# The new Companies Ordinance: are you ready?

The new Companies Ordinance, which comes into force in March this year, has been billed as an attempt to simplify, rationalise and deregulate our company law wherever possible. While the new ordinance certainly brings in a number of measures to this effect, there is a sting in the tail which directors and company secretaries need to watch out for. In this two-part article, Billy Lam, Loretta Chan and Wilson Fung of Mayer Brown JSM, highlight a number of key areas where the new Companies Ordinance increases directors' and company secretaries' exposure to legal liabilities.

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.

### New formulation of 'responsible person'

Officers of companies need to be aware of the new formulation of 'responsible person', which replaces the concept of 'officer who is in default' and may widen the scope of criminal liability for officers of companies. Under section 3, the formulation of 'responsible person' applies where a provision of the new CO (or its subsidiary legislation) provides that a responsible person commits an offence if there is:

- a contravention of the new CO or of a requirement, direction, condition or order, or
- a failure to comply with a requirement, direction, condition or order.

For example, where a company fails to change its name pursuant to a direction of the Companies Registry, it will be necessary to identify the company's responsible persons, who may be prosecuted together with the company. The term 'responsible person' encompasses two categories:

1. an officer or a shadow director of a company who authorises, permits or participates in the contravention or failure, and
2. an officer or a shadow director of a body corporate which is an officer or a shadow director of the subject company, if both the body corporate and the person authorise, permit or participate in the contravention or failure.

The word 'officer' is defined to include directors, company secretaries and managers of companies. For this purpose, managers are regarded as officers if they are entrusted with the power to manage the whole of the affairs of the company.

Compared with the concept of 'officer who is in default' which can be found in the current CO, the new formulation of responsible person includes officers and shadow directors of corporate officers and corporate shadow directors (that is, the second category of persons referred to above). Another major difference is that, compared with the provision in section 351 of the current CO regarding an officer who is in default, the words 'knowingly and wilfully' have been removed in the new regime. The intention behind this change is to lower the prosecution threshold with a view to enhancing enforcement by extending the scope to cover reckless acts or omissions of officers. There is also a possibility that

## Highlights

- the new Companies Ordinance increases directors' and company secretaries' exposure to legal liabilities
- where companies are in breach of the new Companies Ordinance, the identification of the company's responsible persons may become important as such persons may be prosecuted together with the company
- the intention behind the removal of the words 'knowingly and willfully' in the definition of 'responsible person' is to lower the prosecution threshold with a view to cover reckless acts or omissions

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the removal of the words 'knowingly and wilfully' will have the effect of shifting the burden of proof such that instead of the prosecution having to prove that the responsible person has the requisite knowledge of the contravention or failure, it will be up to the defendants to show that they do not have such knowledge.

### Codification of directors' duty of care, skill and diligence

Currently, directors' duty of care, skill and diligence is governed by common law. Previous cases show that the standard of care has moved from a subjective test to an objective test (that is, what a reasonable director will do). Following the footsteps of the English jurisdiction, such duty is to be codified under the new CO and a mixed objective and subjective test will be introduced.

Section 465 of the new CO requires directors to exercise 'reasonable care, skill and diligence', which is defined as 'the care, skill and diligence that would be exercised by a reasonably diligent person', with the general knowledge, skill and experience:

1. that 'may reasonably be expected of a person carrying out the same functions carried out by the director in relation to the company', and

2. that 'the director has'.

These two limbs represent the objective and subjective tests respectively.

In other words, when deciding whether directors have exercised reasonable skill, care and diligence, their conduct is first compared with that of a person who is reasonably diligent and taken to be carrying out the same functions as the director in question; and if directors have additional knowledge or qualifications, then their conduct will be compared against that of a person with the same additional knowledge or qualifications as well. Considering both tests as a whole, directors need to achieve at least the objective standard, but this standard will be raised where a particular director possesses additional knowledge or qualifications.

### Ratification of directors' conduct

At present, shareholders' approval is needed to ratify directors' conduct. Where directors are also the company's majority shareholders, their conduct can be ratified rather conveniently. The new CO plugs this loophole by introducing procedures regarding ratification which can be found in section 473. The new procedures only apply to a director's conduct involving negligence, default, breach of duty or trust in relation to the company. Passing an ordinary shareholders' resolution remains the method of ratification, but every vote in favour of the resolution made by a member within any of the following three categories shall be disregarded:

1. a member who is the director in respect of whose conduct the ratification is sought

2. a member who is an entity connected with such directors (including their family members, bodies corporate associated with the director, etc), and

3. a member who holds shares in trust for such directors or entities.

These three categories of members may nevertheless still attend the meeting and be counted towards the quorum.

### Uniform solvency test

Many countries have in recent years moved away from strict capital maintenance doctrine in favour of a solvency test. In keeping with this international trend, the new CO introduces a uniform solvency test which will apply to three kinds of transaction under Part 5 of the new CO: capital reduction, share buyback/ redemption and the giving of financial assistance. In addition to this uniform solvency test, Part 13 of the new CO also provides for a solvency test which will be applicable to intra-group amalgamation. This article will focus on the uniform solvency test under Part 5 of the new CO.

This cash flow-based uniform solvency test is not something new to private companies. Under the current CO, there are already two major solvency tests which they can make use of. One is applicable to the giving of financial assistance by unlisted companies for the purpose of purchasing shares in the company or its holding company, the so-called 'whitewash procedure'; the other applies to share redemption and buyback out of capital by private companies. These two tests are subject to minor differences. The main difference is that the first one provides for the situation where the company contemplates winding up within the next 12 months. The uniform solvency test under the new CO is the same as that which is currently applicable to financial assistance.

## Action required

- Company secretaries need to brief directors on the implications of the codification of directors' duty of care, skill and diligence in the new CO. All directors need to achieve at least the objective standard (the standard which 'may reasonably be expected of a person carrying out the same functions carried out by the director in relation to the company'). This standard will be raised where a particular director possesses additional knowledge or qualifications.
- Existing D&O contracts should be reviewed to ensure that they cover the increased legal liabilities for directors and company secretaries under the new CO.
- Company secretaries need to brief directors on their potential liabilities under the new CO when making solvency statements. Before signing a solvency statement, directors are under a statutory duty to inquire into the company's state of affairs and prospects, taking into account all liabilities of the company, including contingent and prospective liabilities.
- It is advisable to keep proper and detailed records of directors' reasons for their decisions when making solvency statements in case there is any subsequent challenge to the reasonableness of those decisions.
- The new CO introduces a court-free procedure for capital reductions, but court approval may be worth considering for non-standard cases, for example where objections are anticipated from shareholders/ creditors or where there are divided views on the solvency position of the company among directors.
- Interested/ connected directors and associates must be excluded from a vote to ratify directors' conduct; they may nevertheless still attend relevant meetings and be counted towards the quorum.

Pursuant to such tests, a solvency statement has to be made by the directors to confirm that the company would be able to pay its debts immediately after the transaction; and either:

- in the case where the company intends to commence winding up within the next 12 months, it will be able to pay its debts in full within 12 months after commencement of winding up, or
- in any other case, it will be able to pay its debts as they become due in the 12 months following the transaction.

Though the solvency test is not a new concept, its use has been substantially extended under the new CO in a few ways.

First, a court-free procedure for capital reduction based on the uniform solvency test will be introduced. This is an alternative to court approval and will be available to all companies. Second, all companies, not only private companies, will be allowed to make payment for share buyback and redemption out of capital subject to the uniform solvency test. On-market buyback by listed companies is an exception. Share buyback by listed companies through other means such as general offer or private contract may be funded by capital. Lastly, subject to the uniform solvency test, all companies (whether listed or unlisted) can give financial assistance for acquisition of their own shares or those of its holding company.

While the extended use of the solvency test results in relaxations of the capital maintenance doctrine, it is balanced by the right of members (as well as creditors

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except in the case of financial assistance) who do not vote for the transaction to make a court application to set it aside subject to certain procedures.

The extended use of the solvency test as mentioned above in effect means that there are more circumstances in which the making of a solvency statement by directors will come into play. Directors are expected to have reasonable grounds in giving their opinion as to the solvency status of the company. Directors who make a solvency statement without reasonable grounds will be subject to criminal liabilities under the new CO which can take the form of a fine or imprisonment. There are also potential civil liabilities for directors, which could, for example, amount to a breach of fiduciary duty to the company. The extended use of the solvency test will accordingly increase the directors' exposure to potential liabilities.

As the application of the solvency test with respect to share buyback/ redemption out of capital and the giving of financial assistance will no longer be confined to private companies under the new CO, directors of listed companies may find themselves facing a new and important task after the commencement of the new CO while more flexibilities are given to their companies at the same time.

The court-free alternative procedure for capital reduction based on the uniform solvency test essentially transfers responsibility from the court to the directors, especially in terms of ensuring that the creditors' interests are not prejudiced by the capital reduction.

In the case of financial assistance, apart from making the solvency statement, directors also have responsibility for confirming that the giving of financial assistance is in the best interests of the company and the relevant terms and conditions are fair and reasonable to the company.

The new CO has dispensed with the need for an auditor's report which is currently required for share buyback/ redemption out of capital by private companies. It is considered that the auditors would not be in a better position than the directors when it comes to confirming the solvency position of the company. This in a way places the burden of making a forward-looking judgement on the company's solvency solely on the shoulders of the directors, although they are always free to seek professional advice if in any doubt.

So, how can directors protect themselves in view of the potential liabilities that might arise from making the solvency statement under Part 5 of the new CO?

Before signing a solvency statement, directors are under a statutory duty to inquire into the company's state of affairs and prospects, taking into account all liabilities of the company, including contingent and prospective liabilities. In discharging such duty, directors are advised to make sure their opinions are based on the findings of a detailed financial review and the updated management accounts of the company. If they have any doubts, they should consult the company's auditor. It is also advisable to keep proper and detailed records of their reasons for making their decision in case there is any challenge to the reasonableness of the solvency statement in the future.

With regard to capital reduction, while the court-free procedure can save costs and time, a court approval may be worth considering in several situations, for example where there is a sizeable capital reduction or where an objection from the members or creditors to the proposed capital reduction is anticipated. Divided views on the solvency position among the directors may also indicate that it is a marginal case where directors should err on the side of caution. Instead of asking the dissenting directors to resign to facilitate the making of the solvency statement by all directors, which is required by the new CO (for court-free procedure for capital reduction as well as share buyback/ redemption out of capital), it is advisable to proceed with

the capital reduction in the alternative manner – that is, apply for a court order confirming the capital reduction. Though this is bound to be more expensive and time consuming, it is likely to provide more certainty as to the legality of the transaction and to reduce the risk exposure for the directors affirming the transaction.

It is worth noting that in the *Improvement of Corporate Insolvency Law Legislative Proposals* consultation document published by the Financial Services and Treasury Bureau in April 2013, it was proposed that if a company is wound up insolvent within 12 months of a share redemption/ buyback, directors who made the solvency statement without reasonable grounds and the recipient of the payments of the redeemed or bought-back shares should be jointly and severally liable to return the money to the company. Directors should be aware of this proposal which may have a further impact on their liabilities.

Given the potential liabilities (both civil and criminal) arising from the making of the solvency statement, directors may wish to enquire whether the directors' and officers' liability insurance taken out by the company is wide enough to cover such liabilities, and to ensure that any potential liabilities to third parties are indemnified by the company, to the extent allowed under the new CO.

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*The second part of this article will be published in next month's CSj. The HKICS has organised a series of seminars on the new Companies Ordinance; please refer to the 'ECPD' section of the Institute's website (www.hkics.org.hk) for details.*

*This journal will also feature a new column devoted to the Companies Ordinance to highlight the key issues for practitioners on an ongoing basis.*

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