

I. INTRODUCTION

“What powers does a company have?” “What can a company do?” “How many shareholders are required to be present at the annual general meetings to form a quorum?” Answers to these questions, as well as to other questions on the constitution of a limited company, are currently to be found in two essential documents called the memorandum of association and articles of association under the Companies Ordinance, Cap 32 (“CO”) of the laws of Hong Kong.

There will be fundamental changes to the constitutional documents required for a company in Hong Kong upon the commencement of operation of the New Companies Ordinance, Cap. 622 (the “New Companies Ordinance”) of the Laws of Hong Kong, when enacted on 3 March 2014. Under the New Companies Ordinance, the memorandum of association is no longer required and a company when it is incorporated will only be required to have articles of association. We will discuss these in details as below.

1.001

II. THE MEMORANDUM OF ASSOCIATION

In General

Currently, under the CO, the memorandum of association and the articles of association are the two important constitutional documents, as they lay down the ambit of power and the constitution of a limited company. We will first examine the memorandum of association, the usual clauses, and then the articles of association. We will also examine the implication of the commencement of the operation of the New Companies Ordinance, upon these constitutional documents.¹

The memorandum of association is required under section 4 of the CO to be subscribed to when a limited company comes to life. Section 4 of the CO states that

“any one or more persons may, for any lawful purpose, by subscribing his or their name or names to a memorandum of association (which must be printed in the English or Chinese language) and otherwise complying with the requirements of the Companies Ordinance in respect of registration, form an incorporated company, with or without limited liability.”

The CO prescribes the various forms of memorandum of association for different types of companies.² The form should be followed as closely as possible. Under the New Companies Ordinance, the requirement of memorandum of association will be abolished; most of the clauses used to be found in the memorandum of association will be moved to the articles of association. The articles of association would become the *only* constitutional document of a company.

The usual clauses commonly found in a memorandum of association under the CO are examined in the following paragraphs.

1.002

¹ The present discussion is premised upon the assumption that the New Companies Ordinance will be come into operation without any amendment.

² CO, s.14.

The Name Clause

1.003

Under the CO, a company must state its name in its memorandum of association.³ A company's name may be in Chinese or English or in both languages. The last word of a company's name should be the word "Limited" or "有限公司" in Chinese.⁴ The format of the name would be the same after the commencement of the New Companies Ordinance.⁵ With the commencement of the New Companies Ordinance, the name of the company must be stated in a company's articles.⁶

A name will not be permitted and accepted by the Registrar of Companies if it is identical to that of an existing Hong Kong company or non-Hong Kong company already registered in Hong Kong. The Registrar of Companies has the power to strike out a company

- whose name bears a striking similarity to the name of an existing limited company, or
- the use of which constitutes a criminal offence or is offensive.

There are other restrictions on the use of certain words in the name of a company:

- any name which, in the opinion of the Chief Executive, would be likely to give the impression that such company is connected in any way with the Central People's Government or the Government of Hong Kong or any department of either Government cannot be used; and
- any word or expression prescribed by the Chief Executive under section 22B of the CO shall only be used if prior approval of the Chief Executive is obtained.

Notwithstanding what has been laid down in the above sections of the CO, it is not the practice, nor is it required, to "obtain the prior approval" of the Registrar of Companies on the use of a particular company name, and the Registrar of Companies will not take a view on whether the proposed company name would be easily confused with the name of another company, before it issues a Certificate of Incorporation or Certificate on Change of Name. However, the Registrar of Companies has discretion to require a company to change its name within 12 months after the issue of that certificate, if in his opinion its name is too similar to that of another company.⁷

Sections 100 and 101 of the New Companies Ordinance continue to maintain such restrictions upon the commencement of the New Companies Ordinance. Under sections 101 and 102 of the New Companies Ordinance, the Financial Secretary instead of the Chief Executive will be empowered to consider the use of the name of a company.

The Financial Secretary has made the Companies (Words and Expressions in Company Names) Order on 29 January 2013 for words to be used.

³ CO, s.5(1).

⁴ CO, s.5(1).

⁵ New Companies Ordinance, s.102.

⁶ New Companies Ordinance, s.81.

⁷ CO, s.22A(1).

The Registrar of Companies has the power to direct a company to change its name pursuant to a court order (section 22(3B) of the CO and section 109 of the New Companies Ordinance). If the company fails to comply with such direction within the specified period, the Registrar of Companies may replace the company name with that of its registration number (section 22AA of the CO). Such powers are preserved under section 110 of the New Companies Ordinance.

The Registered Office

Under the CO, a limited company which is incorporated in Hong Kong has to state in its memorandum of association that "*the Company's registered office is to be situated in Hong Kong*".

Under the New Companies Ordinance, it is no longer mandatory to include the abovementioned registered office clause in the articles of association.

The Objects Clause and the Dilution of the Ultra Vires Doctrine

The objects clause of a company sets out what the company has been set up for. Under the CO, a limited company can include in its memorandum of association the objects and powers it is to be vested with. In addition, the CO provides that a company formed after 30 August 1984 has some additional powers, which can be exercised to achieve its objects. These powers are laid down in Schedule 7 of the CO, unless excluded or modified.⁸

Before the introduction of section 5 of the Companies (Amendment) Ordinance 1997, it was mandatory for every Hong Kong incorporated company to include and set out its objects clause in its memorandum of association. The objects clauses of a company define the capacity of a limited company when it deals with third parties.

A company incorporated under the CO has legal personality only for the purposes laid down in its objects clause. An action carried out by the company outside its objects clause is null and void; and this is described as *ultra vires*. Action *ultra vires* cannot be enforced by either party and cannot be ratified by a company in a general meeting⁹:

The *ultra vires* rule has caused hardships to innocent parties. To avoid these hardships, a commercial practice has been generally developed to extend the objects of a company as wide as possible and independent objects clauses are introduced. Whilst this attempt has tried to address the hardships encountered by innocent parties, it has at the same time has also caused quite a large numbers of disputes and court proceedings.

With the commencement of section 5 of the Companies (Amendment) Ordinance 1997 on 30 June 1997, a company, save and except those companies listed in the CO, is not required to state the objects of such company in its memorandum of association.

Those companies which are required to state their objects clauses in their memorandum upon incorporation¹⁰ are:

- Those companies for which the Registrar of Companies has exercised its power to dispense with the word "Limited" (or "有限公司" in Chinese) in their names pursuant to section 21 of the CO; and

⁸ CO, s.5(5).

⁹ See *Ashbury Railway Carriage and Iron Co Ltd v Riche* (1875).

¹⁰ CO, s.5(1A).

- (ii) Any company which is subject to any other legislation which has prescribed the inclusion of objects clause.¹¹

Under the Companies (Amendment) Ordinance 1997, the doctrine of *ultra vires* was effectively abolished for any company

- incorporated after 30 June 1997 (i.e. the commencement date of section 5 of the Companies (Amendment) Ordinance 1997),
- elects not to have an objects clause.
- By the same amendment, a company has the capacity and the rights, powers and privileges of a natural person.¹²

Notwithstanding the above provision, a limited company can still elect to include an objects clause in its memorandum of association. If the limited company elects to include objects clauses in its memorandum of association, then that company:

- (i) may do anything which it is permitted or required to do by its memorandum of association or by any other legislation or rule of law;¹³
- (ii) shall not carry on any business or do anything that is not authorised by its memorandum of association and shall not exercise any power which is expressly excluded or modified by its memorandum and articles of association;¹⁴ and
- (iii) a member of a company may bring proceedings to restrain the doing of an act in contravention of its stated objects clauses;¹⁵
- (iv) an act of that company (including a transfer of property to or by the company) is not invalid by reason only that it has done anything in contravention to its stated objects clauses.¹⁶

Upon the commencement of the New Companies Ordinance, when the memorandum of association is technically “absorbed” by the articles of association, a limited company, except those companies listed below, can elect to include an objects clause in its articles of association.¹⁷ Those companies which are still mandatorily required to state their objects clauses in their articles of association upon incorporation in accordance with the New Companies Ordinance are:

- (i) Those companies for which the Registrar of Companies has exercised its power to dispense with the word “Limited” (or “有限公司” in Chinese) in their names pursuant to section 103 of the New Companies Ordinance;¹⁸ and

¹¹ CO, s.5(1B).

¹² CO, s.5A(1).

¹³ CO, s.5A(2).

¹⁴ CO, s.5B(1).

¹⁵ CO, s.5B(2).

¹⁶ CO, s.5B(3).

¹⁷ New Companies Ordinance, s.82(2).

¹⁸ Equivalent to CO, s.21.

- (ii) Any company which is subject to any other legislation which has prescribed the inclusion of objects clause.¹⁹

If a limited company does not include an object clause in its articles of association, it will have the capacity and the rights, powers and privileges of a natural person of full age.²⁰ On the other hand, if a limited company elects to include objects clauses in its articles of association, then, that company:

- (i) may do anything which it is permitted or required to do by its articles of association or by any other legislation or rule of law;²¹
- (ii) shall not carry on any business or do anything that is not authorised by its articles of association and shall not exercise any power which is expressly excluded or modified by its articles of association;²² and
- (iii) a member of a company may bring proceedings to restrain the doing of an act in contravention of its stated objects clauses.²³
- (iv) an act of that company (including a transfer of property to or by the company) is not invalid by reason only that it has done anything in contravention to its stated objects clauses.²⁴

The Capital Clause

The memorandum of association includes capital clauses which provides for the share capital of a limited company. This capital clause is a must for a company *limited by capital*; for a company *limited by guarantee* not having share capital, that company is not required to include such a capital clause.

The share capital of a Hong Kong company comprises

- (i) its authorised share capital, which is the maximum amount of its capital that can be issued,
- (ii) its issued capital, which is that amount of the authorised capital which the directors have issued to members and
- (iii) its paid-up capital, which is that amount of the issued capital which the directors resolve should be paid up by the members to whom the shares are allotted.

A company's authorised share capital can be denominated in any currency at the time the company is created. The currency of a company's share capital may be different from the currency in which its books of account are maintained. That requires only a resolution of the directors.

¹⁹ New Companies Ordinance, s.82(3).

²⁰ New Companies Ordinance, s.115(1).

²¹ New Companies Ordinance, s.115(2).

²² New Companies Ordinance, s.116 (1) and (2).

²³ New Companies Ordinance, s.116 (3).

²⁴ New Companies Ordinance, s.116 (5).

The CO only requires a company having a share capital to state in its memorandum of association the amount of its authorised share capital.²⁵ The following capital clause, by way of an example, is sufficient: “the capital of the Company is HK\$10,000 divided into 10,000 shares of HK\$1.00 each”.

There is no prescribed minimum or maximum share capital under the CO. In the past authorised share capital attracts a capital duty at the rate of 0.1 per cent per HK\$1,000 (subject to the amount of the fee so calculated not exceeding HK\$30,000). This requirement is now abolished. There are no more capital duty levied by the Registrar of Companies on the issue of shares whether at par value or at a premium.

The concept of nominal value of share has been removed by section 135 of the New Companies Ordinance. With this change, it is no longer required to set out the nominal value of share in capital clause in a company's constitution document. Instead, a company with a share capital may state the maximum number of shares that the company may issue in its articles of association.²⁶ Further, pursuant section 98(4) of the New Companies Ordinance, to a condition in the memorandum of association of an existing company on the authorized share capital or the par value of the company's shares is regarded as deleted and is not to be regarded as a provision of the company's articles of association.

Other Clauses

Liability of its Member and Initial Shareholding

1.007

The memorandum of association of a limited company (both the companies limited by shares and the companies limited by guarantee) must state that its members' liability is limited.²⁷

If a company is limited by guarantee, its memorandum of association must provide for the members' undertaking to contribute the amount specified under the memorandum of association to the assets of the company upon winding up of such company.²⁸ At the end of the memorandum of association, the initial shareholding of subscribers is set out. Upon the commencement of the operation of the New Companies Ordinance, the liability of members will be contained in the articles of association.²⁹ The members have to set out its initial shareholding in the company's incorporation form.³⁰

Participation of Profit by Non-Member

For a company limited by guarantee not having a share capital, it cannot have a clause in its memorandum of association or articles of association to the effect that any non-member may have a right to participate in the divisible profits of the company. Such a clause shall be void.³¹ The same is provided for under section 99 of the New Companies Ordinance. There is no such provision for other types of companies.

²⁵ CO, s.5(4)

²⁶ New Companies Ordinance s.85(2).

²⁷ CO, s.5(2).

²⁸ CO, s.5(3).

²⁹ New Companies Ordinance ss 83 and 84.

³⁰ New Companies Ordinance s.85.

³¹ CO, s.24.

Manner of Execution

The memorandum of association must be signed by each founder member.

Under the Companies (Amendment) Ordinance 2010, it is no longer required to deliver to the Registrar of Companies a memorandum of association, signed in the presence of a witness, for registration. It is only required to deliver to the Registrar of Companies an unsigned memorandum of association for registration.

As the memorandum of association has been removed by the New Companies Ordinance, therefore it is no longer a requirement to sign and deliver to the Registrar of Companies a memorandum of association for registration.

Alteration to the Memorandum of Association

A memorandum of association is a fundamental and essential document of a company, and that being the case, the memorandum of association cannot be altered except as expressly permitted by the CO.³² The ways in which the memorandum can be altered are set out below.

Name Clause³³

A company may by *special resolution* change its name. That company shall, within 15 days of the passing of the special resolution to change its name, give notice in the specified form of the change of its name to the Registrar of Companies. Upon the issue by the Registrar of Companies of a certificate of incorporation of the change of name, a company can use its new name.

A special resolution is a resolution passed by not less than three quarters of the votes cast by such members.³⁴

The Objects Clause³⁵

A company may, by special resolution, alter its objects clause.

A member of the company who does not agree to the alteration of the object clause can apply to the court to cancel the alteration.

The CO provides that the members of a private company, holding in aggregate of not less than five per cent in nominal value of such company's issued share capital, may apply to the court for an order to cancel the alteration.

An application for cancellation of alteration to the objects clause shall be made within 28 days after the date of the relevant special resolution. If the Court approves the alteration of the objects clause, that private company has to submit a printed copy of its memorandum of association as altered and certified as correct by an officer of the company together with an office copy of the order to the Registrar of Companies within 15 days of the date of the relevant court order. If no opposition to the proposed alteration of its objects clause is raised, and no application has been made to the court to oppose the alteration, the private company has to submit a printed copy of its memorandum of association as altered and certified as correct by an officer of the company to the Registrar of Companies within 15 days of the expiry of the aforesaid 28 day period.

³² CO, s.7.

³³ CO, s.22.

³⁴ CO, s.116.

³⁵ CO, s.8.

1.008

I. DIRECTORS

Scope of Chapter

This chapter covers the classification, appointment, qualification vacation of office, and disqualification of directors. The new Companies Ordinance (Cap.622) comes into effect on 3 March 2014. This is the focus of the chapter although the current regime under Companies Ordinance (Cap.32) is also covered¹. Importantly the new Ordinance introduces a statutory duty of care which replaces the general law. This has been covered too. As for the fiduciary duties of directors this is covered in Chapter 7 below.

6.001

II. CLASSIFICATION OF DIRECTORS

Black's Law Dictionary defines "director" as "[a] person appointed or elected to sit on a board that manages the affairs of a corporation or other organisation by electing and exercising control over its officers".² For our purposes, this definition is somewhat too narrow as under the Companies Ordinance as well as at common law a person who has not been appointed or elected to sit on the board can be treated as a director, as will be seen in the discussion below.

6.002

De jure, de facto and Shadow Directors

In terms of the ways in which a person becomes (to be treated as) a director by law, directors can be classified into appointed directors (or "*de jure* directors"), *de facto* directors and shadow directors. The need for treating a person who is not a *de jure* director as director lies in the necessity for ensuring that persons who exercise the functions of directors do not escape their legal responsibilities by not being formally appointed as director.³

6.003

A person who is appointed or elected to sit on a board of directors becomes a *de jure* director upon the appointment or election. Cap.622 s.2 states that "director" includes any person occupying the position of director by whatever name called. That definition is wider than the one quoted at para.6.002, as a person can occupy the position of director even if he or she has never been appointed to sit on the board. The statutory definition covers *de facto* directors but not shadow directors.

6.004

¹ Companies Ordinance (Cap.32), re-named as Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap.32) upon the commencement of the new Companies Ordinance (Cap.622 on 3 March 2014). The contents of the chapter is largely taken from paragraphs chapters 7 and 8 of Lo and Qu "The Law of Companies in Hong Kong" (Sweet & Maxwell 2013).

² Black's Law Dictionary (8th edn, West Publishing, St Paul, Min, 2004) 492.

³ *Re Hydrodan (Corby) Ltd* [1994] BCC 161; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1; *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565; *Securities and Futures Commission v Mandarin Resources Corp Ltd* (unrep., HCCW 348/1996, [1999] HKEC 688); *Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793 (SC(E)); *Lisa Alford, Neil Money (as Joint Liquidators of Snelling House Limited) v Sally Ann Barton, Philip Barton, Sarah Barton, Solipetit SL* [2012] EWHC 440 (Ch).

De Facto Directors

6.005 The term “*de facto* directors” refers to persons who act as directors of the company, even though they have not been properly appointed as directors.⁴

6.006 In *Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793, Lord Hope endorsed the definition that Millett J formulated in *Re Hydrodan (Corby) Ltd*:⁵

“A *de facto* director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a *de facto* director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company’s affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.”

6.007 This idea of “*de facto* directors” is covered by the s.2 definition of “director” in the Companies Ordinance (which defines a director as including any person occupying the position of director by whatever name called), although the common law concept of *de facto* directors predates the current statutory definition.⁶ Whether a person would be regarded as a *de facto* director would depend on the duties performed by the person in the context of the operations and circumstances of the particular company.⁷ Where a person takes on an active role in top-level management functions, and is reasonably perceived by outsiders dealing with the company as a director, then the person will be treated as a *de facto* director.⁸ All the circumstances of the case must be examined, but it is relevant to look at factors such as whether there was a holding out by the company of the person as a director, whether the person used the title, whether the person had to make major decisions and whether the person had proper information (such as management accounts) on which to base decisions.⁹

6.008 In *Deputy Commissioner of Taxation v Austin*,¹⁰ Madgwick J held the defendant to be a *de facto* director of the company for the purpose of determining his liability for an unfair preference given in favour of Australia’s tax authority. In that case, the defendant had resigned as a director but continued to perform directorial duties such

⁴ *Aktieselskabet Dansk Skibsfart v Wheelock Marden & Co Ltd* (unrep., Court of Appeal, 17 November 1994); *Re Hydrodan (Corby) Ltd (in liq)* [1994] BCC 161, 163, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293 (CFI) (reversed by the Court of Appeal on other grounds). See also Susan Watson and Chris Noonan, “Defining Directorship” <http://ssrn.com/abstract=1695796>.

⁵ *Re Hydrodan (Corby) Ltd* [1994] BCC 161, 163; cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293, CFI (reversed by the Court of Appeal on other grounds).

⁶ The definition was first introduced in the Companies Act 1900 (UK) s.30; and in Hong Kong see Companies Ordinance (No 58 of 1911) s.261. On the historical background to the definition, see *Corporate Affairs Commission v Drysdale* (1978) 141 CLR 236.

⁷ *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565.

⁸ *Ibid.*

⁹ *Re Kaytech Intl Plc, Secretary of State for Trade and Industry v Kaczor* [1999] 2 BCLC 351, 423. See further *Red Label Fashions Ltd* [1999] BCC 308; *Secretary of State for Trade and Industry v Jones* [1999] BCC 330; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1. See also *Holland v Revenue and Customs Commissioners* [2011] 1 All ER 430, [2010] UKSC 51.

¹⁰ (1998) 28 ACSR 565.

as conducting negotiations with creditors (including the tax commissioner) on behalf of the company, countersigning and affixing of the company’s seal, as well as signing company cheques.

In a recent UK case, *Alford v Barton* [2012] EWHC 440 (Ch), Moss QC ruled that the second defendant, who was not an appointed director, was a *de facto* director on the basis that he was the person at the company in a position to prevent damage to creditors by taking proper steps to protect their interests. The things that the defendant did included the handling of VAT issues following the sale of the company’s only property, and withdrawing of the company’s monies (for the benefit of himself, and/or his family and/or his family company).

One of the situations where a person’s liability as a *de facto* director can arise is where a corporate director is interposed between the defendant, who is a *de jure* director of that corporate director, and the subject company. The issue in such a situation is often whether the defendant can be characterised as a *de facto* director where his or her actions can be attributed entirely to the position which he or she occupied *de jure* as a director of that corporate director. Lord Hope answered this question in the negative in *Re Paycheck Services 3 Ltd*, holding that it was impossible to overcome the distinction between a company (the corporate director here) and its directors simply by pointing to the quality of the acts done by the director and asking whether he was the guiding spirit of the subject company. His Lordship agreed with Millett J in *Re Hydrodan* that “for a creditor of the subject company to obtain those remedies (for the defendant’s breach of fiduciary duties) the individual must be shown to have been a director, *not just of the corporate director but of the subject company too* (emphasis added).”¹¹ In *Holland v Revenue and Customs Commissioners*,¹² a 3:2 majority of the UK Supreme Court held that as long as the relevant acts are done by the individual entirely within the ambit of the discharge of his duties and responsibilities as a director of the corporate director, then the individual would not be regarded as a *de facto* or shadow director of the company in which the corporate director is director.

Shadow Directors

Section 2 of Cap.622 defines shadow director as a person in accordance with whose direction or instructions the directors or a majority of directors of the company are accustomed to act.¹³ In *Re Hydrodan (Corby) Ltd*,¹⁴ Millett J held that to establish that the defendant is a shadow director, the plaintiff must allege and prove:

“(1) Who are the directors of the company, whether *de facto* or *de jure*; (2) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act.”

¹¹ *Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793, SC(E); *Re Hydrodan (Corby) Ltd* [1994] BCC 161.

¹² [2011] 1 All ER 430, [2010] UKSC 51, [42], [53]–[54], [96] (sole director of a corporate director of another company held not to be *de facto* director of the latter company for the purposes of liable for misfeasance).

¹³ However, a person is not to be considered as a shadow director by reason only that the directors or a majority of them act on advice given by the person in a professional capacity: Cap.622 s.2 definition of “shadow director”.

¹⁴ [1994] BCC 161,163.

6.012 The concept of a shadow director is different from that of *de facto* director, although in some situations there could be an overlap.¹⁵ The purpose of the notion of shadow director is to identify those with real influence in the corporate affairs of the company, although it is not necessary that such influence should be exercised over the whole field of its corporate activities.¹⁶ A shadow director has been described as like a "puppet master who controls the actions of the board".¹⁷ The influence or control exercised by a shadow director may be strategic in character, defining the context in which, or conditions upon which, the company operates, or else contriving the transactions of significance to the company.¹⁸ For a person to be a shadow director, his or her influence over the board must occur over a period of time and so the mere fact that the directors acted in accordance with the person's instructions on a single occasion would not be sufficient.¹⁹

6.013 A parent company can be held to be a shadow director where its directors give directions to the board of a subsidiary entity and the directors of that entity were accustomed to act in accordance with such directions.²⁰ In *Standard Chartered Bank of Australia Ltd v Antico*,²¹ Hodgson held the parent entity of a company to be the latter's shadow director where the former imposed reporting requirements on the latter, exercised controls over the composition of the board of the latter and had played a decisive role in relation to a number of significant transactions entered into by the subsidiary entity. The board of the child entity in that case simply accepted the decisions of the parent entity in relation to those significant transactions as something necessary or as a *fait accompli*.²²

¹⁵ *Aktieselskabet Dansk Skibsfart nansiering v Wheelock Marden & Co Ltd* [1994] 2 HKC 264; *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340.

¹⁶ *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340.

¹⁷ *Re Unisoft Group Ltd (No 2)* [1994] BCC 766, 775, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sit Hin Olivia* [2009] 3 HKLRD 265, 293, CFI (reversed by the Court of Appeal on other grounds). In *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, Morritt LJ in the English Court of Appeal qualified this by stating that the requirement that the directors are accustomed to act in accordance with the putative shadow director's directions or instructions does not necessarily mean that the directors must have surrendered their own discretion and were simply subservient to the putative shadow director. Morritt LJ considered that if the board were accustomed to act on the directions or instructions of the putative shadow director, it is not necessary to demonstrate that their action was mechanical rather than considered. But for a critique of this approach, see Chris Noonan and Susan Watson, "The Nature of Shadow Directorship: Ad Hoc Statutory Intervention or Core Company Law Principle?" (2006) *Journal of Business Law* 763. Morritt LJ's approach was accepted by Lewison J in *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 but Lewison J also accepted the correctness of earlier case law that held that creditors are entitled to protect their own interests by making demands on the debtor company and that creditors will not be regarded as shadow directors merely because the directors agree to requirements imposed by the creditors. On the latter point, see also *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2010) 77 ACSR 410, [243].

¹⁸ *Australian Securities Commission v A S Nominees Ltd* (1995) 133 ALR 1, 52–53.

¹⁹ *Re Unisoft Group Ltd (No 2)* [1994] BCC 766, 775, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sit Hin Olivia* [2009] 3 HKLRD 265, 293, CFI. In the latter case, a claim that a non-executive director and member of the audit committee of a company was a shadow director of the subsidiary companies was struck out where there was no evidence that she exercised real influence over the affairs of the subsidiaries which were, on the evidence, controlled by the majority family owners of the companies. The CFI decision was reversed by the Court of Appeal on other grounds: [2010] 2 HKLRD 1096.

²⁰ *Re Hydrodan (Corby) Ltd* [1994] BCC 161. See also *Ho v Akai Pty Ltd (in liq)* (2006) 24 ACLC 1526; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2010) 77 ACSR 410.

²¹ (1995) 18 ACSR 1.

²² *Ibid.*, [63].

Types of Directors According to Functions

Managing Director or Chief Executive Officer

6.014 The managing director is a director who is appointed by the board as the company's chief executive officer. A managing director is both a director and a company employee²³ who is conferred, by the directors, with any of the powers exercisable by the directors.²⁴ During his tenure, a director so appointed is often not subject to retirement by rotation or be taken into account in determining the rotation of retirement of directors.²⁵ A typical function of the managing director is to oversee the day-to-day running of the company's business and to supervise other senior executives. The precise role of a managing director is, however, not fixed by law but determined by the terms of his engagement.²⁶

6.015 CEO. The term "chief executive officer" (CEO) is often used nowadays instead of "managing director". The functions of a director appointed as CEO are usually similar to those of managing directors.

Executive Directors and Non-Executive Directors

6.016 Executive directors are full-time employees of the company. Non-executive directors (NEDs) do not have full-time involvement with the company. They are also known as part-time, outside or independent directors. NEDs are often able to provide a perspective that is wider than executive directors in corporate decisionmaking, and they are likely to be more objective and more balanced in thinking.²⁷ NEDs may also be able to protect certain interests within the company or the interest of stakeholders who do not have a voice on the board, such as small shareholders and creditors.²⁸ Another important function of NEDs is that they serve as a check on the executive directors' control of company management.²⁹

6.017 Listed companies, under the Listing Rules, are to appoint at least three independent non-executive directors who represent at least one-third of the board.³⁰ The meaning of independent non-executive directors is defined in Listing Rules r.3.13 and GEM rules r.5.09. There is little doubt that NEDs are subject to the same fiduciary obligations as executive directors.³¹ NEDs are also subject to the duty of care, skill and diligence.

Alternate Directors

6.018 An alternate director is a person appointed to act in the place of a director when the latter is unable to attend meetings or otherwise function as a director. The appointment of an alternate director is possible if the articles of the company authorise a director to do so.³²

²³ *Anderson v James Sutherland (Peterhead) Ltd* [1941] SC 203.

²⁴ Model Articles (public companies) art.33; Cap.32, Table A, reg.111.

²⁵ Model Articles (public companies) art.33(2); Cap.32, Table A, reg.109.

²⁶ *Harold Holdsworth & Co (Wakefield) Ltd v Caddies* [1955] 1 WLR 352, Eng HL.

²⁷ E J Jacobs, "Non-executive directors" (1987) *JBL* 269.

²⁸ *Ibid.*; Saleem Sheikh, "Non-executive Directors: Self-regulation or Codification?" (2002) 23 (10) *Comp Law* 269–270.

²⁹ See fn 27 above, 270.

³⁰ Listing Rules (Main Board), rr.3.10, 3.10A; for Growth Enterprise Market (GEM), rr.5.05, 5.05A.

³¹ *ASIC v Adler* [2002] NSWSC 171 (Confirmed on appeal [2003] NSWCA 131; *ASIC v Vizard* [2005] FCA 1037).

³² See, e.g., Model Articles (private companies) art.28; Model Articles (public companies) art.30. The Table A articles in Cap.32 do not have provisions for alternative directors.

6.019 Unless the company's articles provide otherwise, whether expressly or impliedly, an alternate director is deemed to be the agent of the director who appoints him or her, and the director who appoints the alternate director is vicariously liable for any act committed by the alternate director during his or her office.³³ The alternate director, however, remains personally liable for any act or omission.³⁴ The relevance of whether an alternate director is an agent of the appointor director is illustrated in *Anaray Pty Ltd v Sydney Futures Exchange Ltd* (1988) 6 ACLC 271. In that case, the alternate appointed by a director attended a board meeting and voted for a resolution on a matter on which the appointor director had a personal interest. A number of the articles of the company prohibited directors from voting on proposed resolutions on matters where they had a personal interest. The validity of the resolution that the alternate director voted for was challenged on the basis that the alternate director was disqualified from voting as he was his appointor's agent. The Supreme Court of New South Wales rejected the contention that an alternate director was an agent of his appointor. The basis of the court's decision on this point was that there were no provisions in the articles making an alternate director an agent of his appointor, nor was there any suggestion of any collusion between the alternate and his appointor. If *Anaray* was decided in Hong Kong, the case might have been decided differently because of the effect of Cap.622 s.478, which deems the alternate the agent of the appointing director.

6.020 Generally speaking, an alternate director is treated as being in the same position as any other director and is consequently subject to the normal duties that a director owes to his or her company.³⁵ An alternate director is, however, not subject to directorial duties unless and until he or she has assumed directorial authority. Thus, a person who has been appointed as an alternate director but who has never been called upon to fulfil this role cannot be held liable for breaching of a directorial duty. Under the company's articles an alternate does not have any duty to exercise power until he or she is called upon to fulfil the role.³⁶ Also, an alternate has no status as a director when his or her appointor is present at the meeting.³⁷

Nominee Directors

6.021 At a general level, the term "nominee director" can be used to refer to "persons who, independently of the method of their appointment, but in relation to their office, are expected to act in accordance with some understanding or arrangement which creates an obligation or mutual expectation of loyalty to some person or persons other than the company as a whole".³⁸ In practice, a nominee director can be appointed to represent the interest of a stakeholder, such as a party to a corporate joint venture, the holding company,³⁹ a creditor,⁴⁰ or even employees or a government body.⁴¹

³³ Cap.622, s.478(1) (Cap.32 s.153B).

³⁴ Cap.622 s.478(2).

³⁵ *Markwell Bros Pty Ltd v CPN Diesels Queensland Pty Ltd* [1983] 2 Qd R 508, 519, per Thomas J.

³⁶ *Playcorp Pty Ltd v Shaw* (1993) 10 ACSR 212.

³⁷ *Markwell Bros v CPN Diesels (Qld) Pty Ltd* [1983] 2 Qd R 508; *Playcorp Pty Ltd v Shaw* (1993) 10 ACSR 212.

³⁸ Australia. Companies and Securities Law Review Committee, "Nominee Directors and Alternate Directors" (Report No 8, 1989) 8.

³⁹ *Scottish Co-operative Wholesale Soc Ltd v Meyer* [1958] 3 All ER 66.

⁴⁰ *Levin v Clark* [1962] NSW 686.

⁴¹ Phillip Lipton, et al., *Understanding Company Law* (16th edn, LBC, Pyrmont, NSW 2012) 384.

Reserve Directors

Under Cap.622 s.455, a private company with one member, who is the sole director, may, in general meeting, notwithstanding anything in the company's articles of association, nominate a person (other than the company itself) of 18 years or above to be a reserve director of the company to act in the place of the sole director in the event of his or her death. The nominee will cease to be the reserve director where (i) he or she has resigned from this post, (ii) the company in general meeting has revoked his or her nomination, or (iii) the director in respect of whom the reserve director was nominated has ceased to be the sole director.⁴²

III. QUALIFICATIONS

Generally speaking, the law does not prescribe any minimum professional or educational requirements before persons can act as director. Historically, in the 19th century, directors were not necessarily appointed for their business acumen. For example, well-known figures might be appointed to the board in order to attract investors to the company on the basis of their reputation. Greater managerial abilities are expected of directors of commercial enterprises today,⁴³ but the law only provides for certain minimal qualifications for persons to be appointed as directors.

A natural person can be appointed as director only if the person is of 18 years of age or above.⁴⁴ There is no maximum age limit unless provided for in the articles.

An undischarged bankrupt is prohibited from acting as a director or taking part in the management of a company, either directly or indirectly, without the leave of the court: Cap.622 s.480. A person who contravenes this prohibition commits an offence⁴⁵ and also becomes personally liable for the debts and liabilities of the company incurred at a time when the person was involved in the management of the company in contravention of s.480.⁴⁶ A person against whom a disqualification order has been made is also banned from acting as a company director.⁴⁷ The articles of companies also commonly provide that a director must not be of unsound mind.⁴⁸

Under Cap.32, s.155 provides that where the articles of association of the company impose a share qualification upon the company's directors, the directors who are not so qualified are under an obligation to obtain such qualification within two months with their appointments unless the articles provide a shorter period.⁴⁹ This provision is not reproduced in Cap.622 and is repealed upon the commencement of Cap.622.

⁴² Cap.622 s.455(2).

⁴³ See Chapter 8.

⁴⁴ Cap.622 s.459(1). See also para.6.037 below.

⁴⁵ Cap.622 s.480(2).

⁴⁶ Cap.32 ss.1680(1)(a) and (3)(a). A person who is involved in the management of the company and acts or is willing to act on instructions given by a person who is an undischarged bankrupt will also be personally liable to the extent set out in s.1680(1)(b) and (3)(b). Section 1680 of Cap.32 is not replaced and continues to have effect after the commencement of Cap.622.

⁴⁷ Cap.32 Pt.IVA; Table A reg.90(c). See (Cross ref) for further discussions on disqualification.

⁴⁸ E.g. Model Articles (private companies) art.25(c); Model Articles (public companies) art.27(c); Cap.32 Table A reg.90 (d).

⁴⁹ See also Cap.32 Table A regs.79 and 90(a).

I. INTRODUCTION AND OVERVIEW

Introduction

Profits of the company may be: (a) distributed to shareholders by way of dividends; (b) capitalized for the issue of further shares to shareholders; or (c) simply retained by the company as reserves. The question of whether profits ought to be distributed to shareholders or retained in the company is an important question faced by managers and directors of companies. Whilst creditors lend money to companies on the expectation of a positive return by way of interest over the principal sum, shareholders expect a return in the form of capital growth upon the realization of their shares and/or a share of the profits of the business commonly, in the form of dividends. The first section of this chapter discusses the economic and legal rationales for the distribution of profits by companies to shareholders. This forms the background before examining more closely the legal restrictions on the declaration and payment of dividends by companies. Later sections of this chapter then discuss the actual mechanics involved in the declaration and payment of dividends together with a discussion on the rights and liabilities of shareholders and directors arising from the declaration and payment of dividends. The final section of this chapter deals with where a company decides not to distribute profits but retains the profits in the company's reserves for other purposes.

11.001

Economic Rationale for the Distribution of Profits

Investor Preference for Dividends

Whether investors generally prefer companies to pay out large dividends or would be satisfied with any capital gain upon realization of their shares in the market is a matter that has been hotly debated by the academics. A number of theories have been put forward but no one model is accepted as the correct model or is free from criticisms. It can readily be seen how in practice, this question may bear some importance to finance managers and those charged with raising funds for the business. Understanding investor preference may, for example, ensure the success of raising money through equity and shed light on what is the optimum or target *dividend payout ratio* (percentage of net income paid out as dividend). In particular, for smaller companies and new businesses with more limited access to capital markets and a desire to maintain a heavy debt to equity balance, if shareholders do not prefer to receive dividends or do not place a higher value on companies with high dividend payout, these companies may be better off utilizing their retained earnings as a source of funding.

11.002

The Dividend Irrelevance Theory

One theory advocated by Merton Miller and Franco Modigliani¹ known as the *dividend irrelevance theory* is that the level of dividends declared by the company has no effect on either the price of the company's shares or its costs of capital. A company that retains its earnings and reinvest that sum in the business of the company

11.003

¹ See Merton H. Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," (Oct 1961) *Journal of Business*, 411-433.

would enjoy a growth in earnings and dividends in the future. Those shareholders who want cash can in effect create their own dividend payment by realizing that portion of their investment as desired to capture the growth of the share value of the company. On the other hand, a company that pays out high dividends would retain and reinvest less of the earnings in the business and in theory this reduces the future earnings and dividends payout. The reason given is that if the company wanted to increase dividend payout without changing their investment plans and borrowing, it may issue more shares but there must necessarily be a transfer of value from the old to the new shareholders. The capital loss borne by the shareholders sets off the increased dividend they receive. Hence advocates of the dividend irrelevance theory argue that investors will not place a higher value on companies with high dividend payout. Therefore, companies ought to let dividends fluctuate according to the manager's investment and financing decisions and not be influenced by investor preference for dividends.

Signalling Effect of Dividend Payments

- 11.004 But how do proponents of the dividend irrelevance theory explain the commonplace phenomenon that an increase in dividend is often accompanied by an increase in the price of the shares whilst a dividend cut lead to the fall of the share price? They do so by the theory that there is a *signalling effect* when dividends are declared. By reason of the information asymmetry between those managing the business and the general shareholders, the former obviously with better information about the business and its prospects, higher dividends signal to shareholders that the managers foresee good prospects of higher future earnings. The assumption made however is that directors cannot lie to seek to boost the value of the companies' shares by declaring high dividends notwithstanding the prospects of business is not good as the company does not have the future cash-generating power to maintain any inflated dividends.² However, one empirical study shows the signalling effect of dividend may be less prominent in Hong Kong than in the United States. It has been reported that in Hong Kong dividend payout ratio varies a lot more than in the United States and there is no significant underperformance or out performance whether one year before, during or after dividend cuts or dividend increases respectively.³

Criticisms of the Dividend Irrelevance Theory

- 11.005 The dividend irrelevance theory is now believed to be correct only in an efficient capital market and where one excludes the effect of tax and transaction costs. Even in the absence of any withholding tax on the dividends or capital gains tax in Hong Kong, there will be transaction costs such as brokerage fees and other levies incurred as well as the inconvenience to shareholders in realizing shares in the market for cash. Hence shareholders may prefer dividend payments. Furthermore, the model

² For more on the signalling hypothesis see Brigham and Houston, *Fundamentals of Financial Management*, (Australia: Thomson/South-Western, 10th edn, 2004), pp 527–528.

³ See Thomas J. Chemmanur and Y. Helen Liu, "Dividend Policy: New Insights from a Comparative Study of Hong Kong and the United States", a paper presented at the Third Annual Conference of the Chinese Finance Association, September 1996, New York (http://www.aimhi.com/VC/tcfa/conference/archives/cfa_work.html).

assumes that all shares are readily realizable in the market at a price which reflects the true value of the business of the company. It does not take into account market irrationality. Moreover, in the case of shares of small or private companies, shares are highly illiquid and shareholders who want cash would rely heavily on the payment of dividends.

An Alternative Theory

An alternative theory that has been advanced by academics such as Myron Gordon⁴ and John Linter⁵ is that investors value current dividends more highly than any future capital growth. The reason being is that there is an uncertainty that shareholders will receive capital gain in the future even where profits are retained and reinvested in the business. It also assumes that shareholders can trust the managers of the company to properly employ the retained earnings in pursuing profitable business opportunities or not otherwise enriching themselves through acquisition of assets which cannot be justified or paying huge salary and emoluments to themselves. However, this alternative theory is not without criticisms. One criticism is that investors often reinvest their dividends in companies of similar type rather than to pocket the immediate gain. Another is the observation that often the riskiness of future returns to shareholders is not determined by dividend payout policy but the riskiness of operating cash flows.⁶

A Different Phenomenon for Hong Kong Companies

The interest and preference of shareholders and managers may more be aligned where shares of the company are closely held or family-owned, as is characteristic of many companies in Hong Kong and other South-east Asian economies. An empirical study of Hong Kong listed companies shows that there is no statistically significant relationship between family ownership and dividend policy for all companies sampled generally and for large market capitalization firms. For small market capitalization firms, there is a negative relationship between dividend yield (dividend per share divided by share price) and family ownership (percentage of shares held by controlling family) up to 10 per cent of the company's stock but a positive relationship for firms with greater family ownership between 10 to 35 per cent.⁷ The positive relationship in small firms has been explained as being due to investors demanding a higher dividend payout from companies with potentially the highest risk of expropriation of minority shareholders or alternatively, the larger payouts representing the extraction of company resources by the controlling family shareholders who empirically receive a large amount of dividend income.

⁴ Myron J. Gordon, "Optimal Investment and Financing Policy", (May 1963) *Journal of Finance*, 264–272.

⁵ John Linter, "Dividends, Earnings, Leverage, Stock Prices, and the Supply of Capital to Corporations, *Review of Economics and Statistics*, 243–269.

⁶ See Brigham & Houston, *Fundamentals of Financial Management*, 10th ed. (Australia: Thomson/South-Western, 2004), p 524.

⁷ Zhilan Chen, Yan-Leung Cheung, Aris Stouraitis, Anita W.S. Wong, "Ownership Concentration, firm performance and dividend policy in Hong Kong", (2005) 13 *Pacific-Basin Finance Journal* pp. 431–449. See in particular pp 443–447.

11.006

11.007

Legal Rationale for the Regulation of Distribution

Capital Maintenance

- 11.008 If, as some economic theories suggest and empirical data shows, shareholders like dividends, one would have thought that the question of whether profits are distributed and the amount to be distributed is best left to the better judgment of those charged with running the business. Yet it is not a purely commercial decision as the law regulates the distribution of profits by companies to their shareholders by restricting the funds out of which the distribution may lawfully be made. In effect, this restricts the level of dividends that may be declared by the company. The need for the law to regulate distributions by companies stems from a fundamental principle of company law that capital must be maintained. It is often said the principle of capital maintenance is the price to be paid for limited liability by choosing to incorporate a company for the carrying of business activities. The capital maintenance principle⁸ as traditionally understood restricted: (a) the use of capital otherwise than for properly pursuing the objects of the company; and (b) the return of capital to shareholders unless with the sanction of the court. An often cited passage explaining the rationale for the need to maintain capital is that of Lord Watson in *Trevor v Whitworth*:⁹

“One of the main objects contemplated by the legislature, in restricting the power of limited companies to reduce the amount of their capital as set forth in the memorandum, is to protect the interests of the outside public who may become their creditors. In my opinion, the effect of these statutory restrictions is to prohibit every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the Court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company’s trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of business.”

The Implied Contract

- 11.009 Before express statutory regulations were introduced into this area of the law, the courts resorted to the notion of an implied contract between the company and its creditors to justify the protection afforded to creditors in prohibiting payment of dividends out of capital. It is said that creditors dealing with the company or otherwise advance money to companies with limited liability are entitled to rely on the faith of an implied representation by the company that capital is only applied for the purposes

⁸ For further discussion on capital maintenance see [Part 2].

⁹ (1887) 12 App Cas 409 at 423–424.

of the business and not returned to its shareholders. As explained by Jessel MR in *Re Exchange Banking Co, Flitcroft’s Case*:¹⁰

“A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business. It cannot reduce its capital except in the manner and with the safeguards provided by statute, and looking at the Act 40 and 41 Vict c 26, it clearly is against the intention of the Legislature that any portion of the capital should be returned to the shareholders without the statutory conditions being complied with. A limited company cannot in any other way make a return of capital, the sanction of a general meeting can give no validity to such a proceeding, and even the sanction of every shareholder cannot bring within the powers of the company an act which is not within its powers. If, therefore, the shareholders had all been present at the meetings, and had all known the facts, and had all concurred in declaring the dividends, the payment of the dividends would not be effectually sanctioned. One reason is this - there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, that persons dealing with the company give it credit. The creditor has no debtor but that palpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders...”

II. THE REGULATION OF DISTRIBUTION BY COMPANIES

The Common Law

General Rule

Before statutory provisions were introduced to regulate the distribution of profits by a company, the general principle at common law was that dividends must not be paid out of capital.¹¹ This prohibition was said to be implicit even where the memorandum and articles of association of the company do not expressly prohibit the payment of dividends out of capital.¹² Even where the articles of the company purport to allow payment of dividend out of capital, such an article would be invalid.¹³ Nor can shareholders sanction the payment of dividends out of capital.¹⁴ Before the introduction of statutory rules expressly governing the distribution of profits, the prohibition against the payment of dividend out of capital was held to be implicit. The courts

11.010

¹⁰ (1882) 21 Ch D 519 at 533–534.

¹¹ See eg *Re Exchange Banking Co Flitcroft’s Case* (1882) 21 Ch D 519 at 533–534.

¹² *Guinness v Land Corporation of Ireland* (1883) 22 Ch D 349.

¹³ *Harmer v General and Commercial Investment Trust* [1894] 2 Ch 239.

¹⁴ *Re Exchange Banking Co Flitcroft’s Case* (1882) 21 Ch D 519 at 533.

have explained that it would be contrary to the legislative provisions against the return of capital to shareholders to allow the distribution otherwise than out of profits.¹⁵ Nor can shareholders at a general meeting sanction the payment of dividend out of capital.¹⁶

The Distinction Between Profits and Capital

- 11.011 Although at common law the distinction was often drawn between profits and capital, it is probably more correct to say, the prohibition was that dividends cannot be paid out of capital and not that it must only be paid out of profits, though the latter requirement was commonly found in the articles of association of companies. As was pointed out by Farwell J in *Bond v Barrow Haematite Steel Co*:¹⁷

“...the law (1) that dividends must not be paid out of capital, and (2) that dividends may only be paid out of profits - are not identical, but diverse. The first is the requirement of the statutes, and cannot be dispensed with; the latter is in Table A or the articles of the particular company, and is one of the regulations of this company which has to be construed. A company which has a balance to the credit of its profit and loss account is not bound at once to apply that sum in making good an estimated deficiency in value of its capital assets. It may carry it to a suspense account or to reserve, and if the assets subsequently increase in value the amount neither has been nor will be part of the capital. If, therefore, a part of that balance is used in paying a dividend, that dividend is not paid out of capital, because the sum has never become capital, although it still remains a question whether it has been paid out of profits or not. It has been pointed out by Lindley LJ in *Lee v Neuchatel Asphalt Co*¹⁸ that there is nothing in the statutes requiring a company to keep up the value of its capital assets to the level of its nominal capital. The requirement is merely negative, that dividends shall not be paid out of capital, and the balance to the credit of profit and loss account does not automatically become part of the capital assets because the value of the actual capital assets has depreciated to an amount equal to or exceeding that balance.”

Accordingly, at common law, the payment of dividend out of share premium account was held not to be capital and could be lawfully made.¹⁹

Non-Cumulative

- 11.012 Another matter to note about the common law rule is that there was no requirement that trading losses made in the previous years had to be taken into account in determining whether there were profits available for distribution.²⁰ The financial position of the company was therefore looked at in isolation each year. Notwithstanding huge losses

¹⁵ *Verner v General And Commercial Investment Trust* [1894] 2 Ch 239 at 264.

¹⁶ *Re Exchange Banking Co Flitcroft's Case* (1882) 21 Ch D 591.

¹⁷ [1902] 1 Ch 353 at 365.

¹⁸ (1889) 41 Ch D 1.

¹⁹ *Drown v Gaumont-British Picture Corp Ltd* [1937] Ch 402.

²⁰ See eg *Ammonia Soda v Chamberlain* [1918] 1 Ch 266 at 289.

may have been incurred in the past, so long as there were profits for the year in which dividends are proposed, such profits could be properly distributable.

No Requirement to take into Account Losses

At common law, there was no rule which required any loss in capital to be made good before profits could be distributed unless the articles so required²¹ so long as there were profits to distribute when the whole of the accounts were fairly taken into account.²² On the other hand, though profits could be distributed notwithstanding a loss in capital, any loss in revenues could not be made good by any appreciation in capital and used for distribution.²³ This follows from the strict segregation between the capital and revenue accounts maintained by the court in previous cases.

11.013

No Distinction Between Realized and Unrealized Profits and Losses

There was also no requirement to distinguish between realized and unrealized profits for the purposes of determining what profits were distributable, which as will be seen later is no longer the case by reason of the distinction now introduced by statute. At common law, any increase in the value of capital could be realized and distributed as profits and not capital.²⁴ Even unrealized profit was said to be properly distributable.²⁵

11.014

The Problem with the Common Law Rule

As already has been mentioned, the distinction between capital and profits was thus important in previous cases in determining whether a distribution can be made. However, courts often lamented on the difficulty of such a distinction and emphasized that cases were decided on the specific facts of each case such that no easy rule can be drawn from previous cases. In *Dovey v Cory*,²⁶ Earl of Halsbury LC thus remarked: “It is easy to lay down as an abstract proposition that you must not pay dividends out of capital; but the application of that very plain proposition may raise questions of the utmost difficulty in their solution.” Fortunately, the previous case law and the distinction between capital and revenue can now happily be disregarded with the introduction of statutory provisions in the CO which now governs the distribution of profits by a company.

11.015

The Companies Ordinance

Legislative History

The regulation of distribution of profits by companies by legislation was first introduced when the former Part IIA (sections 79A to 79P) of the CO was added by Companies (Amendment) Ordinance 1991, was passed on 4 July 1991 and became effective as of

11.016

²¹ *Verner v General Investment Trust* [1894] 2 Ch 239

²² *Foster v New Trinidad Lake Asphalt Co Ltd* [1910] 1 Ch 208.

²³ *Hall v London & Provincial Trust Ltd* [1920] 1 Ch 45.

²⁴ *Ibid.*, citing *Lubbock v British Bank of South America* [1892] 2 Ch 198 in approval. See also *Cross v Imperial*

Continental Gas Association [1923] 2 Ch 553.

²⁵ *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] 2 WLR 253.

²⁶ [1901] AC 477 at 487.