REVIEW OF THE HONG KONG COMPANIES ORDINANCE

CONSULTANCY REPORT

EXECUTIVE SUMMARY

MARCH 1997

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PREFACE

This Executive Summary and the Consultancy Report on which it is based have been prepared in the context of the ongoing, comprehensive review of the Hong Kong Companies Ordinance undertaken by Ermanno Pascutto.

Cally Jordan prepared this Executive Summary and the Consultancy 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.

Initiation. In his budget speech of March 2, 1994, the Financial Secretary announced the Hong Kong Government's intention to undertake a comprehensive review of the Companies Ordinance (Cap. 32):

> 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.

On November 23, 1994, the Hong Kong Government appointed Mr. Ermanno Pascutto, the former Deputy Chairman of the Securities and Futures Commission in Hong Kong, to lead the review of the Hong Kong Companies Ordinance (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.

Need for the Review. Companies law can remain relatively stable for long periods of time; it is not in need of constant major revision. Nevertheless, the last major review of the Companies Ordinance reported in 1973; the recommendations which issued from that review looked to bring the Companies Ordinance 1932 broadly into line with the U.K Companies Act 1948. By the time the recommendations were implemented in 1984, many of them were nearly forty years out of date.

The Standing Committee on Company Law Reform (SCCLR) 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. In the years since 1984, the SCCLR has been very active and many of its recommendations for legislative amendment have been acted on. It has attempted to stay abreast of a multitude of legislative developments in the United Kingdom. A more fundamental question has been the extent to which Hong Kong should

continue to look to U.K. companies law as a model at all.

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. In the past, Hong Kong, like many other countries, borrowed and adapted its legislative regime from the United Kingdom. This used to be a relatively straight-forward process in Hong Kong, aided by the political, educational and professional integration with the United Kingdom. Times have changed, both in Hong Kong and the United Kingdom.

The Review Process. This Review picks up directly from the 1973 Second Report of the Companies Law Revision Committee on Company Law and the work of the SCCLR. The Terms of Reference for the Review reflect the major issues faced by the SCCLR in recent years. In response to the Terms of Reference, 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 a number of jurisdictions (the United Kingdom, Australia, New Zealand, Canada, South Africa, the United States, Singapore, the People's Republic of China, France, Germany, the European Union, and Bermuda). The overview and the comparative survey were published in January 1996 and are available in English and Chinese at the Government Publications Centre. The legislative history of the current Ordinance and a summary of the Comparative Survey appear as Appendices 1 and 2 to the Consultancy Report.

For purposes of investigation, the issues raised in the Terms of Reference were regrouped into five broad areas or modules, to be addressed sequentially. This approach was adopted primarily in order to discuss and determine the acceptability of an overall direction to the Review. Much of the consideration of the substantive issues that ensued would depend on this overall approach. It was also hoped that this approach would accelerate the process of consideration and coordinated legislative action. 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.

Working parties were formed to advise on a module by module basis, drawing on various areas of specialised expertise. The working parties also ensured channels of communication with the professional and business communities having the greatest interest in the Ordinance. A list of working party members is included at the end of this Summary. Continuity from one working party to another was provided by the Companies Registry and Mr. John Allen of the Attorney General's Chambers. Each working party met a number of times for a total of 23 meetings. For working party purposes, a variety of reports, background memoranda and briefing books were prepared. A list appears at the end of this Summary.

Comments and assistance were provided over the Internet and in personal interviews with academics and others around the world. In addition, law reform bodies in Australia, New Zealand, Canada and the United Kingdom, the Company Law Committee of the U.K. Law Society and consultants to the Commission of Legislative Affairs of the National

People's Congress, 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. In particular, the Hong Kong Companies Registry and the Secretary to the SCCLR were a constant source of comment and assistance.

The Review engaged three outside consultants at various times. Mr. David Goddard provided the benefit of his experience with very recent law reform initiatives in this area in New Zealand. Professor Len Sealy, the S. J. Berwin Professor of Corporate Law, Gonville and Caius College, Cambridge University provided ongoing assistance and commentary at every stage of preparation of the Consultancy Report. Mr. John Howard, one of the three original members of the Dickerson Committee responsible for the highly successful Canada Business Corporations Act, also provided assistance and commentary in the final stages of preparation of the Consultancy Report.

The Consultancy Report draws on the working party papers and deliberations to outline the framework for a new companies ordinance for Hong Kong and makes detailed recommendations with respect to its substantive provisions.

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

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

EXECUTIVE SUMMARY

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

2. The recommendations in the Consultancy Report are primarily based on modern companies legislation in the United States, Canada and New Zealand. These countries all share common legal roots with Hong Kong. As new as some of the recommendations 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 existing Ordinance is retained, with certain parts being consolidated and others subdivided into more balanced and coherent units.

3. This Summary is intended to provide an outline to the Consultancy Report and follows its general structure. All of the recommendations of the Consultancy Report, part by part, are included at the end of each section. Not all recommendations are discussed and reference should be made to the Consultancy Report for greater detail.

COMPANIES AND COMPANIES LAW: THEIR PURPOSE

4. **A Basic Building Block.** The company or business corporation is a basic building block of modern commercial activity. By limiting the personal liability of the individual participants in the enterprise, the company serves to promote risk-taking business activity. Because the company has a separate legal identity and, in theory at least, perpetual existence, the company provides greater stability to a business enterprise than may be found in other arrangements. The company is not susceptible to the vagaries of mortal existence. The company provides continuity in the event of the death or disability of the individual business people involved. The company can carry on.

5. The use of a company also makes it easier to "grow" or "sell" a business. The corporate form provides the structure and organisation that can easily accommodate business of increasing size and complexity. Successful private companies can "go public", by soliciting public investors thus reducing their cost of funds. There are many circumstances which may make it desirable to segregate various business operations and assets. Companies can effectively do this. The company form also makes it simpler to sell a business. Rather than a time-consuming and tedious transfer of individual assets comprising the enterprise, the transfer of shares in the company can quickly and easily transfer control of a business.

6. **Companies Law.** Company law itself does several things. Company law determines the procedures for creating the entity.

7. Company law provides a structure for the ordering of the private interests of the participants in a business. Companies are owned and operated by people. Where ownership and management are the same, there is a high degree of identity of interest and little need for formality. Where ownership and management diverge, there are different interests to be balanced. The role and responsibilities of decision makers need to be specified as well as

their accountability. They are dealing with other people's money as well as, in most cases in Hong Kong, their own. Passive investors, in companies big and small, need the means to assess their investment and the desirability of continuing in their relationship with the company. Company law should provide them with the means of doing so.

8. Businesses grow and change and die. Company law must provide the mechanisms for this to happen. There must be a means to permit fundamental changes to the nature of the business and the structure of the company. There must be a means to dissolve and liquidate the company in a cost effective manner which protects the interests of creditors and shareholders.

9. Although company law is concerned primarily with the ordering of private interests and enterprise, there has always been a public interest in the operations of companies. In the interests of creditors and the investing public, company law determines the information required to be on the public record as to ownership, management, organisation, location of the business, essentially where to find the business and the people running it. Company law also functions to promote fair dealing generally in the commercial marketplace.

10. Company law serves a variety of other purposes in different jurisdictions. In the People's Republic of China, for example, company law has been designed to facilitate the transition to a socialist market economy. Company law there is the vehicle for the transformation of state-owned enterprises. In Germany, as well, companies law has served to promote state industrial policy, particularly with respect to management-labour relations. And, in many places, including Hong Kong, companies law can play handmaiden to Inland Revenue.

11. In common law countries, companies law has had a profit-making focus. This is still the case, despite a debate, largely academic, as to the other "constituencies" served by companies law: creditors, employees, the environment, the public at large.

12. The recommendations in this Report are very traditional in this respect; they focus on the ordering of private interests and the profit-making purpose of the company. The approach adopted has been that of a "core company law", a term coined recently by the New Zealand Law Reform Commission.

MAJOR CONSIDERATIONS FOR THE REVIEW OF THE HONG KONG COMPANIES ORDINANCE

13. The recommendations of the Consultancy Report take into account the international, regional and local context in which Hong Kong companies law operates. The recommendations are also responsive to general trends in companies law around the world.

14. **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. Professor Michael Enright, formerly with the Harvard Business School, recently identified Hong Kong's "unique set of strengths" which include a balance and interaction between government and business as well as between local and overseas firms. This particular balance has been highly successful.

15. Hong Kong's place at the centre of the rapid internationalisation of trade and finance has several important implications for its commercial law. The presence of a recognised and fairly sophisticated body of commercial law in Hong Kong has undoubtedly been one of its attractions for international businesses locating in Hong Kong.

16. This has meant that Hong Kong legislation, in important commercial areas such as companies, insolvency, finance, does not exist in isolation. It operates in the international arena and is held up to international scrutiny as never before. At the least, Hong Kong companies legislation should meet international expectations. In its current state, it does not. This fact has ramifications for Hong Kong's competitive position in Asia.

17. There are several general trends discernible in companies law around the world. The use of electronic communications and information technology has speeded up business transactions as well as making them increasingly international. This in turn has led to calls for the elimination of unnecessary formalities as well as simplification of business processes and the legislation governing them. New Zealand, Canada and the United States all have very streamlined corporations statutes. Australia followed in their footsteps with its Corporations Law Simplification Task Force.

18. In commercial legislation, there has been greater specialisation and focus. The traditional scope of companies law has been narrowed; it is no longer the repository of the great body of law associated with commercial activity. A "core company law" approach has developed or been adopted in the United States, Canada, New Zealand and even the United Kingdom.

19. With the rise in importance of capital markets, both domestically and internationally, the regulation of financial markets and the protection of public investors has surged to the forefront leading to the development of a distinct body of law, securities regulation. It has also led to sharper distinctions between private companies (with no outside shareholders) and public or listed companies (with a significant number of public investors). Great innovations in the financial instruments used for financing business has resulted in the need for flexible capital structures. No longer is debt simply debt and equity simply equity.

20. Heightened commercial activity also brings with it the greater likelihood of disputes. In commercial matters, there are indications of greater reliance on pragmatic rather than legal dispute resolution. The courts are a last and least favoured resort. Legal actions are expensive and time consuming. Commercial arbitration and non-binding mediation are gaining in popularity.

21. Finally, in companies with public shareholders, the dynamics of the relationship between investors and management has changed. Public investors are no longer necessarily passive, especially given the rise in prominence of the institutional investor. There have been repeated calls for greater accountability on the part of those entrusted with other people's money.

22. **Hong Kong Companies Law in the Asia Pacific Region.** Hong Kong is very much a regional business centre as well as an international one. As Hong Kong has taken a lead in the region in the development of its financial markets regulation, companies legislation which would set the standard in the region would be a natural complement.

23. History has made 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. Legislation in Hong Kong should be responsive to it. A notable characteristic of overseas Chinese commercial operations is the predominance of family controlled businesses. 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.

24. Another factor of significance in the Asia Pacific region is the mix of the two major Western legal traditions, the civil law and the common law. Each legal tradition has a distinctive approach to business enterprise law, using different structural techniques and balancing different interests. Under the Basic Law, which will serve as Hong Kong's constitution after June 30, 1997, the common law system will continue in Hong Kong for the next 50 years.

25. **Hong Kong Companies Law in the Local Commercial Context.** 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 non-interventionist policies, however, are concerns of fair dealing in the market place. These concerns have been acute with respect to the public capital markets. Both the Stock Exchange of Hong Kong and the Securities and Futures Commission are determined to promote integrity in the market and good corporate governance. In addition, the Commercial Crime Bureau in Hong Kong has jurisdiction with respect to commercial fraud.

26. *Role of the Companies Registry.* These generalised concerns with fair dealing have also focused attention on 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 Companies Registry also acts as policy advisor on companies law and related legislation. 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.

27. The nature of the complaints received by the Companies Registry does not appear to indicate a compelling need for investigatory activity similar to that undertaken by the U.K. Department of Trade and Industry. The Companies Registry would continue to administer the legislation it oversees and apply appropriate sanctions for administrative misdemeanours. As for the level of public intervention in internal company matters, there should be less necessity for action on the part of the Companies Registry under the type of legislation being proposed. It is highly "enabling" as opposed to "regulatory"; the goal has been to propose legislation which is self-executing and self-enforcing. The oversight of the public interest involved in banking, insurance, insolvency, and capital markets regulation is left to the Monetary Authority, the Insurance Commissioner, the Official Receiver, the Securities and Futures Commission and the Stock Exchange of Hong Kong. Allegations of outright fraud would continue to be taken to the Commercial Crime Bureau.

28. *Hong Kong Companies Law through the Transition.* The recommendations in the 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, as the Review is recommending the enactment of a new Ordinance (rather than a consolidation or line by line 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.

29. *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 the use of foreign incorporation by Hong Kong businesses. In some respects, this is a phenomenon sparked by a conjuncture of political and commercial forces unique to Hong Kong. Although there is abundant speculation as to the implications of political risk for Hong Kong businesses, strictly commercial factors emerged from working party discussions as primarily responsible for the wave of offshore private company incorporations. Approximately 50% of Hong Kong listed companies are incorporated in Bermuda, an offshore jurisdiction of convenience. It has been estimated that there may be as many as 100,000 British Virgin Islands companies in Hong Kong, of which only 1,000 or so are registered under Part XI of the current Ordinance. These are astonishing statistics, likely unparalleled in any other jurisdiction.

MAJOR AREAS OF REFORM

30. Until recently, Hong Kong, like many other jurisdictions, looked exclusively to the United Kingdom in structuring its public institutions and formulating its legislation. The reasons were obvious. There is still much merit in aligning Hong Kong legislation with that of other jurisdictions. In company law, the United Kingdom, however, no longer provides a model that is easily emulated. In fact, Hong Kong companies law has been looking elsewhere for direction for quite some time now. Other common law jurisdictions including South Africa, Singapore, New Zealand, Australia and Canada have done the same.

31. This Report recommends a shift to a new, coherent Ordinance, drawing on new models rather than cobbling bits and pieces of foreign legislation together with the current Ordinance. The piecemeal approach to legislative change in company law, along U.K. lines, has been criticised both in the United Kingdom and in Hong Kong. The new model will provide a coherent legislative framework for commercial entities in Hong Kong, internally consistent, conceptually clear and well articulated.

32. The recommendations that follow are drawn primarily from four interrelated sources: the U.S. Model Business Corporations Act (1984) (as annually revised), the American Law Institute Principles of Corporate Governance (1994), the Canada Business Corporations Act (and its provincial variants) and the New Zealand Companies Act 1993. The Model Business Corporations Act and the ALI Principles of Corporate Governance represent the expression of modern and sophisticated thinking for companies law. The Model Business Corporations Act 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 ample annotation and a rich body of commentary to inform the legislation and guide practitioners and the judiciary alike.

33. The Canadian and New Zealand legislation both impart Commonwealth sensibilities to the U.S. model; they share the same roots with the Hong Kong legislation. In particular, the prevalence in both New Zealand and Canada of majority held, publicly traded companies and family controlled businesses (again, characteristics shared with Hong Kong) argues for a different balancing of shareholder/management powers than in the United States.

34. As well, unlike the United States, Canada and New Zealand tend to be considerably more litigation averse in commercial matters. Alternative dispute resolution has flourished. Ontario, the major commercial jurisdiction in Canada, has just made mandatory mediation a precondition to any non-family law civil litigation. Mediation and other alternative dispute resolution mechanisms should be highly suited to Hong Kong businesses. The New Zealand and the 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. Finally, the use of internationally recognisable models for companies law will enhance Hong Kong's role as a centre for international and regional business.

35. The overall objective of the following recommendations is the simplification, rationalisation and modernisation of Hong Kong companies law. The recommendations propose a new structure and conceptual basis for Hong Kong companies law and address every aspect of it.

1.00 GENERAL RECOMMENDATIONS FOR A NEW BUSINESS CORPORATIONS ORDINANCE

36. **Simplification, Rationalisation and Modernisation.** The Report has adopted a "core company law" approach to new companies legislation for Hong Kong. Companies law should confine itself to the birth, life and death of the enterprise. Capital markets regulation, insolvency, the creation of personal property security interests, all would be dissociated from company law. The decision to adopt the core company law approach has been primarily dictated by the emphasis in the Terms of Reference on simplification, rationalisation and modernisation. It is also highly consistent with the current direction being taken in these matters in Hong Kong. By removing specialised and technical areas of the law from the Companies Ordinance, the resulting legislation is greatly simplified. For example, removing the insolvency provisions alone from Part V, Winding Up, would reduce the bulk of the current Ordinance by approximately one-third.

37. Simplification and modernisation do not stop at substance. A sample of model legislation is included as Appendix 10 to the Consultancy Report to illustrate the clarity and conciseness which is possible in modern legislative drafting in this area. 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.

38. Modern language, modern ideas. The sample of model legislation exemplifies the language of a modern corporate statute. Substantively, the recommendations of the Consultancy Report draw from modern corporate legislation; they reflect current issues and current thinking.

39. The overall approach recommended in the Consultancy Report is that of adoption of a "core company law" in line with existing legislative models in the United States, Canada and New Zealand. This approach is most responsive to the Terms of Reference for this Review. The goal is to provide a simple, efficient and cost effective means of incorporating and maintaining a business. The legislation should be permissive rather than prohibitive and written in a clear, concise language. There should be a balance struck between the interests of management or majority shareholders on the one hand and shareholders or minority shareholders on the other.

40. **Business Corporations Ordinance.** In line with modern legislation elsewhere, the new Ordinance should be a "Business Corporations Ordinance". It should deal exclusively with profit making enterprises. The current Ordinance would continue to apply to not-for-profit enterprises and consideration should be given to their separate treatment.

41. **Securities Regulation.** Capital markets regulation and the protection of the investing public should be left to more specialised legislation under the oversight of the Securities and Futures Commission, and to the extent applicable, the Stock Exchange of Hong Kong. The distinction between securities regulation and companies law has been evolving in Hong Kong over a number of years and is well accepted in Hong Kong. Companies law and securities law apply in different circumstances and have different

objectives. Securities regulation operates to protect local investors and regulate local trading in the securities of listed or public companies, irrespective of jurisdiction of incorporation of the issuer. 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 as the jurisdictional nexus. Historically, this would have been the case in the United Kingdom. It is today the case in Australia and New Zealand where 99% of listed companies are locally incorporated.

42. The very great importance of Hong Kong as an international financial centre has made it crucial to consider carefully the legal regimes in Hong Kong implicated in capital market activity. The current Ordinance was not drafted at a time when Hong Kong had achieved such international prominence. Less than 30% of Hong Kong listed companies are incorporated under the Hong Kong Companies Ordinance and the regulation of their capital markets activities is not appropriately dealt with by local companies legislation.

43. The securities law aspects of the current Ordinance should be pared away and reenacted in securities legislation. The Securities and Futures Commission is in the process of rationalising and consolidating the provisions of the existing eleven Ordinances that deal with securities law matters in Hong Kong and has also embarked upon a three year plan designed to build a modern securities law regime.

44. The recommendations in this Report are complementary to the efforts of the Securities and Futures Commission in this respect. The recommendations are also premised on there being a comprehensive, modern securities law regime in place. Great care should be taken to avoid creating regulatory gaps, which would result in important information and protections not being available to the public investor. To this end, the following general recommendations are made:

- 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 information in, 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 might be established where cases would be based on the civil standard 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.

45. **Insolvency.** Also complementary to law reform initiatives currently underway in Hong Kong, is the recommendation to remove from the Companies Ordinance those provisions dealing with insolvency. The Law Reform Commission's Sub-Committee on Insolvency is considering in detail the Winding Up provisions of Part V of the current Ordinance as well as other associated issues such as the relationship between receivership and winding-up. A Law Reform Commission Report can be expected in late 1997 or early 1998.

46. This Review recommends that the insolvency provisions of the Companies 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 Companies Ordinance deal exclusively with solvent dissolution and liquidation.

47. **Charges.** The Review has made no substantive recommendations with respect to Part III of the current Ordinance. Rather, the recommendation is for separate consideration being given to the creation of a modern, comprehensive regime for the creation and registration of security interests in personal property. Existing Part III of the current Ordinance is based on the U.K. system of registration adopted some fifty years ago and has been described as archaic and highly unsatisfactory.

48. The granting of security interests in personal property is a technical and self contained system in modern commercial law. It involves a wider range of issues and legislation than that contained in Part III of the current Ordinance. Individuals give security as well as companies and yet there may be no public record to consult or protection given to creditors.

49. This recommendation is made with some urgency. Since inception, the problems relating to the current inadequate system governing the creation, registration and realisation

of security interests over personal property have been repeatedly brought to the attention of the Review. Of the numerous studies 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 U.S. Uniform Commercial Code or a variation of it, is the world standard. It is possible to create fairly readily a comprehensive, cost effective system. Such a system is particularly adapted to the application of sophisticated information technology.

50. **Financial Institutions.** With the 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 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, for example, of the 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.

51. 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 financial institutions in Hong Kong, essentially incorporation and its incidents. The Banking Ordinance and the Insurance Ordinance, however, would provide an overlay to the companies legislation, imposing additional requirements and regulation in keeping with the nature of the institutions to be regulated. As to those provisions of the current Ordinance that now pertain exclusively to authorised financial institutions in Hong Kong, the Monetary Authority would be prepared to accept their "migration" to the Banking Ordinance, if it is practically and technically feasible.

52. **Single Regime.** Although discussed at some length, the Report 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. All companies would have the benefit of a simplified, flexible company law regime.

53. 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 Stock Exchange of Hong Kong and the Securities and Futures Commission. A fairly traditional definition of private company has been retained and provision made for private companies to operate in a highly informal and consensual manner more in keeping with commercial realities.

54. **Structure of new Ordinance.** Lastly, this part of the Report outlines the proposed structure of a new Business Corporations Ordinance. As noted above, 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 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 some miscellaneous parts, the Ordinance has been divided into ten more balanced and logically coherent Parts.

RECOMMENDATIONS

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

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

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

55. Part 2.00 of the proposed Ordinance would be primarily a consolidation and updating of Part VII of the existing Ordinance with respect to the operational aspects of the Companies Registry. The Companies Registry is already in the process of applying information technology to its operations.

56. There are virtually no major changes recommended in this Part, other than perhaps the elimination of the Twelfth Schedule on offences. With the shift to a more enabling, self-enforcing and less regulatory model of legislation, many minor offences should simply disappear or the regulatory burden shift to other more appropriate entities such as the Securities and Futures Commission. Those offences retained should be regrouped into more generic categories and matched with appropriate sanctions.

RECOMMENDATIONS

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

57. **Ultra vires and constructive notice.** The Companies (Amendment) Ordinance 1997 has already implemented the recommendation presented to working parties some time ago with respect to abolishing the ultra vires and the constructive notice doctrines. This has been done by according to companies the capacity, powers and privileges of a natural person. Third parties are also no longer deemed to have notice or knowledge of the contents of documents on the public record. The elimination of these two doctrines promotes speed and certainty in commercial dealings.

58. **Simple, Speedy Incorporation.** The thrust of the remaining recommendations in this Part is to promote simple, speedy incorporation which would rival that provided by offshore jurisdictions. 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 there is probably no need to make special provision for pre-incorporation contracts. Ontario (Canada), a highly reputable commercial jurisdiction, boasts of 20-minute incorporations.

59. A corporation would come into existence upon issuance of a certificate of incorporation by the Registrar following filing of a simple one or two page application. There would be no Memorandum of Association and no need to file Articles of Association. By eliminating the need in most instances for the use of shelf incorporations, one step incorporation would reduce the costs and artificial complexity of 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.

60. **One person companies.** The Report is also recommending one person companies. One highly beneficial consequence of adoption of a North American style corporate model is that the conceptual difficulty under the current Ordinance associated with creating one person companies 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.

61. **Numbered companies.** The Report also recommends the availability of numbered companies, either on an interim or permanent basis. Numbered companies have proven very popular where they have been introduced. A multi-digit number (plus an indication of jurisdiction and the designation "Ltd") could be used, e.g. "1234567 (Hong Kong) Ltd". The name can subsequently be changed for a descriptive one if desired. 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.

RECOMMENDATIONS

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 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

62. **Flexible capital structure.** 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 and existing shareholders given the benefit of their bargain.

63. **No par value shares.** Perhaps the most significant changes proposed by the Report deal with capital structure. In the interests of creating a simple, flexible capital structure both par value and partly paid shares would be prohibited.

64. Par value shares no longer serve the purpose for which they were originally intended and, worse, are considered to be misleading. They are now prohibited in many jurisdictions, including many US states, most Canadian jurisdictions, New Zealand, and soon, Australia.

65. The importance of eliminating the concept of par value cannot be over-emphasised if simplification of capital structure rules is to be achieved. The difficulties associated with issuing shares at a discount or splitting overvalued shares fall away. "A share is simply a proportionate interest in the net worth of a business", in the words of one famous company law report.

66. **Solvency Test.** Complicated capital maintenance tests would be replaced by simpler solvency tests. Redemption and repurchase of a company's shares can be effected with little formality provided the company is solvent. Distributions (e.g. payments of dividends and other transfers of corporate assets) would only be permitted if the company would remain solvent on a balance sheet and cash flow basis after the payment. This is a key recommendation which will do much to simplify the new Business Corporation Ordinance.

RECOMMENDATIONS

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

67. This Part of the proposed Ordinance deals with financial disclosure, charges, share transfers and various corporate housekeeping matters.

68. **Charges.** Part III of the current Ordinance, "Charges", would continue in effect. The Report strongly recommends, however, that a study be conducted with a view to implementing a comprehensive regime for the creation and registration of security interests. Also, provisions with respect to a modern paperless method of holding and transferring shares should be implemented in consultation with the Securities and Futures Commission, the Stock Exchange and the Hong Kong Securities Clearing Company Limited.

69. **Accounting Standards.** Most significant among the recommendations are those with respect to the use of accounting standards and auditing requirements. The requirement that "true and fair" accounts be prepared continues. There was, however, virtual unanimity that the information required by the current Tenth Schedule (Accounts) was outdated and no longer consistent with accounting practice. Accounting practices change too rapidly to be frozen in legislation.

70. **Generally Accepted Accounting Principles.** For this reason, the Report recommends in one of its key recommendations that the proposed Ordinance not contain detailed line by line item accounting requirements. Instead, as has been successfully done elsewhere, reference should be had to generally accepted accounting principles (GAAP) developed by the Hong Kong Society of Accountants or an independent accounting standards body. All companies would be required to prepare their accounts in accordance with GAAP. Consideration should be given, however, to permitting such a requirement to be waived by unanimous agreement among the shareholders. Especially for one person companies, the requirement may be too onerous. Commercial requirements, Inland Revenue considerations and local practice would dictate the circumstances in which small companies would in fact choose to prepare more formal accounts.

71. **Audited Accounts.** As a general rule, all companies should be required to provide audited accounts to shareholders. Audited accounts provide an important safeguard for shareholders, especially minority shareholders, in companies where there is a separation of ownership and management. Shareholders, by unanimous action, should however be able to dispense with an audit of the company's accounts. The indiscriminate imposition of audited accounts on all companies is unjustified and burdensome. Audited accounts may be required for other reasons, by Inland Revenue, for example, or by individual creditors as a condition of doing business. Accounts would not be required to be filed with the Companies Registry.

RECOMMENDATIONS

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

72. **Board of Directors.** The recommendations in Part 6.00 deal with some of the most difficult issues in modern company law. First of all, the Report recommends keeping the existing traditional unitary board structure, at least for public and listed companies. Companies would be permitted to have a minimum of one director. In private companies, however, a formal board of directors should be optional. In some jurisdictions the board of directors has simply been eliminated in private companies. This is not being recommended in Hong Kong. In fact, some working party members did not consider the requirement to have a board of directors an onerous one and favoured its retention for all companies. The guiding principle in all recommendations affecting private companies has been to provide maximum flexibility for the ordering of their internal affairs. Where there is an identity of ownership and management, it should be possible to eliminate artificial formalities, including the board of directors. Where the board is eliminated, shareholders would assume the responsibilities and liabilities of directors.

73. **Directors Duties.** With respect to directors themselves, a much debated issue in recent years has been their accountability for their actions. Several of the recommendations flow from this concern. Some are new; some are not. There was unanimity among working party members that there should be a statutory statement of directors duties, as appears in many other company statutes. The statutory statement of directors duties would have the beneficial effect of clearly setting out the standard against which directors' actions would be measured. The professional advisors on the working parties suggested that such a statement would be helpful to them in counselling their clients.

74. 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. Directors would be required 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. Certain corporate officers are included in the US and Canadian formulation of the statutory duties, in recognition of the commercial reality of managerial responsibilities. This recommendation suggests applying the standards to 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.

75. Directors and executive officers should be able to rely on financial statements and other reports prepared by other officers and employees as well as professional advisors. This simply reflects commercial reality. Indemnification of company directors and executive officers should be permitted and companies should be able to purchase directors and officers insurance.

76. **No Corporate, Shadow or Alternate Directors.** In furtherance of the goal of greater accountability of directors, the use of corporate directors would be prohibited. For similar but slightly different reasons, it has been recommended that shadow and alternate directors be eliminated. Alternate directors have been used in Hong Kong primarily for reasons of convenience. For private companies under the proposed Ordinance, there should

be no necessity for alternate directors. More informal means of decision making should be the rule.

77. For public and listed companies, the use of alternate directors now runs counter to the general trend towards greater accountability. Directors should be "truly available" as one recent study has put it. In addition, modern telecommunications technology will increasingly make physical presence at meetings unnecessary thus permitting directors to participate despite temporary absences. Shadow directors present different issues, primarily related to liability and enforceability. When it is considered desirable to impose duties and 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. When personal liability is at issue, it is important that there be reasonable certainty.

78. **No Director Disqualification.** There appears to be no need for general director disqualification provisions under the proposed Ordinance. Dishonest or incapable directors would be dealt with in the context of insolvency, securities and criminal legislation. The broad statutory unfairly prejudicial remedy or derivative action should provide the means of removing rogue directors without recourse to specific disqualification provisions.

79. **Company Officers.** Neither does there appear to be a necessity for stipulating in the legislation a requirement for any particular configuration of corporate officers. Given the informality of structure which is being proposed for private companies, mandatory requirements with respect to company officers are inappropriate. The Stock Exchange and other interested regulators can make a determination as to whether certain corporate officers are required for other companies.

80. **Conflicts of Interest.** The statutory treatment of directors conflicts of interest is a very unsatisfactory area of the law. The Report recommends that consideration be given to the creation of a duty of fair dealing for directors and executive officers in their dealings with the company. This would be a commercial standard based on honesty and fair dealing, consistent with the underlying principles in the case law in the area. The familiar procedure of disclosure of the director's interest would be required, as well as disinterested voting by the board. The transaction would have to be fair and reasonable to the company. Unanimous shareholder consent to an interested transaction would uphold an interested transaction as well as ratification by special majority. Generally, directors and executive officers should not disclose corporation information or use a corporate opportunity without the consent of the disinterested board.

RECOMMENDATIONS

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

81. **Shareholders Remedies.** Several new shareholder remedies are proposed to be created in Part 7.00: the statutory derivative action, the appraisal or buy-out remedy, and the statutory compliance and restraining order. Existing rights and remedies are refined. The two existing statutory shareholder remedies, the unfairly prejudicial action and just and equitable winding-up, are retained. Also introduced is a statutory unanimous shareholder agreement. The statutory unanimous shareholder agreement gives great latitude to shareholders to redistribute decision-making power within the company.

82. No one statutory remedy is perfect; each has its own characteristics and inherent limitations. Shareholders are best served by an overlapping system of protections.

83. **Just and Equitable Winding-Up.** Prior to the introduction of the statutory unfairly prejudicial action, just and equitable winding-up was the only statutory remedy open to an unhappy shareholder. As it, in effect, kills the company, a just and equitable winding up order was accorded sparingly by the courts. The limited scope of the just and equitable winding-up remedy led to introduction of the unfairly prejudicial remedy. A firmly entrenched traditional remedy, the just and equitable winding-up still has its uses, particularly in cases of simple deadlock where oppressive or unfairly prejudicial conduct is not made out. To soften the drastic nature of the remedy, a court should have the ability to give alternative relief as it sees fit.

84. **Oppression or Unfairly Prejudicial Remedy.** The statutory oppression or unfairly prejudicial remedy has become the shareholder remedy of choice since its introduction. The Report is recommending that it be broadened to increase its availability and utility. The courts have said that shareholders who entrust their money to companies are entitled to expect fair play and fair dealing. Conduct which departs from these standards should give shareholders grounds for complaint.

85. The remedy is not, however, restricted to shareholders. As recommended, the remedy gives the right to complain to all securities holders, past and present, as well as directors and executive officers and the Financial Secretary. The Financial Secretary can take an action in the public interest if necessary, although this should happen very rarely. Despite the wide open nature of this remedy, where it exists, it has been used primarily by minority shareholders.

86. 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.

87. **Derivative Action.** The derivative action, whereby a shareholder takes an action in the name of and on behalf of the company, already exists at common law. It is usually invoked where there is wrongdoing of some kind at the board level which results in decision making which is not in the best interests of the company. The problem is that the remedy is based on an old 1843 U.K. case that even predates company law as such. It is slow, expensive and rarely used.

88. The principle is sound however. The proposed statutory remedy codifies the common law and provides clear cut procedures, with checks and balances, which permit shareholders to take an action on behalf of the company. Where it exists in conjunction with a broad oppression or unfairly prejudicial remedy, the derivative action has been somewhat eclipsed. It is easier to get into court with the unfairly prejudicial action.

89. However, there are still very persuasive reasons for codifying the derivative action. Where it has been codified, it clearly serves as a deterrent. It also appears to be the only way in which to lay to rest the unruly ghost of Foss v. Harbottle, the 1843 case which created the "rule".

90. There have been some unfortunate turns in recent years in the case law based on Foss v. Harbottle. They have created unnecessary hurdles for shareholders in international disputes being played out in the U.K. It would be unwise to permit this case law to be imported into Hong Kong.

91. **Appraisal or Buy-Out Remedy.** The creation of a statutory "appraisal" or "buy-out" remedy is also recommended. The remedy is American in origin. It has been adopted by Canada and New Zealand. Where a company has, quite legitimately, decided upon a major change in course, the buy-out remedy gives an unhappy shareholder a way out. The company can proceed with its course of action unimpeded provided it buys out the unhappy shareholder.

92. The beauty of the action is that it provides great managerial freedom while at the same time defusing possible internal disputes, usually without recourse to the courts. The remedy is inspired by contractual dispute resolution provisions often found in partnership agreements. The circumstances in which a shareholder has the right to request to be bought out are limited to certain fundamental changes in the nature of the business or investment.

93. In private companies, where there is, by definition, no market for an unhappy shareholder's shares, the buy-out remedy is very useful. Shareholders in public and listed companies who are unhappy with management's decisions can sell into the market. As it happens, however, in Hong Kong there may be limited liquidity in the public market for some listed companies given the large number of majority controlled companies and limited public float. For this reason, the Listing Division of the Stock Exchange of Hong Kong was cautiously in favour of introducing the buy-out remedy. However, the Listing Rules and Takeovers Code provide certain protections for fundamental changes and an alternative is to exclude listed companies from the application of the remedy.

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

95. **Alternative Dispute Resolution.** It should be noted here that recourse to the courts is viewed as a last resort, especially in the Hong Kong context. The high cost of civil litigation (as well as a cultural bias against it) casts doubt on the effectiveness of civil remedies for aggrieved shareholders. In addition, many Hong Kong companies are family

controlled and particularly vulnerable to difficulties engendered by family squabbles. Because the business partners often go home to each other, privacy and informal, non-adversarial dispute resolution are important. Commercial arbitration and mediation are an attractive alternative to civil litigation for these reasons.

96. **Unanimous Shareholder Agreement.** The statutory unanimous shareholder agreement serves a similar function. It permits companies to function very much like partnerships. In addition to providing great latitude in the allocation of decision making powers within the company, it permits shareholders to decide, in advance, on contractual dispute resolution mechanisms that avoid litigation. And like a partnership agreement, the unanimous shareholder agreement is private; it is not on the public record as is the case with articles of association.

97. The statutory unanimous shareholder agreement has several advantages over ordinary contractual arrangements among shareholders. Although not required to be put on the public record, it is considered a constitutional document of the company and binds future shareholders. It may also go much further in permitting shareholders to operate their business in an informal and flexible manner. For example, it may permit the shareholders to dispense with a board of directors.

98. It would be difficult to underestimate the significance of statutory unanimous shareholders agreements where they have become accepted. They build into the corporate structure much of the flexibility and sensitivity to individual business needs that are found in partnerships.

RECOMMENDATIONS

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

99. One striking inadequacy of the existing Ordinance is the absence of any mechanism for routine corporate restructuring of solvent companies without the necessity of court intervention. The recommendations in this Part focus primarily on providing such mechanisms.

100. **Routine Amalgamations.** Routine amalgamations of solvent companies should not require recourse to the courts provided shareholders and creditors are adequately protected. The interests of shareholders can be protected by super-majority voting requirements and the buy-out remedy. Creditors can be protected by notice provisions, the application of a solvency test and certification by the directors that the interests of creditors are not prejudiced by the amalgamation. For related companies and wholly-owned subsidiaries, the procedure can be even more streamlined.

101. **Export and Import.** A more controversial recommendation is to permit the "export" and "import" of companies in Hong Kong. Foreign companies should be permitted to re-incorporate in Hong Kong under the new Ordinance without the necessity of liquidation and the resulting disruption and interruption corporate existence. Hong Kong incorporated companies should be able to continue under the laws of incorporation of another jurisdiction.

102. Especially with the volume of international transactions with a Hong Kong nexus, import and export of companies should be permitted. Hong Kong businesses can choose to incorporate overseas with relative ease. The "exporting" or "redomiciling" of existing Hong Kong companies can already be accomplished, albeit at some effort and expense. Several major Hong Kong listed companies have, in effect, shifted their jurisdiction of incorporation from Hong Kong to Bermuda.

103. On balance, it would seem preferable to face the commercial reality of the situation and 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.

RECOMMENDATIONS

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

104. The recommendation to remove insolvency from companies law dramatically simplifies the dissolution and liquidation provisions of Part V of the current Ordinance. In Hong Kong the voluntary dissolution procedures are so tedious and cumbersome that the usual practice is to cease compliance with the Ordinance deliberately and wait several years for the Registrar to strike the company off the register.

105. There are essentially three categories of circumstance in which dissolution and liquidation of solvent companies may take place: voluntary dissolution, administrative dissolution and court ordered dissolution. Voluntary dissolution should be by means of simple filing, together with a few other formalities in the interests of protection of creditors and shareholders.

106. Administrative dissolution should be retained, primarily as an administrative sanction for failure to comply with the Ordinance. With the administrative formalities imposed on companies under the legislation being considerably reduced, there is a strong argument for strictly enforcing compliance.

107. Court ordered dissolution is a drastic, if traditional, remedy of last resort. Although other less drastic remedies which permit continuance of corporate life while resolving deadlock or removing other difficulties may be preferable in most circumstances, the traditional just and equitable winding up should be continued.

108. 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. There should also be broad discretion vested in the Financial Secretary or a delegated authority to revive companies. Mistakes do happen and unforseen circumstances arise. There should be a ready cure available.

RECOMMENDATIONS

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

109. Nearly 99% of Hong Kong incorporations are private companies. A frequent observation during the course of the Review was that the current Ordinance was originally drafted with 19th century public companies in mind. It was simply not suited to private companies.

110. The proposed new Ordinance is largely devoid of those more traditional aspects of public company law found in U.K.-style statutes. Many of the public company provisions, such as the prospectus provisions, have been recharacterised as more properly pertaining to securities law. They should be left to the Securities and Futures Commission and the Stock Exchange. A great many of the remaining provisions of "core company law", incorporation procedures for example, are equally applicable to public (including listed) and private companies.

111. **Characteristics.** Nevertheless, it was decided to propose a separate part in the new Ordinance dealing with private companies/closely-held corporations, given their special characteristics. These characteristics are remarkably similar across jurisdictions. There will be a small number of shareholders, often family members or otherwise sharing a personal relationship. There will not be a public market for the shares. The shareholders will be knowledgeable about the company. Management will be informal.

112. **A Wish List.** The Small and Medium Sized Enterprise Committee of the Hong Kong General Chamber of Commerce made a submission to the Review and outlined its "wish list":

- 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 mechanism for deadlock;
- 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 being personally liable for wilfully defrauding creditors;
- simple dissolution procedures and deregistration for persistent non-compliance with the Ordinance.

The recommendations in Part 10.00 are responsive to these desires.

113. **Incorporated Partnership.** The concept of the "incorporated partnership" is now widely accepted in many jurisdictions and is the basis of these recommendations. 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. 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.

114. 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. A great number of local businesses incorporate in the British Virgin Islands, in large part because it is quick and easy. Some professional members of the working parties estimated that 90% of these businesses would in fact incorporate in Hong Kong if a quick and easy means of doing so were available to them under a modern streamlined companies law regime.

115. In other jurisdictions, small local businesses tend to prefer the certainty, familiarity and convenience of incorporation under local law. It 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.

116. There are two main varieties of private company. There is the small business operating informally on the basis of "handshake" deals. There is also the wholly-owned subsidiary or holding company used in sophisticated business enterprises. The provisions in this Part aim to accommodate both.

117. **Standard Provisions.** For the small business which operates informally and without the benefit of ongoing legal advice, this Part will provide standard provisions to address the most common aspects of their operations. There would be standard share transfer restrictions; preservation of limited liability despite failure to observe corporate formalities; no mandatory audit; standard form share buy-sell and buy-back provisions to permit shareholders to leave the company; recourse to mediation or arbitration; the possibility of applying to court for the

appointment of a rehabilitative receiver in the event of deadlock.

118. These provisions would apply unless excluded by the company in its constitutional documents. More sophisticated business enterprises engaged in formal corporate planning could tailor provisions to meet their specific needs.

RECOMMENDATIONS

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. This 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

119. As discussed above, Hong Kong is a significant international business centre. There is a large number of multinational businesses which have a presence in Hong Kong. In addition, local business in Hong Kong is remarkably international in its reach. As well, in recent years there has been a proliferation of overseas incorporations of truly local Hong Kong businesses. There are several implications for companies law in Hong Kong.

120. Part XI of the current Ordinance applies to "oversea companies", companies incorporated outside Hong Kong and which "establish a place of business in Hong Kong". 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. The vast majority of foreign incorporated private companies in Hong Kong do not, and are currently not obligated, to register under Part XI.

121. In addition, throughout the current Ordinance, there are provisions which are made expressly or impliedly applicable to foreign incorporated companies but not in a consistent manner. These are the provisions on registration of charges, production of books and records, investigations, disqualification of directors, winding-up and restrictions on sale and offer of shares.

122. **Law of the Place of Incorporation.** In private international law, the traditional rule is that the law of the place of incorporation applies to the creation, internal affairs (such as shareholders remedies) and termination of a company. It is a rule which is simple to apply and provides certainty and predictability. Where the company has a presence and is operating in a foreign jurisdiction, many of the other laws of that jurisdiction will apply.

123. Not all jurisdictions look to the law of the place of incorporation to govern internal company matters. California and New York, in particular, will apply provisions of their domestic company law to the internal affairs of foreign-incorporated companies. This approach is controversial, even within the United States. It creates great potential conflicts with the laws applicable to such companies abroad.

124. In Hong Kong it appears preferable to continue to recognise place of incorporation as the law governing the creation, internal affairs and termination of companies. 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 financial markets regulation, health and safety concerns, worker protection and the like, domestic legislation will apply to the activities of foreign incorporated companies. Hong Kong law, however, should not apply to the core company law aspects of foreign incorporated businesses.

125. Under the current Ordinance, there are five main areas of concern that have prompted 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. The new Ordinance proposes a different approach to companies law and these areas of concern should

disappear for the most part.

126. **Charges.** In the interests of local creditors, there should be a public register of charges or security interests granted over Hong Kong assets, irrespective of the nature or nationality of the owner of the property. This approach would see the removal of Part III, Charges, of the current Ordinance and the confusion surrounding its application to non-registered oversea companies.

127. **Winding-Up.** Statutory winding-up provisions have been used as a means of creditor protection in cases of insolvency and as a sanction for various commercial or administrative misdeeds on the part of the company. In the cases of corporate 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. 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.

128. 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. 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.

129. **Shareholder Remedies.** The primary shareholder remedy in the current Ordinance is the unfairly prejudicial remedy. Extending its availability to shareholders of foreign incorporated companies has been suggested on several occasions 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 do extend to their residents the shareholder protections of local law in certain circumstances. The better view, however, is that Hong Kong should not do so. It is unwarranted and unnecessary.

130. 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.

131. **Disqualification of Directors.** The disqualification of directors provisions of the current 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. Such provisions should not be applied to directors of a foreign incorporated company. Who can be a director of a foreign incorporated private company is surely a matter of the internal affairs of a company, to be dealt with by 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 Companies Ordinance. The recommendation for a new Ordinance, in fact, proposes to eliminate the director disqualification provisions entirely.

132. **Investigative Powers.** Investigative powers with respect to the local commercial activities of foreign incorporated companies, on the other hand, are entirely justified. They should be maintained and made applicable to foreign companies in the interest of fostering a commercial environment of confidence and fair dealing.

133. **Registration.** On the different but related issue of registration of foreign companies in Hong Kong, the Consultancy Report is recommending a "carrying on business" test. This test will require more foreign companies to register but the related recommendations should make it easier to make and maintain a registration. Filing requirements serve three purposes: they help authorities monitor the activities of foreign companies; they protect local creditors and businesses by making available a minimum of information ; and thirdly, they give local courts jurisdiction.

134. **International Business Companies.** Finally, the Terms of Reference for the Review 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 creation of small, island jurisdictions of convenience. They are accorded favourable tax treatment but restricted in their ability to do business within their jurisdiction of incorporation. Not all IBCs are the same however and requirements in different jurisdictions vary widely.

135. Two jurisdictions predominate in Hong Kong, Bermuda for publicly listed companies and the British Virgin Islands for private companies. Fifty percent of companies listed on the Stock Exchange of Hong Kong are incorporated in Bermuda. Estimates have it that there are 100,000 British Virgin Islands companies in Hong Kong.

136. There appears to be little reason to consider "regulating" in any way the operations of IBCs in Hong Kong companies law, other than by means of routine registration of foreign companies. Bermuda is a respectable jurisdiction of incorporation. Oversight of the capital markets activities of Bermuda incorporated companies can be left to the Stock Exchange and the Securities and Futures Commission.

137. As for British Virgin Islands companies, there was little evidence of "abuse" of their flexible, speedy incorporations. Possible issues of tax avoidance are best left to the Inland Revenue. Some professionals are of the view that a "superior product", combined with skilful marketing by the British Virgin Island authorities and professionals contributed to their proliferation among Hong Kong businesses. There is also some evidence that Hong Kong incorporation for private companies may be experiencing a bit of a revival, according to recent Companies Registry statistics.

138. 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 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 the British Virgin Islands IBC with Hong Kong's natural advantages as a major international business centre and gateway to mainland China, would be "unbeatable.".

RECOMMENDATIONS

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

139. It is proposed that there be a transitional period with respect to implementation of the new Ordinance. All new incorporations would be under the new Ordinance and existing companies would have a period of three to five years to reregister under the new Ordinance. Reregistration procedures would be kept very simple. This approach has been successful in other jurisdictions. Reregistration, provided it requires minimal effort , could be a welcome tonic to Hong Kong business.

RECOMMENDATIONS

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.

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REPORTS, BRIEFING BOOKS AND BACKGROUND MEMORANDA*

REPORTS

Inception Report: An Ordinance for the 21st Century (February 1995)

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)

BACKGROUND MEMORANDA

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.