Standing Committee on Company Law Reform (SCCLR)

The Tenth Annual Report

1993/94

Standing Committee on Company Law Reform (SCCLR)

Tenth Report to His Excellency the Governor in Council

Subjects considered by the

Standing Committee during 1993/94

Table of Contents

		Page No.
1.	Terms of Reference of the Standing Committee on Company Law Reform	(i)
2.	Membership of the Standing Committee for 1993/94	(i) - (ii)
3.	Meetings held during 1993/94	(ii)
4.	Options Trading	1
5.	Investigatory Powers of the Securities and Futures Commission (SFC) Amendments to the Companies Ordinance (CO) Amendments to the Securities and Futures Ordinance (SFCO)	2 - 8
6.	Disqualification of Company Directors and Removal of Directors because of unsoundness of mind and Review of the Provisions of Table A	9 - 12
7.	Section 165 of the Companies Ordinance 'CO' (Provisions as to liability of officers and auditors of a company)	13 - 14
8.	Sec. 267 of the Companies Ordinance (CO) Floating Charges	15 - 16
9.	Sec. 48B Companies Ordinance (CO) Share Premium Account Merger Accounting	17 - 21
10.	Statutory Protection for Auditors of Listed Companies	22 - 23
11.	Inner Reserves and The Report of the Working Group on Financial Disclosure	24 - 30
12.	Section 265 of the Companies Ordinance (CO) Section 38 of the Bankruptcy Ordinance (BO) Protection of Wages on Insolvency Ordinance (POWOIO)	31 - 33

Page No.

13.	Amendments to the Company Winding-up rules (CWUR) - Rules 160, 162, 163, 166, 181 and 182	34 - 35
14.	Incorporation of CPA Practices	36 - 39
15.	Financial Assistance by a company for the acquisition of its own shares Secs. 47A - 47G Companies Ordinance Sec. 48 Companies Ordinance (CO)	40 - 43
16.	Company Accounts and Audit Sections 121 and 123 of the Companies Ordinance (CO)	44 - 46
17.	Bank of International Settlements - 'Netting" under Hong Kong Law	47 - 50
18.	Company Law Reform : International Developments	51 - 53
19.	Paragraph 9(1)(c) of the Tenth Schedule to the Companies Ordinance 'CO' - Prohibition of financial assistance by a company for the purchase of its own shares	54 - 55
20.	Financial Disclosure by Authorised Institutions	56 - 57
21.	Theft of Assets by Controllers of Companies	58 - 60
22.	The Legality of Capital Contributions	61 - 62

Terms of Reference of the Standing Committee on Company Law Reform

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

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

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

Membership of the Standing Committee for 1993/94

<u>Chairman</u> : The Hon Mr Justice Jones

<u>Members</u> : Mr Richard E T Bennett

Mr Christopher M de Boer

Mr John R Brewer

Mr Dennis G D Cassidy

Mr Ambrose W S Cheung

Mr Marvin K T Cheung

Mr CHOW Man Yiu, Paul

Mr David W Gairns

Mr Stefan Gannon

Mr Robert G Kotewall, Q.C.

Mrs Angelina P L Lee

Mr Alan Smith

H H Judge Tyler

Mr. J.T. Allen

<u>Ex-officio Members</u> :

Mr A R Hearder, JP
The Official Receiver

Mr Gordon Jones, JP
The Registrar of Companies

Mr David T R Carse
The Commissioner of Banking

Mr TAM Wing Pong
Deputy Secretary for Financial Services

Mr Robert Nottle
Chairman, Securities & Futures Commission

<u>Secretary</u> : Mr P Murphy (until 9th October 1993)

Mr E T O'Connell (from 9th October 1993)

Meetings held during 1993/94

Ninety-third Meeting	-	6th February
Ninety-fourth Meeting	-	6th March
Ninety-fifth Meeting	-	1st May
Ninety-sixth Meeting	-	10th July
Ninety-seventh Meeting	-	9th October
Ninety-eighth Meeting	-	4th December
Ninety-ninth Meeting	-	29th January

Options Trading

1. At the 93rd Meeting of the Standing Committee (6th February 1993) an information paper on the subject was tabled.

2. The first in a series of consultation papers drawn up by the Stock Exchange of Hong Kong had just been released seeking opinions and comments on how traded options on individual equities could be introduced into Hong Kong.

3. The Committee was further advised that other consultation papers would focus on the areas of trading, clearing, settlement, risk management, financing and regulatory framework. These further consultation papers would be tabled before the Standing Committee when available.

Investigatory Powers of the Securities and

Futures Commission (SFC)

Amendments to the Companies Ordinance (CO)

Amendments to the Securities and Futures Ordinance (SFCO)

Summary of Recommendations

1. At the 93rd and 94th Meetings of the SCCLR, (6th February and 6th March 1993 respectively), members supported the Financial Services Branch's (FSB) proposals to amend the (CO) and the (SFCO) in the following manner :

   (a) To amend Sec. 152A(1)(b) of the 'CO' along the lines of Sec. 447 of the 1985 UK Companies Act to enable the Financial Secretary to requisition a company's documents;

   (b) To amend Sec. 152A(1) of the 'CO' to enable the Financial Secretary to appoint persons other than public officers to require the production of certain documents;

(c) To amend the SFCO to provide the SFC with powers, in relation to listed companies, of the kind provided to the Financial Secretary under Sec. 152A of the Companies Ordinance;

(d) To amend the SFCO to enable the SFC to make an application to the court if it appeared to it that the business of a listed company was being conducted in a manner unfairly prejudicial to the interests of any part of its members;

(e) To amend the 'CO' to allow an Inspector to delegate to any person any power conferred on him by Sec. 145 of the 'CO'; and

(f) To amend the 'CO' to clarify that the court was empowered to make an order that a receiver or manager of the whole or any part of a company's property or business could be appointed in circumstances where Sec. 168A(2) of the 'CO' applied. The proposed amendment would allow the court to specify the powers and duties of the receiver or manager and to fix his remuneration.

Background

2. Sections 142 and 143 of the 'CO' contain a number of

provisions whereby in certain circumstance the Financial Secretary must, and in other circumstances may, appoint inspectors to investigate the affairs of a company.

3. Sec. 152A of the 'CO', which was enacted in 1984 and which was based on Sec. 109 of the 1981 UK Companies Act empowers the Financial Secretary to require a company to produce certain books and papers and if a company or person appears to be in possession of certain books, he may authorise a public officer to seek production of them. At the time of its enactment it was thought that the section would provide a discreet and less costly way to assess whether a full inspection was warranted. As the UK Department of Trade and Industry in its "Investigations Handbook" puts it:

> "This [the section 152A equivalent] power allows the Department to carry out enquiries discreetly, including enquiries for determining whether a full scale inspection by inspectors ..... would be justified. By making such enquiries it may be possible to avoid the potential damage to a company which could result from the knowledge that

inspectors have been appointed ..... It may also be possible to avoid the expense and delay inherent in the more searching investigations....."

4. Unfortunately, the present wording of Sec. 152A inhibits its use because :

(a) it requires the Financial Secretary to reach the same state of mind as is required for the initiation of a full inspection; and

(b) the powers in Sec. 152A can only be used by the Financial Secretary himself or by a "public officer". This prevents the appointment of someone with experience and expertise who is not a public officer to undertake the necessary review.

5. The equivalent UK section i.e. Sec. 447 of the UK Companies Act avoids those aforementioned pitfalls by setting a lower threshold for the use of the power equivalent to Sec. 152A and by allowing for the appointment of "a competent person" to examine the books and records.

Amendments to the 'SFCO'

6. Over a period of time, the administration has been led to conclude that the SFC did not have sufficient investigatory powers to carry out its statutory functions. Notwithstanding that in performing those statutory functions, the SFC encountered possible fraud or misfeasance etc. in the management of listed companies, it did not have the statutory authority to investigate the surrounding circumstances. It was therefore felt necessary to insert a provision in the 'SFCO' similar to Sec. 152A of the 'CO'.

7. For similar reasons - principal amongst which is the potential need for urgent action to curtail improper activities and to protect creditors and shareholders - an amendment to give the SFC standing to apply to court for orders of the kind provided for in Sec. 168A of the 'CO' was required.

Other Amendments to the 'CO'

8. Section 145A of the 'CO' only permits an inspector to delegate certain of the powers conferred by Sec. 145 viz :-

(a) the production of books; and

(b) the questioning of officers and agents otherwise than an oath.

Experience has shown that the limited extent by which the powers of section 145 could be delegated by Section 145A has delayed the inspector's investigations and also added to costs. Hence the recommendation recited at paragraph 1(e) above.

9. Sec. 168A(2) of the 'CO' enables the court to make a wide range of orders once it has been satisfied that the affairs of the company are being conducted in a prejudicial manner. These include (inter alia) restraining orders, the purchase of shares etc. It is not, however, clear that Sec. 168A empowers the court to appoint a receiver or manager. The administration considers and the SCCLR concurs that empowering the court to appoint a receiver and manager with regard to the affairs of the company could well be the best method of protecting creditors and shareholders alike.

10. The SCCLR also considered the proposal that the term "Affairs of a Company" which appears in a number of places in the 'CO' should be defined and modelled along

the lines of the definition set out in the Australian Corporations Act. After considerable debate members doubted the wisdom of importing into the Hong Kong legislation such a definition which had been adequately developed by the courts over a long period of time. Rather, members felt that the approach taken by the courts hitherto allowed for flexibility, and room for manoeuvre and should remain undisturbed.

Disqualification of Company Directors

and

Removal of Directors because of unsoundness of mind

and

Review of the Provisions of Table A

Summary of Recommendations

1. These subjects were discussed at the 94th (6 March 1993) and 97th (9th October 1993) Meetings of the Standing Committee respectively when members agreed :

    (a) that the recommendation of the administration to exclude from the draft Disqualification of Directors Bill the equivalent of Section 600 of the Australian Companies Code should be accepted;

    (b) that the present legal safeguards contained in the Mental Health Ordinance dealing with declarations of 'Unsoundness of Mind' in relation to the removal of directors for unsoundness of mind were satisfactory and adequate; and

(c) that a sub-committee should be set up to review the provisions of Table A in Part I of the First Schedule to the Companies Ordinance.

Background

2. At the 88th Meeting of the SCCLR (6th June 1992), members agreed to recommend the addition of a provision similar to Section 600 of the Australian Companies Code as a supplement to the draft bill on disqualification of company directors. This draft legislation had been supported by the SCCLR at their 75th Meeting (2nd March 1991).

3. The Australian section i.e. Section 600 applied to a person who had been a director of two or more companies which had been wound up as insolvent within 7 years of each other and where the ordinary unsecured creditors had received less than a 50% dividend. It was proposed that the Official Receiver (OR) could serve such a person with a notice requiring him to show cause why he should not be prohibited from being a director or from being in any way concerned with the management of a company without leave of the court.

4. During the drafting process, it became apparent that the implications of the proposal would involve the OR in a quasi judicial function. As there were no existing procedures for conducting hearings, they would have to be established which would involve questions of legal representation, whether there should be public or private hearings, whether the evidence should be published and whether the rules of evidence would apply. In view of this the OR felt that such a provision would be unacceptable. In addition the costs involved in setting up appropriate procedures for the hearings would be high. The administration shared this view.

5. With regard to the question of the removal of a director if found to be of unsound mind, this was discussed following a request from a LegCo member for the SCCLR to consider the position.

6. The Standard Article of Association on the subject is Article 90(d) of Table A in Part I of the First Schedule to the Companies Ordinance. This provides for the disqualification of a director if he becomes of unsound mind. There is, however, no definition of the

term 'unsound mind' in the Mental Health Ordinance though the concept is recognised. Whether or not someone is of unsound mind will be determined by the courts and this will be done on the weight of the medical evidence before them.

7. After discussion and debate, members felt that the present legal safeguards with regard to directors who became of unsound mind were satisfactory and did not require change.

Review of the Provisions of Table A in Part I of the First Schedule to the Companies Ordinance

8. Following on from the discussions regarding Article 90(d) of Table A (Directors becoming of unsound mind) members agreed that it was timely to review all of the provisions of Table A. The provisions in Table A had received scant attention from the SCCLR and it was now considered appropriate to see whether the other articles needed updating or change.

Section 165 of the Companies Ordinance 'CO' (Provisions as to liability of officers and auditors of a company)

Summary of Recommendations

1. At the 95th Meeting of the SCCLR, (1st May 1993) members recommended that Section 165 of the 'CO' be amended to permit a company to purchase indemnity insurance for either its auditor or any of its directors or officers. Section 137 of the 1989 UK Companies Act was enacted to enable UK companies to purchase indemnity insurance for its officers.

Background

2. Under Sec. 165, any provision contained in the company's articles or in any contract with the company which exempts any officer of the company or its auditors from, or indemnifying him or them against, any liability for negligence etc. is void.

3. A company however is not precluded from indemnifying its officers or auditors against the costs incurred by

them in defending any civil or criminal proceeding where judgement is given in their favour or where relief is granted under Sec. 358 of the 'CO'. Article 137 of Table A of the first schedule to the 'CO' permits this. However, Section 165 only allows for reimbursement of the director or officer concerned in respect of a successful defence of any action arising out of their position as a director or officer of the company.

4. In other jurisdictions such as Australia, or Japan and since 1991, the UK, it has long been possible for companies to purchase indemnity insurance for their directors. Members felt that such a provision should also be permissible under Hong Kong law. Members accepted that in today's business environment where the business and legal demands on directors and other officers of the company are heavy and complex, it was commercially right that companies should be able to purchase indemnity insurance for its directors and officers. In the event of a successful legal action against a negligent director, at least the company concerned will have recourse to the insurance company for any successful claim for damages.

Sec. 267 of the Companies Ordinance (CO)

Floating Charges

Summary of Recommendations

1. At the 95th Meeting of the SCCLR, (1st May 1993), members recommended that Sec. 267 of the 'CO' be amended along the lines of Sections 79(1) and 265(3B) of the 'CO' to provide that the term "floating charge" in the section should be deleted and replaced with the expression : "A charge which, as created, was a floating charge".

Background

2. In 1991, Sections 79(1) and 265(3B) of the 'CO' which gave preferred creditors priority over floating charges were amended specifically to reverse the decision in Re Brightliffe Ltd. (1987) Ch. 200. Floating charges may contain clauses which specify that when a certain event occurs, the charge will automatically crystallise and become a fixed charge. In Re Brightliffe, it was held that a term of the charge specifying that it would

crystallise on the borrower receiving notice was valid. Until the ordinance was amended, the holders of a floating charge which crystallised automatically were regarded as the holders of a fixed charge and so they avoided the priority given to preferential creditors by Sections 79 and 265 of the CO. These sections were therefore amended to overcome this difficulty and to provide that preferred creditors still enjoyed priority notwithstanding that the floating charge may have crystallised.

3. The opportunity to amend Sec. 267 along the same lines was unfortunately overlooked. Section 267, which provides for the invalidity of a floating charge created by a company within 12 months of the commencement of the winding-up unless it was proved to be solvent, was intended to be an important safeguard for unsecured creditors of a company in liquidation. As the section remained unaltered, the decision in Re Brightliffe Ltd. could still be relied upon to circumvent the operation of Section 267.

4. Members unanimously recommended the amendment to Sec. 267 as described in paragraph 1 above.

Sec. 48B Companies Ordinance (CO)

Share Premium Account

Merger Accounting

Summary of Recommendations

1. At the 95th Meeting of the SCCLR (1st May 1993) members agreed in principle to the amendment of the Companies Ordinance to provide for 'merger relief' in cases of acquisitions, mergers and reconstructions along the lines of Sections 130-134 of the 1985 UK Companies Act.

Background

2. Sec. 48B(1) of the 'CO' provides that : "Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to ..... the share premium account and the provisions of this ordinance relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the share premium account were paid-up share capital of the company."

3. Until the decision in the case of "Shearer V Bercain Ltd" (1980) 3All ER 295 it was widely assumed by practitioners that the need to credit share premiums to the share premium account could be avoided when shares were issued for a consideration other than cash by the contract for the issue of the shares providing that the consideration to be given for their issue should be deemed to have a value equal to the nominal or paid up value of the shares, even though the market value of the consideration for the shares was clearly greater than their nominal value.

4. However the Shearer V Bercain decision held that under Sec. 56 of the 1948 UK Companies Act, (Sec. 48B of the 'CO' is largely modelled on this UK section) a 'true value' must be attributed to non-cash assets acquired in consideration for the issue of shares and that any excess over the nominal value of the shares issued must be transferred to a non-distributable share premium account.

5. As a result of this decision, and because of its effects particularly in regard to mergers, acquisitions

and reconstructions, Sections 39(1) - (3) of the 1981 UK Companies Act was passed to retrospectively validate the action of any company which issued shares in consideration of the issue, transfer or cancellation of shares in another company even though the first company did not credit to its share premium account with a sum equal to the excess of the market value over the nominal value of the new shares issued.

6. The 1985 UK Companies Act (Sec. 130-134) now provides that if a company holds 90% or more of the issued share capital of another company as a result of an arrangement for the issue of shares by the first company in consideration of the issue or transfer to it of equity shares of the other company, any share premiums arising need not be credited to the share premium account and the first company's accounts may show the shares acquired at an acquisition cost equal to the nominal value of the shares issued by it in exchange.

7. The most important results arising from this change in the law in the UK to permit merger accounting are :

(a) the assets and liabilities of both companies are incorporated into the group accounts at book value;

(b) the pre-acquisition profits or reserves of the acquired company are not capitalised (i.e. transferred to the share premium account) but are available to the group for distribution; and

(c) the shares issued as consideration are recorded at nominal value.

8. Before any final recommendations were made to the administration concerning a change in the law, it was agreed, in view of the reservations of the Hong Kong Society Accountants (HKSA), over the UK legislation on the subject, to postpone further debate to enable the HKSA to satisfy itself that there were no unresolved problems with the UK legislation. It was understood that UK regulators had experienced difficulties with the relevant provisions of the 1985 UK Companies Act and there were suggestions that the use of merger accounting would be restricted further.

(N.B. At the 100th Meeting of the SCCLR (7th May 1994) it was agreed that the 'CO' be amended to permit merger accounting with the provisions of the 1985 UK Companies Act forming the precedent for legal changes to be implemented in Hong Kong. It was further agreed that a statement of Standard Accounting Practice (SSAPS) which the HKSA would draft and seek approval for, would have statutory backing).

Statutory Protection for Auditors of Listed Companies

Summary of Recommendations

1. At the 96th Meeting (10th July 1993) of the SCCLR members agreed in principle to extend to auditors of companies listed on the Stock Exchange statutory protection to enable them to report reasonable suspicions of fraud to the Securities and Futures Commission (SFC) and the Stock Exchange of Hong Kong (SEHK). This will entail an amendment to the Companies Ordinance (CO).

Background

2. Under Sec. 61 of the Banking Ordinance, Sec. 89A of the Securities Ordinance and Sec. 51A of the Commodities Ordinance, an auditor is granted statutory protection and immunity when reporting in good faith to the appropriate regulatory authority reasonable suspicion of fraud or wrongdoing which he comes across in his capacity as an auditor. There is no equivalent section in the 'CO' extending the same kind of protection and immunity to an auditor of a listed company.

3. The present legal position is that confidentiality is an implied term of the auditors contract with the body appointing him. In addition there is considered to be a 'public interest' in maintaining that confidential client relationship. Therefore if an auditor in breach of that implied term reported a reasonable suspicion of fraud to the appropriate regulatory authority, he would be in breach of the implied confidentiality term and thus be susceptible to a claim for damages by the body appointing him.

4. The administration now believes the time has come for auditors of listed companies on the SEHK to be afforded the same statutory protection as is currently granted to auditors under Sec. 61 supra, Sec. 89A supra, and Sec. 51A supra. In the UK the Cadbury Committee in its final report on "The Financial Aspects of Corporate Governance" recommended that the UK authorities should consider introducing legislation extending to auditors of all companies the statutory provisions applicable to auditors in the regulated sector. This would enable them to freely report in good faith reasonable suspicion of fraud or wrongdoing.

5. After discussion and debate, the SCCLR accepted the administration's proposals and accepted the recommendation set out in paragraph 1 above.

Inner Reserves and The Report of the Working Group on Financial Disclosure

Inner Reserves

1. An information paper prepared by the Hong Kong Monetary Authority (HKMA) was tabled at the 97th Meeting of the SCCLR held on 9 October 1993.

2. The 'HKMA' had held discussions with local banks and other institutions on the question of disclosure of inner reserves. The HKMA had also adopted a policy of asking banks to notify it prior to the transfer to or from, inner reserves. The HKMA was also encouraging these institutions to produce written policy statements on their position with regard to inner reserves.

3. It was also intended that those discussions on proposed transfers to and from inner reserves would be undertaken on an annual basis prior to the finalisation of the accounts. The objective of the HKMA was to try to achieve greater consistency in the use and treatment of inner reserves by the banks in Hong Hong.

Report of the Working Group on Financial Disclosure

4. At the same meeting, the report of the Working Group on Financial Disclosure was also tabled for information purposes only. This group had been established in November 1992 and consisted of members from the Securities and Futures Commission (SFC), the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Society of Accountants.

5. Its terms of reference were :

"(a) to review financial disclosure requirements and identify deficiencies in the laws, rules and regulations governing financial disclosure of listed companies in Hong Kong;

(b) to recommend such changes to the requirements as are within the jurisdiction of the SFC and SEHK'

(c) to propose to the HKSA any priority areas identified in the course of the review that may require a revision of accounting standards;

(d) to review and make recommendations on systems for ensuring ongoing compliance with financial disclosure requirements; and

(e) to make recommendations on whether there should be a permanent institutional structure to consider financial disclosure issues for listed companies."

6. A summary of the major recommendations were as follows :

"The HKSA should :

(a) continue to be responsible for setting accounting standards but should formally

broaden the involvement of other interested parties to include the SEHK, SFC, the investment community, listed companies and academics. Standard setting should be the responsibility of a Financial Reporting Standards Committee of the HKSA, which should establish subcommittees on Standard Setting and Emerging Issues;

(b) consider the recommendations of the Working Group ..... with respect to new or revised standards and develop a work programme for the timely development, consultation and implementation of such standards.

The SEHK should :

(a) play a more active role in identifying emerging accounting issues, standard setting and compliance and enforcement

with a view to ensuring that Hong Kong's financial disclosure requirements and level of compliance and oversight are consistent with those of leading international financial markets;

(b) prepare a public consultation paper on amendments to the Listing Rules to deal with the disclosure deficiencies ..... with a view to implementing Listing Rules changes by December 31, 1993;

(c) establish a separate unit dedicated to the review of accounts of listed companies by December 31, 1993. The unit should, at least initially, review all listed company accounts i.e. annual, interim and preliminary announcements for compliance with the Listing Rules and statutory requirements as described in para. 48;

(d) establish a Financial Reporting Advisory Panel consisting of Listing Committee and FRSC representatives, to act as an expert advisory consultative unit to the SEHK in dealing with problematic financial statements and disclosure issues.

The SFC should :

(a) take a more active role in emerging accounting issues and standard setting with a view to ensuring that Hong Kong's financial disclosure requirements are consistent with those of leading international financial markets and in keeping with Hong Kong's status as a financial centre;

(b) prepare a public consultation paper on the need for statutory disclosure obligations for listed companies,

including the requirement that annual accounts give a true and fair view and be prepared in accordance with declared accounting standards and policies, such as Hong Kong SSAPs.

The SEHK and SFC should be adequately resourced so as to enable them to discharge the additional responsibilities referred to above.

The Government should re-examine the exemptions given to banking, insurance and shipping companies in the Tenth Schedule of the Companies Ordinance. Attention should also be given to accelerating the process of revising and updating the provisions of the Tenth Schedule in general."

7. The SCCLR is to be kept abreast of all future proposals on the question of greater financial disclosure by Banks and other 'Authorised Institutions' and also by the listed companies of the 'SEHK'.

Section 265 of the Companies Ordinance (CO) (Cap. 32)
Section 38 of the Bankruptcy Ordinance (BO) (Cap. 6)
Protection of Wages on Insolvency Ordinance
(POWOIO) (Cap. 380)

Summary of Recommendations

1. This subject was discussed at the 97th Meeting of the SCCLR held on 9th October 1993 when debate was adjourned to enable the 'Official Receiver' to take further soundings from the commercial sector on proposals to bring those amounts in respect of arrears of wages, wages in lieu of notice, and severance set out in Sec. 265 of the 'CO' into line with the amounts laid down in the 'POWOIO'.

Background

2. The 'POWOIO' was enacted in 1985 to provide :

   (a) for the establishment of a board to administer the Protection of Wages on Insolvency Fund;

(b) for the payment of monies from the fund to employees whose employers become insolvent; and

(c) for other matters connected therewith or incidental thereto.

3. Under Sec. 15 of the 'POWOIO', an applicant to whom

(a) wages are due and unpaid;

(b) wages in lieu of notice are due and unpaid; and

(c) the liability to be paid a severance payment has arisen and the severance payment is unpaid may apply for an ex-gratia from the fund in respect of any or all of the items set out in (a) - (c) above.

4. By virtue of Sec. 24 of the 'POWOIO', a statutory right of subrogation in favour of the fund arises in respect of any 'ex-gratia' payment.

5. By virtue of an amending ordinance to the 'POWOIO' in 1993, the payments from the fund in respect of wages and wages in lieu of notice have been increased to

$18,000.00 and $6,000.00 respectively from $8,000.00 and $2,000.00 respectively. The 'POWOIO' already provides for additional ex-gratia payments of 50% of severance payments in excess of $8,000.00 (the maximum under the 'CO' and 'BO' is $8,000.00). Hence there is disparity between the payments under the 'POWOIO' and those under the 'CO' and 'BO'.

6. The proposals for increasing the amounts treated as preferential under the 'CO' and 'BO' seek to abolish this disparity even though this will likely decrease the amounts of dividend payments to ordinary unsecured trade creditors.

Amendments to the Company Winding-up rules (CWUR) - Rules 160, 162, 163, 166, 181 and 182

Summary of Recommendations

1. At the 97th Meeting of the SCCLR (9th October 1993) members unanimously supported the administration's proposals to amend the abovementioned rules so as :

    (a) to remove the existing requirement for statutory declarations or affidavits to accompany the liquidators submission of accounts; and

    (b) to substitute the need for the signatures of all members of a committee of inspection (CWUR 160) by that of a liquidator in any request to the Official Receiver to invest or withdraw funds of a company in liquidation in or from the companies liquidation account.

Background

2. CWUR 162, 163, 166, 181 and 182 require liquidators (other than the Official Receiver) of companies in

compulsory liquidation to file statutory declarations or affidavits when they are filing with the Official Receiver their accounts. CWUR 160 provides that in a liquidation, where there is a committee of inspection, all members of the committee of inspection are required to sign a certificate of investment and request directing the Official Receiver to withdraw or invest funds of the company lodged in the companies liquidation account. The companies liquidation account is maintained by the Official Receiver and all liquidators are required under Sec. 202 of the 'CO' to lodge into that account all monies received by them in the course of the liquidation.

3. The objective of the amendments was to streamline existing procedures and do away with unnecessary administrative requirements which only added to the time and cost of the liquidation to the ultimate disadvantage of the creditors.

Incorporation of CPA Practices

Summary of Recommendations

1. At the 97th Meeting of the SCCLR (9th October 1993) members supported the Administration's proposals and those of the Hong Kong Society of Accountants (HKSA) to allow Certified Public Accountants (CPA) firms to incorporate if they so wish. This was on the basis that :

    (a) the proposed arrangements for the mandatory Professional Indemnity Insurance (PII) scheme advanced by the HKSA were adequate;

    (b) the operation of the practice review arrangements by the HKSA pursuant to the provisions of the Professional Accountants (Amendment) Ordinance 1992 was satisfactory;

    (c) to ensure the independence of incorporated practices, only accountants could qualify as directors and shareholders of incorporated entities; and

(d) to preserve the right of civil action against the individual auditor responsible for a particular audit on the grounds of negligence, the responsible certified accountant should be clearly identified in the audit report.

Background

2. At the 74th Meeting of the SCCLR (2 February 1991) members supported in principle the proposal put forward by the HKSA to permit firms of CPA to incorporate into limited liability companies. This agreement in principle however was subject to those matters outlined in paragraphs 1a - 1c above. At present, accountants can only join together in unincorporated business partnerships where each partner is jointly and severally liable for the actions of the partnership.

3. The passage into law of the Professional Accountants (Amendment) Ordinance 1992 now enables the HKSA to undertake regular practice reviews of CPA firms to ensure that high auditing standards are being maintained. Under the programme, the HKSA sends

reviewers to individual practices to monitor compliance with auditing standards and requirements. This will continue on a rolling basis.

4. With regard to the arrangements for mandatory PII, the scheme will take the form of a master policy with the HKSA as the policy holder and all CPA firms who participate in the scheme will be covered by it. Both the administration and the SCCLR have accepted the minimum level of indemnity proposed.

5. The HKSA has accepted the administration's proposal that the responsible accountant who undertakes the audit should be named in the audit report. This will preserve the right of civil action against that person if the audit is undertaken negligently.

6. The underlying reason permitting incorporation is not to deny the public the right to recover damages from negligent CPA's but to protect the innocent partners from liability - hence the reason for naming the person responsible for the audit report referred to in para. 5.

7. In the UK accountancy practices have been allowed to incorporate since 1991 whilst in Australia there was no legal impediment to incorporation. However only 'natural persons' can be appointed auditors. In USA some of the smaller states permit accountants to incorporate. It is understood, however, that in the UK none of the 'big six' accountancy firms have incorporated.

Financial Assistance by a company for the acquisition of its own shares

Secs. 47A - 47G Companies Ordinance

Sec. 48 Companies Ordinance (CO)

Summary of Recommendations

1. At the 98th meeting of the SCCLR (4th December 1993), members agreed to await the outcome of a consultation exercise presently being undertaken in the UK by the Department of Trade and Industry (DTI) in respect of Sections 151 -158 of the 1985 UK Companies Act, before embarking on our own exercise in Hong Kong. Sections 47 - 47G and 48 of the 'CO' are largely modelled on Sections 151 - 158 of the 1985 UK Companies Act.

Background

2. Sec. 47A of the 'CO' provides that it is unlawful for a company or any of its subsidiaries to :

   (a) give any financial assistance for the purpose of a

person acquiring the company's shares, whether directly or indirectly; or

(b) reduce or discharge any liability incurred for the purpose of acquiring the company's shares.

3. Sec. 47(c)(3) and (4) sets out the transactions which do not fall within the general prohibition on giving financial assistance whilst Secs. 47D sets out special restrictions for listed companies and Sec. 47e relaxes the operation of Sec. 47A for unlisted companies.

4. In October 1993, the DTI issued a consultative paper seeking views on its proposals for a reform of Sections 151 - 158. As was stated in the paper at paragraph 4.1:

> "The main specific objectives of a prohibition on financial assistance are capital maintenance for creditor protection, prevention of misuse of assets by controlling shareholders and by directors, and equal treatment of shareholders."

5. However, the law has been criticised as being uncertain in scope and liable to prohibit some transactions which may be innocent or in the interests of the company. These criticisms have increased as a result of the House of Lords decision in the case of '<u>Brady v Brady</u>' (1988) BCLC 579 where it was argued that the provision of financial assistance by the company in question was permitted under Sec. 153(1) - Sec. 47C of the CO - because if the assistance had not been provided, it would not have been possible to complete a restructuring scheme without which eventual liquidation of the company was a probable result. The court, however, held, that the purpose of the financial assistance was to enable the shares to be acquired and thus the financial assistance did not fall within the exemption in Sec. 153(1) - Sec. 47C of the 'CO'.

6. A further criticism levelled at the sections is that there was a doubt as to whether the use of "subsidiary" in Sec. 151 - Sec. 47BA 'CO' - prohibits the giving of financial assistance by a foreign-incorporated subsidiary for the acquisition of shares in its parent company. This doubt has recently been dispelled by

Millet J in his judgment in the case of <u>Arab Bank PLC v Merchantile Holdings and Anor 1993 ChD</u> where it was held that the term "<u>any of its subsidiaries in Sec. 151</u> .....

> must be construed as limited to those subsidiaries which are subsidiary companies, that is to say English companies."

7. In the circumstances it was felt appropriate to await the outcome of the results of the DTI consultative paper, when the subject will be reconsidered.

Company Accounts and Audit

Sections 121 and 123 of the Companies Ordinance (CO)

Summary of Recommendations

1. At the 98th Meeting of the SCCLR (4th December 1993), it was agreed to defer indefinitely any further consideration of proposed legislative amendments to Sections 121 and 123 of the 'CO' (these deal with the requirements to keep and maintain books of account and the form and content of accounts respectively).

Background

2. This subject has been under consideration by the SCCLR since 1988. In the 8th Annual Report (1991), it was stated :

> ....."We have been considering the subject of auditors reports and the question of why there are so few 'adverse opinion' reports in respect of

the accounts of listed companies in Hong Kong for some time ..... it had become clear during our previous discussions that many of the points being made related to actual practice....."

3. Concerns had been expressed in the past by certain members that the use of qualified audit reports appeared widespread in Hong Kong. However, during the course of a debate on the subject at the 97th Meeting (5th October 1993) it was pointed out that the Hong Kong legislation was identical to the UK legislation as were the auditing and accounting standards. Other members opined that ultimately the question of responsible audit reports was a matter of professional integrity for the individual auditor concerned and that it was the responsibility of the Hong Kong Society of Accountants (HKSA), the professional body, to ensure that high auditing and accounting standards were adhered to by its membership.

4. Members were advised that legislative amendments were in the pipeline to equip the HKSA with investigatory

powers so as to enable it to undertake an examination of the work of a Certified Public Accounts (CPA) firm without awaiting the receipt of a formal complaint. In addition the Professional Accountants Ordinance had been amended in 1992 to enable the HKSA to undertake practice reviews of CPA firms on a 'rolling basis'. The aim was to ensure that satisfactory auditing standards were being kept. This was ultimately for the benefit of the major end users of the service, namely the commercial and business community.

5. Armed with the twin weapons of practice reviews and (soon to be enacted) investigatory powers, members expressed the hope that the HKSA would ensure that auditing and accounting practice were maintained at a high level and reflected the status of Hong Kong as an international financial centre. In the meantime, it was agreed that further debate should be adjourned. If satisfactory standards were not maintained, it would then be a matter for the administration to decide what further measures ought to be introduced.

Bank of International Settlements - 'Netting' under Hong Kong Law

Summary of Recommendations

1. At the 99th Meeting of the SCCLR held on 29 January 1994, a paper titled : "BIS paper on netting": was tabled by the Hong Kong Monetary Authority (HKMA) for members' information only.

Background

2. The Bank for International Settlements (BIS) is a profit-making clearing agency based in Basle, Switzerland, for central bank shareholder members in foreign exchange and Eurocurrency markets. In April 1993, the Basle Committee on Banking Supervision issued a paper, inter alia, on 'netting'. This paper has been circulated to the Hong Kong Association of Banks and also the Deposit Taking Companies Association for their comments.

3. On the question of netting the paper stated :

> "On the subject of netting, currently the 1988 Capital Accord allows swaps and other derivative exposures to be reported on a net basis only in a very narrowly defined circumstance i.e. bilateral netting by novation for the same currency and same value date, which does not allow much capital benefit to most banks. In the consultative paper on netting, it was proposed that the 1988 Capital Accord should be revised to recognize, in addition to netting by novation, other forms of bilateral netting (e.g. by close-out) for the purposes of arriving at the credit exposure on off-balance sheet transactions such as swaps, options and similar contracts. This will be subject to, among other things, a requirement that the relevant banking supervisors are satisfied that the netting

arrangement is enforceable under the laws of the relevant jurisdictions."

4. The HKMA has received a guidance note issued by the Financial Law Panel in the UK which has examined the legal position of netting under UK law. It concluded that UK law would support bilateral netting of "off balance sheet" transactions. Therefore this would enable swap transactions and other "off balance sheet" transactions contracted under English law, to be netted off, which under BIS rules, would lead to a lower capital requirement. This was very important for the development of London as a financial centre because 'swap' transactions could be executed with a lower capital requirement.

5. As a result of these developments, the HKMA was endeavouring to establish whether or not netting was permissible under Hong Kong law. Therefore the HKMA is consulting legal opinion and other interested parties on the position. If legal opinion was positive, this would prove to be beneficial to the development of Hong

Kong as a financial centre in that swap transactions could be executed with a lower capital requirement. If the legal opinion was negative, this would raise the question of whether the insolvency legislation in Hong Kong should be amended to allow netting to take place.

6. The HKMA is to keep the SCCLR abreast of developments on the issue with updates on the progress of its deliberations with other parties.

Company Law Reform :

International Developments

Summary of Recommendations

1. At the 99th Meeting of the SCCLR, an article written by Professor J.J. Du Plessis, Professor in Commercial Law, Rand Afrikaans University which appeared in Vol. 14 No. 11 of Company Lawyer and which examined company law reform in jurisdictions such as Australia, New Zealand, UK and South Africa was tabled and discussed for information purposes only. However, it was agreed that further discussions on whether there should be an overall review of the Hong Kong Companies Legislation should be deferred to a later date. (N.B. At the date of writing the decision to go ahead with an overall review has now been taken.)

Background

2. The article by Professor Du Plessis pointed out that companies legislation in a number of common law

jurisdictions had undergone considerable change and amendment over a period of time. In the UK e.g. the 1948 Companies Act (CA) was based on the Cohen Report of 1945. The 1948 CA was amended and often substantially in 1967, 1972, 1976, 1980, 1981, 1983, 1985 and 1989. Many of the more recent changes were a direct result of directives from the European community which has the long term aim of harmonisation of the company law of its member states. As Professor Len Sealy said in 1984, the volume which will contain English Company Legislation in the year 2000 will be ....."an eight pound monster.....running to something like 3,000 pages" ("The legislators: Do the Companies Acts help or hinder - company law and commercial reality 1984")

3. During the debate that followed certain members argued forcibly in favour of Hong Kong undertaking its own overall review of its companies legislation given

   (a) the growing size and complexity of company law. This made regulation more problematic as it was increasingly difficult to comprehend. Hong Kong's companies legislation was largely modelled on the 1948 UK Companies Act;

(b) the piecemeal nature of the amendments hitherto without considering whether such amendments harmonised with existing provisions;

(c) the explosion in the number of private companies and whether it was right to subject that type of corporate vehicle to a regulatory regime which had evolved since the 19th century to deal with the needs of public companies.

4. As against the sentiments expressed in the preceding paragraph, certain members expressed caution over the proposal. Whilst it was right for Hong Kong to be open and receptive to the influences of other jurisdictions, it was worthwhile remembering that Hong Kong did not rise to become one of the great trading nations of the world with its legal and commercial infrastructure in a poor state of repair. Hong Kong had to be wary of the type of 'social engineering' which characterised the legal and commercial development of jurisdictions under socialist governments.

5. At the conclusion of discussions, members agreed to defer further debate until another meeting.

Paragraph 9(1)(c) of the Tenth Schedule to the Companies Ordinance '(CO)' - Prohibition of financial assistance by a company for the purchase of its own shares

Summary of Recommendations

1. At the 99th Meeting of the SCCLR (29th January 1994), members recommended that the references in paragraph 9(1)(c) of the Tenth Schedule to the 'CO' be amended to Sections 47C(4)(b) and (c) of the 'CO'.

Background

2. The original Section 48 of the 'CO' was repealed in 1991 and replaced by a new Section 48 which does not contain, unlike the original section, any provisos. Unfortunately, during the drafting process, the cross reference in paragraph 9(1)(c) of the Tenth Schedule to provisos (b) and (c) of Sec. 48 (1) was overlooked and is still contained in the 'CO". It is clear that the cross reference should now be to Sec. 47C(4)(b) and (c)

of the 'CO' which exclude from the workings of Sec. 47A any scheme by a company which enables a trustee to purchase shares on behalf of employees or the making of loans to employees to enable them to acquire shares in the company. The general rule under Sec. 47A prohibits any company providing direct or indirect assistance to any person to acquire its shares.

Financial Disclosure by Authorised Institutions

Summary of Recommendations

1. At the 99th Meeting of the SCCLR (29th January 1994), a paper was tabled by the Hong Kong Monetary Authority (HKMA) for information purposes only. The purpose of the paper was to update members on the question of greater financial disclosure by authorised institutions in Hong Kong.

Background

2. The Securities and Futures Commission (SFC) Working Group on Financial Disclosure issued a report in August 1993 which criticised the level of disclosure by banks in Hong Kong, describing it as incompatible with Hong Kong's position as an international financial centre. In addition, the Stock Exchange of Hong Kong was about to publish its own consultation paper on the listing rules and whether listed companies should disclose far more detailed financial information than they had hitherto. This could possibly be achieved through the listing rules.

3. The key question to be addressed was that whilst the HKMA was in favour of more disclosure by banks in Hong Kong, this had to be consistent with the need to maintain the stability of the banking system.

4. There was a general trend towards greater openness in financial reporting but the level of financial reporting in Hong Kong was lower than in other comparable jurisdictions. This could lead to a lower than justified perception of the quality of banks in Hong Kong and perhaps inhibit their ability to undertake international business.

5. As against that, the HKMA recognised that banks were different from other companies. News of a deterioration in the financial position of a bank may undermine confidence in the institution, leading, in a worse case scenario, to a bank run. Loss of confidence in one institution may spread to others thus undermining the foundations of the banking system itself.

6. Against this background, the HKMA had entered into discussions with representatives of the banking sector on the way forward and will be conducting regular meetings to see if a basis for the optimum level of financial disclosure can be agreed upon. Regular reports on progress would be submitted to the SCCLR and the working group on financial disclosure.

Theft of Assets by Controllers of Companies

Summary of Recommendations

1. At the 99th Meeting of the SCCLR (29th January 1994), members considered a paper on the above subject which had been tabled for information purposes only. It arose out of the House of Lords decision in the case of: R V. Gomez (1993, 1All ER 1) which had determined that controllers of companies may steal from those companies.

Background

2. Until this decision, the question of misappropriation of a company's assets by those who controlled it for their own use was beset with uncertainty and difficulty. As Mustill L.J. pointed out in McHugh and Tringham (1988) cr App R 385 (CA):

   "Where the actor is beneficially entitled to the entire issued share

capital ..... of the company it may be that his act is not an appropriation because :

(a) his act is equivalent to an act of the company and his intent is the intent of the company so there can be no circumstances in which any of his acts are unauthorised; and or

(b) since he has the irresistible power to determine what policies the companies shall pursue, there is nothing which he himself may do in the company's name which could in practice be unauthorised....."

3. However, in R V Gomez, Lord Browne-Wilkinson dispelled this view by holding :

".....It would offend both common sense and justice to hold that the very control which enables such people to extract the company's assets constitutes a defence to a charge of theft from the company. The question in each case must

> be whether the extraction of the property from the company was dishonest, not whether the alleged thief has consented to his own wrongdoing."

4. Members welcomed this decision of the House of Lords which no doubt will also be welcomed by the Police and other regulatory authorities in Hong Kong.

The Legality of Capital Contributions

Summary of Recommendations

1. At the 99th Meeting of the SCCLR (29th January 1994) members agreed to defer further discussion on this subject until the outcome of certain legal proceedings was known.

Background

2. The practice of capital contribution involves a contribution of cash or equivalent by shareholders to their company in proportion to their respective shareholdings which is not in connection with an allotment of shares and which imposes no obligation on the company to repay the sum contributed.

3. The question was raised whether under the Hong Kong Companies Ordinance (CO) it was possible for a person who was e.g. a sole shareholder to have a transaction with the company in his capacity as a shareholder. Once the shares were paid up in full, the shareholder's

future relationship with the company was limited to the receipt of dividends, the conferral of rights to subscribe for further shares or receiving a distribution upon liquidation of the company.

4. However, it was recognised that there were no provisions in the 'CO' to cover what amounted to a capital injection where no shares were issued by way of consideration. During discussions, it became apparent that the practice was common where the company in question had accumulated deficits which were reduced by this injection of cash or kind by those who controlled the company. Members were advised that this particular 'grey area' or uncertainty in the 'CO' did not lead to abuse. In view of this, members agreed to defer further discussion for the reasons outlined in para. 1 above.