Charltons - Hong Kong Law Newsletter - 08 September 2010

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# Consultation Conclusions On The First Phase Consultation Of The Draft Companies Bill Published

On 30 August 2010, the Financial Services and the Treasury Bureau ("**FSTB**") published its Consultation Conclusions on the First Phase Consultation of the draft Companies Bill ("**CB**") ("**Consultation Conclusions**"). This is part of a major and comprehensive exercise launched in 2006 to rewrite the Companies Ordinance ("**CO**") with the aim of making it more user-friendly and facilitating the conduct of business to enhance Hong Kong's competitiveness and attractiveness as a major international business and financial centre.

The purpose of this note is to provide a summary of the proposals that the FSTB will adopt with regards to the draft CB following the first phase of consultation. However, only the major issues are covered in this note. The technical or drafting issues are not covered, but they are available in Appendix III of the Consultation Conclusions.

The Consultation Conclusions are available on [the FSTB website](http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccfp_conclusion_e.pdf).

## Major Issues From The First Phase Of Consultation

The draft CB is the result of previous public consultations in 2007 and 2008. The first phase of consultation for the draft CB began on 17 December 2009 and ended on 16 March 2010. In summary, the proposals to be adopted by the FSTB are as follows:

* retaining the headcount test for approving members' schemes of compromise or arrangement for listed and non-listed companies and creditors' schemes but giving the court the discretion to dispense with the test for members' schemes in special circumstances;
* allowing directors to provide a service address for display on the public register of the Companies Registry ("**CR**") whereas their residential addresses will be kept on a confidential record to which access will be restricted;
* masking certain digits of identity card or passport numbers ("**identification numbers**") of individuals on the public register;
* subject to the introduction of a new disinterested members' approval exception to prohibitions on loan and similar transactions in favour of the directors of public companies and their connected persons, modifying the concept of relevant private company to cover only private companies which are subsidiaries of a listed or public company;
* retaining the right to take common law derivative action; and
* proceeding with the codification of directors' duty of care, skill and diligence.

### Headcount Test for Members' Schemes of Listed and Non-Listed Companies and Creditors' Schemes

Under section 166(2) of the CO, a compromise or arrangement between a company and its members must be approved by a majority in number of those who cast votes at a meeting ordered by the court before it can be sanctioned by the court and become binding on the parties. This "majority in number" requirement is known as the "headcount" test. In addition, the majority in number who approve the compromise or arrangement must hold at least 75% in value of the holdings of those present at the meeting. Critics suggest that the headcount test fails to reflect the views of beneficial owners of shares as many listed company shares are held by custodians and nominees. It is also argued that this test is open to abuse by share splitting and gives disproportionate weight to the views of minority shareholders.

The FSTB believes that the proposed introduction of a scripless market in Hong Kong can address the criticism that the test fails to reflect the views of beneficial owners of shares of listed companies. Furthermore, the Securities and Futures Commission ("**SFC**") has advised that there is no evidence to suggest that vote manipulation is common. Lastly, the FSTB believes that the rights of minority shareholders need statutory protection, which cannot be substituted by the protection offered by the SFC's Code on Takeovers and Mergers.

Although a majority of respondents favoured abolishing the headcount test for members' schemes of listed companies, the FSTB will retain the headcount test for listed companies as well as for non-listed companies and creditors' schemes. The primary justification for this decision was the protection of the rights of minority shareholders and small creditors. However, to address the possibility of vote manipulation in the future, the FSTB will give the court the discretion to dispense with the test for members' schemes in special circumstances.

### Disclosure of Directors' Residential Addresses and the Identification Numbers of Directors and Company Secretaries on the Public Register

Currently, the CO requires directors and secretaries of companies incorporated or registered in Hong Kong (including non-Hong Kong companies) to provide their residential addresses and identification numbers to the CR. This information is available for inspection on the CR's public register, giving rise to concerns over data privacy and possible abuses. The FSTB will adopt the proposals below based on the need to strike a balance between protecting personal information and access to such information on bona fide grounds.

Directors and company secretaries will be allowed to provide a service address for display on the public register. Company secretaries are no longer required to disclose their residential addresses, but directors' residential addresses will be kept on a confidential record to which access will be restricted. With regards to identification numbers of both directors and company secretaries, the FSTB will mask certain digits of these numbers on the public register, as it believes that the remaining digits together with the name of the individual should be sufficient for identification purposes.

Access to any unmasked identification numbers or directors' residential addresses will be restricted to public and enforcement/regulatory authorities, liquidators, provisional liquidators and those who have obtained court orders for disclosure. Identification numbers and directors' residential addresses in the existing records will only be purged upon application and payment of a fee.

### Regulation of Directors' Fair Dealings in Respect of Private Companies Associated with a Listed or Public Company

A private company that is a member of a group of companies that includes a listed company (a "**relevant private company**") is treated essentially in the same manner as a public or listed company in the CO in respect of prohibitions on loans, quasi-loans and credit transactions in favour of directors or directors of its holding company or another company controlled by one or more of its directors. These prohibitions also apply to certain connected persons (e.g. the spouse, children and step-children) of the directors of listed companies and relevant private companies. A relevant private company may be a subsidiary, holding company or a fellow subsidiary of a listed company. The relevant private companies are thereby subject to more stringent restrictions than other private companies.

It was proposed in the draft CB that the prohibitions on public companies in respect of these transactions should be relaxed. A new exemption will be added to allow public companies to lend, make a quasi-loan or enter into a credit transaction in favour of a director or connected entity subject to the approval of disinterested shareholders. Assuming that this exemption will be introduced, the FSTB will modify the concept of relevant private company to cover only private companies that are subsidiaries of a listed or public company. Thus, for example, a private company which has a common holding company with a listed company will no longer be a relevant private company.

### Common Law Derivative Action

Part IVAA of the CO provides a statutory derivative action ("**SDA**") procedure that a member of a company may take on behalf of the company. This right co-exists with the right to take a common law derivative action ("**CDA**") which is preserved in section 168BC(4) of the CO. The Legislative Council has recently passed the Companies (Amendment) Bill 2010, which proposes to extend the scope of SDA so that members of an associated company of a specified corporation could also pursue an SDA. In anticipation of this change, it was suggested that the right to take a CDA should be abolished from the CO. However, the FSTB will retain this right because it provides necessary protection to shareholders in Hong Kong for obtaining remedies in Hong Kong in relation to non-Hong Kong companies.

### Codification of Directors' Duty of Care, Skill and Diligence

It was suggested in the draft CB that directors' duty of care, skill and diligence should be codified along the lines of section 174 of the UK Companies Act 2006 so that a director would be required 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 (the "**objective test**"); and
* the general knowledge, skill and experience that the director has (the "**subjective tes**t").

Concerns were raised during the first phase of consultation that the subjective test would set an even higher standard for those directors having special knowledge or experience, thus discouraging them from taking up directorships in Hong Kong. Some respondents considered that a clear set of statutory guidelines on the subjective test would be required and proposed a "safe harbour" to protect directors from liability under the test arising from their background and qualifications. In response, the FSTB noted that the subjective test is not significantly different from the current common law position in Hong Kong of directors' duty of care, skill and diligence.

Another concern was that the objective test would raise the standard to be followed by non-executive directors to the standard of executive directors. In response, the FSTB notes that clause 10.13 of the draft CB requires the courts to also consider the different functions of executive and non-executive directors when assessing their exercise of care, skill and diligence. Additionally, clause 20.10 (which was introduced in the second phase of consultation) allows the court to relieve an officer of a company from liability for any misconduct if he has acted honestly and reasonably and ought fairly to be excused having regard to all the circumstances (including those connected with his appointment). The FSTB considers there to be no obvious need for a "safe harbour".

Lastly, some respondents believed that a "business judgment rule" should be adopted to protect directors from liability for bona fide business decisions that subsequently turn out to be mistaken. In response, the FSTB cited the Standing Committee on Company Law Reform, which concluded in 2007 that such a rule is unnecessary. The FSTB believes that the existing common law on review of management decisions is sound.

The FSTB considers all concerns to be adequately addressed and it will not make any changes to the proposal of codifying directors' duty of care, skill and diligence.

## The Second Phase Of Consultation

The second phase of consultation of the draft CB began on 7 May 2010 and ended on 6 August 2010. The consultation conclusions for the second phase of consultation are not yet published. The FSTB aims to introduce the CB into the Legislative Council in late 2010.

*This note constitutes a summary only of the FSTB's Consultation Conclusions on the First Phase Consultation of the draft Companies Bill, which can be viewed on* [*the FSTB's website*](http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccfp_conclusion_e.pdf)*.*

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