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Client Alert

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The Companies Ordinance Rewrite

Introduction

Over the past decade, the Hong Kong government and the Standing Committee on Company Law Reform (the “**Committee**”) have conducted several major reviews of Hong Kong’s company law to modernize and upgrade its regulatory and governance regime. Some of the resulting recommendations were implemented by several amendments, notably the Companies (Amendment) Ordinance 2003 and the Companies (Amendment) Ordinance 2004. Despite these changes, the consensus was that further amendment to the Companies Ordinance (the “**Ordinance**”) was necessary.

In mid-2006, the Financial Services and the Treasury Bureau (“**FSTB**”) launched a major exercise to rewrite the Ordinance. After rounds of public consultations, the Companies Bill (the “**New Ordinance**”) was passed by the Legislative Council on 12 July 2012, gazetted on 10 August 2012, and is expected to come into force in 2014.

While the New Ordinance captured much attention in the press on issues relating to the liability of auditors, it contains important changes that will affect the operation and administration of Hong Kong companies. This client alert highlights some of these changes.

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Major Changes in the Ordinance

The New Ordinance introduces important reforms to Hong Kong's company law. Some of the major changes are:

1. Codifying directors' duty of care, skill and diligence;
2. Restricting the appointment of corporate directors;
3. Abolishing par values for shares;
4. Providing better protection of personal data;
5. Strengthening rights of auditors to obtain information;
6. Facilitating simplified reporting for private companies;
7. Providing a court-free procedure for reducing capital;
8. Allowing financial assistance to acquire shares;
9. Abolishing common law derivative action and replacing it with a statutory counterpart;
10. Replacing the headcount test in a scheme of arrangement;
11. Reducing threshold to demand poll in general meetings; and
12. Relaxing the requirement on the use of common seal.

Each of these is examined in greater detail below.

Codifying Directors' Duty of Care

There is no statutory provision on directors' duty of care, skill and diligence under the existing legislation. Directors' duties are laid down in a long series of

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case law. The Companies Registry also outlines some common law principles in its publication "[A Guide on Directors' Duties](#)".

The New Ordinance imposes statutory objective and subjective standards on directors of Hong Kong companies. A director must exercise reasonable care, skill and diligence that would be exercised by a reasonably diligent person with:

- (1) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (objective standard); and
- (2) the general knowledge, skill and experience that the director has (subjective standard).

Corporate Directors

Since March 1985, public and private companies that are members of a group of companies containing a listed company are prohibited from appointing a corporate entity as their director, but other private companies do not fall under this restriction. Under the New Ordinance, those private companies are required to have at least one director who is a natural person. Companies which do not comply with the new requirement will have six months to add or change their directorship.

If a company fails to comply with the new requirement, the Registrar of Companies may direct the company to appoint a director who is a natural person. The company and every responsible person who fail to comply with such direction are each liable to a fine of HKD 100,000 and to a further fine of \$2,000 for each day during which the offence continues.

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Abolishing Par Value

Currently, companies incorporated in Hong Kong with a share capital are required to have a par value for their shares.

In a public consultation commissioned by FSTB in 2003, a significant proportion of respondents commented that par value had caused problems such as misleading unsophisticated investors and greater complexity in accounting. The Committee concurred with the majority of respondents in the 2003 consultation and recommended implementing a mandatory no-par regime for companies.

Further consultations were conducted in 2008 and 2009, in which a majority of respondents supported the mandatory no-par proposal, in line with jurisdictions such as Australia, Zealand and Singapore. As a result, the New Ordinance abolishes par value for all Hong Kong companies and the provisions in the Memorandum of Association of all existing Hong Kong companies relating to authorized share capital and par value will be regarded as deleted.

Personal Data

Under the current regime, directors and company secretaries are required to provide their residential addresses and Hong Kong ID card or passport numbers to the Companies Registry for incorporation and registration purposes. Such information is available on the Companies Register and is accessible by the public.

Under the New Ordinance, upon a director or company secretary's application, director's residential addresses and ID numbers can be withheld from public inspection. Their correspondence address would be made available on the register instead. However, the court may make an order for the disclosure by the Registrar of a withheld address or withheld ID number if there is evidence that the

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service of documents at the correspondence address is not effective to bring them to the director/company secretary's or to enforce a court order.

Auditors' Rights

Under the New Ordinance, auditors are empowered to obtain such information and explanations they may reasonably require for the performance of their duties from a wider range of persons, including:

- (1) a person holding or accountable for any accounting records of the company;
- (2) any officer or former officer of the company at a time to which the information and explanation relates; and
- (3) any officer or former officer in the company's Hong Kong and non-Hong Kong incorporated subsidiaries.

If an auditor has required a person to provide any information or explanation, the person must provide the information or explanation as soon as practicable. Any officer of a company who fails to comply with an auditor's request may be liable to criminal sentence.

Simplified Reporting

Under section 141D of the current Ordinance, a private company may, with the written agreement of all its members, prepare simplified accounts and simplified directors' reports in respect of one financial year at a time. Section 141D is not applicable to groups of companies.

The New Ordinance introduces new criteria to allow companies (or a group of companies in aggregate) that meet any two of the three criteria below to prepare simplified accounts:

- (1) the annual revenue of the company is less than HK\$100 million;

- (2) its assets are less than HK\$100 million; and
- (3) the average number of employees in the company during the financial year does not exceed 100.

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Larger private companies that do not meet the above criteria will also be entitled to prepare simplified financial statements and directors' reports provided that members holding 75% of the voting rights so resolve and no member objects if they meet any two of the three criteria below:

- (1) the annual revenue of the company is less than HK\$200 million;
- (2) its assets are less than HK\$200 million; and
- (3) the average number of employees in the company during the financial year does not exceed 200.

Reduction of Capital

Under the existing regime, a reduction of share capital is only allowed if it is approved by shareholders by special resolution and by the Court. The purpose of these provisions is to protect shareholders as well as creditors.

However, the process is time consuming, expensive and often serves little purpose to preserve the capital left in the company. Consequently, the New Ordinance introduces an alternative court-free procedure for reduction of capital. Key features of the procedure include:

- (1) all directors sign a statement that the company satisfies the statutory solvency test;

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- (2) members approve the reduction of capital by special resolution within 15 days of the solvency statement;
- (3) the Company publishes a notice in the Gazette within one week after the special resolution is passed, and in at least one specified Chinese language newspaper and at least one specified English language newspaper or gives written notice to that effect to each of its creditors;
- (4) any creditor or non-approving member may apply to the court for cancellation of the resolution within five weeks after passing of the resolution; and
- (5) registration of the statement of solvency with the Companies Registry after five weeks and no later than seven weeks after passing the special resolution.

Financial Assistance

Subject to certain exceptions, a company and its subsidiaries are generally prohibited from giving financial assistance for the purpose of acquiring shares in the company under section 47A of the current Ordinance.

However, the rules on financial assistance have become very complex and case law has imposed an increasingly broad interpretation on the prohibition. As a result, companies incur substantial costs to comply with the rules. In some cases, directors acting in good faith who are involved in transactions for the benefit of the company but unwary of the prohibition may be caught by the rules prohibiting financial assistance in acquiring shares.

Under the New Ordinance, financial assistance restrictions are relaxed and streamlined. Companies are generally allowed to provide financial assistance

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to another party to acquire the company's own shares or the shares of its holding company, subject to the following requirements:

- (1) directors approve the financial assistance by resolution;
- (2) directors sign a statement certifying the company's solvency; and
- (3) at least one of the following is met:
 - (i) the proposed and cumulative financial assistance already made are, in aggregate, not more than 5% of a company's total share capital and reserves;
 - (ii) the financial assistance is approved unanimously by written members' resolution; and
 - (iii) if the financial assistance is approved by ordinary resolution, notice is given to enable shareholders holding at least 5% of the total voting rights or members representing at least 5% of the members of the company to object to the assistance in court within 28 days of the ordinary resolution.

Abolishing Common Law Derivative Action

Generally, a shareholder is not allowed to bring a lawsuit against a third party for a wrong done to the company unless such action is commenced on behalf of the company by derivative action. In Hong Kong, a shareholder's right to bring a derivative action is provided under both the current Ordinance and common law. However, the current Ordinance only provides for a simple derivative action where a shareholder of a company brings proceedings on behalf of that company. It does not provide for a multiple derivative action, which is an action brought by shareholders of a parent company on

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behalf of its subsidiary. Multiple derivative actions is only recognized under common law as laid down by the Court of Final Appeal in *Waddington Limited v Chan Chun Hoc* (2008).

The co-existence of both statutory and common law derivative actions, and their different rules, were criticized in Waddington (above) for causing confusion and unnecessary complication. In light of such criticism, the New Ordinance will abolish the common law derivative action and extend the statutory derivative action to include multiple derivative actions.

Headcount Test in Scheme of Arrangements

Under section 166(2) of the existing Ordinance, where a scheme of arrangement is proposed between a company and its members or creditors, the court may order a meeting of the members or creditors. If a majority in number (headcount test) representing 75% in value (share value test) of the members or creditors present vote for the proposed scheme at the meeting, the scheme of arrangement shall bind all members or creditors and the company, provided that it is sanctioned by the court.

The current headcount test came under the spotlight in 2009 during the landmark PCCW case. In that case, the number of those who voted in favour was thought to have been manipulated by splitting larger parcels shares into single board lots which were then distributed to various persons registered as separate shareholders.

Following the PCCW case, the question whether the headcount test should be abolished was much debated. After numerous discussions, the New Ordinance introduces new provisions to replace the headcount test in privatization and takeover schemes: the number of votes cast against the resolution to approve a scheme of arrangement must not be more than 10% of the votes attached to all disinterested shares (disinterested shares test). This is in line with the 10% objection rule in

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the Takeovers Code for listed companies. Accordingly, such schemes are subject to the share value test and disinterested shares test.

Poll Demand

Under the New Ordinance, the threshold requirement for members to demand a poll is reduced from 10% to 5% of the shares carrying voting rights. In other words, shareholders who collectively hold 5% or more of the total voting rights of a company can ask for a poll at any general meeting after the New Ordinance takes effect. Any provisions to the contrary in a company's articles are void.

Common Seal Optional

Section 93(1)(b) of the existing Ordinance stipulates that every company shall have a common seal. The use of companies' common seal is generally required for executing deeds, issuing share certificates and share warrants. After the New Ordinance takes effect, the use of a common seal is optional.

Conclusion

The New Ordinance introduces important changes to the Hong Kong company law regime and practice, but it will take some time before the effects of the New Ordinance come into full operation because several pieces of subsidiary legislation are yet to be passed. The consultation paper for subsidiary legislation is available here:

http://www.cr.gov.hk/en/publications/docs/092012_Consultation_full-e.pdf

The New Ordinance is also available online through the following link:

http://www.cr.gov.hk/en/companies_ordinance/docs/full-e.pdf

A summary of the other major initiatives contained in the New Ordinance can be downloaded from the Company Registry's website:

<http://www.cr.gov.hk/en/publications/docs/ec5-2012-annex-e.pdf>

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