The new Companies Ordinance: are you ready?

In this second and final part of their article, Billy Lam, Loretta Chan and Wilson Fung of Mayer Brown JSM, highlight the key issues that directors and company secretaries need to watch out for in the new Companies Ordinance.

As we all know, the new Companies Ordinance (CO) comes into force on 3 March 2014. Among the many changes that the new CO introduces, there are some which may have a more direct or important impact on directors' and company secretaries' liabilities. This article discusses those changes and their implications.

Directors' reports – business review

The new requirement for an analytical and forward-looking business review which forms part of the directors' report may have an impact on directors' liabilities. This new requirement applies to public companies and the larger (that is, those which do not qualify for simplified reporting) private companies and guarantee companies. Private companies not qualified for simplified reporting are also allowed to opt out of this requirement by special resolution. Further, this new requirement does not apply to wholly-owned subsidiaries.

The business review has to contain a fair review of the company's business, a description of the principal risks and uncertainties facing the company, and an indication of likely future development of the company's business. To the extent necessary for an understanding of the development, performance or position of the company's business, the business review should also include an analysis using financial key performance indicators and a discussion of the company's environmental policies and performance, its relationships with its key stakeholders etc. However, impending matters in the course of negotiation do not have to be disclosed if the directors consider that such disclosure would seriously prejudice the company's interest.

For private companies, this business review requirement may be something rather new. However, listed companies in Hong Kong might have already included some of the above information in their preliminary announcements of interim/ annual results as well as interim and annual reports pursuant to either mandatory requirements or recommended disclosures under the listing rules.

To ease directors' concerns about their potential liabilities and to encourage meaningful reporting, a 'safe harbour' has been introduced to limit directors' civil liability for statements in, or omissions from, the directors' report.

Directors are liable to compensate the company for any loss it suffers as a result of any untrue or misleading statement or an omission if:

- they knew the statement to be untrue or misleading, or were reckless as to whether it was untrue or misleading, and

Highlights

- companies which do not qualify for simplified reporting will need to include an analytical and forward-looking business review in their directors' reports, but a 'safe harbour' provision has been introduced to limit directors' civil liability for statements in, or omissions from, these reports
- directors can be indemnified for liabilities towards third parties in connection with any negligence, default, breach of duty or breach of trust if certain requirements are met
- the new CO expands the requirements relating to directors' disclosure of interest

- in respect of omission, they knew the omission to be a dishonest concealment of a material fact.

As regards directors' civil liability (or that of the other parties such as professionals involved in the preparation of the directors' report) to any third party relying on the directors' report, for example investors, this is also excluded under the new CO. So, it seems that directors need not be too worried about their potential civil liabilities arising from the new requirement for a business review as long as there is no recklessness or dishonesty on their part.

Indemnification of directors' liabilities

Directors may incur contractual, tortious, or other personal liabilities towards their company and third parties, and even criminal liabilities. However, they may be protected by indemnity provisions in some cases. Section 165 of the current CO governs such indemnity provisions but it does not expressly deal with indemnity provisions in respect of a director's liabilities towards third parties. Further, under the current CO, a director may apply for relief in respect of liability for negligence, default, breach of duty and breach of trust pursuant to section 358.

Part 10, Division 3 of the new CO expressly defines the scope of permitted indemnifications in respect of a director's liabilities towards third parties. The aim is to make void any provision for exemption or indemnity of a director's liability in connection with any negligence, default, breach of duty or breach of trust (section 468), but creates an exception in respect of a director's liability towards a third party (section 469(1)) if certain requirements as laid down in section 469(2) are met.

Section 469(2) requires that the provision must not provide indemnities against:

a. any liability of the director to pay a fine imposed in criminal proceedings or a sum payable by way of a penalty in respect of non-compliance with any regulatory requirement, or

b. any liability incurred by the director in defending criminal proceedings in which he is convicted, and in defending civil proceedings brought by his company or an associated company or on behalf of such company in a derivative action or multiple derivative action in which judgment is given against the director, and in connection with an

Companies Registry guidance

To prepare for the commencement of the new Companies Ordinance, Chapter 622 of the Laws of Hong Kong, on 3 March 2014, the Companies Registry issued four external circulars and four guidelines last month.

The four external circulars are:

i. No 1/2014 – Commencement of the new Companies Ordinance (Cap 622)

ii. No 2/2014 – The New Companies Ordinance (Cap 622) – Guidelines issued by the Registrar of Companies

iii. No 3/2014 – The New Companies Ordinance (Cap 622) – A Guide on Directors' Duties, and

iv. No 4/2014 – The New Companies Ordinance (Cap 622) - Major Changes in Filing Requirements.

The four guidelines are:

i. A Guide on Directors' Duties

ii. Guide on Communications to and by Companies

iii. Guideline on Registration of Company Names for Hong Kong Companies, and

iv. Guideline on Registration of Corporate Names for Registered Non-Hong Kong Companies.

Copies of the external circulars and guidelines are available and can be downloaded from the 'New Companies Ordinance' section of the Companies Registry's website (www.cr.gov.hk).

For enquiries relating to the new Companies Ordinance, a dedicated hotline 3142 2822 has been set up. The hotline operates from Monday to Saturday 9 a.m. to 8 p.m. (excluding public holidays).
Email enquiries can be sent to cr.nco@cr.gov.hk.

Source: Companies Registry

> "it is important that directors fully understand and live up to the new standard that is expected of them under the new regime as well as ensure that their companies comply with the new requirements"

unsuccessful application for relief under section 358 of the current CO (or sections 903 and 904 of the new CO).

Liability incurred by directors in defending proceedings will essentially be liability in respect of their legal costs. As subsection (b) does not mention regulatory action, it would appear directors can still be indemnified for their legal costs incurred in an unsuccessful defence of a regulatory action.

New provisions governing conflicts of interests

Part 11 of the new CO contains provisions governing conflicts of interests which deal with the following four subject matters.

1. Loans, quasi-loans and credit transactions

The current CO prohibits a company from making loans to its directors, or a director of its holding company, or a company in which its directors have controlling interest. In the case of a listed company or a relevant private company, the prohibition also extends to a director's connected entities. In respect of quasi-loans and credit transactions, these are similarly prohibited if the company is a relevant company.

Changes are introduced by the new CO. Under section 491, the concept of 'relevant company' is changed to 'specified company' which is narrower in scope and only covers a public company or a private company or company limited by guarantee that is a subsidiary of a public company. Section 492 defines 'body corporate controlled by director' – there is controlling interest if a director has more than 50% voting power at general meetings of the body corporate, or the directors or majority of the directors of the body corporate are accustomed to act according to his directions. Additionally, the new CO expressly defines 'connected entity' under section 486 and has expanded its scope. A director's cohabitee, minor child and associated body corporate (a body corporate in which the director and related persons have 30% voting power at general meetings) are included as connected entities.

Other changes are relatively minor. For example for loans, the prohibition is extended to cover loans to a body corporate controlled by a director of a holding company. The new CO further restricts loans, quasi-loans made to and credit transactions entered into for an entity connected with a director of a holding company.

Under the new CO, transactions which would otherwise be prohibited are allowed if the prescribed approval of members of the company and/ or holding company in question is obtained. Under section 496, members' prescribed approval means approval obtained by a resolution of the members prior to the transaction, and requires that there is a memorandum sent to members setting out specified matters in respect of the transaction. In the case of a specified company, there is an additional requirement that the resolution is passed after disregarding affirmative votes by interested members. A prior unanimous consent of all relevant members can also constitute members' prescribed approval.

There will only be civil consequences for contraventions (see section 513). The new CO does not provide for criminal liability for contraventions.

The existing exceptions under the current CO are retained with some variations.

Company secretaries and the Companies Ordinance rewrite

The expertise and experience of company secretaries is a valuable resource for the government and regulators when it comes to legislative and regulatory reforms, and this is particularly true when it comes to companies legislation which forms part of the core expertise of company secretaries in Hong Kong. Now that the Companies Ordinance rewrite exercise, one of the largest-scale and most complex legislative reforms ever undertaken in Hong Kong, is nearing completion, it is perhaps fitting to acknowledge the key role played by representatives of the Institute in guiding this monumental project to a successful conclusion.

The following members of the Institute have served on the Standing Committee on Company Law Reform (SCCLR):

- Peter Greenwood FCIS FCS
- Anthony Rogers FCIS FCS
- Mike Scales FCIS FCS
- Edith Shih FCIS FCS(PE), and
- Wendy Yung FCIS FCS.

The SCCLR was set up in 1984 to advise the government on amendments to the Companies Ordinance and the Securities and Futures Ordinance on matters relating to corporate governance and shareholders' protection. Members of the SCCLR include representatives from relevant government departments and regulators, as well as from the relevant business sectors and the professions.

The SCCLR has played a central role in reviewing the Companies Ordinance and several of its recommended amendments to the ordinance were implemented by means of amendment bills prior to the launch of the Companies Ordinance rewrite exercise in 2006. Most recently, the SCCLR considered the provisions of various draft subsidiary legislation necessary for the implementation of the new Companies Ordinance, which was passed by the Legislative Council in July 2012.

Since the launch of the rewrite exercise, which has been led by a dedicated Companies Bill Team at the Companies Registry, many Advisory Groups have been formed to advise the rewrite exercise on specific topics under consideration. The following members of the Institute have served on these Advisory Groups:

- John Brewer FCIS
- Richard Leung FCIS FCS
- Paul Moyes FCIS FCS
- Natalia Seng FCIS FCS(PE)
- Bernard Wu FCIS FCS, and
- Eirene Yeung FCIS FCS.

In addition, the Institute has made numerous submissions to the public consultations launched as part of the rewrite exercise. The members of the Institute who have contributed to the work of the Institute's Technical Consultation Panel (TCP) over the eight years of the rewrite exercise are too numerous to mention by name, but this is certainly a good juncture to collectively recognise their contributions to this important and often highly technical work.

The Institute will continue to make its voice heard in the ongoing governance debate in Hong Kong.

The SCCLR's 2012-2013 annual report is now available at the websites of the Financial Services and the Treasury Bureau (www.fstb.gov.hk/fsb) and the Companies Registry (www.cr.gov.hk).

In addition, three new exceptions are introduced:

i. where the value of a transaction does not exceed five percent of the company's net assets or called up share capital (section 505)

ii. where funds are provided to a director for defending civil or criminal proceedings regarding misconduct (section 507), and

iii. where funds are provided to a director for defending regulatory actions by a regulatory authority (section 508).

For (ii) and (iii), the funds must be repayable to the company if the director's defence is unsuccessful.

2. Material interest in transactions, arrangements or contracts

Section 536 of the new CO has expanded the scope of section 165 of the current CO to also cover transactions and arrangements in which a director is interested, in addition to contracts. Of the three terms, 'arrangement' has the widest meaning and may cover a number of transactions with different parties. Also, under the new CO, directors need to declare the extent of their interest in addition to the nature of their interest. Presumably, if a director's interest is his shareholding in a company, he should also disclose the percentage of his shareholding. However, if a director is not aware of his interest or the transaction in question, he is not liable to make a declaration unless he ought reasonably to be aware.

Section 537 provides when and how a director should declare his interest. If the transaction has already been entered into, he must make a declaration as soon as is reasonably practicable. For a proposed transaction, he must declare his interest before the transaction is entered into. Under section 538, the declaration can be made at a directors' meeting, through a written notice to other directors or by a general notice; section 538 (4) to (8) set out the requirements for a general notice.

3. Payment for loss of office

There are provisions in the current CO which govern payments to directors or former directors for compensation of loss of office etc. Under the new CO, they are extended to also cover payments to directors or former directors of a holding company; entities connected with the directors or former directors; payments made at the direction or for the benefit of the directors or former directors or their connected entities; payments in connection with transfer of undertaking or property of a subsidiary; and transfer of shares of the company or a subsidiary resulting from a takeover offer. The prescribed approval of members (or affected members in case of takeover) is required. Sections 524 and 525 provide for exceptions.

4. Director's service contract

Section 534 of the new CO is new and it regulates long-term service contracts of directors with a company. Without the prescribed approval of members, a company shall not agree to any provision under which a director's guaranteed term of employment exceeds or may exceed three years.

Widening the scope of unfair prejudice

Section 168A of the current CO has been a key provision in the protection of the interest of minority shareholders. There are only minor changes to the regime under the new CO.

First, 'objectionable conduct' is widened by section 724 so that a member may rely on a 'proposed act' or 'actual or proposed omission' as unfairly prejudicial conduct. Because proposed acts or omissions are included, more applications for interim reliefs in proceedings under the new CO can be expected.

In addition, section 725 gives the court wider powers and empowers the court to make any order it thinks fit for giving relief in respect of the matter in question. A new set of subsidiary legislation entitled *The Companies (Unfair Prejudice Petitions) Proceedings Rules* will be introduced which set out the procedures applicable to a petition under the new CO.

Conclusion

As discussed above, directors' liabilities may to a certain extent and in one way or other be impacted by the changes introduced by the new CO. It is important that directors fully understand and live up to the new standard that is expected of them under the new regime as well as ensure that their companies comply with the new requirements.

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Further information can be found on the Financial Services and Treasury Bureau and Companies Registry websites: www.fstb.gov.hk and www.cr.gov.hk.

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