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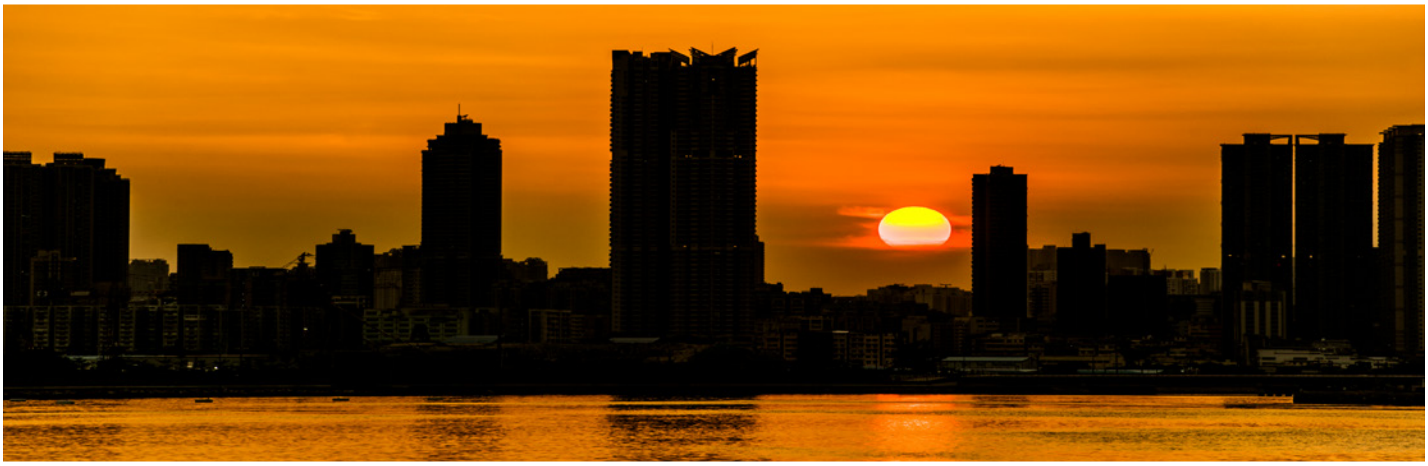

Hong Kong Law

12 **February** 2014

KEY CHANGES UNDER THE NEW COMPANIES ORDINANCE

PART ONE – KEY CHANGES AFFECTING DIRECTORS

Introduction

The New Companies Ordinance (Cap. 622) (the **New CO**) will come into force on 3 March 2014. Following commencement of the New CO, the current Companies Ordinance (Cap. 32)(the **Old CO**) will be retitled as the "Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)". The core provisions affecting the operation of companies under the Old CO will be repealed, except those provisions relating to winding-up and insolvency of companies and prospectuses.

Charltons is preparing a series of newsletters summarising the key changes to the company law framework under the New CO. In this first newsletter, we discuss the key changes affecting directors of Hong Kong companies.

Standard of Directors' Duty of Care, Skill and Diligence

New CO references: sections 465 to 466

Position under the Old CO

The Old CO does not contain specific provisions on directors' duty of care, skill and diligence. General common law and fiduciary duties of directors are based on case law.

Key changes under the New CO

The New CO codifies a director's duty to exercise reasonable care, skill and diligence.

Section 465 of the New CO requires a director to exercise reasonable care, skill and diligence, meaning the care, skill and diligence that would be exercised by a reasonably diligent person with:

- 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 (an objective test); and
- the general knowledge, skill and experience that the director has (a subjective test).

The new statutory duty applies equally to a shadow director of a company, being a person in accordance with whose directions the directors, or a majority of directors, are accustomed to act. Section 466 retains the existing civil consequences of breach of the duty.

Practical considerations and recommended steps

In carrying out his duties, a director of a Hong Kong company must bring to bear his own general knowledge, skills and experience (the subjective part of the assessment), as well as the knowledge, skills and experience that would reasonably be expected of a director carrying out the same functions (the objective part of the assessment).

If a director has special knowledge, skill or experience, then such director will be subject to a higher standard of care under the New CO compared to a director without such knowledge. Conversely, a director will be expected to meet an objective reasonable standard of care, even if the director is in fact under-qualified for the role.

The New CO does not codify common law fiduciary duties, which will remain subject to current case law. These fiduciary duties include the duty to act in good faith in the interests of the company, the duty to exercise powers for their proper purpose, and the duty to avoid conflicts of interest (as explained below, directors are also required under the New CO to disclose material interests in significant transactions of the company). A director may have additional duties and obligations under a company's articles of association, as well as under the director's individual terms of engagement. Directors of Hong Kong listed companies will also need to consider additional requirements under the Hong Kong Listing Rules.

Ratification of Director's Conduct

New CO reference: section 473

Position under the Old CO

There is no specific provision in the Old CO on shareholder ratification of director's conduct. Under common law, shareholders can ratify breaches by directors of their fiduciary duties. Ratification means that the company is barred from bringing actions against the director for damages arising from the ratified breach (although a dissenting minority shareholder may still be able to pursue an unfair prejudice or statutory derivative claim). Ratification can give rise to potential conflicts of interest where a majority shareholder is also a director, or is otherwise connected to a director.

Key changes under the New CO

The New CO requires that any ratification by a company of a director's (including a shadow director's) conduct amounting to negligence, default, breach of duty or breach of trust must be approved by a resolution of disinterested shareholders (i.e., shareholders that are not connected to the director or to any of his trusts or other connected entities). If none of the shareholders are disinterested, then approval must be by unanimous consent of all shareholders.

Practical considerations and recommended steps

The independent ratification requirement should provide a more preventative protection for minority shareholders, compared to statutory derivative or unfair prejudice remedies, which would normally be taken by a dissenting minority shareholder after a breach has already occurred. At the same time, the new rule should not impact significantly on small companies that normally take shareholder decisions by way of unanimous written consent.

Liability and Indemnification of Directors

New CO references: sections 467 to 472

Position under the Old CO

There are no specific provisions in the Old CO regulating a director's right to be indemnified against liabilities to third parties. The scope of the right of directors to be indemnified against liabilities to third parties, which has developed in case law, has not been clear.

Key changes under the New CO

The New CO clarifies the rules on indemnification of directors against liabilities to third parties (i.e. parties other than the company or its associated companies). The definition of "associated company" in the New CO is identical to that of "related company" in the Old CO, which it replaces, and means a company's subsidiaries, holding companies and subsidiaries of such holding companies. Section 469 permits a company to indemnify a director against liability incurred by the director to a third party provided certain conditions are satisfied. In particular, certain liabilities cannot be covered by the indemnity, including the following:

- criminal fines;
- regulatory penalties;
- defence costs of criminal proceedings in which the director is convicted; and
- defence costs of civil proceedings brought by or on behalf of the company and in which judgment is given against the director.

A company which provides any permitted indemnity to its directors must disclose the indemnity provision in the directors' report under section 470 of the New CO. It must also keep a copy of any permitted indemnity at its registered office until one year after its expiry and make it available for inspection by members on request (sections 471 and 472 of the New CO). Failure to retain copies of permitted indemnities at the registered office is an offence for which the company and its responsible persons may be fined.

The New CO also prohibits a company from exempting a director from liability for negligence, default, breach of duty or breach of trust by the director in relation to the company.

Practical considerations and recommended steps

Companies and their directors should review the scope of any indemnities granted to directors to see if these should now be extended to cover indemnification against third party liabilities.

Although the New CO prohibits a company from exempting a director from liability for negligence, default, breach of duty or breach of trust by the director in relation to the company, it does not prohibit a company from taking out insurance for directors of the company and/or its associated companies against such liabilities (except for fraud) to the company or an associated company. Therefore, any existing directors' and officers' (D&O) insurance policies should also be reviewed to see if coverage should be extended.

Permitted exemptions from liability, indemnities for liability to a third party and any undertaking to take out D&O insurance should be clearly set out in a director's service contract, even if the company's articles already include standard exemption, indemnification and insurance wording. The articles are a contract between the company and the shareholders, so a director would have difficulty enforcing an exemption, indemnity or undertaking contained only in the articles. Hong Kong courts have also been reluctant to imply provisions from a company's articles of association into the terms of appointment of a director, particularly if there is a contract between the director and company that is expressed to constitute the entire agreement between the parties. A director should therefore ensure that any provisions in the articles on which he wishes to rely should be expressly incorporated into the terms of the director's engagement.

The scope of any director indemnity should also be considered, in particular whether it covers only liabilities arising from the performance of the director *qua* director, or in other capacities (for example, as chief financial officer) or in a personal capacity.

Copies of permitted indemnity provisions to directors must be kept at the company's registered office and made available free of charge upon request by a member of the company.

For listed companies, paragraph A.1.8 of Appendix 14 (Corporate Governance Code and Corporate Governance Report) of the Hong Kong Listing Rules requires a listed company to arrange appropriate insurance cover in respect of legal action against its directors. Compliance with this code provision is not mandatory, but a listed company would need to explain the reasons for any non-compliance in its annual report.

Loans to Directors and Similar Transactions

New CO references: sections 484 to 490, 491 to 515

Position under the Old CO

The Old CO prohibits a company from entering into loans (or providing security for or guaranteeing a loan) with its directors or directors of its holding company (**holdco directors**), or to Hong Kong companies controlled by such persons. The Old CO also prohibits listed companies (and companies within a listed group) from entering into quasi- loans or credit transactions (and related guarantees and security) with directors or holdco directors, or certain persons connected with such persons (i.e. a spouse, minor children, specified categories of trustees and partners, and companies in which the director (or the above categories of persons) holds a controlling interest). The term "director" includes a shadow director under both the Old CO and the New CO.

Key changes under the New CO

Hong Kong companies

The New CO prohibits a Hong Kong company from making loans (or providing security for or guaranteeing a loan) to:

- the company's directors;
- holdco directors; or
- corporates (including non-Hong Kong companies) controlled by the company's directors or holdco directors (**controlled entities**).

The New CO has therefore extended the loan prohibition to non-Hong Kong incorporated controlled entities.

Specified companies

For “specified companies” (i.e. public companies, or private companies (or companies limited by guarantee) that are subsidiaries of a public company), the prohibition also extends to the provision of quasi-loans and entering into credit transactions as creditors (or providing security for or guaranteeing such quasi-loans or credit transactions). This is wider than the Old CO, which only caught private companies (or companies limited by guarantee) that are members of a listed group.

Connected entities

The prohibitions on loans, quasi-loans and credit transactions (and guarantees and security in connection with same) are also extended in the case of “specified companies” to include certain categories of persons connected with a company’s directors or holdco directors. The New CO widens the definition of connected entities to cover the following additional categories of persons connected to a director or holdco director:

- adult children, step-children and illegitimate children;
- adopted children of any age;
- parents;
- cohabitees;
- minor children, step-children, illegitimate children and adopted children of the cohabitee who live with the director;
- “associated body corporates”, meaning corporates in which the director and / or his spouse, minor children or connected trustee have control over more than 30% of the voting power of the company;
- a trustee of a trust which includes the director’s minor adopted child; and
- a business partner of the director’s minor adopted child.

The full list of persons deemed to be connected with a director for the purposes of the prohibition on loans and similar transactions is now as follows:

- a spouse;
- a child, step-child, illegitimate child or adopted child of any age;
- a parent;
- a cohabitee;
- a minor child, minor step-child, minor illegitimate child or minor adopted child of the cohabitee who lives with the director;
- a trustee of a trust the beneficiaries of which include the director, his spouse, his minor children (other than employee share schemes or pension schemes) (**connected trustee**);
- an associated company, meaning a company in which the director and / or his spouse, minor children or connected trustee control over more than 30% of the voting power of the company; and

- a business partner of the director or his spouse, minor children or connected trustee.

Shareholder approval

Under the Old CO, private companies that are not part of a listed group are exempt from the prohibition on loans provided shareholder approval is obtained. Under the New CO, all companies (including public companies) will be exempt from the above prohibitions with prior shareholder approval. In the case of public companies and their subsidiaries (including private companies and companies limited by guarantee), disinterested shareholders' approval is required.

Other exemptions

There are certain other exemptions (**other exemptions**) from the prohibition on loans and similar transactions described above which are set out in sections 505 to 512 of the New CO. These include new exemptions for transactions with a value below 5% of the net assets of the company or 5% of the called-up share capital, or expenditure in connection with defending proceedings, investigations or regulatory actions for misconduct (provided the director repays the company if he is found guilty or to have committed the misconduct).

Other exemptions have been carried over from the Old CO (in some cases with modifications), including intra-group transactions, expenditure on company business, secured home loans below a certain value that are ordinarily entered into by the company for its employees, and arm's length transactions below a certain value involving hiring or leasing of goods or land.

Assignments

The New CO retains the previous prohibition on a company arranging an assignment to it, or the assumption by it, of any rights, obligations or liabilities under a "questionable transaction" (i.e. a transaction that, if entered into by the company, would contravene the above prohibitions). Similarly, a Hong Kong incorporated company is prohibited from taking part in any arrangement under which a third party would benefit from the company or its associated company carrying out a questionable transaction.

Summary table

The table below summarises the prohibitions on loans and similar transactions to directors and other parties under the New CO.

TRANSACTION (INCLUDES SECURITY OR GUARANTEE IN CONNECTION WITH TRANSACTION):	PRIVATE COMPANIES	PUBLIC COMPANIES AND SUBSIDIARIES OF PUBLIC COMPANIES (INCLUDING PRIVATE COMPANIES AND COMPANIES LIMITED BY GUARANTEE)
Loans to directors of Hong Kong company or body corporates controlled by those directors	Prohibited unless approved by shareholders, or other exemption applies	Prohibited unless approved by disinterested shareholders, or other exemption applies
Loans to holdco directors or body corporates controlled by those holdco directors	Prohibited unless approved by shareholders and holdco's shareholders (if holdco is a Hong Kong company)*, or other exemption applies	Prohibited unless approved by disinterested shareholders and holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies

TRANSACTION (INCLUDES SECURITY OR GUARANTEE IN CONNECTION WITH TRANSACTION):	PRIVATE COMPANIES	PUBLIC COMPANIES AND SUBSIDIARIES OF PUBLIC COMPANIES (INCLUDING PRIVATE COMPANIES AND COMPANIES LIMITED BY GUARANTEE)
Loans to connected entities of directors	Not prohibited	Prohibited unless approved by disinterested shareholders, or other exemption applies
Loans to connected entities of holdco directors	Not prohibited	Prohibited unless approved by disinterested shareholders and holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies
Quasi-loans to directors	Not prohibited	Prohibited unless approved by disinterested shareholders, or other exemption applies
Quasi-loans to holdco directors	Not prohibited	Prohibited unless approved by disinterested shareholders and the holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies
Quasi-loans to connected entities of directors	Not prohibited	Prohibited unless approved by disinterested shareholders, or other exemption applies
Quasi-loans to connected entities of holdco directors	Not prohibited	Prohibited unless approved by disinterested shareholders and holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies
Credit transactions for directors	Not prohibited	Prohibited unless approved by disinterested shareholders, or other exemption applies
Credit transactions for holdco directors	Not prohibited	Prohibited unless approved by disinterested shareholders and holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies
Credit transactions for connected entities of directors	Not prohibited	Prohibited unless approved by disinterested shareholders, or other exemption applies
Credit transactions for connected entities of holdco directors	Not prohibited	Prohibited unless approved by disinterested shareholders and holdco's disinterested shareholders (if holdco is a Hong Kong company)*, or other exemption applies

** Note: Only holdco disinterested shareholder approval required if company is a wholly-owned subsidiary and holdco is a Hong Kong company*

Practical considerations and recommended steps

Companies should amend their existing policies and internal controls in respect of loans and similar transactions with directors to ensure that they cover the additional categories of entities (such as non-Hong Kong incorporated controlled entities, and new types of connected entities) that fall within the scope of the prohibitions.

At the same time, some of the new changes are likely to facilitate business for Hong Kong companies, in particular the introduction of new exemptions, and the extension of the shareholder approval exemption to all companies (albeit requiring approval of disinterested shareholders in the case of "specified companies").

Where a company is seeking shareholder approval for a particular transaction, it must send shareholders a memorandum containing information on the nature of the transaction, the amount of the loan, quasi-loan or credit transaction, its purpose and the extent of the company's liability.

Transactions entered into in breach of the prohibitions discussed above are voidable at the option of the company unless:

- restitution is no longer possible;
- the company has been indemnified for loss or damage resulting from the transaction;
- a third party has in good faith acquired rights for value under the transaction, and those rights would be affected; or
- the transaction is affirmed by the shareholders of the company and / or the holding company (as applicable) within a reasonable period after it is entered into.

Whether or not the transaction is avoided by the company, the following persons will be liable to account to the company for any gain that the person has made from the transaction and will also be jointly and severally liable to indemnify the company for any loss or damage resulting from the transaction:

- a director or holdco director for whom the company entered into the transaction;
- a controlled entity or connected entity for whom the company entered into the transaction (unless they were not aware of the circumstances constituting the breach);
- the director or holdco director who controls such a controlled entity or with whom such a connected entity is connected (unless they have taken reasonable steps to ensure the company's compliance with the relevant provisions of the New CO); and
- any other director of the company who authorised the transaction (unless they were not aware of the circumstances constituting the breach).

Criminal sanctions will no longer apply for breaches of the prohibitions.

Directors' Service Contracts

New CO references: sections 530 to 535

Position under the Old CO

There is no provision in the Old CO that requires shareholder approval before a company can enter into a service contract with a director for longer than three years.

Key changes under the New CO

The New CO now requires shareholder approval for any contracts under which the guaranteed term of employment of a director (including a shadow director) with the company exceeds or may exceed three years. If the company is a public company, approval of the company's disinterested shareholders is required.

Practical considerations and recommended steps

The shareholder approval for a long-term contract must be given before the company agrees to the provision granting the director a long-term employment. A memorandum explaining the proposed contract must also be provided to each shareholder prior to the relevant vote or written resolution. If a service contract is entered into in breach of these requirements, the provision granting long-term employment will be void and the company may terminate the contract with reasonable notice. The restrictions also apply to service contracts which relate to services to be provided by a director to a company's subsidiary.

Payment for Loss Of Office

New CO references: sections 516 to 529

Position under the Old CO

Under the Old CO, payments to directors as compensation for loss of office or as consideration for retirement from office are prohibited without the company's prior approval. However, the Old CO does not expressly prohibit payments made indirectly via other parties. The Old CO also requires shareholder approval for any payment in connection with transfer of its undertaking or property to a director for loss of office or as consideration for retirement (but does not cover transfers of a subsidiary's property). Finally, the Old CO requires payments to a director for loss of office (or retirement) made in connection with transfers of shares in the company pursuant to a takeover offer to be disclosed and approved by shareholders (but again, this provision does not cover shares in a subsidiary).

Key changes under the New CO

The New CO extends the loss of office payment provisions to include:

- payment to an entity connected with the director;
- payment to a person made at the direction, or for the benefit, of the director or an entity connected with the director;
- payments to a holdco director;
- payments made in connection with a transfer of the undertaking or property of a company's subsidiary; and
- payments made in connection with a transfer of shares of a company's subsidiary resulting from a takeover offer.

Where shareholder approval is required, it must be obtained before the payment for loss of office is made and a memorandum containing particulars of the payment must be sent to shareholders prior to the relevant vote or written resolution. In addition, where the payment is made by a public company, disinterested shareholder approval is required.

Practical considerations and recommended steps

The recipient of a payment for loss of office that breaches the New CO will hold the relevant amount on trust for the company, and any director who authorised the payment will be liable to indemnify the company for any loss resulting from the payment.

The New CO provides for a *de minimis* exemption for payments that do not exceed HK$100,000. In addition, the loss of office payment provisions do not apply in respect of a *bona fide* payment to a director by way of damages for breach of contract or under a pension scheme.

Disclosure of Interests

New CO references: sections 536 to 542

Position under the Old CO

The Old CO requires a director who has a material interest in a contract or proposed contract with the company that is of significance to the company's business, to disclose to the board of directors the nature of such interest at the earliest meeting of directors that is practicable.

Key changes under the New CO

The scope of disclosure under the New CO is widened to cover “transactions” and “arrangements” as well as “contracts”, and directors must disclose the “extent” as well as the “nature” of the interest. Directors of public companies will additionally be required to disclose material interests of their connected entities (but only if they are aware, or ought reasonably to be aware, of the interest or the relevant transaction, arrangement or contract). Section 540 of the New CO extends the disclosure requirements to shadow directors and sets out the procedures for a shadow director to provide general notice of his interests.

Practical considerations and recommended steps

Directors and shadow directors should be made aware of the new disclosure requirements. In many cases, directors disclose their interests in particular businesses by way of general notice (to avoid the need for repeated declarations). Directors should consider updating any general disclosures in order to ensure that their disclosures comply with the wider disclosure obligations under the New CO.

Restricting Corporate Directorships in Private Companies

References: sections 456 and 457

Position under the Old CO

Under the Old CO, public companies and private companies within the same group as a listed company are prohibited from appointing a body corporate as their director. However, the prohibition does not apply to other private companies.

Key changes under the New CO

Section 456 of the New CO restates the prohibition on corporate directorships for public companies, private companies within the same group as a listed company and companies limited by guarantee. Section 457 now also requires other private companies (other than those within the same group as a listed company) to have at least one director who is a natural person.

Practical considerations and recommended steps

Hong Kong private companies that are engaging corporate secretarial service providers to provide nominee corporate directors will need to ensure that at least one natural person is appointed as a director.

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