



RE-WRITE OF THE COMPANIES ORDINANCE
Draft Companies Bill
Second Phase Consultation

The Law Society's Company and Financial Law Committee and Intellectual property Committee have reviewed the Consultation Paper *Draft Companies Bill – Second Phase Consultation* published by the Financial Services and Treasury Bureau on 7 May 2010 and has the following submissions in relation to the questions posed and commentary on the draft Bill:

Question 1(a)

Do you agree that the restrictions on financial assistance should be abolished for private companies?

Law Society's response

This is a repeat of Question 19(b) in the Consultation Paper published in June 2008 on "Share Capital, the Capital Maintenance Regime and Statutory Amalgamation Procedure". The Law Society then favoured retention of the restriction.

The Law Society remains of the same view:

(a) The underlying principle behind the financial assistance provisions remains sound: the resources of a target and its subsidiaries should not be used to assist a purchaser financially in connection with the purchase of shares of the target which might be prejudicial to the interests of creditors or minority shareholders generally. While there are arguments that the "maintenance of capital" doctrine provides illusory protection against corporate failures and modern day creditors rarely rely on "capital maintenance" for protection, the streamlined whitewash procedures in Division 5 adopt a "solvency" approach, and provide a good balance between (i) preserving the protection for creditors and minority shareholders and (ii) creating a more liberal regulatory framework that allows flexibility for corporate transactions;

(b) One of the main arguments for the abolition of the ban on financial assistance for private companies is that it is a "trap for the unwary". Abolition of the ban does not, however, remove "the trap" altogether. In fact, it may give the unintended wrong perception that a private company will be free to offer financial assistance. Even with abolition, the giving of financial assistance will still involve consideration of directors' fiduciary duties and whether the "financial assistance" amounts to an unauthorised reduction of capital. A common form of financial assistance, for example, is the giving of a loan, guarantee or security by the

target or its subsidiary. The giving of a loan, guarantee or other security will have neutral effect on a company's net assets unless the directors have reasons to believe that the loan will not be repaid or the guarantee or security will be enforced. In such case, a provision will need to be made that will reduce a target's net assets by the same amount. Under the proposed whitewash procedures, the "solvency test" will have to be satisfied. Even with the abolition of financial assistance, the Companies Bill prohibits unauthorised reduction of share capital (Part 5) and permits distribution only out of "distributable profits" (Part 6). The directors will also have to consider whether the "financial assistance" is in the interests of a company. What is in the interests of a target may not be in the interest of a "subsidiary" which provides the assistance. There will still be need for legal advice and the argument that there will be substantial cost savings for private companies may be misconceived.

While the streamlined "whitewash procedures" may still be perceived as restrictive as compared to the removal of the ban, it provides a useful checklist for directors to consider before they authorise the financial assistance. It also offers safeguard and certainty to financial institutions which finance any leveraged buyouts. Section 5.72 of the Companies Bill provides a "saving" and makes it clear that a transaction will not be unlawful only because of contravention of the financial assistance provisions. It remains to be seen whether removal of the 'whitewash procedures' in the UK with the uplifting of the ban on financial assistance for private companies will in fact offers certainty for financiers for leveraged buyouts along with the flexibility that the legislative change intends to introduce.

(c) Under the streamlined financial assistance provisions as proposed in the Companies Bill, the costs of ensuring compliance should not be exaggerated. Unlike the previous UK whitewash procedures, there is no requirement for an auditors' report to be attached to a declaration of solvency.

Question 1(b)

If you answer to (a) is positive, which of the following options concerning regulation of listed and unlisted public companies would you prefer:

(i) existing rules for listed and unlisted public companies in the CO be retained (i.e. listed companies cannot give financial assistance except for certain exceptions as set out in sections 47C and 47D of the CO while unlisted public companies may give financial assistance subject to solvency test and a special resolution of the shareholders (section 47E of the CO));

(ii) the rules for both listed and unlisted public companies to be streamlined using a solvency test as set out in the draft clauses in Division 5 of Part 5; or

(iii) any other option (please elaborate),

having regard to the need to protect small investors of public companies?

Law Society's response

The proposals in (i) to (iii) are not applicable.

(c) If your answer to (a) is negative (i.e. you believe that private companies should still be subject to certain restrictions on financial assistance), do you have any specific comments on the draft clauses in Division 5 of Part 5? Please elaborate.

Law Society's response

(i) In respect of Section 5.70(1)(d) which defines "financial assistance": given that under the streamlined whitewash procedures, the "cashflow" solvency test is adopted for private companies, consideration should be given to modifying the definition in sub-paragraph (d)(ii) that states that "any other financial assistance given by a company if....(ii) the company has no net assets" to "any other financial assistance given by a company if... (ii) the net liabilities of the company are increased to a material extent by the giving of the assistance";

(ii) Section 5.79 – financial assistance not exceeding 5% of shareholders funds: the threshold may be increased for private companies;

(iii) Section 5.81 – the right of a member to contest could be subject to some threshold requirements so that a member, with a nominal shareholding, could not tactically hold up a commercially viable transaction.

Question 2

Do you agree that there is no need to impose a statutory requirement in the CB for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong where members holding not less than 5% of voting rights have so requested to prepare separate directors' remuneration reports?

Law Society's response

We agree that in view of the concerns raised in paragraphs 3.9 and 3.10 of the CP there is no need to impose a statutory requirement for directors' remuneration report.

Question 3

Do you have any comments on the proposed changes to the provisions concerning the investigation of a company's affairs and enquiry into company's affairs that maybe exercised by the FS described in paragraphs 4.6 to 4.13, the Explanatory Notes on Part 19 and Divisions 1 to 3 and 5 in Part 19 of the CB?

Law Society's response

We generally agree with the proposed changes and have no specific comments on the proposals.

Question 4

Do you have any comments on the proposed new powers for the Registrar to obtain documents, records and information as described in paragraphs 4.14 to 4.17, the Explanatory Notes on Part 19 and Divisions 1, 4 and 5 in Part 19 of the CB?

Law Society's response

In light of proposed criminal sanctions for non-compliance and the right to delegate power to any public officer, we disagree with the proposal that the Registrar be given a new but limited power to obtain documents, records and information for the purposes of ascertaining whether any conduct that would constitute certain offences relating to the provision of false information in documents delivered to the CR.

Any investigation of a company's affairs and inspection of books and papers should continue to be initiated by the Financial Secretary, and not by the Registrar.

Question 5(a)

Do you think the CB should make it obligatory for a company to give reasons explaining its refusal to register a transfer of shares?

Law Society's response

Yes. Reason for refusal should be given because (i) there should be transparency in the exercise of directors' power and (ii) the directors' power should be exercised for the benefit of the company and should be seen to be so.

Question 5(b)

If your answer to (a) is in the affirmative, should the company be required to provide reasons with the refusal:

- (i) in the manner of the UKCA 2006 (i.e. mandatory whenever there is a refusal); or*
- (ii) upon request, as in the case of transmissions by operation of law under section 69(1A) of the CO?*

Law Society's response

It should be enough that the obligation to give reason is triggered by a request. It is a fundamental feature of a private company that there are restrictions on transfers of shares. There should also be consistency in the two cases, i.e. transfer or transmission.

Comments on the Draft Companies Bill

Part 3: Company Formation and Related Matters, and Registration of Company

We note the Companies (Amendment) Bill 2010 ("Amendment Bill") passed by the Legislative Council on 7 July 2010 already addressed issues relating to company names with the intention to tackle the problem of "shadow companies" in Hong Kong. The draft Companies Bill has consolidated the amendments introduced in the Amendment Bill into the rewrite of the Companies Ordinance.

The Amendments - Part 3 Division 3 – Company Name

1. Clause 3.39 (2)(c) of Subdivision 1- Restriction on Company Name

This provision is the same as the new section 20(2A) introduced by the Amendment Bill, which provides that except with the consent of the Registrar, a company must not be registered by a name that is the same as a name for which a direction has been given under section 22 (for being “too like” another company name) or 22A (for being misleading or offensive name etc.) of the Companies Ordinance (“Ordinance”).

We repeat our submissions on the Amendment Bill made on 23 March 2010 and our additional submissions on the Ordinance and the Amendment Bill on 31 March 2010. The restriction on company name should be expanded to cover company names that are “too-like” the name of a company for which a direction to change its name has been given by the Registrar under section 22(2) of the Ordinance. A name shall be deemed “too-like” another name if it contains the same or substantially the same distinctive element, being the well-known trademark/name of another party.

2. Clause 3.48 of Subdivision 3 – Change of Company Name

Clause 3.48(1)(b) is the same as section 22 (2) of the Ordinance (change of name for being “too like” another company name). We repeat our earlier submissions on the Ordinance and the Amendment Bill on 31 March 2010. In determining under sub-section 22(2) of the Ordinance whether a name is the same or too like another, we propose explicitly providing that the Registrar shall take into consideration whether the proposed new name may contravene an earlier right in the name, in particular by virtue of the laws of trade mark and/or passing-off.

Clause 3.48 (2) is the same as the new section 22(3B) introduced by the Amendment Bill, which empowers the Registrar to direct the company to change its name within a specified period, upon receipt of a court order requiring a company to change its name. We repeat our submissions on the Amendment Bill made on 23 March 2010. This is a useful provision and would relieve rights holder of the need to sue the individual shareholders of the company which would often entail service of proceedings outside of Hong Kong.

Under clause 3.48(5), if a company fails to comply with a direction to change the name within the period specified by the Registrar, the company and every responsible person of the company commit an offence, and each is liable to a fine at level 6, and in the case of a continuing offence, to a further fine of \$2,000 for each day during which the offence continues. Under the current provision of the Ordinance, the company and every officer of the company who is in default shall be liable to a fine and, in the case of an individual, imprisonment; and for continued default, a daily default fine.

We are concerned that the removal of liability for imprisonment on the part of officer(s) of the company will likely reduce the deterrent effect in non-compliance with such direction.

3. Clause 3.50 of Subdivision 3 – Change of Company Name

This clause is equivalent to the new section 22AA added by the Amendment Bill which empowers the Registrar to substitute the name of the company with a new name consisting of the words “*Company Registration Number*” followed by the company’s registration number as stated in its certificate of incorporation, where the company fails to comply with the Registrar’s direction to change the name given under, inter alia, the new section 22(3B) introduced by the Amendment Bill or section 22(2) of the Ordinance.

We repeat our submissions on the Amendment Bill made on 23 March 2010 and our additional submissions on the Ordinance and the Amendment Bill on 31 March 2010.

The effectiveness of this new section will depend on what constitutes non-compliance with the Registrar's direction to change the name, which in turn is dictated by how the direction is formulated.

It is hoped that the direction will target change of the distinctive part (i.e. the well-known mark in question), and not the company name as a whole. In this regard, a direction made pursuant to the new power under section 22(3B) which refers to a court order restraining the company from using its name or *any part of the name* can follow the terms of the court order, such that the company is directed to change its name to one not incorporating any distinctive part of that name (or as provided in the court order).

On the other hand, it is hoped that the Registrar will similarly formulate a direction under section 22(2) to change the distinctive part of the company name that he considers "too-like" the distinctive part of another name on the register.

Further Consultation

We have yet to see how the provisions in the Amendment Bill will be implemented and their effectiveness in tackling the problem of "*shadow companies*".

As we consider some of the provisions in the Companies Bill inadequate in tackling the problem of "shadow companies", we look forward to the opportunity of discussing with the Registrar further strategies in tackling the problem of "shadow companies", including but not limited to regulating the secretarial service companies by code of conduct to maintain a high professional standard in the industry.

In respect of Parts 5, 6, and 7 we have the following drafting comments on the draft Bill as highlighted in red

PART 5: Transactions in relation to Share Capital

5.4 Solvency Statement

- (1) A solvency statement in relation to a transaction is a statement that each of the directors making it has formed ~~the~~ a reasonable opinion that the company satisfies the solvency test in relation to the transaction.
- (2) In forming an opinion for the purpose of making a solvency statement, a director must-
 - (a) inquire into the company's state of affairs and prospects (including reviewing the latest financial statements of the company);

5.11 Special resolution for reduction of share capital

- (2) The special resolution and the reduction of share capital take effect on the day when the return under section 5.20 or 5.21 in relation to the reduction is registered by the Registrar.

5.20 Registration of return if no court application

Notes:

1. The special resolution and the reduction of share capital take effect on the day when the return is registered by the Registrar (see section 5.11(2)).

5.21 Registration of return if court application

Notes

1. The special resolution and the reduction of share capital take effect on the day when the return is registered by the Registrar (see section 5.11)).

5.30 Terms, conditions and manner of redemption

- (1)(b) by resolution* of the company.

* Note: Specify the type of resolution

5.32 Retention and inspection of share buy-back contracts

- (3) The copy or memorandum must be kept from the conclusion* of the contract or agreement until the end of the period of 10 years beginning on the day on which the buy-back of all the shares under the contract is completed or the day on which the contract otherwise terminates.

* Note: What does “conclusion of the contract” mean? Suggest to use the “date of the contract”.

5.33 Share buy-back under general offer

- (1) A listed company may buy back its own shares under a general offer that is authorised in advance by a resolution* of the company.

* Note: Please consider specifying that the resolution is a special or an ordinary resolution.

5.34 Share buy-back on recognised stock market or approved stock exchange

- (1) A listed company may buy back its own shares on a recognised stock market or on an approved stock exchange if the buy-back is authorised in advance by a resolution* of the company.

* Note: Please consider specifying that the resolution is special or an ordinary resolution.

5.35 Share buy-back otherwise than under section 5.33 or 5.34

- (1) A listed company may buy back its own shares otherwise than under section 5.33 or 5.34 if the contract for buy-back of the shares is authorised in advance by a special resolution of the company.

5.38 Release of right to buy back own shares

- (1) An agreement by a listed company to release its rights under a contract authorised under section 5.35 or under a general offer authorised under section 5.33 is void unless the terms of the release agreement are authorised in advance by a special resolution of the company.

5.39 Share buy-back under contract

- (1) An unlisted company may buy back its own shares under a contract that is authorised in advance by a special resolution of the company.

5.42 Variation of authorised contract

- (1) An unlisted company may agree to a variation of a contract authorised under section 5.39 if the variation agreement is authorised in advance by a special resolution of the company.
- (2) The authorization for a variation agreement may be varied, revoked or from time to time renewed by a special resolution of the company.

5.46 Release of right to buy back own shares

- (1) An agreement by an unlisted company to release its rights under a contract authorised under section 5.39 (as varied from time to time under section 5.42) is void unless the terms of the release agreement are authorised in advance by a special resolution of the company.
- (2) The authorisation for a release agreement may be varied, revoked or from time to time renewed by a special resolution of the company.

5.49 Variation of release of right to buy back own shares

- (1) An unlisted company may agree to a variation of a release agreement authorised under section 5.46 if the variation agreement is authorised in advance by a special resolution of the company.
- (2) The authorisation for a variation agreement may be varied, revoked or from time to time renewed by a special resolution of the company.

5.53 Special resolution for payment out of capital

- (1) Subject to section 5.52(3), a company may make a payment out of capital in respect of the redemption or buy-back of its own shares by a special resolution in accordance with this Subdivision.

5.70 Interpretation

(1)(c)(i)

by way of a loan or any other agreement or arrangement (whether enforceable or unenforceable, and whether made on the person's own account or with any other person) under which any of the obligations of the person giving the assistance are to be fulfilled at a time when in accordance with the agreement or arrangement any obligation of another party to the agreement or arrangement remains unfulfilled; or

5.79 Financial assistance not exceeding 5% of shareholders funds

- (3)(c) the names of the persons receiving the assistance and, if a different person, the names of the beneficial owners of those shares;

5.81 Financial assistance by notice to members

- (1)(c)(i) the nature and terms of the assistance and the names of the persons to whom it will be given;
- (ii) if it will be given to a nominee for another person, the names of that other persons;

5.83 Power to adjourn application

- (1) The Court of First Instance may adjourn proceedings on an application under section 5.82 so that an arrangement may be made to the Court's satisfaction for the protection of the interests of dissentient members or the company.

PART 6: Distribution of Profits and Assets

6.14 Interim financial statement specified for purposes of section 6.11

- (10) A copy of the financial statement and of the accompanying directors' declaration must have been delivered to the Registrar for registration. If the financial statement and declaration is not in English or Chinese, the copy must have been accompanied by a certified translation of the financial statement and declaration in either of those languages.

6.15 Initial financial statement specified for purposes of section 6.11

- (10) A copy of the financial statement, of the accompanying directors' declaration, of the auditor's report of the financial statement, and of any written statement under subsection (9), must have been delivered to the Registrar for registration. If the financial statement, declaration, report or written statement in either of those languages.

PART 7: Debentures

7.7 Power to close register of debenture holders

- (3) Subject to Subsection (4), the period of 30 days mentioned in subsection (1) may be extended in respect of any year by a resolution passed in that year by a majority in value of the debenture holders present in person or, if proxies are permitted, by proxy at a meeting summoned for the purpose or otherwise in accordance with the trust deed or any other document securing the debentures.

PART 9: Accounts and Audit

We generally agree with the proposed amendments, save for the following comments:

Part (d) Requiring companies to prepare a more comprehensive directors' report which includes an analytical and forward-looking business review whilst allowing companies qualified for simplified accounting to prepare a simplified directors' report

We do not agree that "large" private and guarantee companies (i.e. other than those qualified to apply the simplified accounting and reporting requirements) should be required to prepare more analytical and forward-looking information in the directors' report, unless the members "opted-out".

In view of the significant compliance burden of this proposed requirement, we believe that an "opt-in" arrangement would be more appropriate, particularly in the context of private and guarantee companies, which are private contractual arrangements between individuals.

(e) Enhancing auditor's right to information and strengthening enforcement by imposing criminal sanctions for breaches in relation to the provision of information to auditors

While we agree that the auditor's right to information should be enhanced, we believe that the scope of proposed Clause 9.56(3) is over-reaching as the concept of "assistance" is too broad and undefined. Clause 9.56(2) already contains a requirement to provide auditors with information or explanations, with criminal sanctions for such breaches.

The Law Society of Hong Kong
Company and Financial Law Committee
Intellectual Property Committee
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