepts of shadow and alternate directors should be eliminated.

6.09 **Company officers.** There should be no requirement for the appointment of any particular company officer such as a company secretary.

6.10 **Removal of directors by shareholders.** Shareholders should be able to remove directors by ordinary resolution, subject to class voting rights and the company constitution.

6.11 **Meetings of directors.** Meetings of directors should be permitted by means of electronic communications, unless otherwise specified in the company constitution.

6.12 **Unanimous action.** Directors should be able to act unanimously by written resolution without a meeting.

6.13 **Statutory statement of directors' duties.** There should be a statutory statement of directors' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would. These duties should also be made applicable to those corporate officers appointed by the board.

6.14 **Reliance on reports.** Directors and officers should be able to rely in good faith on financial statements and other reports prepared by officers and employees as well as the professional advice of lawyers, accountants, etc.

6.15 **Business judgment rule.** There should be no need of a statutory formulation of the 'business judgment rule'.

6.16 **Indemnifying directors.** Companies should be permitted to indemnify directors and officers in specific circumstances; companies should be required to indemnify directors and officers in specific circumstances.

6.17 **Insuring directors.** Companies should be permitted to insure directors and officers except for a failure to act honestly and in good faith with a view to the best interests of the company.

6.18 **Disqualification of directors.** Disqualification of directors provisions should be eliminated for company law purposes. Those existing provisions relating to securities, insolvency or criminal activity should be reenacted in appropriate legislation.

6.19 **Conflicts of interest.** Consideration should be given to placing directors and executive officers (i.e. those appointed directly by the board) under a duty of fair dealing with respect to transactions they enter into with the company.

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

6.21 **Shareholder approval of interested transactions.** Shareholders should be able to vote to uphold a transaction by special resolution in certain circumstances.

6.22 **Loans to directors.** Transactions involving loans to directors should continue to be prohibited subject to certain exceptions.

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

7.00 SHAREHOLDERS' RIGHTS AND REMEDIES

7.01 **Shareholders' rights and remedies.** A separate part of the new Ordinance should be dedicated to matters dealing with shareholders, their rights and remedies.

7.02 **Proposal at annual meeting.** Any shareholder entitled to vote at an annual meeting should be able to submit a proposal to the company to be raised at the annual meeting and circulated prior to the meeting. The board of directors could refuse to circulate proposals in certain circumstances such as proposals designed to redress personal grievances or espousing political or other causes. In addition, or in the alternative, a proposal put forward by a minimum number or percentage of shareholders (e.g. the lesser of 25 shareholders or those holding 2½% of the voting shares) could not be refused by the board of directors.

7.03 **Requisition to call meeting.** Shareholders holding 5% of the voting shares should be able to requisition the directors to call a meeting of shareholders or, if the directors fail to act, a shareholder should be able to call a meeting itself. The time delay in which the directors may act should be fairly short, 21 days for example. The requisitioners should be reimbursed their expenses unless the meeting otherwise resolves.

7.04 **Shareholders' rights to dispense with meeting.** A resolution in writing signed by all shareholders entitled to vote should be sufficient to preclude the necessity of a meeting. A meeting should be required, however, in the event of the resignation or removal of a director or auditor who wishes to explain or contest the action. Shareholders should be able to dispense with the requirement for an annual general meeting (or other meetings) by unanimous shareholder agreement.

7.05 **One share entitled to one vote.** Unless otherwise provided by the company constitution, one share should be entitled to one vote. "Circular holdings" should be prohibited from voting.

7.06 **Unanimous shareholder agreement.** All companies should be able to make use of unanimous shareholder agreements to regulate (1) the exercise of corporate powers and management and (2) the relationship among shareholders.

7.07 **Statutory remedies.** There should be made available to shareholders a variety of statutory remedies designed to induce accountability of management and achieve the desired balance between flexibility in management powers and protection of shareholders, especially minority shareholders' interests. These statutory remedies should include the following:

- Statutory Derivative Action
- Oppression or Unfairly Prejudicial Action
- Buy-Out or Appraisal Remedy
- Compliance and Restraining Orders
- Just and Equitable Winding-up

7.08 **Statutory derivative action.** There should be a statutory derivative action in the new Ordinance.

7.09 **Unfairly prejudicial remedy.** The current unfairly prejudicial or oppression remedy should be broadened. The remedy should be available to a broader class of persons, to include

- any registered holder or beneficial owner, and any former registered holder or beneficial owner, of a security of the company or any of its affiliates;
- any director or officer or former director or officer; and
- the Financial Secretary.

The scope of the conduct that may be complained of would also be broadened to include conduct that is oppressive, unfairly prejudicial to or that unfairly disregards the interests of any security holder, director or officer.

7.10 **Statutory compliance and restraining order.** A shareholder or director should have the standing to apply to court for a statutory compliance and restraining order.

7.11 **Just and equitable winding-up.** The traditional "just and equitable" winding-up remedy should be retained, but the court should be given the option of making any other order it sees fit. The remedy should be dissociated from the more undesirable consequences of winding-up procedures in insolvency (such as the freezing of bank accounts).

7.12 **Appraisal or "buy-out" remedy.** A form of appraisal or "buy-out" remedy which does not necessitate judicial intervention should be adopted; the statutory buy-out remedy gives shareholders the right to have the company buy their shares upon the occurrence of a limited number of fundamental changes while permitting the company to proceed unimpeded with its proposed action. In the alternative, consideration should be given to introducing such a procedure but excluding its application to listed companies.

8.00 FUNDAMENTAL CHANGES

8.01 **Amendments by special resolution.** There should be regrouped in one section, all amendments to the company constitution that may be effected by special resolution of the shareholders. A special resolution should require a "super-majority" vote, i.e. 75%.

8.02 **Dissenting shareholder entitled to be "bought-out".** Where an amendment to the constitution would (1) affect substantially the nature of a shareholder's investment (e.g. remove or change any restriction on the nature of the business of the company or change the characteristics of its shares) or (2) where the company proposes a fundamental change such as an amalgamation, continuance in

another jurisdiction (see recommendation with respect to continuance), or sale of substantially all of its property, a dissenting shareholder should be entitled to be bought out of the company at a "fair" price.

8.03 **Class vote.** In certain circumstances, a class vote should be held where a proposed amendment to the constitution would affect, directly or indirectly, the rights of that class of shares.

8.04 **Corporate restructuring procedures.** Simple procedures should be made available to provide for corporate restructuring such as by way of amalgamation without the necessity for court intervention or liquidation.

8.05 **Restructuring of related companies.** Restructuring of related companies and wholly-owned subsidiaries should be facilitated.

8.06 **"Import" and "export" of companies.** "Import" and "export" of companies into and out of Hong Kong should be permitted. Foreign companies should be able to re-incorporate in Hong Kong under the new Ordinance without the necessity of liquidation and the resulting disruption and interruption of corporate existence; Hong Kong incorporated companies should be able to continue under the laws of incorporation of another jurisdiction in the same manner.

8.07 **Court ordered arrangements.** Provision should be made for court ordered arrangements for solvent companies where it is impracticable to restructure under other provisions of the legislation.

9.00 SOLVENT DISSOLUTION AND LIQUIDATION

9.01 **Solvent dissolution and liquidation.** Only solvent dissolution and liquidation should be dealt with in the new Ordinance.

9.02 **Voluntary dissolution by simple filing.** Voluntary dissolution should be effected by a simple filing (depending on the nature of the dissolution sought) and should take effect upon filing; the corporate existence would then be continued only for the purpose of winding up and liquidating the business and affairs of the entity.

9.03 **Circumstances for simple filing.** Voluntary dissolution by way of simple filing should be available in two instances; (1) before the company has commenced business and (2) where initiated by directors and shareholders.

9.04 **Revocation of dissolution.** Within a limited period of time a company should be able to revoke dissolution essentially in the same manner as it has been initiated.

9.05 **Claims of creditors.** Provision should be made for the claims of known and unknown creditors.

9.06 **Administrative dissolution.** The Registrar should be able to commence an administrative dissolution in limited circumstances, primarily where a company has failed to comply with its filing obligations under the new Ordinance.

9.07 **Dissolution by the court.** A court should be given broad discretion, both in terms of the grounds and the procedures adopted, to dissolve a company upon the application of the Financial Secretary or a delegated authority, a shareholder or a creditor.

10.00 PRIVATE COMPANIES/CLOSELY HELD CORPORATIONS

10.01 **No separate ordinance.** There should not be a separate specialised ordinance pertaining only to

private companies/closely held corporations.

10.02 **Purpose of legislative provisions.** The purpose of legislative provisions specifically applicable to private companies/closely-held corporations should be to facilitate the creation of incorporated entities that, for internal purposes, function like partnerships or sole proprietorships.

10.03 **Statutory definition.** There should be a statutory definition of or conditions to be met for private companies/closely held corporations.

10.04 **Definition of "private company".** The traditional definition of "private company" should be retained. A private company has restricted the right to transfer its shares, has limited the number of shareholders to 50 and prohibits any invitation to the public to subscribe for its securities. In addition, a company which by means of a unanimous shareholder agreement abolishes the distinction between ownership and management, irrespective of number of shareholders, should also fall within the definition.

10.05 **Optional regime.** A separate part of the new Ordinance should contain an optional regime applicable to private companies/closely held corporations. The regime could be varied in the corporate constitution or by unanimous shareholder agreement. It should contain the following provisions:

- Standard share transfer restrictions and exceptions (e.g. transfer to trustee in bankruptcy, by operation of law);
- Preservation of limited liability despite failure to observe corporate formalities;
- No mandatory audit;
- Standard form buy-sell and buy back provisions to permit shareholders to leave;
- Recourse to mediation or arbitration to resolve shareholder disputes;
- Possibility of applying to court for the appointment of a rehabilitative receiver in the event of deadlock, etc.

10.06 **Possibility of Eliminating Corporate Formalities.** Private companies/closely held corporations should be able, by unanimous shareholders agreement or in their constitution, to eliminate certain corporate formalities and otherwise derogate from standard statutory provisions:

- no need to have an annual meeting of shareholders unless requested by a shareholder;
- no need to have separate bylaws/articles of association if constitution and statute sufficient;
- ability to choose limited corporate life if desired;
- possibility of dissolution at the request of a shareholder (or certain % of shareholders) or upon the occurrence of a specified event;
- elimination of board of directors;
- restriction of discretion or powers of the board or weighted voting rights;
- operation of enterprise as if a partnership among shareholders;
- creation of relationship among shareholders that would otherwise be only appropriate among partners.

11.00 FOREIGN CORPORATIONS/OVERSEA COMPANIES

11.01 **Conflict of laws rule.** For purposes of the new Ordinance, the traditional common law conflict of laws rule applicable to companies, i.e. that their creation, internal affairs, and termination are governed by the law of their place of incorporation, should be respected.

11.02 **No extraterritorial effect.** As a general principle, the new Ordinance should not contain provisions having an extraterritorial effect.

11.03 **Threshold of registration.** Registration of foreign incorporated companies should be required in Hong Kong but the threshold test should be changed.

11.04 **Threshold test.** The threshold test of carrying on business in the jurisdiction, including both an inclusionary and exclusionary list of what is or is not considered carrying on business, should be adopted for purposes of the new Ordinance.

11.05 **Filing requirements simplified.** The filing requirements for registration as a foreign company should be simplified. It should not be necessary to file the company constitution or accounts.

11.06 **Service of process.** An agent for service of process within Hong Kong should be required; alternative methods of service of process should be stipulated in default of an agent.

11.07 **Disclosure of foreign status retained.** Current requirements with respect to the obligation to disclose the foreign status of the company (on letterhead, at the place of business, etc.) should be retained.

11.08 **Filing requirements.** The filing requirements applicable to foreign companies under the new Ordinance should be coordinated with those of the Business Registration Ordinance; registration under the new Ordinance should be deemed to satisfy requirements of the Business Registration Ordinance.

11.09 **International business companies.** There appears to be no need to address the use of international business companies in a new Ordinance or otherwise.

12.00 TRANSITIONAL PROVISIONS

12.01 **Mandatory continuance for companies.** A new Ordinance should include a requirement of mandatory continuance for companies created under the old legislation over a transitional period of three to five years.

12.02 **Simple reregistration procedure.** Continuation under the new Ordinance should be effected through a simple reregistration procedure which should involve only minimally more effort and expense than the current annual filing and audit requirements.

1.00 GENERAL RECOMMENDATIONS FOR A NEW BUSINESS CORPORATIONS ORDINANCE

The general recommendations which follow are based on the Report on Module 1: Identification of Core Company Law which was prepared in February 1996 for limited circulation. These recommendations have not changed substantially since February 1996; they served as the foundation for the specific recommendations as to model, structure and detail for a new Ordinance.

1.01 RECOMMENDATION: Aims and Objectives. The proper aims and objectives of companies law in Hong Kong should be:

- **to provide a simple, efficient and cost effective method of incorporation and ongoing corporate maintenance;**
- **to be enabling and permissive rather than regulating and prohibitive;**
- **to the extent possible, to be self-enforcing so as to avoid intervention of public authorities and to limit the necessity of recourse to the judicial system;**
- **to be written in clear, concise language so as to be accessible to business people as well as lawyers and accountants;**
- **to focus on "core company law", the birth, life and death of the enterprise;**
- **to strike a balance between the interests of management or majority shareholders on the one hand and shareholders or minority shareholders on the other hand, in keeping with modern commercial practices;**
- **to promote continuity, stability and certainty in commercial dealing;**
- **to refrain from being a vehicle for implementation of industrial relations, tax, social or monetary policy;**
- **to take account of and to meet international expectations with respect to the incorporation, operation and administration of modern companies.**

COMMENTARY: The aims and objectives identified above continue Hong Kong companies law in a tradition which derives from the major companies law reform efforts in the common law world: Gower's Ghana Code, the Canadian Dickerson Report, New Zealand's Report No. 9, all of which have been informed by the Model Business Corporations Act in the United States. These aims and objectives form the guiding principles for the specific, detailed recommendations which follow. Each of the specific recommendations below has been measured against these guiding principles.

The first objective of a modern companies law is to provide a simple, efficient and cost effective method of incorporation and ongoing corporate maintenance. The pace and complexity of modern commercial dealings has far outstripped the nineteenth century company law forms and procedures, the vestiges of a more leisurely and localised business environment. The modern corporation has become a basic building block of commercial activity. It should be possible, in Hong Kong as elsewhere, to incorporate quickly and cheaply. In the course of working party discussions, the costs and complexity of incorporation and maintenance of a Hong Kong company were cited frequently as the underlying cause for recourse to BVI incorporations. Hong Kong based businesses should have a local alternative which is competitive with foreign incorporations of convenience.

With the emergence of specialised regulatory regimes in other areas such as insolvency and securities regulation, companies law can be freed from carrying a heavy regulatory burden. Companies law can become, as it has in other jurisdictions, permissive, facilitative and enabling.

Rather than relying upon externally imposed administrative and criminal sanctions, company law can be structured so as to be primarily self-enforcing. This is a corollary of a permissive, facilitative and enabling regime; there are few mandatory provisions and little to prohibit. The current Ordinance contains a multitude of offences; compliance is spotty and enforcement necessarily ineffectual. In the proposed regime, greater reliance is placed upon civil and contractual remedies. The burden of enforcement is shifted to those most directly aggrieved and, to the extent possible, the participants themselves are encouraged to fashion their own dispute resolution mechanisms in advance. Recourse to court order is exceptional and the use of alternative dispute resolution such as commercial arbitration and mediation is recommended.

In terms of simplifying and rationalising the current Ordinance, form is as important as content. This Review recommends a break with the 19th century drafting style of the current Ordinance which tends to be prolix to no good end. Much of the language in older U.K.-style statutes is at odds with modern drafting techniques to say nothing of modern English usage. The language itself was often drawn straight from the 19th century case law. One of the major considerations in including a sample of model legislation in this report is to demonstrate the clarity and economy of modern drafting techniques applied to a commercial statute. The language in the sample of model legislation is taken from a variety of modern statutes which have operated effectively and been subject to judicial scrutiny over the years.

This recommendation is also consistent with the current thinking in Hong Kong, arising out of the translation of all English legislation into Chinese. The aim is to bring greater clarity and conciseness to legislative drafting. The Legal Department is considering "a systematic programme to rewrite laws in both languages to make them clearer" ("Plan to rewrite century-old laws in modern language", South China Morning Post (13 Nov 1996) at 3). In the same article, Bar Association chairman Gladys Li Chi-hei is quoted as saying "Let us strive to do what we can to simplify and inform, rather than to transform what is impenetrable in English into impenetrable Chinese" (ibid). The experience has been similar in other jurisdictions (such as Canada) in the move to a bilingual legislative system; the discipline of the translation process has instilled a belief in the virtues of simplicity and

clarity.

The overall approach recommended by this Review is one characteristic of North American corporate law regimes, a "core company law". It is the approach recently followed in New Zealand in its Companies Act 1993. Several substantive areas have been identified as more appropriately dealt with in separate legislation: capital market activities of public and listed companies; charges; insolvency; regulation of financial institutions; and not-for-profit enterprises. With the increasing complexity of commercial dealings and the development of areas of specialised regulatory focus, company law should no longer serve as a general repository for all statutory commercial law. This recharacterisation of certain aspects of "company law" is already well under way in Hong Kong and this recommendation only serves to complement this trend. Attached as Appendix 4 is a chart based on the current Ordinance which breaks out the different substantive areas of law (securities, insolvency and restructuring, financial institutions, not-for-profit entities, charges), on a Part by Part basis.

Obscurity does little to promote continuity, stability and certainty in commercial dealing. These recommendations attempt to build on the company law institutions and concepts familiar to the common law world but place them in a more coherent and rational framework. Where older contructs no longer serve a purpose they have been replaced with newer working formulations. There is very little in these recommendations that has been cut from whole cloth; in the interests of continuity, stability and certainty, the recommendations are drawn from existing legislative models which are time tested and for which a body of judicial interpretation and commentary exists. Most importantly, in addition to clearing out the legislative accretions of decades, the recommendations strive to obviate the convolutions of the old case law which only add to the cost of doing business.

These recommendations do not purport to be ideologically neutral; they are made very much with the Hong Kong policy of minimum government intervention in the market in mind (as is expressly required by the Terms of Reference). For this reason, the recommendations do not serve to implement industrial relations, tax, social or monetary policy. The goals are more modest, the creation of a basic building block for commercial activity. Viewed as such, a company law regime can remain relatively stable for long periods of time. Other areas of the law are subject to much greater and more frequent shifts in underlying policy. Tax policy can be notoriously changeable, for example. During the working party sessions, it became evident at several points that the primary purpose served by some Ordinance provisions was related to Inland Revenue considerations. Such a purpose was not viewed as a compelling reason to retain a provision which did not otherwise serve core company law ends.

Finally, as attuned to local circumstances as it may be, companies law in Hong Kong can not afford to be parochial. Hong Kong is an international commercial and financial centre the importance of which is disproportionate to its size. Both international and Hong Kong businesses are nimble and well aware of the alternatives available to them. To continue to compete effectively, companies law in Hong Kong must take into account and meet international expectations with respect to the incorporation, operation and administration of modern companies.

(DR: para.11. NZLC R9: paras.20,69,284,286.)

1.02 RECOMMENDATION: Business Corporations Ordinance. Hong Kong should implement a modern, streamlined Business Corporations Ordinance drawing on the most appropriate aspects of existing North American and Commonwealth models. Continued primary reliance on the U.K. model of companies law is not advised.

COMMENTARY: The difficulties associated with reliance on a U.K. companies law model for Hong Kong were recognised as long ago as 1973 and are discussed more extensively above. In the future, company law in Hong Kong will be complemented by separate, comprehensive regimes governing insolvency and securities regulation which are in the process of being developed and refined. These regimes find their inspiration in North America and other Commonwealth jurisdictions. For this reason, it is appropriate to look to those same models for companies law in Hong Kong.

North America, in particular, has developed highly successful statutory models for companies law which are compatible with the basic concepts and assumptions now understood in Hong Kong. Continuance under North American models will constitute a natural progression for Hong Kong companies law, as it did in North America where these models evolved and differentiated themselves from their U.K. roots.

North American models of company law have been highly successful in fulfilling their goals because of their conceptual clarity and streamlined procedures. These models are particularly responsive to the considerations set out in the Terms of Reference to this Review: to seek to rationalise, simplify and codify companies law. They are "core company laws" and focus on commercial entities, business corporations.

In order to signal the change in underlying model, it is recommended that the new Ordinance be entitled the "Business Corporations Ordinance". This change should serve to point the judiciary and professional advisors alike in the right direction in terms of sources and interpretation of the new Ordinance. It is likely, as is the case in North America, that "companies" will continue to be referred to in common parlance.

The legislation, however, should be more precise in its nomenclature so as to avoid the conceptual confusion that might otherwise result. For example, Australia, which has remained quite faithful to the U.K. Companies Acts until recently, calls its companies legislation the "Corporations Law". New Zealand, on the other hand, which has looked primarily to North American corporations statutes for its new legislation, continues to refer to the Companies Act. The preferable course is that taken by South Africa; in 1984, it signalled its move away from a U.K.-style companies act by entitling its new legislation the Close Corporations Act.

(DR: see generally. NZLC R9: paras.29,32,33,281,282.)

1.03 RECOMMENDATION: Single Regime. With respect to core company law matters, the same regime should be applicable to both public and private companies. In addition, the new Ordinance should provide a basic optional regime for private companies that would facilitate their operation in an informal and consensual manner.

COMMENTARY: This Review is not recommending separate legal regimes for public/listed companies and private companies. This is primarily a function of the "core company law" approach which has been put forward. The basic, streamlined provisions applicable to the creation, operation and dissolution of companies would apply equally to all companies, irrespective of whether they have had recourse to the public capital markets. All companies would have the benefit of a simplified, flexible company law regime; this would avoid the duplication which might otherwise result from the creation of two separate ordinances.

Those aspects of a company's activities involving the capital markets (and raising issues of protection of the investing public) have been recharacterised as matters more properly the subject of securities regulation and better left to the oversight of the SEHK and the SFC. A fairly traditional definition of private company has been retained, primarily as a legislative drafting tool. Provision has been made for private companies to operate in a highly informal and consensual manner more in keeping with commercial realities.

(NZLC R9: paras.67,76,80.)

1.04 RECOMMENDATION: Securities Regulation. The new Ordinance should not regulate the capital markets activities of companies nor the protection, in the largest sense, of public investors; this should be left to the SFC and the SEHK. With the removal from companies legislation of securities regulation, the SFC should consider the need to re-enact existing, updated or comprehensive new provisions in securities legislation. In the process of extracting the securities law aspects from companies legislation, careful consideration needs to be given to the dangers of creating regulatory gaps as well as the need to address any inadequacies in existing statutory regulation.

COMMENTARY: In Hong Kong, there has historically not been a clear separation of company law and securities law as it relates to the regulation of capital market activities of companies. The distinction began to emerge in recent years. Company law looks primarily to the internal relationships within a company. Securities regulation looks primarily at investor protection and the capital market activities of companies. Companies law and securities regulation have grown to the point where the boundaries are blurred and, to some extent, they overlap, particularly in the realm of corporate governance and the relationship among shareholders, directors and the company.

The area of overlap between companies law and securities regulation may be greater or less depending on a number of factors. It remains the case, however, that securities regulation and companies law should serve very different functions and be responsive to very different pressures.

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

Securities regulation, on the other hand, is very much concerned with the "public interest" in fair and efficient capital markets, thus the emphasis on disclosure, fairness,

enforcement and compliance. Securities law is essentially regulatory in nature and applicable to a narrow range of companies, a fact recognised in the New Zealand reforms:

> A core company law is only part of the wider law which applies to companies. In the reform, we endorse and build on the distinction in our current law between securities law and company law ... Much less than one percent of companies raise capital from the public (the exact number is not known but listed companies acount [sic] for only 209 of the approximately 150,000 New Zealand registered companies). For those companies, investor confidence and protection is principally safeguarded in other ways (NZLC, Report No. 9 (NZLC R9) at 3).

The original purpose of securities legislation was investor protection. Over the years this mission evolved to include the facilitation of capital formation and efficient markets. Fair and efficient markets require, among other things, regulation of the capital market activities of companies. This is the express mission of the SFC :

> To promote user confidence in the efficiency and fairness of Hong Kong's securities and futures markets so as to support their continuing development, especially in relation to capital formation for the China region (*SFC Annual Report* 1995/96 at 1).

It is generally accepted that public confidence in the markets requires, among other things, that:

(i) investors be capable of making informed investment decisions at the time of the initial offer of securities by a company and subsequently while those securities are trading publicly;
(ii) all public investors be treated fairly; and
(iii) there be appropriate monitoring of the integrity of the management of companies with public investors.

These objectives are achieved through two basic techniques - full disclosure and substantive regulatory requirements. The former leads to the enactment of laws (or the introduction of rules) on disclosure and, in particular, prospectus disclosure, the requirement for periodic financial disclosure, and on-going disclosure of price sensitive information. Disclosure of material information is the life-blood of markets. The latter technique leads to requirements relating to corporate governance (such as independent shareholder approval of connected transactions and the appointment of independent directors) or substantive requirements for fair treatment (such as pre-emptive rights and the mandatory offer obligation under the Code on Takeovers and Mergers).

Companies and securities law apply in different circumstances. The application of substantive provisions of a companies law is generally based upon the company's place of incorporation. Securities regulation, on the other hand, operates to protect local investors and to regulate local trading in the securities of listed or public companies, irrespective of the jurisdiction of incorporation. Jurisdiction for purposes of securities regulation should be determined by the residence of the shareholders or geographical locality in which a company has sought to raise funds or uses securities trading facilities.

Where there is substantial identity of place of incorporation and place of listing or public offering, then place of incorporation may serve the purposes of both company and

securities law in determining jurisdiction. Historically, this would have been the case in the United Kingdom. This is today the case in Australia and New Zealand where approximately 99% of listed companies are locally incorporated. Where, as is the case in Hong Kong, many foreign incorporated companies seek to participate in local capital markets, the basis for securities law jurisdiction should not be the jurisdiction of incorporation. Jurisdiction for securities law purposes should be based upon a company having sought access to Hong Kong's capital markets to raise funds or for listing.

The distinction between securities regulation and companies law has been evolving in Hong Kong for a number of years. The establishment of the SFC and the evolution of securities regulation over the last several years in Hong Kong has already resulted in a shift in characterisation of several matters from companies law to securities regulation. For example, in 1992 the Ordinance was amended to transfer prospectus vetting responsibilities from the Companies Registry to the SFC and SEHK. A function previously that of the Registrar of Companies is now the responsibility of securities regulators.

The need to differentiate between companies law and securities regulation is now well accepted in Hong Kong. Those provisions of the Ordinance which apply to the capital market activities of companies (or an updated comprehensive version of them) should be transferred to securities legislation administered by the SFC. The securities regulatory regime should apply to all companies that offer their securities to the public (i.e., even if they are not listed on the SEHK), again, regardless of jurisdiction of incorporation.

The existing statutory requirements applying to listed companies in Hong Kong are limited - primarily the prospectus provisions in the Ordinance, the financial disclosure requirements applicable to locally incorporated companies, the inspection provisions in the Ordinance and in the SFC Ordinance, and the disclosure of interests requirements in the Disclosure Ordinance. The bulk of regulation of listed companies is found in the non-statutory Listing Agreement and Listing Rules of the SEHK and Codes on Takeovers and Mergers and Share Repurchases of the SFC. In the case of non-listed public companies, the requirements are even more sparse, essentially being limited to prospectus requirements. Developed securities markets in other jurisdictions including North America, Australia and the United Kingdom place greater reliance on statutory requirements than does Hong Kong.

The very great importance of Hong Kong as an international financial centre has made it crucial to consider carefully the legal regimes involved in capital market activity. The Ordinance, in particular, was not drafted at a time when Hong Kong had achieved such international prominence. It is important to design companies legislation and securities legislation that work well together in the international arena.

Less than 30% of Hong Kong listed companies are incorporated under the Ordinance. The majority of listed companies (some 70%) are domiciled overseas with the primary jurisdictions of incorporation being Bermuda, the People's Republic of China and the Cayman Islands. It is not appropriate to regulate the securities market activities of these companies in the Ordinance. This would, among other things, result in confusion over the respective roles of companies law and securities regulation. (As a general rule, the substantive company law applicable to these companies would be that of their jurisdiction of incorporation).

Provisions which have securities law implications should be removed from the Ordinance, primarily those dealing with prospectuses for local and overseas companies in Parts II, XII and Schedules 2, 3 and 4. These recommendations for a new Ordinance have been rethought with private companies in mind, i.e. from an enabling rather than a regulatory perspective. Underlying this approach is the very necessary assumption that any additional safeguards or regulatory features that are necessary for listed or public companies with respect to their capital market activities exist in a securities ordinance or elsewhere.

It is important to keep in mind that these recommendations assume that the new Ordinance, in its more streamlined form, would continue to apply to all "core company law" aspects of Hong Kong incorporated public and listed companies, i.e. their creation, operation and termination.

In the process of extracting the securities law aspects of the Ordinance, however, careful consideration should be given to the dangers of creating regulatory gaps between the companies law and securities regulation. The SFC is in the process of rationalising and consolidating the provisions of the existing 11 Ordinances that deal with securities law matters. It has also published a three year plan designed to build a modern securities law regime for Hong Kong. The substantive recommendations which follow are premised on the existence of comprehensive, modern securities law regime; without it, there may be important information and protections which would not be available to the public investor. It would be important going forward with the reforms recommended in this Report that efforts be coordinated with the SFC and the SEHK to ensure that legislation in these two important and interrelated areas works well together.

Given the "core company law" approach advocated in this Report, and the current efforts of the SFC to build a modern securities law regime for Hong Kong, this Report is not making detailed recommendations for a separate public or listed companies ordinance. The Report on Module 1 which was prepared in February 1996, and put before the SCCLR for consideration, did however make general recommendations on the need for and nature of a new regulatory regime to govern companies with public investors. It made several observations and recommendations which could serve as points of reference for the coordinated creation of modern companies and securities regimes. The following is a summary of some of the key recommendations and observations in the Report on Module 1:

- In order to avoid regulatory gaps and to eliminate existing deficiencies in statutory securities regulation, the securities regulators should enact comprehensive new provisions in respect of the regulation of listed and other public companies.

- An updated version of the prospectus provisions currently found in the current Ordinance would be reenacted as securities legislation.

- In addition, a regime generally applicable to listed and other public companies might include the following:

    - Any new provisions would be applicable to all listed companies regardless of jurisdiction of incorporation and to certain other public

companies (e.g. those which make a public offering in Hong Kong)

Companies to which the legislation applied:

- would have a statutory obligation to issue and file annual and interim financial statements as well as to issue and file announcements of material/price sensitive information;

- would commit an offence by including misleading or omitting material information from accounts, shareholders circulars, announcements of material/price sensitive information, takeover and share repurchase circulars;

- might be subject to sanctions in relation to the issuance of misleading documents. Criminal sanctions for non-compliance are not necessarily desirable; an administrative tribunal could be established where cases would be based on civil standards of proof; civil penalties could be created such as those that may be imposed by the Insider Dealing Tribunal (i.e. fines and banning offenders from the market) together with statutory civil liability so as to provide a means for investors who suffer financial loss to seek compensation;

- An alternative to enacting separate statutory obligations might be to bolster the continuous disclosure requirements already found in the Listing Rules by providing statutory backing for such Rules. However, this would not address the issue of non-listed public companies.

These considerations were put forward with a view to encouraging public discussion. The securities regulators would decide what further study of these issues would be appropriate and any definitive proposal would only emerge after careful consideration by the SFC and the SEHK and after full public consultation.

(NZLC R9: paras.17,18,34,35,68.)

1.05 RECOMMENDATION: Insolvency. The new Ordinance should not apply to insolvent winding up; matters pertaining to insolvency should be left to a comprehensive Insolvency Ordinance.

COMMENTARY: It is increasingly recognised in a number of jurisdictions that winding up for reasons of insolvency should form part of the body of law dealing with insolvency, whether of individuals or companies, rather than company law. Gower considers it to be an advance that "the essential unity of bankruptcy and insolvent liquidation" has been recognised in the United Kingdom by the creation of a separate insolvency regime for both companies and individuals under the *Insolvency Act 1986*. Gower discusses whether the voluntary winding up of *solvent* companies should have been left in the Companies Act rather than being relocated in the Insolvency Act 1986:

> Hitherto the winding up of companies had been seen as a branch of company law divorced from the bankruptcy law relating to individuals. Now both need to be regarded as branches of a single subject -Insolvency Law. It is, perhaps, anomalous that members' voluntary winding up of solvent companies should be dealt with in the Insolvency Act; it might have been better if that had remained in the Companies Act (or, failing that, if the Insolvency Act had been entitled the Bankruptcy and Winding up Act). But it is an advance to have recognised the essential unity of bankruptcy and insolvent liquidation and, accordingly, that Company Law should concentrate on the life, rather than the death and interment, of companies. That, of course, does not mean that companies (or books on Company Law) can wholly ignore what will happen if companies become insolvent.
>
> ...
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> But, although insolvency is the most common reason for winding up, it is far from being the only one and, when the company is fully solvent, it seems, on the face of it, somewhat illogical to treat the process as part of Insolvency Law rather than Company Law. The reason why the legislation relating to liquidation of solvent companies is in the Insolvency Act is probably to avoid duplicating those many provisions that apply whether or not the company is insolvent - to repeat them in the Companies Act would have added substantially to the length of the combined legislation. But it can also be justified as realistic. Once a company goes into liquidation the distinction between shareholders and creditors becomes more than usually difficult to draw; the members' interests will, in effect, have become purely financial interests deferred to those of the creditors. (Gower's at 52 and 761).

This recommendation is consistent with the direction being taken by the Sub-Committee on Insolvency of the Law Reform Commission of Hong Kong which has been at work since September 1990. The mandate of the Sub-Committee has been to review the law and practice relating to the insolvency of both individuals and bodies corporate in Hong Kong and, in particular, "the winding-up provisions of the Ordinance". Several reports have already appeared, on Bankruptcy and Corporate Rescue and Insolvent Trading, looking to the United Kingdom, Australia, the United States and Canada. The Bankruptcy (Amendment) Ordinance 1996, which substantially updates the regulatory framework for personal insolvencies, was passed by the Legislative Council in December 1996 and will be brought into effect during 1997.

Drafting instructions with respect to the Companies (Amendment) Bill 1997 for Corporate Rescue and Insolvent Trading are proceeding apace. Corporate rescue would create a procedure known as "provisional supervision". This would involve a moratorium on proceedings against the company during which time a "provisional supervisor" would attempt to bring about a voluntary arrangement with creditors.

The Sub-Committee has gone on to consider in detail the winding-up provisions of Part V of the Ordinance as well as other associated issues such as the relationship between receivership and winding-up. The Sub-Committee is again looking to approaches adopted in the United Kingdom, Australia and Canada. A Law Reform Commission Report can be expected in late 1997 or early 1998.

This Review recommends that the insolvency provisions of the Ordinance and the Bankruptcy Ordinance be combined in a separate, comprehensive Insolvency Ordinance. Consistent with the proposed "core company law" approach, the recommendations for a new Ordinance deal exclusively with *solvent* dissolution and liquidation. This recommendation alone would reduce the bulk of the current Ordinance by approximately one-third, and greatly

simplify the dissolution and liquidation regime.

[DR: para.440, Draft Act Part 17.00. NZLC R9: paras.74,114, Draft Act s.86.]

1.06 RECOMMENDATION: Charges. A study should be undertaken with a view to introducing a separate, comprehensive regime governing security interests in personal property (such as recommended by the U.K. Diamond Report). It would permit the elimination of Part III of the Ordinance, Charges. Until such time, Part III would continue in effect in conjunction with the new Ordinance.

COMMENTARY: Part III of the Ordinance deals with the registration of charges created by companies. The Ordinance requires that the Registrar of Companies maintain a register in respect of each company and that each individual company also maintain its own register of charges. The SCCLR has considered the reform of the charges provisions virtually on an annual basis since the Committee's creation. The charges provisions are based on the U.K. system of registration adopted some fifty years ago, and which have been described as archaic and highly unsatisfactory. Although the SCCLR had proposed adoption of new legislation inspired by recent law reform efforts in the United Kingdom, difficulties with implementation there led to withdrawal of the Hong Kong proposals.

In the United Kingdom, the reform of the law of charges and security over interests in property other than land has been the subject of several reports. In 1988 Professor A.L. Diamond concluded that the law required comprehensive reform and that this reform should be based on a North American style personal property security law regime:

> 1.9 My main recommendation is that there should be a new law on security interests to replace the multitude of different rules we now have. This would simplify the law enormously and speed up business transactions, and would ensure that like transactions are treated alike. There is a well-tried model in Canada and the United States on which the new law should be based.
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> ...
>
> 1.11 A new register of security interests should be set up to replace the existing register of company charges.
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> ...
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> 7.1.2 These various pieces of legislation and draft legislation provide useful models of the sort of enactment that could well be introduced into the United Kingdom. The legislative style of the Canadian Acts is probably closer to that with which we are accustomed than is Article 9 of the American Uniform Commercial Code, though the Acts are a little longer: the Uniform Act, for example, has 75 sections, and the Saskatchewan Act 74 sections. (A. Diamond, *A Review of Securities Interests in Property* (London: DTI, 1988) at 2 and 25)

Professor Diamond's proposals would have resulted in the eventual replacement of the existing system of registration of charges under the Companies Act 1985. In his report Professor Diamond reviewed the proposals in two earlier reports, the Crowther Report of 1971 and the Halliday Report of 1983. The Crowther Report had also recommended a

system based closely on Article 9 of the Uniform Commercial Code (i.e. the North American model).

The recommendations of the Diamond Report and its predecessors have not been adopted, in part, due to difficulties with the Land Registry System. The United Kingdom is still in the process of considering how to deal with the problems that have been identified with the current regime.

New Zealand and Australia are both considering the co-ordinated introduction of a new regime applicable to personal property security interests. Australia's efforts have been somewhat hampered by the constitutional difficulties associated with state jurisdiction in the area. New Zealand has had proposals in place for sometime but wishes to co-ordinate its efforts with those in Australia.

The New Zealand Law Reform Commission in *A Personal Property Securities Act for New Zealand (1989), Report No. 8* proposed the introduction of a North American style regime. The Commission recommended a new statute to be enacted in place of the New Zealand equivalent of Part III of the current Ordinance:

> a) The present law is complex, uncertain, anomalous, and inflexible;
>
> b) There is an overwhelming case for reforms which will result in a comprehensive system for appropriate legal recognition and ranking of the various rights and interests in personal property - a system that is easily understood, efficient, and cheap; and
>
> c) The next stage in the reform process is the preparation of draft legislation - based on contemporary North American models with appropriate adaptations for New Zealand conditions - to replace both Part IV of the Companies Act 1955 and the Chattels Transfer Act 1924. (New Zealand Law Commission, *A Personal Property Security Act for New Zealand, Report No. 8* (1989) at 2).

The registration of charges should not form part of core company law and should therefore not be included in a new Ordinance. The granting of security interests is a technical, self-contained system in modern commercial law involving a wider range of issues and legislation than that contained in Part III of the Ordinance. It is recommended that the Government mount a separate review to examine the law relating to charges over, and interests in, property other than land, with a view to creating a comprehensive regime governing personal property security interests.

This recommendation is made with some urgency. Since the inception, the problems relating to the current inadequate regime in Hong Kong have been repeatedly brought to the attention of the Review. Of the numerous studies which have been done in this area in various jurisdictions, the overwhelming consensus is that the North American personal property security interests regime, modelled on Article 9 of the Uniform Commercial Code or a variation of it, is the world standard.

1.07 RECOMMENDATION: Financial Institutions. The new Ordinance would continue to serve as the basic legislation governing the "core company law" aspects of regulated financial institutions in Hong Kong, essentially incorporation and its incidents; the regulatory aspects would be determined by the Hong Kong Monetary Authority and the Insurance Authority, as appropriate and would preferably appear in their related legislation.

COMMENTARY: Financial institutions in Hong Kong may be incorporated under the Ordinance (or, if incorporated abroad, registered under the Ordinance) and are generally subject to its provisions. In addition, "authorised institutions" (banks, restricted licence banks and deposit-taking companies) are subject to the Banking Ordinance, Cap.155, in Hong Kong. Insurance companies are subject to the Insurance Companies Ordinance, Cap. 41 and the supervision of the Insurance Authority.

Under the Ordinance, certain provisions are specifically, and sometimes exclusively, applicable to authorised institutions. Most important of these are the exemptions granted to authorised institutions and insurance companies from certain of the financial disclosure requirements of the Tenth Schedule. In other cases, additional requirements, such as disclosure of, and record keeping with respect to loans to officers, are imposed on authorised institutions. Other provisions of the Ordinance are made specifically applicable, in part, to authorised institutions through incorporation by reference into the Banking Ordinance and the Insurance Ordinance; in this way, the basic regime applicable to the winding up of companies under the Ordinance is equally applicable to authorised institutions and insurance companies. Preferences upon liquidation are accorded to insurance policy holders and also to bank depositors. As well, to the extent that the Ordinance is applicable to overseas incorporated companies (especially in relation to liquidation of such companies), foreign financial institutions are caught by such provisions.

The Banking Ordinance was enacted in 1986 to "regulate banking business and the business of taking deposits and to make provision for the supervision of authorized institutions so as to provide a measure of protection to depositors and to promote the general stability and effective working of the banking system ...". It has been amended on numerous occasions since 1986. The Banking Ordinance is primarily licensing legislation replete with a multiplicity of penalty and sanction provisions. The statutory provisions are supplemented by statutory guidelines that are issued by the Monetary Authority, from time to time. In addition, the Monetary Authority also recently published the "Guide to Applicants", which sets out clearly, among other things, the Monetary Authority's interpretation of the minimum criteria for authorisation and grounds for revocation. As well, non-statutory "best practice" guidelines, most notably in the area of financial disclosure and the duties and responsibilities of directors are issued by the Monetary Authority. The Monetary Authority is very active and the recent amendment exercise concerning the Banking Ordinance, in addition to a number of policy initiatives, includes a consolidation of the penalty and appeal provisions.

In a manner comparable to the Banking Ordinance, the Insurance Companies Ordinance concentrates on the authorisation and supervision of insurers in Hong Kong. The Insurance Companies Ordinance was enacted in 1983 (and frequently amended since then) "[t]o regulate the carrying on of insurance business, to provide for the appointment of an Insurance Authority, to confer powers of authorization and intervention on the Insurance

Authority in respect of insurers and to require insurers to furnish financial statements and other information to the Insurance Authority ...." (Preamble). As with the Banking Ordinance, the legislation is supplemented by a Code of Practice. With respect to the sale of insurance products which are "investment arrangements", authority is split between the Insurance Authority and the SFC. A recent amendment has introduced asset maintenance requirements; an insurer is required to maintain a certain amount of assets in Hong Kong.

In several respects, the Banking Ordinance and the Insurance Companies Ordinance provide an overlay to the Companies Ordinance, imposing additional requirements on authorised institutions and insurers; for example, the approval of the Hong Kong Monetary Authority is required for the appointment of chief executives and directors of authorised institutions. To the extent that there is any conflict or inconsistency between provisions of the Banking Ordinance and the Companies Ordinance, the provisions of the Banking Ordinance take precedence:

> An authorized institution which is incorporated or registered by or under the Companies Ordinance (Cap.32) shall be subject to that Ordinance as well as to this Ordinance, except that where there is any conflict or inconsistency between this Ordinance and the Companies Ordinance (Cap.32) the provisions of this Ordinance shall prevail (*Banking Ordinance*, s.3(5)).

The Insurance Companies Ordinance in s.2(6), contains a comparable provision which gives priority to the Insurance Companies Ordinance in the event of conflict or inconsistency with a provision of the Companies Ordinance.

With respect to new provisions applicable to authorised institutions, such provisions are sometimes characterised as "banking" and placed within the context of the Banking Ordinance although others are characterised as primarily company law matters specifically applicable to financial institutions. For example, recent provisions with respect to priority payments for bank depositors were included in the Companies Ordinance, and not the Banking Ordinance. As these provisions represent a compromise, and an alternative to a deposit insurance scheme, they could also be characterised as a banking matter under the Banking Ordinance, the stated purpose of which is to "provide a measure of protection to depositors and to promote the general stability and effective working of the banking system ..." (Preamble). As the entire liquidation regime is currently in the Companies Ordinance, it was decided that it was more appropriate to include such provisions with those applicable to preferential creditors generally in the case of liquidation of a company.

With the very rapid rise of Hong Kong as an international financial centre, the proper supervision of financial institutions will continue to gain in importance. In addition, international pressures for coordination of regulatory approaches among jurisdictions (the adoption of international capital adequacy standards has been a prime example) will continue to have an influence on the regulatory regimes applicable to financial institutions in Hong Kong as elsewhere. It has always been the policy of the Hong Kong Monetary Authority to devise a supervisory framework which conforms as much as possible with international supervisory standards, in particular those recommended by the Basle Committee on Banking Supervision. The Authority follows closely new standards proposed by the Basle Committee, e.g. those on market risks, and incorporates them into the Hong Kong framework. In the

future, the treatment of foreign financial institutions in Hong Kong, especially in circumstances of insolvency, will be of particular interest.

The Hong Kong Monetary Authority would like to see the companies legislation continue to serve as the basic legislation governing the "core company law" aspects of authorised institutions in Hong Kong, essentially incorporation and its incidents. The Hong Kong Monetary Authority would prefer to continue to rely on the general statutory companies law regime, for example, with respect to winding up. As to those provisions of the current Ordinance that now pertain exclusively to authorised financial institutions in Hong Kong, the Hong Kong Monetary Authority would be prepared to accept their "migration" to the Banking Ordinance, if it is practically and technically feasible. The two main areas identified by the Hong Kong Monetary Authority for inclusion in the Banking Ordinance are provisions relating to the financial disclosure of banks and the disclosure of loans to officers (now in ss. 161B and 161BA of the Companies Ordinance.)

Attached as Appendix 4 and 5 are analyses prepared by the Hong Kong Monetary Authority and the Commissioner of Insurance of those provisions of the Companies Ordinance which have implications for authorised institutions and insurance companies, respectively.

1.08 RECOMMENDATION: Not-for-profit Enterprises. The new Ordinance would not be applicable to not-for-profit enterprises, currently formed as companies limited by guarantee; the current Ordinance would continue to apply to such entities until such time as consideration is given to their separate treatment.

COMMENTARY: The current Ordinance applies to both business enterprises and to companies not carried on with a view to profit. Charitable and quasi-charitable organisations are generally registered as companies limited by guarantee. Many North American statutes are for "business corporations" alone so that not-for-profit companies are the subject of a separate regime.

Although in an ideal world it would be desirable to have a regime for not-for-profit enterprises sharing the same conceptual underpinnings as the proposed new Ordinance for business enterprises, there are several practical reasons militating against this approach. In comparison to business incorporations, the number of not-for-profit incorporations is quite limited. According to statistics from the Companies Registry as of December 31, 1996 only 5,523 or 1.14% out of the 483,181 companies registered were not-for-profit (i.e. companies limited by guarantee). There are seldom the same imperatives with respect to the need for a speedy, streamlined form of incorporation for not-for-profit enterprises in comparison to business enterprises. In addition, many of the not-for-profit enterprises currently organised as companies limited by guarantee are well established in the community and would benefit very little from a change in their form of organisation.

The Canadian experience is instructive. A companion bill for not-for-profit corporations was prepared following close on the heels of implementation of the CBCA in 1975. There was however no pressing need for the legislation and it was never enacted. That part of the prior legislation, the Canada Corporations Act, dealing with not-for-profit

incorporations was simply left in place. It is not that this legislation is considered satisfactory; it is cumbersome, at odds with the sleek business corporations statutes in Canada, and the domain of a specialised group of practitioners. The economic significance of these organisations, however, simply did not justify the legislative effort of fashioning a specialised regime for them at the time.

New Zealand took another tack in its Companies Act 1993. Although strongly influenced by North American business corporations statutes in framing its new legislation, New Zealand attempted to provide for not-for-profit incorporations within such a framework.

> A BUSINESS CORPORATIONS ACT
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> 281 In the discussion paper, we raised the question whether the Act should be available only to companies set up to make profit. In that case, a separate statute would be devised for non-profit companies. The responses received to the discussion paper favoured the retention of a single statute applying to both types of company. That is the New Zealand system and appears well accepted.
>
> 282 The North American statutes are "business corporations" statutes. The benefit of such specialisation is that it permits assumption of shared purpose to a certain extent. A profit purpose is at least a measure against which the best interests of the company can be weighed. Interestingly enough, however, none of the statutes we have seen impose a profit-maximising purpose on companies and, indeed, very often it would be misleading to assume such a purpose.
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> 283 The Law Commission has concluded that for New Zealand circumstances a statute covering both business and other companies is appropriate. The standard constitution in the draft Act does, of course, envisage a business enterprise in which profits are distributed to shareholders. Companies formed for charitable purposes will have to opt out of the standard form by their constitution. For example, a charitable company (which, with the elimination of companies limited by guarantee, will be required to adopt a share structure) may provide for its directors to hold all the shares in the company and provide that the shares do not carry any rights to distribution. (NZLC R9 at paras. 281-283).

According to practitioners, the results have not been particularly satisfactory although it is still relatively early to tell. It should be noted that New Zealand also has an Incorporated Societies Act which dates back to 1908 and is available to not-for-profit organisations.

[DR: para.44.]

1.09 RECOMMENDATION: A new Not-for-profit Corporations Ordinance. Serious consideration should be given to implementation of an Ordinance governing incorporated not-for-profit organisations.

COMMENTARY: Part III of the current Ordinance, Charges, forms a discrete and self-contained Part which may continue in force and operate in conjunction with the new Ordinance with little difficulty until replaced. In order to retain the existing regime for not-for-profit organisations, on the other hand, it is necessary to keep much of the infrastructure of the current Ordinance in place. This has been done in other jurisdictions, but is not the ideal solution. Once the structure of the Business Corporations Ordinance is finalised, it is

a relatively easy task to adopt a complementary format for not-for-profit organisations; there are numerous models to draw from. Since it is proposed that the current Ordinance and the proposed Ordinance operate side by side for a three-to-five year transitional period, there would be an opportunity to bring such legislation into place concurrently with the full implementation of a new Business Corporations Ordinance.

1.10 RECOMMENDATION: Structure of a New Ordinance. The following structure is proposed for the organisation of a new Ordinance.

OUTLINE FOR A BUSINESS CORPORATIONS ORDINANCE

PART 1: INTERPRETATION

PART 2: ADMINISTRATION OF THE ORDINANCE

PART 3: INCORPORATION; CAPACITY AND POWERS

PART 4: CAPITAL STRUCTURE

PART 5: MANAGEMENT AND ADMINISTRATION

PART 6: DIRECTORS AND EXECUTIVE OFFICERS

PART 7: SHAREHOLDERS' RIGHTS AND REMEDIES

PART 8: FUNDAMENTAL CHANGES

PART 9: SOLVENT DISSOLUTION AND LIQUIDATION

PART 10: PRIVATE COMPANIES/CLOSELY HELD CORPORATIONS

PART 11: FOREIGN CORPORATIONS/OVERSEA COMPANIES

PART 12: TRANSITIONAL PROVISIONS

PART 13: GENERAL

COMMENTARY: The proposed structure for a new Ordinance builds on the traditional organisation of the current Ordinance but breaks out separate parts for, Capital Structure, Directors and Executive Officers, Shareholders Rights and Remedies from the existing Part IV of the current Ordinance. Two new parts are created, Fundamental Changes and Private Companies. Winding Up has been replaced by Solvent Dissolution and Liquidation. Leaving aside the parts on Interpretation, Transitional Provisions and General, the Ordinance has been reorganised into 10 more balanced and logically coherent Parts. Attached as Appendix 5 is a chart prepared by the Companies Registry which compares the structures of the current Ordinance and the proposed new Ordinance.

2.00 ADMINISTRATION OF THE ORDINANCE

2.00 ADMINISTRATION OF THE ORDINANCE

2.01 RECOMMENDATION: Consolidation and Updating Part VII. The provisions of Part VII of the existing Ordinance, General Provisions as to Registration, should be consolidated, and if necessary, updated in this Part. In particular, provision for the electronic keeping and filing of notices and other documents should be made.

CURRENT ORDINANCE: Part VII, General Provisions as to Registration, contains the following provisions: registration offices and appointment of officers for purposes of this Ordinance (s.303); taking of affidavits, etc.(s. 303A); fees (s.304); inspection, production and evidence of documents kept by Registrar (s.305); enforcement of duties under Ordinance by court order (s.306).

COMMENTARY: The use of information technology is the most important single consideration to be kept in mind in terms of any recommendations to be made concerning the operational aspects of the Companies Registry. To this end, the Companies Registry has already undertaken a major review of all the forms currently filed by companies in order to make them "more user-friendly and computer compatible" (Letter of Gordon Jones, Registrar of Companies, to Cally Jordan (25 April 1996)). Various other matters such as facilitating evidentiary use of Registry filings, etc. are already addressed for the most part in Part VII.

(OBCA: ss.273.1,273.2.)

2.02 RECOMMENDATION: Role of Registrar. The role of the Registrar should continue to be primarily an administrative and policy advisory one.

CURRENT ORDINANCE: The Registrar maintains a central database of all registered Hong Kong companies (both local and oversea companies registered under Part XII).

COMMENTARY: Consistent with the recommendation to create a highly enabling legislative regime for companies, the Companies Registry should continue to focus its energies on facilitating the administrative formalities associated with incorporation and the operation of a company.

> The overall thrust of making companies law self-enforcing and self-executing is generally supported. In this respect the CR [Companies Registry] by providing a central database on all registered Hong Kong companies (both local and oversea) will play a crucial role in enabling the private sector to police itself. However, by placing the emphasis in civil action, much will depend on the recommendations in [Remedies], and whether it is possible, in a Hong Kong context, to assume that civil action is a feasible proposition for an aggrieved party bearing in mind the usually financially prohibitive cost of such an action (*ibid.*, Appendix III, at 1-2).

There has been a considerable amount of comment made in the course of the Review with respect to the difficulties associated with the use of civil litigation by private parties as a remedy in Hong Kong. Civil litigation is extremely expensive. In addition, given the prevalence of family controlled enterprises and a marked reluctance to resort to civil litigation (with its attendant confrontation and publicity), reliance on civil remedies to balance abuse of corporate form may be illusory. As well, shareholders seeking information about the operations and state of a company may encounter insurmountable difficulty even in their attempts to gather enough evidence to state a claim.

Adjustments in other areas might alleviate these difficulties. The use of private alternative dispute resolution might address concerns of confrontation and publicity in purely internal company matters. Provision for interim orders for costs in certain circumstances (to be borne by other than the plaintiff) might go some way to removing the impediment created by the high cost of litigation. Beefing up important and basic shareholder rights to information (on pain of swift, drastic and exceptional action by the Registrar) might be another means to address these concerns.

The role of the Companies Registry should continue to be primarily one of an administrative nature. It should concentrate on providing an efficient and cost effective means of incorporation and administration of all of the associated consequences of incorporation, including disincorporation or dissolution. At present, the Companies Registry's principal functions are:

> to provide facilities to allow the promoters of companies to easily incorporate their companies and to register all documentation required by the Companies Ordinance; to provide the public with facilities to search for the information held by the Registry; to ensure compliance by companies and their officers with their obligations under the Companies Ordinance; and to advise the Government on policy and legislative issues regarding company law (*ibid.*, Appendix III, at 1).

The Companies Registry should provide information to the public with respect to companies registered with it in a similarly efficient and cost effective manner. The use of information technology, a path along which the Companies Registry has already embarked, should greatly enhance these efforts.

The Companies Registry does not and should not be required to play a major role in investigation of company activities or the quasi-criminal "enforcement" of company law itself. The Companies Registry does not have the resources to police commercial activity and this role is best left to the Attorney-General's Chambers, the SFC and the CCB, as appropriate. The recommendations of this Review are designed to "decriminalise" company law which should serve to reinforce the administrative role of the Companies Registry. As for administrative offences and their enforcement, the simplification of filing and other housekeeping matters associated with incorporation should in fact eliminate a number of "administrative " offences.

(DR: paras.13-14. NZLC R9: paras.312-321. U.K. Companies Act 1985: Part XXIV.)

2.03 RECOMMENDATION: Charges. Pending reconsideration of the legislative treatment of "Charges", the Companies Registry would continue its administration of Part III of the current Ordinance.

CURRENT ORDINANCE: The Registrar's Office keeps a registry of company charges in accordance with Part III(ss. 80-91).

COMMENTARY: This Review has recommended that Part III of the current Ordinance, Charges, be made the subject of a separate study with a view to implementing a modern, comprehensive system for the creation and publication of personal property security interests. This regime would in no way affect the current registration of interests in real property. The Diamond Report in the United Kingdom recommended implementation of such a regime on

November 7, 1988 (Great Britain, Department of Trade and Industry, *A Review of Security Interests in Property* (London: H.M.S.O, 1989) (The Diamond Report)).

The use of information technology is highly effective in this particular area and there are well-tested and efficient models which have been operational for many years. The savings in terms of the cost and reliability of publicly available information and the promotion of stability and certainty in commercial dealings would be significant. Such a system would be primarily (but not exclusively) to the benefit of all commercial lenders and trade creditors. Until such a regime is considered and implemented, Part III of the existing Companies Ordinance would remain in place and the Companies Registry would continue to administer it.

2.04 RECOMMENDATION: Subsidiary legislation. Subsidiary legislation and standard forms should be used extensively to deal with technical filing requirements, fees, etc. in order to facilitate timely updating and amendment.

CURRENT ORDINANCE: Standard forms and fees are currently found in the schedules attached to the Ordinance (schs. 1,2,4,5,6,8).

COMMENTARY: The complexity and length of the forms currently required under the Ordinance have long been perceived as creating an unduly heavy compliance burden on companies. The use of streamlined, standardised forms should in and of itself reduce compliance costs to the user and processing costs to the Companies Registry. This process is ongoing. The vast majority of the clauses contained in the Companies (Amendment) Ordinance 1997 relate to the deregulation of the forms that companies are required to file under the Ordinance. These amendments aim to accord the Registrar of Companies the necessary powers to determine the format of forms in order to make them more "user friendly" and "computer compatible" (SCCLR, Annual Report 1995/96 at 60).

(DR: *para.12.*)

2.05 RECOMMENDATION: Offences. With respect to offences, the Twelfth Schedule should be eliminated; such offences which are to be retained or created should be regrouped in more generic categories in this Part of the Ordinance and accorded appropriate sanctions.

CURRENT ORDINANCE: The Ordinance has over 160 provisions that create an offence; it lists every section creating an offence, the nature of the offence and the consequences (sch. 12).

COMMENTARY: With the rationalisation, simplification and streamlining of the Ordinance, many provisions giving rise to minor offences should simply disappear. With the shift in the enforcement burden to civil remedies and to bodies like the SFC, the necessity for other statutory offences should also disappear. Those offences retained or created under a new Ordinance should be regrouped and matched with appropriate sanctions: administrative and filing offences (fine or administrative sanction; possible deregistration); and failure to comply with statute or company constitution to such a degree that public intervention is justified (compliance order, fine, etc).

(DR: paras.474-496, Draft Act Part 19.00. OBCA: Part XVII. NZLC R9: Draft Act Part 18.)

2.06 RECOMMENDATION: Enforcement. To the extent possible, companies legislation should be self-enforcing and self-executing; investigation and inspection by a government body should essentially be a residual remedy, available in the event that private civil recourses are inadequate or ineffective. Powers comparable to the existing investigation and inspection powers would be maintained.

CURRENT ORDINANCE: Under its enforcement powers, the Companies Registry sanctions administrative offences which are primarily ancillary to the operation of the Registry (s.306). The Financial Secretary has the power to appoint inspectors to conduct a full scale investigation of a company (ss.142-152). In addition, the Financial Secretary has the power to require a company to produce documents (ss.152A-152F). In light of information obtained under its investigatory powers, the Financial Secretary under s.147(2) has the right to make petition under the unfairly prejudicial remedy if it appears to him that the affairs of a company are being conducted in a manner unfairly prejudicial to the interests of a shareholder or shareholders (ss.147(2), 168A).

COMMENTARY: As a function of the shift to a highly enabling companies law regime (and the separate administration and enforcement of securities legislation), companies law should be, to the greatest extent possible, self-enforcing and self-executing. Since such "enabling" regimes are highly permissive, it is important that there be mechanisms to counter the possibilities of abuse. However, rather than placing the burden of enforcement on public authorities through criminal sanctions and powers of investigation, these highly enabling regimes try to shift the balance of enforcement to those most directly aggrieved.

By creating broad avenues of civil recourse to those most directly affected, these regimes achieve the laudable goal of decriminalisation of companies law as well as relieving public authorities of the largely impossible task of policing commercial activity. As the Dickerson Committee put it:

> ...a corporations Act should be largely self-enforcing by civil action initiated by the aggrieved party, not by severe penal sanctions or sweeping investigatory powers. If this policy is not adopted, it is our opinion, given the state of the common law, that we must continue to rely on ever broader powers of investigation as a means to remedy corporate ills, which become increasingly complex as businesses become more and more sophisticated (Dickerson Report at para. 479).

The types of civil and other recourses recommended are discussed elsewhere in relation to shareholders' remedies and private companies/close corporations. For its part, the Dickerson Committee identified six general categories of remedial techniques: disclosure (e.g. access to corporate records); structural techniques (e.g. shareholder proposals); civil action (e.g. court review of an election of directors); administrative proceedings (e.g. cancellation of certificate of incorporation); director's personal liability (e.g. improper payment of a dividend); and civil penalties (e.g. failure to distribute financial statements).

In this particular area, investigation and offences, care should be taken not to uncritically emulate U.K. approaches. First, the substantive companies legislation being proposed is not modelled on U.K. companies law for the reasons given earlier in this Report and the assumptions underlying it are different. The most important assumption is that the role of protection of the investing public (in listed and unlisted companies) has been and will be assumed by the SFC and the SEHK. This dramatically reduces the scope and necessity for public intervention in the internal affairs of companies under the companies legislation.

The second reason for wariness in emulating U.K. institutional approaches in this area is the current instability and unsatisfactory state of the regulatory structures. The protection of public investors calls for the highest degree of regulatory intervention but the structures put in place in the United Kingdom after the "Big Bang" reforms in 1986 have been called "a messy compromise".

> Self-regulatory organisations (SROS) stayed. But a new body, the Securities and Investments Board (SIB), was set up to police both the SROS and the markets. However, unlike the Securities and Exchange Commission (SEC), America's chief markets watchdog, the SIB has virtually no powers to fine and punish miscreants. And the only sanction given to it to discipline unruly SROS was to abolish them. To fight financial fraud, the government set up the Serious Fraud Office (SFO) in 1987.
>
> [...]
>
> More generally, the rules have been broken with impunity. Since 1991 the LSE has referred 75 suspected cases of insider trading to the Department of Trade and Industry (DTI), the ministry responsible for prosecuting this crime. Only 11 convictions have been secured, of which four have been overturned on appeal. The SFO's record (341 defendants brought to trial; 215 convictions that have withstood appeal) is better. But its successes are not widely appreciated: many of its highest-profile prosecutions have failed.
>
> With luck, this state of affairs will improve: both the main political parties are considering rewriting the rules after the general election that must be held by next May. What should the politicians do? A good idea would be to plump for a single securities regulator, like America's SEC. This would be less confusing for the small investor and might well be less costly. Mike O'Brien, the Labour Party's City spokesman, says that his party will take this route should it win the election.
>
> Two more reforms would also help. First, responsibilities for surveillance and prosecution are still too widely dispersed - between the Stock Exchange, the SIB, the SROs, the SFO, the DTI, the Crown Prosecution Service, and the police. It would be far simpler to have one monitor and one prosecutor. The second change would be to make insider trading and some other types of financial fraud civil as well as criminal offences, with big fines for wrongdoers. This lowers the burden of proof needed to win such cases, and would be an extra deterrent to wrongdoing ("The morning ten years after" *The Economist* (26 October 1996) 105-106).

These observations on the situation in the United Kingdom highlight the difficulties generally of applying and enforcing criminal standards in commercial dealings; absent outright fraud, civil standards are more appropriate and more effective. Secondly, to the extent there is "surveillance and prosecution", these efforts should be sharply focused; surveillance and prosecution should not be the function of the Registrar of Companies or companies law.

The "fundamental question" which has been raised in the Financial Services Liaison Committee in Hong Kong is whether there is a necessity for a "public body specifically concerned with the corporate conduct of companies" given the "comparative lack of regulation of unlisted companies" (Memorandum of Gordon Jones, Registrar of Companies, to Cally Jordan (29 January 1996.)). In the framework of a highly enabling (and not a regulatory) companies law regime, the answer is no. The protection of public investors in all companies, listed or unlisted, should be provided by the SFC; additional protective measures for listed companies should be left to the SEHK. "Authorized institutions" (banks and insurance companies) as noted, are already subject to specialised prudential supervision

and regulation. "The Companies Registry enforces the regulatory requirements, as they apply to both listed and unlisted companies. Most of the offences prosecuted by the CR are easy to prove, and do not require in depth investigations before hand" (*ibid.*). These are primarily administrative offences ancillary to the operation of the Registry.

At issue are the company investigation provisions of sections 142 to 152 (full scale company investigations) and sections 152A to 152F (power to require production of documents). "To date, these provisions have hardly ever been invoked because the Government does not have the necessary 'in-house' capability to undertake such investigations" (*ibid.*). An index set up recently at the Companies Registry to monitor complaints made to it against companies suggested there were few serious grounds for invoking these provisions. Between July 1994 (when the index was established) and December 1996, a total of 137 complaints were indicated on the register (of which 13 had been filed prior to July 1994). The majority (110) "were concerned about failure to comply with the provisions of the Companies Ordinance and internal disputes within companies and only 10, involving suspected fraud, were referred to the Commercial Crime Bureau (CCB) for follow-up action" (Letter from Gordon Jones, Registrar of Companies to Cally Jordan (13 March 1997)).

On the basis of the statistical data, "it would be difficult for the Government to justify the establishment of an in-house companies inspectorate to undertake preliminary investigations of possible corporate misconduct, particularly given the cost of such an inspectorate" (*ibid.*). This conclusion is consistent with the observations of the Dickerson Committee (noted above) 25 years ago.

This is not to say there are no problems in need of consideration. Rather, formal investigatory or inspection procedures under the aegis of the Companies Registry are not the answer. There seem to be two distinct issues. The first is the extent to which participants in private companies (oversight of the activities of public companies being left to the SFC and the SEHK) should be entitled to recourse to public authorities to monitor their corporate behaviour. The second, quite distinct, issue is the extent to which public intervention is required with respect to the commercial dealings of companies with third parties which may be outside the ambit of company law.

There would appear to be little justification for the intervention of public authorities in the internal ordering of private companies (absent fraud, of course), and in particular, if a broad range of speedy and cost effective private remedies are available. It is important to note that civil recourse should not necessarily be premised on resort to expensive and perhaps commercially undesirable civil litigation. Alternative dispute resolution should be examined closely in the context of civil remedies available to interested parties.

(DR: paras.13-14. CBCA: see generally. OBCA: Part XIII. MBCA: §1.30. NZLC R9: paras.315-321.)

2.07 RECOMMENDATION: Role of the Financial Secretary. The Financial Secretary should continue to have residual discretion to act in the public interest in certain circumstances (such as investigation).

CURRENT ORDINANCE: The Registrar has the power to make an application to the court for the winding up of a company if it believes that a company is being carried on for an unlawful purpose (s.177(2)(a)). On the basis of information discovered through its investigative powers (ss.146, 152 or 152B), the Financial Secretary has the right to petition a court for the winding up of a company if it believes it to be in the public interest (ss.147(2)(a), 179(1)(d)) and residual authority to act in a number of instances.

COMMENTARY: The U.S. MBCA accords the equivalent of the Registrar with "the power reasonably necessary to perform the duties required of him by this Act" (MBCA, s. 1.30). The extent to which wide discretionary powers are desirable under the Hong Kong Companies Ordinance should be considered carefully.

The Dickerson Committee, for example, considered that

> there are few places where administrative discretion is needed in a corporations Act; there is certainly too much of it under the present [Act]. Thus, wherever possible, we have set out the consequences which will follow the taking of certain steps, without requiring review or decision by the Registrar. The Registrar's function, for the most part, is to ensure that the law has been observed. Where an adjudication on conflicting rights is required, the adjudication should be made by a court, not a government official. The Draft Act therefore provides liberally for simple and speedy applications to court by interested or affected parties, and it gives the courts wide discretion to make appropriate remedial orders....The flexibility which, it is argued, can be achieved by granting wide administrative discretion is better achieved, we think, by allowing many of the detailed rules to be laid down by regulation... (Dickerson Report at paras. 13-14).

The appropriateness of this approach in the Hong Kong context should be carefully assessed.

Investigations of a company's affairs are conducted by inspectors appointed by the Financial Secretary. In recent years, they have been mostly (if not entirely) in relation to listed companies and associated companies. Investigations have been expensive and have not been perceived to have achieved all of their objectives although this may be the result of an "expectation gap" i.e. the difference between the actual purpose of the investigation and the public's assumptions as to its purpose.

The purpose of an investigation is to ascertain what is or has been happening in the affairs of the company, either to expose malpractice or to dispel suspicions of malpractice. The purpose is not to obtain evidence admissible in proceedings following the investigation (although the inspection report will provide a road map to police and regulatory authorities where it appears that there has been fraud or breach of regulatory requirements). This justifies the unusually intrusive powers, particularly the interrogative powers, the public announcement of the appointment of inspectors, and the publication of the report of their investigation. Those aspects of the investigation powers have the advantage of enabling examinations of instances of serious breakdowns in corporate life, which could not be scrutinized and revealed to anything like the same extent under other laws. Now that the SFC has broader powers of investigation under s.29A of the SFC Ordinance, it may be that there will be a significantly reduced need for s.143 inspections initiated by the Financial Secretary.

A residual discretion to intervene should be sufficient to address those exceptional and unforeseeable instances where the public authority should involve itself in essentially private matters. This is not to underestimate the difficulties encountered by shareholders and others

in their efforts to ascertain their rights and the state of affairs of the company. Emphasis should rather be put on facilitating the efforts of those most directly aggrieved to look after themselves.

[DR: paras.13-14,477. CBCA: ss.229,235,238. OBCA: s.167. MBCA: §1.30. NZLC R9: para.316.]

3.00 INCORPORATION; CAPACITY AND POWERS

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3.01 RECOMMENDATION: One-step incorporation. The new Ordinance would provide one-step incorporation by filing a simple application for incorporation.

CURRENT ORDINANCE: At present, incorporation is a two step process. First two or more persons must subscribe their names to a memorandum of association (s.4(1)). Second, the memorandum and articles of association must be delivered and registered to the Registrar (s.15). Once the memorandum and articles of association have been registered they bind the company and its members like a contract (s.23(1)).

COMMENTARY: A corporation would come into existence upon issuance of a certificate of incorporation by the Registrar following filing of a simple application for incorporation. The incorporator need not be a shareholder or director. By moving to one-step incorporation, the new Ordinance would be responding to the calls for a simple, quick and inexpensive means of incorporation. The historic two-step process of forming a company by memorandum of association (essentially a contract) and then registering it, is primarily an evolutionary relic in the development of corporate form.

In jurisdictions which have adopted the concessionary or status model of incorporation, the one-step incorporation process can often be accomplished in less than one hour (rather than the current 6 days in Hong Kong). This has been the case in North America for some time; both Australia and New Zealand have recently moved to one-step incorporation. By eliminating the need in most instances for the use of shelf incorporations (where speedy incorporation is required for business reasons), the one-step incorporation process will reduce costs and artificial complexity in structuring transactions. The professional advisors on the working parties to the Review cited speedy, simple incorporation procedures as one of the reasons for recommending offshore incorporation, such as in the British Virgin Islands, to their clients. The British Virgin Islands provides 48 hour processing of incorporation requests.

Simple, speedy incorporation is not the preserve of small, offshore jurisdictions of dubious reputation. Incorporation in the United States is so quick and easy that the Official Comment to the MBCA doubts that there is any need for dealing legislatively with pre-incorporation contracts. Ontario, Canada, a highly reputable commercial jurisdiction, boasts of 20-minute incorporation (J. Ziegel, "The CBCA - Twenty Years Later: Where Do We Go From Here?" in *Meredith Lectures 1994/1995: Corporations at the Crossroads* (Montreal: Faculty of Law, McGill University, 1995) 3 at 8).

A minimum amount of mandatory information would be required in the application for incorporation. The name of the corporation, place of registered office and whether the corporation is private should suffice. Other information would be optional, such as the classes of and number of authorised shares (if limited), restrictions on share transfer (if any), number of directors and restrictions (if any) on the businesses that the corporation may carry on, for example. Although most businesses do use professional advisors to incorporate, in Canada the CBCA Directorate does facilitate self-incorporation by providing "kits" with line by line instructions.

In addition, one-step incorporation is highly conducive to computerisation and would

have the salutary effect of reducing the paper burden at the Registry. One-step incorporation, being the norm in many other jurisdictions, would make Hong Kong a more attractive choice as jurisdiction of incorporation for both local Hong Kong-based businesses and international enterprises doing business in the region.

There should be awareness on the part of counsel and the judiciary that the conceptual basis of the corporate form would no longer be that of the 19th century registered partnership, the joint stock company. This has been the primary reason for entitling the proposed legislation "Business Corporations Ordinance", to flag the shift in model. Care should be taken in interpreting the legislative provisions not to apply the wrong line of cases, essentially those arising from the UK memorandum of association form of company. On the positive side, as an aid to interpretation, there is a rich and well developed case law in existence in North America.

(DR: paras.50-53, Draft Act Part 2.00. CBCA: ss.6-9. OBCA: ss.4,6,7. MBCA: §§1.20-1.25. NZLC R9: paras:75,351-353.)

3.02 RECOMMENDATION: One person companies. The new Ordinance would permit one person/one director incorporation.

CURRENT ORDINANCE: The Ordinance does not allow for one shareholder/one director companies. The memorandum must be signed by at least two subscribers (s.4(1)). No subscriber may take less than one share (s.5(4)(b)), so there must be at least two shareholders in any company. Moreover, s.153(1) provides that every company, whether public or private, must have at least two directors.

COMMENTARY: One highly beneficial consequence of adoption of a North American theory of incorporation is that the conceptual difficulty of creating one person corporations disappears. Without the need to have two parties to the contract to create a company by memorandum of association (in conformity with partnership principles), there is no conceptual impediment to the recognition of one person corporations. A corollary to the one shareholder corporation is the one director corporation; it should also be possible in such circumstances to dispense with the formality of the rather artificial distinction between sole shareholder/sole director where both are in fact one and the same. In certain circumstances (such as public corporations), it is desirable to require a minimum of three directors.

(DR: para.48, Draft Act 2.01. CBCA: s.5. OBCA: s.4(1). MBCA: §§2.01,8.03(a). NZLC R9: paras.75,351-353. U.K. Companies Act 1985: ss.1(3A),282(2).)

3.03 RECOMMENDATION: Numbered companies. Provision should be made for numbered companies, and use of the company name.

CURRENT ORDINANCE: There are no provisions for the use of numbered companies or for the reservation of company names. No company can register a name which is the same as: 1) a name appearing in the Registrar's index of company names; 2) a name of a body corporate under another Ordinance; 3) names the use of which, in the opinion of the Governor, constitute a criminal offence; or 4) names which are offensive or otherwise contrary to the public interest (s.20).

COMMENTARY: Since 1991, the Registrar has been relieved of the burden of making a judgment with respect to similar names. Computerisation of the Registry should permit incorporation of numbered companies (and even provide a choice of as to the numbers). The availability of numbered corporations, either on an interim or permanent basis, should reduce

the need for shelf incorporations by permitting incorporation virtually on the spot. Incorporation by use of a number format is extremely popular where it has been introduced in Canada. A multi-digit number (plus an indication of jurisdiction and the designation "Ltd.") is used, e.g. "1234567 (Ontario) Ltd." or "9876543 (Canada) Ltd.". The numbered name can subsequently be changed for a descriptive one. Where numbered companies are used within a group for corporate structuring purposes, the numbered name is often retained for the duration of the company's existence.

Provision should be made for the circumstances in which use of the registered corporate name is mandatory, e.g. in contracts, invoices, etc.

(NZLC R9: para.80. U.K. Companies Act 1985: s.8 (refers to Table A, Companies Regulations 1985 (SI 1985/805)).)

3.04 RECOMMENDATION: Pre-incorporation contracts. Provisions for the adoption by the company of pre-incorporation contracts should be simplified.

CURRENT ORDINANCE: Pre-incorporation contracts are binding on the person who acted on behalf of the yet to be incorporated company; accordingly, promoters are both personally liable and entitled to enforce such contracts (s.32A(1)(a)). Section 32A(1)(a) does not, however, apply if there is an express agreement to the contrary. A company may, after incorporation, ratify a pre-incorporation contract as if the contract had been entered into on its behalf by an agent acting without its authority (s.32A(1)(b)).

COMMENTARY: Speedy incorporation should reduce the extent of resort to pre-incorporation contracts. However, such provisions could continue to be useful in a number of circumstances and a modern statutory formulation of the ability of the company to adopt pre-incorporation contracts (and providing for the allocation of liability to the promoter) should be retained.

(DR: para.17. CBCA: ss.10-11. OBCA: ss.8,9,10(2). NZLC R9: para.336.)

3.05 RECOMMENDATION: Capacity, powers and privileges of natural person. A corporation should be given the capacity, powers and privileges of a natural person. Restrictions may be placed on the activities of a corporation in its constitution but the rights of third parties should be preserved in the event a corporation acts in contravention of its articles or the Ordinance.

CURRENT ORDINANCE: The memorandum of the company need no longer state the objects of the company.

COMMENTARY: As recommended by the SCCLR in 1992, the Companies (Amendment) Ordinance 1997 introduced new sections (5A,5B, and 5C) which have abolished the doctrine of *ultra vires* along the lines of the Canadian OBCA. Under the new provisions, an objects clause would be optional, and if the company does not state its objects, it would have the powers of a natural person. If a company's memorandum states its objects, then its business activities would be restricted, but an act carried out in contravention of those restrictions would not be invalid. Although at its inception dubbed "admittedly a clumsy formulation" (Dickerson Report at para. 79), this particular statutory formulation has proven singularly successful in eradicating the noisome doctrine of *ultra vires*. For greater certainty, it would be possible, but not necessary, to add a provision that only corporate "insiders", their legal representatives, and the authority responsible for enforcement of the ordinance could challenge a corporate act on the basis of lack of power to act. Such a provision is found in

the MBCA (s.3.04(b)).

This particular statutory formulation has also been responsible for the elimination of the lengthy and quite useless "objects" clauses found in articles of association, thus relieving the paper burden on both business and the Registrar. The U.S. MBCA, for good measure, does include a non-limitative statutory list of corporate powers, but the Canadian experience has proven this to be quite unnecessary.

Given the prevalence of foreign incorporated businesses operating in Hong Kong, concerns have been raised with respect to the implications of the continued existence of the *ultra vires* doctrine in the jurisdiction of their incorporation. "It should, however, be noted that the *ultra vires* rule appears to survive in Bermuda, where a very large number of companies listed on the Hong Kong Stock Exchange are domiciled. In view of this, the abolition of the *ultra vires* rule in Hong Kong will have no impact on many listed companies" (Letter of Gordon Jones, Registrar of Companies, to Cally Jordan (25 April 1996)).

This concern may be addressed in several ways. It is expected that a new modern companies ordinance would reverse the trend towards the use of offshore incorporation, making Hong Kong incorporation more attractive. There are a very limited number of jurisdictions such as California, Louisiana and Ohio in the U.S. that have gone so far as to apply their domestic statutory abolition of the *ultra vires* doctrine to foreign corporations (MBCA, Official Comment, s.3.04). The recommendations in Part XI, Foreign Corporations/Oversea Companies, eschew the application of Hong Kong law to matters, such as capacity, traditionally left to the jurisdiction of incorporation. A legislative attempt to prohibit in Hong Kong the application of the *ultra vires* doctrine operative in a foreign jurisdiction is not a preferred response. Better to rely on commercial practices to take into account the possible risks of dealing with a foreign-incorporated entity. Assistance could be provided to Hong Kong creditors dealing with foreign incorporated entities by requiring, as does Delaware, an officer's certificate to be filed upon registration as a foreign corporation. The officer's certificate would be to the effect that the foreign corporation is authorised under the laws of its home jurisdiction to conduct the business it conducts in Hong Kong.

(DR: paras.62,68-73, Draft Act s.2.10. CBCA: s.14. OBCA: s.21. MBCA: §2.04. U.K. Companies Act 1985: s.36C.)

3.06 RECOMMENDATION: Constructive notice. The constructive notice doctrine should be eliminated except, temporarily, with respect to charges.

CURRENT ORDINANCE: A person is no longer deemed to know, i.e. have constructive notice, of a company's objects, constitution and other publicly filed documents because the company's memorandum is open to inspection by the public at the Companies Registry.

COMMENTARY: The Companies (Amendment) Ordinance 1997 also abolishes the doctrine of constructive notice to the extent no person would be deemed to have notice or knowledge of the contents of documents only by reason of filing with the Registrar or availability for inspection at the office of the corporation. Although commercial practice may still dictate the consultation of documents on the public register, there is no compelling reason for the retention of the constructive notice doctrine. Its elimination promotes speed and certainty in commercial dealings. As well, other changes recommended in this Review would greatly

reduce the volume and change the nature of information that would be available on the public register (in particular, with respect to those corporations which do not have public shareholders).

The only, temporary, exception in this regard would be with respect to the continuation of Part III of the existing Ordinance, Charges, which relies on the doctrine of constructive notice for its operation.

(DR: paras.74-83, Draft Act ss.3.01-3.03. CBCA: s.15. OBCA: ss.15,17-19. MBCA: §3.01. NZLC R9: paras.342-348,588, Draft Act ss.8,142(1)(a).)

3.07 RECOMMENDATION: Indoor Management rule. A statutory formulation should be given to the indoor management rule (the so-called rule in Turquand's case).

CURRENT ORDINANCE: There is no statutory formulation of the indoor management rule.

COMMENTARY: The policy behind the rule in the case of *Royal British Bank* v. *Turquand* (1856), 6 El. & Bl. 327, 119 E.R. 886 (Ex.Ct.) is well accepted; in order to promote stability and certainty in commercial transactions, a person dealing with a company is entitled to assume that its internal procedures and formalities, the aspects of "indoor management" that may or may not be readily discernible to outsiders, have been complied with.

The usual statutory formulation protects anyone dealing with the company (in the absence of actual knowledge or, in certain circumstances, presumptive knowledge of the irregularity invoked). The statutory formulation of the rule that appears elsewhere is based upon s.142 of Gower's Draft Ghana Companies Code, and appears to have worked well (see Ghana Report). It usually includes a statement of normal agency principles as well. The Australian Second Corporate Law Simplification Bill (June 1995) contains certain assumptions in sections 131-32 which may be relied upon by third parties in their dealings with the company.

Prudent commercial practice may dictate varying degrees of investigation of a company's internal affairs but this should be left to the appreciation of the parties involved.

(DR: paras.84,193, Draft Act s.9.01. CBCA: s.17. OBCA: s.18. NZLC R9: paras.347,588, Draft Act s.143.)

4.00 CAPITAL STRUCTURE

4.00 CAPITAL STRUCTURE

4.01 RECOMMENDATION: Modern capital structure. A new Business Corporations Ordinance should provide for a modern, flexible capital structure.

CURRENT ORDINANCE: Part II of the Ordinance, "Share Capital and Debentures", is based on the general principle that shares must not be issued at discount to their nominal par value (i.e. below par value). This general principle that underlies Part II was established by the courts in the 19th century (see Gower's at 202).

COMMENTARY: The rapid developments in modern corporate finance and accounting have long overtaken the 19th century assumptions of Part II of the current Ordinance. On the one hand, it is essential to give corporate management the means to raise capital and restructure related entities in the most effective and responsive manner. On the other hand, creditors must be protected (although not necessarily entirely by resort to companies law protections) and existing shareholders given the benefit of their bargain (very much the companies law protections against dilution and other changes detrimental to their interests).

(DR: para.24. CBCA: ss.24-25. OBCA: Part III. MBCA: §§6.01 6.04,6.30-6.40. NZLC R9: paras.10,84, Draft Act s.28.)

4.02 RECOMMENDATION: No par value shares. Par value shares should be prohibited.

CURRENT ORDINANCE: A company's memorandum must state the amount of share capital it proposes to be registered as well as its division into shares of a fixed nominal value or par value (s. 5(4)(a)).

COMMENTARY: The concept of par value share originally served to protect the interests of shareholders and creditors. "Since par value defined the permanent capital invested in the corporation by shareholders, it also thereby described the irreducible minimum of the corporate assets that could not be used for the payment of dividends or otherwise paid out to shareholders before satisfaction of all creditors" (MBCA, Official Comment, s.6.21).

Par value shares historically were viewed as a protection to existing shareholders as well as creditors. "The concept of 'par value' for shares is apparently as old as the concept of shares in commercial enterprises. All early charters and general corporation laws assumed that the corporation would receive money as consideration for shares equal to the par value or stated value of the shares....During the latter part of the 19th century, the issuance of shares for less than the 'par' or 'stated' values was viewed as a serious evil and the cause of widespread fraud and speculation. Often described as 'watered' shares, the issuance of par value shares for less than par was viewed as potentially misleading to creditors and shareholders" (MBCA, Official Comment, Historical Background, s.6.21).

Par value shares no longer serve the purpose for which they were originally intended. They are now prohibited in many jurisdictions, including many U.S. states, most Canadian jurisdictions, New Zealand and, soon, Australia. "Practitioners and legal scholars have long recognized that the statutory structure embodying 'par value' and 'legal capital' concepts is not only complex and confusing but also fails to serve the original purpose of protecting creditors and senior security holders from payments to junior security holders. Indeed, to the extent security holders are led to believe that it provides this protection, these provisions

may be affirmatively misleading. The Model Act has therefore eliminated these concepts entirely and substituted a simpler and more flexible structure that provides more realistic protections to these interests" (MBCA, Official Comment, s.6.21).

The Dickerson Report in 1971 explained, in very simple terms, the fundamental problem with the concept of par value:

> ...par values are arbitrary and misleading. If an investor buys 1,000 shares at $1 par value in a corporation with an issued capital of 10,000 shares of $1 par value the true measure of his investment is not $1,000 but a 10% share in the business, the value of which must necessarily fluctuate as the fortunes of the business change. He is unlikely to have paid exactly $1,000 for his shares, nor will $1,000 represent their current market value or liquidation value. *A share is simply a proportionate interest in the net worth of a business.* Par value obscures this reality, while the concept of a share without par value precisely embodies it (though the words no par value are, strictly, redundant). What matters to an investor is the proportionate size of his investment in a corporation, not the arbitrary monetary denomination attributed to that investment. Par value may be especially misleading to an unsophisticated investor. A share with a par value of $5 might well appear to be a bargain at $2, even though the share is in fact worthless [emphasis added] (Dickerson Report at para. 98).

The elimination of the concept of par value has several additional advantages. It permits greater flexibility in adjusting a company's capital structure. The difficulties associated with issuing shares at a discount or splitting overvalued shares fall away: "...if the market price has fallen below the issue price, a corporation can raise additional capital by issuing additional shares at the current market price without running into obstacles against the issue of shares at a discount..."(Dickerson Report, at para. 99).

Another benefit of eliminating the concept of par value is the simplification of the legislative provisions relating to capital structure and the accounting problems associated with par value.

> Much confusion has been caused in the past by such terms as 'paid-in surplus', 'contributed surplus' and 'distributable surplus' which have been used to reflect the amount in excess of par value received by a corporation upon the issue of its shares. Terms like these have cluttered and confused many a corporate balance sheet. Par value leads to a great deal more confusion when corporations are allowed to purchase their own shares. Each such purchase leads to problems of accounting for and reflecting the 'profits' or 'losses' arising when the shares are purchased at prices different from par (Dickerson Report at para. 100).

The importance of eliminating the concept of par value cannot be over-emphasised if simplification of capital structure rules is to be achieved. "The elaborate rules" in the UK that make "the concept of share capital unnecessarily complicated and confusing is [due to] the insistence that shares shall be given a fixed nominal value and that the amount of the company's share capital shall be determined exclusively by that nominal value" (Gower's at 242).

The U.K., regrettably according to Professor Gower, is now locked into the concept of par value, and all the complexity it spawns, by virtue of EC directives. The rules governing capital structure in the U.K. are now driven by European civil law concepts that rely on minimum capital requirements and notions of par value. These rules impose rigidity

and complexity that, arguably to judge by the great success of flexible capital structures elsewhere in the common law world, is unnecessary in a common law jurisdiction. In continental European jurisdictions they have developed as a means of building creditor protection mechanisms into corporate structures in the absence of other satisfactory means of providing creditor protection such as chattel mortgages and their modern equivalents.

> The nominal value of a share need not bear any relationship to its true value even at the time of its issue and is most unlikely to do so after the company has been trading for some time. Nor, does the nominal value of issued share capital provide the yardstick for determining whether the company can lawfully make a distribution to its members. When shares have been issued at a premium that will depend on the amount of the issued share capital plus its share premium account and, when shares have been redeemed or repurchased, on the aggregate amount of its issued share capital plus its share premium account plus its capital redemption reserve.
>
> All of this could be avoided if, like some countries (notably the USA and Canada) we permitted the issue of no-par-value shares... In 1954 the Gedge Committee recommended the legalisation of no-par equity shares and in 1962 the Jenkins Committee recommended it in respect of any class of shares. An attempt was made to introduce legislative provisions to that effect in what became the 1967 Act; but without success. And there is now little likelihood of their being introduced since nominal par values are required under the EC Directives. This is regrettable; particularly so in the light of the Government's efforts to increase individual share ownership, for no-par would render the true position more readily intelligible to unsophisticated investors and protect them from being misled. There would, however, be little point in introducing them unless they were made compulsory. If par and no-par existed side-by-side, confusion would be worse confounded and the unscrupulous would continue to adopt par shares when they wished to mislead (Gower's at 242).

(DR: paras.24,97-100, Draft Act s.5.01. CBCA: S.24(1). OBCA: s.22(1). MBCA: §6.21. NZLC R9: paras.10,84, Draft Act s.28.)

4.03 RECOMMENDATION: Classes and rights of shares. The corporate constitution should prescribe the classes of shares (if more than one) and the number of shares of each class that the company is authorised to issue if there is a limit (which there need not be). If there is only one class of shares, that class must have three fundamental rights of share ownership: the right to vote, the right to receive dividends when declared; and the right to receive the net assets of the company upon dissolution. Where there is more than one class of shares, the rights, preferences, etc. should be stated in the corporate constitution; the three fundamental rights of share ownership should be attached to at least one class of shares although not all rights need be attached to any one class. For statutory purposes, the traditional distinction between common or ordinary shares and preference shares should be eliminated.

CURRENT ORDINANCE: The Ordinance does not require that the three fundamental rights of ownership be attached to at least one class of shares.

COMMENTARY: The three fundamental rights identified in the recommendation are those normally associated with "common or ordinary shares". In keeping with practices of modern corporate finance, the recommendation eliminates, for statutory purposes only, the traditional distinction between "common/ordinary shares" and "preference" or "preferred" shares.

> Traditional corporation statutes work from a perceived inheritance of concepts of 'common

> shares' and 'preferred shares' that at one time may have had considerable meaning but that today often do not involve significant distinctions. It is possible under modern corporation statutes to create classes of 'common' shares that have important preferential rights and classes of 'preferred' shares that are subordinate in all important economic aspects or that are indistinguishable from common shares in either voting rights or entitlement to participate in the assets of the corporation upon dissolution. The revised Model Act breaks away from the inherited concepts of 'common' and 'preferred' shares and develops more general language to reflect the actual flexibility in the creation of classes of shares that exists in modern corporate practice (RMBCA, Official Comment, s.6.01).

Not only has the traditional distinction between common and preferred shares faltered in the face of the remarkable pace of innovation and change in corporate finance, so too has the traditional distinction between debt and equity. "Hybrid" securities, sharing the characteristics of debt and equity have developed. The recommendation, in effect in North America and now appearing elsewhere, would authorise the creation of new and innovative classes of securities, the terms of which would appear in the public record.

> Innovative classes of shares may be created in connection with raising debt or equity capital. Securities with novel provisions are often created to meet perceived corporate needs in specific circumstances or because of financial problems generated by market conditions for capital. Novel classes of shares may also be created in order to effectuate desired control relationships among the participants in a venture. Classes of shares are likely to be used for this purpose in closely held corporations, whether or not statutory close corporation status is elected, but may also be used for this purpose by publicly held corporations.
>
> Examples of innovative classes of shares are the following:
>
> (1) Shares of one class may be authorized to elect a specified number of directors while shares of a second class may be authorized to elect the same or a different number of directors.
>
> (2) Shares of one class may be entitled to vote as a separate voting group on certain transactions, but shares of two or more classes may be only entitled to vote together as a single voting group on the election of directors and other matters.
>
> (3) Shares of one class may be nonvoting or may be given multiple or fractional votes per share.
>
> (4) Shares of one class may be entitled to different dividend rights or rights on dissolution than shares of another class (MBCA, Official Comment, s.6.01).

These changes are being recommended so as to provide the legal framework within which modern techniques of corporate finance may operate.

As is the case in other jurisdictions, business usage of the terms "common/ordinary share", "preferred share", "debt" and "equity" will continue no doubt to be made. From the point of view of the business person, very little will change; business counsel, on the other hand, will be given the latitude necessary to tailor capital structure in keeping with financing and other goals. Furthermore, restrictions may continue to be imposed by securities regulation on the securities that may be offered to the public and listed on the Stock Exchange (e.g. the prohibition on the listing of "B" shares or shares with differential voting rights, would not be affected).

[DR: para.102, Draft Act s.5.01. CBCA: s.24. OBCA: S.22(2)-(6). MBCA: §6.01(a),(b). NZLC R9: paras.82-83, Draft Act ss.22,26.]

4.04 RECOMMENDATION: Series. Statutory provisions with respect to the use of series within classes of shares are unnecessary.

CURRENT ORDINANCE: The Ordinance neither authorises nor prohibits the use of series within classes of shares.

COMMENTARY: There is often confusion as to the distinction between the attributes of a series and of a class of shares. The balance which must be achieved is with respect to the power the directors should have to determine the attributes of certain shares at the expense of shareholder control. Although the attributes of a class of shares must be set out in the corporate constitution, in North America series within a class have been used to permit directors to determine the attributes to be attached to such shares without the necessity for shareholder involvement.

The argument in favour of permitting wide discretion to directors to determine series attributes is flexibility and nimbleness in responding to market conditions in raising capital. On the other hand, so called "blank cheque" series, where the directors are given total discretion in fashioning the attributes of a series within a class, have also been used as a take-over defence and could be seen as facilitating the entrenchment of management at the expense of shareholders.

Certain U.S. states have permitted directors to have limited discretion with respect to determining series attributes, essentially only those fundamental to capital raising activities; for example, they permit directors to determine the dividend rate or redemption amount to be attached to a series but not other attributes (which would have to be set out in the corporate constitution as attributes appertaining to the larger class). The MBCA, on the other hand, permits the creation of "blank check series".

> Section 6.02 permits the board of directors, if authority to do so is contained in the articles, [constitution] to fix the terms of a class of shares to meet corporate needs, including current requirements of the securities market or the exigencies of negotiations for acquisition of other corporations or properties, without the necessity of holding a shareholders' meeting to amend the articles. This section therefore permits prompt action and gives desirable flexibility. The articles of incorporation [constitution] may also create 'series' of shares within a class (rather than designating that 'series' as a separate class) if that is deemed desirable.
>
> The board of directors may create new series within a class or set the terms of a class or series only if there are no outstanding shares of that class or series. This section recognizes that in some contexts there is no substantive difference between a 'class' and a 'series within a class', and that the labels are often a matter of convenience... Shares of stock to be issued in different classes or series that vary in terms to be set by the board of directors are sometimes referred to as 'blank stock'. The granting of the power to vary the terms gives the board of directors broad power to affect the capital structure of the corporation. Exercise of this power may in some circumstances dilute the interest of existing shareholders. But on balance it is desirable to permit this flexibility. (MBCA Official Comment, s.6.02).

The MBCA requires a simple official filing to amend the corporate constitution so that the share attributes are on the public record, but shareholder action is not required.

The Dickerson Committee weighed more heavily in favour of shareholder protection

in its recommendations.

> After careful consideration we have concluded that it is the shareholders and not the law which should set the limits on directors' discretion in this area. [We do] require, however, that where the issue of shares in series is permitted, the articles [constitution] must also set out the limits imposed on the directors. ...[We do] ensure that, whatever other differences there may be, all shares of the same class are equal upon liquidation or when dividend payments are in arrears.
>
> [We] require that, once the terms of a series are established by the directors, those terms must be crystallized by an appropriate amendment to the articles. Once issued, therefore, the terms of the shares cannot again be amended by the directors alone, but only by the shareholders... (Dickerson Report at paras. 112-113).

It may be that the considerations before the Dickerson Committee no longer reflect commercial practice. The Dickerson Committee considered that in practice the only case in which the need to issue in series would normally arise was with respect to creation of shares having a preferred dividend right. Not only have the intricacies of corporate finance evolved considerably since 1971, but blank cheque preferred shares have been put to other uses, especially as a take-over defence mechanism. As well, the ingenuity of counsel in drafting share capital provisions has in fact conferred virtually unfettered discretion on directors to issue shares in series and statutory limitations are illusory.

In the Hong Kong context, the better alternative is the elimination of "series". As the MBCA points out, the distinction between a class and a series is often artificial. Permitting only "classes" of shares, the attributes of which would be included in the corporate constitution, could be a means of eliminating an artificial and confusing distinction, and providing shareholders with some measure of oversight to significant changes to capital structure.

4.05 RECOMMENDATION: Partly paid shares. Partly paid shares should be prohibited.

CURRENT ORDINANCE: Partly paid shares are permitted (Table A, art. 15).

COMMENTARY: The use of partly paid shares adds considerable complexity to capital structure with little, if any, benefit. With a modern, flexible capital structure they are unnecessary. They were prohibited in Canada over 20 years ago.

> The Draft Act goes further, however, in that it requires shares to be fully paid before they are issued. With this rule, the concepts of "subscribers", "partly-paid shares" and "calls" are abolished. There is no need to retain these complexities: normal practice where shares would have a high issue price is to effect a share split so as to make the shares more readily marketable. ... We can see no point in retaining in the law complications created by commercial practices which are no longer followed ... (Dickerson Report at para. 104).

(DR: para.104, Draft Act s.5.02. CBCA: s.25(3). OBCA: s.23(3). MBCA: §6.21. NZLC R9: para.84, see generally Draft Act ss.26-41.)

4.06 RECOMMENDATION: Optional pre-emptive rights. Pre-emptive rights for

existing shareholders should be optional; they may be provided for in the corporate constitution.

CURRENT ORDINANCE: Pre-emptive rights for existing shareholders are optional and may be provided for in a company's memorandum and articles.

COMMENTARY: In balancing the desire for flexibility of capital structure and the rights of existing shareholders to be protected against dilution of their interests, the question of pre-emptive rights is a difficult one. Where they are mandatory and created by statute, pre-emptive rights have fettered the financing activities of modern corporations. The use of pre-emptive rights may now be more appropriate in the context of private companies/closely-held corporations where dilution of shareholder interest is more critical, given the usual illiquidity of the investment. Pre-emptive rights for publicly listed companies should be a matter for securities law requirements, i.e. it should be found either in a Securities Ordinance or listing rules. A recent article in The Economist acknowledged the fact that pre-emptive rights raise the cost of capital for companies but on balance was in favour of their retention as a matter of law, given that they acted as a "valuable buffer against the whims of a company's board" ("Rights at issue" *The Economist* (18 May 1996) 85 at 86). This recommendation weighs in favour of cutting the cost of capital.

(CBCA: s.26(1). OBCA: s.26. MBCA: §6.30.)

4.07 RECOMMENDATION: Solvency test. The concept of impairment of capital should be replaced by a solvency test to be used to determine the ability of the company to engage in a variety of activities: repurchase of its own shares (by way of redemptive provisions in the corporate constitution or otherwise), payment of dividends and other activities in the nature of a transfer of corporate assets to the possible detriment of creditors.

No "distribution" (widely defined) of company assets should be permitted if, after giving effect to it:

(1) the company would not be able to pay its debts as they become due in the usual course of business; or

(2) the company's total assets would be less than the sum of its total liabilities plus (unless the constitution provides otherwise) the amount that would be needed, if the company were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

CURRENT ORDINANCE: The Ordinance has several provisions which aim to ensure that a company's share capital is maintained and not impaired, for example:

- financial assistance given by a company for the purchase of its own shares is prohibited subject to certain exceptions (ss.47A-G, 48);
- shares may only be issued at a discount (i.e. below par value) in limited circumstances (s.50).
- restrictions are imposed on companies seeking to buy back their own shares (ss.49B-S);
- there are controls on the reduction of a company's capital (ss.58-63);
- there are controls on the paying of dividends (ss.79A-P).

COMMENTARY: The capital maintenance and dividend rules in the United Kingdom (upon which the current Ordinance's rules are based) are now extremely detailed and complex. They are founded in notions of minimum capital requirements and par value now imposed by EC Directive. While Professor Gower laments the inability to follow another road (the North American one), he does consider these rules to constitute an improvement, if an imperfect one.

> While, perhaps, lawyers and businessmen, may fairly complain that not all the present capital maintenance and dividend rules...are expressed in a way which is readily intelligible to anyone other than a specialist corporate accountant, at long last we have rules which on the whole are logical and sensible. For this we have to thank our membership of the EC. It should again be emphasised, however, that while these rules afford protection against the risk that a public company's assets will not be milked by distributions to its members to the detriment of its creditors, they afford little protection in relation to private companies - and will not do so unless they too are required to raise and maintain a minimum capital and are made subject to section 264. Of that there is no immediate likelihood (Gower's at 261-62).

In Hong Kong, there is no compelling reason to follow the dictates of EC Directives in this area and continue in a civil law tradition of great complexity. As Professor Gower notes, capital maintenance requirements offer little protection to trade creditors where, as in the common law, security can readily be granted on the undertaking and assets of the company (see Gower's at 262). The provisions of the current Ordinance, such as those applicable to redeemable shares, share repurchase, distributions of profits and assets and financial assistance are drawn from the U.K. Companies Act 1985, and ultimately, EC Directives based on principles of capital maintenance. They are highly technical and cumbersome.

The alternative afforded by the MBCA, in particular, is elegant and starkly simple compared to the contortions of the U.K. Companies Act 1985. The MBCA approach is the alternative recommended by the NZLC R9 in preference to the older Canadian provisions (which are somewhat of a halfway house):

> 330 The solvency test...is pivotal to the scheme of the Act. It applies to all transactions which transfer wealth from the company to the prejudice of creditors and, where some shareholders only receive benefit, to the prejudice of non-participating shareholders. The test is designed to be a substantial constraint in such circumstances because they are those in which limited liability and management power are most open to abuse.
>
> 331 The test is a two-pronged one to ensure both 'balance sheet' solvency and 'cash-flow' solvency. It recognises that measuring current assets against current liabilities may not be sufficient to establish solvency. The test ensures that decisions are based on cash-flow analysis showing that known obligations of the company can reasonably be expected to be satisfied during the time they will fall due. (NZLC R9 at paras. 330-331).

Prior to 1980, the MBCA in the United States also contained "elaborate" rules with respect to capital structure based on the concept of stated capital and various surplus accounts to be used for distributions. Ingenious corporate counsel however could usually circumvent the rules and sophisticated creditors looked elsewhere for protection.

> Given these exceedingly complex rules with various escape valves it is not surprising that creditors eventually realized that the elaborate statutory rules about the capitalization of a corporation did not provide them meaningful protection against distributions to shareholders

> that may impair the security of their position. As a result, sophisticated creditors negotiated contractual restrictions on the distribution of assets to shareholders....[In 1980] it was recognized that the effective restriction on distributions imposed by the Model Act was the prohibition against distributions made while the corporation was insolvent or that would render the corporation insolvent (MBCA, Official Comment, Historical Background, s.6.21).

All manner of transfer of corporate assets (dividend payments, share repurchases, share redemptions) are regrouped in the MBCA under the concept of "distribution" and made subject to the single, uniform solvency test (as well, of course, as to any restrictions in the corporate constitution).

> 'Distribution' means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise (MBCA, s.1.40).

This reconceptualisation of all manner of transfer of corporate assets into one definition and one section in the statute renders superfluous dozens of pages of statutory language on share repurchases and share redemptions in other jurisdictions.

The two-pronged solvency test proposed in this recommendation is found in s.6.40(d) of the MBCA and emulated in New Zealand. The test is not without its own difficulties; however, the MBCA has studiously avoided importing accounting language and principles and expressly permits directors to base their determination on financial statements "prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances" (MBCA, s.6.40(d)). The inclusion of preferential share payments as a liability in the second prong of the solvency test (which requires assets to exceed liabilities) is optional.

A director who assents to an unlawful distribution may be personally liable if he or she does not meet the statutory standards of conduct set out in the legislation (and should be deemed to have assented unless a dissent is formally recorded). Thus the importance of a clear statutory statement of the standards of conduct imposed on directors; these standards bear a heavy burden and obviate the need for lengthy technical statutory provisions in a variety of areas.

[DR: paras. 140-142, Draft Act ss.5.14, 9.16. CBCA: s.42. OBCA: s.38(3). MBCA: §6.40(c),(d),(e). NZLC R9: paras.146,214,330-333, Draft Act s.42.]

4.08 RECOMMENDATION: Financial assistance. Provisions with respect to "financial assistance" for the purchase of company shares should be eliminated.

CURRENT ORDINANCE: As noted above, as a general rule no financial assistance may be given by a company for the purchase of its own shares except as provided by the Ordinance (ss.47A-G, 48).

COMMENTARY: The provisions with respect to so-called "financial assistance" have raised difficulties wherever they have taken root. As with some of the other older concepts such as par value, in the dramatically changed and increasingly sophisticated world of corporate finance, they no longer serve the purpose for which they were originally designed. Worse

still, at once technical and overbroad, they have often served to frustrate perfectly justifiable commercial transactions.

The prohibition on a company providing "financial assistance" to someone for the purpose of purchasing the company's own shares is often traced back to *Trevor v. Whitworth* (1887), 12 App.Cas. 409 (H.L.), where it was termed "trafficking" in a company's shares. The rule, erroneously, found its source in the 19th century concept of capital maintenance as a protection for creditors. The justification for the prohibition was that it would prevent the reduction of the capital of a company primarily to the detriment of creditors who would rely on the capital in a limited liability company not being reduced by returns of such capital to shareholders. In fact, as Professor Gower points out (see *infra*), the prohibition has little to do with capital maintenance. Later objections (such as those raised by the Greene Committee in 1926) were to the abuse of what would now be called the leveraged buy-out.

Professor Gower traces the history of the financial assistance provisions in the United Kingdom:

> Superficially, for a company to provide finance to enable someone else to buy its shares may seem to resemble a purchase by the company itself and to be similarly objectionable as reducing the company's capital. In fact it raises completely different issues and in no way affects 'capital' in the sense of issued capital, share premium account or capital redemption reserve; nor does it necessarily result in a reduction of the value of the company's net assets. Nevertheless it is a practice which is open to the gravest abuses - abuses which have continued to this day despite prohibiting legislation-originally section 45 of the 1929 Act which was reenacted with amendments as section 54 of the 1948 Act. That section, despite its relative brevity, became notorious as unintelligible and liable to penalise innocent transactions while failing to deter guilty ones. The Jenkins Committee suggested an alternative approach very similar to that now adopted in relation to private companies, but at the time no action was taken on that suggestion and, when the Second Company Law Directive was adopted, it became impracticable in relation to public companies.
>
> However in 1980 two reported cases caused considerable alarm in commercial and legal circles, suggesting, as they did, that the scope of the section was even wider, and the risk of wholly unobjectionable transactions being shot down even greater, than had formerly been thought. Hence it was decided that something had to be done about it in the 1981 Act which was then in preparation. Probably more midnight-oil was burnt on this subject than on all the rest of that Act and the resulting elaborate provisions are certainty [sic] some improvement on section 54 (Gower's at 226-27).

As Professor Gower points out, the financial assistance prohibition may not address at all the issue of capital maintenance. And, as for the "gravest abuses" involved in leveraged buyouts, this language appeared in the 1926 Greene Committee report and may be an assessment which no longer reflects commercial reality. To the extent that leveraged buyouts are a fact of modern corporate life and the solvency test described above, rather than concepts of capital maintenance, would provide protection to creditors and minority shareholders, there would seem to be little utility in preserving the financial assistance prohibitions. According to Professor Len Sealy, the situation in the United Kingdom has subsequently deteriorated further with the House of Lords decision in *Brady v. Brady* [1989] A.C. 755 which has added even greater confusion to the statutory tests.

The United Kingdom and Hong Kong prohibitions have no equivalent in the United

States and are being seriously reconsidered in Canada (where they were continued in the Canada Business Corporations Act in 1975 from prior legislation). One proposal in Canada is simply eliminating them.

(NZLC R9: paras.425-431, Draft Act ss.58-59. NZLC R16: para.38, Draft Act s.78A.)

5.00 MANAGEMENT AND ADMINISTRATION

5.00 MANAGEMENT AND ADMINISTRATION

A) FINANCIAL DISCLOSURE

5.01 RECOMMENDATION: Companies' accounts. Companies should be required to prepare accounts that give a true and fair view of the state of affairs of the company. Details as to the form and content of accounts, to the extent required to be specified, should appear in subsidiary legislation; the Tenth Schedule of the Companies Ordinance (Accounts) should be eliminated.

CURRENT ORDINANCE: Every company must keep proper books of account (s.121(1)). The books of account must give a true and fair view of the state of the company's affairs and explain its transactions (s.121(2)). In addition, companies must prepare a balance sheet and profit and loss account in accordance with the Tenth Schedule (s.123(2)).

COMMENTARY: The requirement for "true and fair" accounts is, as the New Zealand Law Commission put it, "universal" and should be the general standard against which a company's accounts should be measured. Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements. Accordingly, compliance with accounting standards will normally be necessary for financial statements to give a true and fair view.

The Tenth Schedule (Accounts) contains detailed line item information which is to appear in company accounts. There is virtual unanimity of comment that the information required is outdated and no longer consistent with accounting practice. As in other jurisdictions which have eliminated its equivalent, accounting practices have changed too rapidly to be accommodated by the relatively inflexible vehicle of legislation. The Dickerson Committee recommended that financial information, to the extent it is stipulated at all as to its form and content, should be included in subsidiary legislation. "History indicates, however, that legislation on matters such as financial disclosure is changed only infrequently, sporadically and usually because some dramatic financial catastrophe or fraud revealed how outmoded the law had become" (Dickerson Report at para. 326).

In the view of one accountant member of a working party, in "the dynamic Hong Kong business environment, new and even more complex transactions and financial instruments are continuously being developed. To keep pace with these changes, the concept of what is true and fair and the process by which it is interpreted must be equally dynamic. The law is a very cumbersome vehicle with which to try and keep pace with these changes".

(DR: para.325-329, Draft Act Part 13.00. NZLC R9: paras.102,600, Draft Act s.160. U.K. Companies Act 1985: s.226(2).)

5.02 RECOMMENDATION: Generally accepted accounting principles. Rather than detailing line item by line item the information to be contained in accounts, reference should be made to preparation of accounts in accordance with generally accepted accounting principles (GAAP). GAAP would be embodied in standards set by an independent accounting standards body or by a Hong Kong Society of Accountants process that would involve a wider representation of interested parties.

CURRENT ORDINANCE: Companies must prepare their balance sheet and profit and loss account in accordance with the detailed requirements of the Tenth Schedule (s.123(2)).

COMMENTARY: Accounting standards are evolving too rapidly to be frozen in legislation, even subsidiary legislation. Considered at the time to be a radical proposition, the decision in the federal Canadian legislation in 1975 to require (by regulation) that financial statements "be prepared in accordance with the standards as they exist from time to time of the Canadian Institute of Chartered Accountants set out in the C.I.C.A. Handbook" (Canada Business Corporations Regulations, s. 44) has been well accepted. It is being emulated elsewhere, as in Australia.

In Hong Kong, the Hong Kong Society of Accountants (HKSA) is continuously formulating accounting standards for local use. More and more, these standards are converging with international accounting standards, which themselves are attaining levels of certainty and definition which makes their use more acceptable. The standard setting function of the HKSA is exercised by the Financial Accounting Standards Committee in conjunction with the Accounting Standards Advisory Panel; both bodies have representation from outside the profession. It is the view of certain practitioners that an independent standard setting body should be created (along the lines of the Accounting Standards Board in the U.K.) which would look at recommendations of the HKSA but provide a more neutral arbiter of standards. Should generally accepted accounting standards in Hong Kong develop and stabilise to the degree necessary to provide the external reference for the content of company accounts, reference to them in the legislation should be sufficient. The great advantage of this technique, of course, is that it eliminates the possible conflict between legislative standards and accounting practice, a conflict that can be costly to companies.

From a practical view point, if the contents of the tenth schedule were removed from the Ordinance and replaced by a reference to Accounting Standards, the impact on current requirements would have to be considered. Hong Kong Accounting Standards have been drafted in the context of current Hong Kong legislation with the aim of ensuring consistency between Accounting Standards and the Law.

A review of the contents of the Companies Ordinance and in particular Schedule 10 highlights the following types of financial statement disclosures:

(i) disclosures now completely covered by Hong Kong Accounting Standards

(ii) disclosures relating to the format of accounts (IAS 5)

(iii) requirements that may no longer be relevant

(iv) requirements related to the following:

- Distributability of reserves
- Financial assistance
- Public interest
  - Directors remuneration - (related party transactions - ED)
  - Auditors remuneration

Accordingly, it may be appropriate during any pre-implementation period to review certain existing Standards to highlight the need for revision or additional Standards. In particular, an equivalent statement to IAS 5 in the Hong Kong context would probably be required

[otherwise a standard format of accounting may need to be set out in the Ordinance].

If compliance with Accounting Standards were to become a requirement of the Hong Kong Companies Ordinance, the need would then arise for the process by which they are developed to be more consultative and therefore more representative of the interests of preparers and users of financial statements. In this regards, the approach adopted by the ASB in the UK may prove a useful role model (Submission by Steve Taylor, Deloitte Touche Tohmatsu to Working Party 2).

The introduction of a new standards setting process has been under consideration in Hong Kong for some time. In 1993 a working group composed of representatives of the SFC, SEHK and the HKSA produced a report which recommended that a new Financial Reporting Standards Committee be established under the auspices of the HKSA. "This Committee would invite representatives from the SEHK, SFC, investment community, commerce and industry and others, including academics, so as to serve and secure participation from a much wider constituency. It is believed that such a move would involve the HKSA in taking a lead in bringing accounting standards and disclosure requirements closer together, better serve the interests of maintaining and developing Hong Kong as an important financial centre, and bring the profession, market users, and regulators closer together" (Report of the Working Group on Financial Disclosure (Hong Kong, August 1993) at 10).

The Hong Kong Monetary Authority has noted that most "authorized institutions in Hong Kong are required to comply with the Best Practice Guide on Financial Disclosure by Authorized Institutions (BPG) issued by the HKMA which lists, line by line, the items to be disclosed in their accounts. Hence it is important that there are no disclosure gaps for other companies and authorized institutions which meet the exemption criteria under the BPG. Accordingly, these disclosure gaps should be identified and efforts made to ensure that they are incorporated in the accounting standards or by other means or discarded if considered unnecessary" (Letter of Raymond Li, Executive Director (Banking Policy) to Ermanno Pascutto (31 January 1997)).

(CBCA: Regulations, s.44. OBCA: Regulations, s.40. MBCA: §16.20.)

5.03 RECOMMENDATION: Waiver of generally accepted accounting principles. All companies should prepare their accounts in accordance with generally accepted accounting standards; consideration should be given as to whether private companies should be able to dispense with this requirement by means of unanimous shareholder agreement (unless required for other purposes).

CURRENT ORDINANCE: If all the shareholders agree, a private company can exempt itself from the requirement of publishing full accounts in accordance with the Tenth Schedule (s.141D). An exempt private company under the current Ordinance must nevertheless prepare proper books of account and its balance sheet must comply with the much shorter and less onerous requirements of Eleventh Schedule (s.141D).

COMMENTARY: Public and listed companies should be subject to stringent standards and public filings of their financial information under stock exchange rules and securities regulation; companies law requirements with respect to the presentation and format of financial information will thus be largely applicable to non-public companies, many of which are very small. There is no doubt that the provision of fair and true financial information to shareholders is of fundamental importance; where unanimity of shareholders can be

obtained, however, financial information of a less formal nature may be entirely adequate.

The MBCA in the United States does not require any financial statements to be prepared on the basis of generally accepted accounting principles. It adopts this position because of its applicability primarily to small, closely held corporations, "since enterprises whose securities are registered under federal statutes are required to supply audited financial statements to shareholders" (MBCA, Official Comment, s.16.20).

> Many small corporations have never prepared financial statements on the basis of GAAP [generally accepted accounting principles]. 'Cash basis' financial statements (often used in preparing the tax returns of small corporations) do not comply with GAAP. Even closely held corporations that keep accrual basis records, and file their federal income tax returns on that basis, frequently do not make the adjustments that may be required to present their financial statements on a GAAP basis. In light of these considerations, it would be too burdensome on some small and closely held corporations to require GAAP statements. If a corporation does prepare financial statements on a GAAP basis for any purpose for the particular year, however, it must send those statements to the shareholders...(MBCA, Official Comment, s. 16.20).

Commercial requirements, Inland Revenue considerations and local practice (especially in lending) should dictate the circumstances in which small companies would in fact choose to prepare more formal accounts. It should be noted here that working party members were of the view that all companies should prepare accounts in accordance with generally accepted accounting principles. Given the possibly onerous consequences of such a requirement, particularly for one person companies, the recommendation as proposed has adopted the approach set out in the MBCA. As noted by the MBCA, many small businesses may prepare accounts on a cash basis only and the imposition of GAAP as a matter of company law could be highly burdensome. The recommendation, of course, does not derogate from the principle that accounts should provide a true and fair view of the companies financial situation. Further consideration should be given to the views expressed by the working party members.

(MBCA: §16.20.)

5.04 RECOMMENDATION: Minimum financial information. As an aid to small companies in particular, the minimum financial information to be delivered to shareholders, unless they agree otherwise, should be stipulated in the legislation, or subsidiary legislation.

CURRENT ORDINANCE: Directors must send and present to all shareholders all financial statements, auditor reports, the company's balance sheet and profit and loss account before and at each annual general meeting (ss.122, 129G).

COMMENTARY: Most jurisdictions stipulate at a minimum the financial information which must be delivered annually to shareholders: a balance sheet, an income statement or profit and loss account and, variously, a statement of retained earnings and statement of changes in financial position or changes in shareholders equity.

(DR: para.330. CBCA: Regulations, s.46. OBCA: s.154(1). Regulations s.42(1). MBCA: §16.20. NZLC R9: para.603, Draft Act s.158. U.K. Companies Act 1985: s.226.)

5.05 RECOMMENDATION: Filing of accounts. Unless required by other legislation

(as should be the case for public and listed companies), companies would not be required to file accounts.

CURRENT ORDINANCE: Public companies are required to attach accounts to their annual return (s.109(3), sch. 5). Private companies are not required to file their accounts.

COMMENTARY: In many jurisdictions, securities legislation provides for the filing of financial statements in the interests of the protection of public shareholders and the protection of the integrity of capital markets generally. Where a company does not have public shareholders, there is little compelling reason for accounts to be made public; current creditors can take little comfort in such stale-dated information. Creditors should look to negotiated contractual or other statutory protections. (In this context, as recommended elsewhere in this Review, a modern computerised system of personal property security law would greatly benefit creditors in Hong Kong). The New Zealand Law Commission came to this conclusion:

> ...the draft Act does not require the inclusion of annual accounts in the annual return, which is simply an update of information held on the register which relates to identification of the company and its directors.
>
> 620 Most of the submissions we received in response to Preliminary Paper No. 5 favoured abolition of the requirement because the accounts were seen as providing information of historic interest only which was no guide to the current state of health of a company for those wishing to deal with it. Some respondents, however, pointed out that the historical record was itself in many cases a useful pointer to the performance of a company over time. That point was made, in particular, by a journalist who regularly uses such accounts.
>
> 621 The Law Commission, while sympathetic to the public record argument, has concluded that the cost of requiring all companies to file annual accounts is not warranted... (NZLC R9 at paras. 619-621).

As was pointed out in the working party meetings, other business entities such as partnerships and sole proprietorships are not required to file accounts. Given that the vast majority of companies incorporated under the new Ordinance will in fact be incorporated partnerships or sole proprietorships, there seems to be little rationale for imposing an additional filing burden on them which serves little public purpose.

It should be noted in this regard that public companies which are not listed are not currently subject to filing requirements with respect to accounts under securities legislation. This is an area in which a regulatory gap should be avoided in the event that this recommendation is adopted. This recommendation is premised upon a corresponding requirement being implemented under securities legislation that all public as well as listed companies make their accounts publicly available.

(DR: para.330, Draft Act s.13.06. CBCA: s.160. OBCA: s.156. MBCA: see generally §§16.01-16.22. NZLC R9: para.619.)

5.06 RECOMMENDATION: No mandatory audit. Company accounts should continue to be audited but shareholders should be able to dispense with an audit by unanimous agreement.

CURRENT ORDINANCE: All companies are required to have their accounts audited (ss. 141, 141D(1)(e)).

COMMENTARY: Audited accounts provide an important safeguard for shareholders, especially minority shareholders and in companies where there is a separation of ownership and management. As a general rule, all companies should be required to provide audited accounts to shareholders. There are circumstances, however, where there is a sufficient identity of ownership and management, especially in one person companies, where an audit is of little use to shareholders; shareholders by unanimous action should be able to dispense with the audit. Audited accounts may be required by individual creditors as a condition of doing business; audited accounts should be required of public and listed companies. Audited accounts may be required by Inland Revenue. A mandatory audit requirement in all cases does not exist in offshore jurisdictions which have become jurisdictions of choice for private Hong Kong businesses. Hong Kong incorporated businesses find themselves at a competitive disadvantage in this respect.

The indiscriminate imposition of audited accounts on all companies is unjustified and burdensome. Although across the board auditing requirements are considered useful as an administrative matter by Inland Revenue, this is not an argument for their inclusion in company law. Practices at Inland Revenue are, in any event, undergoing considerable change; there are moves to implement a self-assessment regime and to "beef up" the field audits of corporations. The new tax commissioner has recently indicated that the Inland Revenue will be "increasingly vigilant in scrutinising the corporate sector, modelling itself more closely on the Australian and US tax departments" (N. Tabakoff, "Turning the tide on tax avoidance", *The South China Morning Post, Business Post* (7 July 1996) 5).

This is not to say that audited accounts would simply disappear for non-public companies. As noted above, they may continue to be required for commercial and tax reasons; barring other reasons, however, shareholders should be able by unanimous resolution to dispense with the requirement of an auditor and an annual audit.

(DR: para.335, Draft Act s.13.09. CBCA: s.163. OBCA: s.148(1). NZLC R9: para.606, Draft Act s.167.)

B) DIRECTORS MEETINGS

5.07 RECOMMENDATION: Formalities associated with directors' meetings. The formalities associated with routine directors' meetings such as notice, quorum, attendance, dissent, etc. should be set out in Part V, Management and Administration of the new Ordinance.

CURRENT ORDINANCE: The formalities associated with directors' meetings are primarily found in the First Schedule (Table A, arts. 100-108).

COMMENTARY: Many of the formalities associated with routine directors' meetings will likely be dispensed with in private companies. In fact, the board itself may be dispensed with. For those companies which do not elect to tailor-make their meeting procedures, these provisions will provide a basic set of rules to govern the routine aspects of directors meetings.

(CBCA: Part X. OBCA: Part IX. MBCA: §§8.01-8.25. NZLC R9: Draft Act Part 7.)

C) SHAREHOLDERS MEETINGS

5.08 RECOMMENDATION: Formalities associated with shareholders' meetings. The formalities associated with routine shareholders' meetings such as notice, quorum, attendance, proxies, record date, etc. should be set out in Part V, Management and Administration of the new Ordinance.

CURRENT ORDINANCE: The formalities associated with shareholders' meetings and proceedings are primarily found in Part IV, Management and Administration and in the First Schedule (ss.111-120, Table A, arts. 49-75).

COMMENTARY: The issues to be addressed would be fairly routine: how ordinary and extraordinary meetings are called, where and how conducted, fixing a record date, notice and waiver, adjournment, quorum, and the use of proxies. More technical details and time limits could be contained in subsidiary legislation. Certain provisions, in the interests of certainty and protection of shareholders, would be mandatory; others, such as standard quorum requirements, could be varied by the company constitution or otherwise. In private companies, these formalities will likely be dispensed with and recourse had to written resolutions.

(CBCA: Part XII. OBCA: Part VII. MBCA: §§7.01-7.28. NZLC R9: Draft Act ss.90-94. U.K. Companies Act 1985: Part IX, Chapter IV.)

D) SHARE TRANSFERS

5.09 RECOMMENDATION: Negotiable instruments. Securities certificates should be statutorily recognised as negotiable instruments.

CURRENT ORDINANCE: Share certificates are not recognised as negotiable instruments.

COMMENTARY: As for the nature of a negotiable share instrument, there are two key concepts. First, an 'instrument' is a thing. It must be physical. The whole legal analysis of negotiable instruments is built up around the concept of some physical thing, usually a printed bit of paper which can pass from hand to hand. Second, the word 'negotiable' describes the legal significance of the transfer of an instrument. When a 'negotiable' share certificate is transferred, the transferee acquiring the instrument also acquires the bundle of rights attached to the shares being transferred. This bundle of rights is normally described on the share certificate (Welling at 705).

In jurisdictions that follow the British system, such as Hong Kong, share certificates are not negotiable instruments. The transferee only obtains legal title to the bundle of rights attached to a share when his name is registered in the company register. Despite the law, in the U.K. and Hong Kong, share certificates have been treated in commercial practice as if they were negotiable instruments; and, courts have generally been inclined to support this useful practice as much as possible.

Canada broke from the U.K. model with regards to share transfers in 1975 with the introduction of the CBCA. The purpose of the change was to align the law with commercial practice by turning share certificates into negotiable instruments (*ibid.* at 701-702). The change was accomplished by looking to Article 8 of the U.S. Uniform Commercial Code (UCC). Article 8 deals with investment securities. It provides a set of rules governing the rights and obligations of parties in connection with issuance and transfer of stocks, bonds, and other evidences of indebtedness commonly sold to, and traded among, investors.

In 1971, the Dickerson Committee, the committee whose recommendations laid the foundation for the CBCA, described the advantages of adopting Article 8 in Canada:

> [...] UCC Article 8 has two unassailable advantages: first, it is written in the language of transfer agents, reflecting business reality; second, it has worked for a considerable time in many jurisdictions without the need for substantial judicial interpretation. In light of this experience , tampering with a demonstrably good model hardly appears warranted (Dickerson Report at para. 175).

Accordingly, under s.48(3) of the CBCA a security certificate issued by a corporation "is a negotiable instrument".

The recognition of share certificates as negotiable instruments avoids the previous uncertainty under the British system. With negotiability, transfers of physical shares function relatively smoothly (Welling at 716). The transferor may initiate a share transfer by endorsing the certificate to the transferee and delivering it. Where he does so, the transferee to whom it is endorsed becomes the legal and equitable owner of the share under the statute (*ibid.* at 716). Although the company remains statutorily authorised to treat whoever is named in the share register as the shareholder for all purposes, the transferee, upon receiving and possessing an endorsed share certificate, as owner, has the status to invoke the full range of shareholder rights, including the right to have the share register kept up to date (*ibid.* at 710). Once registered, the former shareholder, now deregistered, drops out of the picture completely (*ibid.*).

(DR: Draft Act s.6.01(3). CBCA: s.48(3). OBCA: s.53(3).)

5.10 RECOMMENDATION: Modernised security certificates system. Provisions with respect to security certificates, their form, content, registration and transfer should be modernised to provide for the optional use of "scripless" (book entry or "uncertificated") securities and, to the extent not dealt with under other legislation, the mechanics of their transfer (including the use of clearing agencies).

CURRENT ORDINANCE: There are no provisions which provide for the use and transfer of scripless (book entry or uncertificated) securities.

COMMENTARY: Some jurisdictions permit only the use of "scripless", book entry or "uncertificated" securities by entities established under their laws; paper share certificates have been abolished. Although this is obviously the way of the future, it is likely too early to make such a recommendation in Hong Kong. Provision should, however, be made for the optional use of book entry securities, the formalities associated with their registration and their transfer. The extent to which detailed provisions should be included (with respect to

title to securities passing, creating a security interest in them as well as the operation of clearing agencies) will depend on the extent to which these matters are dealt with elsewhere. This is particularly the case with public and listed companies.

To the extent that this is an area that is developing quite rapidly at the moment, working party members were of the view that it was too early to make concrete proposals for statutory provisions in the companies legislation. The SFC, the SEHK and the Hong Kong Securities Clearing Company Limited have considerable expertise in this area and it would be useful to draw upon it at a later time in deciding upon statutory treatment which would reflect market practices.

E) REGISTRATION OF CHARGES

5.11 RECOMMENDATION: Part III retained. Pending consideration of the creation of a separate regime for the granting of security interests in personal property, Part III of the current Ordinance, Registration of Charges would continue to apply.

CURRENT ORDINANCE: Part III of the Ordinance governs the registration of company charges with the Registrar of Companies.

COMMENTARY: The Review has recommended a separate study which would examine the creation of a separate, North American style personal property security interest regime. Such regimes, which trace their origins to Article 9 of the UCC in the United States, provide a comprehensive system for the creation and publication of all kinds of security interests in personal property, applicable to all individuals and business entities. Highly compatible with the use of information technology, these regimes promote certainty and efficiency in commercial transactions by eliminating the archaic assortment of inconsistent rules and practice associated with the "charging" of personal property. Unfortunately, the United Kingdom has not been able to make the move to adopting such a regime. Hong Kong should not await action in the United Kingdom in this respect. These modern regimes are well established in North America and it is possible to virtually buy them, and their associated computer technology, off the shelf, so to speak.

In the interim, given that Part III of the current Ordinance is more or less a stand alone component, it would be possible to leave it in place pending implementation of a modern system. The transitional period leading to full implementation of a new Business Corporations Ordinance should provide ample opportunity to concurrently implement a personal property security interest regime.

(NZLC R16: paras.133-138.)

F) REGISTERED OFFICE, RECORDS, CORPORATE SEAL

5.12 RECOMMENDATION: Modern record keeping. Provision should be made for modern record keeping, including electronic data processing. An obligation should be

imposed to ensure the accurate preservation of data and its accessibility in written form to those entitled to it within a reasonable period of time.

CURRENT ORDINANCE: There are few provisions in relation to modern record keeping such as electronic data processing; however, the Ordinance does allow, subject to certain conditions, a company to keep its register of shareholders by "mechanical or electrical means" (s.95(2)).

COMMENTARY: This recommendation merely recognises modern techniques of data storage and retrieval, while balancing the needs of accuracy and accessibility.

(DR: para.95, Draft Act s.4.04. OBCA: s.139(1). U.K. Companies Act 1985: ss.722-723.)

5.13 RECOMMENDATION: Company records. The new Ordinance should contain a clear and concise statement of the records which must be kept by the company, their location and who has access to them (and in what circumstances and to what purposes.)

CURRENT ORDINANCE: The provisions governing the various records that must be kept at the company's registered office, as well as the rules governing who has access to them, are found in different places in the Ordinance, for example:

- register of debenture holders (s.74A);
- register of shareholders (s.95);
- register of charges (s.89) and copies of instruments creating charges (s.88);
- register of directors and secretaries (s.158A);
- the minutes of the proceedings of general meetings and meetings of directors (s.120).

COMMENTARY: It is recommended that information which is required to be put on the public record, especially as concerns non-public companies, be significantly reduced. For this reason, care should be taken in formulating the requirements applicable to record keeping by the company itself and those to whom rights of access should be given. It is usual to require that a company keep minutes of shareholders', directors' and committee meetings as well as a record of action taken which does not require a meeting; a register of shareholder and other securities holders; a register of directors; a copy of all required notices; the constitutional documents of the company (including "quasi-constitutional documents" such as unanimous shareholders agreements) and adequate accounting records. New Zealand has added a register of "directors' interests" where directors must record conflict of interest transactions (as well as interests in company shares), but this is not recommended for Hong Kong.

Shareholders should be given a copy of constitutional documents upon request. Directors should be able to consult the accounting records and minutes of directors' meetings. Shareholders, creditors and the Registrar should have access to specified records: constitutional documents; shareholders minutes and resolutions; various notices and the securities holder register. They should also be able to obtain a shareholders list provided they make assurances that it will be used for certain limited and proper purposes. Accessibility to these records should be broadened for companies with public shareholders, unless duplication with information available on the public record under other ordinances results.

(DR: Draft Act s.4.02. CBCA: ss.20-21. OBCA: s.140. MBCA: §§16.01-16.04. NZLC RS: paras.591-592, Draft Act ss.147-149.)

5.14 RECOMMENDATION: Corporate seal. Use of a corporate seal should be voluntary and no agreement should be invalid merely because a corporate seal is not affixed to it.

CURRENT ORDINANCE: Every company must have "as its common seal a metallic seal on which it shall have its name engraven in legible characters" [s.93(1)(b)].

COMMENTARY: Obligatory use of a corporate seal should be eliminated in conformity with the approach adopted in many other jurisdictions. In 1971, commenting on the use of the corporate seal, the Dickerson Committee stated:

> At one point we considered abolishing the whole idea of the corporate seal, an anachronism carried over from a less literate age. The amount of money spent every year in buying and storing this redundant ironmongery must be substantial. In the end, however, we concluded that we would probably create more trouble than we would save by abolishing the seal. Many people, bank managers in particular, are devoted to the seal and would be very upset if its use was prohibited. The law need not deprive people of such simple and harmless pleasures (Dickerson Report at para. 96).

The Dickerson Committee may have underestimated the significance of the corporate seal as it has remained, even in jurisdictions where its use is voluntary, a standard feature of corporate life. There may be any number of reasons for this, some of which may be stronger in Asia. Those companies which wish to retain and use a company seal will of course be able to do so; those that do not will not risk invalidation of their agreements. This will also facilitate international transactions where use of a corporate seal is not required of foreign corporations.

[DR: para.96, Draft Act s.4.05. CBCA: s.23. OBCA: s.13. MBCA: §3.02(2). NZLC R9: para.96. U.K. Companies Act 1985: s.36A(3).]

6.00 DIRECTORS AND EXECUTIVE OFFICERS

6.00 DIRECTORS AND EXECUTIVE OFFICERS

6.01 RECOMMENDATION: Unitary board structure retained. The traditional unitary board structure should be retained.

CURRENT ORDINANCE: The Ordinance provides for a unitary board structure.

COMMENTARY: The traditional unitary board structure found in U.K. style companies legislation is not universal and has been subject to close questioning in recent years. Many non-Commonwealth jurisdictions (including the PRC) require a two-tier structure derived primarily from German law, composed of a managerial board and a supervisory board. Such a structure, its proponents argue, is more suited to large corporations where not only has there been a separation of ownership and management, but a further internal division of the traditional management and supervisory functions within a board (as evidenced by executive and non-executive directors in U.K. and U.S. style companies). In addition, the German-style dual board structure has permitted the development of the corporate principle of "co-determination", or worker participation, in management to which much of post-World War II German industrial success has been attributed. A more detailed discussion of these issues appears in the Comparative Survey prepared as a background paper to this Review.

Although certainly open to refinement, the unitary board should be maintained. It is a structure that is well understood and accepted in Hong Kong and is the model for the Commonwealth jurisdictions which Hong Kong follows. The New Zealand Law Commission (NZLC) came to an identical conclusion at an early stage in its review of New Zealand company law in 1987:

> There remains the question whether director management is a sensible assumption for company law to make. In the case of large companies, there is a great deal of evidence to suggest that the directors, far from managing the company, may not even exercise effective supervision. Except in times of crisis their main function may be advisory only. Alternative systems discussed as being more in accordance with reality involve prohibiting outsider directors, and creating two boards (or at least giving the company the option of going to a two-tier system), in which managerial and supervisory functions would be clearly segregated. Comment is specifically invited upon the adoption or option of a two-tier board. The present suggestion, however, is that the division of responsibility and accountability in this manner is undesirable. The Law Commission suggests:
>
> (1) that an obligation to supervise cannot sensibly be separated from the obligation to manage without diluting accountability to an extent that is unacceptable
>
> (2) that the standards exacted by the Courts from directors in fact may recognize a distinction between insiders and outsiders
>
> (3) that the right to manage includes the right to delegate while continuing the responsibility to set up safe systems and ensure competence in the managers to whom powers are entrusted
>
> (4) that the ability of the outside directors to supervise is enhanced by their participation on the board with insiders

(5) that in New Zealand business conditions the unitary system and the responsibilities it imposes upon directors are well understood and there appears to be no wish for any great change

(6) that it is not necessary to provide for a board which is advisory only (since the directors can set up such formal or informal systems for outside advice as they think necessary, as part of their powers of management)

(7) that there is a risk in a two-tier board system that the function of advising the managerial board would obscure the necessary function of providing effective supervision (NZLC, *Preliminary Paper No.5 Company Law A Discussion Paper* (Wellington: Law Commission, 1987, at para. 172).

(DR: see generally Part 9.00. CBCA: ss.2,102. OBCA: ss.115-116. MBCA: §8.01. NZLC R9: Draft Act ss.97-98.)

6.02 RECOMMENDATION: Board of directors. In private companies/closely-held corporations, a single decision making body should be an option; the responsibilities of the directors would be assumed by the shareholders.

CURRENT ORDINANCE: Every company, whether public or private, must have at least two directors (s.153(1)).

COMMENTARY: The South African Close Corporations Act of 1984 completely eliminates the board of directors. Section 7.32 of the MBCA and its Model Statutory Close Corporation Supplement provide incorporators and shareholders with the option of eliminating the board of directors or restricting its discretion or powers. Where the company being formed is closely-held, a family business or an incorporated partnership, the mandatory requirement of a board of directors may constitute an unnecessary formality. Elimination of the board of directors can be effected in several different ways, for example, by way of unanimous shareholders agreement or stipulation in the company constitution. Responsibilities of the board of directors, including the statutory obligations imposed on the directors, are then assumed by or imposed on the shareholders. Where the board has been eliminated as a formal corporate structure, it would still be possible for the owner-managers to nominally use the title "director" for commercial purposes. Some working party members did not consider the requirement to have a board of directors an onerous one and favoured its retention. In keeping with the principle of providing maximum flexibility to private companies to order their internal affairs, the recommendation does provide the option of creating a boardless private company or eliminating the board by unanimous action. For a more detailed discussion of board structure in private companies, see Part X, Private Companies/Closely-Held Corporations.

(DR: paras.298-302, Draft Act ss.11.14. CBCA: s.146(2),(5). OBCA: S.108(2). MBCA: §7.32, see generally Model Close Corporation Supplement.)

6.03 RECOMMENDATION: Statutory power of directors. The board of directors should be given a direct grant of statutory power to manage, or supervise the management of, the company. This power should be made subject to any unanimous shareholder agreement.

CURRENT ORDINANCE: There is no direct grant to directors of statutory power to manage or supervise the management of the company. Power is delegated from shareholders and the extent of the delegation depends on the articles of

association. In practice, power to manage is delegated to directors. (Table A, First Schedule, s.82).

COMMENTARY: In practice, this recommendation does not alter the current management structure of Hong Kong companies; the change is conceptual in nature and in keeping with the underlying concepts of the different models which are being drawn on in other recommendations. The advantages of the conceptual change are manifest primarily in the ease with which the one person corporation is accommodated.

There are two conceptual approaches to characterising the actual source of the board's powers: 1) delegation from the shareholders and 2) direct grant by statute. The traditional U.K. view (which the current Ordinance reflects) is that a board's powers are delegated by the shareholders: the power of the board derives from the contract formed between the members of the company. This implies a certain amount of variation in the power, depending on the memorandum and articles of each company, and any residual power remains in the hands of the shareholders. On the other hand, the statutory division of powers model views the corporate statute as an enabling device; it confers limited liability on individuals who fulfil the requisite formalities, grants the corporation legal personality, and creates a division of powers within the corporation. The two poles of this division of powers are the board of directors (who are empowered to manage the corporation) and the shareholders (whose power is largely reactive). Shareholders cannot directly manage the corporation but have control over the composition of the board, are entitled to use certain remedies to enforce their rights and safeguard their interests, and in some cases may restrict the activities of the board or eliminate it entirely. Thus, the power of the board to manage the corporation is seen as a direct grant of power under statute.

In keeping with other recommendations, this recommendation is based on a statutory division of powers model found in other Commonwealth and North American jurisdictions.

> The directors' power is original, not delegated; as such, it is not subject to controls by the shareholders, except as specified in the applicable statute. This was not the case in English-based corporate law where the directors' power extended only so far as the terms by which it was delegated, usually in the corporate constitution. [Because] the original power lies with the directors and not the shareholders, there is no basis for any shareholder power to either extend the scope of the directors' power or to forgive the directors for having breached their statutory duties (Welling at 318).

This structure serves to attenuate the situation which arose in *North-West Transportation Co. v. Beatty* (1887), 12 App. Cas. 589 (P.C.), where a shareholder/director acting in his capacity as shareholder, ratified his own actions as a director despite a conflict of interest.

The statutory power to manage is made subject, however, to variation by means of unanimous shareholder agreement. Where there is unanimity among the shareholders, there is complete freedom as to the structuring of the decision-making authority and line of command. Accommodation is thus made for all varieties of companies, from public companies with varying degrees of identity of ownership and management which choose to rely on traditional and familiar board structures, through a wide range of other business enterprises where such formality is ill-suited.

> The board of directors is the traditional form of corporate governance but it need not be the

> exclusive form. Patterns of management may also be tailored to specific needs in connection with family controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures through a shareholder agreement [...](MBCA, Official Comment, s. 8.01).

With respect to the role and function of the board of directors, again, flexibility should be provided. It is possible within the unitary board structure to accommodate different levels of active management.

> In a small corporation and in some larger corporations where the board of directors is composed entirely of persons actively involved in the management of the corporate business, it may be reasonable to describe management as being 'by' the board of directors. But a different model is appropriate for the boards of directors of publicly held corporations, which usually include individuals not actively involved in management. In these corporations it is not feasible to impose a requirement that the business and affairs of the corporation be managed 'by' the board of directors (*ibid.*).

(DR: paras.191-195, Draft Act s.9.01. CBCA: ss.102, 146(2). OBCA: s.115(1). MBCA: §8.01. NZLC R9: paras.161,496, Draft Act s.98.)

6.04 RECOMMENDATION: Delegation of powers. The board of directors should be permitted to delegate all those powers which it is not required to exercise itself.

CURRENT ORDINANCE: There is no obstacle to the delegation of the board's powers. A board may delegate its powers to committees of the board or to a managing director (Table A, arts. 104, 111).

COMMENTARY: This recommendation reflects the practical realities and common law position with respect to delegation of authority by the board of directors, either to committees composed of directors, or in certain circumstances where powers are not required to be exercised by the board of directors, non-directors. In the United States, the use of committees is highly developed in public companies, not only as an effective management technique but also in response to investor concerns with board accountability.

> Committees of the board of directors are assuming increasingly important roles in the governance of publicly held corporations [...] Executive committees have long provided guidance to management between meetings of the full board of directors. Audit committees also have a long history of performing essential review and control functions on behalf of the board of directors. In recent years nominating and compensation committees, composed primarily or entirely of nonmanagement directors, have also become more widely used by publicly held corporations (MBCA, Official Comment, s.8.25).

It is not intended that the types of committees possible, or required, be set out in the companies legislation. Rather, the authority to create such committees is merely recognised. The requirements for the composition of any particular committee may be found in guidelines for directors prepared by various professional bodies, listing rules, or other legislation.

(DR: paras.219-221, Draft Act s.9.14. CBCA: ss.115,121. OBCA: s.127. MBCA:§§8.25,8.40. NZLC R9: para.503, Draft Act s.100.)

6.05 RECOMMENDATION: Functions not subject to delegation. Certain functions of the board of directors should not be subject to delegation, for example:

- **submission to shareholders of any question requiring their approval**
- **filling an interim vacancy among directors, in the office of auditor, appointing or removing the chief executive officers**
- **in most circumstances, issuing securities**
- **declaring dividends**
- **purchasing, redeeming or otherwise acquiring shares issued by the company**
- **approving financial statements**
- **adopting, amending, repealing any constitutional documents.**

CURRENT ORDINANCE: Not applicable.

COMMENTARY: The MBCA identifies "competing considerations" with respect to delegation of directors authority. On the one hand, delegation is highly desirable. It is "likely to improve the functioning of larger and more diffuse boards of directors; on the other hand, wholesale delegation of authority to a board committee, to the point of abdication of director responsibility as a board of directors, is manifestly inappropriate and undesirable" (MBCA, Official Comment, s.8.25). The legislation in many jurisdictions thus identifies certain matters which may not be delegated by the board of directors, primarily where the consequences of the decision are irrevocable, or where the interests of shareholders deserve greater protection.

(DR: paras.219-221, Draft Act s.9.14. CBCA: s.115(3). OBCA: s.127(3). MBCA: §8.25(e). NZLC R9: para.503, Draft Act s.100.)

6.06 RECOMMENDATION: Directors' minimum qualifications. Directors should meet certain minimum qualifications:

- **age of majority**
- **mental capacity (i.e. not found legally incapable)**
- **only individuals (no corporate directors)**
- **no one who has the status of an undischarged bankrupt unless permitted by court order**
- **no one who has been disqualified from acting as a director.**

CURRENT ORDINANCE: Directors must meet the following minimum qualifications:

- age of majority (s.157C);
- no corporate directors, however, private companies may have such directors so long as they do not belong to a group of companies which includes a listed company on the SEHK (s.154A);
- no one who has the status of a bankrupt unless they receive court permission to act as a director (s.156);
- no one who is subject to a disqualification order (s.168D(1)).

COMMENTARY: The main issue for consideration here is the necessity for the imposition of any statutory minimum qualifications for directors. The MBCA, for example, has never specified mandatory qualification requirements for directors although many U.S. statutes did so in the past. Given the responsibilities of the board, however, it is advisable to mandate minimum capacity (age of majority, mental capacity and no undischarged bankrupts; see CBCA, s.105) as well as precluding those who have been disqualified from acting as a

director. This recommendation of course would not prohibit companies providing for more stringent qualification requirements in their constitution.

Permitting corporations to be directors cuts directly across current preoccupations of proper exercise of directors' discretion and board accountability. It should not be permitted. This was the position taken by the U.K. Jenkins Committee in 1962 and, in vain, by the Second Report of the Committee on Company Law Reform here in Hong Kong in 1973. If anything, the reasons for prohibiting corporations from acting as company directors are more compelling now than they were then. Most major jurisdictions surveyed do not permit corporate directors. In the United States, corporations may not act as directors; the MBCA requires that the board be composed of individuals (MBCA, s. 8.03(a)).

(DR: paras.199-201, Draft Act s.9.04. CBCA: s.105. OBCA: s.118. NZLC R9 para.544, Draft Act s.115.)

6.07 RECOMMENDATION: One director. Private companies should be permitted to have a minimum of one director.

CURRENT ORDINANCE: All companies must have at least two directors (s.153(1)).

COMMENTARY: With one person companies being permitted, equally, one director companies should be permitted. It is obviously desirable for public companies to have more than one director and as a matter of course they will do so. The issue is the extent to which the requirement should appear in companies legislation; for listed companies, board composition will be subject to listing rules but for unlisted public companies this may not be the case.

(DR: para.192, Draft Act s.9.01(1). CBCA: ss.2(1),102(2). OBCA: s.115(2). MBCA:§8.03(a). NZLC R9: paras.75,335,543, Draft Act ss.5(e),114. U.K. Companies Act 1985: s.282(3).)

6.08 RECOMMENDATION: Shadow and alternate directors. The troublesome concepts of shadow and alternate directors should be eliminated.

CURRENT ORDINANCE: An alternate director is not defined in the Ordinance. However, an alternate director of company falls within the general definition of a "director": "any person occupying the position of director by whatever named called (s.2(1))."

Shadow directors are defined in relation to the maintenance of a register of directors and secretaries as "a person in accordance with those directions or instructions the directors of a company are accustomed to act [...]" (s.158(10)(a)).

COMMENTARY: An alternate director, according to the 1995 *Guidelines for Directors* published by the Hong Kong Institute of Directors, is "someone empowered to perform the duties of a director, usually only at board meetings, in the temporary absence of a director"(Institute of Directors, Hong Kong Branch, *Guidelines for Directors* (Hong Kong: Institute of Directors, Hong Kong Branch, 1995) at para. 88). Alternate directors are not authorised, nor prohibited, by the current Ordinance. They are usually provided for in the articles as a matter of convenience where business people travel frequently and are otherwise engaged.

Alternate directors should be unnecessary under a new Ordinance, even as a matter of convenience. For private companies/closely-held corporations, especially those which

would choose to eliminate the board of directors entirely, decision making by means of formal meeting will be exceptional. More informal means of decision making will be the rule.

With respect to public companies, the use of alternate directors raises different issues. Accountability of directors is now a prime concern in every major commercial jurisdiction and outweighs matters of personal convenience. To this end some jurisdictions, Germany for example, restrict the number of boards upon which any one individual may sit. Restrictions on the number of boards upon which a director may sit are now being considered as well in the United States. Recently, with respect to board restriction for directors, the Blue Ribbon Commission on Director Professionalism of the U.S. National Association of Corporate Directors recommended that boards should prefer "individuals who hold no more than three or four public-company directorships in addition to membership on their own organisation's board" (National Association of Corporate Directors (NACD), *Report of the NACD Blue Ribbon Commission on Director Professionalism* (Washington: NACD, 1996) at 12).

The use of board directorships as honorific positions has also been highly criticised of late. "Part-time, ornamental 'star directors' may appear to add luster to a board roster, but a director cannot provide outstanding professional service unless his or her energies and competencies are truly available" (*ibid.* at 10). The use of alternate directors thus runs counter to the general trend towards greater accountability for company directors. In addition, modern telecommunications technology will increasingly make physical presence at meetings unnecessary, thus permitting directors to participate in board meetings despite temporary absences. Where absence is unavoidable, a statutory mechanism should permit a director to formally dissent from the action taken at that meeting in order to avoid possible liability. Not all working party members were convinced of the necessity of eliminating the alternate director concept. They pointed out that alternate directors can be useful in certain circumstances (e.g. where there is an agreement among major shareholders as to the fixed number of directors that would represent each major shareholder on the board of directors) and were reluctant to have this flexibility eliminated.

"Shadow" directors present different issues, primarily related to liability and enforceability.

> A 'shadow director' is not defined in the general interpretation section of the Companies Ordinance but the term relates to any person in accordance with whose directions or instructions the directors of the company are accustomed to act. Under section 351(2) of the Companies Ordinance, liability to a fine or penalty may extend beyond appointed directors to such "shadow directors". Accordingly, liability can extend to banks, for example if directors of a defaulting borrower act on their instructions. Parent companies or directors of parent companies may also find themselves liable as "shadow directors", where a "hands on" policy is operated in relation to their management of a subsidiary. Examples of situations in which the liability of directors is extended to shadow directors include the following:
>
> - Sections 107 to 109 of the Companies Ordinance (relating to annual returns);
> - Section 158 of the Companies Ordinance (relating to the maintenance of a register of directors and secretaries);
> - Sections 168C to 168T of the Companies Ordinance (relating to the disqualification of directors);

> Section 271 of the Companies Ordinance (relating to offences by officers of companies in liquidation) (Institute of Directors, Hong Kong Branch, *Guidelines For Directors* (*supra*, at para. 111)).

Again, for private companies/closely-held corporations, the removal of artificial distinctions in terms of company management should render the concept of "shadow" directors unnecessary. With respect to public companies, the concept, in its vagueness, is troublesome and unenforceable and should be eliminated. Where it is considered desirable to impose duties or liabilities on non-directors, rather than deeming a non-director to be a director, consideration should be given to identifying those to whom liability would attach, for example, executive officers or major shareholders. Where personal liability is at issue, it is important that there be reasonable certainty. Measures which are vague or commercially uncertain will inevitably be difficult to enforce, thereby undermining their utility.

6.09 RECOMMENDATION: Company officers. There should be no requirement for the appointment of any particular company officer such as a company secretary.

CURRENT ORDINANCE: All companies must have a company secretary who may be one of the directors (s.154(1)) and who must reside in Hong Kong.

COMMENTARY: Given the informality of structure which is being proposed for private companies/closely-held corporations, mandatory requirements with respect to company officers are inappropriate. Specific requirements with respect to company officers, for example for signing purposes, can be left to commercial practice. As for public and listed companies, the necessity for certain corporate officers should be left to the determination of the SEHK and other interested regulators.

This is not to suggest that a company secretary, particularly a professionally qualified secretary, such as a member of the Hong Kong Institute of Company Secretaries, does not play an important role. In fact, a professionally qualified secretary can help the board of directors meet a high standard of best practice with respect to corporate governance, particularly with publicly listed companies. Due diligence and monitoring of corporate governance concerns are of increasing importance for public companies; the role of the corporate secretary can only grow in significance, as has been the experience in the United Kingdom and the United States. It may be appropriate that all public companies be required to have a professionally qualified secretary.

However, such a statutory requirement in companies legislation would be somewhat at odds with the highly enabling and flexible statutory structure which is being proposed. In the words of the New Zealand Law Commission:

> The draft Act does not attempt to provide a structure for the operation of a company below the level of directors. That is a deliberate decision based upon our belief that the directors are the organ of the company responsible for its management and that to provide for management functions below the level of directors in the Act would be to undermine director responsibility and accountability. The directors are given power to delegate, but retain the obligation to set up safe management systems and to monitor those to whom they delegate their powers (NZLC R9 at para. 287).

This approach is consistent with North American models.

[DR: see generally Part 9.00. CBCA: see generally Part X. OBCA: see generally Part IX. MBCA: §8.40. NZLC R9: para.101.]

6.10 RECOMMENDATION: Removal of directors by shareholders. Shareholders should be able to remove directors by ordinary resolution, subject to class voting rights and the company constitution.

CURRENT ORDINANCE: A company may by special resolution vote to remove a director [...] before the expiration of his period of office (s.157B(1)).

COMMENTARY: This recommendation espouses the view that "since the shareholders are the owners of the corporation, they should normally have the power to change the directors at will" (MBCA, Official Comment, s.8.08). Given the fundamental nature of this right, an ordinary shareholders resolution should be sufficient.

[DR: paras.209-211, Draft Act s.9.08. CBCA: s.109. OBCA: s.122(2). MBCA: §8.08. NZLC R9: para.553, Draft Act s.119. U.K. Companies Act 1985: s.303.]

6.11 RECOMMENDATION: Meetings of directors. Meetings of directors should be permitted by means of electronic communications, unless otherwise specified in the company constitution.

CURRENT ORDINANCE: The Ordinance neither explicitly prohibits nor authorises the holding of board meetings by means of electronic communications.

COMMENTARY: With the advent of modern telecommunications, directors should no longer be required to meet in person. A company, for its own reasons, could impose this requirement.

> The advantage of the traditional meeting is the opportunity for interchange that is permitted by a meeting in a single room at which members are physically present. If this opportunity for interchange is thought to be available by the board of directors, a meeting may be conducted by electronic means although no two directors are physically present at the same place and no specific place for the meeting is designated (MBCA, Official Comment, s.8.20).

Modern telecommunications can and should be accommodated by companies legislation.

[CBCA: s.114(9). OBCA: s.126(13). MBCA: §8.20(b). NZLC R9: para.742, Draft Act Second Schedule Clause 3(b).]

6.12 RECOMMENDATION: Unanimous action. Directors should be able to act unanimously by written resolution without a meeting.

CURRENT ORDINANCE: Directors are allowed to act unanimously by written resolution without a meeting except in certain limited circumstances such as interested director transactions (Table A, arts. 86(2), 108).

COMMENTARY: Again, as an accommodation to both the private company (where decisions are often made informally), and to public companies (which desire the ability to act nimbly without the necessity for holding a meeting of directors), directors should be able to take action without a meeting. This is based on "the pragmatic consideration that in many

situations a formal meeting is a waste of time" (MBCA, Official Comment, s.8.21), especially where prompt action is desired and the decision non-controversial. Unanimity "precludes the possibility of stifling or ignoring opposing argument" (*ibid*).

(DR: para.222, Draft Act 9.15. CBCA: s.117(1). OBCA: s.129. MBCA: §8.21. NZLC R9: Draft Act Second Schedule Clause 7.)

6.13 RECOMMENDATION: Statutory statement of directors' duties. There should be a statutory statement of directors' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would. These duties should also be made applicable to those corporate officers appointed by the board.

CURRENT ORDINANCE: There is no statutory statement of the directors' and officers' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would.

COMMENTARY: A statutory statement of directors' duties would have the beneficial effect of clearly setting out the standard against which actions by directors would be measured. As in other jurisdictions, there is no doubt that the long history in the case law would continue to inform the statutory language, but the statutory standard would prevail. The duties incumbent upon company directors are the product of a long evolution at common law; their development was also influenced by certain equitable notions. Directors' duties may be classified into two categories: fiduciary duties and the duty of care and skill. Directors' fiduciary duties represent Equity's most significant contribution to company law; they place the directors under a fiduciary obligation to act in the best interests of the company, not to abuse or fetter their powers, and not to place themselves in situations of conflict of interest.

At common law, the duty of care incumbent upon directors was anything but onerous; in *Re Brazilian Rubber Plantations and Estates Ltd.*, Neville J. said the following:

> A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its despatch.
>
> Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf. His is clearly, I think, not responsible for damages occasioned by errors in judgment... (*Re Brazilian Rubber Plantations and Estates*, [1911] Ch. 425 (C.A.) at 437).

The duty of care as it has evolved in the case law is derived from a gross negligence standard.

In counterbalance to this very low standard of care (and partly due to the historical development of the company where directors were originally seen as true "trustees" or fiduciaries), fiduciary duties have been imposed on directors. Initially the fiduciary duties

imposed by the courts were quite strict, in keeping with the view that directors were in fact trustees. With time, and in the interests of the promotion of commerce and risk-taking enterprises, these strict fiduciary duties were relaxed by the courts. A more modern view of these new fiduciary-like duties would include some or all of the following:

- to act in good faith
- not to fetter their discretion (such as agreeing to vote in a certain way in future)
- to avoid conflicts of interest (such as interested director transactions)
- not to misuse corporate property, information, or opportunities
- not to compete with the company

There are various statutory formulations of directors' duties but all are derived from the standard of care (essentially a negligence standard) and the fiduciary duty attributed to directors by the courts. Such formulations have become the accepted norm in company statutes. Delaware is a notable exception, relying instead on its highly specialised judiciary to formulate the standards. Until recently, it seemed that the United Kingdom was moving in the direction of statutory standards. According to the U.K. Department of Trade and Industry working group on Directors Duties, there was "support emerging for the codification of directors' duties similar to the approach adopted in other Commonwealth countries. The DTI favours a reduced Part X coupled with a 'statement' of directors' duties" (Great Britain, Department of Trade and Industry, *DTI's Programme for the Reform of Company Law – Progress Report* (London: Department of Trade and Industry, 11 June 1996)). A subsequent Progress Report (October 1996) indicates, however, that such an initiative has been again derailed.

The U.K. Jenkins Committee, in 1962, considered that a general statement of the basic principles underlying the fiduciary relationship of directors towards their companies would be useful to directors and others concerned with company management. The Second Report in Hong Kong in 1973 agreed and so recommended. The SCCLR has also so recommended. Efforts were made to develop a statutory formulation of directors' fiduciary duties in Hong Kong, the most recent being the Companies (Amendment) Bill 1991. The Bill was not enacted due to objections expressed in particular by the Law Society. The Law Society was of the view (among other things) that any attempt to draft a statutory formulation of directors' fiduciary duties would be incomplete and that it was better to continue with the present system where a director should consult his professional advisors whenever a question involving his fiduciary duties to the company arose. When the Bill was withdrawn, the Government encouraged the private sector to draft guidelines to better inform directors of their duties. In 1995 the Hong Kong branch of the Institute of Directors published *Guidelines for Directors* which was, in part, intended to be responsive to the need for some private sector guidelines. Of special interest in this area is the SEHK Listing Rules' formulation of directors' duties, which demonstrates its affinity to modern statutory formulations. This is a measure which is long overdue and upon which there was considerable consensus in the working party.

There are several issues associated with the statutory formulation of directors' duties. Under the "negligence" branch (the duty to act with care, diligence and skill), the issues are primarily the level of diligence required and the degree of objectivity of the test. There appears to be a fairly general consensus that the "gross negligence" standard of the common

law is too low and that the test should be an objective one, to this extent displacing the case law. On the other hand, setting too high a standard has been resisted on several grounds: commercial expediency and the ability to attract good business people to fill directorships. So that although serious consideration has been given to setting a "professional" standard and in fact encouraging the development of a professional class of directors, these efforts have not materialised. The MBCA rejects the notion of raising the standard to that of professional expertise.

> The reference to 'ordinarily prudent person' embodies long traditions of the common law, in contrast to suggested standards that might call for some undefined degree of expertise, like 'ordinarily prudent businessman'. The phrase recognizes the need for innovation, essential to profit orientation, and focuses on the basic director attributes of common sense, practical wisdom, and informed judgment (MBCA, Official Comment, s.8.30 (a)).

As for the "fiduciary" branch of directors' duties, the main issues are the breadth of the duty owed, by whom and to whom it is owed (e.g. does it encompass individual or groups of shareholders). There is little quarrel with requiring directors to act honestly, in good faith and in the best interests of the company. Obvious issues of conflict of interests (which under traditional fiduciary standards are dealt with strictly) or duties to a third person may be addressed separately in the legislation. Although it does appear in the New Zealand legislation, care should be taken not to import the "proper purpose" test into the standards. The "proper purpose" test was not recommended by the New Zealand Law Commission but included in the resulting legislation at the behest of Parliament. The Law Commission in New Zealand correctly noted that the "concept of proper purpose was originally derived from the case law on powers and today arguably there is a lack of underpinning objects against which powers could be assessed. On the other hand, recent cases seem to use 'proper purpose' to impose an objective standard where the good faith of directors is accepted" (NZLRC 9, at 119). A proper purpose test is unnecessary given the statutory statement of directors duties proposed.

Corporate officers are included in the U.S. and Canadian formulation of both branches of the duties, in recognition of the commercial reality of managerial responsibilities. The MBCA makes the duties applicable to corporate officers with "discretionary authority". This recommendation suggests applying the standards to those corporate officers appointed directly by the board of directors. Where most executive officers are also directors, as is often the case in Hong Kong, there would, in fact, be no extension of duties and liabilities.

In connection with the statutory formulation of directors duties in the United States, there has been a recent flurry of so-called "stakeholder," or "constituency" statutes. These statutes widen the range of factors directors may consider in making decisions to include interests such as those of employees, suppliers, customers, the community in which the corporation is situated, and, in some cases, all other "pertinent factors". By 1995, twenty-nine states had enacted such provisions. However, of these, only one, Connecticut, had made these considerations mandatory; the others were worded in a permissive fashion.

The stakeholder statutes were not designed to widen the range of persons to whom directors owe fiduciary duties; none permit any of the mentioned classes to take action if boards fail to consider their interests. Rather than to cause a sea of change in corporate

decision-making, these statutes were actually intended, as transcripts from state legislatures reveal, to be anti-takeover defences; in the event that none of the other legislative or corporate anti-takeover defences prevail, directors can always cite constituency concerns as reason for rejecting a hostile bid. They may also have reduced directors' potential fiduciary liability. There has been little litigation over these provisions and their effect on American corporate law has been non-existent for all practical purposes. For these reasons, stakeholder or constituency provisions are not being recommended; they are not relevant or appropriate in the Hong Kong context.

(DR: paras.236-242, Draft Act s.9.19. CBCA: s.122. OBCA: S.134. MBCA: §8.30(a). NZLC R9: paras.184-195,497,504-520, Draft Act ss.100(2),101-107. NZLC R16: para.55, Draft Act s.101.)

6.14 RECOMMENDATION: Reliance on reports. Directors and executive officers should be able to rely in good faith on financial statements and other reports prepared by officers and employees as well as the professional advice of lawyers, accountants, etc.

CURRENT ORDINANCE: There are no provisions which allow directors and officers to rely in good faith on financial statements and other reports prepared by officers and employees as well as the professional advice of lawyers, accountants, etc.

COMMENTARY: The reliance defence reflects commercial reality and should be coterminous with the statutory duties. In the United States, under the MBCA it is available to officers who are subject to statutory duties as well as directors. However, an officer's "ability to rely on information, reports, or statements, may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation [...] Nondirector officers with more limited discretionary authority may be judged by a narrower standard, though every corporate officer or agent owes duties of fidelity, honesty, good faith, and fair dealing to the corporation" (MBCA, Official Comment, s.8.42).

This reliance defence was previously narrower in Canada; financial statements were the only reports which could be relied upon. However, the CBCA was amended in June 1995 and brought into line with MBCA. Now directors in Canada can rely on reports prepared by other professionals (s.123(4)(b)).

(DR: Draft Act s.9.16(9). CBCA: s.123(4). OBCA: S.135(4). MBCA: §8.30(b). NZLC R9: paras.520-522. NZLC R16: Draft Act s.107.)

6.15 RECOMMENDATION: Business judgment rule. There should be no need of a statutory formulation of the 'business judgment rule'.

CURRENT ORDINANCE: There is no statutory formulation of the 'business judgment rule'.

COMMENTARY: The business judgment rule is a feature of U.S. corporate law that has no direct Commonwealth equivalent, although Australia has been considering introducing it (see J.H. Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 Corp. and Bus. L.J. 365). It is a jurisprudential rule; none of the U.S. states have attempted to codify it, leaving its formulation up to the courts. It is characterised as the presumption that in any given business decision the board "acted on an informed basis,

in good faith, and in the honest belief that the action taken was in the best interest of the company" (*Smith* v. *Van Gorkom*, 488 A 2d 858 at 872 (Del. S.C. 1985)). Thus, plaintiffs must demonstrate by preponderance of evidence that the board was not in fact acting in such a way before the courts will substitute their judgment for that of the board in relation to the decision being reviewed.

The American Law Institute, after numerous failed attempts, finally produced a codification of the business judgment rule in its *Principles of Corporate Governance: Analysis and Recommendations*.

> A director or officer who makes a business judgment in good faith fulfils the duty under this Section if the director or officer: (1) is not interested [...] in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interest of the corporation (s. 4.01(c)).

Essentially, the business judgment rule is the jurisprudential expression of the unwillingness of U.S. courts to indulge in *ex post facto* review of the merits of business judgments. It is based on the argument that a greater likelihood of judicial review of business decisions will lead boards to choose overly conservative courses of action instead of making decisions with regard to optimal results, thereby damaging corporate performance.

Another argument is that judicial and business decision-making are different processes taking place in different environments: it is doubtful whether judges, who may lack the business expertise required to appreciate all the factors involved in a complex business decision, and whose methods of analysis are legal rather than commercial, will be able to make a decision superior or even equal to the one made by the board. Even if this were not the case, the fairness of allowing review of business decisions on the basis of perfect judicial hindsight is questionable. It must be noted that much of the U.S. case law in this area has dealt with takeover situations, so that the major issue in these cases has been entrenchment of management by the adoption of certain plans of action such as sales of crown jewels, where the board authorises the sale of the asset or division that is motivating the takeover bidder.

It has been argued that courts in Commonwealth jurisdictions implicitly apply similar reasoning in duty-of-care judgments. Certainly, Commonwealth courts are reticent to review business judgments where gross negligence or self interest are not to be found, and will not find directors liable for mere errors of judgment (see, e.g. *Re City Equitable Fire Insurance Co. Ltd.* [1925] 1 Ch. 407). Professor Ziegel states that:

> To a large extent, Anglo-Canadian courts have given implicit recognition to the concerns expressed by [the business judgment rule] in their duty of care judgments. For instance, Lord Wilberforce, in *Howard Smith Ltd* v. *Ampol Petroleum Ltd.*, [1974] A.C. 821 at 832, stated that:
>
> > There is no appeal on merits from management decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

> In this respect, rather than being articulated as a clearly identifiable doctrinal rule, the considerations underlying the business judgment rule have simply been imported into the formulation of the final standard of care that governs directorial conduct. Viewed in this way, the integration of the business judgment rule into the relevant standard of care takes Anglo-Canadian courts to the same endpoint as their American counterparts (J.S. Ziegel et al., *Cases and Materials on Partnerships and Canadian Business Corporations*, 3rd ed. (Toronto: Carswell, 1994) at 478).

Recently, there have been suggestions that Australia enact a statutory equivalent to the business judgment rule. The Australian Government has so far been unwilling to do so for the following reasons: 1) the wisdom of importing an American common law rule into the Australian Corporations Law is questionable (compatibility problems might arise); 2) codification of the business judgment rule had, at the date the objections were made, proved impossible; 3) Australian common law contains a rule, which although expressed differently and occurring as part of the standard of care, produces similar results; 4) the Corporations Law allowed the court to excuse directors from liability where they had acted honestly and ought fairly to be excused; and 5) the precise objective of enacting the business judgment rule was unclear. However, following the recent election in Australia, it would appear that the new government is once again considering the adoption of the business judgment rule (see Hon. Brian Gibson, "The Government's View on the Corporations Law" (speech delivered in Sydney, 14 May 1996)).

6.16 RECOMMENDATION: Indemnifying directors. Companies should be permitted to indemnify directors and officers in specific circumstances; companies should be required to indemnify directors and officers in specific circumstances.

CURRENT ORDINANCE: Under the Ordinance a contract indemnifying directors for breach of duty is void, as is any provision to such effect in the company's articles (s.165). However, a company may indemnify directors for costs incurred while successfully defending themselves against a civil or criminal action (s.165, art. 137). Furthermore, a court, "having regard to all the circumstances of case", may grant relief to a director who has acted "honestly and reasonably" even though held liable for "negligence, default, breach of duty or breach of trust" (s.358, art. 137).

COMMENTARY: Where a director has behaved properly and faithfully, there should be a claim to indemnification from the company. However, blanket indemnification is undesirable. Indemnification where a director has acted in breach of fiduciary duties would effectively involve a waiver of such duties. The factors to be balanced are the need to recruit qualified directors against the use of corporate funds by directors to avoid the costs imposed on them for certain forms of misconduct. Indemnification should be permissible where it furthers "sound corporate policies" and should be prohibited where it would "protect or encourage wrongful or improper conduct", according to the MBCA. The CBCA indemnification provisions, upon which this recommendation is based, are quite liberal.

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

Indemnification should be mandatory where the manager has been substantially successful on the merits of a defence (see CBCA, s. 124).

(DR: paras.243-246, Draft Act s.9.20(1)-(3),(5)-(7). CBCA: s.124. OBCA: s.136. MBCA:§§8.50-8.51. NZLC R9: paras.88,560-563, Draft Act s.125. NZLC R16: para.58, Draft Act s.125. U.K. Companies Act 1985: ss.310(3),144,727.)

6.17 RECOMMENDATION: Insuring directors. Companies should be permitted to insure directors and officers except for a failure to act honestly and in good faith with a view to the best interests of the company.

CURRENT ORDINANCE: Under the Ordinance a company cannot purchase insurance on behalf of directors (s.165) although the directors themselves may do so. This is comparable to the position taken in the United Kingdom prior to recent amendments to the U.K. Companies Act.

COMMENTARY: The current prohibition on companies purchasing directors' and officers' liability insurance directly is easily circumvented as was the case in the U.K. prior to recent reforms. Companies increased directorial compensation to cover insurance premiums. This was not an ideal state of affairs, however. The CBCA provisions with respect to insurance are, again, quite liberal, essentially permitting the market to decide what risks will be insurable. The only limitation is with respect to acts which are not done honestly and in good faith with a view to the best interests of the company.

Apart from breach of fiduciary duty, the company should be able to purchase directors' and officers' insurance for any risks which the market is prepared to insure. The Dickerson Committee wrote in 1971: "Until experience shows that this broad power to obtain indemnity insurance from commercial carriers has been abused by directors and officers, there appears no reason to limit the insurance coverage that may be obtained" (Dickerson Report at para. 250).

(DR: paras.249-251, Draft Act s.9.20(4). CBCA: s.124(4). OBCA: s.136(4). MBCA:§8.57. NZLC R9: paras.88,560-563, Draft Act s.125. NZLC R16: para.58, Draft Act s.125. U.K. Companies Act 1985: s.310. U.K. Companies Act 1989: s.137(1).)

6.18 RECOMMENDATION: Disqualification of directors. Disqualification of directors provisions should be eliminated for company law purposes. Those existing provisions relating to securities, insolvency or criminal activity should be reenacted in appropriate legislation.

CURRENT ORDINANCE: The provisions governing disqualification orders are long and complex (ss.168C-S, sch. 15). There are four principal grounds on which a court may make a disqualification order:

- conviction of an indictable offence in connection with the promotion, formation, management, receivership or liquidation of a company or any other indictable offence which involves a finding that he acted fraudently or dishonestly (s.168E(1));
- persistent default in relation to filing requirements of the Ordinance requiring any return, account, or other document to be delivered to the Registrar (s.168F(1));
- fraud in the course of winding up a company or the appearance of guilt for fraudulent trading even if the director has not been convicted (s.275); and
- unfitness -- the court is required to consider the conduct of a person who has been or is a director of an insolvent company (s.168H).

COMMENTARY: In general, the existing disqualification of directors provisions (drawn from the Company Directors Disqualification Act 1986 in the United Kingdom) are

overbroad, for the purposes of core company law. Those provisions dealing with insolvency, capital markets and criminal fraud should be left to other specialised regulatory and enforcement agencies. In addition, the use of director disqualification as an enforcement mechanism for rather mundane administrative offences (such as failure to keep a register of members) may be too draconian. In a new Ordinance, with its simplified structure and emphasis on self-enforcement, there should be fewer administrative offences to police.

The real question is the necessity for broad director disqualification provisions at all. There have been mixed experiences in the jurisdictions which have enacted the U.K. - style provisions.

> It is difficult to reach firm conclusions as to whether disqualification has proved to be an effective device or sanction. Whether disqualification of bankrupt or dishonest persons, of directors whose companies fail to comply with reporting obligations, or those whose companies go into insolvent liquidation has achieved significant protection of the public interest cannot be conclusively ascertained. All one can say is that disqualification probably has added usefully to the other sanctions and devices enacted by legislation in the public interest (A. Hicks, "Disqualification of Directors - Forty Years On" (1988) J. Bus. L. 27 at 47).

If dishonest or incapable directors are dealt with in the context of insolvency, securities and criminal legislation, is there a need for further more generalised sanction under company law? There may be a certain amount of political expediency behind the U.K. legislation, a public response to perceived abuses in the corporate world in the 1980s. Certainly, there is a strong argument for leaving whatever other situations which might arise to shareholders themselves to police, especially if shareholders possess a broad unfairly prejudicial remedy as part of their arsenal. This would be consistent with the objective of creating a self-enforcing regime for companies.

The CBCA (which preceded the U.K. director disqualification legislation) does not contain director disqualification provisions, although they do appear in some provincial securities laws and the new Quebec Civil Code. The CBCA, however, does create a very broad statutory duty on directors and officers to act in compliance with the statute and the company constitution. It also provides shareholders with a broad assortment of remedies, including an extremely open-ended oppression or unfairly prejudicial remedy.

The MBCA, on the other hand, does provide a form of director disqualification at s. 8.09, "Removal of Directors by Judicial Proceeding". These provisions are much narrower than those in the United Kingdom; a director may be barred from re-election for a period of time, but only to the board of that corporation. The director must have engaged in fraudulent or dishonest conduct or gross abuse of authority or discretion, with respect to the corporation. Removal must be in the best interest of the corporation. Unlike the United Kingdom, where shareholders do not have standing to initiate most forms of disqualification proceedings, the action may be taken by the corporation or shareholders holding at least 10% of the shares. A derivative action for removal may be commenced by a shareholder with less than a 10% share.

The elements of a derivative action are clearly discernible in s.8.09 but the MBCA sees the court ordered removal as being quicker and simpler.

> The purpose of section 8.09 is to permit the prompt and efficient elimination of dishonest directors. It is not intended to permit judicial resolution of internal corporate struggles for control except in those cases in which a court finds that the director has been guilty of wrongful conduct of the type described (MBCA, Official Comment, s.8.09).

New York's variation of the MBCA also permits the state Attorney General (the public official responsible for enforcing corporations legislation) to take an action. Disqualification can thus be seen to be an exceptional recourse.

In the context of the current recommendations, the broad statutory unfairly prejudicial remedy or derivative action should provide the means of removing rogue directors without recourse to specific disqualification provisions.

(MBCA: §8.09.)

6.19 RECOMMENDATION: Conflicts of interest. Consideration should be given to placing directors and executive officers (i.e. those appointed directly by the board) under a duty of fair dealing with respect to transactions they enter into with the company.

CURRENT ORDINANCE: Not applicable. There is no statutory mechanism through which interested transactions may be upheld. However, a company may provide a procedure by which interested transactions become non-voidable and directors are not liable for any profit realized from such a transaction (Table A, art. 86). In general, companies do not adopt Table A. It is customary for articles to provide for general notice as being sufficient, to require no specific disclosure and to permit interested directors to vote.

COMMENTARY: In the United Kingdom in particular, this is a very unsatisfactory area of the law; there are numerous sections dealing with different varieties of interested director contracts assorted with various sanctions, some of which are criminal. This state of affairs is an indication of the lack of unifying conceptual basis underlying the statutory treatment. At common law, in the mid-nineteenth century, directors were subject to the strict rules of trust law with regards to conflicts of interest such as interested transactions between themselves and their companies. As a result, interested transactions were voidable at the option of the company and the director was accountable for any profit derived from the transaction.

To this day, under trust law, trustees have a fiduciary duty not to place themselves in a conflict of interest in which their personal interests could potentially conflict with their duties as trustees. These rules aim to prevent trustees from misappropriating trust property for their own personal profit instead of managing the property in the best interest of the trust's beneficiaries. The same rules were applied by analogy to directors in order to protect companies from directors who would divert company assets and business opportunities from the company for personal benefit.

The application of this strict trust standard to directors of companies received its clearest expression in *Aberdeen Railway* v. *Blaikie* (1854) 1 Macq. H.L. 461 (H.L. Sc.). In that case, a contract between the company and a partnership, of which one of the directors was a partner, was made voidable at the instance of the company notwithstanding that its terms were fair and reasonable. Lord Cranworth L.C. said on that occasion:

> [I]t is a rule of universal application, that no one, having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect. So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.

The imposition of the trust standard on directors stems in large part from the history of joint stock companies, which were originally created by trust instruments called deeds of settlement. The use of deeds of settlement finds its origins in the Bubble Act which was enacted in the early 18th century. The Bubble Act aimed to stamp out the outbreak of speculation in freely transferable shares in the 1720's. It took direct aim at unincorporated companies which had freely transferable shares (the objects of speculation). Accordingly, the Act made it very difficult for unincorporated associations to obtain corporate status and enjoy the advantages of incorporation (Gower's at 29-30). Despite the Bubble Act, deeds of settlement enabled unincorporated associations to operate with many of the advantages of incorporation. Under such deeds, company members would agree to be associated in an enterprise with a prescribed joint stock divided into a specified number of shares; management would be delegated to a committee of directors; and the company's property would be vested in a separate body of trustees, some of whom would often also be directors (*ibid.*).

Under the first Joint Stock Companies Act of 1844, the deed of settlement was recognised to be the joint stock company's constitution; it had to be filed with the Registrar of Companies in order for the company to become incorporated. It was only after the passage of the Joint Stock Companies Act 1856, the first modern Companies Act, that deeds of settlement were superseded by the modern memorandum and articles of association (Gower's at 45). *Thus, at the time Aberdeen was decided, in 1854, many company directors were in effect true trustees, hence the apparently logical conclusion of imposing a trust standard upon them for conflicts of interest.*

These fiduciary duties imported directly from the law of trusts came to be seen as increasingly inappropriate and impractical for corporate directors working in a commercial context. For instance, it became more common for directors to serve on the boards of several companies. This was particularly the case where a company was member of a group of related companies or associated with other companies by means of interlocking directorates. Problems arose because directors owed fiduciary duties to each company of which they were directors and not the group as a whole. It was often in the interests of all companies in a group that they deal with one another (P. Lipton, "Has the "Interested-Director Cloud" been Lifted? -- A Comparison between the US and Australian Approaches" (1994) 4 Australian Journal of Corporate Law 239 at 242).

As early as the turn of the century, the appropriateness of the trust standard was questioned by Lord Herschell of the Privy Council in *Bray* v. *Ford*, [1896] A.C. 44 at 51-52:

> It is an inflexible rule of a Court of Equity that a person in a fiduciary position [...] is not [...] entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It has [...] been deemed expedient to lay down this positive rule. *But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong inflicted, and without any consciousness of wrong-doing* [emphasis added].

Uncertainty is the bane of commercial existence and any rule which renders a commercial transaction "voidable" creates undesirable uncertainty.

As noted in the Official Comment to the MBCA, a conflict of interest is not in itself a crime or a tort or necessarily injurious to the company. A "conflict of interest" is not something a director is 'guilty of'; it is simply a state of affairs. It is a state of affairs which can potentially, but not necessarily, lead to an abusive situation. Indeed, in many situations, a company and its shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest (MBCA, Introductory Comment, s. 8.60).

Given that the imposition of the trust standard was commercially impractical, draftspeople took advantage of the fact that the common law recognised that there was no legal limitation upon what the members of a company could agree to in the articles of association. As a consequence, articles were drafted so that interested transactions would be upheld so long as interested directors disclosed their interest to the board and did not vote. In other cases, articles were widened to such an extent that directors were not required to disclose their interests, were permitted to vote and were absolved altogether of any duty to account for profits derived from an interested transaction.

Such wide articles had become so widespread before 1929 that the Companies Act was amended that year to include what is now s.317 of the U.K. Companies Act 1985. Section 317 of the U.K. Companies Act 1985 and s.162 of the current Ordinance require directors to divulge the nature of their interest in any contract, transaction, or arrangement involving the company to the board of directors. Criminal sanctions apply to non-disclosure, even in the context of one director companies.

Over the last thirty years or so, Commonwealth and U.S. legislatures have come up with various statutory mechanisms through which an interested director or officer transaction may be upheld so as to increase predictability and enhance the practical administration of interested transactions. Third parties and directors cannot function effectively in an environment where companies can challenge and subject interested transactions to *ex post facto* court review years later. To use the language found in the MBCA, these mechanisms have the advantage of providing "safe harbours" and "bright lines" for companies and directors involved in interested transactions; that is to say, they provide clear procedures and criteria by which directors can insulate interested transactions from court review (P.E. Kay, "Director Conflicts of Interest Under the Model Business Corporation Act: A Model For All States?" (1994) 69 Washington L. Rev. 207 at 210).

These statutory mechanisms are based on procedural and/or substantive requirements of fairness. In terms of procedural fairness, they often resemble the articles of association drawn up to uphold interested transactions, in that they usually include two requirements. The first requirement is transparency through disclosure – directors in a conflict of interest must disclose both the nature and the extent of their material interest in the transaction. Moreover, directors are generally required to also disclose any material interest they may have in a person who is, or proposes, to be a party to a contract with the company. A material interest is generally defined as an interest that an outside observer would reasonably expect to influence a director's judgment. This objective standard does not require the existence of actual influence upon the director, but only an interest that may be reasonably

expected to affect a director's actions (Kay, *supra* at 218). The second requirement is disinterested decision making -- the director in a conflict of interest is not allowed to take part in the board's decision making on matters relating to his conflict of interest.

All Commonwealth statutes, the MBCA and s.5.02 of the American Law Institute's (ALI) *Principles of Corporate Governance* require directors to disclose their interests. The MBCA, in subchapter F (ss. 8.60-8.63), requires disinterested decision making at the board level. The New Zealand Companies Act 1993 at s.144 does not require disinterested decision making.

In addition to the requirement of procedural fairness, several jurisdictions have added a requirement of substantive fairness: from an objective standpoint the interested transaction must be reasonable and fair to the corporation. For a transaction to be substantively fair, it must not only have a fair price but also be in the best interests of the corporation. However, in considering the fairness of a transaction, the court will in addition be required to look at not only the price but also whether the transaction provided a benefit to the corporation. (MBCA, Official Comment, s.8.61). The CBCA, the New Zealand Companies Act 1993, the MBCA and s.5.02 of the *Principles of Corporate Governance* all have tests that require interested transactions to be reasonable and fair to the corporation.

It is important to understand the underlying rationales of these requirements. Obviously, the requirement of disclosure aims to make a company board aware that a conflict of interest exists; this allows the company to protect itself against directors acting in their personal interest. For example, they might exclude the interested director from the decision making process, or at least filter the interested directors' pronouncements in light of their personal bias, before arriving at a decision.

Disinterested decision making generally goes hand in hand with the requirement of disclosure, but not necessarily so. The rationale for excluding interested directors is again rather obvious: it allows the board to take a decision without theoretically having the interested director's personal interest coming into play and biasing the board's final decision in his or her favour.

The requirement of substantive fairness is in some ways a final safety net. Although all the requirements of procedural fairness may be respected in terms of disclosure and decision making, the board might still come to a decision that is substantively unfair to the company for various informal reasons -- the interested director is an important and respected director or a personal friend of the other directors, the interested director is the majority shareholder of the corporation, etc. Accordingly, the requirement of substantive fairness is a last stop measure to protect the corporation and its shareholders from a board entering into transactions that are grossly unfair to the corporation.

> Absent the constraints of fiduciary duty [substantive fairness], the majority rule represents a spoils system in which the party that obtains working or numerical voting control has unbundled opportunities for its own self-aggrandizement.(D.M. Branson, "Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors" (1988) 57 Fordham L.R. 375 at 394).

The concepts of procedural and substantive fairness are not alien to Hong Kong company and securities law. As noted above, the requirement of disclosure is already a part of the current Ordinance. In terms of disinterested decision making and substantive fairness, companies incorporated under the Ordinance can choose to include such requirements in their articles of association; they are, however, under no obligation to do so. As a matter of practice, articles of Hong Kong companies often provide that interested directors may vote on interested transactions and need not account.

It is noteworthy that Chapter 14 of the SEHK's Listing Rules for "connected transactions" (the SEHK's term for interested transactions) already require disinterested decision making and substantive fairness. For example, Rule 14.26 lays out the circumstances where certain connected transactions are subject to disclosure and disinterested shareholder consent (ie. contrary to *Beatty*, a director cannot vote qua shareholder to uphold an interested transaction). It is also noteworthy that Rule 14.31 states that the primary objective of the circular sent to shareholders should be to demonstrate the reasonableness and fairness of the proposed connected transaction.

Moreover, Rule 14.23(2) gives the Exchange the power to grant a waiver from the requirement to obtain shareholders' approval; instead, the Exchange may require a letter from the company's auditors or financial advisors stating that in their opinion the transaction is fair and reasonable so far as the shareholders of the company are concerned ("fairness" opinions are found in other jurisdictions as well). However, one should take note that these rules do not apply to public companies that are not listed.

At present, the current Ordinance contains only the requirement of disclosure. The other important procedures governing interested transactions are found in the articles of association and case law, which in many important respects, is in an unsatisfactory state. As noted above, much of the case law supposedly applicable to interested transactions and directors' conflict of interest is drawn from a now inappropriate line of trust law cases. Modern directors are not trustees and the role of a corporate manager is not the same as that of a trustee. The trustee's role of preserving the trust capital while investing conservatively to produce income is fundamentally at odds with the risk-taking required of corporate directors and officers in search of profit maximisation (see Welling at 379).

A statutory mechanism that allows interested transactions to be upheld not only enhances predictability and practical administration of interested transactions but is more in keeping with the commercial context in which directors function. Generally speaking, the standard governing commercial relations is one based on good faith and fair dealing. The fiduciary standard for directors has evolved more toward this commercial standard based on honesty and fair dealing; it has been reflected in the CBCA's statutory formulation of directors' duties at s.122(1): "Every director and officer of a corporation in exercising his powers and discharging his duties shall (a) act honestly and in good faith with a view to the best interests of the corporation ...".

The recommendation made here that directors and officers be placed under a duty of fair dealing with respect to interested transactions flows logically from the duty found at s.122(1) CBCA, but is a further refinement of it. The s.122(1) statutory formulation of directors' duties has been heavily interpreted in light of the fiduciary duty line of cases

(which obviously import variations on the trust standard). The specific duty of fair dealing in interested director transactions finds its source in the 1994 ALI Principles of Corporate Governance at s.5.02. It is a statutory expression of the commercial standard which has in fact evolved in this area, away from the commercially impracticable trust standard. The imposition of an impracticable standard prompted the search for a means of validating commercially reasonable transactions. By stating a duty of fair dealing, the commercial nature of the standard should be made readily apparent and distinguished from stricter fiduciary duties.

The ALI Principles explain the evolution of this duty of fair dealing in the United States.

> Many states have "safe harbour" statutes relating to transactions between directors and the corporation. These statutes have generally approached conflict-of-interest transactions in terms of the voidability of transactions and the effect of approval by disinterested directors or shareholders, rather than imposing an affirmative duty of fair dealing. This may reflect the evolution of the law in this area from a rule that originally permitted all transactions with directors to be set aside without regard to fairness, and a tendency to leave the development of affirmative duties of fair dealing to the case law (Comment, s.5.02).

The creation of a statutory duty of fair dealing in interested transactions is a new approach but one which is consistent with the underlying principles in the case law in this area. Further research and careful consideration should be given to introducing this concept.

It is also consistent with concerns expressed by many working party members that shareholders in Hong Kong required greater statutory protections, especially minority shareholders.

(DR: para.226, Draft Act s.9.17(3)(c). OBCA: s.132(7). MBCA: §§8.60-8.63. NZLC R9: paras.193,523-542, Draft Act ss.108-113.)

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

CURRENT ORDINANCE: Article 86 of Table A allows a company to provide a procedure by which interested transactions can be upheld and directors are not liable for any profit realized from such a transaction. Under this procedure a director must 1) disclose the nature of their interest in accordance with s.162 of the Ordinance – the company's articles of association cannot eliminate the s.162 disclosure requirement; and 2) not vote on the interested transaction nor be counted in the quorum present at the meeting that considers the transaction (art. 86).

COMMENTARY: The CBCA requires that an interested transaction be both procedurally and substantively fair while the MBCA requires such transaction to be either procedurally or substantively fair. There has been some debate in the literature as to the value of a disjunctive or conjunctive scheme. In particular, the MBCA's disjunctive approach has been criticised as being too lax, in that it may allow directors to engage in substantively unfair transactions by simply following the MBCA's requirements of procedural fairness (see

generally, M.A. Eisenberg, "Self-Interested Transactions in Corporate Law" (1988) Journal of Corporation Law 997; Kay, *supra*).

However, the difference between a disjunctive test and conjunctive test is arguably more one of form than substance. Commenting on the "reasonable and fair" branch of their draft act which eventually became the CBCA, the Dickerson Report underlined that this branch served only to give content and substance to the directors' general duty to act in the corporation's best interest.

> Particularly noteworthy is the overriding criterion that the contract be "reasonable and fair to the corporation", which is necessary to preclude mutual "back-scratching" by directors who might otherwise tacitly agree to approve one another's contracts with the corporation. Of course directors who indulge in such conduct will be liable under the general provisions of s. 9.19 [the draft act's provision laying out the directors' general duty to act in the corporation's best interest] in any event [...] *The "reasonable and fair" standard set out in subsection (3)(c) serves only to underline the director's specific duties in the circumstances* [emphasis added] (Dickerson Report at para. 228).

Likewise, the Official Commentary to the MBCA in discussing its safe harbour procedures (disclosure and disinterested decision making) made a similar observation:

> ... neither the transaction nor the director is legally vulnerable if the procedures of section 8.62 [disclosure and disinterested decision making] have been properly followed. Subsection (b)(1) is, however, subject to a critically important predicate condition... The condition -- an obvious one-- is that *the board's action must comply with the care, best interests and good faith criteria prescribed in section 8.30(a) for all directors' actions* [emphasis added] (MBCA, Official Comment s. 8.61).

Working party members were generally in favour of tightening the rules in this area provided there was a manner by which transactions could be upheld by shareholder approval (see Recommendation 6.21). The working party members thus supported the conjunctive test which, on balance, is being recommended here.

Professor Sealy noted that the disclosure and disinterested voting procedures were too formalistic for many private companies and suggested the approach adopted in the New Zealand Companies Act 1993 at s.107(3). If all "entitled persons", essentially shareholders, agree to or concur in a company entering into a transaction in which a director is interested, no further formalities would be required.

[DR: paras.226-32, Draft Act s.9.17. CBCA: s.120(7). OBCA: s.132(7). MBCA: §8.61. NZLC R9: paras.193,523-542, Draft Act ss.108-113 (but note voting by interested directors is permitted).]

6.21 RECOMMENDATION: Shareholder approval of interested transactions. Shareholders should be able to vote to uphold a transaction by special resolution in certain circumstances.

CURRENT ORDINANCE: There is no statutory mechanism through which disinterested shareholders may vote to uphold an interested transaction.

COMMENTARY: This recommendation aims to provide another mechanism by which

interested transactions may be upheld. Under s.242 of the CBCA, shareholder ratification serves only an evidentiary purpose and not a curative one. Under this provision, a legal action (such as an oppression or unfairly prejudicial action) cannot be stayed or dismissed by reason only that an alleged breach of the director's fiduciary duty has been approved by the shareholders; however, evidence of shareholder approval may be taken into account by the court in making an order under the CBCA's oppression remedy or derivative action. Commenting on this provision, the Dickerson Committee stated:

> ... we think it better to characterize shareholder ratification or waiver as an evidentiary issue, which in effect compels the court to go behind the constitutional structure of the corporation and examine the real issues. If, for example, the alleged misconduct was ratified by majority shareholders who were also the directors whose conduct is attacked, evidence of shareholder ratification would carry little or no weight. If, however, the alleged misconduct was ratified by a majority of disinterested shareholders after full disclosure of the facts, that evidence would carry much more weight indicating that the majority of disinterested shareholders condoned the act or dismissed it as a mere error of business judgment... By giving the court wide discretion to consider the pertinent facts and by barring the court from following a simplistic path such as applying the shareholder ratification rule, we in effect compel the court to adjudge the issue on its merits (Dickerson Report at para. 487).

Although the approach taken in the CBCA definitely has its merits, the Ontario Business Corporations Act (OBCA) and Alberta Business Corporations Act (ABCA), which are in many ways more modern updates of the current CBCA, allow for shareholder ratification by special resolution of interested transactions upon disclosure at sections 132(8) and 115(7), respectively. There was general support for this approach in the working party; in some circumstances, a director may inadvertently fail to make proper disclosure. This defect could be cured by special resolution.

(OBCA: s.132(8). MBCA: §8.63.)

6.22 RECOMMENDATION: Loans to directors. Transactions involving loans to directors should continue to be prohibited subject to certain exceptions.

CURRENT ORDINANCE: The Ordinance lays down a general prohibition on loans to directors subject to certain exceptions (s.157H).

COMMENTARY: At present, s.157H of the Ordinance lays down a general prohibition of loans to directors. This general prohibition is subject to certain exceptions such as: shareholder approved loans in private companies; loans made by a company whose ordinary course of business includes lending money and giving guarantees; or loans for house purchases, etc; transactions for the purposes of the company; and transactions within a group of companies. There is a cap on the aggregate of some of these exceptions.

The MBCA treats loans to directors no differently from any other interested director transaction. Therefore, loans, guarantees, pledges, or other forms of assistance to directors are permitted and enforceable so long as the disclosure and disinterested approval requirements are observed and the solvency requirements pertaining to a "distribution" are met. This approach is similar to the SEHK's rules for listed companies in Hong Kong; Rule 14.26(6) requires financial assistance to connected persons which is not upon normal commercial terms in the ordinary and usual course of business to be disclosed and approved

by a disinterested shareholder vote.

Although this approach was discussed in the working party meetings, loans to directors were viewed as particularly open to abuse in Hong Kong. "Why should companies be providing their directors with loans in the first place?" was the comment of one working party member. For this reason, the working party was inclined to retain the existing prohibition and narrow the exceptions somewhat. An issue to be resolved is whether private companies should be able to provide such loans with shareholder approval. Some jurisdictions (such as Singapore) provide for this while others (such as the U.K., in following a recommendation of the Jenkins Committee) do not.

Unfortunately, retention of the prohibition and exceptions will add complexity to the drafting and, in the opinion of Professor Sealy, risks being ineffective. Directors and their counsel can show great ingenuity in structuring transactions to avoid the prohibition.

(DR: Draft Act s.5.16(2). CBCA: s.44. OBCA: s.20. MBCA: §§8.60-8.63. NZLC R9: see generally Draft Act ss.108-113.)

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

CURRENT ORDINANCE: There is no statutory scheme to deal with the use of corporate information or the diversion of corporate opportunity.

COMMENTARY: At present, Hong Kong has no statutory scheme to deal with the acquisition or diversion of "corporate opportunities" by directors. As a consequence, this area is governed by the same strict trust standard that governs interested transactions. The general rule established in *Regal (Hastings)* v. *Gulliver*, that any party acting in a fiduciary capacity may not enter into any engagement in which he might have an interest conflicting with that of the beneficiary, and this irrespective of the absence of bad faith, has been accepted in much of the Commonwealth. The law is somewhat different in Canada because of the leading Canadian case of *Peso Silver Mines Ltd.* v. *Cropper* [1966] S.C.R. 673. Canadian courts are unwilling to find a director in breach of his or her duties where both good faith is shown, and where no special or privileged information was delivered from the position as a director.

Both Australia and New Zealand have innovated in this area by introducing statutory provisions to deal with the problem of corporate opportunities by way of rules regulating the use of company information. Under s. 232(5) - (6) of the Australian Corporations Law, directors must not make improper use of their position, or information acquired by virtue of their position, to gain, directly or indirectly, an advantage for themselves or for any other person, or to cause detriment to the corporation. Section 232 is in addition to, and not in derogation of, any other law relating to the duty of a director (e.g. under the common law a director is liable to account even where he has not improperly used the position of director).

However, New Zealand has gone one step further than Australia. At s. 145 of the Companies Act 1993, directors may disclose or make use of information obtained in the course of their employment, if they disclose to, as well as receive consent from, the board and the disclosure or use of the information will not prejudice the company. Disclosure is also recorded in an "interest register" which is available to shareholders. The emphasis on disclosure in New Zealand is based on pragmatic considerations. There is greater tolerance of situations of potential conflict of interest given the commercial reality of a small, close-knit business community with a high degree of cross-shareholdings in a small number of large companies.

The better approach to yet another register is simply to note the disclosure in the minutes of meeting.

(MBCA: §8.60-8.63. NZLC R9: paras.92,536-539, Draft Act s.112.)

7.00 SHAREHOLDERS RIGHTS AND REMEDIES

7.00 SHAREHOLDERS RIGHTS AND REMEDIES

7.01 RECOMMENDATION: Shareholders' rights and remedies. A separate part of the new Ordinance should be dedicated to matters dealing with shareholders, their rights and remedies.

CURRENT ORDINANCE: There is no separate part dealing with shareholders.

COMMENTARY: Currently, Part IV of the current Ordinance, "Management and Administration", contains well over a hundred provisions dealing with a wide variety of matters ranging from registered office and accounts to directors and other officers. Two sub-parts, "Meetings and Proceedings" and "Minorities", deal with shareholder matters. It is proposed to break out of the current Part IV those provisions dealing with directors, accounts and audit, inspection and shareholders matters, and to regroup these provisions separately in a more coherent fashion.

(DR: Part 11.00. CBCA: see generally Part XX. OBCA: Parts VII, XVII. MBCA: see generally Chapter 7. NZLC R9: paras.196-213,456-490, Draft Act Part 6.)

7.02 RECOMMENDATION: Proposal at annual meeting. Any shareholder entitled to vote at an annual meeting should be able to submit a proposal to the company to be raised at the annual meeting and circulated prior to the meeting. The board of directors could refuse to circulate proposals in certain circumstances such as proposals designed to redress personal grievances or espousing political or other causes. In addition or in the alternative, a proposal put forward by a minimum number or percentage of shareholders (e.g. the lesser of 25 shareholders or those holding 2½% of the voting shares) could not be refused by the board of directors.

CURRENT ORDINANCE: Members who hold 5% of the total voting rights or 100 members holding shares on which there has been paid up an average of at least $2,000 per member have the right to make a requisition for a resolution to be considered at an annual general meeting (s. 115A).

COMMENTARY: The formulation of this recommendation would be based on North American models. Any shareholder may submit a proposal; there would be no minimum percentage of shares held. The proposition is that shareholders are "entitled to have an opportunity to discuss corporate affairs in general meeting and that this is a right and not a privilege to be accorded at the pleasure of management" (Dickerson Report at para. 276). In order to prevent abuse, specific limitations are put on the right to require circulation of a proposal where the proposal is not submitted in time to be circulated before the meeting, or where the primary purpose of the proposal is to redress a personal grievance or promote "general economic, political, racial, religious, social or similar causes" (CBCA, s.137(5)); the proposal was submitted and defeated in the preceding two years; or where the right is being abused to secure publicity, etc.

There were two concerns raised in the working party with respect to this approach. The first was the indiscriminate use of shareholder proposals if there were no minimum thresholds imposed (such as a minimum percentage (2½ - 3%) of shareholders required to put the proposal forward). One concern was that shareholders without a substantial interest

in the company would abuse the expanded shareholder right. Any person with a grievance or strongly held views on a subject could acquire one share for the express purpose of submitting a shareholder proposal. A further concern was with the uncertain nature of the grounds upon which the board of directors could refuse to put the proposal forward. On the other hand, a concern was also raised that boards of directors in Hong Kong, if given the discretion, would refuse to consider any shareholders proposals, as a matter of course, and the provisions would be ineffective.

The recommendation is formulated in a way so as to address both these concerns. There is discretion on the part of the board to refuse to put forward a proposal made by any individual shareholder in circumstances where the proposal may be self serving or of nuisance value. The circumstances combine both bright line tests, such as a similar proposal having been put forward and deferred within the previous two years, and more subjective determinations with respect to political or other motivations. There is case law in North America to draw on in interpreting these provisions, but there are no particular indications of their overuse or abuse (likely as a result of the well-documented phenomenon of "shareholder apathy"). There is little expense to the company in including a shareholder proposal in its routine proxy materials sent out to shareholders for the annual general meeting as a limit on the number of words is usually imposed (e.g. 250) where such statutory provisions exist.

Secondly, in a departure from North American models, and to address the concern that directors would routinely refuse to consider shareholder proposals, it is also recommended that a minimum percentage of voting shareholders have the right to put a proposal before the annual meeting. The costs and "inconveniences" of permitting shareholders proposals in these circumstances are greatly outweighed by the right of shareholders to discuss corporate affairs at a shareholders meeting. Given that a special meeting of shareholders may be requisitioned by a minimum percentage of shareholders (currently 10% and proposed to be reduced to 5%) a right to put a proposal forward at an annual meeting should be available to a substantially lower percentage or number, 2½% or 25 shareholders, whichever is less, for example. This approach is consistent with the demands for greater accountability of corporate management and, as with the requisitioning of special meetings, is likely to be invoked only exceptionally. The constraints of shareholder apathy and the use by shareholders of informal means to make their wishes known to management will likely make recourse to this provision infrequent.

(DR: paras.273-279, Draft Act s.11.05. CBCA: s.137. OBCA: S.99. MBCA: §7.02. NZLC R9: para.740, Draft Act First Schedule Clause 10. U.K. Companies Act 1985: ss.376-377.)

7.03 RECOMMENDATION: Requisition to call meeting. Shareholders holding 5% of the voting shares should be able to requisition the directors to call a meeting of shareholders or, if the directors fail to act, a shareholder should be able to call a meeting itself. The time delay in which the directors may act should be fairly short, 21 days for example. The requisitioners should be reimbursed their expenses unless the meeting otherwise resolves.

CURRENT ORDINANCE: On the requisition of members holding 10% or more of the paid-up capital of the company which carries the right to vote at general meetings, the directors must convene an extraordinary general meeting (s.113(1)). If the directors fail to convene a meeting, the requisitionists, subject to certain statutory time limits and voting rights

requirements, may themselves convene a meeting. Any reasonable expense incurred by the requisitionists will be repaid by the company out of the fees of the defaulting directors (s.113). Two or more members holding 10% or more of the issued share capital of the company may call a meeting, but this rule is only effective if the company's articles do not provide otherwise (s.114A(1)(b)).

COMMENTARY: In the interests of promoting legitimate corporate purposes and accountability of management to shareholders, the ability of shareholders holding a small percentage of voting shares to call a meeting should be facilitated. In order to prevent abuses of this right, at the meeting the shareholders should be able to preclude the reimbursement of expenses to those requisitioning the meeting. There was general support for this proposal lowering the percentage required from the current 10% to 5%, especially in view of the limited public float of many Hong Kong listed companies.

(DR: paras.288-292, Draft Act s.11.11. CBCA: s.143. OBCA: s.105(1). MBCA: §7.02(a)(2). NZLC R9: para.486, Draft Act s.91. U.K. Companies Act 1985: s.368 (but note higher threshold).)

7.04 RECOMMENDATION: Shareholders' rights to dispense with meeting. A resolution in writing signed by all shareholders entitled to vote should be sufficient to preclude the necessity of a meeting. A meeting should be required, however, in the event of the resignation or removal of a director or auditor who wishes to explain or contest the action. Shareholders should be able to dispense with the requirement for an annual general meeting (or other meetings) by unanimous shareholder agreement.

CURRENT ORDINANCE: A resolution signed by all shareholders is regarded as a resolution duly passed at a general meeting and, where appropriate, as a special resolution (s.116B).

COMMENTARY: Written resolutions in lieu of meetings are particularly useful in one person companies and other private companies with a small number of shareholders. In companies other than one person companies there should, however, be an actual meeting with respect to those situations where a director or an auditor resigns or is removed and wishes to explain or contest the action. In these circumstances, there will likely be factors leading to the removal or resignation which should be aired before all shareholders.

Section 116B of the current Ordinance permits the use of written resolutions and is now used extensively. Any doubts as to the effectiveness of written resolutions in lieu of meetings should be categorically removed. This recommendation reflects commercial reality and the informality of much commercial dealing, in particular, as with respect to private companies. It also accommodates the pace and nature of business in the modern world, especially in Hong Kong where there is a high level of international activity and business people engage in a great deal of travel. Modern communications have dispensed with much of the necessity for formal meetings demanding a physical presence. This is no longer the 19th century when leisured gentlemen could afford to spend a day in the City at a proforma shareholders meeting.

(DR: para.287, Draft Act s.11.10. CBCA: s.142. OBCA: s.104. MBCA: §7.04. NZLC R9: para.487, Draft Act s.92. U.K. Companies Act 1985: s.381A.)

7.05 RECOMMENDATION: One share entitled to one vote. Unless otherwise provided by the company constitution, one share should be entitled to one vote. "Circular holdings" should be prohibited from voting.

CURRENT ORDINANCE: Unless otherwise provided by the company constitution, one share is entitled to one vote (Table A, art. 64). Subject to certain exceptions, circular holdings are prohibited from voting: a subsidiary, which is a shareholder of its holding company, does not have the right to vote at meetings of the holding company (s.28A(7)).

COMMENTARY: One share, one vote is a basic principle of company law. Subject to voting rights which may be accorded to non-voting shares in certain circumstances such as the sale of all or substantially all of the property of the company, the company constitution may provide for any number of permutations on voting rights.

"Circular holdings" should be prohibited from voting. The MBCA prohibits the voting of shares held by a corporation which is itself a majority-owned subsidiary of the corporation issuing the shares (s.7.21(b)). "The purpose of this prohibition is to prevent management from using a corporate investment to perpetuate itself in power" (MBCA, Official Comment, "Circular Holdings," s.7.21).

(DR: paras.102,123-126, Draft Act s.5.01(3). CBCA: ss.33,140(1). OBCA: s.22(5). MBCA: §7.21. NZLC R9: paras.371-372, Draft Act s.26(2)(a).)

7.06 RECOMMENDATION: Unanimous shareholder agreement. All companies should be able to make use of unanimous shareholder agreements to regulate (1) the exercise of corporate powers and management and (2) the relationship among shareholders.

CURRENT ORDINANCE: The Ordinance makes no specific provision for the use of unanimous shareholder agreements.

COMMENTARY: A unanimous shareholder agreement differs from other non-statutory agreements among shareholders in two respects. Firstly, it is generally considered to be a constitutional document of the company. Furthermore, unlike ordinary contracts, the agreement binds future shareholders.

A unanimous shareholder agreement may, in fact, substitute for a definition of private company. Being able to achieve unanimity indicates an entity in which the sometimes artificial boundaries between ownership and management can be eliminated. Statutory recognition of the unanimous shareholder agreement also dissipates difficulties (which have arisen in the United States, for example) with the legitimacy of fettering the discretion of directors by contract.

The main issues with respect to the statutory formulation of the unanimous shareholder agreement are two-fold: the extent of matters which can be dealt with in the agreement and the necessity for its publication. The unanimous shareholder agreement does operate in some jurisdictions in many respects like a partnership agreement. The issues of content and publicity are joined. To the extent that the agreement serves as a quasi-constitutional document, there is a greater argument for placing it in the public record. However, to the extent partnership agreements are not made public and the unanimous shareholder agreement acts very much like a partnership agreement, the publicity argument is less persuasive. The better route is notice but not necessarily public disclosure.

In the CBCA, there is an older, comparatively narrow version of the unanimous shareholder agreement which permits the shareholders by written agreement to in effect

assume the functions of the board of directors (without eliminating the board however). In this case, the shareholders and creditors have the right to examine a unanimous shareholder agreement (CBCA, s.21(1)), and share certificates must contain a notice of the existence of the agreement.

A later and broader formulation of the original CBCA unanimous shareholder agreement provisions appears in the Alberta Business Corporations Act (ABCA) which permits such agreements to:

- regulate the rights and liabilities of the shareholders, as shareholders among themselves or between themselves and any other party to the agreement;
- regulate the election of directors;
- manage the business and affairs of the corporation, including the restriction or abrogation, in whole or in part, of the powers of directors;
- any other matter that may be stipulated in the legislation (ABCA, s. 140).

In commenting on the Alberta provisions, a recent Discussion Paper released by Industry Canada stated:

> From a policy perspective, there do not appear to be strong reasons to prohibit shareholders from entrenching in a unanimous shareholder agreement "any provision which they want to make about the internal affairs and organization of the corporation" (Industry Canada, Canada Business Corporations Act, Discussion Paper, *Unanimous Shareholder Agreements* (Ottawa: Industry Canada, April 1996) at 24).

In the United States, statutory unanimous shareholder agreements are a more recent phenomenon; for example, s.7.32 MBCA dates from 1991. The statutory provisions are rather more complex than those in Canada. A list of seven general kinds of provisions that may be included in a unanimous shareholder agreement (plus a catchall category) are deemed not to be inconsistent with the statute. A unanimous shareholder agreement can:

- eliminate the board of directors or restrict its powers;
- govern the authorization or making of distributions whether or not in proportion to ownership of shares (subject to certain exceptions);
- establish who will be directors, officers, their terms of office and manner of selection or removal;
- govern the exercise of voting power among shareholders and among directors;
- establish terms of interested director/shareholder/officer/employee contracts;
- transfer to one or more shareholders or others all or part of the authority to exercise corporate powers or to manage the business and affairs of the corporation;
- require dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency.

According to the Official Comment, unanimous shareholder agreements as formulated in the

MBCA are subject to public policy limitations and the *ejusdem generis* rule.

Although some states in adopting s.7.32 have tied it to use by corporations which are in effect closely-held (i.e. those with less than 35 or 100 shareholders), the Official Comment to s.7.32 states that it is not intended to establish or legitimise an alternative form of corporation. Instead, it is intended to add, within the context of the traditional corporate structure, legal certainty to shareholder agreements that embody various aspects of the business arrangement established by the shareholders to meet their business and personal needs. The subject matter of these arrangements includes governance of the entity, allocation of the economic return from the business, and other aspects of the relationships among shareholders, directors, and the corporation which are part of the business arrangement (MBCA, Official Comment, s.7.32). It should also be noted in passing that Delaware permits less than unanimous shareholders agreements (majority only) to restrict the power and discretion of the board of directors; these agreements, however, are only available to statutory close corporations.

The question may readily be asked, what if any advantages do unanimous shareholder agreements provide over existing memoranda and articles of association (which due to their origins in partnership law share certain of the same characteristics and deal with many of the same matters). The first advantage is that unanimous shareholder agreements, such as those envisaged in the MBCA, may go much further than standard memoranda or articles of association in terms of redistributing the decision making powers within a company. There is greater control and flexibility provided to shareholders, more in keeping with an informal partnership structure. There is also privacy, as in a partnership; the agreement is usually not required to be registered, although it may be consulted by shareholders and creditors. And, because the agreement may be entered into at any time and is not an essential element to the actual incorporation of the company, its later availability facilitates speedy incorporation.

It would be difficult to overestimate the significance of unanimous shareholder agreements where they have become accepted as a routine form of corporate organisation. They build into the corporate structure much of the flexibility and sensitivity to individual business needs that are found in partnerships. In particular, unanimous shareholder agreements provide the means of tailoring, in advance, effective shareholder dispute mechanisms which do not depend on judicial intervention.

(DR: paras.299-302, Draft Act s.11.14(2)-(6). CBCA: s.146(2). OBCA: s.108. MBCA: §7.32.)

7.07 RECOMMENDATION: Statutory remedies. There should be made available to shareholders a variety of statutory remedies designed to induce accountability of management and achieve the desired balance between flexibility in management powers and protection of shareholders, especially minority shareholders' interests. These statutory remedies should include the following:

- **Statutory Derivative Action**
- **Oppression or Unfairly Prejudicial Action**
- **Buy-Out or Appraisal Remedy**
- **Compliance and Restraining Orders**

Just and Equitable Winding-up

CURRENT ORDINANCE: At present, the Ordinance only provides two statutory remedies for minority shareholders: 1) just and equitable winding up remedy (ss.177, 179); 2) unfairly prejudicial action (s.168A).

COMMENTARY: The nature and effectiveness of remedies available to shareholders are very much determined by the business environment in which companies operate. In Hong Kong, as in many other jurisdictions, nearly 99% of companies are private. Again, like many other jurisdictions (the United States is here a notable exception) most public and listed companies are majority controlled and not widely held. Even in public companies there may be a considerable degree of identity of ownership and management. And, as has been much documented elsewhere, both public and private companies in Hong Kong are usually still family businesses. The family holdings in Hong Kong, however, may now be in the process of becoming much more diffuse as many of these businesses head into the second and third generation.

Unlike the United States, there is considerably less commercial litigation in Hong Kong. The costs of litigation here are prohibitively high. Class actions are virtually unheard of and the awarding of costs is a deterrent to "frivolous" actions. In addition, a cultural bias, it is maintained, weighs heavily against litigation as a dispute resolution mechanism. (See generally P. Lawton, "Corporate Governance and Informal Decision Making: the Theoretical and Practical Limits of Hong Kong's Legal Regime (Part I)" (1995) 1:1 Corporate Governance Quarterly 17; P. Lawton, "Corporate Governance and Informal Decision Making: the Theoretical and Practical Limits of Hong Kong's Legal Regime (Part II)" (1995) 1:2 Corporate Governance Quarterly 29; G. Redding, *The Spirit of Chinese Capitalism* (Berlin: Walter de Gruyter, 1990)).

What are the implications of these factors in terms of shareholder remedies? Given the high degree of identity of ownership and management in both private and public companies, disputes may more often pitch shareholders against shareholders (and, more often, majority shareholder against minority shareholder) rather than shareholder against manager. Remedies should be tailored to the private company. Remedies should look to dispute resolution mechanisms that are not heavily reliant on civil litigation or judicial or governmental intervention.

Although all the statutory remedies recommended below would be available to both private and public companies, they are not exhaustive. With respect to private companies, non-litigious dispute resolution mechanisms are highly desirable and many of those options are recommended in Part X on private companies/close corporations. In addition to corporate law remedies, for public companies recourse may be had to remedies provided to public shareholders under securities regulation and listing rules. These remedies are balanced against the desirability of governmental agency and stock exchange intervention in the public interest.

As has been noted elsewhere, Hong Kong businesses, both large and small, are still overwhelmingly family businesses. Although there are cross cultural differences in terms of degree and intensity, statistical and case studies on Chinese family controlled companies tend to support the proposition that they are similar to their Western counterparts on several levels. In terms of size and corporate form, they tend to be small to medium sized private

companies with ownership and management concentrated in the hands of a patriarch or a small group of family members. Chinese and Western family controlled companies share common strengths: decision making is rapid and quick; their organisational structure is flexible and informal; they are better than public companies in undertaking long term plans and investments; employees are managed in a paternalistic but caring "family-like" way which in turn breeds strong employee loyalty and more effective clientele service. All these strengths combined make family controlled companies particularly adept at carving out market niches (see Background Memorandum: Family-Controlled Companies (September 1996)).

However, the sharp distinction that has been made between Hong Kong (and other Asian) businesses and the composition of "Western" businesses is overbroad, especially with respect to public companies. The real distinction to be made is between the "Fortune 500" U.S. companies and the rest of the world. In virtually all Western economies, apart from the United States and possibly the U.K., the public markets are characterised by the prevalence of majority, usually family, controlled public companies (see Background Memorandum: Family-Controlled Companies (September 1996)). Even in the United States, approximately 80% to 95% of the nation's 8 million or so businesses are family controlled companies of which the vast majority are private companies (*ibid.*).

Among family controlled businesses, certain problems cut across national and cultural lines. The decision making in Chinese family controlled companies, like their Western counterparts, has inherent weaknesses. Given that decision-making and ownership are heavily centralised, senior management tends to become overburdened. Centralised decision-making also leads to inefficiencies and frustration among middle management which in turn makes it difficult for family controlled companies to attract and retain competent, outside, professional managers. The lack of constructive outside advice and criticism inhibits the development of fresh business ideas. But most importantly in the context of shareholders remedies, family controlled companies are particularly vulnerable to family disputes which vary from the fair renumeration of family members, to sibling power struggles, to generational conflicts over the issue of succession (*ibid.*). This problem becomes particularly acute as family businesses head into the third generation, and ownership becomes more diffuse, the greater the likelihood for divergence of opinion and frequent shareholder disputes.

Family disputes are often the downfall of family controlled companies, thus the importance of effective dispute resolution techniques tailored to their particular configurations. Recent statistics support the proverb that "wealth does not last more than three generations". The life expectancy of a family business is 24 years, against 45 years for public companies. Of those that survive the first five years, less than three in ten are handed on to the next generation and only one in ten makes it to the third generation.

There are several characteristics of disputes in family controlled businesses which cut across national and cultural lines. Since the business partners often go home to each other, informal and non-adversarial dispute resolution is preferable to litigation. Privacy is also a major concern. Although particularly prone to disputes, family controlled business have the competing desire to keep the family squabbles private and outside the very public arena of the court room. Mediation and arbitration are well suited to settling differences in

the family controlled business. Preventive measures are highly desirable; shareholder agreements are the best vehicle for implementing them. Despite the reluctance to resort to judicial intervention, statutory remedies do play an effective deterrent role and, in that respect, their importance should not be discounted. Given the similarities in the problems encountered in family controlled businesses across jurisdictions, remedies developed in one jurisdiction can to good effect be introduced in Hong Kong. These statutory remedies are discussed individually below.

As for majority controlled public and listed companies, the small public float and relative illiquidity of the markets exacerbates the situation of minority shareholders. Minority shareholders with significant holdings may not truly have the "exit option" of voting with their feet and selling their holdings into the market. Alternatives should be provided and in some cases are provided by the Takeovers Code and Listing Rules.

Undoubtedly, however, the primary issue in these circumstances is that of minority shareholder rights and remedies. Several concerns were raised in working party meetings. On the one hand, there was the concern that a proliferation of shareholder remedies would lead to an unwanted rash of litigation, interfering with the creation of wealth in Hong Kong. Companies should not be held to ransom by irresponsible shareholder actions. Support was voiced for the traditional primacy of majority rule. Minority shareholders participating in Hong Kong companies did so on a more or less take it or leave it basis; once a minority shareholder bought into such a company (often on the basis of the individual controller's reputation), acceptance of management decisions was implicit.

On the other hand, there were those of the view that the current Ordinance was inadequate to deal with abuses by management and majority shareholders in Hong Kong companies; action should be "bold and innovative" in this area. Particularly given the internationalisation of capital markets and Hong Kong's pivotal position in Asia, the regulators participating in the working parties were anxious to achieve the proper balance between self-enforcing shareholder protections and regulatory intervention.

The third concern raised in the working party meetings regarded means to make remedies effective. The high cost of civil litigation casts doubt on the effectiveness of civil remedies for aggrieved shareholders. In addition, the great difficulty of obtaining documentary evidence upon which to build a civil case was cited. Both these concerns, cost and evidentiary difficulties, raised the question of greater public regulatory intervention as a counter balance.

As has been acknowledged in the ALI Principles of Corporate Governance, "...no single technique of accountability (including market and legal remedies) is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations, and, as a result, shareholders are best served by an overlapping system of protections" (ALI Principles of Corporate Governance, The Derivative Action, Introductory Note). Overlapping and alternative remedies are preferable to inadequate ones especially in Hong Kong where there is a perception (irrespective of the reality) of minority shareholder abuse.

(DR: paras.474-496, Draft Act Part 19.00. CBCA: Part XX; ss.190,239,241,247. OBCA: Part XVII, ss.246,248,253. MBCA: §§7.40-7.47, 13.01-13.31. NZLC R9: paras.564-585, Draft Act ss.126-135.)

7.08 RECOMMENDATION: Statutory derivative action. There should be a statutory derivative action in the new Ordinance.

CURRENT ORDINANCE: There is a form of derivative action provided under the unfairly prejudicial action: a court may order that an action "be brought in the name of the company against such person and on such terms" as it sees fit (s.168A).

COMMENTARY: This current form of derivative action has been completely ineffective in the United Kingdom, requiring as it does two full court hearings. It is slow, expensive, and rarely, if ever used. The necessity for a statutory derivative action is not obvious, on its face, in other jurisdictions either. Its usefulness is very much dependent on the nature and availability of alternative remedies. Where there exists a broad statutory unfairly prejudicial remedy (such as in Canada), there has been very little recourse to the statutory derivative action. Some commentators have attributed this lack of recourse primarily to the procedural complexity of the statutory derivative action and its inhospitable reception by the courts. In a recent comparison of U.K. and Canadian remedies, it was suggested that although the United Kingdom could benefit from an appraisal or buy-out remedy and reconsideration of its unfairly prejudicial remedy, a statutory derivative action was not as essential.

> Canadian experience suggests that English law would do well to follow the Canadian example. To a certain extent, this would require statutory revisions, such as the introduction of appraisal rights and perhaps some minor amendments to s. 459. On the other hand, a statutory derivative action may well not be needed, given that it is not often used in Canada and given that English judges appear prepared to allow s. 459 actions to proceed in spite of *Foss v. Harbottle*" (B. Cheffins & J.M. Dine, "Shareholder Remedies: Lessons from Canada" (1992) 13 The Company Lawyer 89 at 95).

On the other hand, John Howard (an original member of the Dickerson Committee) maintains that the statutory derivative action has had a clear prophylactic effect.

In the United States, there is broad use of the statutory derivative action (in its various formulations); this may be attributed to the lack of an unfairly prejudicial remedy comparable to that in Canada. The statutory derivative action is a complement to the remedies for shareholders in public corporations under the U.S. federal securities laws (although the famous "10(b)-5 actions" may now be more difficult to maintain given the Private Securities Litigation Reform Act of 1995, 15 U.S.C. s. 78a et seq.). The statutory derivative action in the United States is also structured quite differently in most states than the Canadian remedy. In the interests of promoting the "business judgment rule", the decision to permit a derivative action to proceed is usually left with a committee of independent directors (and not the courts). This position has been criticised as undermining the utility of the derivative action (on the basis that the truly independent director simply does not exist). The Official Comment to the MBCA, however, does attempt some justification of this approach:

> Section 7.44 expressly requires the dismissal of a derivative suit if independent directors have determined that the maintenance of the suit is not in the best interests of the corporation. This section confirms the basic principle that a derivative suit is an action on behalf of the corporation and therefore should be controlled by those directors who can exercise an independent business judgment with respect to its continuance. At the same time, the court is required to assess the independence and good faith of the directors and the reasonableness of their inquiry, and if a majority of the board is not independent, the burden is placed on the corporation to prove each of these elements.

> Section 7.44 also provides a procedure for the determination to be made by a panel appointed by the court (MBCA, Subchapter D, Derivative Proceedings, Introductory Comment, s.7.4).

Delaware actually has a more shareholder favourable approach which permits a court to second guess the decision of the independent directors committee (see discussion below).

Canada, New Zealand and most of the states in the United States do have a statutory derivative action. Australia is currently contemplating its introduction. There are even signs that the U.K. may move towards a new derivative action; the U.K. Law Commission in a recent Consultation Paper suggested:

> ... a partial abrogation of the rule in *Foss* v. *Harbottle* and its replacement with a new derivative action. This would ... be available to any member if the case fell within the following situation:
>
> > that, if the company were the applicant, it would be entitled to any remedy against any person as a result of any breach or threatened breach by any director of the company of any of his duties to the company.
>
> [...]The effect of this reform would be to abrogate the fraud on the minority limb of the rule in *Foss* v. *Harbottle* and to replace it with consideration by the court of all the circumstances. Our aim is to create a more flexible and modern criterion for leave to bring a derivative action than fraud on the minority (Great Britain, Law Commission, *Shareholder Remedies* (Consultation Paper No. 142) by the Honourable Mrs. Justice Arden (Chairman) DBE, Andrew Burrows, Diana Faber, Charles Harpum, Stephen Silber, QC (London: H.M.S.O. 1996) at paras. 15.2, 16.1).

A statutory derivative action eliminates the noisome case law spawned by the 1843 case of *Foss v. Harbottle*. Commentators on the rights of minority shareholders have generally been critical of the state of the common law in this area (cf J.G. MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal" (1988) 13 Can.-US L.J. 299 at 302). The Dickerson Committee, which was the architect of the current CBCA, wrote that:

> In the preface (page v) to the second edition of his text, *Modern Company Law*, Professor Gower states that '...an attempt has been made to elucidate the mysteries of the rule in *Foss* v. *Harbottle*; I believe that I now understand this rule, but have little confidence that readers will share this belief'. We have been so persuaded by Professor Gower's elucidation of these 'mysteries' that we have relegated the rule to legal limbo without compunction, convinced that the alternative system recommended is preferable to the uncertainties - and obvious injustices - engendered by that famous doctrine" (Dickerson Report at para. 482).

The introduction of a statutory derivative action effectively replaces the common law derivative action of fraud on the minority. Minority shareholders in Canada and New Zealand are no longer obliged to struggle with the complexities and uncertainties of the exception to the rule in *Foss* v. *Harbottle*. To launch a statutory derivative action, minority shareholders must meet the black letter requirements set out in their governing statute.

Under the CBCA, shareholders may bring an action on behalf of the corporation, but only with the permission of a court. The CBCA specifies three conditions that must be satisfied before the court will grant permission to sue. These are: 1) reasonable notice to the

directors; 2) a finding that the complainant is acting in good faith; and 3) a finding that it appears to be in the interests of the corporation that the action be brought.

The Dickerson Committee articulated three main reasons for requiring satisfaction of these conditions. The first was to prevent lawsuits designed to extort a settlement from the corporation, the concern that shareholders would hold the company to ransom. Because a derivative action potentially imposes costs on the corporation, it may be cheaper for the corporation to settle a meritless claim than to devote time and resources to challenging it. The second reason was to exclude derivative actions which, while not undertaken in bad faith, were nonetheless groundless or which sought to recover trivial amounts. A third reason for requiring leave was to ensure that the corporation, or those against whom relief was sought in the action, were not exposed to a multiplicity of lawsuits. Under the procedure of getting court permission, conduct of the action is ceded to a single litigant and, because of the legal principle of *res judicata* and the fact that the true plaintiff is the corporation, the result effectively binds all shareholders and excludes further litigation (J.G. MacIntosh, "The Oppression Remedy: Personal or Derivative?" (1991) 70 C.B.R. 29 at 32-33).

The MBCA in the United States has different requirements. The MBCA states that the plaintiff in a derivative suit must first demand permission of the board of directors of a corporation at least 90 days before initiating a lawsuit (MBCA, s.7.42). Upon receiving the demand, the corporation will be able to dismiss the shareholders' demand if it determines in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation (MBCA, s.7.44 (a)). The recommendation for dismissal must be made by a committee of two or more independent directors of a so-called 'special litigation committee', or by a court appointed panel of independent persons (MBCA, s.7.44(b), (f)).

The MBCA, in so formulating its procedural requirements for dismissal of a demand for derivative action, does not allow the famous second step test laid out in the Delaware case of *Zapata Co.* v. *Maldonado*, 430 A.2d 779 (Del. 1981). This test, which is still followed in many states, gives the courts the discretion to review the merits of a plaintiff's allegation and overrule a special litigation committee's decision, essentially creating a remedy comparable to the statutory remedy in the CBCA. The Listing Division of the SEHK has indicated that supervision of the remedy by the court rather than a committee of independent directors, as in the United States, is more likely to promote confidence and ensure consistency.

In Canadian corporate law, corporations do not have the right to dismiss a shareholders' derivative action by means of ratification by a majority of shareholders or through special litigation committees. However, decisions made by such bodies may be taken into account by the court in making an order in relation to a claim made under the derivative action or oppression remedy (CBCA, s.242; Welling at 531-533; M.A. Maloney, 'Whither the Statutory Derivative Action?' (1986) 64 C.B.R. 309 at 340).

The rationale for not allowing majority shareholders to dismiss a derivative action is the view that the corporate person should not to be identified with the will of the majority of shareholders. Consequently, formal attempts by the shareholders to forgive alleged

breaches of duty to the corporation cannot deprive the corporation of its right of action. Only a judge, by exercising discretion against the shareholder, can do that. Refuge cannot be taken behind the majority view as English judges have done in the so-called ratification cases (Welling at 541-542).

Some working party members did not see the necessity for a statutory derivative action, especially given the availability of the unfairly prejudicial and just and equitable winding up remedies. They favoured an expanded statutory unfairly prejudicial remedy instead. Other working party members, for example, members of Working Party 2, were of the view that Hong Kong shareholders would benefit from a statutory derivative action.

On balance, in the interests of certainty, simplicity and conformity with other Commonwealth jurisdictions, a statutory derivative action is desirable. The prophylactic effect of such an action is salutary. It also appears to be the only way in which to lay to rest the unruly ghost of *Foss v. Harbottle*, which it must be remembered, was decided before the advent of even 19th century statutory company law. The U.K. case law on the rule in *Foss v. Harbottle* has taken some unfortunate turns in recent years creating unnecessary hurdles for shareholders in international disputes being played out in the United Kingdom. Characterised as a procedural rule under principles of U.K. private international law, the intricacies of the rule have been superimposed on shareholders of companies incorporated in other jurisdictions which provide more modern remedies. There is some evidence that this line of U.K. case law would also be applied in Hong Kong.

(DR: paras.481-483,487-489, Draft Act s.19.02-.03. CBCA: s.239. OBCA: s.246. MBCA: §§7.40-7.47. NZLC R9: paras.568-572, Draft Act ss.127-130.)

7.09 RECOMMENDATION: Unfairly prejudicial remedy. The current unfairly prejudicial or oppression remedy should be broadened. The remedy should be available to a broader class of persons, to include

- **any registered holder or beneficial owner, and any former registered holder or beneficial owner, of a security of the company or any of its affiliates;**
- **any director or officer or former director or executive officer; and**
- **the Financial Secretary.**

The scope of the conduct that may be complained of would also be broadened to include conduct that is oppressive, unfairly prejudicial to or that unfairly disregards the interests of any security holder, director or officer.

CURRENT ORDINANCE: Any member of the company can apply to the court for an order on the ground that the affairs of the company are being, or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally. A court may grant relief through any "order it thinks fit" such as:

- an order regulating the conduct of the company's affairs in the future;
- an order restraining the commission of any such act or the continuance of such conduct;
- an order that an action "be brought in the name of the company against such person and on such terms" as it sees fit (i.e. a derivative action).

- an order for the buying out of the shareholder's shares by other shareholders or the company;
- an order that alters the company's memorandum and articles (s.168A).

COMMENTARY: Following the recommendations of the Cohen Committee, the Parliament of the United Kingdom brought in an unfairly prejudicial remedy at s. 210 of the 1948 Companies Act. The provision was intended primarily to provide alternative remedies to winding-up, as opposed to introducing new conduct which could give rise to judicial intervention. It was necessary for a successful applicant to prove grounds justifying a winding-up order as well as oppressive conduct. Ironically, it was sometimes easier to prove the grounds for winding-up than it was to show oppressive conduct within the terms of the provision. The oppressive conduct had to affect the applicant in his or her capacity as a shareholder and had to constitute a course of conduct which continued to exist at the time of the application (B. Cheffins, "The Oppression Remedy in Corporate Law: The Canadian Experience" (1988) 10 University of Pennsylvania Journal of International Business Law 305 at 310). In 1980, the U.K. oppression remedy was widened to include conduct which was unfairly prejudicial. This amendment brought the British remedy into closer line with the generous wording of the Canadian remedy.

"....[T]he essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealing, and a violation of the condition of fair play on which every shareholder who entrusts his money to a company is entitled to rely" (*Elder v. Elder and Watson Ltd.*, [1952] SC 49 at 55 per Lord Cooper). The Dickerson Committee quoted Lord Cooper in support of their proposal to introduce an extremely broad version of the unfairly prejudicial remedy of s.210 of the U.K. Companies Act 1948. They sought to "strip away the self-imposed judicial qualifications that have limited the application of s. 210 and that have therefore cast considerable doubt upon the effectiveness of the original provision" (Dickerson Report at para. 485). Subsequent legislative tinkering in the United Kingdom has attempted to broaden the scope of the unfairly prejudicial remedy, but it remains fairly narrow and circumscribed in comparison to the Canadian version. New Zealand too has taken a fairly conservative approach to updating the remedy.

In ordering relief under the oppression remedy, courts have often borrowed from the legitimate or reasonable expectation analysis that was used in *Ebrahimi* v. *Westbourne Galleries Ltd.*, [1973] A.C. 360 (H.L.). This analysis is based on the assumption that each shareholder buys shares with certain expectations. The legitimate expectations of a shareholder vary considerably, depending on the size, structure and nature of the company and on the circumstances under which he became a shareholder. The principle of shareholder expectations is not restricted to private companies, though it is more likely to arise and to generate judicial sympathy in those situations.

Both Canada and New Zealand have decided not to restrict the application of the oppression remedy to private companies. This decision is based on the premise that oppressive or unfairly prejudicial conduct can occur in corporations which do not fall within the traditional definitions of a private company.

In New Zealand, the Law Commission proposed restricted standing to shareholders and for acts directed towards them (see NZLC R9 at para. 573). However, as enacted, this

proposal was broadened to include "a shareholder or former shareholder of a company, or any other entitled person" as possible complainants for actions that are "oppressive, unfairly discriminatory, or unfairly prejudicial to him or her in that capacity or in any other capacity" (see New Zealand Companies Act 1993, s.174). "Entitled person is narrowly defined as a shareholder and any person upon whom the company constitution confers any of the rights and powers of a shareholder".

In Canada, the statutory unfairly prejudicial remedy has altered the landscape of shareholders' actions; it has become the most widely used shareholder remedy, eclipsing by far all others. The class of "complainant" is wide; it accords standing to

(a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,
(b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
(c) the Director [of the Corporations Directorate], or
(d) any other person who, in the discretion of a court, is a proper person to make an application under this Part" (CBCA, s.238).

Equally, the conduct which may be complained of is broadly stated; it is not restricted to conduct directed towards shareholders per se. It includes conduct "that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer".

According to at least one member of the original Dickerson Committee, the Canadian courts have generally interpreted the statute, and this provision in particular, in a manner very much in keeping with the intentions of the drafters of the legislation. They have not shied away from exercising the very wide open discretion accorded to them by the statutory remedy. The "oppression remedy", as it is referred to in Canada, has become the statutory remedy of choice. And despite its breadth, there does not appear to be untoward abuse of the remedy; actions by or on behalf of creditors, for example, are very rare. The remedy appears to be invoked very much in circumstances where fair dealing is at issue; it provides the court with the ability to resolve an issue in a commercially reasonable manner without resort to dissolution of a going concern.

This recommendation narrows the CBCA formulation of the remedy. Trade creditors have other remedies and should not have standing under the unfairly prejudicial remedy. Standing has however been granted to directors and officers, past and present, and the scope of the conduct complained of would be broadened to include them as well. Although primarily a shareholder remedy, there may be situations where a non-shareholder director or officer should be able to bring a matter before the court. Given the actual experience with the remedy in Canada, there also seems little justification for the wide discretion granted to the courts under the CBCA provision to accord standing to any other "proper person". "Security holder", on the other hand, is a broader class than the "members" or "shareholders" given in standing in other statutory formulations of the remedy and would include debenture holders, for example.

(DR: paras.484-487, Draft Act s.19.04. CBCA: s.241. OBCA: s.248. NZLC R9: para.573, Draft Act s.135. NZLC R16: paras.61-62, Draft Act ss.135-135A.)

7.10 RECOMMENDATION: Statutory compliance and restraining order. A shareholder or director should have the standing to apply to court for a statutory compliance and restraining order.

CURRENT ORDINANCE: At present, shareholders can bring a personal rights action to enforce their contract with the company (s.23), if the act complained is beyond the company's capacity (i.e. *ultra vires*) or if the company's memorandum and articles (i.e. the company constitution) has not been respected. Moreover, a court may make an order restraining the commission of or the continuance of unfairly prejudicial conduct which is in breach of the company's memorandum and articles, upon the application of a shareholder (s.168A).

COMMENTARY: Compliance and restraining orders are provided for in Canada under the CBCA, at s.247. Following the Canadian model, New Zealand has also introduced these types of orders. These generalised remedies do not exist as such in the United Kingdom, the United States, or Australia.

Compliance and restraining orders are statutory remedies available to shareholders which allow them to ensure that directors and the company comply with the corporate constitution, including mandatory statutory rules. These orders help protect shareholders' personal rights of action against the directors and the company wherever duties are imposed by the corporate constitution for their benefit. The Listing Division of the SEHK has suggested broadening the class of applicant to include directors, creditors and employees but this suggestion is not supported with respect to creditors and employees.

(DR: para.493, Draft Act s.19.10. CBCA: s.247. OBCA: s.253. NZLC R9: para.566, Draft Act s.126. NZLC R16: para.59, Draft Act s.126(1).)

7.11 RECOMMENDATION: Just and equitable winding-up. The traditional "just and equitable" winding-up remedy should be retained, but the court should be given the option of making any other order it sees fit. The remedy should be dissociated from the more undesirable consequences of winding-up procedures in insolvency (such as the freezing of bank accounts).

CURRENT ORDINANCE: Shareholders may apply to a court for a just and equitable winding-up of a company (ss.177, 179).

COMMENTARY: The lack of viable alternative remedies at common law frequently meant that the only course of action open to dissatisfied minority shareholders was to apply to have the company wound-up. Under s.461(6) of the U.K. Companies Act 1985 (by reference to s.411 and s.122(g) of the Insolvency Act 1986) a court may wind-up or dissolve a company on the application of a shareholder where such a solution would be just and equitable.

The English winding-up remedy, a remedy which has been adopted in all Commonwealth jurisdictions, finds its source in partnership law. The courts of equity would dissolve partnerships if it was just and equitable given the circumstances. This type of remedy was extended to the law governing companies, particularly in instances of deadlock.

English courts have always operated under the assumption that a winding-up order is a drastic remedy to be granted sparingly. Before the introduction of the oppression or unfairly prejudicial remedy, there was no statutory authorisation for alternative remedies and most judges accepted that the courts did not have the jurisdiction to grant such remedies

(Cheffins, *supra* at 309). The limited scope of relief possible under the winding-up remedy led to the introduction of the oppression remedy.

Although there is obvious overlap with a broad oppression remedy, just and equitable winding up is a firmly entrenched traditional remedy which should be retained. There are instances, deadlock for example, where the grounds for oppression may not be made out but the court should be able to provide relief. In the face of a just and equitable winding-up application, however, the court should have the discretion to make any other appropriate order. This discretion should serve to discourage *ad terrorem* abuses of the remedy, for example, where an opportunistic shareholder attempts to hold a viable business to ransom by threatening a just and equitable winding-up.

In working party discussions, there was the suggestion that the just and equitable winding-up remedy be subsumed under the unfairly prejudicial remedy. This recommendation retains just and equitable winding-up as a distinct remedy because it may be triggered in circumstances where there is no oppression as such, simply deadlock.

(DR: paras.453-458, Draft Act s.17.07. CBCA: s.241(3)(1). OBCA: ss.207,248(3)(1). MBCA: §14.30, NZLC R9: para.661, Draft Act s.203(1)(c)(iv).)

7.12 RECOMMENDATION: Appraisal or "buy-out" remedy. A form of appraisal or "buy-out" remedy which does not necessitate judicial intervention should be adopted; the statutory buy-out remedy gives shareholders the right to have the company buy their shares upon the occurrence of a limited number of fundamental changes while permitting the company to proceed unimpeded with its proposed action. In the alternative, consideration should be given to introducing such a procedure but excluding its application to listed companies.

CURRENT ORDINANCE: There is no separate appraisal or buy-out remedy. The buy-out remedy provided for under the unfairly prejudicial remedy necessitates judicial intervention (s.168A).

COMMENTARY: The appraisal or buy-out remedy is American in origin. The buy-out remedy permits an unhappy shareholder to leave a company which has decided, for quite legitimate commercial reasons, to embark on a fundamental change in course, usually with the support of the great majority of shareholders. The beauty of the remedy is that it permits the company to proceed unimpeded provided it buys out the unhappy shareholder; there is no necessity for judicial intervention unless a dispute arises as to the valuation of the shareholder's interest.

The Canadian buy-out remedy (CBCA, s.190) was adapted from similar provisions of New York's Business Corporations Law. New Zealand modelled its buy-out remedy on the Canadian one. Neither the United Kingdom nor Australia has a buy-out remedy. A recent paper by the U.K. Law Commission on Shareholder Remedies suggests a very limited variation which involves a court ordered purchase of a shareholder's interest in very small companies on the basis of exclusion from management (Great Britain, Law Commission, *Shareholder Remedies* (Consultation Paper No. 142) by the Honourable Mrs. Justice Arden (Chairman) DBE, Andrew Burrows, Diana Faber, Charles Harpum, Stephen Silber, QC (London: H.M.S.O, 1996)).

A statutory buy-out remedy gives shareholders the right to have the corporation buy their shares upon the occurrence of certain fundamental changes in the corporation. Fundamental changes that trigger recourse under the buy-out remedy under the CBCA are limited to the following:

1) the sale of all or substantially all of the assets of the business;

2) mergers with another company;

3) changes in the type of business that the company may carry on (this is only relevant if the constitution limits activities of the company);

4) emigration (moving the company to another jurisdiction through continuation under a foreign company law statute); and

5) variations to share provisions (changing share issue or transfer restrictions or changes in rights of a class of shares).

Generally the buy-out remedy is designed to supplement and not supplant alternative remedies to which the shareholder might have resort (J. MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal", *supra* at 303).

For shareholders in widely-held companies which have well-developed markets for their securities, the value of the buy-out remedy is controversial; the shareholders, in theory, have a ready market-exit option --they can sell their shares on the open market at fair market value-- if they do not approve a fundamental change (*ibid.* at 309). As well, shareholders in public and listed companies benefit from the shareholder protections, formal and informal, of the securities regulatory regime.

Equally, the absence of a market-exit option increases enormously the importance of the buy-out remedy. If protection is desired against unwise or opportunistic fundamental changes that the majority has approved, the buy-out remedy is likely to be the only exit option available (*ibid.* at 313-314). Thus, the buy-out remedy is most useful for shareholders in public corporations with very limited markets for their shares and closely-held corporations which generally have no market for their shares; shareholders in these type of corporations have no reliable market-exit option (*ibid.* at 310-311).

The buy-out remedy has several benefits for both the corporation and dissenting shareholders because it is a relatively cheap dispute resolution mechanism in comparison to other available forms of relief. Moreover, the automatic nature of the buy-out remedy reduces uncertainty for shareholders seeking relief.

There are variations on the form and circumstances in which the buy-out remedy operates. It is one form of relief available under the unfairly prejudicial remedy. In fact, according to some commentators, it is the most sought after relief under the unfairly prejudicial remedy and for good reason: "By far the most common order under section 461 U.K. is that the respondents purchase the shares of the petitioner, and given that a successful petitioner will normally have been a member of an incorporated partnership, it is difficult

to envisage what other remedy could be granted." (see D.D. Prentice, "The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of The Companies Act 1985" (1988) 8 Oxford Journal of Legal Studies 55 at 83).

One formulation of the buy-out remedy actually operates in favour of and at the behest of the company. In some large commercial states in the United States, a corporation or majority shareholder can avoid involuntary dissolution by purchasing the shares of the petitioning shareholder at fair value; the corporation and majority shareholder in effect are given a call option on the shares of a rambunctious shareholder. Most states limit this recourse to closely-held corporations, but in California, it is open to all corporations.

The main advantage of the statutory buy-out remedy in its Canadian and, even more so, in its New Zealand formulation, is that it is designed, at optimum use, to avoid recourse to the courts. It can operate without court or administrative intervention. In this respect, the remedy is very much in keeping with recommendations made elsewhere to promote self-enforcing mechanisms in the legislation in an effort to provide alternatives to litigation. For private companies, where there has been a fundamental change in the nature of the business to be carried on by the company, the buy-out mechanism provides a remedial, and much more effective, substitute for the *ultra vires* doctrine.

In public companies, the requirement for "fair value" (and not fair market value) is significant. The terms of the "exit" provided by the market may be profoundly changed by the actions taken by the corporation; it may also be the case that the dissenting shareholder, itself, in a thinly-traded market, might significantly affect the market price simply by virtue of unloading its shares into the market. Nonetheless, many U.S. states do not provide a buy-out remedy where there is a public market for the shares, i.e. where they are listed on a major stock exchange or quoted on a major over-the-counter market. This may be an appropriate restriction in the United States, with its deep and liquid markets and prevalence of widely-held public corporations, but not, perhaps, elsewhere.

The Listing Division of the SEHK is cautiously in favour of such a remedy given the relative illiquidity of the market for many Hong Kong listed companies.

> On the question of a market in the shares, it must be admitted that, in the case of many HK second and third-liners, the market may be lacking in true liquidity. Further, there would of course be no market in the case of suspensions.[...]
>
> On balance, and provided that the introduction of the remedy would not result in an alternative "market" to the Exchange, we see merit in providing an equitable exit route for dissentient shareholders, provided that the remedy did not prove irreconcilable with the Listing Rules (Letter of SEHK (Listing Division) to the Review (2 September 1996)).

A recent study on corporate governance by the HKSA confirmed the "widespread view that the extent of control by one shareholder or one family group of shareholders in the shareholding of listed companies in Hong Kong is significant" (Second Report of the Corporate Governance Working Group, January 1997, at 4). Nearly 90% of all Hong Kong listed companies have one shareholder or one family group of shareholders owning 25% or more of their entire issued capital, and more than half have one person or family group owning 50% or more. The market "exit" in Hong Kong may be illusory in the case of

shareholders with significant holdings in listed companies where the market for their shares is illiquid.

Some members of Working Party 3/4 were firmly opposed to the buy-out remedy considering that it would give excessive power to minority shareholders and undermine the concept of majority shareholder rule which they felt was widely accepted. Shareholders could hold a company to ransom where it did not have the funds to buy them out. Some members were also concerned that a multiplicity of shareholder remedies would spawn litigation and impede business actively even though this particular remedy is structured to avoid litigation. However, the members of Working Party 2 were favourably disposed to the availability of a wide range of remedies including the buy-out remedy.

As noted above, one of the prime advantages of the buy-out remedy is that, should there be resort to the courts, there is only one narrow justiciable issue for decision, the fair value of the shares. New Zealand has addressed the quite understandable reluctance of the courts to make such determinations (on the basis of expert testimony, of course) by referring the actual appraisal to arbitration. In the United States, an interesting statistic would seem to confirm that the buy-out remedy does work as a matter of course without judicial intervention. Between 1972 and 1981 there were only 20 or so reported cases on the appraisal remedy (J. Seligman, "Reappraising the Appraisal Remedy" (1986) 28 Corporate Practice Commentator 2 at 2). There are several reasons advanced for this remarkably low incidence of litigation in a most litigious jurisdiction. The buy-out or appraisal remedy works; dissenting shareholders are quite happy to be bought out, usually at a premium. And in many states, it is a requirement that, prior to any judicial recourse being taken, an initial appraisal be performed.

The appraisal remedy, as noted by the Listing Division of the SEHK, may be particularly appropriate in the Hong Kong context due to the relative illiquidity of the public markets. Although recourse to mandatory arbitration as an appraisal mechanism has its limitations, in fact, in Hong Kong appraisal issues may prove easier to resolve than in other markets given the preponderance of real estate as a company asset.

An alternative to a generally applicable appraisal remedy would be to exclude the fewer than 300 Hong Kong incorporated listed companies. The appraisal remedy would then apply to private companies and some 6,000 unlisted public companies. The main argument for this approach (in addition to the availability of the market exit) is that the Listing Rules and Takeovers Code provide alternative protections in the context of the fundamental changes which trigger the appraisal remedy. The Listing Rules and Takeovers Code provide substantive protection for shareholders, unlike the securities regime in the United States which concentrates on disclosure. The following are the fundamental changes which trigger appraisal rights and to which securities requirements apply in Hong Kong:

- the sale of all or substantially all of the assets; this is a major transaction under the Listing Rules (Chapter 14) triggering requirements such as shareholder approval;

- mergers; the Takeovers Code applies which may require up to 90% shareholder approval for "privatisations", a mandatory offer to all

shareholders when there is a change in control or where control is consolidated, etc;

- changes in constitutional limits on business activities; as a generally rule listed companies have extremely broad objects claims;

- emigration; the SEHK only permits emigration to Bermuda and the Cayman Islands with additional shareholder protection being built into the constitution so that shareholders have comparable protection to that available under the Hong Kong Companies Ordinance; and

- variations of share provisions; this is not an issue with listed companies since the only shares permitted to be listed on the SEHK are standard common (one share/one vote) type of shares.

(DR: paras.373,442, Draft Act s.14.17. CBCA: s.190. OBCA: s.185. MBCA: §13.02. NZLC R9: paras.89,202-204,470-476, Draft Act ss.81-86.)

8.00 FUNDAMENTAL CHANGES

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8.01 RECOMMENDATION: Amendments by special resolution. There should be regrouped in one section, all amendments to the company constitution that may be effected by special resolution of the shareholders. A special resolution should require a "super-majority" vote, i.e. 75%.

CURRENT ORDINANCE: Amendments that must be carried out by special resolution (75%) (defined at s.116) are not grouped in one section of the Ordinance.

COMMENTARY: The kinds of common amendments to the constitution that would be consolidated in one place would include changing the name of the company, changing the place in which its registered office is situated, changing the restrictions, if any, on the business that the corporation may carry out, increasing the number of authorised shares, if there is a limit, creating new classes of shares, changing the number or maximum number of directors, etc. The power to make a proposal to amend the constitution should be given to any voting shareholder as well as any director.

(NZLC R9: para.67.)

8.02 RECOMMENDATION: Dissenting shareholder entitled to be "bought-out". Where an amendment to the constitution would (1) affect substantially the nature of a shareholder's investment (e.g. remove or change any restriction on the nature of the business of the company or change the characteristics of its shares) or (2) where the company proposes a fundamental change such as an amalgamation, continuance in another jurisdiction (see recommendation with respect to continuance), or sale of substantially all of its property, a dissenting shareholder should be entitled to be bought out of the company at a "fair" price.

CURRENT ORDINANCE: There is no general statutory buy-out or appraisal remedy. However, the Ordinance provides for a court ordered buy out remedy when a company alters its objects by special resolution (s.8). Dissenting shareholders, representing at least 50% in nominal value of the company's issued share capital or 5% of any class, may make an application to a court to cancel the alteration (s.8(2)). If such an application is made by dissenting shareholders, the court must make an order confirming the alteration, either wholly or in part, and on such terms as it thinks fit; it may also order that dissenting shareholders be bought out (s.8(4)).

In addition, a court may also make an order for the buying out of the shareholder's shares by other shareholders or the company in order to grant relief under the unfairly prejudicial remedy (s.168A).

COMMENTARY: The so-called dissent and appraisal rights accorded to shareholders in some jurisdictions are an attempt to balance the interests of majority and minority shareholders. Management (and the majority shareholders) should have the flexibility to effect fundamental changes to the structure and operations of their companies, especially in times of rapid commercial change. On the other hand, minority shareholders, especially those in companies with no public market for their shares, should not be locked into companies where the nature or structure of the business initially invested in, or the very nature of their investment itself, their shares, is to be significantly changed.

> [...] Instead of relying on common law standards to restrict the conduct of majority shareholders who propose to make a fundamental change, the provisions in this Part confer upon a shareholder who dissents from the fundamental change the privilege of opting out of

the corporation and demanding fair compensation for his shares. In short, if the majority seeks to change fundamentally the nature of the business in which the shareholder invested, and if the shareholder dissents from the change, he may demand that the corporation pay him the fair value of his shares as determined by an outside appraiser. Of course, if enough shareholders dissent, creating a heavy drain on the corporation's cash resources, the proposed change will be effectively blocked. Thus the general policy of the common law is not only changed but in fact reversed. Instead of placing the minority shareholder at the mercy of the majority, these provisions permit the minority shareholder to withdraw from the enterprise and, if enough minority shareholders are affected, to bar the proposed change. Nevertheless, the majority shareholders can, if they go through the proper formalities and if they pay any dissenting shareholders, effect almost any fundamental change with impunity. The result is a resolution of the problem that protects minority shareholders from discrimination and at the same time preserves flexibility within the enterprise, permitting it to adapt to changing business conditions. (Dickerson Report at para. 347).

The changes which trigger dissent and appraisal rights may be cast widely or narrowly depending on the balance it is desired to achieve. (See Part 7.00 for a further discussion of the appraisal or buy-out remedy).

8.03 RECOMMENDATION: Class vote. In certain circumstances, a class vote should be held where a proposed amendment to the constitution would affect, directly or indirectly, the rights of that class of shares.

CURRENT ORDINANCE: If the terms of issue of a class of shares specify how their rights are to be varied those provisions must be respected. Where there are no such provisions, the manner in which class rights are varied depends on where the special class rights are specified:

- if special class rights are specified in the memorandum, those rights may be varied if all members of the company agree to the variation (s.63A(3));
- if special class rights are not specified in the memorandum and the articles do not provide for the variation of those rights, the articles are deemed to contain a provision that the rights may be varied with written consent of shareholders holding 75% in nominal value of the issued shares of the class, or with sanction of a special resolution passed at a separate class meeting (s.63A(1)).

The Ordinance provides a device for minority shareholders to protect themselves against changes to their class rights. When a variation of class rights is approved by shareholders of the same class, shareholders, who hold no less than 10% in nominal value of the issued shares of the class, have the right to make an application to a court in order to have the variation cancelled. When such an application is made, a proposed variation cannot have effect unless a court confirms it (s.64).

COMMENTARY: Again, a provision of this nature safeguards the interests of minority shareholders with respect to the nature of their investment while providing to management and majority shareholders the flexibility necessary to adjust the capital structure of the company to change. A shareholder has the right to vote (whether or not voting rights are attached to the shares held) in the case of any proposed amendment that affects those rights.

A variation of this concept was proposed by the New Zealand Law Commission in its Report No. 9, "Interest Group Voting":

477 In the first place, the groups which vote on alteration of rights attached to shares are interest groups, rather than classes. That means that where two or more classes have identical rights in relation to a matter affected by a proposal, they vote together, rather than separately. Voting groups will often be larger than one class [...]

479 We consider that requiring interest group vote on particular issues rather than class

> vote is logical. It does mean that members of particular classes may have less control over a company decision but this is more than compensated for by their right to buy-out [dissent and appraisal right], which may be a more effective brake on alteration of shareholder rights than any voting requirement (NZLC R9 at paras. 477, 479).

Determination of the "interest group" entitled to vote could, however, be a source of dissension. Professor Sealy has called the interest group concept a "pernicious idea" and one which could breed unnecessary disputes. In the interest of certainty, the more objective class voting provisions are preferable.

(MBCA: Model Close Corporation Supplement §3(b). U.K. Companies Act 1985: s.1(3).)

8.04 RECOMMENDATION: Corporate restructuring procedures. Simple procedures should be made available to provide for corporate restructuring such as by way of amalgamation without the necessity for court intervention or liquidation.

CURRENT ORDINANCE: A company can make compromises and arrangements with its shareholders in order to restructure the company, but court sanction is required (s.166). There is a specific section that applies where the proposed compromise or arrangement relates to a scheme of reconstruction or amalgamation (s.167).

COMMENTARY: Provided that minority shareholders and creditors are not prejudiced, management and majority shareholders should have the flexibility to restructure companies by way of amalgamation without the necessity for court intervention or liquidation and reconstitution. Shareholder approval of an amalgamation agreement by special majority whereby all shareholders of each amalgamating company may vote (irrespective of whether voting rights attach to their shares), combined with dissent and appraisal rights, can adequately protect minority shareholders. Creditors would be notified of the proposed amalgamation; each company would have to meet a solvency test in order to finalise the amalgamation; management of each company would have to certify either that creditors were not being prejudiced or that notice to them went unobjected; and all assets, liabilities and actions would continue. No court or administrative intervention would be required; on receipt of articles of amalgamation (or other constitutional document of the amalgamated entity) and supporting documentation, the Registrar would issue a certificate of amalgamation.

(MBCA: Model Close Corporation Supplement §3(b).)

8.05 RECOMMENDATION: Restructuring of related companies. Restructuring of related companies and wholly-owned subsidiaries should be facilitated.

CURRENT ORDINANCE: There is no simplified procedure in the Ordinance for the restructuring of related companies and wholly-owned subsidiaries; such restructurings are subject to the requirements of ss.166-167.

COMMENTARY: Simplified procedures for the amalgamation of a parent with a wholly-owned subsidiary or among wholly-owned subsidiaries would not require shareholder approval (for the obvious reason) or court approval. The amalgamation would be approved by directors' resolution. No amalgamation agreement would be necessary. Creditors should be adequately protected by their own contractual arrangements, the solvency test and certification described in the commentary to Recommendation 8.04.

8.06 RECOMMENDATION: "Import" and "export" of companies. "Import" and "export" of companies into and out of Hong Kong should be permitted. Foreign companies should be able to re-incorporate in Hong Kong under the new Ordinance without the necessity of liquidation and the resulting disruption and interruption of corporate existence; Hong Kong incorporated companies should be able to continue under the laws of incorporation of another jurisdiction in the same manner.

CURRENT ORDINANCE: There are no continuance provisions in the Ordinance which allow the "import" and "export" or companies into and out of Hong Kong.

COMMENTARY: Given the volume of international transactions with a Hong Kong nexus, import and export of companies without the necessity of liquidation and the resulting disruption and interruption of corporate existence should be permitted. The property and obligations of the company continue to be those of the Hong Kong continued company; any existing causes of action, claims, liabilities etc. are unaffected. Some jurisdictions impose a precondition that the "import" is authorised by the laws of the jurisdiction of original incorporation. Even such reciprocity is not necessary and is not being recommended.

With respect to exporting a Hong Kong company to another jurisdiction there are other factors to be considered. Obviously the continuance provisions under the laws of the other jurisdiction must permit it. However, the interests of shareholders and creditors in Hong Kong must be protected. With respect to export provisions, the Dickerson Committee stated that it was

> ...inherently a hard case, defying the application of fixed rules or even general standards of fairness, for there is always the possibility that unscrupulous management will recommend export to a jurisdiction with easier standards to evade their duties under the [Act]. For this reason broad discretion is given to the Registrar to block a proposed export. Note, too, that a shareholder has the right to vote in respect of continuance under the laws of another jurisdiction (export) whether or not he is otherwise entitled to vote. In addition, in such a case a dissenting shareholder has the right to opt out and to claim the appraised value of his shares... (Dickerson Report at para. 367).

The SEHK currently determines the acceptable jurisdictions for listed companies. For non-listed companies, consideration should be given to whether a public body would have the standing to commence or intervene in an action to determine whether the export would be detrimental to shareholders and creditors. The laws of the export jurisdiction would have to provide continuity with respect to assets, liabilities, causes of action, etc. of the company.

Some concerns were raised in working party meetings as to the political acceptability of "export" provisions in the face of the "redomiciling" phenomenon experience in Hong Kong. Over the course of the past few years, several major Hong Kong based businesses have, in effect, shifted their jurisdiction of incorporation from Hong Kong to Bermuda. This has been done by means of a scheme of arrangement which authorised the creation of a Bermuda incorporated holding company the shares of which were exchanged for shares in the Hong Kong entity. Other working party members were of the view that local businesses would be in favour of export/import provisions as they would facilitate foreign operations, particularly those of small companies.

Given the relative ease with which Hong Kong businesses can choose to incorporate

overseas and the fact that something similar to a "redomiciling" of existing Hong Kong companies can nevertheless be accomplished, albeit at some effort and expense, there does not appear to be a reason not to offer the convenience and cost effectiveness of simple import and export provisions. This approach is consistent with Hong Kong's traditional openness to international business and facilitation of legitimate commercial activity.

The export/import provisions are also a door that swings both ways. With a modern, streamlined companies law regime in place, Hong Kong could very well become a jurisdiction of choice for incorporations; there may be the possibility of foreign incorporated Hong Kong businesses "redomiciling" to Hong Kong under quick and easy import provisions.

8.07 RECOMMENDATION: Court ordered arrangements. Provision should be made for court ordered arrangements for solvent companies where it is impracticable to restructure under other provisions of the legislation.

CURRENT ORDINANCE: The Ordinance provides for court ordered arrangements of solvent companies (ss.166, 167).

COMMENTARY: Although the above recommendations permitting restructuring of corporate form are intended to permit great flexibility without the necessity of court intervention (and still safeguard legitimate interests of shareholders and creditors), it is impossible to predict every circumstance which may arise. For this reason, there should be a residual ability to ask for a court ordered restructuring where the company is solvent. The court should be given the widest latitude in making any interim or final order to effect the restructuring and at the same time protect the interests of shareholders and creditors. As this is envisaged as an exceptional recourse and one where there may be broader public interests involved, the Financial Secretary (or an appointee), should have standing to appear in the proceedings. Recourse of this nature would only be available to solvent companies.

9.00 SOLVENT DISSOLUTION AND LIQUIDATION

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9.01 RECOMMENDATION: Solvent dissolution and liquidation. Only solvent dissolution and liquidation should be dealt with in the new Ordinance.

CURRENT ORDINANCE: At present Part V of the Ordinance on "Winding Up" takes up nearly one third of the entire ordinance. It provides for two modes of winding up: by court order or voluntarily (s.169). In both modes there are provisions that allow for the winding up and dissolution of solvent companies as well as insolvent companies. As for solvent companies, under a voluntary winding up, a company may make a declaration of solvency (s.233). A solvent winding up is called a "a members voluntary winding up"; there are specific rules applicable to this type of winding up (ss.234-239A).

COMMENTARY: The mandate of the Review and that of the Sub-committee on Insolvency of the Law Reform Commission overlap to the extent that both require review of Part V of the current Ordinance, "Winding-Up". Recommendation 1.05 recommends that the new Ordinance contain provisions only with respect to solvent dissolution and liquidation of companies, the "death" of the company. This Review would defer to the Sub-committee on Insolvency and the Law Reform Commission on those aspects of liquidation and dissolution associated with insolvency. There are indications that the Sub-committee may recommend a comprehensive insolvency ordinance.

Assuming that insolvency and its very different policy considerations are dealt with elsewhere, companies law provisions with respect to solvent dissolution and liquidation can be dramatically simplified. There are essentially three categories of circumstance in which a dissolution and liquidation may take place: voluntary dissolution; administrative dissolution and court ordered dissolution. In Hong Kong, the voluntary dissolution procedures are so tedious and cumbersome that the usual practice is to deliberately cease compliance with the Ordinance and wait several years for the Registrar to strike the company off the register.

In this particular area, the most satisfactory model appears to be the U.S. MBCA, operating as it does in the context of the existence of a separate, comprehensive corporate insolvency regime. The MBCA acts as model for the following recommendations also because it is simple and elegant. For this reason, the recommendations follow the MBCA in their entirety. It should be noted at the outset that dissolution precedes liquidation under the MBCA.

The Monetary Authority has noted that a shift in protection of creditors to an insolvency regime must ensure that the current provisions with respect to priority payments for depositors in financial institutions is maintained in both the Companies Ordinance and any proposed insolvency regime.

9.02 RECOMMENDATION: Voluntary dissolution by simple filing. Voluntary dissolution should be effected by a simple filing (depending on the nature of the dissolution sought) and should take effect upon filing; the corporate existence would then be continued only for the purpose of winding up and liquidating the business and affairs of the entity.

CURRENT ORDINANCE: Under the existing rules, winding up precedes dissolution. A company can first resolve by special resolution that the company be voluntarily wound up (s.228(1)). After a positive resolution, a company may only carry on

business for the purpose of winding up its affairs, but the company continues to exist as an entity until it is dissolved under s.239 (s.231). Once the company is wound up, the liquidator must call a general meeting of the company for the purpose of laying before it the account of the winding up (s.239(1)). Within one week of the meeting the liquidator must send a copy of the account to the Registrar (s.239(3)). The Registrar upon receiving the account registers it, three months after the registration the company is considered officially dissolved (s.239(4)).

COMMENTARY: What the state giveth, the state can take away. Dissolution should precede liquidation and be effected by a simple filing in the case of voluntary dissolution and liquidation. The filing of articles of dissolution has the effect of prohibiting the entity from engaging in commercial activity except in furtherance of its winding-up.

9.03 RECOMMENDATION: Circumstances for simple filing. Voluntary dissolution by way of simple filing should be available in two instances; (1) before the company has commenced business and (2) where initiated by directors and shareholders.

CURRENT ORDINANCE: A company may be voluntarily wound up and subsequently dissolved on the initiative of its members by special resolution (s.228). Moreover, a company can be wound up by court order if it does not commence business within a year from its incorporation (s.177(1)(b)). A company, creditors and shareholders are among those that have the right to petition a court for such an order (s.179).

COMMENTARY: Dissolution should be available by means of a simple filing where the company has not commenced business. Where a company has not issued shares nor commenced business, a filing by the majority of incorporators or initial directors to that effect and stating that no debt of the company remains unpaid should suffice. Where shares were issued, the filing should state that the net assets have been distributed to shareholders.

Where a company has carried on business, there are the interests of shareholders and creditors to protect in the event of dissolution and liquidation. The board of directors should propose dissolution to the shareholders who should vote to approve it. Flexibility must be balanced by minimum standards. Dissolution must be approved by a majority vote of shareholders. The directors or the constitution may require a greater vote or require class voting. The directors should be able to condition the submission of the proposal to shareholders on any basis. Directors should also be required to recommend the dissolution (triggering consideration of their fiduciary duties and duty of care) unless precluded from doing so by a conflict of interest or other special circumstance (that must, in the event, be communicated to shareholders).

9.04 RECOMMENDATION: Revocation of dissolution. Within a limited period of time a company should be able to revoke dissolution essentially in the same manner as it has been initiated.

CURRENT ORDINANCE: At any time within two years of the date of dissolution, upon receipt of an application to declare a dissolution void from the liquidator or by any other person who appears to the court to be interested, the court may declare a dissolution to have been void. Subsequent to such a declaration, proceedings may be taken as if the company had not been dissolved (s.290).

COMMENTARY: Circumstances change. If ease of dissolution is provided for by statute, it should be possible to revoke the dissolution within a limited time (e.g. 120 days) in the same manner without the necessity of judicial intervention. The revocation should relate back to the date of filing of articles of dissolution and the company should resume carrying

on its business as if dissolution had never occurred. For those exceptional circumstances which may arise, court ordered revocation of dissolution should be available at any time.

9.05 RECOMMENDATION: Claims of creditors. Provision should be made for the claims of known and unknown creditors.

CURRENT ORDINANCE: There is no provision in the Ordinance that a company must give notice of its winding up to known creditors and provide them with a minimum period to make their claim, after which the claim is barred. The Ordinance simply provides that all claims against the company shall be admissible as proof with the obligation being on creditors to come forward and prove their claims (s.263). However, there are several sections throughout Part V that aim to protect creditors (ss.229, 233, 239, 237A, 287, 290).

COMMENTARY: Where a company wishing to dissolve has been carrying on business, creditors are particularly vulnerable. The dissolved company, however, should not be in liquidation for a lengthy or indefinite period; this would be to the detriment of all involved. The company should give notice of the dissolution to known creditors and provide them with a minimum period (e.g. 120 days) in which to submit their claim for payment, after which the claim is barred. Action should be taken by a known creditor within a brief period if a claim is rejected by the company; contingent claims and those based on an event occurring after the date of dissolution should not be permitted under these provisions but should be provided for as "unknown claims".

Provision must also be made for unknown claims; notice of dissolution should be made by publication and state that a proceeding to enforce must be commenced within five years after publication of the notice. The claim should be enforceable against the undistributed assets of the company or, where assets have been distributed to shareholders, against the shareholders on a pro rata basis up to the amount of assets received.

9.06 RECOMMENDATION: Administrative dissolution. The Registrar should be able to commence an administrative dissolution in limited circumstances, primarily where a company has failed to comply with its filing obligations under the new Ordinance.

CURRENT ORDINANCE: A court may wind up a company on the application of the Registrar if it appears to the court:

- the number of shareholder is reduced below 2;
- the company is being carried out for an unlawful purpose or any purpose lawful which cannot be carried out by a company;
- the company has not had at least 2 directors or secretary for a period of not less than 6 months ending on the date of the winding up petition;
- the company has failed to pay the annual fee; or the company has been persistently in breach of its obligations under the Ordinance (ss.177, 179).

In addition, following the notice procedure laid out in s.290A, the Registrar may strike off a company from the register and dissolve it if the company has for 2 consecutive years failed to forward to the Registrar the annual return and fees required by the Ordinance. The Ordinance also empowers the Registrar to strike a defunct company off the register after following certain procedures (ss.291, 291A).

COMMENTARY: Where the administrative formalities imposed on companies under the legislation have been drastically reduced, there is a strong argument for strictly enforcing compliance with such formalities. Note that the assumption must be that administrative formalities have been reduced to a minimum and the legislation essentially decriminalised.

Rather than relying on the existence of a multitude of penal sanctions, major and minor, to enforce the administrative aspects of the legislation, the sanction should be loss of incorporation. Adequate provision for notice to the company should be made, a grace period provided for rectification and a simple procedure instituted for reinstatement or revival at the initiative of the company within a period of a few years after dissolution. Notice of administrative dissolution should be served and the company would then be required to cease operations and notify creditors essentially in conformity with the procedures provided for voluntary liquidation.

There has been some concern recently that rather than paying the HK$20,000 to HK$40,000 charged by accountants to effect a member's voluntary winding-up, business people are simply failing to comply with the filing requirements of the Ordinance and waiting to be struck off by the Registrar. The current administrative practice of striking off on a case by case basis under s.291 of the Ordinance has been used by the Registrar to do so. "The procedures under s.291 are discretionary provisions for the Registrar to use when he considers it fit to do so". The Registrar does not, however, want to encourage "professionals in the private sector as well as defunct companies and their directors or officers to use the striking-off provisions under section 291 to dissolve companies" (Letter of Gordon Jones, Registrar of Companies, to Cally Jordan (11 December 1996.))

9.07 RECOMMENDATION: Dissolution by the court. A court should be given broad discretion, both in terms of the grounds and the procedures adopted, to dissolve a company upon the application of the Financial Secretary or a delegated authority, a shareholder or a creditor.

CURRENT ORDINANCE: Both creditors and shareholders can petition a court for a winding up order (ss.177, 179). As detailed above, the Registrar may also petition for a winding up order (s.177). On the basis of information discovered through its investigative powers, the Financial Secretary may petition a court for the winding up of a company if it believes it to be in the public interest (ss.146, 147, 152A, 152B, 179).

COMMENTARY: Court ordered dissolution is a drastic, if traditional, remedy of last resort and the choice of grounds upon which it may be granted will in large measure be determined by the existence of other recourses.

The traditional remedy of court ordered dissolution and liquidation has been used by shareholders in a number of situations, primarily where the board is deadlocked or voting power results in an inability of the company to act. In addition, court ordered dissolution and liquidation has been provided on "just and equitable" grounds, where the directors or controlling interests in a company are acting in a manner that is illegal, oppressive or fraudulent or in cases of misappropriation or wasting of corporate assets. Although other less drastic remedies which permit continuance of corporate life while resolving deadlock or removing other difficulties may be preferable in most circumstances, a formulation of the traditional just and equitable winding up should be continued. (See Part VII, Shareholders' Rights and Remedies).

The Financial Secretary or a delegated authority should be able to commence proceedings in the public interest in the event incorporation has been obtained through fraud. As well, there may be circumstances in which dissolution commenced voluntarily should be

continued under court supervision.

Broad discretion should be given to a court with respect to the orders which it can make in the course of dissolution proceedings, including the appointment of a manger of the business in dissolution and/or a liquidator per se. Winding-up, notification of creditors, etc, would otherwise proceed in accordance with the general procedures outlined above once a dissolution decree is filed with the Registrar.

In this regard it should be noted that the Financial Secretary or a delegated authority should have broad powers of revival. Mistakes do happen and unforseen circumstances arise. There should be a ready cure available.

10.00 PRIVATE COMPANIES / CLOSELY HELD CORPORATIONS

10.00 PRIVATE COMPANIES / CLOSELY HELD CORPORATIONS

10.01 RECOMMENDATION: No separate ordinance. There should not be a separate specialised ordinance pertaining only to private companies/closely held corporations.

CURRENT ORDINANCE: There is no separate specialised ordinance dealing only with private companies.

COMMENTARY: In the last fifteen years there has been a considerable amount of debate internationally with respect to the creation of separate specialised regimes for small businesses. Various factors have motivated the debate. In some jurisdictions the impetus has been primarily political; action with respect to a specialised small business vehicle has been a highly visible gesture thereby satisfying a large sector of the electorate that government intends to ease regulatory burdens. In jurisdictions following the U.K. model of companies legislation, an argument raised for the creation of a separate regime for closely held or private companies has been the undue burden of compliance with the general companies law which, in its 19th Century origins, developed as a vehicle for public investment. Yet again, in the United States an alternative company law regime in the form of the limited liability company has been introduced and flourished in many states, primarily for tax reasons.

A notably successful experiment with a separate close corporations statute is the South African Close Corporations Act of 1984, enacted to overcome the difficulties associated with an aging U.K.-style companies act. The Close Corporations Act of 1984 operates side by side with the older Companies Act which has remained in place. There are no shares and no board of directors. Incorporation is effected by registration of a single document. Capital maintenance requirements have been abandoned in favour of solvency and liquidity tests. The close corporation has the capacity and powers of a natural person. There is a simple statement of fiduciary duties of members and the negligence standard of care. One person corporations are possible. All members must actively participate in the business and have equal rights to do so (although these provisions may be waived). There must be annual accounts prepared by an accountant. It is not necessary that the accounts be audited by an auditor. In other jurisdictions, many of these features exist already in the general corporations legislation.

The South African legislation, innovative as it is, has not been widely emulated. Australia examined it and went so far as to enact, but not proclaim, a close corporation statute which was subsequently repealed. There were immediate constitutional reasons at the time which doomed the legislation in Australia but dissatisfaction with the complexity of the form of enterprise proposed was also a factor. In 1993, the Corporations Law Simplification Program in Australia immediately set about to incorporate aspects of the proposed Close Corporations Act into the general corporations legislation.

In the U.K., the complexity of the companies law and political pressures forced consideration of options for small owner-managed companies. A new corporate form and simplification of the Companies Act 1985, in particular, through the creation of a separate single statute were considered. Deliberations by the DTI and the Law Commission have so

far been inconclusive. The focus has shifted recently from companies law to possible reform of partnership law in the interests of small business (see Great Britain, Department of Trade and Industry, *DTI's Programme for the Reform of Company Law* – Progress Report (London: Department of Trade and Industry, 8 October 1996) at 4-5).

A separate regime for closely-held corporations has never really taken root in the United States; it was specifically rejected in Canada in 1975 (although there may now be second thoughts). The main reason given for this is the fairly straightforward nature and flexibility of the general corporations law regimes which can accommodate both public and non-public corporations (and which do not contain detailed provisions with respect to regulation of capital market activities). For example, many of the features of the South African Close Corporations Act of 1984 were already standard provisions in the general business corporations statutes in North America. The view is that, provided the general corporations law is flexible enough, with accommodations made on a functional basis for closely-held corporations, the advantages of a single system outweigh any to be gained from the creation of parallel specialised regimes. New Zealand recently found these views persuasive in implementing its Companies Act 1993.

Professor Sealy, in his consultations with this Review, has expressed similar observations.

> 1. Extracting from the main Act those parts which apply to private companies, and enacting them as separate legislation
>
> This has been mooted by some as a way of making the law governing small companies less bulky and more accessible to those who use it. I did a count of sections and pages and I think I concluded that the end result would still be about two-thirds as long as the present Act. It is a poor option, perpetuating everything that's wrong with the law as it now is. Of course, since Hong Kong is planning a new 'main' Act, we can assume that there won't be anything wrong with it! But this suggestion was made on the assumption that there would be no new general Companies Act in the U.K. (Letter of Len Sealy to Cally Jordan (2 February 1996)).

An additional concern to that of the duplication and overlap of two separate regimes is the administrative complexity imposed. As well, there is the danger that introduction of a specialised regime would preclude overhaul of the general companies law, in effect constituting a half measure, as is the case in South Africa.

The characteristics of private companies/closely held corporations are remarkably similar across jurisdictions.

> The following factors generally characterize a closely-held corporation: (1) a small number of shareholders; (2) lack of a public trading market for the corporation's stock; (3) a close relation between management and at least the principal shareholders; (4) a personal relationship among all or some of the shareholders; (5) shareholder knowledge about the corporation; (6) shareholder desire to exert some control over the corporate voting process; and (7) an informality in day-to-day management of the corporation. Also, due to the informality and personal relationships often existing within the close corporation, most legal arrangements between the various corporate actors will, unfortunately, be oral (J.J. Norton, "Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas" (1985) 39 Southwestern L.J. 781 at 785).

Attached for reference purposes as Appendix 6 is a chart drawn from the Canada Business Corporations Act Discussion Paper on Unanimous Shareholder Agreements (April 1996) which provides a useful comparison of the characteristics of public companies and closely held corporations.

The Small and Medium Sized Enterprise Committee of the Hong Kong General Chamber of Commerce in its submission to Working Party 2 was particularly concerned with the companies law regime applicable to its constituents. The current Ordinance was criticised as being inappropriate and inadequate to meet the needs of small and medium sized business. The particular characteristics of the vast majority of Hong Kong business were outlined: owner-managed/proprietary companies/quasi-partnerships; shareholders closely related family members; relatively unsophisticated with respect to companies formalities to assure statutory compliance. The companies were generally under-capitalized and, unlike other jurisdictions, the tax benefits of incorporation were minimal. As noted above in Part VII, the characteristics of the vast majority of Hong Kong businesses are strikingly similar to those in many other jurisdictions where family owned businesses are still the rule.

In its submission, the Small and Medium Sized Enterprise Committee outlined a wish list: small businesses in Hong Kong wanted one step incorporation; one shareholder/one director companies; one constitutional document; a model shareholders agreement; abolition of the distinction between authorised and paid up capital; option for the shareholders to eliminate the board of directors; optional annual general meeting of shareholders; non-mandatory audit; optional corporate seal; built-in dispute resolution mechanisms for deadlock and minority protection without the necessity for court intervention or winding up; full legal capacity and the abolition of the *ultra vires* doctrine; creditor protection but not transparency; obligatory returns to the Companies Registry being kept to a minimum; directors to be personally liable for wilfully defrauding creditors; and simple dissolution procedures and deregistration for persistent non-compliance with the Ordinance (*Report on consultations with the Small & Medium Enterprises Committee (Hong Kong General Chamber of Commerce) Review of Companies Ordinance*, submission by Phyllis K.Y. Kwong, Phyllis K.Y. Kwong & Leung (Solicitors), to Working Party 2 (15 February 1996)).

Nearly ninety-nine percent of companies incorporated in Hong Kong are private companies. A comment from a working party member is useful to note here. If the vast majority of companies incorporated are private or closely-held, should not recommendations for a new Ordinance focus on creating legislation specifically adapted to such companies? A separate part might be devoted to those aspects which are unique to companies with public shareholders. This approach is, in fact, what is being proposed, but in a different guise.

The new Ordinance being proposed is largely devoid of those more traditional aspects of public company law found in U.K.-style statutes. Many of these provisions have been recharacterised as properly pertaining to the capital markets activities of companies and more appropriately dealt with by the SFC and the Stock Exchange. A great many of the remaining provisions of "core company law" are equally applicable to public and private companies.

10.02 RECOMMENDATION: Purpose of legislative provisions. The purpose of legislative provisions specifically applicable to private companies/closely held

corporations should be to facilitate the creation of incorporated entities that, for internal purposes, function like partnerships or sole proprietorships.

CURRENT ORDINANCE: In the Ordinance there are several specific provisions applicable to private companies, for example:

- there is a definition of what constitutes a private company (s.29);
- Part II of Table A provides default articles that are applicable to private companies (sch. 1);
- there are special provisions applicable to private companies for the redemption or purchase of their shares out of capital (ss.49I-49O);
- if all shareholders agree, private companies can exempt themselves from keeping full accounts in accordance with the Tenth Schedule and keep their accounts in accordance with the Eleventh Schedule which is much shorter than the Tenth Schedule (s.141D);
- private companies are exempted from the requirements of the Fourth Schedule (s.43);
- private companies are exempted from filing certified copies of their accounts with the Companies Registry (s.109).

COMMENTARY: The attractions of limited liability and separate legal personality appeal to business enterprises large and small, closely-held and publicly-held. Some commentators have raised the issues of the illusory nature of limited liability for small incorporated enterprises and possible abuses of legal personality (A. Hicks, R. Drury & J. Smallcombe, The Chartered Association of Certified Accountants (ACCA), *Alternative Company Structures for the Small Business* (Research Report No. 42) (London: Certified Accountants Educational Trust, 1995)). It remains the case however that many small (and not so small) enterprises will choose incorporation over partnership as the vehicle for conducting their affairs, for a variety of reasons. There would seem to be no compelling reasons for fettering the ability to make such a choice. In many civil law jurisdictions, partnership-like business entities have long been recognised as having legal personality. Neither should limited liability prove a stumbling block provided third parties are given adequate protection.

The concept of the "incorporated partnership" is widely accepted in the United States. Inspired primarily by the approach in Delaware, the concept now underpins the Model Statutory Close Corporation Supplement to the MBCA:

> This section authorizes the shareholders to make any agreement they wish regulating the business of the corporation and their relationship to one another and to the corporation [...] All the shareholders must enter into the agreement and, if the agreement specifies that the corporation is not to have a board of directors or that one or more shareholders is to have a special right to dissolve the corporation, the articles of incorporation must include appropriate language authorizing these provisions [...] A shareholder agreement is valid and enforceable under this section [s.20] even if it, in effect, permits the business to be operated essentially as a partnership without a board of directors... Close corporations in which most or all of the shareholders are employees of the corporation are often referred to as 'incorporated partnerships'. This section gives legal sanction to the customary arrangements made by the shareholders of these corporations. Section 25 reinforces this concept by providing that shareholder limited liability is to be recognized in spite of an agreement that the corporation is to be operated essentially as a partnership (MSCCS, Official Comment, s.20).

The aspect of the "incorporated partnership" concept that is structurally most significant is the ability to eliminate the board of directors and the use of bylaws (the non-registered equivalent of articles of association).

> Since the type of shareholder agreement contemplated by section 20 includes much of the information normally included in bylaws, requiring the adoption of bylaws in many cases involves unnecessary duplication. This is particularly true in closely held corporations in

which most or all of the investors are active in the business. These corporations normally operate on an informal basis. The highly structured formalities in typical bylaws, although necessary in larger corporations with numerous shareholders, can be cumbersome when imposed on closely held corporations (MSCCS, Official Comment, s.22).

The ready availability of a simple form of business enterprise which may be incorporated quickly and with little formality is particularly important in Hong Kong. Some professional members of the working parties estimated that 90% of local Hong Kong businesses now choosing to incorporate in the British Virgin Islands would in fact incorporate in Hong Kong if a quick and easy means of incorporation under a modern streamlined regime were available to them.

In other jurisdictions, small local businesses tend to prefer the certainty, familiarity and convenience of incorporation under local law which provides local remedies and recourse to local courts if necessary. Where there is a ready choice and great disparity in the legal regimes on offer, however, local businesses will choose to incorporate under a more modern streamlined regime. This was graphically the case in Canada after the introduction of the modern, streamlined CBCA in 1975 which provided the availability of federal incorporation to all business and was particularly attractive to businesses operating nationally and internationally across provincial and national borders. Ontario virtually immediately harmonised its provincial incorporation statute (and coordinated it with its securities legislation) and retained its volume of incorporations. The province of Quebec did not, keeping in place an ancient letters patent incorporation statute modelled on the U.K. Companies Act 1862. The flood of Quebec businesses incorporating federally rather than provincially after 1975 was such that the federal Government substantially raised incorporation fees to discourage small Quebec-based businesses from incorporating federally. The Quebec Government hastily enacted legislation based on the federal model.

Given the particular circumstances of Hong Kong, where it has been estimated that there may be as many as 100,000 British Virgin Island incorporations of small local business concerns, providing a more flexible local form of incorporation that permits private companies to function like partnerships or sole proprietorships is highly desirable.

10.03 RECOMMENDATION: Statutory definition. There should be a statutory definition of or conditions to be met for private companies/closely held corporations.

CURRENT ORDINANCE: A private company is defined by statute as a company which by its articles:

- restricts the right to transfer its shares; and
- limits the number of shareholders to 50;
- prohibits any invitation to the public to subscribe for any shares or debentures in the company (s.29).

COMMENTARY: In formulating provisions which may be uniquely applicable to private companies/closely held corporations, the question arises as to determining what is a private company/closely held corporation. One of the oldest definitions of "private company", that introduced by the U.K. Companies Act 1907, is still current today, notably in North America although not in the United Kingdom (which has had to conform to European Commission Directives in this regard). The traditional definition states that a private company is one in which (1) the right to transfer its shares is restricted; (2) the number of

its shareholders (with certain exceptions such as shareholders who are employees) is limited to not more than fifty (in some jurisdictions, thirty); and (3) offers of its securities to the public are prohibited. Of the three elements of this traditional definition, the last is now likely unnecessary given the separation of company law and securities regulation which has occurred in many jurisdictions. The traditional definition appears in the current Hong Kong Companies Ordinance and a variation of it in the United States in the MBCA, the Delaware General Corporations Law, and most other state legislation.

The question which has arisen (as it did in the 1962 U.K. Jenkins Report) is whether the distinction, and thus the definition, is necessary. The Jenkins Report recommended abolishing the distinction between the private company and the public company; the recommendation was not adopted. The Canadian Dickerson Report picked up on the same recommendation with more success:

> 36. We have not preserved the traditional private-public corporation dichotomy. Instead, we have defined 'corporation' in different ways in different parts of the Draft Act where it seemed necessary or desirable to create a distinction. Corporations are therefore distinguished on functional rather than on doctrinal grounds. Thus, under Part 13.00, certain corporations will not have to make public their financial statements; in Part 12.00 some corporations will not have to solicit proxies from their shareholders, and so on. In each case, the corporations are differentiated according to criteria which are relevant in the circumstances.
>
> 37. It will still be possible for incorporators of corporations to set out in the articles of incorporation those features which have traditionally distinguished 'private' corporations, such as restrictions on the transferability of shares. The realities are unchanged, only the label has been dropped.
>
> 38. At the same time, we have improved the position of those who may wish to have a truly 'private' corporation. By expressly legitimating the device of the unanimous shareholder agreement in Part 11.00 we allow the closely-held corporation to avoid much of the formalism that is not appropriate to it, and to operate, in effect, as a partnership with limited liability. The provisions allowing signed resolutions in lieu of minutes of meetings, for example, have a similar effect (Dickerson Report at paras. 36-38).

As a practical matter, the distinction and the definition lived on in Canada even after implementation of the Dickerson Report recommendation in 1975 in the CBCA. The 1907 definition of private company continues under provincial securities legislation (for purposes of exemption from prospectus and other public filing requirements). The CBCA itself contains a definition of "distributing corporations" (i.e. those which have made a distribution of securities to the public) which perpetuates both the distinction and, de facto, the three elements of the traditional definition. Despite the intellectual appeal of the Dickerson Report approach of distinguishing corporations on "functional grounds", on balance, it seems preferable to include a definition of a private company.

10.04 RECOMMENDATION: Definition of "private company". The traditional definition of "private company" should be retained. A private company has restricted the right to transfer its shares, has limited the number of shareholders to 50 and prohibits any invitation to the public to subscribe for its securities. In addition, a company which by means of a unanimous shareholder agreement abolishes the

distinction between ownership and management, irrespective of number of shareholders, should also fall within the definition.

CURRENT ORDINANCE: The definition of a private company in the Ordinance corresponds to the traditional definition of such an entity (s.29).

COMMENTARY: The utility of a definition of private company is primarily as a drafting technique; it provides the shorthand which permits a highly streamlined set of statutory provisions applicable to private companies (however defined), to operate within the general companies law.

There are advantages to retaining the traditional 1907 definition; its prevalence and longevity attest to the fact that it works; as well, it is a concept well known and understood internationally as well as in Hong Kong. On the other hand, as noted above, the third prong of the definition (offers of securities to the public prohibited) is likely superfluous in some jurisdictions, given the rise of detailed securities law regimes separate from companies law, which "catch" the capital market activities of all companies. Another criticism is the possible arbitrariness of the second prong, the 50 shareholder limit; why not 30 as in Delaware? 10 as in South Africa?

The Canadian federal statute, which abolished the definition of "private company", relies instead on a very elegant concept of unanimous action. Provided there is unanimity in a shareholder agreement, the sometimes artificial distinction between ownership and management can be eliminated. Unanimity provides the outer limit in terms of number of shareholders.

Despite these drawbacks, we would recommend retention of the traditional definition. To the traditional definition we would add those companies, irrespective of number of shareholders, where the shareholders have entered into a unanimous shareholders agreement.

10.05 RECOMMENDATION: Optional regime. A separate part of the new Ordinance should contain an optional regime applicable to private companies/closely held corporations. The regime could be varied in the corporate constitution or by unanimous shareholder agreement. It should contain the following provisions:

- **Standard share transfer restrictions and exceptions (e.g. transfer to trustee in bankruptcy, by operation of law);**
- **Preservation of limited liability despite failure to observe corporate formalities;**
- **No mandatory audit;**
- **Standard form buy-sell and buy back provisions to permit shareholders to leave;**
- **Recourse to mediation or arbitration to resolve shareholder disputes;**
- **Possibility of applying to court for the appointment of a rehabilitative receiver in the event of deadlock, etc.**

CURRENT ORDINANCE: As noted above, Part II of Table A provides standard articles that permit a private company to meet the requirements of the statutory definition of a private company (s.29).

COMMENTARY: It is certainly a debatable issue as to whether a separate part of the Ordinance needs to be dedicated to private companies/closely held corporations if the general regime is streamlined and flexible, and especially if it includes a broad provision with respect to unanimous shareholder agreements applicable to all companies. This is the case with many of the Canadian and American statutes. Professor Sealy is of the view that a separate part of the new Ordinance devoted to private companies/close corporations may simply not be necessary:

> 2. Having a 'main' Act that is 'neutral' as between large and small companies, or even biased towards the small company.
>
> I believe that this may be Hong Kong's best option, following the MBCA, New Zealand and Canadian models. There could then be either separate legislation dealing with public issues of securities, insider dealing, etc; or separate Parts of the Act governing such topics. There could be a classification either by reference to size (as in the EC reporting obligations and as currently being proposed for Australia) or by whether securities are on offer to the public, or different criteria for each of these different purposes. It would also be possible to have another separate Part confined in its application to 'small' companies (or close corporations, however defined) which (eg) allowed them to dispense with directors and have a one-tier management structure (in effect, an incorporated partnership); but I rather think that if the 'main' Act is drafted in a sufficiently enabling style this may not be necessary.
>
> [...]
>
> 4. A close corporation supplement.
>
> This is in effect what has already been suggested in (2) above. What the MBCA supplement could be useful for - even if we don't enact a counterpart - is as a check-list to see what sort of things a small company ought to be allowed to do, and to see that whatever legislation is eventually enacted for Hong Kong permits companies to do all these things, or at least all those that the legislators consider desirable (Letter of Professor Len Sealy to Cally Jordan (2 February 1996)).

Both Delaware, in Subchapter XIV, "Close Corporations; Special Provisions", and the MBCA, in the Model Statutory Close Corporation Supplement, have adopted separate close corporation parts in what is termed, rather incongruously, the "integrated" approach. As noted above, the majority of U.S. state corporations laws do not have a separate chapter devoted to the close corporation, but rather, have provisions specifically relating to them sprinkled throughout the relevant acts.

The interesting observation in the United States is that despite the intellectual appeal of gathering together in one part of the statute all those provisions which might apply specifically to close corporations, the elective regimes provided by these separate chapters are rarely used, either in Delaware or in states adopting the MSCCS. An empirical study conducted in Wisconsin, for example, shortly after adoption of the MSCCS there, revealed that of the 1000 articles of incorporation filed in the 14 months following the effective date of the legislation, only 5% had elected close corporation status. Data from other states confirmed this phenomenon, even after years of availability of the MSCCS (see M. Harris, "Comment, Assessing the Utility of Wisconsin's Close Corporation Statute: An Empirical Study" (1986) Wis. L. Rev. 811 at 827-8).

There have been any number of explanations given for this in the academic commentaries. The flexibility of the general corporations statutes in the United States makes recourse to a specialised close corporations regime not especially attractive. The "opt in" feature of these regimes (where they must be elected) lowers their usage. The MSCCS is too cumbersome and complicated an overlay to the general statute.

Despite this experience in the United States, it may still be advantageous in Hong Kong to put together in a separate part of the Ordinance provisions with respect to private companies/closely held corporations. For one thing, the "opt in" feature, conforming constitution documents to the definition of private company, is a well established practice which should not encounter the resistance it may have in the United States. A cumbersome and complicated overlay could also be avoided, as Professor Sealy suggests, by looking to the MSCCS as a checklist of features to draw from rather than as a drafting model.

As noted above, there are certain reservations among the commentators as to the necessity of a separate regime or part applicable exclusively to private companies/closely-held corporations, especially in the United States. Professor Norton in his article cited above doubts the overall utility, especially where there is the great latitude to order internal affairs by means of a unanimous shareholder agreement, such as exemplified by s.7.32 MBCA. He sees an advantage primarily in three situations: 1) one or two person corporations; 2) where certain aspects of a unanimous shareholder agreement might be subject to attack as against public policy; and 3) where a client cannot maintain corporate formalities (at 789). He has further concerns that protection of minority shareholders may not be adequately dealt with and that fiduciary duties might be diluted.

The empirical study cited above identified two main uses for close corporations. The first was the enterprise operating with little detailed planning on the basis of informal "handshake deals", often among family members, relying on family allegiances, and often dominated by one or more forceful personalities. These corporations could benefit from streamlined constitutional documents that permitted incorporation with minimal drafting effort (and which could provide ready-made minority protections and dispute resolution mechanisms). The other use for the close corporation was for more sophisticated business enterprises which engaged in formal corporate planning but wished to tailor normal corporate structures to meet their specific needs. Arguably, a special regime such as the MSCCS, which applies to the extent not varied, would be attractive to the first type of enterprise and the more sophisticated enterprise could achieve its ends by use of unanimous shareholder agreements such as provided for in the general corporate law regime in s.7.32 MBCA.

Recommendations 10.05 and 10.06 are based in large measure on the MSCCS which itself was inspired by Delaware. The conceptual underpinning of the approach is the ability to operate essentially as a partnership but with the benefits of an incorporated entity. Care has thus been taken, in providing for great contractual freedom, to ensure that the protections of limited liability are maintained.

10.06 Recommendation: Possibility of Eliminating Corporate Formalities. Private companies/closely held corporations should be able, by unanimous shareholders agreement or in their constitution, to eliminate certain corporate formalities and

otherwise derogate from standard statutory provisions:

- **no need to have an annual meeting of shareholders unless requested by a shareholder;**
- **no need to have separate bylaws/articles of association if constitution and statute sufficient;**
- **ability to choose limited corporate life if desired;**
- **possibility of dissolution at the request of a shareholder (or certain % of shareholders) or upon the occurrence of a specified event;**
- **elimination of board of directors;**
- **restriction of discretion or powers of the board or weighted voting rights;**
- **operation of enterprise as if a partnership among shareholders;**
- **creation of relationship among shareholders that would otherwise be only appropriate among partners.**

Current Ordinance: Not applicable.

COMMENTARY: As with Recommendation 10.05, this Recommendation serves to further the goal of permitting private companies/closely held corporations to function like a partnership should they so choose, without the layers of corporate formality. The provisions would permit deviation from such standard principles of company law as the requirement that there be an annual general meeting of shareholders. Private companies/closely held corporations would also be able to choose certain structural techniques that serve as dispute resolution mechanisms which do not require judicial intervention, for example, the ability to dissolve the company upon the occurrence of a specified event.

Dispute resolution is a primary concern of private companies. The legislation should encourage the use of a range of primarily non-judicial dispute resolution techniques. The experience in the United States provides ample inspiration in this regard. These provisions are designed to break a deadlock through transfer of shareholdings, or otherwise, without recourse to judicial action, and look to dissolution and liquidation only as a last resort. Two aspects of the optional dispute resolution mechanisms in the recommendation do, however, cut across traditional corporate law givens, namely perpetual existence and the impossibility of dissolution at will or upon the occurrence of a specified event. Perpetual existence and the formalities associated with dissolution provide stability and certainty to the corporate form. They are often cited as contributing to its success as a form of business entity and its superiority to partnership. It may very well be worth retaining them. [...]In addition to the optional provisions above, which provide an alternative to judicial recourse in the event of disputes, there is an array of other contractual dispute resolution mechanisms which may be included in a unanimous shareholder agreement.

The unanimous shareholders agreement is key to the operation of these recommendations, functioning as it does very much like a partnership agreement. The most significant aspect of the above provisions, of course, is the ability to eliminate the board of directors. As radical as this may appear, it is not a new concept. Even under older formulations of the unanimous shareholder provisions such as in the CBCA, it was possible to in effect operate without a board of directors. The South African Close Corporations Act of 1984 simply eliminated the board of directors for all close corporations. These provisions

merely reflect the reality of private companies/close held corporations where there may not be a separation of ownership and management. The above provisions do not, as do the South African, create a new form of boardless entity; rather they provide for it as an option for the private company/closely-held corporation. There may be situations where some degree of separation of management and ownership is desirable.

11.00 FOREIGN CORPORATIONS / OVERSEA COMPANIES

11.00 FOREIGN CORPORATIONS / OVERSEA COMPANIES

11.01 RECOMMENDATION: Conflict of laws rule. For purposes of the new Ordinance, the traditional common law conflict of laws rule applicable to companies, i.e. that their creation, internal affairs, and termination are governed by the law of their place of incorporation, should be respected.

CURRENT ORDINANCE: Not specifically stated.

COMMENTARY: Two provisions of the Terms of Reference apply specifically to foreign companies in Hong Kong and international business companies:

> [C]onsider and make recommendations on the following matters: -...
>
> C. Whether Part XI of the Ordinance is sufficient to regulate the activities of companies incorporated overseas with a place of business in Hong Kong.
>
> D. The relevance with respect to Hong Kong of the development of international business companies.

Part XI of the Companies Ordinance applies to "oversea companies", companies incorporated outside Hong Kong and which "establish a place of business in Hong Kong" (s.332). It imposes registration requirements and the filing of certain information with the Registrar of Companies in Hong Kong. The provisions of Part XI are of fairly ancient vintage.

In addition, throughout the Ordinance are provisions which are made expressly or impliedly applicable to foreign incorporated companies, albeit not in an entirely consistent manner (see, e.g., Part III - Registration of charges, Part IV - Production of books and records, investigations, Part IVA - Disqualification of directors, Part X - Winding-up of unregistered foreign companies, Part XII - Restrictions on sale and offer of shares for sale).

Most jurisdictions impose various registration requirements with respect to the operations of foreign-incorporated companies operating or having a presence within their territorial limits. In federal states, these requirements are often applied domestically as well as internationally. With respect to the international operations of companies, the traditional common law conflict of laws rule which determines the law applicable to the creation, internal affairs and termination of such companies, however, is that of the jurisdiction of incorporation, not the jurisdiction in which they may be operating.

Exceptionally, provisions extending the application of local law beyond its borders are found in company statutes, even with respect to what would normally be considered the internal affairs of a foreign incorporated company; usually these provisions are directed to the protection of local interests: creditors, shareholders, employees within the territory. Such local provisions may very well create a conflict with the rules applicable to the foreign company under its jurisdiction of incorporation. In addition, provisions purporting to have an extraterritorial effect are at odds with the usual presumption that legislatures, when enacting legislation, do not intend its application to extend beyond national boundaries.

What are conflict of laws rules, how do they work and why are they of significance to the Companies Ordinance? Conflict of laws rules, or private international law, as it is also known, is the body of law in a given jurisdiction that in private cases presenting a material foreign element or connection will:

1) determine before the courts of which jurisdiction such a case should be heard; and

2) the substantive law of which jurisdiction is to be applied to the issues raised in the case.

A court may very well determine that it has jurisdiction to hear a case (on the basis of a significant connection to the jurisdiction) and yet, under its own conflict of laws rules, determine that a foreign substantive law should be applied to the issues before it.

Assuming jurisdiction is established, a court will usually proceed in two separate steps, the first determining or "characterising" the foreign issue before it, and the second, based on the characterisation of the issue, determining the law applicable to resolve it. For example, if a court characterises the issue as one of contract then it will look to the conflict of laws rules to determine the substantive law of which jurisdiction to apply to the contract. This will usually be the "proper law of the contract", the choice of law made by the parties themselves in the contract, for example. Thus it would not be unusual to find a Hong Kong court, having jurisdiction, resolving a contractual dispute under Australian or Canadian law, the proper law of the contract, if that were the choice of law specified in the contract.

The first step of the process, characterisation of the issue, is obviously crucial to the second step. An issue which is "mischaracterised" may have applied to it the substantive law of an inappropriate jurisdiction. For example, if an issue is characterised as one of insolvency, the substantive law applicable to resolve the issue may be quite different than if the issue were characterised as one of company law.

The significance of this two-step process for the Companies Ordinance is important in the light of the recommendations made in the first stage of this Review; that a new Companies Ordinance concentrate on "core company law" and that certain existing provisions, which could be more properly characterised as pertaining to securities regulation, insolvency and the creation of security interests in personal property, be removed. Characterisation as a company law issue for conflict of laws purposes may lead to the application of the substantive law of the place of incorporation, which may in fact be quite inappropriate.

To overcome the application of a clearly inappropriate substantive law in certain areas, Hong Kong has resorted to company law provisions which "override" the traditional conflict of laws rule and require the resolution of issues under Hong Kong law, irrespective of the law of the place of incorporation. This in fact produces the right result in some circumstances. Hong Kong law should apply to protect local public investors and the integrity of local capital markets (the traditional domain of securities regulation), and to protect local creditors in the event of insolvency or with respect to security interests created in property in Hong Kong. Unfortunately, the result is obtained through resort to the

creation of rules appearing to have extraterritorial effect and which entail all the difficulties associated with such rules (discussed in greater detail below).

With the removal of these provisions from core company law and their proper characterisation for conflict of laws purposes, it would no longer be necessary to create in the company legislation rules of purported extraterritorial effect which "override" the traditional conflict of laws rule based on place of incorporation. For example, it would no longer be necessary to have provisions in the Companies Ordinance with respect to the "winding up" of oversea companies and so avoid a possible conflict with the law of the jurisdiction of incorporation which may not recognise the Hong Kong winding up cast in such terms. Protection of assets within the jurisdiction for the benefit of local creditors of a foreign incorporated company would be dealt with in the insolvency legislation and according to conflict of laws rules applicable to insolvency, the operation of which may have a greater chance of being recognised by a foreign jurisdiction.

With respect to the internal affairs of the company, the traditional conflict of laws rule, which points to the application of the law of the place of incorporation would, thus, in most cases be quite appropriate for core company law purposes. This conflict of laws rule is not universal however (see discussion below of civil law jurisdictions and certain U.S. jurisdictions) but it does have several virtues. It is quite simple and, in a complex area such as conflict of laws, provides certainty and predictability as to the law applicable to a given issue. This may have been one of the initial attractions in the United Kingdom to adoption of this conflict of laws rule; it would assure the applicability of U.K. law for most purposes to U.K. companies operating in the overseas Empire (see D. Tzouganatos, "Private International Law as a Means to Control the Multinational Enterprise" (1986) 19 Vanderbilt J. of Transnational Law 477 at 479). Simplicity of application and certainty of result are still compelling factors in commercial matters.

Freedom of choice as to jurisdiction of incorporation (with the certainty that the laws of that jurisdiction will apply) is also consonant with the principles applicable in other areas of international commercial dealing, such as contract.

> The incorporation theory's flexibility is both its primary strength and most significant weakness. An enterprise's freedom to choose the law of any country to govern its corporate affairs, without also being required to have any real contact with the country of incorporation and without having to confront the problem of its recognition as a legal entity by the states in which it conducts its business activities, guarantees to the enterprise a great deal of entrepreneurial choice and certainty of law [...] The unlimited "freedom to choose", however, can also be misused to circumvent unpleasant laws of the host state (*ibid.* at 480 - 481).

Comments have been made to the effect that the Ordinance should override the laws of the place of incorporation, for example in the interests of discouraging international money laundering. Other concerns have been expressed with respect to the prevalence of the use by Hong Kong businesses of jurisdictions of convenience for incorporation (most notably, Bermuda for listed companies and the British Virgin Islands for private companies). With respect to legislative responses to issues such as the use of overseas incorporation to mask illegal activity such as money laundering, the better argument would be to deal with these issues elsewhere than in the Companies Ordinance; they raise concerns which, strictly

speaking, are not inherent in core company law. As for the implications of the proliferation of international business companies in Hong Kong, they are discussed below.

Not all jurisdictions look to the law of the place of incorporation to govern internal company matters. In some countries belonging to the civil law tradition a different doctrine, termed the "effective seat" or corporate seat theory, is followed:

> The effective seat theory is of more recent origin. It was developed mainly in France and Germany during the nineteenth century...The corporate seat concept has been defined in two different ways. The first regards the corporation as centred at the place at which it "carries on the manufacturing, trading, or other activities indicated in [its] charter [siege d'exploitation]." The second focuses on the corporation's place of central administration, that is the place from which its operations are directed and policy controlled (siège réel, siège social).
>
> Although France applied the first corporate seat theory initially, most Continental-European countries now regard the site of the corporate headquarters as the determining factor in locating the corporation (*ibid.* at 480).

The attraction of this conflict of laws rule for jurisdictions where company laws are particularly stringent, or which contain burdensome requirements designed to further government policies, is clear; it prevents local business people from avoiding the requirements imposed upon companies incorporated in their home jurisdiction by choosing to incorporate in another jurisdiction. A case in point is Germany, where company law imposes significant employee board representation requirements on larger companies. There the academic debate over the seat theory has been intense (see generally Tzouganatos, *supra*).

One issue of significance should be noted here. United States legislation has historically had a bias in favour of extraterritorial effect, to the extent that it has prompted international rebukes and the implementation in many jurisdictions of "blocking" statutes to preclude compliance with U.S. law outside the United States. Several U.S. states, New York and California in particular, apply provisions of their domestic company law to the internal affairs of foreign-incorporated companies with a presence in their jurisdictions, giving rise to great potential conflicts with the laws applicable abroad. For example, California will apply its rules governing voting rights to the shares of many foreign incorporated companies held by California residents. New York applies the New York Business Corporation Law generally to all companies operating in New York unless they meet certain criteria that establish that they are sufficiently foreign or otherwise worthy of exemption. In effect, both New York and California are ignoring the place of incorporation conflict of laws rule in favour of their own modified version of the "seat theory".

On balance, it appears preferable to continue to recognise the place of incorporation as the conflict of laws rule in Hong Kong with respect to the creation, internal affairs and termination of companies and eschew the inclusion in the Ordinance of provisions which purport to have an extraterritorial application. The traditional rule is consistent with Hong Kong's general openness to foreign business and its policies to promote entrepreneurial activity and freedom of choice in commercial dealings. Obviously, where there is a high degree of local public interest, such as health and safety concerns, worker protection and the like, domestic legislation will apply to the activities of foreign incorporated companies, but

these are not core company law issues per se and are unlikely to involve questions of the creation, internal affairs and termination of the company.

11.02 RECOMMENDATION: No extraterritorial effect. As a general principle, the new Ordinance should not contain provisions having an extraterritorial effect.

CURRENT ORDINANCE: The Ordinance has several provisions that may have an extraterritorial effect:

- registration of charges (Part III, s.91);
- production of books and records, investigations (ss.143-150);
- disqualification of directors (ss.168C, 168H, 168I);
- winding up of unregistered foreign companies (Part V, ss.169-296, Part VI, ss. 297-302A, Part X, ss.326-331A);
- restrictions on sale of shares and offers for share for sale (Part XII, s.342).

COMMENTARY: A corollary of the recognition of the law of the place of incorporation as governing the creation, internal operation and termination of a company is the exercise of restraint in the use of provisions having an extraterritorial effect in domestic companies law. The use of extraterritorial legislation can be indicative of several situations: a highly protectionist or interventionist economy; economic or political imperialism; or simply, as it appears to be the case currently in Hong Kong, inappropriate characterisation, from a private international law point of view, of certain legal issues.

The United States is often castigated as deliberately enacting legislation purporting to have an extraterritorial effect, but it is not alone. In company law matters, Australia, for example, on both interventionist and possibly protectionist grounds, has enacted provisions purporting to have broad extraterritorial effect. The extraterritorial application of the substantive provisions of the Australian Corporations Law is, as one commentator put it, "far from clear" (J. Albrechtsen, "Extraterritorial Application of the Corporations Law - A Case for Reform" (1994) 12 Company and Securities Law Journal 476 at 476). Two provisions, sections 110D and 1313A, grant the Corporations Law an extraterritorial application that is potentially enormous, depending upon the interpretation given. Thus, the full extent of the extraterritorial application of the Australian Corporations Law remains uncertain. There has been a suggestion made that this particular aspect of the law has suffered from neglect on the part of Australian legislators, and that it is in dire need of reform (see generally, Albrechtsen, *supra*).

The difficulty with such provisions lies in their relative ineffectiveness. They will almost invariably cause potential conflicts with the laws applicable to the same situation in the foreign jurisdiction. Unless associated with the political or economic might of a country like the United States, they will be at best ignored and at worst the subject of a diplomatic tiff. They are not suited to small jurisdictions dependent on international trading for their survival. With the rise in international commerce and competing economic and political blocs, even the United States has had to moderate some of its extraterritorial legislation.

Under the current Ordinance, apart from the requirements of Part XI, there are five main areas of concern prompting an extraterritorial response: (i) shareholders' remedies, (ii) disqualification of directors; (iii) charges; (iv) winding-up; and (v) investigations and production of records. These concerns arise primarily because of the international character

of Hong Kong business and the high incidence of Hong Kong businesses choosing to incorporate outside Hong Kong (a phenomenon somewhat at odds with the usual preference for local incorporation by local businesses in other jurisdictions).

The result is that many foreign incorporated businesses in Hong Kong are in fact very local, with operations, assets, management and shareholders in Hong Kong. Barely 1,000 BVI companies are registered as oversea companies under Part XI of the Companies Ordinance, but Professor Phillip Smart observes that there may be as many as 100,000 actually operating locally (Preliminary Discussion Paper -- Foreign/International Business Corporations (Professor Philip Smart) (June 1996)). When difficulties arise, the first port of call is local Hong Kong law, thus prompting suggestions that substantive remedies be available locally under the Ordinance rather than looking to the law of the place of incorporation. This response, certainly justifiable in the interests of local creditors and public investors, would cause unnecessary complexity and logical inconsistencies in the new Ordinance.

It should be noted in this regard that in these circumstances there should be no impediment to actually getting into a Hong Kong court but that the substantive company law applicable to the dispute may be that of the jurisdiction of incorporation and may not be as favourable as Hong Kong law. The Hong Kong court may also decline to hear a case on the basis of *forum non conveniens* if, in fact, it is being asked to provide a remedy which it is patently not capable of doing, such as directing a foreign companies registrar to strike a company off its register.

(i) Charges - s. 91

To deal with the easiest case first, s.91, on charges. This is an example of unnecessary complexity engendered by a mischaracterisation of the law of "charges" as company law. Obviously, in the interests of local creditors, there should be a public register of security interests granted over Hong Kong assets, irrespective of the nature (i.e. individual or company) or nationality of the owner of the property. The defect is in characterising this as a matter of companies law generally; elsewhere the recommendation has been made to consider creating a separate regime for the registration of all security interests in personal property situated in Hong Kong, irrespective of the nature (i.e. individual or company) or nationality of the owner of the property. This approach would remove Part III of the current Ordinance and the confusion surrounding its application to non-registered oversea companies.

Section 91 of the Ordinance extends Part III (Registration of Charges) to charges on Hong Kong property created or acquired by any company "incorporated outside Hong Kong which has a place of business in Hong Kong". As Professor Smart observes in his paper, because the "place of business" test does not necessarily catch all foreign companies operating in Hong Kong, the registration of charges section must be made applicable to foreign companies whether or not they are registered under Part XI in order to protect local creditors and make some semblance of commercial sense (Smart, *supra* at 11-12). Recourse is had to U.K. jurisprudence in Slavenburg's case (*N.V. Slavenburg's Bank* v. *International Resources Ltd.*, [1980] 1 W.L.R. 1076) to accomplish this. Professor Smart sets forth a fine point of statutory interpretation as well in order to accomplish the same result: the "place of business" definition in section 341 only applies to Part XI (Registration of an oversea

company) and therefore does not restrict the application of a broader test for the purposes of Part III, Charges.

Security interests, charges, on Hong Kong property should be subject to registration and information made publicly available in the interests of Hong Kong creditors, irrespective of the nature or nationality of the owner. This is essential to promote certainty and speed in modern commercial dealings. This has been the primary impetus behind the recommendation of this Review that a separate study be undertaken with a view to the creation of a comprehensive personal property security interest regime.

(ii) Winding-up (Part V, ss.169-296; Part VI, ss.297-302A; Part X, ss.326-331A)

Statutory winding-up provisions have been used variously as a means of creditor protection in cases of insolvency, shareholder protection in the event of deadlock or paralysis of company operations, and as a sanction for various commercial or administrative misdeeds on the part of the company. (The SFC has also used winding-up to protect shareholders of both Hong Kong and foreign incorporated listed companies).

With respect to the use of winding-up procedures as a means of creditor protection in the event of insolvency, the difficulties engendered by their application to foreign companies (whether registered or not) having assets, operations and creditors in Hong Kong should be resolved by its recharacterisation as insolvency law and removal from the Ordinance. In cases of insolvency with substantial connections to Hong Kong, measures for the protection of local creditors are quite justified and would be subject to a comprehensive insolvency regime. Obviously there are thorny issues of competing claims in other jurisdictions, but a sophisticated body of law and practice is developing internationally to deal with these issues.

Emphasis on company law mechanisms as a means of creditor protection may also simply be misplaced. Winding-up is not an ideal creditor protection mechanism; it is a question of too little, too late. Prevention is the best creditor protection and there are numerous commercial practices that Hong Kong creditors employ in the protection of their interests, especially when dealing with foreign incorporated entities (letters of credit, personal guarantees, bonds, collateral in the jurisdiction etc.). Hong Kong is a sophisticated international commercial trading jurisdiction; astute Hong Kong traders can be counted on to effectively protect their interests.

As for winding-up as a sanction for commercial or administrative misdeeds of a foreign company, this can obviously not extend to dissolution or deregistration in a foreign jurisdiction (without the cooperation of that jurisdiction), and such measures are likely to be ineffective. Unsavoury commercial dealings, fraudulent trading, preferences, etc., are not limited to companies (or foreign companies for that matter), and are better dealt with through the regulation of commercial fraud and deceptive practices generally.

Finally, winding-up of unregistered companies on just and equitable grounds (s. 327) is primarily a shareholder remedy of last resort for a private company in cases of deadlock or other situations of commercial paralysis. In instances involving insolvency, this will be dealt with under a comprehensive insolvency regime. Where issues arise in a solvent private

company incorporated offshore, involving a dispute among shareholders, there is no compelling reason for Hong Kong law to provide the substantive solution. If the business is primarily Hong Kong based but the shareholders have chosen to use an offshore jurisdiction of incorporation for purposes of convenience, they should be prepared to live with the consequences of the substantive remedies available to them there.

This is not to say that participants in a primarily Hong Kong based business incorporated offshore should be deprived of access to the Hong Kong courts. (On the contrary, use of the Hong Kong judicial system as a regional judicial system for Asia should be encouraged). Where there are substantial connections to Hong Kong, for the convenience of the parties involved, disputes should be easily brought before Hong Kong courts; the substantive law applicable to resolution of these disputes does not necessarily have to be Hong Kong law, however (see discussion above). Foreign law is proved by means of expert testimony and Hong Kong has a plethora of eager foreign law experts available locally.

(iii) Shareholder Disputes

The unfortunate rule in *Foss* v. *Harbottle*, the basis of the common law derivative action by shareholders on behalf of the company, has some equally unfortunate consequences for Hong Kong shareholders of offshore companies. Having been characterised as a procedural rule by the U.K. courts (and one thus applicable in the United Kingdom to foreign companies by virtue of the conflict of laws rules which state that matters of procedure are governed by the law of the place of the litigation), it creates an additional hurdle to shareholders of foreign companies trying to get their action before a U.K. court (*Heyting* v. *Dupont* (No. 2), [1964] 1 W.L.R. 843). Not only do they have to have a substantive cause of action in the jurisdiction of incorporation, but in addition they must squeeze themselves within one of the exceptions of an antiquated and roundly criticised piece of early 19th century English case law.

According to Professor Smart, this unfortunate situation has been imported into Hong Kong (Smart, *supra* at 12-13). Arguably, there are two ways of addressing this situation; the first would be by means of an amendment to the rules of procedure which would make it clear that the rule in *Foss* v. *Harbottle* would not be an impediment to local shareholders of a foreign company getting into court should they prefer Hong Kong to the jurisdiction of incorporation. An alternative would be to abolish the rule in *Foss* v. *Harbottle* by including a statutory derivative action in the new Ordinance. This state of affairs may be one of the most compelling justifications for the creation of a statutory derivative action in Hong Kong.

The primary shareholder remedy in the current Ordinance is the unfairly prejudicial remedy (s.168A). Extending its availability to shareholders of foreign incorporated companies has been suggested on several occasions to the SCCLR as an alternative to winding-up. It is likely that the suggestion is driven by the prevalence of Hong Kong based businesses which are foreign incorporated. It should be noted that both California and New York extend to their residents the shareholder protections of local law even where the corporation is foreign; it is done. The better view, however, is that the suggestion should not be adopted. Its extraterritorial reach is unwarranted and unnecessary.

Local shareholders of public and listed foreign companies should be able to look to

Hong Kong securities regulation and listing rules for their remedies. As for private companies, the shareholders have chosen to become members of a company incorporated in a jurisdiction of convenience and should look there for their remedies. Several members of the SCCLR are of this view: management disputes and shareholder unhappiness in foreign private companies should be left to the jurisdiction of incorporation, in deference to the traditional conflicts of law rule. There are no compelling reasons to change this provided that the investing public is adequately protected by securities regulation and listing rules (Hong Kong, SCCLR, 12th Annual Report 1995/1996 (Draft) at 14-15).

(iv) Disqualification of directors

The current provisions governing disqualification orders were introduced by the Companies (Amendment) Ordinance 1994 and came into effect on 1 July 1994. The ordinance repealed sections 157E to 157F which governed such orders and replaced them with a new Part IVA, ss.168C to 168S, entitled Disqualification of Directors. Section 168C(2) makes s.168H, the duty of the court to disqualify unfit directors of insolvent companies, and s.168I, which empowers the Financial Secretary and the Official Receiver to make an application under s.168H, applicable to unregistered foreign incorporated companies. The disqualification of directors provisions in the Ordinance are drawn from the U.K.'s Company Directors Disqualification Act and their effectiveness there, even in a purely domestic context, has been questioned. Who may be a director of a foreign incorporated private company is surely a matter of the internal affairs of the company and best left to the law of the place of incorporation. With respect to public and listed foreign companies, misdeeds of their directors should be addressed elsewhere than in the Ordinance.

(v) Investigations and Production of Books and Records

The use of provisions with extraterritorial effect should be avoided as a general matter except where there is a high degree of local public interest at stake. Whereas most substantive company law matters do not justify the creation of rules of extraterritorial application, investigative powers with respect to local commercial activities are a different matter. Depending on the extent of these investigative powers and the agency exercising them, they should be maintained and made applicable to foreign companies in the interest of fostering a commercial environment of confidence and fair dealing (see existing s.146A derived from s.453 of the U.K. Companies Act 1985). An adjunct to the investigatory powers is the ability to require production of books and records in the course of an investigation (see s.152A). This is certainly a useful tool but, where the books and records are kept offshore, one which may prove difficult to implement. Where such requests are not simply ignored by foreign companies, compliance may in fact be prohibited by the laws of the jurisdiction of incorporation, creating irresolvable conflict. To the extent that many foreign incorporated private companies do keep their books and records in Hong Kong, the provision will be effective.

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By way of comparison, in the United States there are two diametrically opposed approaches to the use of companies legislation with extraterritorial effect. On the one hand,

the RMBCA does not include extraterritorial provisions. It is a model act, a statement of corporate law in a fairly pure form. Section 15.05 which deals with the effects of the issuance of a certificate of authority (analogous to registration) to foreign corporations, states: "[...] (c) This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state" (MBCA, s.15.05)

The Official Comment to this provision states that it "preserves the judicially developed doctrine that internal corporate affairs are governed by the state of incorporation even when the corporation's business and assets are located primarily in other States". The MBCA has rejected the "quasi-domestic corporation concept established by section 2115 of the California Corporations Code" (MBCA, Official Comment, Historical Background, s. 15.05). It should be noted that the major commercial states of New York, Delaware and California do not follow the MBCA; it is used by states of lesser economic significance which may not be able to impose extraterritorial provisions on other jurisdictions.

New York and California have a broad range of extraterritorial provisions in their corporations laws. New York applies its domestic corporate regime to foreign corporations in situations where the conflict of law rules would normally lead to the application of foreign law. While California's approach is based on a test to determine a substantial presence in California, New York simply applies a large body of provisions to all companies transacting business within its borders, subject to exclusions based on the number of connections to New York or the applicability of other domestic statutory regimes such as federal securities laws.

The provisions of the New York Business Corporations Law which are automatically applicable to non-exempt foreign companies (and their directors, officers, and shareholders) are those governing:

- voting trust records
- directors' and officers' liability
- actions for directors' and officers' misconduct
- liability on the part of the corporation for failure to disclose information regarding

  - dividends or distributions of cash or property
  - share distribution and changes
  - reacquired shares
  - some reductions of stated capital
  - certain provisions concerning surplus or reserves

- enforcement of shareholders' right to receive payment for shares
- statutory derivative action and security for shareholders' expenses associated with derivative actions
- indemnification and insurance of directors and officers
- merger with a domestic corporation (ss. 1316-1319).

Section 1320 lays out the exemption criteria. A corporation which is either listed on a national U.S. securities exchange or which has less than one-half of its business income allocable to New York for franchise tax purposes, is exempted from the following provisions:

- voting trust records
- directors' and officers' liability
- liability for failure to disclose
- insurance and indemnification of directors and officers.

Thus, although it is possible to exempt a foreign-incorporated company from the bulk of the domestic New York corporations statute, some provisions will still remain applicable, notably those pertaining to shareholder actions.

As for California, the California Corporations Code displays a great deal of idiosyncrasy in its treatment of foreign corporations. This is due in part to the existence of certain provisions designed to facilitate application of a controversial unitary taxation scheme to foreign corporations and which is reflected in its application of domestic corporate governance provisions to foreign corporations.

Foreign corporations with a significant California presence meeting certain criteria will be subjected to a remarkably large number of the provisions that normally govern domestic corporations, *to the exclusion of the law of the jurisdiction of incorporation* (see California Corporations Code, s.2115). The application criteria are set out in a bipartite test based on 1) assets and revenues and 2) share holdings in California. Corporations with property, payroll, and sales factors in California exceeding 50% of world-wide income and more than half of the voting securities of which are concentrated in Californian hands are caught. There are some exceptions; s.2115 does not apply to corporations listed on the New York Stock Exchange, American Stock Exchange, or to companies with more than 800 shareholders traded on NASDAQ, the major over-the-counter market. Section 2115 applies the following provisions to non-exempt foreign corporations:

- annual election of directors
- removal of directors without cause
- removal of directors by court proceeding (not analogous to disqualification; this is done in cases of fraud, dishonesty, or abuse of authority)
- directors' standard of care
- much of the section governing directors' liability for unlawful distributions
- indemnification of directors and officers
- limits on corporate distributions or sales of assets
- shareholder liability for receipt of unlawful distribution
- annual shareholders' meeting
- cumulative shareholder voting provisions
- certain super majority voting requirements
- limits on mergers and reorganizations
- appraisal remedy
- record keeping and reporting
- inspection rights

The effect of s.2115 can be likened to forcible continuance into California; the MBCA commentary refers to "quasi-domestic" corporations law. California law will apply regardless of the targeted company's jurisdiction of incorporation, or location of its corporate

seat. As corporate legislation with an extraterritorial effect, it is astonishingly aggressive.

In addition, the California Corporations Code goes even further; s.2115 is followed by a provision stating that California courts may, with regard to foreign corporations transacting intrastate business, hold directors liable to the corporation and its shareholders and creditors under California law or that of its jurisdiction of incorporation for the following breaches of directors' duties, regardless of where the breach of duty took place:

- unauthorised dividends
- unauthorised purchase of shares or distribution of assets
- falsification of certificates, reports, or notices
- any other "violation of official duty"

This provision is drafted so as to be applicable to all foreign corporations; the exemption at s.2115 does not apply.

Thus, a foreign corporation transacting intrastate business in California will find its directors subject to certain duties imposed by California law as well as that of its jurisdiction of incorporation. In addition, California's courts will take jurisdiction over the corporation, both with regard to California law and the law of the jurisdiction of incorporation, and should the corporation meet the right criteria, it will suddenly find its internal governance subjected to California law as well.

The suggestions for the inclusion in the new Ordinance of provisions with an extraterritorial effect are primarily motivated by the high incidence of offshore incorporation by local Hong Kong businesses. Although this could very well serve as a justification for the application of Hong Kong companies law to these businesses (under the "seat theory", for example), these concerns can be more appropriately dealt with by other means. In addition, a proliferation of extraterritorial provisions would also indiscriminately, and arguably, unjustifiably, catch truly foreign businesses operating in Hong Kong. There is also the possibility that, as one working party member has put it, these offshore incorporations by Hong Kong businesses are a passing fad. If this is the case, and if a new modern Business Corporations Ordinance makes local incorporation an attractive and convenient alternative to offshore incorporations, then the concerns prompting recourse to extraterritorial measures will diminish.

Provided that protection is given to local investors and creditors by other means, and that investigatory powers remain under the Ordinance with respect to commercial activities in the jurisdiction, there should be little need for provisions with extraterritorial import in the Ordinance. They are not suited to a small jurisdiction dependent upon international trade and are at odds with the open and non-interventionist environment in which business operates in Hong Kong.

In recognition of the reality of offshore incorporation by Hong Kong business, recourse to Hong Kong courts should be readily available where there is a substantial connection to the jurisdiction. In this way, Hong Kong businesses can have the convenience of recourse to their own judicial system for dispute resolution without compromising on the flexibility and certainty provided by offshore incorporation.

There may be other advantages for Hong Kong associated with the use of the Hong Kong judiciary in commercial law dispute resolution in the Asia Pacific region. The judicial system is reputable and the courts experienced in commercial matters. This fact, combined with a modern, efficient companies law may actually serve to promote incorporations in Hong Kong, as has been the case in Delaware in the United States, for example.

11.03 RECOMMENDATION: Threshold of registration. Registration of foreign incorporated companies should be required in Hong Kong but the threshold test should be changed.

CURRENT ORDINANCE: The current trigger for registration under Part XI is the establishment of "a place of business in Hong Kong" (s.332). A "place of business includes: a share transfer or share registration office; and any place used for the manufacture or warehousing of goods (s.341).In 1984 amendment was made to Part XI to "exempt" representative offices from having to register. Since 1984 a "place of business" has been defined as excluding "a place not used by the company to transact any business which creates legal obligations" (s.341).

COMMENTARY: Regardless of whether the process is termed registration, licensing, qualification or issuance of a certificate of authority, companies wishing to maintain a certain profile or transact a certain amount of business in a jurisdiction other than their jurisdiction of incorporation must generally file certain documents in the local jurisdiction. Filing requirements serve three purposes; firstly, they help authorities to monitor the activities of foreign incorporated companies, facilitating their task of ensuring fair dealing in the commercial community; secondly, they protect local creditors and businesses by making available a minimum of information about the company; and thirdly, they give local courts in personam jurisdiction in order to permit lawsuits in the local jurisdiction.

The documents filed usually include:

- a copy of the corporate constitution
- a copy of the certificate of incorporation or equivalent document
- names (and often addresses) of the directors
- name and address of the company's authorised agent in the local jurisdiction
- address of the company's head office in the foreign jurisdiction
- address of the company's main office in the local jurisdiction.

Often, periodic filing requirements, such as annual or material change reports, are applicable to foreign-incorporated companies. Provisions governing permissible names and their reservation or registration are also common.

In general, with regard to registration requirements, there are three issues worth consideration. Firstly, enforcement; there are a variety of approaches to ensure compliance with foreign-incorporated company registration provisions. Some jurisdictions impose fines and penal sanctions; other jurisdictions bar unregistered foreign incorporated companies from maintaining actions in their courts. New York authorities may issue an injunction against a foreign corporation barring it from doing business in New York.

Secondly, there is the question of the extent of the registration requirements. Excessively burdensome registration requirements may prove to be self-defeating as foreign

incorporated companies merely avoid complying with them; it is arguable that this is one of the reasons many foreign incorporated companies in Hong Kong do not register under Part XI. On the other hand, excessively lax requirements may lead to insufficient protection being given to local creditors and shareholders.

Thirdly, there is the question of balance; aside from non-compliance, burdensome or poorly designed provisions may provide impediments to international commercial transactions. Some requirements, such as the filing of stale financial reports, may simply be ineffective as well as burdensome. Provisions with too sensitive a trigger may capture foreign incorporated companies involved in activities that do not justify application of the registration provisions. The New York Business Corporation Law, which specifically exempts isolated transactions, is an example of a statute that takes steps to avoid this problem. On the other hand, lack of oversight is just as undesirable as excessive oversight. The aim of facilitating international business must be balanced with the need to provide some form of effective oversight over the commercial activities of foreign incorporated companies.

The current trigger for registration under Part XI, "establishment of a place of business in Hong Kong", is unsatisfactory in the view of many (including the Hong Kong Bar Association and the Companies Registry). It is an old test dating back to the last century. The criticisms of it are numerous. It is an uncertain test; it is still unclear what constitutes establishing a place of business, although it has been determined that it is different from carrying on business (the threshold test under the Business Registration Ordinance). The filing requirements triggered by the test may have been considered too onerous and a hindrance to business thus prompting the carving out of representative offices from the test. In 1984 amendment was made to Part XI to "exempt" representative offices from having to register. (Since 1984 a "place of business" has been defined as excluding "a place not used by the company to transact any business which creates legal obligations" (s.341). In *Elscint (Asia-Pacific) Ltd.* v. *Commercial Bank of Korea Ltd.* [1994] 3 HKC 365, it was held that a representative office was not required to register under Part XI -- at least so long as the activities undertaken in Hong Kong were limited to promotion, public relations, collection of financial data etc.) It is suspected that, given the uncertainty surrounding the test and the fairly onerous filing requirements, there may be substantial non-compliance.

The "establishment of a place of business" test dates from the 19th century and was appropriate at a time when business was primarily manufacturing and shopkeeping, both of which assumed a physical presence, the "establishment of a place of business". An established place of business permitted service of process and in personam jurisdiction for purposes of suit. This test is patently unsuited to modern business practices in Hong Kong which has, more dramatically than many other jurisdictions, made the transition from a manufacturing based economy to a service economy. When combined with modern telecommunications, physical establishment is less relevant to an active business being conducted within the jurisdiction. In addition, alternative modes of service of process have developed, such as requiring the appointment of an agent within the jurisdiction or the authorisation of service by other means.

Registration should be encouraged in the interests of creditor protection and general oversight of commercial activity in the jurisdiction. The threshold for registration should be low enough to catch most business activity by foreign companies but without being a

hindrance to such activity. A low threshold combined with minimal filing requirements should encourage compliance. Otherwise, the market can be left to monitor registration as is the case now, where banks and other creditors require proof of registration as a condition to doing business.

11.04 RECOMMENDATION: Threshold test. The threshold test of "carrying on business" in the jurisdiction, including both an inclusionary and exclusionary list of what is or is not considered carrying on business, should be adopted for purposes of the new Ordinance.

CURRENT ORDINANCE: See above.

COMMENTARY: The "carrying on business" test casts a wider net than the "establishment of a place of business" and can be structured to provide greater certainty than the latter. The carrying on business test is already found in Hong Kong in the Business Registration Ordinance and is the test now adopted in New Zealand, Australia, and much of North America.

Greater certainty is provided to the test by the inclusion of a list of activities which are considered not to constitute carrying on business. What is included in this list is very much a question for each jurisdiction. For example, in Singapore and Ontario, the holding of real estate is considered carrying on business sufficient to trigger registration. In Singapore, maintaining a share transfer office is considered carrying on business whereas it is specifically excluded from the definition under the MBCA. The inclusion or exclusion of a particular activity within the definition of carrying on business may be in furtherance of policy goals not entirely consonant with simple creditor protection and public notice of economic activities in the jurisdiction. In some cases it accompanies restrictions on foreign ownership of land or is used as a revenue generating measure.

The most generic listing of what would NOT constitute "carrying on business" is found in s.15.01 of the MBCA:

- involvement in a legal proceeding
- holding board or shareholder meetings
- maintaining bank accounts
- maintaining share transfer offices
- sales through independent contractors
- taking orders by mail or through employees or agents if the orders require acceptance outside this state to form contracts
- taking, securing, collecting on or acquiring debts or other security interests
- owning real or personal property;
- conducting an isolated transaction that is completed within 30 days
- transacting business in interstate commerce.

Singapore draws on the MBCA test in s.15.01 and combines it, for good measure, with examples of what DOES constitute carrying on business (for example, managing or dealing in property in Singapore as an agent).

The Monetary Authority has noted that changing the threshold test regarding registration of foreign incorporated companies would catch the local representative offices of foreign banks (LROs). "These LROs are currently not required to be registered as they are already submitting information to the HKMA on a regular basis and some of this information is opened to the public and available in the search office of the HKMA. Hence, if the same documents are required to be filed with the Registrar, there will be duplication of effort. Accordingly, we see no ground to remove this exemption and suggest that LROs of foreign banks be included in the exclusionary list proposed in the recommendations if the new threshold test is incorporated (Letter of Raymond Li, Executive Director (Banking Policy) to Ermanno Pascutto (31 January 1997)).

11.05 RECOMMENDATION: Filing requirements simplified. The filing requirements for registration as a foreign company should be simplified. It should not be necessary to file the company constitution or accounts.

CURRENT ORDINANCE: Various documents of foreign incorporated companies must be filed at the Registrar (ss.333, 335, 336, 337).

COMMENTARY: In the interests of promoting compliance with registration procedures which cast a broader net, non-essential filing information should be eliminated. Foremost among this information is accounts. Despite the exemption for foreign equivalents of the private company, this requirement is unduly burdensome and of little protection for creditors. For companies with public shareholders in Hong Kong, regular and detailed financial information should be required to be filed under securities regulation, not companies law.

The company constitution is another filing document which is likely unnecessary; a certificate of incorporation from the jurisdiction of incorporation should be sufficient. The information which would be made available by the corporate constitution would vary enormously depending on the jurisdiction of incorporation. If there are concerns with respect to *ultra vires* action of foreign corporations, these concerns could more appropriately be addressed as they are in Delaware: a corporate officer must file a certificate indicating the business to be conducted in Delaware and that the corporation is authorised to conduct such business in its home jurisdiction (General Corporation Law of Delaware, s.371 (b)(2)).

An annual filing should be required, indicating any changes to the information originally filed, as well as upon cessation of business or liquidation in the home jurisdiction.

11.06 RECOMMENDATION: Service of process. An agent for service of process within Hong Kong should be required; alternative methods of service of process should be stipulated in default of an agent.

CURRENT ORDINANCE: The Ordinance requires a list of the names and addresses of Hong Kong residents authorized to accept service of process for the company (s.333(1)).

COMMENTARY: Since the ability to serve process within the jurisdiction is considered critical in the interests of local creditor protection, the requirement for the appointment of an agent is found in most statutes. In Hong Kong there are fairly strict qualifications for

such an agent; the agent must be an individual resident in Hong Kong or a firm of solicitors or accountants. In other jurisdictions a corporate agent is permitted (with no untoward consequences) and consideration should be given to permitting a local company to act as agent in Hong Kong. In the event that there is default in appointing or maintaining an agent, provision should be made for alternative service; in some jurisdictions this is by mail to the home office address, in others it is by service upon a government official within the local jurisdiction.

11.07 RECOMMENDATION: Disclosure of foreign status retained. Current requirements with respect to the obligation to disclose the foreign status of the company (on letterhead, at the place of business, etc.) should be retained.

CURRENT ORDINANCE: The Ordinance requires an overseas company to state the country in which it is incorporated wherever it carries on business in Hong Kong; in all bill heads, letter paper, notices, and other official publications of the company; in every prospectus inviting subscriptions for shares or debentures in Hong Kong (s.337).

The Registrar must be notified if the company is in liquidation in its place of incorporation, and all advertisements by the company must then state its country of incorporation (s.337).

COMMENTARY: Given the large number of foreign incorporated companies present in Hong Kong, these formalities may very well continue to serve a useful function, particularly where reliance is placed on local businesses to act in their own self interest.

11.08 RECOMMENDATION: Filing requirements. The filing requirements applicable to foreign companies under the new Ordinance should be coordinated with those of the Business Registration Ordinance; registration under the new Ordinance should be deemed to satisfy requirements of the Business Registration Ordinance.

CURRENT ORDINANCE: With regards to the filing requirements applicable to foreign incorporated companies, there is duplication and overlap between Part XI of the Ordinance and the Business Registration Ordinance.

COMMENTARY: Currently, there is duplication and overlap concerning foreign incorporated businesses between Part XI of the Ordinance and the Business Registration Ordinance. Each is under different administration, the threshold tests for registration are different, as is the destination of the registration revenues produced.

The Business Registration Ordinance is under the administration of the Commissioner of Inland Revenue, and the funds raised through registration fees serve to protect local employees in the event of insolvency. Foreign companies registered under Part XI of the Companies Ordinance must also register under the Business Registration Ordinance. Because the threshold tests for registration differ, the Business Registration Ordinance catches a broader class of enterprises, including those foreign enterprises which are not caught by Part XI of the Companies Ordinance. Recommendation 11.04 suggests that the new Ordinance adopt the same threshold test for registration under it as under the existing Business Registration Ordinance. The two pieces of legislation should be coordinated so that one filing suffices; a registration under the new Ordinance could be deemed to satisfy the Business Registration Ordinance and availability of information coordinated.

11.09 RECOMMENDATION: International business companies. There appears to be no need to address the use of international business companies in a new Ordinance or otherwise.

CURRENT ORDINANCE: There are no provisions in the Ordinance that specifically address the use of international business companies in the Hong Kong.

COMMENTARY: The Terms of Reference ask that the "relevance with respect to Hong Kong of the development of international business companies" be considered. International business companies (IBCs) are usually the products of small, island jurisdictions. Unsurprisingly, the governments of these jurisdictions, when setting up the legislation creating IBC entities, not only take pains to make it attractive to foreign investors, but also put into place measures to protect local business interests from an influx of foreign competition. Thus, IBCs can be distinguished from companies incorporated under their jurisdiction's regular corporate statute in that they enjoy favourable tax treatment but are restricted (often, in the form of near-total prohibitions) in their ability to do business within their jurisdiction of incorporation. Often, a separate statute will govern the creation and operation of IBCs in their jurisdiction of incorporation.

With respect to operations in Hong Kong, two jurisdictions predominate, Bermuda for publicly listed companies, and the British Virgin Islands for private companies. Statistics with respect to Part XI registrations under the current Ordinance as of January 31, 1997 are found in Appendix 9 together with an indication of the top ten "IBC" jurisdictions. It should be noted, in this regard, that the requirements of jurisdictions promoting IBCs vary considerably; not all IBCs are the same.

Bermuda's position as an offshore jurisdiction of incorporation is well-known in Hong Kong, in no small part due to the growth in number of SEHK companies incorporated in Bermuda in the last decade or so. Bermuda is quite overwhelmingly the offshore jurisdiction of choice for Hong Kong businesses incorporating public companies offshore -- approximately 50% of SEHK listed companies are incorporated there. Bermudian IBCs are acceptable to Hong Kong regulators for listing purposes, as are the Cayman Islands but not those of the British Virgin Islands nor IBCs from other jurisdictions. (The Cook Islands have been permitted for listing purposes, but not actually used). This trend is not unique to Hong Kong; Bermuda is a leading jurisdiction for group holding company incorporations. Many such companies are traded not only in Hong Kong but also on the New York Stock Exchange and the London Stock Exchange.

The Bermudian Companies Act (BCA) is essentially a U.K.-style memorandum of association statute with some North American features; it has been tailored to meet the particular demands of Bermuda's offshore incorporation and insurance industries. The First Schedule to the BCA sets out the powers and objects available to all companies which are generally quite broad; however, in the case of Exempted Companies, they are limited. Under the BCA, an Exempted Company may not:

- hold land in Bermuda save that which it leases to meet the needs of its business, such leases not to exceed 21 years;
- hold mortgages in Bermuda over BD$50,000 (although ministerial consent to

do so may be granted);

- hold any Bermudian bonds or debentures save those issued by the Government or other public authorities;
- acquire shares or interests in any non-exempted Bermudian undertakings;
- enter into any contracts or exercise other corporate powers in Bermuda save for that which is necessary for the undertaking of its extra-Bermudian business.

These limitations are fairly characteristic of IBCs in general.

Bermuda has taken pains to maintain a "squeaky-clean" image with regard to incorporations under its jurisdiction. Incorporation of an exempted undertaking in Bermuda is a privilege. The approval of the Bermuda Monetary Authority is required for all such incorporations. Applications must be accompanied by extensive banking references with regard to the financial standing and integrity of the ultimate owners of the company; one cannot incorporate anonymously in Bermuda. In addition, notice of the proposed incorporation must be published in a Bermudian newspaper prior to incorporation and there are minimum capital requirements.

Bermuda also takes pains to keep its legislation competitive; for example, recent amendments, which came into force in July 1996, loosened the BCA's general prohibition on financial assistance and introduced a new overriding exception which allows financial assistance so long as the company meets a new solvency test (BCA, s.39A); moreover, the requirement for a quorum of Bermuda resident directors was replaced with more flexible "Bermuda representation" requirements (BCA, s.130). There is mounting competition in the offshore incorporation business. For example, according to statistics provided by the Companies Registry, the number of incorporations registered under Part XI of the Ordinance from the Cayman Islands increased by 16% from 128 at December 31, 1995 to 149 at December 31, 1996.

In 1984, the British Virgin Islands enacted the International Business Companies Act (Cap. 291), which provided for the incorporation of IBCs. Like the Bermudian Exempted Company, the BVI IBC is exempted from local taxes and stamp duties, and has significant restrictions placed on its ability to do business in the British Virgin Islands. However, there are some significant differences between the BVI IBC and the Bermudian exempted company. The BVI International Business Companies Act shows a greater degree of North American influence than does the Bermudian Companies Act 1981, notably in its extremely broad granting of corporate powers: IBCs may engage in any activities that are not unlawful under the laws of the British Virgin Islands. Accordingly, they often have very broad and very brief objects clauses in their articles. As well, they are not subject to the *ultra vires* doctrine. Other noteworthy features of the BVI international business company regime include:

- *Less emphasis on "quality control"*. The British Virgin Islands does not go to the same length as does Bermuda to verify the antecedents of individuals incorporating IBCs, and incorporation is not granted on a discretionary basis;

- *A greater degree of confidentiality*. There are no public records on the identity of directors and shareholders. Bermuda requires that companies keep

registers of directors and shareholders available for inspection by the public, and although the British Virgin Islands has the same requirement, inspection of the register must be for a proper purpose;

- *Quick incorporation*. Incorporating a new IBC usually takes two days; shelf companies are also available;

- *No residency or nationality requirements for directors*;

- *Low membership requirements*. The minimum number of subscribers is one; a minimum of one share must be issued and fully paid up, and this may be in bearer form. Only one director is required, and corporate directors are permitted;

- *Minimal filing requirements upon incorporation*. The only documents that are required to be filed are the Memorandum of Association and Articles of Incorporation, as well as the particulars of the company's registered agent;

- *There are no par value or cash consideration requirements with regard to shares*. Shares may be denominated in any currency;

- *No annual shareholders' meeting requirement*. However, directors must hold one if more than half the shareholders request it in writing, and shareholders may vote by proxy;

- *Directors' meetings may be held by telephone or other electronic means, and directors may vote by proxy*;

- *All corporate records, books, and registers may be maintained outside the British Virgin Islands*;

- *No company secretary requirement, although one may be used if desired*;

- *Ease of amendment*. The articles may be amended by a resolution held at a board meeting called with three days notice and attended by at least one-half of the board of directors;

- *No annual audit requirements*;

- *No annual filing requirements with regard to accounts or membership*;

- *Anti-expropriation provisions*. If the shares of an IBC are seized by a foreign government, the British Virgin Islands Court may order the foreign government's actions to be disregarded.

IBCs are often used to hold assets in Hong Kong, in particular, intangible assets, as a hedging device in view of the upcoming transfer of sovereignty. Such assets held offshore

would be less easily expropriated, so the argument goes. BVI IBCs are used in corporate structuring and tax planning by large companies as well as by individuals.

In general, the flexibility of the BVI international business company governance regime has been cited as a determinant factor in choosing it in corporate structuring. For example, Hong Kong's rules on mergers have made such transactions more complex than mergers involving BVI IBCs which are not subject to capital maintenance requirements that "tie up" capital.

Unsurprisingly, tax avoidance has been named by accountants as being one of the prime motivations for the use of IBCs in Hong Kong. Some are of the view that "aggressive tax avoidance" is a driving force behind the IBC phenomenon. This seems largely in keeping with the history of the offshore industry, which is often largely tax-driven.

Discussions with working party members regarding the use of IBCs suggested a multiplicity of reasons for the choice. One stated that in his experience the majority of IBC incorporations were actually due to recommendations by professional advisers; an accountant would identify a potential tax benefit to be gained by using an IBC in some context and the client would generally act upon the recommendation. Another working party member mentioned that there was a certain "herd mentality" at work, and that BVI IBCs, in particular, were rather fashionable at the moment.

Surprisingly, there was a difference of opinion as to whether IBCs were cheaper to incorporate. The total costs incorporation may be affected by a number of factors, including the complexity of the company's constitution, Chinese translation costs in the case of IBCs, initial capital (which affects incorporation fees), professional billing rates, and the like. Accordingly, it is not immediately apparent where it is less expensive to incorporate. However, in terms of maintenance costs, the BVI IBC, not being subjected to annual audit and other filing requirements, is less expensive to operate. As well, the costs and delays in winding up a Hong Kong incorporated company were seen by working party members as being more significant than those associated with a BVI company.

Regardless of initial costs, one factor that may have a significant influence on an incorporators' choice of jurisdiction is that of fees. Currently, Hong Kong-incorporated companies must pay capital duty on new stock issues; BVI IBCs pay no comparable fees. Working party members generally agreed that this factor and the greater flexibility ("user-friendliness" was one term that recurred) of a BVI IBC, were strong incentives to choose one over a Hong Kong incorporated company.

An added attraction, especially for accountants, is the strong professional infrastructure present in the British Virgin Islands. The calibre of local legal and accounting professionals is such that incorporations can be managed quickly and painlessly. Apparently, the British Virgin Islands enjoy something of an advantage over other offshore jurisdictions in this respect; one working party member noted that the availability of professional services might be a factor.

Moreover, the British Virgin Islands have good "product and marketing"; the BVI IBC is seen as being somewhat more reputable than some of its competitors. Indeed, the

image of the BVI IBC in the eyes of mainland China business people was cited by some working party members as being very good. Another stated that the minimal formality, absence of travel requirements, and confidentiality of BVI IBCs made them attractive to mainland investors. It is doubtful, however, that a BVI IBC would enjoy greater credibility on the mainland than would a Hong Kong-incorporated company.

There are drawbacks to using the BVI IBC including a "name drought"; the very large number of existing IBCs mean that ideal names are often no longer available. As well, the precise legal status of Chinese-language names and documents, conceivably an issue of considerable significance to Hong Kong incorporators, was currently uncertain. According to one working party member, there was no Chinese-language translation service available in the British Virgin Islands. In comparison, Western Samoa's Chinese-language facilities have been mentioned with approval.

There appears to be little reason to consider "regulating" in any way the operations of IBCs in the Hong Kong Companies Ordinance, other than by means of registration of all foreign companies carrying on business in Hong Kong as discussed above. Bermuda is a respectable jurisdiction of incorporation. Oversight of the capital markets activities of Bermuda incorporated companies and public investor protection measures in Hong Kong can be left to the Stock Exchange of Hong Kong and the Securities and Futures Commission.

As for BVI companies, there was little evidence of "abuse" of their flexible, speedy incorporations. Issues of tax avoidance are best left to the Inland Revenue. In keeping with the general principle of creating a "core company law" regime, issues such as the development of policies to prevent international money laundering should be handled by authorities other than the Registrar of Companies.

With respect to both Bermudian and BVI IBCs, a recurring comment on their use in Hong Kong was that they were "fashionable", indicating that their popularity may be transitory. One comment was to the effect that a "superior product" combined with skilful marketing by the BVI authorities and professionals contributed to their proliferation among Hong Kong businesses. There is some evidence that Hong Kong incorporation is experiencing a revival in popularity. In 1996 the number of new companies registered in Hong Kong totalled 49,734, which was 16,726, or 51%, more than in 1995 ("Businesses Boost Registrations In Hong Kong", Asian Wall Street Journal (20 January 1997) at 4). In December 1996 alone, Hong Kong incorporations jumped 45% from November 1996, a fact that was "surely largely attributable to the current property boom", according to the Registrar of Companies. "While I do not have the equivalent figures for BVI incorporations, nor could I unless the companies in question were registered under Part XI of the Companies Ordinance, the figures for Hong Kong incorporations certainly seem to indicate that local incorporations still have a considerable degree of attraction, and BVI incorporations have by no means cornered the incorporation market, despite all their alleged 'attractions'" (Letter of Gordon Jones, Registrar of Companies to Professor Cally Jordan (17 January 1997)).

With the exception of the anti-expropriation provisions and the lack of transparency as to control and management in the BVI legislation, the recommendations of this Review with respect to a new Ordinance would result in a "product" as "superior" as that of the British Virgin Islands in terms of speed and efficiency of incorporation. One working party

member considered that the availability in Hong Kong of a business vehicle combining the best attributes of BVI IBC's with Hong Kong's natural advantages as a major international business centre and gateway to mainland, China, would be "unbeatable".

It should be emphasised, however, that this does not mean the introduction into Hong Kong of the IBC as a corporate vehicle. There was some discussion as to whether consideration of IBC legislation for Hong Kong was implied in the Terms of Reference to the Review. Working party members were overwhelmingly opposed to such an idea (although there was some interest in the U.S. tax driven limited liability company by some members). IBC legislation is clearly unnecessary and inappropriate in Hong Kong.

12.00 TRANSITIONAL PROVISIONS

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12.01 RECOMMENDATION: Mandatory continuance for companies. A new Ordinance should include a requirement of mandatory continuance for companies created under the old legislation over a transitional period of three to five years.

CURRENT ORDINANCE: Not applicable.

COMMENTARY: If the full benefits of revised companies legislation are to be realized, then the regime should be given the widest possible scope of application. Permitting old and new ordinances to function indefinitely in parallel would breed marketplace confusion, especially in the light of recommendations being made in this report with respect to the company's capital structure and shareholders' rights. Additionally, a bifurcated system would add an extra level of legal complexity, since the development of two distinct streams of corporate case law would be required to effectively deal with litigious matters. Finally, from an administrative point of view, retention of two parallel companies law regimes would increase the burden on the Registry and impede the process of simplification of filing procedures and computerisation of records at the Companies Registry which is ongoing.

There are several different approaches possible with respect to the implementation of legislation such as that being proposed here. The Dickerson Committee in 1971 outlined the alternatives it considered:

> 514. Section 20.15 deals with the formidably difficult problem of transition. Several alternatives were considered: (a) allow the present Canada Corporations Act to continue but disallow new incorporations under that Act; (b) allow the present Act to continue, disallow new incorporations under it, but permit continuance under the Draft Act; (c) allow the present Act to continue for a limited period of time during which existing corporations may effect continuance under the Draft Act; or (d) repeal the present Act and make the Draft Act applicable to all federal corporations as of the effective date of the Draft Act. The last alternative is superficially attractive, but it is really the most difficult of all, both for corporations and for the Department. It would require many additional and complicated provisions in the Draft Act because the Act would then apply both to corporations created under the old letters patent regime and to those incorporated under the simpler scheme of the Draft Act. The result would be a statute more complicated than the present one, defeating one of the major objectives of the Draft Act. Therefore a variation of the third alternative has been adopted; that is, to require continuance under the Draft Act.
>
> 515. Quite apart from the rather short (and entirely arbitrary) time limit of three years imposed in s. 20.15(1), we recognize that the mandatory continuance rule will impose a burden on every corporation presently in existence under the Canada Corporations Act. It is a question of choosing the lesser evil. Although the continuance procedure in s. 14.14 is straightforward, for corporations incorporated under the wholly different machinery of the present Act continuance is, in fact if not in law, a re-incorporation. Some corporations (those with partly-paid shares outstanding, for example) will no doubt have to do a lot of internal re-structuring before they can apply for a certificate of continuance Subsection (3) alleviates the problem somewhat. A rule which allowed the present Act (and corporations governed by it) to continue indefinitely would be easier at the outset, but much more troublesome and expensive in the long run. It would create two quite different regimes of corporation law at the federal level, two continuing streams of case law would develop and increasingly conflict, and public confusion would deepen, not lessen. We venture to hope that even the legal profession would not want this to happen. It therefore seemed to us that it would be better to

> endure a temporary cost and inconvenience as the price of a better corporation law for the future. Section 20.15 therefore looks to a fairly early transfer of all federal corporations into the Draft Act, following which Part I of the present Canada Corporations Act could be repealed (Dickerson Report at paras. 514-515).

Leaving the old legislation in place indefinitely as an alternative means of incorporation is decidedly the least effective. Where this decision has been made (in the province of Quebec, Canada, one suspects for purely political reasons), it has been roundly criticised. In Quebec, legislation based on the CBCA was adopted in 1981 as part 1A of the Quebec Companies Act, largely in an effort to stem the tide ("haemorrhage" was the word used by commentators), of Quebec businesses incorporating federally under the new CBCA in preference to the archaic letters patent legislation based on the 1862 U.K. Companies Act (Part 1 of the Quebec Companies Act). The old legislation was left in place notwithstanding that the juridical concept of the company under the new legislation (which essentially likened the company to a natural person) was fundamentally at odds with the conception adopted by the prior regime, which closely followed the English model of the company. The continued co-existence of these two regimes was called "unhealthy" (see M. Giguère, "Le Québec à l'heure de la réforme du droit des sociétés (compagnies) ou le législateur schizophrène" (1984) 25 C. de D. 733 at 737).

The ramifications, though, went well beyond the purely theoretical:

> While this bifurcated system presents a series of difficulties on the conceptual level, even greater difficulties are presented thereby in the context of the solution to particular problems, since the applicable regulations may be inconsistent and contradictory, even as they act in virtue of one or other parts of the same law [translation] (*ibid.* at 736).

The approach being recommended is that adopted in implementing the CBCA. John Howard, one of the original members of the Dickerson Committee, still recommends the "elegant solution" of a 3-year or 5-year dissolution rule coupled with the administrator's revival power.

> It has three clear advantages.
>
> (1) It is a strong incentive to companies - and their legal advisers - to turn their attention forthwith to voluntary continuance and, accordingly, to review and amend their corporate constitutions accordingly.
>
> (2) Assuming the Hong Kong company register is like the old Federal Companies Act register, automatic dissolution threshes out a lot of chaff.
>
> (3) Where revival action is required, the Administrator has power to see, in the interests of shareholders, that the affairs of the company are regularized - and perhaps even power to extract an undertaking from the directors and officers that they remain so.
>
> [...] I am presuming, of course, that the continuance formalities will be as straightforward as under the CBCA. That relative simplicity with respect to all formalities under the CBCA was a major inducement to all companies to continue promptly" (Letter of John Howard to Cally Jordan (24 October 1996)).

Many companies were in fact dissolved under section 261 of the original CBCA for failure

to effect a proper continuance. The administration did show a certain amount of clemency though, as the work of dissolving delinquent companies did not begin until some time after expiry of the transition period, thus allowing numerous companies to continue under the CBCA, even after the statutory deadline. A process of administrative revival for dissolved companies, now found at section 209 of the CBCA, was also available at the time. The result was that most section 261 dissolutions did involve inactive companies. The Registrar of Companies in Hong Kong has already embarked for some time on an extensive programme of administrative dissolution of inactive companies consistent with this recommendation.

The New Zealand approach, in implementing its Companies Act 1993, has been a variation on that of the CBCA. Rather than administrative dissolution at the end of the 3 year transition period, the Companies Reregistration Act 1993 provides for a deemed reregistration where the company has not taken appropriate steps to reregister during the three year transition period. Although this approach may have a certain appeal, it has resulted in some rather complex legislation (a separate statute, in fact) to deal with the consequences of deemed reregistration, particularly as regards shareholders rights under existing share provisions. The three year transitional period in New Zealand is not yet over so that it is not possible to comment on how these provisions will operate in practice. It may well be that the deemed continuance provisions, given human nature, will result in fact in a prolonged period of transition, as those companies subject to deemed continuance provisions, if they are inactive, remain on the registers and those which do not like the imposed continuance regime consider amendments to it. In the longer term interests of efficiency, it is preferable to bite the bullet at the end of three to five years.

12.02 RECOMMENDATIONS: Simple reregistration procedure. Continuation under the new Ordinance should be effected through a simple reregistration procedure which should involve only minimally more effort and expense than the current annual filing and audit requirements.

CURRENT ORDINANCE: Not applicable.

COMMENTARY: One working party member commented that the idea of reregistration would send "waves of shock and horror" through the business community. While such a system imposes the burden of reregistration on each company, it represents, in the long run, the most efficient system for implementing a new Ordinance. In other jurisdictions where similar systems have been used, the reregistration has been likened to a "re-incorporation," given the magnitude of changes it allows a company to undergo. Accordingly, by allowing for a reasonable prescribed reregistration period (three years were allowed in New Zealand, five years in federal Canada), reregistering companies are afforded ample opportunity to reorganise their policies, affairs, and capital structures in order to take advantage of the new legislation. Of course, during this re-registration period, some companies will continue to be governed by the former rules, while newly formed companies and those who reregister early will fall under the governance of the new regime. While this does have the effect of creating a bifurcated regime in the short term, it is temporary. New Zealand in fact harmonised its Companies Act 1955 to its 1993 legislation to a fair degree so as to give existing companies the benefit of the new legislation during the transitional period. Since long term success and

acceptance of companies legislation is contingent on the ability of corporate entities to fully utilise the statute's advantages, it is in the general best interest to afford companies a certain amount flexibility in the timing of its adaptation to the new regime. Such a method should lead to less confusion than would be the case where a relatively narrow transition period were allowed, or where an attempt were made to immediately apply a new regime to all companies.

Reregistration, provided it requires minimal effort, could be a welcome tonic to Hong Kong business.

APPENDIX 1

LEGISLATIVE HISTORY OF THE HONG KONG COMPANIES ORDINANCE TO 1984

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1. PHASE ONE: THE U.K. MODEL: 1865-1932

The year 1862 marks the beginning of modern company law in the U.K. with the consolidation of the various enactments and amendments which resulted in the Companies Act 1862. The 1844 Act had conferred the privilege of incorporation (upon satisfaction of certain registration formalities) and ensured that potential investors and creditors would be able to obtain information from a public source about larger commercial enterprises. The creature created, however, was very much one caught in the process of evolution, part large partnership, part Chartered Corporation.

The 1844 Act did not, however, provide limited liability for the company's members; rather, in keeping with the quasi-partnership nature of the joint stock company and in a manner similar to that prevailing in certain partnership regimes, the Act required creditors to exhaust their remedies against the company before proceeding against the members. The issue of limited liability was hotly debated for over a decade before the Limited Liability Act 1855 resolved the issue, subject to subsequent refinements over the ensuing few years. Although originally envisaged as a means of facilitating the raising of capital by large-scale enterprises, the applicability of the statute to private companies was established some forty years later in the landmark case of *Salomon* v. *Salomon*, [1897] A.C. 22.

For nearly fifty years, the 1862 statute, with numerous amendments, remained the governing companies legislation in the United Kingdom. Towards the end of the 19th century, a practice developed of reviewing, consolidating and implementing all company legislation every 20 years. This process of review and consolidation produced the Companies Acts of 1908, 1929 and 1948, after which the process broke down (see Gower's at 49).

Between 1865 and 1948, "the company law of Hong Kong could, due allowance being made for a few years time lag, be said to be almost identical with that of Great Britain" (Second Report at 1). Hong Kong being British territory, the reasons for the similarities in the legislation during this period are fairly obvious.

The U.K. companies legislation during this period served as a model for many, mostly Commonwealth, jurisdictions, not just Hong Kong. Great Britain was one of the pre-eminent industrial and commercial powers in the world at this time and its companies legislation reflected this fact. It was only natural that its Companies Act, in its various formulations, should spread and flourish throughout the British Empire. The original Hong Kong Companies Ordinance 1865 followed close on the heels of the U.K. Companies Act 1862, as did the Companies Ordinance 1911 (following the 1908 U.K. Act) and the Companies Ordinance, 1932 (following the 1929 U.K. Act (see Second Report at 1). "Unquestionably the limited liability company has been a major instrument in making possible the industrial and commercial developments which have occurred throughout the world" (Gower's at 70). The United States had gone its own way somewhat earlier in enacting general incorporation statutes which replaced the practice of incorporation by legislative act.

For a period of over fifty years, the development of Hong Kong companies law was effectively frozen as of 1932. The "provisions of the Companies Ordinance, 1932, based on those of the 1929 Act, were reasonably adequate under local conditions" for several years after the enactment in Britain of the Companies Act 1948 (Second Report at 2).

The synchronisation of U.K. and Hong Kong companies law ended almost fifty years ago, in 1948, and Hong Kong has been out of step with U.K. law since then. A "great gap", as the Second Report put it, opened between company law in Hong Kong and in Britain.

The consolidation of 1948 in the United Kingdom incorporated many of the changes recommended by the Cohen Committee which reported in 1945. The Cohen Committee's terms of reference were "to consider and report what major amendments are desirable in the Companies Act 1929, and, in particular, to review the requirements prescribed in regard to the formation and affairs of companies and the safeguards afforded for investors and for the public interest". In 1945, the Cohen Committee's recommendations largely shaped the reforms which led up to the Companies Act 1947. This Committee had two broad overall objectives: to increase financial transparency in corporate affairs and to strengthen shareholder rights and control over management.

Following the Committee's recommendations, the Companies Act 1947 empowered shareholders in many regards: it guaranteed the holding of annual meetings; it allowed shareholders to initiate propositions at those meetings; it allowed for shareholder removal of directors; and it allowed courts greater flexibility in fashioning remedies for minority shareholders in the face of majority oppression.

Ultimately, the oppression remedy in its later formulations may very well be the most important legacy of the Cohen Committee. To strengthen minority shareholders in resisting oppression by the majority, the Cohen Committee proposed alternatives to winding up as the remedy for minority relief. The Cohen Committee's work ensured publication of most of the facts of interest to shareholders, and brought about great improvements in the presentation of company accounts so as to enable intelligent investors to form a better judgment of share values. Furthermore, it established what are now considered basic shareholder rights. Whatever one's opinion of the Committee, its work had a substantial impact on the evolution of company law. Its recommendations set the benchmark for subsequent reform in major Commonwealth jurisdictions. Many of the Cohen Committee's recommendations appeared in the 1948 U.K. consolidation but Hong Kong did not, as it had in the past, immediately pick up on the new U.K. companies legislation of 1948.

2. PHASE 2: A PERIOD OF LEGISLATIVE STASIS 1932-1984

Between 1932 and 1984, a period of over fifty years, although there were many amendments to the Ordinance, few were of major significance. The most important amendments concerned prospectuses (1972) and accounts (1974). The provisions concerning accounts mirrored those contained in sections 147 to 156 of the Companies Act 1948 and sections 3 to 5 of the Companies Act 1967, as recommended by the Cohen and Jenkins Committees respectively.

There may be any number of reasons to account for this lack of legislative initiative,

the most obvious being that the existing companies law regime was adequate to meet the demands made on it. Companies law regimes are not necessarily continuously in a process of renewal and regeneration. The modern company or corporation is a remarkably stable and, at the same time, flexible instrument. Once the basic mechanisms for incorporation are in place, companies law regimes can run without oiling for a considerable length of time.

Professor Tyler points to the instability of the political and social situation in Hong Kong in the years between 1948 and 1962 as being responsible for the failure to pick up on the 1948 legislative amendments in the United Kingdom (see E.L.G. Tyler, "Hong Kong's Companies Legislation Review" (December 1994) at 22 *et seq* [unpublished]). By 1962, however, the provisions of the 1932 Ordinance, considered for many years to be "reasonably adequate under local conditions," were starting to show their age. In addition, "local conditions" had changed dramatically.

> These conditions have, however, since undergone great changes, and it has been clear for many years that the relatively simple provisions of the [1932] Ordinance are no longer adequate, especially in view of the vastly increased participation by members of all classes of the population in the ownership of public companies. There are therefore a great many changes which must now be made in company law in order to provide a sound basis for the proper management of the Colony's corporate enterprises, and effective safeguards for the protection of all those who invest in them (Second Report at 3).

In light of these changes, a Companies Law Revision Committee was appointed by the Hong Kong Government in April 1962 to "consider and make recommendations as to the revision of the Company Legislation of Hong Kong, and in particular to recommend as soon as possible whether legislation for prevention of fraud in relation to investments is required and if so, the form which it should take" (Hong Kong, *First Report of the Companies Law Revision Committee - The Protection of Investors* (24 June 1971), at v (the First Report)). In keeping with the specific concerns evinced in its mandate with respect to investor protection, the committee's first report, published in 1971, was entitled *The Protection of Investors*. Two years later, in 1973, the Second Report on general companies law appeared.

Eleven years separated the creation of the Companies Law Revision Committee and publication of their Second Report on Company Law in Hong Kong. During this period the Committee was overtaken by a "constant succession of new developments" (First Report at vi). At one point the work of the Committee was suspended due to the mounting pressure of work in the Registrar General's department, which was "seriously aggravated by the collapse of two banks at the beginning of 1965" (First Report, *ibid.*) and the pending enactment of companies legislation in the U.K. as a result of recommendations by the Jenkins Committee in 1962.

When reconstituted in 1968, the Committee turned to a detailed examination of the U.K. Companies Act of 1948 and 1967, in effect spanning twenty years of legislative developments in the United Kingdom. A further complication to the traditional practice in Hong Kong of swallowing U.K. legislation virtually whole was the fact that the U.K. Companies Act 1967 implemented only a small number of the recommendations of the Jenkins Committee. In addition, ancillary legislation was being spun off in the United

Kingdom at a fairly furious rate. Thus the Hong Kong Companies Law Revision Committee was thrown into a full-blown exercise in law reform.

2.1 The Second Report of the Companies Law Revision Committee - Company Law. The recommendations of the 1971 First Report (most of which dealt with the prospectus requirements) were, with some modifications, enacted by the Companies (Amendment) Ordinance 1972 and the Protection of Investors Ordinance. The Second Report dealt with all other aspects of the Ordinance.

The Second Report was not a conceptual overhaul of the Ordinance; rather it was a detailed section-by-section tune-up, the Companies Act 1948 serving as the point of reference.

> With a few exceptions we have dealt with topics in the order in which they appear in the Companies Act, 1948. This order is, we acknowledge, far from being strictly logical, but it has been convenient for us and will, we think be convenient for most professional readers and the draftsman charged with the responsibility of drafting the required legislation (Second Report at xiii).

Each section of the Ordinance was considered in light of (i) the recommendations of the Cohen Committee on the corresponding provisions in the U.K. Companies Act 1929; (ii) changes made by the U.K. Companies Act 1948; (iii) the recommendations made by the 1962 Jenkins Committee on the 1948 Act; (iv) changes made by the U.K. Companies Act 1967; and (v) local considerations. The dominant influence, by far, was the U.K. Companies Act 1948.

The recommendations were detailed and extensive. The summary of the recommendations alone ran to 204 paragraphs. Many of the recommendations were non-controversial, of a housekeeping or fairly technical nature designed to bring the Ordinance into line with the 1948 U.K. statute. For example, it was recommended that the Registrar of Companies should be given a discretion to extend the statutory period for holding an annual general meeting.

Other recommendations were of far greater significance, reflecting the major changes introduced by the 1948 U.K. Act and the debates of the time. Some of these recommendations have still not been implemented. Although the Cohen Committee in 1945 had recommended abolishing the doctrine of *ultra vires*, the later Jenkins Committee had retreated somewhat from this position and the Second Report recommends following the more nuanced position of the Jenkins Committee. The adoption of the unfairly prejudicial remedy for shareholders, introduced by section 210 of the 1948 U.K. statute, was recommended for Hong Kong as an alternative to the more drastic application for winding up and made its appearance in 1978. Detailed changes, based on the 1948 Act, to the contents and form of company accounts were recommended. With respect to overseas companies, i.e. foreign-incorporated companies, the Committee recommended empowering the Hong Kong court to wind up such a company if there were assets in the territory.

Significantly for this Review, the Second Report, following the Jenkins Committee, recommended a statutory statement of the basic principles underlying the fiduciary

relationship of directors towards their companies:

> (i) a director of a company should observe the utmost good faith towards the company in any transaction with it or on its behalf and should act honestly in the exercise of his powers and the discharge of the duties of his office;
>
> (ii) a director of a company should not make use of any money or other property of the company or of any information acquired by virtue of his position as a director or officer of the company to gain directly or indirectly an improper advantage for himself at the expense of the company (Second Report at 30-31).

This recommendation has proved fairly controversial and is still under consideration in Hong Kong. Similarly, the recommendation in the Second Report that insider dealing be made a criminal offence has not been adopted. Hong Kong has preferred instead to set up a tribunal system with administrative sanctions.

These statements are indicative, however, of the concern of the Committee for fair dealing and the prevention of fraud.

> In our comments on some of the penalties recommended we mention that there is perhaps a tendency to treat some types of fraud less seriously than they deserve, and that persons committing them are sometimes let off lightly on the strength of previous good character. In many cases, however, the money lost by creditors or investors is the product of years of hard work and self-denial, and we are most strongly of the opinion that anyone who sets out deliberately to cheat people of their savings should be dealt with very severely, especially if they have enjoyed, or still have the prospect of enjoying, the fruits of their knavery (Second Report at 49).

This concern, of course, is consistent with the original mandate of the Committee to "consider and make recommendations as to the revision of the Company Legislation of Hong Kong, and in particular to recommend as soon as possible whether legislation for prevention of fraud in relation to investments is required..." (quoted in the First Report at v).

The Committee had at the outset of the Second Report expressed reservations as to the appropriateness of continued unquestioning emulation of U.K. legislation in Hong Kong:

> We recognize that there are considerable advantages in Hong Kong's following closely the British law: this certainly makes things easier for lawyers and accountants since they thus obtain the benefit of the authoritative guidance of standard textbooks and decisions of the Courts in Britain, and since it is confusing for those who have qualified in Britain to find that what they have learned there is not applicable here. Nevertheless, conditions in Hong Kong are in many respects very different from those in Britain. What is best for Britain may therefore not always be best for Hong Kong (Second Report at 5).

Despite this circumspection, the Committee's recommendations demonstrated heavy if not exclusive reliance on the U.K. legislative experience. The practicalities of legislative drafting prevailed and the Committee, as in the past, recommended adoption of U.K. legislative provisions with little or no modification.

> Obviously, if our recommendations are accepted, a completely new Ordinance will be required, and we appreciate that the drafting of this will be a major undertaking.

> ...Fortunately, in many cases it will be possible for the draftsman to adopt provisions of the Companies Acts 1948 and 1967 with little or no modification (Second Report at 331).

2.2 The Companies (Amendment) Ordinance 1984. Between publication of the Second Report on Companies Law in 1973 and the enactment of many of its recommendations, another eleven years elapsed.

> The Companies (Amendment) Ordinance 1984 has been described, only a little unfairly, as a 'great leap forward to 1948'. In the main it does, belatedly, implement the remaining recommendations of the *Second Report of the Companies Law Revision Committee* published in 1973 which had largely recommended the implementation in Hong Kong of the changes made to English company law in 1948 with some variations to reflect the views expressed by the Jenkins committee in 1962 and local conditions. While some of these recommendations had already been carried into effect by various amendments, the great bulk of the recommendations (even those of a technical nature) had remained outstanding while the government struggled with the drafting problems raised by implementing the huge number of changes needed to carry the proposals into effect (C. Bates, *The Companies (Amendment) Ordinance 1984 in Perspective* (Hong Kong : Hong Kong L.S. Ltd., 1985) at 1).

The process of 'tuning-up' the Ordinance section by section was, inevitably, long and painful.

Unfortunately, the legislative world did not stand still during this time. As Bates points out in his monograph, four new Companies Acts were enacted in the United Kingdom between the publication of the Second Report and implementation of most of its recommendations in 1984. Bates' assessment of the 1984 Amendment Ordinance was to the effect that technical changes, although welcome, had not addressed major substantive problems:

> It is to be hoped that the amendment ordinance has cleared away the major backlog of technical changes of this nature and that future reforms will concentrate on substantive areas where reform is more clearly needed. Areas of more immediate concern which might be considered are further methods to discourage nominee directors, a general review of ways to promote greater disclosure of information to shareholders and creditors..., greater powers for liquidators to set aside preferential transactions and transactions at an undervalue, and a review of the efficacy of securities regulation and investor protection as it applies to new instruments such as commercial paper and certificates of deposit (*ibid.* at 113).

Although the creation of the SFC and the emergence of a modern securities law regime in the period since 1984 to a certain extent go towards addressing one substantive area of reform identified by Bates, this Review is essentially picking up where the 1984 amendments to the Ordinance left off.

APPENDIX 2

SUMMARY OF THE COMPARATIVE SURVEY OF COMPANIES LAW IN SELECTED JURISDICTIONS

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SUMMARY OF THE COMPARATIVE SURVEY OF COMPANIES LAW IN SELECTED JURISDICTIONS

In order to address two aspects of the Terms of Reference for the Review, Hong Kong's status as an international financial and business centre and recent developments in companies law and regulation in other comparable jurisdictions, a Comparative Survey of Companies Law in Selected Jurisdictions (January, 1996) was prepared. The Comparative Survey looked at the history and current issues of companies law in the major common law and civil law jurisdictions, as well as Singapore, the People's Republic of China and Bermuda. At the request of working party members, an additional paper which included observations on companies law in Japan and Taiwan among other Asian jurisdictions was prepared. For reference purposes, a summary of the Comparative Survey has been included in this Report. The full text of the Comparative Survey has been published by the Hong Kong Government and is available in English and Chinese at the Government Bookstore.

1. THE UNITED KINGDOM

1.1 A Period of Transition and Instability. Company law in the United Kingdom over the last fifteen years has been going through a difficult period of transition and instability. Nearly a dozen major statutory initiatives associated with companies law have been introduced or attempted. Despite this agitated level of legislative activity, the underlying structure and conceptual basis of U.K. companies law has not been reconsidered. The last comprehensive reviews of U.K. companies legislation date from the days of the Cohen Committee Report (1945) and the Jenkins Committee Report (1962). The U.K. legislation is showing the marks of decades upon decades of legislative accretion.

1.1.1 ***The Views of the Commentators.*** Legal commentators following developments in companies law in the United Kingdom have been harsh in their assessment. The state of the legislation, some hold, is such that it undermines its very purpose.

> No matter what camp one belongs to, one cannot but despair at the lack of stability in the current statutory framework governing the operation of limited companies. Surely the paramount function of company law is to provide a consistent matrix for businessmen to work within? (D. Milman, "1967-1987: A Transformation in Company Law?" (1988) 17 Anglo-American L.R. 108 at 127).

In comparing U.K. companies law to North American regimes, Professor Sealy, writing in 1984, was scathing in his criticism of Parliament, the judiciary and the process of reform in the United Kingdom. Parliament continues unwittingly to add to the existing complexity and formality of the legislative regime without consideration for the burdens and costs imposed; the judiciary takes a narrow and technical view at odds with commercial expectations; and the process of reform itself is flawed by "our myopic attitudes and cheeseparing approach to research and fact-finding" (L.S. Sealy, *Company Law and Commercial Reality* (London: Sweet & Maxwell, 1984) at 71).

> But Parliament in this country seems concerned only to add to the formalities, to increase checks and balances and votes and consents, seemingly indifferent to the burden and delays and the extra cost that those requirements impose on commerce - costs which ultimately fall on us all. The courts take a similar line. It is not difficult to find instances, many quite recent instances, where the judge has sent the parties away to get another consent or class vote, or has exercised a discretion in a way that is bound to bring new uncertainties to the conduct of business, or in the name of "equity" has imposed fetters on the shareholder's freedom to vote, with the result that what ought to be a simple democratic process is inhibited from taking its natural course, or has found some technical or procedural difficulty all-important, when on a broader view it wouldn't really matter a whit (*ibid.* at 7).

Professor Gower has stated that by 1985 U.K. companies legislation "was in a worse state than at any time this century" (L.C.B. Gower et al., *Gower's Principles of Modern Company Law*, 5th ed. (London: Sweet & Maxwell, 1992) at 51). He laments the fact that the United Kingdom no longer provides the model for company law to the Commonwealth. His "sad conclusion" is that the U.K. is unlikely to provide a model in the future.

> Nor can it be said that our company legislation has not reacted to changing conditions. Legislation which grew from 212 sections and three schedules in the Companies Act 1862 to 747 sections and 25 Schedules in the Companies Act 1985 cannot be accused of stagnation. [fn.A more legitimate criticism is that it has grown excessively; no other country's legislation goes into such detail.] But if one looks at the major developments this century and at the problems that these have thrown up, it is difficult to avoid the conclusion that there has been a reluctance to recognize their implications for Company Law and that, when those implications have been recognised, the reaction has been to add to the existing framework without ever re-examining its foundations to ensure that they are still sufficiently sound to bear the weight of the expanding superstructure (*ibid.* at 70).

Gower's observations are echoed by other commentators.

1.1.2 ***The Views of the Law Society.*** One of the harshest critics of the U.K. Companies Act has been the Law Society. The Law Society's Standing Committee on Company Law deplores the "lack of overall strategy for company law". In its 1991 paper, *The Reform of Company Law*, the Committee is unsparing in its criticism.

> In a significant number of cases, as a result of the shortcomings to which we have referred:
>
> - legislation fails to achieve its objectives;
> - legislation is unduly complex and obscure;
> - the manner in which the legislation is brought into force leads to confusion as to the state of the law; and
> - there is unacceptable delay.
>
> The result is a waste of time and money as the business community and its advisers try to come to terms with changing legal requirements (The Law Society (U.K.), Company Law Committee, Memorandum, *The Reform of Company Law* (July 1991) (The Law Society) at 11).

The Law Society admits that modern company law deals with complex issues and that company legislation will reflect this complexity, but "complexity is not the same as obscurity" (*ibid.* at 6).

The following factors are identified as sources of the current problems in U.K. company law: a piecemeal approach to reform "on an ad hoc and isolated basis" (*ibid.* at 5), changes inspired "partly by political enthusiasm and partly as a reaction to particular events" (*ibid.*) and the lack of scope for a more considered and longterm view of the underlying objectives of company law.

> Partly as a result of the piecemeal approach to reform to which we have referred, company legislation has increased both in complexity and length. Although a crude measure, it is worth recording that the first edition of Butterworths Company Law Handbook (the edition immediately before the Companies Act 1980) contained 462 pages, while the latest edition contains 3,544 pages. In fact, the increase is greater than that. As a result of the encroachment of the Financial Services Act into many areas of company law, to obtain an accurate comparison it would be necessary to include the huge volumes of subsidiary legislation resulting from the rules of such bodies as the SIB, the SROs, the RPBs and the RIEs (*ibid.* at 6).

Certainty in commercial relations, according to the Law Society, has been the main victim of this unfortunate situation in the U.K. "It is also important that there should be no major areas of uncertainty in our company law, because of the waste of time and money involved in attempting to resolve uncertainty. To the extent that there are uncertainties in company law, the attractiveness of the United Kingdom as a centre for inward investment may be diminished" (*ibid.* at 4).

To this difficult situation has been added the complicating factor of compliance with European Commission Directives on Company Law. U.K. company law is being influenced by the legal systems of other Member States in the European Union "which are radically different from ours" (*ibid.* at 6). Harmonisation is not necessarily undesirable; the concern expressed by the Law Society is more to the effect that these foreign influences are being exerted at a time when the domestic law is in a state of disarray.

> Harmonisation will inevitably lead to some degree of influence by foreign laws, but from the United Kingdom perspective the situation could be much improved if resources were available to take a more positive and reforming lead in the area of company law within Europe, particularly in the early stages before the momentum has built up to introduce what, from the United Kingdom standpoint, are potentially deleterious changes (*ibid.*).

Although the pressures of compliance with European Commission Directives are often identified as the culprit in explaining the difficulties in the U.K., this is only a partial explanation.

The "haphazard" approach to company law reform in the U.K. is an equally important contributing factor. Rather than adopting a conceptual approach like other jurisdictions, where existing concepts and structures may be replaced with new ideas, the U.K. approach has been to make technical amendments. The result is cumbersome and inefficient solutions which prove, more often than not, to be half measures; the problem addressed is not really

solved and associated difficulties remain in place. (For a more detailed discussion of the different approaches to company law, see E. Jacobs, "Conceptual Contrasts - Comparative Approaches to Company Law Reform" (1990) 11 The Company Lawyer 215). The Law Society has looked to several other jurisdictions for guidance in its efforts. Although there is "no one model procedure... there is a considerable amount of activity and development, underlining the need for a similar concentration of effort in the United Kingdom" (The Law Society (U.K.), *supra* at 21).

In looking for approaches and solutions to these difficulties, the Law Society Committee, in particular, endorsed the aims of the New Zealand Law Commission on Company Law Reform:

> A good system of company law should:
>
> - provide a simple and cheap method of incorporation and company organization which is flexible enough to meet the needs of diverse organisations
> - clearly identify the duties and powers within the corporate structure in an Act designed for use by directors and shareholders and not just lawyers and accountants
> - provide for better accessibility to company law by setting up the Act as the statement of first recourse in identifying rights and duties within the company
> - ensure that regulation to prevent abuse is appropriate (that is to say, directed at the abuse of corporate structure or limited liability) and is commensurate with the risk of abuse so as not to frustrate the economic and social benefits of the company form (*ibid.* at 4).

To this list might be added that a good system of company law should state the purposes for which incorporation might be sought and the advantages to be gained.

Satisfactory solutions to the problems of U.K. companies law are not within easy reach. Although the Department of Trade and Industry has instituted a "rolling" programme of company law reform in response to the Law Society's criticism, it may be many more years before there is the concentrated effort urged by the Law Society. In the domestic area, financial market reform and insolvency legislation, given the circumstances of the last decade, have absorbed all the legislative effort thrown at them. Company law reform has been reactive at best, ineffective at worst.

1.2 Recent Trends in U.K. Companies Law. There is no doubt that a precipitating factor in the high level of legislative activity in the U.K. has been the necessity of compliance with numerous European Commission Directives in company law and related areas. This has resulted in the predictable collision of two very different legal traditions; the English common law and the code-based European civil law.

The difficulties of integration of European Commission Directives go beyond simple translation of certain civil law concepts into the common law and reconciliation of differing substantive provisions. A major stumbling block has been the traditional dominance of the German corporate model at the level of the European Commission. Germany has been quite aggressive in promoting its corporate law as the model for all Europe. This includes a

concept of co-determination or worker participation in corporate management which is very much at odds with the U.K. tradition. The opposition in the United Kingdom to the German model has been as much on political grounds as on incompatibility with the integrity of the U.K. legal regime governing companies.

The pressure which the necessity for compliance with European Commission Directives has put on the U.K. companies law regime has manifested itself in other ways as well. It may be ultimately responsible for the "unbundling" of U.K. companies law which occurred in the 1980s as well as the heightened tension in the U.K. between statutory and non-statutory norms.

Despite what the Law Society has characterised as the "lack of overall strategy for company law" in the U.K., the imposition of European Commission Directives to a certain extent did prompt reclassification of some areas of U.K. companies law. The legal regimes upon which the European Commission Directives are largely drawn are much more conceptually rigorous in their structure than the U.K. Companies Act which, for decades, has served as a compendium of commercial law.

The enactment of the Insolvency Act 1986 and the Financial Services Act 1986 left "gaping holes" in the Companies Act, as matters formerly dealt with in the Companies Act were taken over by the new legislation.

> It has, however, also led to a major, and desirable, reclassification of subject-matter, distinguishing Company Law from Insolvency Law and from Securities Regulation....it is an advance to have recognised the essential unity of bankruptcy and insolvent liquidation and, accordingly, that Company Law should concentrate on the life, rather than the death and interment of companies....Even more important are the implications of the Financial Services Act. Many other common law countries have long recognised that what most of them call Securities Regulation is a distinct and important subject...We, however, had treated it, in so far as we recognised it at all, as an unimportant adjunct to Company Law. That has changed.... (*Gower, supra* at 52-53).

With the spinning out of insolvency and securities from the Companies Act, consideration was also given to creation of a North American-style personal property security regime as recommended in the Diamond Report on Charges. This stand alone regime would have replaced Part IV of the Companies Act 1985. This initiative has stalled and the U.K. Government has announced that Professor Diamond's recommendations will not be taken up.

A second major indirect effect of the imposition of European Commission Directives on U.K. company law may very well be the heightened tension between statutory and non-statutory norms in the United Kingdom. The continental European legal model is very much one of "written law", "le droit écrit". Legal norms find their expression in comprehensive codifications (for which the European countries are justly famous) and individual statutory pronouncements.

This has not traditionally been the English way. Even the Companies Act 1985 is only a consolidation (as opposed to a codification) and, even at that, only of the "greater part of the Companies Acts". The Act is supplemented by later statutes such as the Companies Act 1989. Company law also continues in large measure to rely on common law principles

as they have been developed by the judiciary. Finally, non-statutory "rules" continue to play an important role in company law; for example, the City Code on Take-overs and Mergers which assumes voluntary compliance; stock exchange listing rules which now have a "quasi-statutory" nature under a delegation of authority from the Treasury; and "guidelines", such as those developed in response to recommendations in the Cadbury Report, which remain discretionary. The area of directors' duties is a prime example of the complex interplay of these various statutory and non-statutory elements. This complexity is increasingly hard to justify and very much at odds with the continental European approach of codification and "written law". Even in other common law countries, especially Canada and the United States, statutory norms predominate in the area of corporate and securities law.

As to the future direction of U.K. companies law, Gower is not optimistic:

> It seems inevitable that developments in our Company Law over the next 25 years will follow much the same pattern as that of the past twenty five. Reforms will be piecemeal without any review of the basic structure and with a marked reluctance to tackle fundamental problems except to the extent forced upon us by the EC. The latter's initiatives will result in major changes and if these are to be to our liking it behoves us to play a more constructive role in the preparatory stages of Community legislation than we generally have in the past. Domestically inspired changes to our companies' and related legislation are likely to be restricted mainly to technical matters, to the removal of flaws which have come to light in the legislation of 1985-86, and to the closing of loop-holes revealed by scandals as yet unforseen. Our company legislation will continue to increase in length and, since changes in our style of legislative drafting are most unlikely, will become still more complex and opaque. But cheer up: all this should provide grist to the mills of company lawyers (*ibid.* at 78).

THE COMMONWEALTH

2. AUSTRALIA

2.1 Complexity and Constitutionality. The Australian Corporations Law is a huge, complex statute, running, literally, into thousands of sections. For constitutional and political reasons, Australia being a federal state, the Corporations Law fits and operates within a very complex legislative framework of state and federal law. According to the Chief Justice of Australia, "Oscar Wilde, the supreme stylist, would have regarded our modern *Corporations Law* not only as uneatable but also as indigestible and incomprehensible" (A. Mason, "Corporate Law: The Challenge of Complexity" (1992) 2 Aust. J. Corp. L. 1). The complexity has spawned its own legal literature speculating on its sources.

The past twenty years have been ones of ferment and intense legislative activity in corporations law in Australia, and times are still unsettled. Complexity in corporate law statutes, however, may have reached its limits in Australia. A major initiative, the Corporations Law Simplification Program, was announced in October 1993 and has been rapidly producing proposals and draft legislation.

There are several factors, which, working together, have resulted in the legislative situation in Australia being more complex than even in the U.K. The first factor has been the use of U.K. companies legislation itself as the basic model for Australian corporations

law. As in many other Commonwealth jurisdictions, the U.K. Companies Act 1862 and the 19th century U.K. legislation that followed were very influential in the development of Australian companies law and their outlines are still apparent. Over time, variations appeared in response to local circumstances, but the continued use of the U.K. model has left Australian company law with many of the same difficulties as the U.K. legislation (see above).

As local divergences began to appear, so did other changes in the legislation arising "from the emergence of new ways of fund-raising and dealing in securities" (*ibid.*). In a federal country where companies law was governed at a state level, the pressures for uniformity at a national level in the development and regulation of capital markets resulted in efforts to "federalise" companies law in the 1960s and 1970s. In developing a securities regulatory regime within a companies law framework, Australia ran into nearly insuperable constitutional difficulties, of a kind which do not exist in a unitary state such as the United Kingdom. The struggle which ensued now, happily, seems to have reached a point of resolution.

Australia has also, befitting its stature as a mature member of the Commonwealth, been highly attuned to legislative developments both in the United Kingdom and elsewhere, especially to developments with respect to capital markets. The Corporations Law is sprinkled liberally with alphanumeric amendments dealing with such matters as electronic clearing of securities, netting, continuous disclosure, insider trading, repurchase agreements, and so on. Such responsiveness to modern developments comes at a cost, however, as it adds to the already impressive bulk of the Corporations Law.

A further complicating factor (in addition to the constitutional complexity and perhaps arising directly out of the "federalisation" exercise) is the monolithic nature of the Corporations Law. It is an omnibus statute, and despite its "corporations" title (which might suggest a more focused North American approach), it retains the pre-1986 U.K. company law structure, combining charges, securities regulation, insolvency and corporate law in the same legislation. There is certainly a "convenience" argument in favour of this approach. In writing on "dismembering" the Australian Corporations Law, Professor Ralph Simmonds comments:

> ...one may legitimately ask, then why go to the trouble of breaking up the Corporations Law in the first place? The distinctions I am calling for, after all, correspond to Chapters or Parts in the statute which can be kept distinct. Modern lawyers should be used to thinking in functional terms, and do not need separate statutes to ensure that they make sensible distinctions.
>
> Further, there is no denying the significance of securities regulation and personal property security law to corporations. It might be argued that having the law on these topics, at least so far as it concerns corporations, together in one statute with "core" corporations law, would safeguard us against losing sight of how that "core" law is often misleading when read without account for the wider context (R. Simmonds, "Dismembering the Corporations Law and Other Law Reform: Should Something More be Added to the Law Reform Agenda?" (1995) 13 Company and Securities L. J. 57 at 61).

But, quite apart from the fact that this monolithic approach results in a statute that weighs

over 2.3 kilograms (in the Butterworths 1995 softcover edition), there are persuasive arguments militating in favour of separate statutory treatment of these different areas of commercial law:

> I would respond that categories guide thought, and that we should use the best categories to hand. Company law is too wide a category to cover the three fields here. The Corporations Law and recent reform directions in Australia contain, in my view, evidence of the trouble to which sub-optimal categories can lead....By covering securities regulation and personal property security law along with the internal ordering of the corporation, we are making it unnecessarily hard for ourselves to keep the various policy strands of those areas apart. If we want better law in each of these areas, we need to have them in different statutes, if not under different regulatory arrangements (*ibid.* at 61, 63).

Despite these obvious difficulties, there are valuable lessons to be learned from Australian company law, in the largest sense, and from the rethinking which is proceeding there apace. Certainly, from an administrative point of view, the functioning of the Australian Securities Commission, which has oversight of the Corporations Law, and the high degree of computerisation of administration of the legislation may be instructive. One caveat, though, is that the Australian Securities Commission has wide-ranging regulatory powers and an interventionist role, in part modelled on the United States Securities and Exchange Commission, an expensive undertaking. The current process of simplification of the legislation is also of considerable interest as it promises to make a break with the Australian tradition of legislative complexity.

2.2 Corporations Law Simplification Program. There is no doubt that the ambitious Corporations Law Simplification Program in Australia is the current focus of all corporate law developments there. The complexity of the Australian Corporations Law had reached the limits of tolerance. The Simplification Program appears to be a response to a failed initiative, the Close Corporations Act 1989, and the unacceptable level of legislative complexity in the Corporations Law.

The Close Corporations Act 1989 was enacted but never proclaimed, in part because it shared the same constitutional infirmities of the Corporations Act 1989 which had succumbed to a challenge in the courts. The Close Corporations Act 1989 had its origins in a Companies and Securities Law Review Committee initiative "to recommend a simpler and cheaper form of corporate structure for entrepreneurs, with due regard to their particular needs and without burdening them with statutory requirements which are not significant under the circumstances" (Australia, Companies and Securities Law Reform Commission, *Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises* (September 1985) at 3).

In structure, the entity proposed demonstrated many similarities with the South African close corporation: a minimum of one and a maximum of ten members; only natural persons as members; no directors; inability of such corporations to act as a trustee or a holding company. The Parliamentary Committee subsequently charged with reviewing the Close Corporations Act 1989 agreed with the "widely held view that the Corporations Law is complex and that, as a result, small businesses run the risk of inadvertent non-compliance with its many requirements. The Committee also doubts the utility of the filing requirements which small companies must observe. The returns are rarely referred to and are of dubious

value to creditors or others interested in the company" (Australia, Joint Statutory Committee on Corporations and Securities, *Close Corporations Act 1989* (December 1992) at 13).

In addition to the constitutional difficulties, the Close Corporations Act also foundered on the shoals of its own inventiveness. Australia was not quite ready for one person corporations and the elimination of such traditional corporate structures as the board of directors. The successful South African experience apparently did not entirely allay the apprehensions surrounding these innovations. But in recommending "the introduction of a new corporate form, the private company, within the existing Corporations Law [which] would adopt the best features of the proposed close corporation while eliminating those that were the subject of extensive criticism" (*ibid.* at xii), the Committee shifted the focus of simplification efforts to the Corporations Law as a whole.

The Corporations Law Simplification Task Force attempts to practice what it preaches. In its initial publication, the December 1993, *Plan of Action*, the Task Force outlined its objectives in remarkably simple and concise language: simplification of content, clarification of drafting and comprehensive consultation (Australia, Corporations Law Simplification Task Force, *Plan of Action* (December 1993)). With respect to simplification:

> Action to simplify the content will concentrate on those sections of the law where policies:
>
> - are unclear or uncertain or no longer relevant
> - do not cater for the needs of small business
> - place undue regulatory burdens on business
> - thwart the efficient operation of the law
> - do not achieve their objectives on technical grounds
>
> The objective is to streamline the law, procure consistency and coherence, strip away unnecessary complexities, maintain effective protection for investors, and bring significant cost benefits both to business in complying with the law and to relevant authorities in administering it (*ibid.*).

The "central objective" of the Simplification Program, according to the Task Force, is "a law capable of being understood by its users" (*ibid.*)

Legislation has appeared remarkably quickly. The "First Corporate Law Simplification Bill 1994" was introduced December 8, 1994 and passed October 17, 1995. "[T]he Bill prepared by the Task Force will streamline the law, achieve greater consistency and remove unnecessary complexities" (*First Corporate Law Simplification Bill, Exposure Draft* (July 1994) at 2). The first thing the Bill does is repeal the Close Corporations Act 1989.

What else does it do? It addresses a variety of securities and corporate law issues: it simplifies the share buyback provisions for public companies; adopts in modified form some of the provisions of the Close Corporations Act 1989 (for example, it recognises two kinds of proprietary corporations, small and large; it permits single director/single member

corporations although not adopting the boardless close corporation concept); it reduces the financial reporting obligations for smaller companies; it strengthens the accountability of larger companies; it abolishes five of the registers now kept by companies and eliminates duplication with information available through the ASC; it introduces a small business guide which summarises in one place all the rules most important for smaller companies.

The Second Corporate Law Simplification Bill was released for comment June 29, 1995 and according to the Attorney-General for Australia, "represents the most comprehensive rewrite of the underlying principles of company law since the U.K. Companies Act was first adopted in Australia in the 1860s....The Second Bill will cover a much wider area than the first. It will include the provisions on forming a company, share capital, accounts and audit, company meetings, company names, annual returns and defunct companies. Once this Bill is passed most of the core company law areas which impact particularly on small business will have been simplified" (Attorney General for Australia, News Release 64/95, (29 June 1995)). Despite the cloak of "simplification" and changes in form not substance, Australian law is undergoing, as the Attorney-General correctly points out, a "comprehensive rewrite of the underlying principles".

In brief, among other changes, the Second Bill proposes the following:

1. Registration and basic features of a company:

- single stage incorporation process
- rules governing internal affairs will be in the statute and articles (i.e. a constitution) will be optional
- no liability companies and companies limited both by shares and by guarantee will no longer be available as a form of incorporation
- a common seal will no longer be obligatory

2. Meetings

- members holding at least 5% of the votes will be entitled to call a general meeting
- meetings by use of electronic communication devices will be facilitated

3. Share Capital

- shares will no longer have a par value
- capital reductions will no longer require court confirmation and must be fair and reasonable to all shareholders
- financial assistance must not result in a material deterioration of the company's financial position (without shareholder approval)

4. Accounts and audit

- accounting rules will be matters for accounting standards
- improvements in quality of directors' reports to members

5. Annual Returns

- over half the items in annual returns will be deleted

- electronic filing will be facilitated

A quick glance at the outlines of the Second Bill leaves little doubt as to a major source of its inspiration: recent changes to companies law in New Zealand which in turn were based on changes recommended 25 years ago in Canada.

The Simplification Program has been proceeding very rapidly in Australia, which may indicate both the intensity of the crisis in Australian corporate law and also a considerable amount of political will. The worry, expressed by some commentators is that despite the best of intentions, the confusion of some conceptual issues may be counterproductive to the program (for example, see Simmonds, *supra*).

3. CANADA

3.1 A Model for the Commonwealth. Like the United States and Australia, Canada is a federal state with a multiplicity of corporate statutes. Unlike the United States, there is a federal corporations statute, the Canada Business Corporations Act (CBCA), as well as corporate legislation in each of the 10 provinces. Upon implementation of the CBCA in 1975, a deliberate and fairly successful effort was made to harmonise the provincial statutes to the new federal regime in Canada. Nova Scotia and British Columbia resisted the change to the federal model, but over time both have incorporated many features of the CBCA, with British Columbia, in particular, evolving into an "anomalous hybrid" (B. Welling, *Corporate Law in Canada*, 2d ed. (Toronto: Butterworths, 1991) at 39).

Again unlike the United States, there is no federal securities regulator in Canada. Although Canada has adopted securities regimes which are very much American in concept and approach (and, with the advancing state of economic integration in North America, daily becoming more so), each province has its own securities law regime. Sporadically, there are calls for a national or federal securities regulator in Canada, but to date informal efforts at coordination and harmonisation have proved adequate to regulate Canada's capital markets.

Over the last twenty years, regional variations have crept back into the harmonised provincial corporate statutes but overall they remain remarkably similar to the CBCA in general structure and detail. Some provincial legislatures have been more responsive to change than others and have renewed their corporate statutes with greater regularity than the federal government. This has resulted in some divergence in detail.

One of the driving forces behind a current reassessment of corporate law in Canada has been the aggressiveness with which securities regulators have appropriated to themselves issues more traditionally characterised as corporate law. Ontario, Canada's lead commercial jurisdiction, has attempted to consolidate its position as Canada's business centre by coordinating the development of its securities laws and its corporate statute, the Ontario Business Corporations Act (OBCA). Ontario has produced a slick and efficient corporations regime. "Indeed, in Ontario's case, the province prides itself on the fact that a certificate of incorporation can be issued in 20 minutes!" (J. Ziegel, "The C.B.C.A. - Twenty Years Later: Where Do We Go From Here?" in *Meredith Lectures: Corporations at the Crossroads* (Montreal: Faculty of Law, McGill Univesity, 1995) at 6). Developments in Ontario are now exerting an influence on the federal CBCA. For purposes of this discussion, however, the CBCA will be the focus.

When the CBCA was implemented, it was considered to be revolutionary in many respects.

> The Canadian approach has abandoned old concepts and substituted new ones specifically designed for their purpose....First the Canadian approach results in short, straightforward provisions that lead directly to the heart of the matter....It is not just a question of legislative style. It is a question of the approach to reform. The Canadian approach is a truly reforming one. The old law is cut away and new law grafted in...In Canada the root of the problem in the underlying concepts has been recognised and a solution supplied on the conceptual level (E. Jacobs, "Conceptual Contrasts – Comparative Approaches to Company Law Reform" (1990) 11 Company Lawyer 215 at 219).

The CBCA has aged well; it still appears remarkably fresh after twenty years and has required very little "maintenance" by way of statutory amendment.

> When the 20th century history of Canadian corporations law comes to be written, the drafting and enactment of the Canada Business Corporations Act in 1975 will surely be hailed as a major achievement. Federal corporations law in the preceding hundred years had been quite undistinguished. It was almost entirely derivative with no clear underlying philosophy, stodgily drafted, and haphazardly patched up periodically when someone persuaded the government of the day that something needed to be done. It was also badly dated in most respects by the time the Trudeau government commissioned the three wise men – Robert Dickerson, Leon Getz and John Howard – to draft a new statute from scratch.
>
> The CBCA had all of the virtues its predecessors lacked. The drafters had a clear conception of what they wanted the new Act to look like and they pursued a series of well-defined and clearly articulated goals. They endorsed a strong dose of enablingism with respect to incorporation procedures and dispensed with formalism where it served no useful purpose. They embraced a principled scheme of corporate governance and combined it with a strong affirmation of non-excludable obligations to which officers and directors were subject. They were conscious of the vulnerability of minority shareholders and sprinkled the Act liberally with substantive and remedial safeguards for their protection. No less important, the Act was drafted in commendably clear language and crisp sentences. The exposure draft was accompanied by a commentary volume clearly explaining the drafters' goals and what the various provisions were designed to accomplish (Zeigel, *supra* at 5).

The CBCA, and the Dickerson Report which preceded it, continue to influence reforms in jurisdictions as diverse as South Africa, Singapore, Australia and New Zealand where concepts introduced by the CBCA and time-tested in Canada are now making their appearance.

The sources of the CBCA were for the most part American. The most important contribution of U.K. law was the oppression remedy (based on s.210 of the U.K. Companies Act 1948, although a deferential nod of the head was made to Professor Gower for his work on the 1961 Ghana Code). Looking back after 20 years, one of the original members of the Dickerson Committee recollects:

> It is enormously difficult to attribute to the CBCA any one source of law. From Gower's Ghana Code the task force members acquired inspiration in the sense of questioning, as Gower had done with undoubted credibility, every single concept, jettisoning those that had outlived their usefulness, saving some, and synthesizing ideas from several sources to address current problems. From the [U.S.] Model Business Corporation Act, the draftsmen extracted the

> whole structure, system of formalities and administrative law precepts. From the Uniform Commercial Code we derived the share transfer system, which rightly characterizes a share certificate as a special form of negotiable instrument. From various Commonwealth laws we synthesized the oppression remedy, complementing it with the derivative action as developed in Delaware and New York. And from working closely with the Canadian Institute of Chartered Accountants, then led by its Executive Director, Doug Thomas, we developed what was probably the most original and most contentious part of the CBCA, the part dealing with corporate finance. Although very controversial, deleting the concept of par value was only a minor step. Far more significant were two other CBCA characteristics. The first was to discard conceptual labels and to characterize corporate securities as Protean instruments along a broad spectrum of attributes that can be adapted at will to meet market needs. The second was to delete all accounting disclosure standards from the act and, instead incorporate by reference into the CBCA the measurement and disclosure standards of the CICA Handbook. That eliminated a great deal of statutory verbiage, obviated bureaucratic regulation of the accounting system as under the SEC's Regulation S-X, and assigned to an experienced self regulatory organization the obligation to maintain a system of necessarily dynamic accounting standards.
>
> After 20 years of acceptance, those seem like trivial victories, but at the time they appeared to be, if not heresy, potential show stoppers in the political arena (J. Howard, "Opening Remarks" in *Corporations at the Crossroads* (address at the Meredith Lectures, McGill University, Montreal, Canada, 1995) [unpublished]).

The Dickerson Report, which had been published in the form of draft legislation with accompanying commentary, was adopted by the legislature virtually unchanged as the CBCA. The existing Canada Corporations Act had not been comprehensively amended since 1934. Over a five year transition period, the application of the Canada Corporations Act to business corporations was phased out.

What had the Dickerson Report recommended that so changed Canadian corporate law? It is interesting to note what the Report considered to be "minor" reforms and why:

Minor Reforms:

- incorporation by designating number ("scarcely profound but useful")
- recognised validity of pre-incorporation contracts ("simple and long-overdue")
- recognised one person corporation (did away with a "tiresome, unrealistic and easily avoided bit of legal dogma")
- law of dividends ("clarify...a mass of confusing case law")
- permitting corporations to purchase their own shares ("relax a troublesome prohibition")
- change in method of incorporation from letters patent to registration (not a "basic change").

Some of the major reforms recommended, in the view of the Dickerson Committee, were the following:

Major Reforms:

- codification of directors duties and liabilities ("principles....more or less well developed in case law")

- codification of corporate dissolution (goal was to "rationalise")
- continuance and discontinuance provisions (permitting corporations to "transfer their place of jurisdiction")
- new regime for transfer of corporate securities ("eliminate expense and delay")
- new regime for rights and duties of auditors ("long neglected")
- shareholders remedies ("most significant and far-reaching")

In addition to their major and minor reforms, the Dickerson Report notes a variety of miscellaneous recommendations:

Miscellaneous reforms

- elimination of mandatory authorised capital; now may be unlimited ("much confusion in the past")
- elimination of par value ("utterly useless idea")
- prohibition of partly-paid shares ("removes all kinds of difficulties")
- non-voting shares ("shares may be of different classes, with different terms and conditions attached")
- elimination of corporate objects and powers (to "reflect commercial reality ") and elimination of the doctrines of ultra vires and constructive notice ("little more than a playground for the legal scholar")
- no distinction between private-public corporations ("distinguished on functional rather than on doctrinal grounds")
- legitimation of unanimous shareholder agreements ("allow closely-held corporation...to operate, in effect, as a partnership with limited liability")
- elimination of mortgage register for registration of charges ("useless")

This checklist is instructive. Many of these "revolutionary" concepts are now common-place and have guided or are now guiding reform elsewhere.

3.2 Reforms in Canada. Industry Canada, the governmental ministry responsible for the CBCA, is currently in the process of conducting the first comprehensive review of the CBCA since its implementation in 1975. It is telling, and a fitting homage to its drafters, that the issues under consideration are primarily technical and a matter of updating and coordinating the legislation with developments elsewhere.

The duties and liabilities of directors, in Canada as elsewhere, have been the subject of intensive debate. Corporate governance issues have been in the spotlight with a report of The Toronto Stock Exchange (the "Dey Report") following on the heels of the well-known Cadbury Report in the United Kingdom. However, no changes of major significance with respect to directors are under consideration in the context of the review of the CBCA. Financial assistance provisions may be repealed, tightened-up or a disclosure-based approach adopted. Canadian residency requirements for directors of CBCA corporations are being reconsidered. Some technical amendments with respect to liability for unpaid wages and a good faith reliance defence are in the works, as well as provisions for the advance of defence costs and expansion of indemnity provisions for directors.

4. NEW ZEALAND

4.1 A Break from the U.K. Tradition

Following the pattern set in other Commonwealth jurisdictions, the United Kingdom Companies Act 1948 was the watershed for New Zealand companies law. As it had in the past, New Zealand enacted companies legislation in 1955 that "was almost an exact copy of the United Kingdom Act of 1948. The following of English precedent has been a tradition of New Zealand company law since the first Act of 1860" (New Zealand Law Commission, *Company Law - Reform and Restatement, Report No. 9* (June 1989) at 8). The enactment of the New Zealand Companies Act 1955 was the last time New Zealand would follow the U.K. tradition in companies law without question.

The first major break with the U.K. legislative tradition came in 1978 with the separation of securities law from companies law. The Securities Act 1978 came into operation in 1983.

> Previously, when a company wished to raise funds, either by way of a share issue or debenture offer, the procedure it had to follow was regulated by the companies legislation then in force, i.e., the *Companies Act 1955*. A characteristic of companies legislation, past and present, is that it is entity based. It is designed to regulate the activities of those entities called companies.
>
> The *Securities Act*, however, was not drafted to regulate any specific kind of legal entity. Rather it is directed towards the activity of fund raising, thereby automatically bringing within its ambit all legal entities (ie, natural persons, unit trusts, partnerships, corporate bodies) which seek to engage in fund raising. (A. Beck & A. Borrowdale, *Guidebook to New Zealand Companies and Securities Law*, 5th ed. (Auckland: CCH, 1994) at 145).

This distinction between entity-based companies law and activity-based securities regulation is very much North American in inspiration and informs all North American corporate and securities legislation.

The New Zealand securities legislation was drafted in response to a particular scandal which the Companies Act 1955 prospectus provisions (because they were "entity-based") failed to prevent. A huge regulatory gap had existed which only activity-based securities regulation could fill.

> The notorious collapse of Securitibank provided the impetus for the legislation ultimately enacted as the *Securities Act* 1978. In particular, it was a matter of great concern that Securitibank's activities in soliciting investments from the public were apparently not caught by the prospectus provisions of the existing law.
>
> The *Securities Act* has created the Securities Commission and provided a structure for regulating fund raising (*ibid.* at 146).

The excising in 1978 of "securities law" from the Companies Act 1955 was the first, determinative step towards adoption of North American models in other areas of New Zealand law. Future companies law reform along North American lines became virtually inevitable. And, when legislators looked to North American models of companies law, they naturally considered the utility of North American models in other areas of the law.

The Law Commission believed that the new Companies Act should be concerned with what it termed 'core company law', that is, the formation, operation and termination of all companies. According to this philosophy, the statute should contain basic company law applicable to all companies; whereas, legal requirements applicable only to some companies --for example, listed companies-- should be imposed through specific legislation, and as such, be superimposed upon the core company law base contained in the Companies Act.

Despite mild assertions that the draft company law being proposed was not "based on any one overseas model", it remains the case that the "(U.S.) Model Business Corporations Act [was] of great assistance, as was the work of the Dickerson report which preceded the Canada Business Corporations Act" (New Zealand Law Commission, *Company Law Reform: Transition and Revision, Report No. 16* (September 1990) at xvii).

Report No. 9, Company Law — Reform and Restatement, appeared in 1989. It proposed a dramatic rupture with the U.K. tradition in company law. As with the Gower Code and the Dickerson Report, the New Zealand Law Commission approached the company law reform exercise from a conceptual point of view, and not one of tinkering with the old ideas.

In 1988, New Zealand and Australia had formally agreed to harmonise their business laws and, at the time of *Report No. 9*, Australia was still very much under the thrall of the U.K. model. The New Zealand decision to make such a radical departure in its companies law needed careful consideration and justification in this context.

> ...[T]he Law Commission believes that the present Australian legislation does not provide an acceptable model for company law reform. It is outdated and dense in form. While we do not see harmonisation as requiring replication of the law in detail, the difference between what we propose and the existing Australian system goes well beyond detail. To follow the Australian companies legislation would preclude the major reforms proposed in this report of abolition of par value and nominal capital and the introduction of a better and more principled system of director accountability and shareholder remedy. It is the view of the Law Commission that there is little point in bringing in a new Companies Act if it does not achieve these reforms (*Report No. 9, supra* at 11).

New Zealand decided to press on with its reforms despite the gap which this would create between Australian and New Zealand companies law. The Commission felt that

although a high degree of harmonisation was desirable in the regulation of capital markets (i.e., securities law), in the area of companies law the arguments were not as compelling. Again, inspiration for this decision came from North America where there is one federal securities regime in the United States (replicated at state level) but great diversity in state corporations law. The soundness of this decision is evident in the very recent Australian Corporations Law Simplification Program which is now, implicitly or not, taking its lead from the New Zealand legislation. Again, imitation is the highest form of flattery.

The New Zealand Department of Justice took a more cautious approach when it assumed responsibility for preparing the Companies Bill. The Law Commission's draft was retained as the basis for the new legislation, but many details were altered, often to keep the proposed law closer in line with traditional positions. Among the notable changes introduced by the Department of Justice and substantively carried forward in the 1993 Act were those dealing with shareholder voting, directors' duty of care and the company constitution.

A major criticism of the legislation, as finally enacted, was that the Justice Department's draftsmen did not understand the new conceptual underpinning of the draft legislation proposed by the Law Commission and so compromised the integrity and coherence of the legislation by adhering to older U.K. constructs.

4.2 **A Shift to North American Models.** The New Zealand Companies Act 1993 came into effect July 1, 1994. For a transitional period, it will operate concurrently with the 1955 statute which will finally be phased out July 1, 1997. New companies must incorporate under the 1993 Act and existing companies must, before the 1955 Act vanishes, reregister under the new Act. Even so, for this transitional period the 1955 Act has been pruned and modernised so as not to create great disparities in application with the 1993 Act. In the essentials, the two acts have been harmonised.

There is no doubt of the extent of change which the Companies Act 1993 has already wrought in the New Zealand legislative landscape. An entirely new infrastructure for commercial law has emerged to provide support for the Companies Act. In 1993 alone, there appeared the Financial Reporting Act 1993 (establishing an accounting standards board, giving legal force to accounting standards, requiring issuers of securities to the public to prepare audited financials and stipulating the financial reporting requirements for such issuers); the Receiverships Act 1993 (replacing Part VII of the 1955 Act and creating a regime applicable to a wider class than just corporations); the Takeovers Act 1993 (establishing a panel for the purposes of recommending a Takeovers Code which would then have force of law); and the Companies (Registration of Charges Act) 1993 (replacing the charges provisions of the 1955 Act on an interim basis pending implementation of the comprehensive personal property security regime).

In addition, in keeping with the decision to adopt a North American model for Companies Law, it has become virtually inevitable that other complementary regimes will follow. For example, if, in following a North American corporate law model, the provisions on "Charges" are removed from the Companies Act, what replaces them? The Law Commission answered in its *Report No. 8, A Personal Property Securities Act for New Zealand*:

> The Committee believes that the introduction of a Personal Property Securities Act in New Zealand, based on the Canadian and United States models, and consistent with major reforms now being recommended in the United Kingdom by Professor Diamond, will mean that New Zealand will not only provide a lead in the adoption of standardised procedures between Australia and New Zealand but also play a significant role in harmonisation between the Australasian jurisdictions and their major trading partners in Canada, the United States and the United Kingdom (New Zealand Law Commission, *A Personal Property Securities Act For New Zealand, Report No. 8* (1989) at 8-9).

It is early yet to determine the ramifications and ultimate success of New Zealand's new legislation. An initial assessment, based on Australia's obvious interest in the directions which New Zealand has taken, would indicate that a corner has been turned in company law in Australasia.

5. SOUTH AFRICA

5.1 Company Law in a Mixed Jurisdiction. The law of present day South Africa is Roman-Dutch, modified to some extent by the reception of English law (H.R. Hahlo & E. Kahn, *The South African Legal System and its Background* (Cape Town: Juta, 1968) at 330). The term Roman-Dutch law, coined by Simon van Leeuwen in the seventeenth century, signifies a form of civilian, continental law which was received in Northern Europe during the fifteenth and sixteenth centuries. Unlike its present day civilian brothers, Roman-Dutch law has remained unaffected by the wave of codifications which took place in the aftermath of the French revolution (see generally Hahlo & Kahn, *supra* at 563). When the Dutch Colony came under British rule in 1795, the government, administration and judicial machinery were set up along English lines, and English civil and criminal procedure, as well as the law of evidence, were largely adapted. Finally, English commercial and company law were also introduced.

Until relatively recently, the company law of South Africa developed along the same lines as that of the United Kingdom. The Companies Act of 1973 remains very much U.K.-style memorandum of association legislation, with all of the related trappings.

The most significant example of the different roads recently taken by U.K. and South African lawmakers is the adoption in 1984 of the South African Close Corporations Act. This new legislative direction was inspired by the U.K. Green Paper on *A New Form of Incorporation for Small Firms*, itself based on a memorandum (Cmnd 8171) written by Professor Gower. Ironically, although this new direction was warmly received in South Africa, it was never implemented in the United Kingdom.

5.2 South African Close Corporations Act 69 of 1984. The South African Close Corporations Act has proved to be one of the most remarkable innovations in South African company law. This special legislation for the incorporation of small companies combines many of the attributes of partnership with the corporate attributes of legal personality and limited liability.

The purpose of the South African Close Corporations Act was to provide a simple, inexpensive business entity for a single person operation or that involving a small number of persons. No restriction is placed on the size of the business or undertaking, merely on

the number of participants (no more than ten who must generally be natural persons). It was envisaged that a successful business of a close corporation should not outgrow its legal form. The system was carefully designed to appeal to both the unsophisticated business person (who simply adopts the statutory regime) or sophisticated business people who can alter the statutory regime by agreement. And, unlike partnership, there is no requirement that the entity be used for profit.

The impetus for creation of the separate regime for close corporations in South Africa sprang from frustration with the complexity of the existing U.K.-inspired South African Companies Act of 1973 and its unresponsiveness to the needs of small businesses. "It is known that sham compliance with formalities, like the drafting of notices and minutes of meetings that never took place, is common practice. This is a waste of money and skilled manpower. Moreover, the fact that this sham compliance has not given rise to serious prejudice does not prove that the 'system works'. It rather shows that the formalities concerned are meaningless. Sham compliance also fosters disrespect for the law" (S.J. Naudé, "The Need for a New Legal Form for Small Businesses" (1982) 4 Modern Business Law 5 at 6).

The decision was made to create a separate statute rather than amend the existing Companies Act. This decision was influenced in large measure by a similar approach in continental Europe, where separate regimes exist for typically bigger and smaller businesses (see discussion of the German GmbH and French SARL, below). The goal was to achieve "the greatest possible simplicity" and "an attempt to build the required flexibility into the Companies Act could only exacerbate the problem by an inevitable overall increase in complexity" (*ibid.*).

Although the approach was inspired by continental Europe, the models were not the GmbH or the SARL. "Guidance was sought in modern Corporation Acts (for instance the Canada Business Corporations Act of 1975), various partnership codes and Professor Gower's 'The Incorporated Private Partnership Bill' in the *Final Report of the Commission of Enquiry into the Working and Administration of the present Company Law of Ghana* (1961)" (*ibid.* at 12).

The South African Close Corporation may startle a traditional company lawyer. There are no shares and no board of directors. Incorporation is effected by registration of a single document. Capital maintenance requirements have been abandoned in favour of solvency and liquidity tests. The close corporation has the capacity and powers of a natural person; there is no room for application of the *ultra vires* doctrine or constructive notice. There is a simple statement of fiduciary duties of members and the negligence standard of care. One person corporations are possible. All members must actively participate in the business and have equal rights to do so (although these provisions may be waived). There must be annual accounts prepared by an accountant. It is not necessary that the accounts be audited by an auditor.

The legislation has done away with the multitude of criminal offences and administrative duties under the Companies Act.

This is a significant defect of the Companies Act, which bristles with sections creating purely

> technical offences, which are sometimes difficult to explain, and in many cases rarely, if ever, enforced. Criminal law is a blunt and largely ineffective instrument for ensuring that technical or administrative duties imposed in an act like the Companies or Close Corporations Act are complied with (*ibid.* at 16).

Self-enforcement has replaced criminal sanctions; the rules are few, but if they are not followed, members incur personal liability.

The South African close corporations legislation has been looked to by other jurisdictions in Africa, and most recently Australia and Canada. In South Africa itself the expectation was that the new concepts introduced by the Close Corporations Act would spread to the existing Companies Act. This may not have happened as quickly as expected but the hope survives "that various innovative concepts of the act that have survived the proving grounds of competitive corporate practice during the past decade, constitute a convenient and readily available blueprint for the imaginative and speedy reform of important areas of South African company law" (J.J. Henning, "Closely Held Corporations: Perspectives on Developments in Four Jurisdictions" (1995) 58 Journal of Contemporary Roman-Dutlu Law 100 at 101).

6. THE UNITED STATES

6.1 Unity in Diversity. The United States is undoubtedly one of the richest sources of legislation, case law and debate about corporations. There is no federal corporations statute as such (although there has been debate in the past as to its desirability). Each state has its own corporate law regime which has resulted at times in competition among states to attract incorporations (a phenomenon about which a lively literature has developed).

State incorporation has produced a wide diversity of legislation and experimentation in the corporate form. The situation is not, however, as chaotic as might be implied by the existence of fifty or so different corporate laws operating in the same country. There are several mitigating factors promoting harmonisation, cooperation and, in some cases, uniformity across the United States.

The first is the ever important federal Constitution; although there is no express federal jurisdiction to govern incorporations, under the very broad interstate commerce clause a myriad of federal legislative provisions apply to state incorporated entities. In this way, uniformity of standards and treatment in certain areas is assured: anti-trust, bankruptcy, securities, among others. In addition, the court structure is such that the so-called "diversity jurisdiction" of the federal court system may catch commercial litigation, thus developing a body of federal case law applicable to corporations. And the famous "full faith and credit" clause of the U.S. Constitution assures recognition of state legislation and case law from one state to another.

Perhaps the most significant of these federal laws applicable to corporations is the federal securities regime. In the 1930s, in reaction to the stock market crash of 1929, the federal government enacted a series of securities statutes in the interests of public investor protection. The agency created to administer this legislation, the Securities and Exchange

Commission (SEC), grew to be one of the most powerful administrative agencies in the world. Although there have been jurisdictional battles between the SEC and state legislatures over where the lines are drawn between corporate law matters and securities law matters (in the realm of takeovers, for example, during the 1980s), it remains the case that many areas of overlap respecting shareholders have been preempted by SEC action. Thus many matters characterised as "company law" elsewhere have been characterised in the United States as securities law and taken out of the orbit of the state legislatures. Some commentators even speak of a "growing body of 'federal corporation law'" (H. Henn & J. Alexander, *Laws of Corporations*, 3d ed. (St. Paul: West Publishing, 1983) at 7).

A second harmonising factor has been the existence of model statutes. These serve variously as uniform acts or as drafting guides which may be customised by each individual state. The Model Business Corporations Act, in one or other of its variations, is adhered to by a large number of states. As the product of the American Bar Association (Section of Business Law), the MBCA is a good indicator of many of the current debates being held among American practitioners and scholars alike.

The third stabilising factor in corporate law in the United States has been the emergence of a small number of "lead jurisdictions". Delaware, New York and California literally lead rather than follow the Model Acts. The drafters of the Model Acts, at a distance, pick up on trends and innovations in the lead jurisdictions.

Although not itself a state of great commercial activity, Delaware is well-known for its management friendly legislation and as home to the "Fortune 500" corporations in America. Its detractors accuse it of having turned incorporation into an industry in and of itself. Defenders of Delaware cite it as providing a "national law" for large public companies by providing a highly responsive statute, sophisticated practitioners and administrators, and a knowledgeable and specialised judiciary. New York is the leading business law jurisdiction in the United States, and with Delaware is the preeminent corporate law jurisdiction. California, like New York, being a jurisdiction of great commercial activity, has developed its own unique corporate law regime, which in some respects represents a much more invasive or regulatory approach to governing corporations.

6.2 Origins of U.S. Corporate Law. Unlike "gas" and "petrol", the distinction between a corporation in America and a company in the United Kingdom is not one of terminology alone. Thanks to the American Revolution, the corporation in America branched off very early from its U.K. roots and followed a different conceptual and evolutionary path. U.S. corporations are distinct from and do not historically find their origins in the 19th century joint stock company. The statutory regime applicable to American business corporations developed rather from the special charter or special act corporations, which started to appear shortly after the American Revolution.

> In the decade following the Constitution, some 200 more business corporations were incorporated in the United States under special acts of state legislatures. Fears of crown and [sic] monopoly made this a jealously-guarded legislative function. Corruption and bribery of the state legislators and the inefficiency of the system, coupled with the impact of the Industrial Revolution, called for a change. The special charters, however, provided generalized patterns for the resulting state corporate statutes (*ibid.* at 25).

The implications of the very different origin of the American corporation (as opposed to the United Kingdom company) go beyond historical interest. The corporation in America has never been a quasi-partnership entity requiring a "contract" among its "members" for its existence: there has thus been no impediment to the acceptance of the one person corporation; filing and incorporation formalities have been minimised; and the *ultra vires* doctrine never really took root.

6.3 General Characteristics of U.S. Corporations. Given the diversity of corporate law regimes in the United States, it is with temerity that one makes generalisations. The Model Acts and the lead jurisdictions, however, have provided definition to U.S. corporation law:

> In drafting a new corporate statute it is necessary to determine what goals the statute is designed to achieve. Traditionally, the watchwords of the Model Act have been "flexibility" and "modernization". From this perspective, corporation statutes should be designed to assure efficiency and economy of management and to avoid unnecessary costs. In contrast, some academics have criticized most modern corporation statutes on the ground that they are too "permissive" - that they do not provide adequate protection for interests other than incumbent corporate management. This view would make the basic goal of corporation statutes the "protection of shareholders" or "strong" regulatory goals (R.W. Hamilton, *Corporations*, 4th ed. (St. Paul: West Publishing, 1990) at 179).

Although commentators detect a strong management orientation in the MBCA (and point to Delaware as the major influence), the original thesis of the Model Acts "was to attempt to preserve in proper balance the interests of the public, corporations, shareholders, and management, and not to seek to attract local incorporations" (Henn & Alexander, *supra* at 200).

A certain amount of controversy exists with respect to the current MBCA, whether it pursues 'flexibility' and 'modernization' too aggressively, at the cost of 'shareholder protection' (Hamilton, *supra* at 180). There has been a decided weakening of traditional shareholder protections and the elimination of substantive or other mechanisms providing shareholders with control over corporate entities: presumptive cumulative voting for directors has been eliminated; directors are given much more latitude in the declaration of dividends; there are no automatic preemptive rights. There is a lowered threshold for shareholder approval of amendments to the articles of incorporation and standards have been lowered for interested directors' contracts (see generally D.M. Branson, "Recent Changes to the *Model Business Corporations Act*: Death Knells for Main Street Corporation Law" (1993) 72 Neb. L. Rev. 258).

This trend toward lessened shareholder protections should not, however, be viewed in isolation; it may, in fact, be more a product of the recharacterisation of areas of corporate governance as matters more properly subject to the oversight of securities regulators. The protection of public shareholders is the preserve of a powerful regulator in the United States, the SEC, which has in recent years implemented measures designed to promote greater accountability of management of public corporations to shareholders. In addition, despite what some commentators have seen as an "irreversible" trend (following Delaware's lead) towards "permissiveness" in corporate statutes in the United States, Delaware has "come a long way towards protecting the rights of shareholders and promoting the fundamental concept of corporate accountability" in its application of the business judgment rule and its

interpretation of duties owed by majority to minority shareholders (R.C. Ferrara & M. Steinberg, "The Interplay between State Corporation and Federal Securities Laws" (1982) 7 Del. J. Corp. L. 1 at 3).

The debates and trends of the last fifteen years in U.S. corporate law have been well-documented: the era of hostile take-overs and leveraged buy-outs, pitching management against shareholders, giving rise to defensive tactics and provoking jurisdictional battles between state legislators and the SEC; going-private transactions raising issues of abuse of minority shareholders; the rise in prominence of the institutional investor; corporate accountability, to shareholders and to a wider range of constituents; measuring executive compensation against performance. The following observations are necessarily selective.

According to one commentator, "[f]lexibility has become pandemic" in U.S. corporate law (Branson, *supra* at 71). Rather like a U.S. supermarket, there are a staggering number of choices available, even within any one state regime. The corporate statutory regimes have been likened to partnership laws where the statute provides a default regime in the absence of express choice in the articles, bylaws or shareholders agreements.

Although the United States is noted for its public widely-held corporations, as elsewhere, in absolute terms, closely-held corporations predominate (approximately 80 to 95% of U.S. businesses are family-controlled). Various legislative experiments have been conducted with respect to creating special or adapted legislative regimes for close corporations. Not all have been considered successful. Florida enacted the first such statute in 1963 but repealed it in 1975; most of its provisions were then absorbed by the general corporation statute.

The MBCA has a Model Statutory Close Corporation Supplement which accompanies but does not form part of the MBCA. As in many of the other regimes applicable to close corporations (New York and Delaware, for example), an election to "opt-in" to the close corporations regime must be made under the Model Law. A close corporation under the Model Law cannot have more than 50 shareholders. The Model Law regime permits a close corporation to dispense with the board of directors or to restrict the directors' discretion by means of a shareholders' agreement.

It is hard to generalise about the structure of close corporations in the United States as they vary widely. There are provisions dispensing with the board of directors; permitting shareholders to manage the business of the corporation directly; provisions relating to improving remedies for deadlock and dissension; share transfer restrictions; simplification of the internal structure of the corporation; the ability to dispense with bylaws, annual meetings and any requirement that a document be executed by more than one person on behalf of the corporation (see Hamilton, *supra* at 554). Delaware specifically validates any agreement, bylaw or provision in the articles that treats the operation of the close corporation as a partnership (Delaware General Corporation Law, s. 354). After all is said and done, however, it may very well be that specialised regimes are not overly attractive in the United States because of the degree of flexibility accorded corporations as a matter of course under the general corporations statutes.

Of all the states, California may have the most idiosyncratic corporations law,

especially in its treatment of foreign corporations.

> California exercises its legislative jurisdiction over foreign corporations, by applying more of its domestic corporation provisions to foreign corporations than does any other state. Among the more regulatory California provisions which apply, "to the exclusion of the law of the jurisdiction" of incorporation are those requiring annual election of directors by cumulative voting, permitting removal of directors by shareholders without cause or by court proceedings, defining the directors' standard of care, imposing liability on directors for cash or property distributions to shareholders unlawful under California law, spelling out permissible indemnification for directors and officers, limiting cash or property distributions to shareholders, imposing liability on shareholders who receive unlawful distributions, providing for the sale of assets and mergers, innovating the concept of 'reorganizations' and providing for dissenters' rights'" (Henn & Alexander, *supra* at 220-21).

Not all foreign corporations in California are subject to these provisions; those listed on a national securities exchange are exempted as well as those which do not meet tests indicating a substantial number of resident California shareholders and creditors.

Finally, despite the sheer mass of U.S. corporations and the diversity of their form, the increasing internationalisation of commercial transactions is influencing corporate structure and governance. According to certain commentators, this trend is resulting in more convergence with foreign models. According to one commentator (M.J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States" (1993) 102 Yale L.J. 1927), regimes as different as the American, German and Japanese are starting to look a little more like each other. The 1932 Berle and Means paradigm of separation of ownership and control in large U.S. corporations through fragmented and widely held share ownership is changing. That such a pattern of shareholding arose at all may have been indicative of a "local custom", and one which will pass, rather than "the result of an inevitable economic evolution" (*ibid.* at 1936).

CONTINENTAL EUROPE AND THE EUROPEAN UNION

7. EUROPE

7.1 **The Civil Law Company.** Modern commercial associations in Continental Europe have long roots going back, as much of the civil law does, to Roman law and the medieval law merchant. The two principal concepts from which they have developed are the commenda and the societas. Each of these concepts has also, more indirectly, exerted an influence in the development of common law business associations.

The commenda was one of the earliest formalised systems of commercial joint enterprise, combining aspects of a partnership and a financing transaction. The most significant characteristic of the commenda was its early acceptance of the notion of limited liability, permitting a passive investor to provide capital to an enterprise with the assurance that his liability was limited to the capital advanced.

In civil law countries, the commenda developed into the société en commandite which appears to this day in the legislation of many civil law jurisdictions. Some 100 years later the société en commandite was the inspiration for the common law limited partnership

legislation which was introduced in England in 1907.

The modern idea of the company as a separate legal entity may also be traced to the Roman societas, an association of persons with legal rights and duties independent of its individual members. In both the common law and the civil law, the societas developed into the modern concept of general partnership.

Where the civil law and the common law diverge is with respect to the concept of legal personality, which is much more readily attributed in civil codes to unincorporated associations such as partnerships. The concept of legal persons ("les personnes morales") is much more established and pervasive in civil code countries, where it includes a broader class of commercial and non-commercial enterprises. Thus, generally speaking, although the primary attributes of the modern "company", limited liability and separate legal personality, are a relatively recent development in common law jurisdictions, they have a long and venerable history in the civil law.

The early codification of these business entities in 19th century Europe is to a certain extent responsible for modern criticisms directed at them. Rigidity of structure, over-emphasis on formalities of constitution, and the perpetuation of anachronistic 19th century concepts (especially as concerns capital structure) have been cited. The proliferation of specialised forms of entity has been attributed to the lack of flexibility in existing statutory regimes.

In addition, a different weighting developed for the interests of the various "constituencies" within the orbit of the corporate entity. Perhaps in response to an inadequately developed codal regime for the granting of security interests, structural mechanisms for the protection of creditors developed in the corporate law and were buttressed by civil law property concepts.

Germany, in particular, used structural mechanisms within the corporation to balance the interests of employees with those of shareholders. And, given the predominance of majority controlled public corporations in Europe, the necessity for according minority shareholders statutory protections was recognised through exceptions to the principle of shareholder democracy.

Most recently, the emergence of a unified Europe has forced a reconsideration of the fundamentals of European corporate law, juxtaposing the common law traditions of United Kingdom company law against the very different traditions of continental Europe. The point of greatest conflict has been the establishment of a pan-European form of business entity, a supra-national corporation or company, the societas europea. At the national level, harmonisation of corporate law regimes is proceeding apace through the implementation of European Commission Directives, in which the influence of American corporate law concepts, such as the one person corporation, is increasingly apparent.

In addition to numerous European Commission Directives on Company Law which are striving to harmonise national companies laws in major respects, the European Commission has for the last 25 years been unsuccessfully trying to implement a societas europea, a supra-national, pan-European company law. The model has been the French SA

and the German AG, sometimes referred to as a "public limited liability company" or "PLLC".

The structural similarities to the SA and AG are fairly obvious: a minimum capital requirement (to ensure a certain size), par value shares, and 25% of capital to be paid up at the time of incorporation. Since the societas europea represents a compromise of several different national laws, it should not be surprising that certain proposals are controversial: for example, preemptive rights are mandatory (viewed by some as an impediment to capital formation) and multiple voting shares are prohibited. A requirement drawn from national law, that prohibited any one shareholder from exercising more than a certain percentage of votes, was considered and deleted.

By far the most controversial issue has been the extent of mandatory worker participation in management, an issue which pitches supporters of German national law as the model for the societas europea against the United Kingdom. The European Commission strongly supports worker participation in management as a "social right"; others view it as undermining competitiveness in industry. The current compromise provides a choice between a one-tier board or a German-style two-tier board.

The societas europea has still not seen the light of day. In the words of Professor Len Sealy, it is a "dead duck". It has proved too difficult to establish social and political consensus within the European Union concerning the role of business in the member states. In its present state, the proposal has been criticised as deferring too greatly to national law with respect to matters of basic structure and management, resulting in substantial variation from country to country (see generally, T. Blackburn, "The Societas Europea: The Evolving European Corporation Statute" (1993) 61 Fordham L. Rev. 695). The compromises involved in the formulation of the societas europea may have weakened the initiative's primary purpose (the creation of a form of business organization subject to a uniform European company law applicable directly in all the member states) but it is purported to have exerted a harmonising effect on national laws in areas where consensus did develop.

8. FRANCE

Historically, the two main forms of incorporated entity in France were the société anonyme (SA) or "corporation" and the société à responsabilité limitée (SARL) or "limited liability company". Unlike the SA, the SARL has a limitation on the number of members and restrictions on transfers of interests in it. It corresponds roughly to the concept of a "private company" under U.K. law, although it is closer in substance to a registered partnership. As the regulatory, reporting and filing requirements applicable to each entity have converged to a great degree over time, the distinctions between the two forms of incorporation have become less significant.

8.1 Société Anonyme - the Corporation. In some respects, the SA still retains many of the formalities of its 19th century origins; in others, for example, its exclusive use of book-entry securities, it has been brought quite up-to-date. SAs may be quoted or unquoted. A quoted SA has securities listed on a French stock exchange and offered to the general public; it is subject to separate listing, prospectus and other requirements. All SAs are created by registration with the Commercial Court in accordance with the formalities of

French Company Law. They are subject to the provisions of the Commercial Code and the jurisdiction of a specialised tribunal, the Commercial Court.

There are many technical formalities associated with incorporation as an SA, some of rather ancient vintage: a minimum of seven shareholders who may be individuals or other legal entities; a minimum legal capital of FF250,000 of which one-quarter must be paid in at the time of incorporation; a minimum legal par value of shares must be set out in the articles of incorporation. Unlike many common law jurisdictions, the corporation does not have perpetual duration but rather a maximum term of 99 years.

Shareholder protection is provided primarily through the capital structure and the control exercised by the general meeting of shareholders. Non-voting shares are entitled to priority dividends of a fixed amount. There are restrictions on the creation of non-voting shares and on the percentage of capital which they represent (25%). Directors and officers may not hold non-voting shares. Authorised but unissued shares are not permitted. Limitations are placed on inter-related shareholdings. Shareholders must approve dividends and certain other corporate actions. In certain circumstances, unanimous shareholder approval is required. Shareholders are given the power to liquidate the corporation if the value of the net assets falls below a certain threshold. Shareholders can remove directors without notice, cause or indemnity.

Largely as a result of the harmonisation efforts of the European Commission, dominated in this respect to a large degree by Germany, the SA's board structure is fairly complicated with two different options being available. The first option is a board of directors (conseil d'administration) fairly comparable to that in Anglo-American company law, although the rules applicable to its composition are more rigid. There must be a minimum of three and maximum of twelve directors who may be individuals or legal entities; the chairman (president) of the board must be an individual; all members must hold qualifying shares in the corporation; the maximum term is six years (except for first directors). Employees may be members of the board of directors although there are restrictions on their numbers.

The chairman of the board is responsible for operational management and has broad powers. The board may also appoint a general manager (directeur général or DG) who is not necessarily a board member but who has the same powers as the chairman with respect to third parties. Larger SAs can have up to five DGs.

The second option shows more of the influence of the German model. The corporation is managed by a two-tier board, a directorate under the control of a supervisory council. The supervisory council resembles fairly closely the board of directors in structure and function except that it controls the directorate. The directorate may have one to five members (who need not be shareholders). It has broad powers to act and submits quarterly reports to the supervisory council. There can be no overlapping membership between the supervisory council and the directorate.

Employees may be members of the directorate but not of the supervisory council. All enterprises in France of a certain size must have a labour-management committee (comité d'entreprise), which serves as the mechanism for worker participation in corporate

management (again, of German inspiration). The labour-management committee has the right to be informed and consulted on major changes to the business and the conditions of employment.

8.2 Société à Responsabilité Limitée - the Private Company. The SARL, often translated as the limited liability company, has a simpler structure than the SA. It may have no fewer than 2, and no more than 50 members; in the event its members exceed 50, it must convert to a SA. The minimum capital (FF50,000) must be fully subscribed at incorporation and there is a minimum par value of FF100 per share.

In structure, the SARL more closely resembles an incorporated partnership. It does not have shares as such but rather book entry ownership interests which are termed participations in capital (parts sociales). No share certificates are issued and there is a prohibition on the public offering of securities. Although the ownership interests may be freely transferable among members and their representatives, transfers to third parties require the consent of the majority of members representing at least three-quarters of the share capital. Statutory buy-out provisions apply in the case of refusal to authorise the transfer.

Managers, named in the articles or appointed by the members, have very broad powers which cannot be limited in relation to third parties. All decisions except approval of financial statements may be made by the members in writing. A super-majority vote of the members is required to amend the articles of incorporation.

Reflecting a more generalised trend towards acceptance of one-person corporations, member states of the European Union have been enacting legislation to permit this form of incorporation. In France, it is possible to create an EURL (entreprise unipersonnelle à responsabilité limitée) having all the same characteristics of an SARL except that there is a sole shareholder.

The legal nature and status of joint ventures in France is much clearer than its murky counterpart in common law jurisdictions. There are several forms of statutory joint venture available in France, ranging from pure partnership structures, to hybrid entities combining aspects of legal personality with aspects of partnership (the GIE, groupement d'intérêt économique, which itself served as the model for the pan-European GIEE), to the very recent "simplified corporation" (SAS - Société anonyme par actions simplifiées).

Introduced in January 1994 and based on the SA, the SAS is intended to facilitate the formation of joint ventures. It must have at least two shareholders which must be corporations and meet certain size requirements. The management structure is designed to provide great flexibility, being based essentially on principles of freedom of contract. "Collective" management by shareholders may be provided for in the articles of incorporation. Addressing one of the structural weaknesses of alternative joint venture vehicles, the SAS permits greater stability and shareholder cohesion to be built into the articles through various means, such as transfer restrictions and shareholder ouster mechanisms.

9. GERMANY

Comparable to the SA and the SARL, but more modern and streamlined in structure, are the two German corporate vehicles, the Aktiengesellschaft or AG (corporation) and Gesellschaft mit beschrankter Haftung or GmbH (private company or limited liability company). As in France, all business entities in Germany are subject to the Commercial Code.

9.1 Aktiengesellschaft or AG - the Corporation. Although the AG is the vehicle of choice for large public corporations in Germany, it is possible to have a single shareholder AG. All shares have a minimum par value, although it has recently been reduced to a token DM5. The corporation must issue common shares and may issue other forms of share capital. Shares are transferable and usually in bearer form. The most distinctive features of the German corporation are the dual or two-tier board structure and the mechanisms for worker participation in management. There are two boards, the supervisory board (Aufsichsrat) and the board of management (Vorstand).

The supervisory board's function is to supervise, guide and advise management in the best long-term interests of the corporation. It does not have legal powers of direction or ratification as such (unless otherwise provided). In smaller corporations, all representatives on the supervisory board are appointed by the shareholders; in larger corporations, one-third to one-half of the supervisory board representatives are appointed by employees. In any event, shareholder representatives hold the balance of power on the supervisory board. The most important function of the supervisory board is to appoint and dismiss the members of the board of management.

The board of management is responsible for the day-to-day operation of the corporation. There must be at least one member of the board of management.

Shareholders play a potentially larger role in management than in the Anglo-American public company; for example, they vote on appropriation of profits and other management decisions which are submitted to them by the board of management. There may however be limits in the articles on the percentage of the total voting rights that can be exercised by any one shareholder.

9.2 Gesellschaft Mit Beschränkter Haftung or GMBH - the Private Company. Although there is no limit on the number of shareholders in a GmbH, the fact that the transfer of shares is restricted and that traditionally it is the form adopted by most family businesses makes it comparable to the private company of Anglo-American law. Compared to the AG, there are fewer formalities associated with its creation and operation. For example, shareholders are entitled to waive formalities and decision making may take place by means of written resolution.

There is a requirement for a minimum share capital, a portion of which must be paid up at the time of incorporation. Single shareholder GmbHs are permitted.

The management structure is simpler than for an AG, with one or more individual directors (or "registered managers") acting in the place of the AG's board of management.

A supervisory board is not required unless there are more than 500 employees.

ASIA

10. SINGAPORE

10.1 An Eclectic Mix. The Companies Act of Singapore demonstrates an eclectic mix of influences and inspiration. Enacted in 1967, it is directly derived from the Malaysian Companies Act 1965. At the time it was "considered that Singapore's new law relating to companies should not be different from the legislation in force in Malaysia in order to facilitate trade and commercial intercourse with and within this region" (A. Hicks & W. Woon, *The Companies Act of Singapore: An Annotation* (Singapore: Butterworths, 1994) at I4). Although "the nearest equivalent remains the Malaysian Companies Act" (*ibid.*), there seems now a marked tendency to anticipate, rather than to follow, Malaysian legislation. Commentators in Singapore consider the Singapore Companies Act to be "now very much a local product" (*ibid.*).

The legislative foundation of the Singapore Companies Act is provided by the U.K. Companies Act of 1948. The outlines of the 1948 U.K. legislation are still clearly visible in the Singapore Act although the 1948 U.K. statute was not the model followed directly by Malaysia. Rather, Malaysia in 1965 looked to uniform companies legislation in Australia which appeared in 1961, itself based primarily on state legislation in Victoria.

So, although Malaysia has provided the structure supporting the Singapore legislation, subsequent developments, until quite recently, have been driven primarily by legislative activity in Australia. To the extent that legislative change in Australia itself has been heavily dependent upon developments in the United Kingdom, the ultimate source of much of Singapore's companies law remained the United Kingdom.

There have been numerous amendments over the years. In 1987, a major initiative was introduced. A system of judicial management was established, by which companies in financial difficulty could be protected from creditors, rehabilitated and restored to profitability. Although modelled directly on recently enacted U.K. insolvency legislation, a significant influence was Chapter 11 Bankruptcy Code protection in the United States. The accounting and audit provisions were substantially overhauled to improve disclosure and investor protection and the automatic disqualification of directors of insolvent companies was tempered and replaced by court-ordered disqualification.

In 1993, a system of scripless dealing of shares (uncertificated or book-entry securities) was introduced. Other new developments included the introduction of a statutory derivative action and certain prospectus exemptions. Additional provisions for the disqualification of directors convicted of fraud and certain other offences were implemented.

10.2 Significant Provisions of the Singapore Companies Act. There are several aspects of the Singapore Companies Act which are noteworthy. Two directors are still required to form every company, one of whom must be resident in Singapore. Unlike the current situation in Hong Kong, directors may only be natural persons. There is considerable irony

in this, given that Singapore looked to the recommendations of the 1973 Report on the Hong Kong Companies Ordinance as well as the Jenkins Report for inspiration in this regard.

Singapore has included a statutory formulation of directors' duties in section 157: "A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office". The statutory duties have not been extended to officers as they have in some other jurisdictions, but there is a broad definition of "director" which includes so-called "shadow directors", persons "in accordance with whose directions or instructions the directors of a corporation are accustomed to act". A broader class, which includes officers and agents, is caught by the prohibition against improper use of corporate information. The statutory provisions are expressly stated to be in addition to and not in derogation of any other "written law or rule of law", thus continuing the applicability of common law and equitable principles.

Like the Hong Kong Companies Ordinance, the statute has no discrete part or section devoted to shareholder rights and remedies; rather, they are scattered throughout the legislation. Several restrictions imposed upon the activities of directors, however, serve to protect shareholders' interests.

These provisions, for example, require prior shareholder approval for share issues (s. 161) which cannot be deviated from in the articles. There are measures designed to prevent asset stripping by directors, based on both the Jenkins Committee recommendations and later U.K. formulations of the principle (ss. 160-160A). There is also a prohibition on the company making loans to directors and persons related to directors, subject to certain exemptions (ss. 162-163). Certain of the exemptions require prior approval of the shareholders in order to be effective and the prohibition itself does not apply to exempt private companies.

With respect to remedies, there is a U.K.-style oppression remedy which dates back to 1967 but which applies to a broader class than the original formulation; in Singapore both members and debenture holders have standing (s. 216).

A statutory derivative remedy (based on the Canada Business Corporations Act) was implemented in 1993 by section 216A. Although not available for listed companies in Singapore, it is open to a wide class of "complainants": any member of the company; the minister in certain circumstances; and "any other person, who, in the discretion of the Court, is a proper person to make an application under this section".

As in Australia, many of the regulatory provisions concerning capital market activity of companies are found in the Companies Act in Singapore. Provisions regarding prospectuses are found in Part IV together with new provisions dealing with a book-entry system for the transfer of listed securities through a central depository. In addition, s. 213 and s. 214, together with the non-statutory Singapore Code on Take-Overs and Mergers (based on the U.K. City Code), govern take-overs of public companies (whether listed or not).

Certain of the provisions of the Singapore Companies Act are so broadly drafted as to have an extra-territorial application. In addition, accommodations for foreign corporations

participating in the Singapore capital markets are made. Part XI, Division 2, "Foreign Companies", deals specifically with foreign companies which are required to register under the Act in order to carry on business or establish a place of business in Singapore. Much of Division 2 is fairly innocuous, dealing with the power to own land, registered offices, agents for service of process, etc.

There is however a very broad public interest power to refuse registration:

> S. 369(1)...the Registrar shall refuse to register a company under this Division if he is satisfied that the foreign company is being used or is likely to be used for an unlawful purpose or for purposes prejudicial to public peace, welfare or good order in Singapore or is acting or is likely to act against the national security or interest.

In addition, although there are numerous grounds upon which the requirement may be waived or modified, a registered foreign company which is not required by the law of its place of incorporation to hold an annual general meeting or prepare audited accounts is obligated to make such filings in Singapore.

10.3 Local Adaptation and North America Influences. The Singapore Companies Act has retained the general structure of U.K.-inspired companies legislation. Accordingly, in the same legislation archaic vestiges such as wide "powers" clauses co-exist alongside very new indigenous approaches to local issues. Very obvious attempts have been made to rapidly adapt the legislation to changing times. The latest legislative developments in the United Kingdom and Australia are mirrored in various parts of the statute. In addition, particularly in the area of securities and shareholder protection, very marked North American influences are discernible.

The reliance on Australian and U.K. companies law developments has been declining in recent years in Singapore. "The Act has been amended ten times since it came into force. The more recent amendments tend to be 'home-grown'" (Hicks & Woon, *supra* at I4). This independent-mindedness of the Singapore legislature actually dates back to the early days of the legislation. Singapore enacted in 1974 many of the suggestions of the 1962 U.K. Jenkins Committee which did not survive bill form in 1973 in the United Kingdom.

There are also indications in the statute that certain of these "home-grown" provisions may in fact be the result of the adaptation of North American approaches to local circumstances. For example, the statutory requirement introduced in 1989, making it mandatory for a listed company to have an audit committee, is a listing requirement of major stock exchanges in the United States and a statutory requirement for many public corporations in Canada. The statutory derivative action which appeared in the Singapore Act in 1993 is taken from the Canada Business Corporations Act.

The use of prescriptive legal rules, statutory requirements, rather than non-legal regulation based on the formulation of broad principles (the London City Code on Takeovers and Mergers being a prime example), is also indicative of a shift away from U.K.-based models to North American approaches. Critics might point to this trend as one towards over-regulation. Particularly in the areas where there is an overlap with securities regulation, such as the regulation of takeover bids, this movement is evident in Australia as well (see *Ford*

and Austin's Principles of Corporations Law, 7th ed. (Sydney: Butterworths, 1995) at 866 *et seq.*)

The Singapore Companies Act, like the Hong Kong Companies Ordinance, "has been amended a dozen times on an ad hoc basis with no underlying philosophy evident. Most of these amendments are 'issue-driven', i.e. in response to some problem or potential problem" (Letter of Professor W. Woon to C. Jordan 7 July 1995). A review of the Singapore Companies Act was undertaken in July 1995 "with a view to (I hope) rationalisation and refinement" (*ibid.*). Although Australian law, a traditional source of Singapore law, will be taken into account in the review, it was not anticipated that Singapore would look to the Australian simplification efforts.

11. PEOPLE'S REPUBLIC OF CHINA

11.1 Corporatisation of State-Owned Enterprises. On July 1, 1994 the Company Law of the People's Republic of China (PRC) came into effect. Although there are no reliable statistics available, it has been estimated that in the first year after implementation there were approximately 12,000 "joint stock limited liability companies" (comparable to public companies) and 10,000 "limited liability companies" (comparable to private companies) formed under the legislation.

The development of a company law in the PRC, for political, ideological and legal reasons, has been controversial. It has followed a long, slow and winding path which begins with the economic reforms initiated in 1978. At that time, "there was no need for such legislation because almost all industrial entities were state-owned and were covered by legislation on state enterprises" (P.M. Torbert, "China's Evolving Company Legislation: A Status Report" (1993) 14 Northwestern J. Int'l Law & Bus. 1 at 1). The journey is not over.

The Company Law grew out of and to a large measure now supersedes a variety of local laws relating to the organisation and ongoing administration of companies and other enterprises in the PRC. Special laws applicable to various forms of enterprises with foreign participation remain in place and supplement the Company Law (art.18).

Despite the somewhat misleading nomenclature which appears in some English translations, it is important when considering the Company Law to keep in mind the fact that its ultimate source and inspiration is primarily the civil law tradition of continental Europe (Germany in particular), as well as the civilian tradition which has manifested itself in Asia (Japan and Taiwan). The civil law tradition is evident in both the form and the substance of the Company Law. The drafting style is that of the great civil code traditions, with its emphasis on simplicity, clarity and the statement of general principle. In structure and concept the two forms of company created by the PRC Company Law show the influences of the German AG and GmbH.

Since 1978, the PRC has been reforming, inter alia, its highly centralised and unitary banking and financial structure. Economic reform created an urgent need to build up the PRC's financial markets. The economy grew rapidly, as did the corresponding capital requirements of the country's various localities and enterprises. However, capital requirements could not be met due to the state's limited financial resources. The PRC, thus,

began to explore setting up financial markets (A. Qian, "Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China" (1993) 12 Pacific Basin L.J. 62 at 65-66). The creation of capital markets, however, forced the issue of creating a shareholding system.

A fierce debate raged over many years about the creation of a shareholding system, the system of enterprise ownership and property rights being the two most difficult issues to resolve. In the later stages of the debate, theoretical difficulties with respect to the concept of property rights and ownership were addressed and, in large measure due to the difficulties presented by the low-productivity and desperate need for capital of state-owned enterprises, a consensus developed that reform of the "mechanisms of operation and management in the enterprises" was necessary.

Thus, the driving force behind the Company Law is the restructuring or transformation of state-owned enterprises into a shareholding system with the state remaining the majority shareholder.

> The ongoing process may be better characterized as corporatization, where a former state-owned enterprise is restructured into a corporation that has some division of ownership and management, more in line with international corporate management norms. Thus, there may be less emphasis on the social welfare of enterprise employees and more stress on the profit interests of its owners, mainly its shareholders (*ibid.* at 92).

This creates a "hybrid composition of public, collective, and private ownership in one single shareholding enterprise entity" (*ibid.* at 63). Thus the goal is to separate the ownership and management of state-owned enterprises, making them independent entities responsible for their own profit and loss in the market. The 10-year trial period carried out in selected state-owned enterprises manifested tremendous vitality in the market economy and accelerated the pace for establishing a modern enterprise system. Market reforms, a modern enterprise system, corporatisation and the creation of stock markets all interacted to create interesting economic synergies for the PRC.

Just as domestic economic reform contributed to the need for the corporate vehicle, so did the open-door policy which coincided with the economic reforms. In their search for capital, Chinese companies are seeking to list and trade their securities outside the PRC. Although governments and state-owned enterprises of many countries have been raising money outside their domestic markets for decades, the pressures of the international markets has driven inexorably towards a standardisation of vehicle and product.

It would be a safe assumption that the desire to participate in the international capital markets was a spur to the transformation of large numbers of state-owned enterprises into "companies" more as we know them. The creation of a consistent standard and more internationally recognisable form of enterprise makes enterprises created or continued under the Company Law more acceptable to foreign regulators (such as stock exchanges) and investors alike.

In searching to develop internationally accepted norms for their Companies Law, the PRC translated and referenced for drafting the companies legislation of Britain, the United

States, Germany, Japan, France, etc. Jurists who had studied in these jurisdictions joined together in the drafting and review of the legislation. Given the large choice of models and options presented, those considered the most suitable for conditions in the PRC were adopted. Much heavier reliance was placed on Japanese and continental European models than on any other single source in terms of the structure and orientation of the resulting legislation.

11.2 A Civil Law Framework with Common Law Features. There are two kinds of entities created by the Company Law, the joint stock limited company (also translated as company limited by shares) and the limited liability company. Both entities are legal persons and thus subject to the provisions of the Civil Code introduced in 1986. The main significance of this is that they are endowed with legal capacity as discussed above, and their relations with third parties will be governed by the Civil Code. Both entities are liable for their debts to the extent of their assets; and, they are to operate independently and be responsible for their own profits and losses.

The limited liability company corresponds roughly to the private company, the GmbH or SARL. It must have at least two but no more than 50 members. It must have a minimum registered capital, which in certain circumstances varies with the activity of the company. The capital must be paid up (and verified) at the time of subscription. The provisions dealing with paid-up capital are unusually detailed and demonstrate the great concern of the PRC with respect to the protection of creditors. Continental European corporate legislation tends to be more creditor protective than the common law and it is thus not surprising that its influences are apparent here.

The limited liability company does not issue shares but rather capital contribution certificates. There are restrictions on the withdrawal of capital and the transfer of capital contributions. Flexibility is provided to the extent that annual general meetings of shareholders and, for small companies, a board of directors, may be dispensed with. A great many matters may be dealt with in the articles of association.

The shareholders' meeting has much broader powers than that usual in the Anglo-American tradition. It can, among other things: decide on the business policy and investment plan of the company; elect and recall directors and decide on their remuneration; elect and recall supervisors representing shareholders on the supervisory board (discussed below); examine and approve the budget; adopt resolutions on the issuance of company bonds; and exercise many more direct powers of management. The extensive powers granted to shareholders are consistent with a regime where the line between ownership and management is not yet a clear one. This is a transitional phase where state appointed managers share the same interests as the state shareholder.

It is in the management structure of the limited liability company that the adaptation of the German model to PRC circumstances is most apparent. Day-to-day operations continue to be delegated to a "manager" (as in the pre-company law days) by a board of directors which oversees operations. In smaller companies, the board of directors may be replaced by an executive director who may also assume the role of the manager. Where there is significant state ownership, the board of directors must include representatives of the staff and workers of the company. Relatively larger enterprises must, in addition, have a

supervisory board (the well-known German dual board structure) representing shareholders, staff and workers. Shareholder representatives maintain the balance of power on the supervisory board. Unlike the continental European supervisory board, the supervisory board in the PRC is dominated by the shareholders. In the tradition of the French labour council (see Part V, above), in certain matters of direct interest to them, workers and staff, as well as trade unions, must be consulted in advance and their opinions solicited.

There are prohibitions on acting as a director, supervisor or manager of a company, some of which echo recent developments in other jurisdictions. Persons convicted of certain kinds of crimes, those responsible for bankruptcy liquidation of a company within 3 years, etc. are disqualified. There are strict prohibitions on self-dealing and conflicts of interest for directors and managers. These prohibitions are very much inspired by the fiduciary-like duties imposed in Anglo-American law and jurisprudence on directors (rather than the laxer European standard associated with the legal concept of mandate).

In fact, the statutory standard imposed in the PRC is arguably much stricter than that prevailing in most of the common law world. In addition to explicit prohibitions (for example, against taking bribes), there is a more generalised statutory duty imposed on directors, supervisors and the manager to "comply with the articles of association of the company, faithfully perform their duties and maintain the interests of the company and...not take advantage of their position, functions and powers in the company to seek personal gains" (art. 59). Finally, wholly state-owned enterprises may be organised as limited liability companies, with certain adaptations. They do not have shareholders meetings, but do have a board and manager.

The joint stock limited company in structure more closely resembles the public company, the AG or SA of continental law, with the capital raised by either "sponsorship" or offer to the public. Different rules apply to each method. Where there is an offer to the public, prospectus and other investor protection rules apply. In order to promote the stability of an enterprise, promoters are required to hold not less than 35% of the total shares issued by the company.

Again, the powers of the general meeting of shareholders considerably exceed those normally found in the Anglo-American tradition. There is a one-vote, one-share rule, provisions for proxies, and super-majority voting requirements for amendment to the articles of association.

There are provisions incorporated by reference or similar to those applicable to the limited liability company with respect to powers of the board of directors, the appointment and powers of a general manager, consultations with the labour council and directors' duties and disqualification. The supervisory board is mandatory for joint stock limited companies and provisions for its duties and disqualification of its members are incorporated by reference from those applicable to limited liability companies.

11.3 A First Step. The Company Law is viewed as a first step. In certain respects it is simply not as comprehensive or as detailed as the Japanese or German models upon which it draws heavily. There are few statutory protections offered to minority shareholders and the merger and acquisitions provisions are rudimentary at best. However, given the still

dominant role of the state as shareholder, this lack of protection is understandable. The potential for conflict arising from the dual role of the state as administrator and enterprise owner is expected to diminish over time as the two roles diverge. Most commentators expect that the difficulties that have arisen in this transitional period will be overcome.

The Company Law shows an astute adaptation of company law principles from around the world. In style and in much of its substance, it is in keeping with the PRC's civil law tradition. Measures promoting the protection of creditors, the dual board structure, labour councils and co-determination have been easily adapted to suit the "socialist market economy" (art. 1) which is being developed. In other areas, such as strict fiduciary-like duties for directors, managers and supervisors, ideas borrowed from the Anglo-American tradition, the PRC has gone beyond their original sources and raised these standards of conduct. Although some archaic principles are retained, such as par value shares and a minimum of two shareholders for private companies, in most respects (for example, the possibility for uncertificated securities) the Company Law has picked up on some very modern notions.

12. BERMUDA

12.1 Delaware of the Atlantic. Bermuda is of significance to Hong Kong for one reason. Almost 49% of companies currently listed on the Stock Exchange of Hong Kong are incorporated in Bermuda.

Bermuda, like Delaware, has created a local industry catering to incorporations for off-shore business. A U.K.-style statute, the Companies Act 1981 (BCA), has been tailored to some very specific uses. In fact, the familiar terrain of the U.K. memorandum of association company is deceptive. On the one hand, North American influences strongly mark the legislation; on the other, the legislation has been developed in close cooperation with industry and demonstrates a pragmatic and particularised approach.

Bermuda is a popular center for international business. Despite its small size (population approximately 60,000), it has parlayed its natural beauty and political stability into the basis of a healthy economy oriented toward tourism and international business. When the favourable tax situation is combined with relative ease of incorporation, air links to Europe and North America (Bermuda is approximately 90 minutes flight time from New York City), excellent communications infrastructure, minimal regulatory burden, and Government policy that actively fosters foreign investment in exempted undertakings, Bermuda's popularity as a jurisdiction for incorporation becomes clear.

As a place of incorporation, Bermuda demonstrates some very particular characteristics. First of all, since the early 1920s when company legislation was introduced, incorporation in Bermuda has been a privilege, subject to the discretion of the Bermuda Monetary Authority (BMA). Bermuda takes care to promote a "squeaky-clean" image with respect to its incorporation business in part to foster its offshore reinsurance industry which requires a reputable foreign jurisdiction of incorporation. In addition, the use of Bermuda as a place of incorporation for off-shore business does not permit the enterprise to carry on business in Bermuda although it does entail, in some respects, a significant (and expensive)

Bermudian presence.

Secondly, controls on foreign investment in Bermuda-based businesses are very strict. "Local" Bermudian companies (that may do business both in Bermuda and abroad) must be 60% owned by Bermudians. Given the small population and the exclusivity of Bermudian residence requirements, this puts Bermudian business under very tight local control.

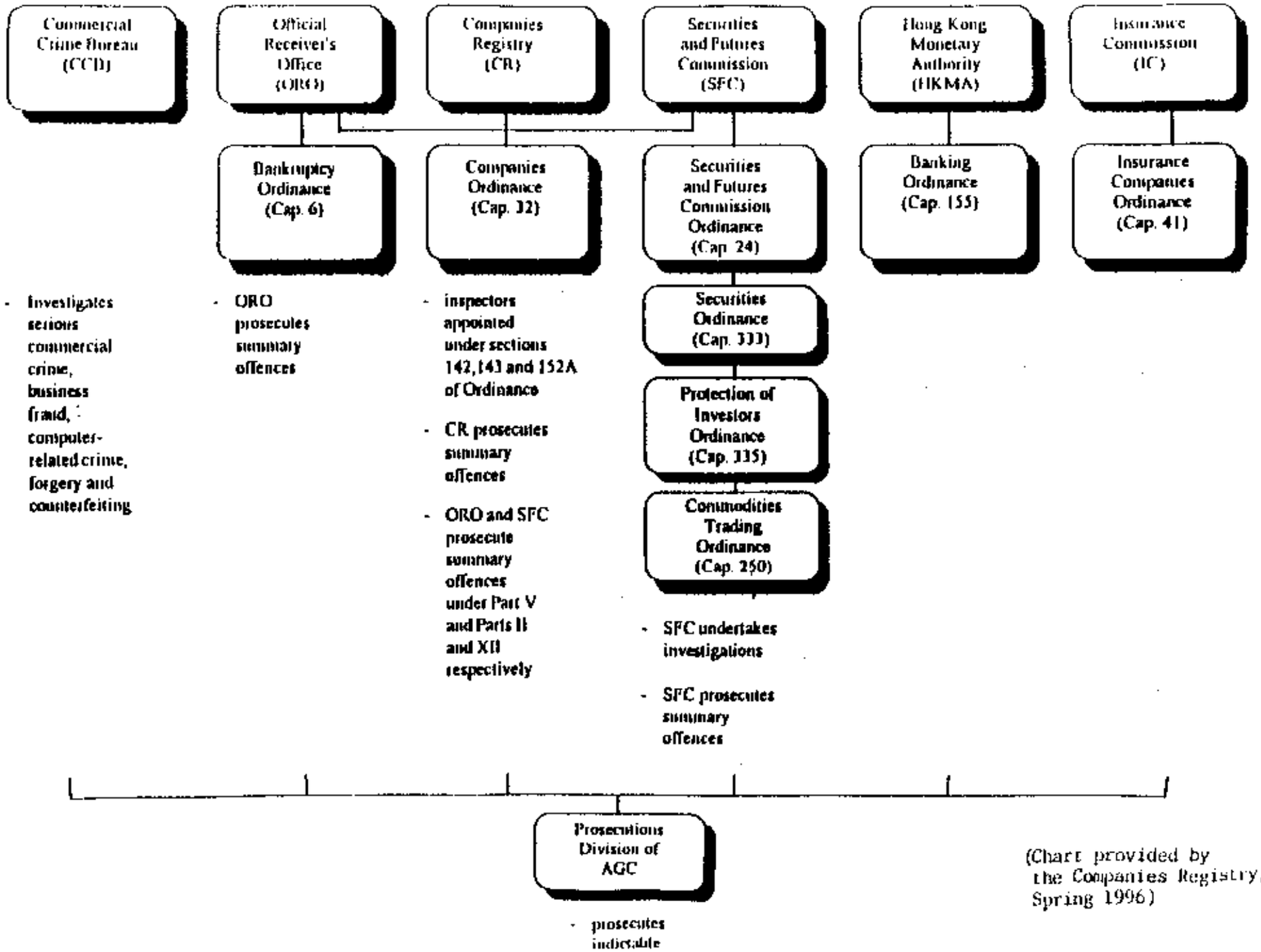
The Bermudian government is concerned with ensuring that companies incorporated in its jurisdiction meet certain basic standards; the BMA is its principal agent of corporate quality control. The approval of the BMA is required for the incorporation of any company. This approval is discretionary; furthermore, on certain limited grounds set forth in the statute, the Registrar may refuse to register a company, although this refusal may be appealed to the Minister. Before granting approval for the incorporation of an exempted undertaking, the BMA requires bank references relating to the "ultimate beneficiaries" of the exempted company. The requirements are quite extensive; for individuals, they include names, addresses, nationality, and occupation, plus statement of financial standing and any other available information concerning the individual's integrity, from a bank with which the individual has dealt for a minimum of three years. For corporations, a banking reference, most recent financial statements, and a complete and detailed list of shareholders are required.

The Bermuda companies legislation has been successful in accomplishing its aims. It is rather like Darwin's finches, an example of highly specialised evolution to suit a niche environment. Its success may be attributed to its focused approach to the goals which it wishes to attain and a high degree of responsiveness to and consultation with its end users.

APPENDIX 3

THE REGULATORY FRAMEWORK IN HONG KONG WITH RESPECT TO ENFORCEMENT MATTERS

The Regulatory Framework in Hong Kong



(Chart provided by the Companies Registry, Spring 1996)

APPENDIX 4

PROVISIONS OF THE HONG KONG COMPANIES ORDINANCE: AREAS OF LAW

PROVISIONS OF THE HONG KONG COMPANIES ORDINANCE: AREAS OF LAW

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
INTERPRETATION - **Definitions**	"Commission" "Exchange Company" "issued generally" "listed company" "prospectus" "Unified Exchange" "unlisted company"	"contributory" "court"	"authorized financial institution"	"company limited by guarantee"	"debenture"
PART I: **Incorporation of Companies**	*Section 30:* Cessation of private company: prospectus or statement in lieu of prospectus.	*Section 5(1):* Deals in part with contributories and costs of winding up where company limited by guarantee. See also *Section 19(6)* re: liability to contribute upon winding up.		Provisions relating to companies limited by guarantee without share capital. For example: *Section 5(3):* Requirements with respect to memorandum of company limited by guarantee. *Section 9:* Articles of association. *Section 10:* Number of members. *Section 14:* Statutory form of memorandum and articles.	*Section 8:* Debenture-holders' right to bring application to annul change to companies' objects.

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART I: (CONTINUED) Incorporation of Companies				*Section 19:* Unlimited companies may be re-registered as companies limited by guarantee. *Section 21:* Company promoting commerce, art, science, religion or charity, etc., and prohibiting payment of dividends to members, ability to register name without "Limited" or to delete "Limited" from name; requirement to notify Registrar of proposed alterations to memorandum or articles. *Section 24:* Where company limited by guarantee and without share capital, right to participate in divisible profits (other than as a member) is void. *Section 28A (10):* Interest to holding company, restrictions.	

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART II: Share Capital & Debentures	*Sections 37 to 41A:* Prospectuses: dating; particulars; exemptions; advertisements; expert's consent; registration; civil and criminal liability for misstatements; deemed prospectus; interpretation of provisions relating to prospectuses. *Sections 42 to 46:* Allotment: prohibition unless minimum subscription received; applications for, and allotment of, shares and debentures; allotments of shares and debentures listed on Stock Exchange; commissions and discounts. *Section 47D:* Financial Assistance: special restriction for Listed Companies for Acquisition of Shares. *Section 48A:* Construction of references to offering shares or debentures to the Public. *Section 49B:* Power of listed company to purchase	*Section 47C(3):* Financial assistance not prohibited where part of an arrangement with creditors. *Section 62:* Contributories on winding up where share capital has been reduced. *Section 79:* Priority of certain claims over floating charge.	*Section 47C(4):* Financial assistance not prohibited where made in the ordinary course of business if lending money is part of the ordinary course of the company's business.		*Sections 74A to 79:* Special Provisions as to Debentures: company's register; rights of inspection and to copies; meetings of holders, liability of trustees, perpetual debentures, power to re-issue; specific performance of contracts to subscribe; priority of certain debts over floating charge.

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART II: (CONTINUED) Share Capital & Debentures	of right to purchase own shares); and *49G* (disclosure of purchase). 50(3) prospectus re shares at a discount. *71A* procedure for replacement of lost share certificate				
PART IIA: Distribution of Profits and Assets	*Section 79C:* Where distribution by listed company permitted. *Section 79D:* Exemption of listed company where investment principal business. *Section 79H:* Interim accounts for proposed distribution by listed company. *Section 79I:* Initial accounts for proposed distribution by listed company.		*Section 79D:* Exemption of listed company where investment principal business. *Section 79E:* Realised profits of insurance company with long term business. *Section 79O:* How provisions relating to accounting requirements for distribution apply to banking and insurance companies.		

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART III: Registration of Charges					*Sections 80 to 87:* Registration of charges; duty of company to register charges; register of charges; entries of satisfaction and release; extension of time and rectification; notice to registrar of appt. of receiver or manager or mortgagee taking possession. *Sections 88 to 90:* Copies of instruments to be kept by company, company's register of charges; right to inspect instruments and register. *Section 91:* Application of *Part III* to company incorporated outside Hong Kong.

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART IV: Management and Administration	*Section 114A(2):* Notice of listed company's general meeting. *Section 114C:* Proxies. *Sections 142 to 152F:* Inspection: investigation of affairs on application of members and FS; power of inspection; production of documents; delegation; reports; overseas companies; proceedings; expenses; appointment by company; power of FS; entry & search of premises, etc. *Section 155A:* Listed companies require approval of general meeting for certain dispositions of fixed assets. *Section 155C:* Directors' duty to shareholders regarding prospectus or statement in lieu. *Section 157H:* Prohibition of loans and other financial assistance to directors, etc., of listed companies. *Section 158:* Register of directors and secretaries.	*Section 166:* Power to compromise with creditors and members. *Section 166A:* Information as to compromises. *Section 167:* Provisions facilitating compromise or arrangement.	*Section 129B(2):* Signing of balance sheet where company carries on banking business. *Section 141D(3):* Shareholders cannot waive compliance with requirements as to accounts if company carries on banking business or insurance business or is a registered securities dealer. *Note:* Banking and insurance companies are exempt from some of the accounting provisions in Part IV of the Ordinance by virtue of Part III of the Tenth Schedule (referred to below). *Section 157H:* Institution licensed or registered under Banking Ordinance exempt from section prohibiting loans to directors, etc.; under certain conditions, loan or guarantee not prohibited where ordinary business of company includes	*Section 108:* Annual return to be made by company without share capital. *Section 129G:* Duty to send balance sheets to members or debenture-holders where company without share capital. *Note:* Many sections in Part IV of the Ordinance make special provision for companies without share capital.	

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART IV: (CONTINUED) Management and Administration	*Section 168B:* Rights of company and minority shareholders in case of successful buy out by share repurchase. See 13th Schedule.		giving loans or guarantees. *Section 161B (4A to 4C):* Accounts of authorized financial institution or its holding company. *Section 161BA:* Further provisions relating to loans to officers, etc., of authorized financial institutions.		
PART IVA: Disqualification of Directors		*Section 168D:* Disqualification from acting as liquidator. *Section 168H:* Disqualification of directors of insolvent companies. *Note:* A liquidator has certain powers to pursue disqualifications under Part IVA of the Ordinance.			

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART V: Winding Up		Provisions specifically referring to court-ordered and insolvent winding up and to restructuring include: *Section 170:* Liability of present and past members as contributories. *Sections 171-174:* Definition of contributory; nature of liability; death or bankruptcy of member. *Section 176:* Jurisdiction of High Court. *Section 177:* When company may be wound up by court. *Section 178:* Definition of inability to pay debts. *Section 179:* Applications to the court for winding up. *Section 179A:* Appearance of Official Receiver. *Section 180:* Powers of court on hearing petition. *Section 180A:* Unopposed petition. *Sections 181-183:* Provisions for protection of assets (power to stay		*Section 170:* Liability as contributories where company limited by guarantee.	

	AREAS OF LAW				
Sections of the Ordinance	Securities	Insolvency and Restructuring	Financial Institutions	Not-for-Profit Companies	Company Charges
PART V: (CONTINUED) Winding Up		proceedings; avoidance of dispositions and attachments) *Section 184:* Commencement of winding up by the court. *Sections 185-187:* Consequences of winding up order. *Sections 188-191:* Statement of company's affairs and report by Official Receiver. *Sections 192-205:* Liquidators: appointment; powers of provisional liquidators; role of Official Receiver; custody of assets and vesting of property; powers of liquidator and their exercise and control; books, payment into bank or treasury, audit of accounts; and release of liquidators. *Sections 206-208:* Committees of inspection. *Section 209-209C:* General powers of court in case of winding up by court.			

	Areas of Law				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
Part V: (Continued) Winding Up		*Sections 210-215, 218:* Various provisions dealing further with contributories. *Section 216:* Official Receiver may apply for appointment of special manager. *Section 217:* Court may fix deadline for proof of claims. *Section 219:* Inspection of books. *Section 220:* Payment of costs of winding up. *Sections 221-225:* Powers to summon and examine certain persons, production of documents, order public examinations, etc., registrar's jurisdiction, power to arrest absconding persons; powers of court cumulative. *Section 226:* Delegation to liquidator of certain powers of the court.			

	Areas of Law				
Sections of the Ordinance	Securities	Insolvency and Restructuring	Financial Institutions	Not-for-Profit Companies	Company Charges
Part V: (Continued) Winding Up		*Sections 226A and 227:* Dissolution of company. *Sections 227A-227E:* When court may make a regulating order; winding up of company where a regulating order has been made; includes provision for compromises and arrangements with creditors and proof of debts. *Section 227F:* Small company may be wound up in summary manner. *Section 237A:* Liquidator in voluntary winding up must call meeting if company insolvent. *Section 239A:* Annual and final meetings if company is insolvent. *Section 254:* Arrangement, when binding on creditors.			

	Areas of Law				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
Part V: (Continued) Winding Up		*Sections 263-265:* Proof of ranking of claims. *Section 266-268:* Fraudulent preferences; floating charge created within 12 months of winding up; disclaimer of property. *Sections 269-270:* Execution or attachment. *Sections 271-277:* Offences and penalties. *Section 278:* Disqualification for appointment as liquidator. *Sections 279-286:* Liquidator's duty to make returns, etc.; notifications; stamp duty; books and papers of company; unclaimed assets; etc. *Sections 287-289:* Supplementary powers of court. *Sections 293-295:* Central accounts. *Section 296:* Rules and fees.	*Section 265* includes provision for preferential payments where company being wound up is an insurer. *Note:* Companies (Amendment) Bill 1995 will introduce preferential payments where company being wound up is a bank.		*Section 267:* Effect of floating charge created within 12 months of winding-up.

	Areas of Law				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
Part VI: Receivers and Managers		As a receiver or manager may be appointed when a company is in winding up, sections 297-306 dealing with receivers and managers may be relevant in an insolvency situation.			As a receiver or manager may be appointed for the protection of debentureholders, sections 297-306 dealing with receivers and managers may be relevant to company charges
Part VII: General Provisions as to Registration					
Part VIII: Application of Ordinance to Companies Formed or Registered under Former Ordinances					

	Areas of Law				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
Part IX **Companies Not Formed under Ordinance Authorized to Register under Ordinance**		*Section 322:* Deals in part with contributories on winding up. *Section 325:* Actions or proceedings stayed on winding up.		*Section 310:* Company registering as limited by guarantee requires undertaking by members re contribution on winding up.	
Part X **Winding up of Unregistered Companies**		*Sections 326-331A:* Winding up provisions apply generally to unregistered companies. This part sets out the particular circumstances for winding up unregistered companies; when company is deemed unable to pay its debts; contributories; stays of proceedings, etc.			
Part XI **Companies Incorporated Outside Hong Kong**	Overseas companies listed on the Stock Exchange register under this Part (authorised representative, accounts, etc *Section 333 (2):* Particulars of directors to be provided by companies listed on Unified Exchange.	*Section 337A:* Notice to registrar where liquidation commenced in country of incorporation.			

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART XII: Restrictions on Sale of Shares and Offers of Shares for Sale	*Sections 342 to 343:* Prospectuses - Dating; particulars; exemption of certain persons and prospectuses; experts' consent; allotment; registration of prospectus; penalty; civil and criminal liability for misstatements; interpretation of provisions as to prospectuses.				
PART XIIA: Dormant Companies			*Section 344A(8):* Financial institutions (banks, insurance companies, dealers, traders, investment advisers, and their parent companies) cannot become dormant		
PART XIII: Miscellaneous			*Section 351B:* Inspection of books or papers of a person carrying on banking business.		

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
PART XIII A: Prevention of Evasion					
PART XIV: Savings					
1ST SCHEDULE	**Table A, Part I.** Regulations for Management of a Company Limited by Shares, Not Being a Private Company.			**Table C.** Form of Memorandum and Articles of Association of a Company limited by Guarantee and not having a Share Capital. **Table D.** Memorandum and Articles of Association of a Company limited by Guarantee and having a Share Capital	
2ND SCHEDULE	Form of Statement in lieu of Prospectus (where private company becomes a public company) and Reports to be set out therein				

	AREAS OF LAW				
Sections of the Ordinance	Securities	Insolvency and Restructuring	Financial Institutions	Not-for-Profit Companies	Company Charges
3RD SCHEDULE	Matters to be specified in Prospectus and Reports to be set out therein.				
4TH SCHEDULE	Form of Statement in Lieu of Prospectus by a company which does not issue a prospectus, etc., and Reports to be set out therein.				
5TH SCHEDULE (Contents and Form of Annual Return)					
6TH SCHEDULE			Form of Statement to be published by Banking and Insurance Companies and Deposit, Provident or Benefit Societies.		
7TH SCHEDULE (Powers)					

	AREAS OF LAW				
Sections of the Ordinance	**Securities**	**Insolvency and Restructuring**	**Financial Institutions**	**Not-for-Profit Companies**	**Company Charges**
8TH SCHEDULE (Table of Fees)					
9TH SCHEDULE	Provisions relating to acquisition of minority shares after successful take over offer.				
10TH SCHEDULE (Accounts)			**Part III:** Exceptions for banking and insurance companies.		
11TH SCHEDULE (Accounts of certain Private Companies)					
12TH SCHEDULE (Punishment of offences)	A large number of offences relate to prospectuses.	Some offences relate to liquidator's duties under the Ordinance.			
13TH SCHEDULE	Acquisition of Minority Shares after successful buy out by share re-purchase.				

	AREAS OF LAW				
Sections of the Ordinance	Securities	Insolvency and Restructuring	Financial Institutions	Not-for-Profit Companies	Company Charges
14TH SCHEDULE (Table of fees to be paid to a company)					
15TH SCHEDULE (Matters for determining unfitness of directors)					

APPENDIX 5

COMPARISON OF STRUCTURE OF CURRENT ORDINANCE WITH A PROPOSED NEW ORDINANCE

Comparison of Structure of Current Ordinance with Proposed New Ordinance

Current Companies Ordinance		Proposed Companies Ordinance	
Part I	Incorporation of Companies and Matters Incidental Thereto	Part III	Incorporation; Capacity and Powers
Part II	Share Capital and Debentures	Part IV	Capital Structure/Securities legislation
Part IIA	Distribution of Profits and Assets	Part IV	Capital Structure/Securities legislation
Part III	Registration of Charges	Part V	Management and Administration
Part IV	Management and Administration	Part V	Management and Administration
-	Registered Office and Name		"
-	Register of Members		"
-	Branch Register		"
-	Annual Return		"
-	Meetings and Proceedings		"
-	Accounts and Audit		"
-	Accounts of certain private companies		"
-	Inspection	Part II	Administration of the Ordinance
-	Inspection of Companies' Books and Papers		"

Prepared by the Companies Registry,
February 1997.

Existing Companies Ordinance		Proposed Companies Ordinance	
-	Directors and other Officers	Part VI	Directors and Executive Officers
-	Avoidance of provisions in Articles or Contracts relieving Officers from Liability		"
-	Arrangements and Reconstructions	Part VIII	Fundamental Changes
-	Minorities	Part VII	Shareholders Rights and Remedies
Part IVA	Disqualification of Directors	Part VI	Directors and Executive Officers
Part V	Winding Up	Part IX	Solvent Dissolution and Liquidation/Insolvency legislation
(i)	Preliminary		"
(ii)	Winding Up by the Court		"
(iii)	Voluntary winding Up	Part IX	Solvent Dissolution and Liquidation
(iv)	-		-
(v)	Provisions applicable to Every Mode of Winding Up	Part IX	Solvent Dissolution and Liquidation/Insolvency legislation
Part VI	Receivers and Managers	Insolvency legislation	
Part VII	General Provisions as to Registration	Part II	Administration of the Ordinance

Existing Companies Ordinance	Proposed Companies Ordinance
Part VIII Application of Ordinance to companies formed or registered under former Ordinances	Part XII Transitional Provisions
Part IX Companies not formed under this Ordinance authorized to register under this Ordinance	To be deleted
Part X Winding Up of Unregistered Companies	Insolvency legislation
Part XI Companies Incorporated outside Hong Kong	Part XI Foreign Corporations/Oversea Companies
Part XII Restrictions on Sale of Shares and Offers of Shares for Sale	Securities legislation
Part XIIA Dormant Companies	Part X Private Companies/Closely Held Corporations
Part XIII Miscellaneous	
- Prohibition of Partnerships with more than Twenty Members	Part III Incorporation; Capacity and Powers
- Provisions relating to Documents and Disposal thereof	Part II Administration of the Ordinance

Existing Companies Ordinance	Proposed Companies Ordinance
- Form of Registers etc.)	Part V Management and Administration
)	
)	Part II Administration of the Ordinance
- Miscellaneous Offences	Part II Administration of the Ordinance
- General Provisions as to Offences	"
- Service of Documents and Legal Proceedings	"
- General Provisions as to Governor in Council	Part XIII General
Part XIIIA Prevention of Evasion of the Societies Ordinance	Part XIII General
Part XIV Savings	Part XIII General

APPENDIX 6

PROVISIONS OF THE ORDINANCE WHICH HAVE IMPLICATIONS FOR INSTITUTIONS AUTHORISED UNDER THE BANKING ORDINANCE AND UNDER THE SUPERVISION OF THE HONG KONG MONETARY AUTHORITY

5 December 1995
Hong Kong Monetary Authority

Review of the Hong Kong Companies Ordinance

Set out below is a summary of those aspects of Companies Ordinance which have implications for institutions authorised under the Banking Ordinance (AIs) and under the supervision of the Hong Kong Monetary Authority ("HKMA"):-

S.28 : Definition of member

This section deals with the membership of a company. In relation to AIs, any person who wishes to become, by definition of the Banking Ordinance, a "majority shareholder controller" (being any person who controls more than 50% of the voting power at any general meeting of the company) or a "minority shareholder controller" (one who controls more than 10% but less than 50% of the voting power at any general meeting of the company) or an indirect controller (any person in accordance with whose directions or instructions the directors of an AI are accustomed to act) is required to obtain the consent of the HKMA.

S 49 - 49S : Purchase by a company of its own shares

Purchase by an AI of its own shares would reduce the capital of an AI and would have a bearing on the capital adequacy of the institution. The HKMA has written to the AIs to ask them to consult it before purchasing any of its own shares.

S.47A-48 : Financial assistance by a company for acquisition of its own shares

These sections prohibit companies subject to certain conditions, from providing financial assistance for the purpose of acquisition of its own shares. Companies whose ordinary business includes the lending of money are exempted from these provisions. Section 80 of Banking Ordinance provides a limitation with a similar implication covered by these sections. It prohibits institutions from lending against security of its own shares.

S.121-141 : Accounts and audits
Tenth Schedule

Banks are exempted from certain of the disclosure requirements by virtue of Part III of the Tenth Schedule. Any proposed revision to the disclosure requirements under the Companies Ordinance should be consistent with the Best Practice Guide issued by Monetary Authority drawn up in conjunction with the Stock Exchange and the Securities and Futures Commission.

The auditors' report of a banking company which avails itself of the benefit of the exemption provisions under Part III of the

Tenth Schedule, is specifically covered by section 141 of the Companies Ordinance. This may need to be reviewed should there be changes made to bring the Companies Ordinance requirements in line with the Best Practice Guide.

It should also be noted that under the Companies Ordinance, only the balance sheet and profit and loss account are to be presented at the annual general meeting of a company. With effect from 31 March 1993, the Hong Kong Statement of Standard Accounting Practice ("SSAP") No. 15 requires cash flow statements to be prepared as part of a company's annual accounts. The auditors are also required to express an opinion on it.

Section 60 of the Banking Ordinance requires an AI to publish its balance sheet and profit and loss statement and notes therein together with a copy of its auditors' report made pursuant to S.141 of Companies Ordinance. As a result of the SSAP on cash flow statement, an amendment to the publication requirement under section 60 has been made in the Banking Amendment Ordinance 1995 to require that if the auditor's report also expresses an opinion on the cash flow statement, the AI should also publish the cash flow statement.

S.153-S.164 : Directors and other officers

Approval from the HKMA is required for the appointment of chief executives and directors of AIs.

The HKMA has issued its own best practice guide on the duties and responsibilities of directors of AIs. It may be of interest to the review team in its proposal to codify the duties and responsibilities of company directors.

S.157H : Prohibition of loans to directors, etc.

This section prohibits the making of loans to directors generally. It however does not apply to authorised institutions. Section 83 of the Banking Ordinance imposes certain limitations on advances to directors and other connected parties.

S.161B : Particulars in accounts of loans to officers, etc.
S.161BA : Further provisions relating to loans to officers, etc. of authorised financial institutions

These two sections have provisions specific to AIs in relation to disclosures in the accounts of loans to officers and record keeping in respect of them.

Part V : Winding up provisions

Section 122 of the Banking Ordinance provides for the winding up of AIs and made reference to the provisions under the Companies Ordinance. Any proposed amendment to the winding up provisions under the Companies Ordinance may therefore have a bearing on the provision in the Banking Ordinance.

It should be noted that section 122(1) of the Banking Ordinance specifically states that the provisions of the Companies Ordinance with regard to a creditors' voluntary winding-up (i.e. sections 240 to 248 of the Companies Ordinance) shall not apply to AIs. There is no similar reference to an exemption given to AIs in the Companies Ordinance.

Section 256 of the Companies Ordinance provides for the priority claim for small depositors in the event of liquidating a bank. Any proposed amendment to the winding up provisions under the Companies Ordinance may have a bearing on the protection of the interest of depositors.

With reference to winding up provisions, the HKMA would prefer to continue to rely on the general statutory regime.

Part XI : Companies incorporated outside Hong Kong

These provisions apply to companies incorporated outside Hong Kong. Any proposed amendment especially in relation to liquidation of such companies will have implications for overseas incorporated AIs. We would wish to be consulted on such issues.

(Updated to November 1996)

APPENDIX 7

PROVISIONS OF THE ORDINANCE WHICH HAVE IMPLICATIONS ON AN AUTHORISED INSURER AND THE INSURANCE COMPANIES ORDINANCE

AND

SPECIFIC REFERENCES IN THE INSURANCE COMPANIES ORDINANCE TO THE ORDINANCE

保險業監理處
香港金鐘道六十六號
金鐘道政府合署二十一樓

OFFICE OF THE COMMISSIONER
OF INSURANCE
21st Floor,
Queensway Government Offices,
66 Queensway,
Hong Kong

傳真 Fax. (852) 2869 0252

來函請註明本處檔號
In reply please quote this ref. INS/LEG/3/5

來函檔號 Your ref. 13255-001

電話 Tel. 2867 2550

2 December 1996

Miss Cally Jordan

Suite 1103, China Building
29 Queen's Road Central
Hong Kong

Dear Miss Jordon,

Review of the Hong Kong Companies Ordinance

Thank you for your letter dated 14 November 1996.

Since my letter of 30 November 1995, there have been some amendments to the Insurance Companies Ordinance. These amendments, however, do not affect the memorandum supplied to you under cover of my above letter and no updating is necessary.

Yours sincerely,

(H Y Mok)
Acting Commissioner of Insurance

CORRESPONDENCE SHOULD BE ADDRESSED TO "THE COMMISSIONER OF INSURANCE" AND NOT TO INDIVIDUAL OFFICERS
來函請直呈保險業監理專員收

Provisions of the Companies Ordinance ("CO") *which have implications on an authorized insurer* and the operation of the Insurance Companies Ordinance ("ICO")

Section 28 : Definition of Member

This section deals with the membership of a company. Under the ICO, a shareholder controller of an insurer, both incorporated locally or overseas, (who holds 15% or more of the voting rights of the insurer or its holding company) must be a fit and proper person to hold such a position. An insurer must report to the Insurance Authority any changes of its shareholder controllers. For a person who wish to become the shareholder controller of an insurer incorporated locally, prior approval from the Insurance Authority is required.

Sections 122 to 141, the Tenth Schedule : accounts and audits

2. Section 122 of the CO requires the directors of a company to lay before the company at its general meeting the profit and loss account/income and expenditure account and balance sheet. As the cash flow statement is required under the Statement of Standard Accounting Practice issued by the Hong Kong Society of Accountants to form part of a company's annual financial statements (relating to periods ending on or after 31 December 1994), it may be appropriate for the cash flow statement to be included as the documents which must be presented in a company's general meeting.

3. Part 3 of the Tenth Schedule to the CO exempts insurers from certain disclosure requirements in their accounts which are available for public inspection. Most of these exemptions however have been lift by the Third Schedule of the ICO for annual reporting purpose. The accounts prepared in accordance with the ICO are also available for public inspection. The exemptions under the CO are therefore effectively redundant and should perhaps be deleted.

4. The auditors' report of an insurer which avails itself of the benefit of the exemption provisions under Part III of the Tenth Schedule, is specifically covered by section 141 of the CO. Following paragraphs 2 and 3 above, it may also be appropriate to amend the requirements of auditors' report accordingly.

Sections 153 - 157D - Directors and Other Officers

5. These sections deal with, inter alia, the appointment and removal of directors. Under the ICO, a director of a company must be a fit and proper person. An insurer must report to the Insurance Authority any changes of its directors.

Part V : Winding up provisions

6. This Part contains provisions relating to the winding up of companies. The ICO relies heavily on these provisions for the winding up of an insurer.

7. Also, the ICO requires an insurer to maintain assets in Hong Kong to match its Hong Kong general business liabilities. The purpose of this requirement is to ensure that there are sufficient assets in Hong Kong to meet the claims of the Hong Kong policy holders in case of the winding up of an insurer in both Hong Kong and other overseas jurisdictions. This purpose can be achieved because assets in Hong Kong seized by the Hong Kong liquidator are available for distribution to the preferential creditors as specified in section 265 of the CO in priority to all other creditors with a lower priority, including overseas creditors. Hong Kong insurance claimants are included in subsection (1)(e) & (f) thereof as preferential creditor.

8. It is important that the preferential status of the Hong Kong policy holders be maintained.

Part XI: Companies incorporated outside Hong Kong

9. This Part deals with companies incorporated outside Hong Kong. Any proposed amendments especially in relation to liquidation of such companies will have implications for those insurers incorporated overseas and their policy holders in Hong Kong.

* * * * *

(Ref.: review(lon(7))

Specific reference in the Insurance Companies Ordinance ("ICO") to the Companies Ordinance ("CO")

Section 2(1)

Definition of "company", "financial year", "holding company" and "subsidiary" has meaning assigned to them under the CO.

Section 2(6)

An insurer which is a company shall be subject to both the ICO and the CO. Where there is any conflict or inconsistency between the CO and the ICO, the provisions of the ICO prevails.

Section 8(3)(e)

The Insurance Authority shall not authorize an oversea company to carry on insurance business in Hong Kong unless it complies with Part XI of the CO.

Section 15(1)(a)(i)

Every insurer shall not appoint an auditor who is disqualified under section 140 of the CO.

Section 15A(1)(c)(i)(A)

An insurer shall notify the Insurance Authority if it proposes to give special notice to its shareholders of a resolution removing an auditor appointed under section 131 of the CO before expiration of his term of office.

Section 16(1)

Without prejudice to the CO; every insurer shall keep proper books and account as provided for in section 16 of the ICO.

Section 21(1)

Without prejudice to the CO, an insurer is required to submit to the Registrar of Company any document which are required to be submitted to the Insurance Authority under section 17 or 18 of the ICO (except the Hong Kong General Business Returns).

Section 24(7)

An insurer may apply to the High Court to transfer its long term business to another insurer. If such transfer is sanctioned by the High Court, no order shall be made under section 166 or 167 of the CO in respect of so much of any comprise or arrangement as involved any such transfer.

Section 25(3)

Where the High Court makes an order to sanction a scheme to transfer the long term business, it may also, by that order or subsequent order, make provision for the transfer of property, allotment or appropriation of shares and debentures etc. For the purposes of any provisions requiring the delivery of an instrument of transfer as a condition for the registration of a transfer of any property (including in particular section 66 of the CO), the said order shall be treated as an instrument of transfer.

Section 25(6)

The definition of "shares" and "debentures" in this section have the same meaning as in the CO.

Section 25A(8)

The local asset requirement can be relieved to the extent where the insurer is required to and does maintain assets in other jurisdiction to meet it insurance liabilities and such assets falls within the description of assets contained in section 265(1)(e)(i) of the CO.

Section 26(2)

The interventionary powers of the Insurance Authority (conferred by sections 27 to 35) can be exercised on the ground that the Insurance Authority is not satisfied that the insurer is not to be deemed under section 42(1), for the purposes of section 177 or 327 of the CO, to be unable to pay its debts.

Section 34(6)

Reference to books and papers in this section (which empowers the Insurance Authority to inspect books and papers of the insurer) shall be construed as if they were contained in the CO.

Section 35(4)

The residual power of the Insurance Authority to require an insurer to take such actions in respect of its affairs, business or property as the Insurance Authority considers appropriate shall, for an oversea insurer, apply only to its Hong Kong affairs and business and property located in Hong Kong.

Section 38B(6)

Where the Insurance Authority has appointed a Manager to manage the affairs of an insurer, any power conferred on the insurer of its officers or members by, inter alia, the CO which interfering with the powers of the Manager, shall not be exercisable, unless with the consent of the Manager.

Section 38E(7)(b)

Remuneration to an Advisor or Manager of an insurer shall , in any winding up, be accorded the same priority as the remuneration to a liquidator (if voluntary winding up) or as the cost of the Official Receiver (if winding up by High Court).

Section 39(1)

Section 147(3) of the CO shall have effect an insurer. That is, the Financial Secretary is empowered to bring civil proceedings on behalf of an insurer.

Sections 42(1), 43, 44(1), 44(3), 45(4), 45(5), 46(4), 46(7), 49(1), 49(2), 49A(1), 49A(2), 49A(3)

All these sections provide for the winding up of an insurer, which relies heavily on the provisions of the CO.

Section 61(1)(b)

An insurer who immediately before the commencement of the ICO was authorized to carry on insurance business shall be deemed to be authorized under section 8 of the ICO, to carry on insurance business provided that, if it is an oversea insurer, it, inter alia, complies with the provisions in Part XI of the CO.

Section 72(1)(a)

An insurance broker shall not appoint a person as an auditor if he is disqualified under section 140 of the CO.

Section 74(5)

The Insurance Authority is empowered to inspect the books and papers of an insurer, insurance broker and agent. Books and papers in this section shall be construed as if they were contained in the CO.

Section 76(1)(a)

If an insurance intermediary is a company which may be wound up by the High Court under the CO, the Insurance Authority may present a petition for the winding up of it.

Third Schedule, paragraph 1(2)(a)

For the classes of "accident and health" and "pecuniary loss", a risk is deemed to arise in Hong Kong if the policy holder is a company within the meaning of section 2 of the CO.

Third Schedule, paragraph 4(1A)

An insurer shall not appoint a person who is disqualified under the CO to audit the Statement of Assets and the Hong Kong General Business Returns.

APPENDIX 8

COMPARISON OF PUBLIC COMPANIES AND CLOSELY-HELD CORPORATIONS/PRIVATE COMPANIES

COMPARISON OF PUBLIC COMPANIES AND CLOSELY-HELD CORPORATIONS

Public Company	Close Corporation
• Separation between ownership and management	• Ownership and management often substantially identical
• Large number of shareholders with shares traded in the securities market	• One or limited number of shareholders with no public trading of shares
• Unrestricted transferability of shares	• Restrictions on transfer of shares
• Most shareholders are passive investors	• Shareholders often consider themselves partners
• Profits retained or paid out as dividends	• Profits distributed as salaries and dividends
• Most investors have diversified portfolio	• Most personal wealth invested in the enterprise
• No familial or personal relationships between shareholders	• Familial or other personal relationships among shareholders in addition to business dealings
• Financing through a mixture of debt and equity	• Debt most common form of financing
• Defined roles and high degree of formality in decision-making	• Loosely defined roles and informal decision-making

This chart originally appeared in the background paper prepared for Industry Canada by Kazanjian, Ferns and Scavone, note 9.

(Industry Canada, Canada Business Corporations Act, Discussion Paper, Unanimous Shareholder Agreements (Ottawa: Industry Canada, April 1996) Sch. A.

APPENDIX 9

FACTS AND FIGURES ON INTERNATIONAL BUSINESS COMPANIES REGISTERED UNDER PART XI OF THE COMPANIES ORDINANCE

AS OF 31 JANUARY 1997

Facts and Figures on International Business Companies (IBCs) Registered under Part XI of the Ordinance

as of January 31, 1997

IBCs account for no less than 43.4% of all registrations under Part XI of the Ordinance. The top ten IBC jurisdictions are the following:

1)	British Virgin Islands	1131	24.5%
2)	Bermuda	426	9.2%
3)	Cayman Islands	150	3.3%
4)	Liberia	121	2.6%
5)	Panama	68	1.5%
6)	Bahamas	43	0.9%
7)	Western Samoa	25	0.5%
8)	Cook Islands	20	0.4%
9)	Turks & Caicos Islands	13	0.3%
10)	Vanuatu	10	0.2%

Top ten non-IBC jurisdictions:

1)	U.S.A	798	17.3%
2)	U.K.	398	8.6%
3)	Japan	378	8.2%
4)	Singapore	186	4.0%
5)	Australia	108	2.3%
6)	P.R.C.	72	1.6%
7)	Canada	63	1.4%
8)	France	61	1.3%
9)	Netherlands	45	1.0%
10)	Switzerland	38	0.8%

ANALYSIS ACCORDING TO COUNTRIES OF ORIGIN FOR COMPANIES INCORPORATED OUTSIDE HONG KONG WHICH HAVE ESTABLISHED A PLACE OF BUSINESS IN HONG KONG AND REGISTERED DOCUMENTS UNDER PART XI OF THE COMPANIES ORDINANCE

	Registered as at 31.12.1996	New Registrations from 1.1.1997 to 31.1.1997	Registrations closed from 1.1.1997 to 31.1.1997	Registered as at 31.1.1997
Argentina	1	1	0	2
Aruba	2	0	0	2
Australia	107	1	0	108
Austria	3	0	0	3
Bahamas	43	0	0	43
Bahrain	5	0	0	5
Bangladesh	1	0	0	1
Barbados	4	1	0	5
Belgium	19	1	1	19
Belize	2	0	1	1
Bermuda	423	3	0	426
Brazil	3	0	0	3
British Virgin Islands	1121	16	6	1131
Brunei	3	0	0	3
Bulgaria	1	0	0	1
Burma	1	0	0	1
Canada	63	0	0	63
Cayman Islands	149	3	2	150
Chile	1	0	0	1
Cook Islands	21	0	1	20
Cyprus	2	0	0	2
Denmark	8	0	0	8
Dubai, United Arab Emirates	2	0	0	2
Finland	5	0	0	5
France	61	0	0	61
Federal Republic of Germany	43	0	0	43
Federation of St. Christopher and Nevis	5	0	0	5
Gibraltar	6	0	0	6
India	18	0	1	17
Indonesia	10	0	0	10
Iran	2	0	0	2
Israel	2	0	0	2
Italy	22	0	1	21
Jamaica	1	0	0	1
Japan	381	0	3	378
Liberia	123	0	2	121
Liechtenstein	3	0	1	2

ANALYSIS ACCORDING TO COUNTRIES OF ORIGIN FOR COMPANIES INCORPORATED OUTSIDE HONG KONG WHICH HAVE ESTABLISHED A PLACE OF BUSINESS IN HONG KONG AND REGISTERED DOCUMENTS UNDER PART XI OF THE COMPANIES ORDINANCE

	Registered as at 31.12.1996	New Registrations from 1.1.1997 to 31.1.1997	Registrations closed from 1.1.1997 to 31.1.1997	Registere as at 31.1.199
Luxembourg	7	0	0	7
Malaysia	23	0	1	22
Commonwealth of the Northern Mariana Islands	1	0	0	1
Mauritius	2	0	0	2
Mexico	2	0	0	2
Nauru	10	0	0	10
Nepal	1	0	0	1
Netherlands Antilles	8	0	0	8
Netherlands	45	1	1	45
New Guinea	1	0	0	1
New Zealand	32	0	0	32
Norway	11	0	0	11
Pakistan	6	0	0	6
Panama	68	0	0	68
the People's Republic of China	70	2	0	72
Philippines	29	0	0	29
Portugal	2	0	0	2
Portugal (Macau)	15	0	0	15
Republic of Korea	40	0	1	39
Republic of Ireland	7	0	0	7
Republic of the Marshall Islands	1	0	0	1
Republic of Vanuatu (formerly New Hebrides)	10	0	0	10
Republic of Zambia	1	0	0	1
Russia	2	0	0	2
Saudi Arabia	1	0	0	1
Singapore	175	12	1	186
Socialist Republic of Vietnam	2	0	0	2
South Africa	3	0	0	3
Spain	11	0	0	11
Sri Lanka	1	0	0	1
Sweden	16	0	0	16
Switzerland	39	0	1	38
Taiwan	33	0	1	32
Thailand	18	0	0	18

ANALYSIS ACCORDING TO COUNTRIES OF ORIGIN FOR COMPANIES INCORPORATED OUTSIDE HONG KONG WHICH HAVE ESTABLISHED A PLACE OF BUSINESS IN HONG KONG AND REGISTERED DOCUMENTS UNDER PART XI OF THE COMPANIES ORDINANCE

	Registered as at 31.12.1996	New Registrations from 1.1.1997 to 31.1.1997	Registrations closed from 1.1.1997 to 31.1.1997	Registered as at 31.1.1997
Turks & Caicos Islands	14	0	1	13
Union of Myanmar	1	0	0	1
United Kingdom	402	0	4	398
United States of America	800	5	7	798
Venezuela	1	0	0	1
Western Samoa	26	0	1	25
Total:	4604	46	38	4612

Statistics provided by Companies Registr

APPENDIX 10

SAMPLE OF MODEL LEGISLATION

APPENDIX 10

A SAMPLE OF MODEL LEGISLATION

The following is a sample of North American style corporate legislation to illustrate the simplicity of both the drafting style and the substantive approach.

INCORPORATION

1(1) **Incorporators.** -- One or more individuals not one of whom

(a) is less than eighteen years of age,
(b) is of unsound mind and has been so found by a court, or
(c) has the status of bankrupt,

may incorporate a corporation by signing articles of incorporation and complying with section 3.

(2) **Bodies corporate.** -- One or more bodies corporate may incorporate a corporation by signing articles of incorporation and complying with section 3.

2(1) **Articles of incorporation.** -- Articles of incorporation shall follow the prescribed form and shall set out, in respect of the proposed corporation,

(a) the name of the corporation;
(b) the place where the registered office is to be situated;
(c) the classes and any maximum number of shares that the corporation is authorized to issue, and

(i) if there will be two or more classes of shares, the rights, privileges, restrictions and conditions attaching to each class of shares, and
(ii) if a class of shares may be issued in series, the authority given to the directors to fix the number of shares in, and to determine the designation of, and the rights, privileges, restrictions and conditions attaching to, the shares of each series;

(d) if the issue, the transfer or ownership of shares of the corporation is to be restricted, a statement to that effect and a statement as to the nature of such restrictions;
(e) the number of directors or the minimum and maximum number of directors of the corporation; and
(f) any restrictions on the businesses that the corporation may carry on.

(2) **Additional provisions in articles.** -- The articles may set out any provisions permitted by this Act or by law to be set out in the by-laws of the corporation.

(3) **Special majorities.** -- If the articles or a unanimous shareholder agreement require a greater number of votes of directors or shareholders than that required by this Act to effect any action, the provisions of the articles or of the unanimous shareholder agreement prevail.

3. **Delivery of articles of incorporation.** -- An incorporator shall send to the Registrar articles of incorporation and a notice of registered office and directors in prescribed form.

4. **Certificate of incorporation.** -- On receipt of articles of incorporation, the Registrar shall issue a certificate of incorporation as of the date of receipt.

5. **Effect of certificate.** -- A corporation comes into existence on the date shown in the certificate of incorporation.

6(1) **Name of corporation.*** -- The word or expression "Limited", "Incorporated", or "Corporation" or the corresponding abbreviation "Ltd.", "Inc.", or "Corp." shall be part of the name of every corporation, but a corporation may use and be legally designated by either the full or the abbreviated form.

(2) **Alternative name outside the jurisdiction.** -- A corporation may, for use outside the jurisdiction, set out its name in its articles in any language form and it may use and may be legally designated by any such form outside the jurisdiction.

(3) **Publication of name.** -- A corporation shall set out its name in legible characters in all contracts, invoices, negotiable instruments and orders for goods or services issued or made by or on behalf of the corporation.

(4) **Other name.** -- Subject to subsections (3) and 8(1), a corporation may carry on business under or identify itself by a name other than its corporate name if that other name does not contain, either the word or expression "Limited", "Incorporated", or "Corporation" or the corresponding abbreviation.

7(1) **Reserving name.** -- The Registrar may, on request, reserve for ninety days a name for an intended corporation or for a corporation about to change its name.

(2) **Designating number.** -- If requested to do so by the incorporators or a corporation, the Registrar shall assign to the corporation as its name a designating number followed by the word "[name of jurisdiction]" and a word or expression, or the corresponding abbreviation, referred to in subsection 6(1).

8(1) **Prohibited names.** -- A corporation shall not be incorporated or continued as a corporation under this Act with, have, carry on business under or identify itself by a name

(a) that is, as prescribed, prohibited or deceptively misdescriptive; or
(b) that is reserved for another corporation or intended corporation under section 7.

(2) **Directing change of name.** -- If, through inadvertence or otherwise, a corporation

(a) comes into existence or is continued with a name, or
(b) on an application to change its name, is granted a name

that contravenes this section, the Registrar may direct the corporation to change its name.

(3) **Revoking name.** - When a corporation has been directed under subsection (2), to change its name and has not within sixty days from the service of the directive to that effect

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*NB. **Provision would be made here for bilingual names.**

changed its name to a name that complies with this Act, the Registrar may revoke the name of the corporation and assign a name to it and, until changed in accordance with the Act, the name of the corporation is thereafter the name so assigned.

9.(1) **Personal liability.** -- Subject to this section, a person who enters into a written contract in the name of or on behalf of a corporation before it comes into existence is personally bound by the contract and is entitled to the benefits thereof.

(2) **Pre-incorporation and pre-amalgamation contracts.** -- A corporation may, within a reasonable time after it comes into existence, by any action or conduct signifying its intention to be bound thereby, adopt a written contract made before it came into existence in its name or on its behalf, and on such adoption.

(a) the corporation is bound by the contract and is entitled to the benefits thereof as if the corporation had been in existence at the date of the contract and had been a party thereto; and

(b) a person who purported to act in the name of or on behalf of the corporation ceases, except as provided in subsection (3), to be bound by or entitled to the benefits of the contract.

(3) **Application to court.** -- Subject to subsection (4), whether or not a written contract made before the coming into existence of a corporation is adopted by the corporation, a party to the contract may apply to a court for an order fixing obligations under the contract as joint or joint and several or apportioning liability between or among the corporation and a person who purported to act in the name of or on behalf of the corporation and on such application the court may make any order it thinks fit.

(4) **Exemption from personal liability.** -- If expressly so provided in the written contract, a person who purported to act in the name of or on behalf of the corporation before it came into existence is not in any event bound by the contract or entitled to the benefits thereof.

LIST OF ABBREVIATIONS

ALI Principles of Corporate Governance	American Law Institute *Principles of Corporate Governance: Analysis and Recommendations*, vols. 1-2 (St. Paul, Minnesota, USA: American Law Institute Publishers, 1994).
CBCA	Canada Business Corporations Act, R.S.C. 1985,c. C-44, as amended.
CCB	Commercial Crime Bureau.
Cohen Report	Great Britain, Board of Trade *Report of the Committee on Company Law Amendment*, (London: H.M.S.O., 1962).
Dickerson Report or DR	R.W.V. Dickerson, J.L. Howard & L. Getz, *Proposals for a New Business Corporations Law for Canada* (Ottawa: Information Canada, 1971).
FSB	Financial Services Branch, Hong Kong Government.
Ghana Code	L.C.B. Gower, *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana*, 1961.
Listing Rules	The Rules governing the listing of securities on the SEHK.
Gower's	L.C.B. Gower, D.D. Prentice & B.G. Pettet, *Gower's Principles of Modern Company Law*, 5th ed. (London: Sweet & Maxwell, 1992).
Jenkins Report	Great Britain, Board of Trade, *Report of the Company Law Committee* (London: H.M.S.O., 1962).
MBCA	American Bar Association, Committee on Corporate Laws, *Revised Model Business Corporations Act*, 1984. The Revised Model Business Corporations Act replaced the 1969 *Model Business Corporations Act*; the "revised" was recently dropped.
MSCCS	American Bar Association, Committee on Corporate Laws, *Model Statutory Close Corporation Supplement*.
new Ordinance	Proposed new Business Corporations Ordinance.
NZLC R9	New Zealand Law Commission, *Company Law-Reform and Restatement, Report No. 9* (1989).
OBCA	Ontario Business Corporations Act, R.S.O. 1990, c. B.16, as amended.
Ordinance	Hong Kong Companies Ordinance, Cap. 32.
Registry	Companies Registry.
Review	Hong Kong Companies Ordinance Review.

SCCLR	Standing Committee on Company Law Reform, Hong Kong
Second Report	Hong Kong, *Second Report of the Companies Law Revision Committee -- Company Law* (12 April 1973).
SEHK	Stock Exchange of Hong Kong
SFC	Hong Kong, Securities & Futures Commission
Takeovers Code	The Code on Takeovers and Mergers issued by the SFC
UCC	American Law Institute, National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code Official Text --1994*, 13th ed.(St. Paul, U.S.A.: West Publishing, 1995).
Welling	B.L. Welling, *Corporate Law in Canada: The Governing Principles*, 2nd ed. (Toronto: Butterworths, 1991).

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Inception Report: An Ordinance for the 21st Century (February 1996)

Overview of the Hong Kong Companies Ordinance (January 1996)**

A Comparative Survey of Companies Law in Selected Jurisdictions (January 1996)**

Report on Module 1: Identification of Core Company Law (February 1996)

BRIEFING BOOKS

Module 1 Briefing Book: Identification of Core Company Law (May 1996)

Module 2 Briefing Book: Corporate Formalities (November 1995)

Module 3 Briefing Book: Shareholders' Rights and Remedies (May 1996)

Module 4 Briefing Book: Directors' Duties; Corporate Governance Issues (May 1996)

Module 5 Briefing Book: Foreign/International Business Corporations (July 1996)

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Share Transfers (June 1996)

Asian Private Companies/Close Corporations: Malaysia, Singapore, Japan and Taiwan (June 1996)

Preliminary Discussion Paper - Foreign/International Business Corporations (Professor Philip Smart)(June 1996)

Family Controlled Companies (September 1996)

International Business Companies (October 1996)

* Copies of a full set of these reports, briefing books and background memoranda may be obtained upon request at cost from the Companies Registry (15th floor, High Block, Queensway Government Offices, 66 Queensway, Hong Kong. Telephone No.: 2867-2712, Fax No.: 2869-6817).

** Available at the Government Publications Centre (G/F. Low Block, Queensway Government Offices, 66 Queensway, Hong Kong) in English and Chinese.

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III. LETTERS AND CORRESPONDENCE:

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Letter of Gordon Jones (Registrar of Companies) to Cally Jordan (25 April 1996).

Letter of Gordon Jones (Registrar of Companies) to Cally Jordan (11 December 1996).

Letter of Len Sealy to Cally Jordan (2 February 1996).

Letter of the Stock Exchange of Hong Kong to the Hong Kong Companies Ordinance Review (2 September 1996).