partnership can carry on business under the names of its partners or under some business name registered under the Ordinance.

3.3.4 *Nature of a partnership*

1.042 **Partnership not a legal entity separate to its members.** A partnership might be referred to as a "firm", but a partnership is not a legal entity that is separate from its members (the partners). This is illustrated by some of the principles below dealing with the legal rights and liabilities of partners.

3.3.5 *Partnership property*

1.043 **Partnership property and separate property: different treatment.** Property used for the purposes of the partnership business can be categorised either as partnership property (belonging to all the partners) or separate property belonging solely to one or more individual partners. It is important to ascertain whether property is partnership property or not—for example, because partnership property must be applied exclusively for the purposes of the partnership and in accordance with the partnership agreement;[51] and treatment of the property on a winding-up of the partnership (or upon bankruptcy of individual partners) differs depending on whether the property is partnership property or not.[52]

1.044 **Partnership property jointly owned by partners.** Where property is partnership property, the property is not owned by any entity separate from the partners. Rather, the property is owned jointly by the partners, with each having a form of equitable proprietary interest in the partnership assets.[53]

1.045 **Ascertaining whether property belongs to the partnership.** Whether property is partnership property or not is ascertained from either the express agreement of the parties or by reasonable inference from the manner in which the partners have dealt with the property during the subsistence of the partnership.[54]

1.046 ***Miles* case: in absence of express or implied agreement court will only treat property as "partnership property" if required to give business efficacy to arrangements.** In *Miles v Clarke*,[55] a fashion photography business was operated as a partnership between the plaintiff and the defendant. When the business was wound up, it was necessary to ascertain who was entitled to which assets used in the business. There was no express agreement between the partners whether the assets were partnership property or not. The court held that in the absence of express agreement and any other indications of an implied agreement, the court will treat property brought by each of the parties into the business as partnership property only as far as necessary to give business efficacy to the arrangements. In this case, the court took the view that for the business to operate, the stock in trade of the business (such as film) must be the property of the partnership.

[51] Partnership Ordinance s.22.

[52] See Bankruptcy Ordinance (Cap.6) s.38(7).

[53] See *Popat v Schonchhatra* [1997] 3 All ER 800; *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321; *Federal Commissioner of Taxation v Everett* (1980) 54 ALJR 196.

[54] See *Miles v Clarke* [1953] 1 All ER 779; *Law Chou Shing & Anor v Chow Wing Kun & Anor* [1994] 2 HKC 531; *Kelly v Kelly* (1990) 92 ALR 74.

[55] [1953] 1 All ER 779.

However, ownership of other assets could have remained with the original owner. Thus, the defendant, who had originally operated the business on his own account, and who had originally acquired a lease of premises for the business, and had provided the equipment and furniture for the business, was entitled to those assets (not being partnership property). Goodwill brought by the plaintiff to the partnership remained the property of the plaintiff. It was not necessary for these assets to be treated as assets of the partnership business in order for the business to operate. For example, the partnership can be regarded as being entitled to use of the premises for the business on the basis of a licence granted by the defendant.

1.047 ***Law* case: facts.** In *Law Chou Shing & Anor v Chow Wing Kun & Anor*,[56] a Mr Law set up a business in the timber trade. Mr Lam and Mr Chow became partners in the business. In 1988 Mr Chow purchased residential premises in Tai Po—he intended to live in those premises with a Miss Poon whom he was to marry. The property was purchased in the names of Mr Chow and Miss Poon, but was to be in the first instance paid for by the partnership under the following arrangement: the partnership was to make the loan repayments to the mortgagee under a mortgage obtained for the purchase of the property; at the same time, the amount of the loan repayments was to be debited in an account between Mr Chow and the partnership. Under these arrangements, ultimately Mr Chow would need to effectively make the payments. Similar arrangements were already in place with the partnership for certain property owned by Mr Law.

1.048 ***Law* case: in absence of express agreement intentions and actions of parties critical to determining what constitutes partnership property.** Subsequently, the partnership broke down, and a dispute arose whether the Tai Po premises were partnership property or not. There was no express agreement on this matter. The court examined various factors in ascertaining the implied agreement of the parties, and concluded that the parties' intentions were that the property would be the separate property of Mr Chow and Miss Poon (and not partnership property). The court took into account the following factors:

- The attitude of Mr Chow and Miss Poon as to the decorations in the flat when they purchased it. The evidence was that they had chosen the flat because the existing decorations were adequate and it was not necessary for extra spending to re-decorate the place. This indicated the parties' intentions that Mr Chow and Miss Poon were to bear the costs in relation to the flat and that the premises were to be theirs.
- In the partnership accounts, debits were made to Mr Chow's account with the firm with the effect that Mr Chow would ultimately pay for the cost of the purchase. This was the same treatment in the accounts as for Mr Law's own residential property.
- When the partnership had entered into difficulty, the partners had arranged for the Tai Po property to be mortgaged under an all-monies mortgage with funds being used for the partnership. Miss Poon had been very reluctant about this

[56] [1994] 2 HKC 531.

expressed concerns that the restrictions on disclosure would seriously harm investigative journalism and the uncovering of fraud by directors. For the time being the provisions on restriction of access to residential addresses and identification numbers will not commence when the rest of Cap.622 commences operation in 2014. The Government will revisit the issue at a later stage.[220]

5.4.3 *Pt.3—Company formation and related matters, and re-registration of company*

1.134 **Incorporation and basic requirements for companies.** This Part covers incorporation of companies and basic requirements of companies. The memorandum of association is abolished,[221] and the constitution will simply be comprised of the articles of association. Part 3 also contains provisions on company names, corporate capacity and execution of documents. It will no longer be compulsory for companies to have a company seal,[222] and so there are also new provisions for execution of documents without a seal.[223] There are new provisions for a statutory indoor management rule,[224] based on the UK provisions, although the common law indoor management rule is not abolished.[225]

1.135 **Re-registration.** The provisions on re-registration of companies in Pt.3 are derived from the existing law, dealing with conversion of unlimited companies to a company limited by shares.

5.4.4 *Pt.4—Share capital*

1.136 **Provisions on shares.** Part 4 contains provisions on shares, allotment and transfers, transmissions of shares, share certificates, certain alterations to share capital and class rights.

1.137 **Changes to provisions on shares.** Important changes include abolition of par or nominal value of shares;[226] abolition of bearer shares[227] and stock;[228] new provisions enabling transferors or transferees to require the company to give reasons for any refusal by the directors to register a transfer of shares;[229] and extension of the provisions on class rights to companies without share capital.[230]

[220] See the paper of the Financial Services and Treasury Bureau tabled before the Legislative Council Panel on Financial Affairs, "New Arrangements for the Inspection of Personal Information on the Companies Register under the new Companies Ordinance" (LegCo paper CB(1)788/12–13(01)) (28 March 2013). Pursuant to LN 30 of 2013, the following provisions will not commence operation when the rest of Cap.622 commences on 3 March 2014: s. 27(3), (4), (5) and (6) in so far as it relates to a director or reserve director; ss. 47, 49-52 and subdiv.2 of Div.7; s. 643(l)(a)(ii), (2)(b) and (3)(b) in so far as it relates to a correspondence address; s.643(5), 644, 645, 647(4) and (5), 651 and 657(2)(g); ss.791(4), 802(4)-(5); Sch.2 ss.3(1)(a)(iii) and (2); Sch.6 ss.3-4; Sch.11 s.1.

[221] See Cap.622 s.98.

[222] Cap.622 s.125.

[223] Cap.622 s.127(3).

[224] Cap.622 ss.117–119.

[225] See further Chapter 12

[226] Cap.622 s.135.

[227] Cap.622 s.139. Bearer shares in existence before the commencement of Cap.622 can continue to exist.

[228] Cap.622 s.138. Stock already in existence before the commencement of Cap.622 can continue to exist.

[229] Cap.622 s.151.

[230] Cap.622 ss.185–192.

5.4.5 *Pt.5—Transactions in relation to share capital*

1.138 **Provisions on changes to share capital.** This Part sets out the provisions on reduction of capital; redeemable shares; share buy-backs; and financial assistance for acquisition of company's shares.

1.139 **Capital maintenance doctrine retained but new wider exceptions.** The capital maintenance doctrine is retained under Cap.622, but greater flexibility is provided for companies by the enactment of new exceptions to the doctrine. The new exceptions set out in Pt.5 are based on a solvency test. Part 5 retains the existing procedures for a company to engage in a reduction of capital or redemption or buy-back of shares, but there are also new provisions enabling: (a) capital reductions to be made without the need for court approval if the company would remain solvent after the capital reduction; and (b) redemption or buy-back of shares out of capital if the company would remain solvent following the share redemption or buy-back.

1.140 **Prohibition on financial assistance maintained but new exceptions.** The prohibition on a company giving financial assistance for an acquisition of shares in the company is retained in Cap.622. New exceptions are provided, based again on the solvency test.

5.4.6 *Pt.6—Distribution of profits and assets*

1.141 **Dividends and distributions to shareholders.** Part 6 largely restates the provisions on dividends and distributions to shareholders under Pt.IIA of the predecessor Ordinance (Cap.32). As the capital maintenance doctrine is retained, the general principle of dividends out of profits only is retained.

5.4.7 *Pt.7—Debentures*

1.142 **No major changes for debentures.** There are no major changes to the existing law on registers of debenture holders. The predecessor Ordinance (Cap.32) contains some provisions covering both shares and debentures (in relation to transfers etc.). Cap.622 separates out the provisions so that the provisions for debentures are contained in Pt.7. Also, to align with provisions for share allotments, there are some new provisions imposing a requirement for sending a return of allotment of debentures to the Registrar[231] and setting out the time period for registration of in the company's own register of debenture holders.[232]

5.4.8 *Pt.8—Registration of charges*

1.143 **Current registration system retained with some significant changes.** Part 8 is the equivalent of the predecessor Cap.32 Pt.III. The pre-existing charges registration system is largely retained in Cap.622. However, there are some significant changes. For example, there is some modification to the list of registrable charges.[233] The instrument of charge is also to be registered,[234] and this would impact on the matters on which

[231] Cap.622 s.316.

[232] Cap.622 s.317.

[233] See Cap.622 s.334.

[234] Cap.622 ss.335 and 344.

interests involved.[386] Organic models likewise have been criticised, with some commentators arguing that the reification of the company takes the analogy of natural persons too far, leading to erroneous legal arguments.[387]

1.212 **Theories about corporate governance.** Corporate theories have also been developed in other areas of company law, including in relation to corporate governance and corporate social responsibility. Corporate governance looks at the laws and systems for the managing of companies, in particular management of companies in a way that serves the interests of the shareholders. Corporate governance theories[388] examine the mechanisms for achieving optimal alignment between the interests of managers and the owners of companies, including both internal governance structures, such as board composition or shareholder monitoring,[390] and external mechanisms, such as the so-called market for corporate control.[391] Much corporate governance literature in the United Kingdom and United States has traditionally focused on the agency problem that arises from a separation between management and ownership (arising from a dispersed ownership structure). However, large companies in other countries, including in Asia and continental Europe, often do not exhibit this feature of separation between management and ownership (e.g. family-controlled companies),[393] and so different concepts of corporate governance may be needed for differently structured companies.[394]

1.213 **Corporate governance theories have developed to include examination of how to manage companies in interests of wider community known as corporate social responsibility.** In recent decades, corporate governance theories have developed from simply examining the interests of shareholders to examining the way in which the management of companies in the interests of others and the wider community. This is the idea of corporate social responsibility (CSR).[395] Advocates for CSR have proceeded on different theoretical foundations of the company. For example, stakeholder, communitarian or pluralist theories have been proposed, which emphasise that persons other than shareholders (such as creditors, employees, consumers) should also be regarded as legitimate stakeholders companies whose interests need to be

386 Paddy Ireland, "Property and Contract in Contemporary Corporate Theory" (2003) 23(3) *Legal Studies* 453; Michael J Whincop, "Form, Function and Fiction: A Taxonomy of Corporate Law and the Evolution of Efficient Rules" (2001) 24 *University of New South Wales Law Review* 85.

387 M Wolff, "On the Nature of Legal Persons" (1938) 54 *Law Quarterly Review* 494.

388 See also Chapter 8.

389 See, e.g., Donald C Langevoort, "The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability" (2001) 89 *Georgetown Law Journal* 797.

390 See, e.g., Lucian A Bebchuck, "The Case for Increasing Shareholder Power" (2005) 118 *Harvard Law Review* 833.

391 See, e.g., Henry G Manne, "Mergers and the Market for Corporate Control" (1965) 73 *Journal of Political Economy* 110; Michael C Jensen, "Takeovers: Their Causes and Consequences" (1988) 2 *Journal of Economic Perspectives* 21.

392 Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (revised edn., Harcourt, New York 1968); E Herman, *Corporate Control, Corporate Power* (CUP, New York, 1981).

393 See, e.g., L Bebchuk and M Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford Law Review* 127.

394 See, e.g., Philip Lawton, "Berle and Means, Corporate Governance and the Chinese Family Firm" (1996) 6 *Australian Journal of Corporate Law* 349.

395 See generally J E Parkinson, *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993); L E Mitchell (ed.), *Progressive Corporate Law* (Westview Press, Boulder, 1995).

protected.[396] Team production theories have been adopted by others to lead to similar conclusions in relation to corporate social responsibility.[397]

7.3 Economic analysis of law

1.214 **Legal theories based on the "law and economics" perspective.** Legal theories from the "law and economics" perspective have been influential in corporate law jurisprudence in the United States. Broadly, the economic analysis of law stresses the role of the law in achieving efficiencies, in reducing costs, and in maximising social wealth.[398] Principles of law are justified or assessed against the criterion of efficiency. One basic question (under the hypothetical bargaining model) that is asked in determining efficiency is whether the law provides the rules that the parties would create for themselves if they had perfect information.[399] For instance, with respect to directors' duties owed to creditors and wrongful or insolvent trading statutory provisions, the hypothetical bargaining model has been applied to argue that the legal rules are inefficient.[400] In other areas, existing principles of company law have been explained and rationalised on the basis that they do provide efficient rules. For example the doctrine of limited liability of shareholders has been defended on the grounds of efficiency—through the lowering of monitoring costs, the allowing of a more efficient diversification for investors thereby lowering costs of raising capital, and through the notion that the creditors are the most efficient risk-bearers.[401] In relation to corporate governance, common law principles of fiduciary duties imposed on directors have been explained and justified as being required for the reduction of agency costs to ensure that the interests of management and shareholders are aligned.[402] Other areas where economic analysis has been applied include aspects of corporate governance such as employee participation, the role of non-executive directors, and executive remuneration; corporate finance, share buy-backs, mandatory disclosure obligations, shareholder remedies, shareholder voting rights, takeovers and securities markets regulation.[403]

396 See, e.g., W M Evan and R Edward Freeman, "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism" in T L Beauchamp and N E Bowie (eds.), *Ethical Theory and Business* (4th edn, Prentice Hall, Englewood Cliffs, 1993), pp 75–84; L E Mitchell (ed.), *Progressive Corporate Law* (Westview Press, Boulder, 1995).

397 See M M Blair and L A Stout, "A Team Production Theory of Corporate Law" (1999) 85 *Virginia Law Review* 247; L E Mitchell, "A Critical Look at Corporate Governance" (1992) 45 *Vanderbilt Law Review* 1263.

398 See, e.g., Richard Posner, *Economic Analysis of Law* (6th edn, Aspen, New York, 2003); D A Wittman (ed.), *Economic Analysis of the Law* (Blackwell Publishing, Malden, 2003).

399 Frank H Easterbrook and Daniel R Fischel, *Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991) vii; Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) Ch 6.

400 Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997) 528–553.

401 Frank H Easterbrook and Daniel R Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 89; and see also S E Woodward, "Limited Liability in the Theory of the Firm" (1985) 141 *Journal of Institutional and Theoretical Economics* 601.

402 See, e.g., R Cooter and B J Freedman, "The Fiduciary Relationship: Its Economic Character and Legal Consequences" (1991) 66 *New York University Law Review* 1045; Frank H Easterbrook and Daniel R Fischel, *Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991) 90–93.

403 See generally Frank H Easterbrook and Daniel R Fischel, *Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991); Roberta Romano (ed.), *Foundations of Corporate Law* (Oxford University Press, New York, 1993); Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press, Oxford, 1997); William W Bratton (ed.), *Corporate Law* (Ashgate, Aldershot, 2000); Michael J Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (Ashgate, Aldershot, 2001).

- Realist or natural entity theories: Realist or natural entity theories conceive of the company as an association of persons that is a real or natural entity (as opposed to being a purely artificial entity created by statute).[38] Such an association has attributes not found among the humans who are its components. The company is not simply an artificial entity; the statutory recognition of companies as legal entities simply reflects the reality of companies having an independent existence. Some natural entity theorists equate the corporate entity as being a real person analogous to individuals and hence may have moral or legal rights and duties in the same way as natural persons. Other natural entity theorists focus on the group nature of companies. One possible implication of such a focus is that it is necessary to take into account organisational theory in looking at group responsibility.

- Organic theories: A related theory to realist theories is the organic theory. This theory conceives of a company as an organic entity—i.e. the company is likened to a living organism, with natural persons acting as parts of the body corporate. This concept of the company has been used to describe the nature of the board of directors and the general meeting of shareholders—each of these is regarded as independent organs of the company with their own areas of power in relation to decision-making for the company.[39] Thus, the board of directors are not agents of the shareholders, but is a corporate organ itself. The organic conception of the company also underlies the principles of attribution which refer to the "directing mind and will" of companies.[40]

- Contractual theories[41]: These theories focus on the contractual arrangements between the persons behind the company—i.e. the memorandum[42] and articles of association (which have contractual effect between the company and the shareholders). On one view of the company, the corporate entity is no more than a "nexus of contracts"—i.e. contracts between shareholders, directors, employees and creditors. One conclusion that might follow from this conception of the company is that there should be minimal government regulation of companies, as the rights and liabilities of the parties are simply matters of private bargaining between the persons concerned.

[38] See Morton J Horwitz, "*Santa Clara* Revisited: The Development of Corporate Theory" (1985–1986) 88 *West Virginia Law Review* 173; Michael J Phillips, "Reappraising the Real Entity Theory of the Corporation" (1993–1994) 21 *Florida State University Law Review* 1061; Michael J Phillips, "Corporate Moral Personhood and Three Conceptions of the Corporation" (1992) 2 *Business Ethics Quarterly* 435.

[39] See Chapter 6.

[40] See Chapter 12.

[41] See Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; William W Bratton Jr, "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 *Cornell Law Review* 407; Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Cambridge, Harvard University Press, 1991); Melvin A Eisenberg, "The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm" (1999) 24 *Journal of Corporation Law* 819; Margaret M Blair and Lynn A Stout, "Team Production in Business Organizations: An Introduction" (1999) 24 *Journal of Corporation Law* 743.

[42] Under Cap.622, the memorandum is abolished (see Chapter 2), but the contractual analysis can still apply in relation to the company's constitution (composed of the articles).

6. Piercing the Corporate Veil

6.1 General

Separate entity and limited liability can be abused. Although benefits flow from the doctrines of separate entity and limited liability, the combination of these doctrines can undoubtedly be abused. For example, creditors of a company can be prejudiced where a company is deliberately undercapitalised so that it does not have sufficient funds to meet the claims of creditors, or where assets are removed from the company for the purpose of defeating creditors' claims. Trading frauds are not uncommon, both locally and overseas.[43] In Hong Kong, controversies have arisen, for instance, where owners of restaurants (operated through a company) close down their businesses, leaving wages and other debts unpaid, only to open up similar businesses through a new company shortly after.[44] Strict application of the separate entity and limited liability doctrines would mean that the "real" owners[45] of the businesses are able to profit from the enterprises of the company while evading the legal liabilities of the businesses to the detriment of creditors. 3.023

To prevent abuse corporate veil can be lifted: rights or liabilities of company are treated as rights or liabilities of persons behind company. To prevent abuse of the separate entity and limited liability doctrines, the law provides certain mechanisms via both the common law and statute to look through the corporate form to impose the company's liabilities on persons behind the company (usually shareholders or directors of the company). Such mechanisms are referred to as "lifting" or "piercing" of the corporate veil. The terms "lifting of the corporate veil" and "piercing of the corporate veil" are often used interchangeably, and no distinction is made between these terms in this chapter.[46] The doctrine of "lifting" or "piercing" of the corporate veil is used in this chapter to refer to principles where rights or liabilities of the company are treated as rights or liabilities of persons behind the company (shareholders or directors), or vice versa, by disregarding the separate personality of the company.[47] Whatever term is used (whether "lifting" or "piercing"), it is important to distinguish such principles from other principles which do not involve the disregarding of the corporate veil in the above manner. Where, for example, a corporate entity is used to conceal the real actor or to conceal the real relationship between the parties, but where the court uses principles of agency or trust law to impose liabilities of the company onto its controllers or to treat 3.024

[43] See, e.g., Arie Freiberg, "Abuse of the Corporate Form: Reflections from the Bottom of the Harbour" (1987) 10 *University of NSW Law Journal* 67.

[44] See *Man Yee (a firm) v Chi Tao Enterprises Co Ltd* [1986] HKLR 171; Diana Lee, "Restaurant Boss Escapes Prison Over Unpaid Wages" *The Standard* (29 August 2008).

[45] From the legal perspective, the ultimate controllers of the businesses (shareholders/directors of the companies) do not own the business, but the economic reality is otherwise.

[46] However, some commentators use the terms to refer to different aspects of going behind the corporate form: see S Ottolenghi, "From Peeping Behind the Corporate Veil, to Ignoring it Completely" (1990) 53 *Modern Law Review* 338.

[47] See *Prest v Petrodel Resources Ltd* [2013] UKSC 34, [16]. See also *VTB Capital Plc v Nutritek Intl Corp* [2013] 1 All ER 1296 (UKSC), [118]–[119]. In *Maritime Co SA v Avalon Maritime Ltd (No 1)* [1991] 4 All ER 769, 779, Staughton LJ refers to this as a true "piercing" of the corporate veil. His Lordship's view is that the term "lifting" of the corporate veil should be confined to circumstances where one merely looks behind the corporate form to have regard to the shareholding in a company for some legal purpose.

2. The Common Law Position

4.004 **Company cannot be bound by any pre-incorporation contracts.** A company in formation does not have the capacity to make contracts and therefore is unable to appoint an agent. It follows that nobody can contract as the agent of a company before the latter's incorporation.[8] The company, once incorporated, is unable to ratify a contract purportedly entered into on its behalf, since ratification can only be effected by a person ascertained at the time of the act done.[9] For the same reason, the company is not bound by a pre-incorporation contract purportedly made on its behalf, nor can the company sue upon the contract.[10]

2.1 Intention and knowledge

4.005 **Where both parties are aware company not incorporated and enter into pre-incorporation contract such contract may still be binding.** The courts have developed a set of rules based on the parties' intention, which can be imputed on the basis of the parties' knowledge as to the existence of the company as they are unable to use the concept of agency for pre-incorporation disputes. Thus, where both parties knew at the time of contract that the company on whose behalf the contract was entered into had not been incorporated yet, and if the proposed company is subsequently incorporated but fails to perform the contract, the person who purported to make the contract on behalf of a *proposed* company may be held to have contracted as the principal.[11] The reference to the "proposed" company in *Kelner v Baxter* (1866) LR 2 CP 174 indicated that the parties were aware of the non-existence of the company. The parties must have intended, absent evidence to the contrary, that the person acting for the proposed company was to be liable for the contract, as the parties must be taken to have the intention to conclude a binding contract.[12]

4.006 **Rebuttable presumption that person making contract on behalf of company may be personally bound.** There are some New Zealand authorities that suggest that in a situation similar to that in *Kelner v Baxter*[13], where one party has executed his part of the contract, there is a rebuttable presumption that the person who purportedly made the contract on behalf of the proposed company is personally bound to the contract.[14]

4.007 **Harder to impose personal liability where both parties believe company in existence.** Where both parties mistakenly believed that the company was in existence

[8] *Tinnevelly Sugar Refining Co Ltd v Mirrlees Watson and Yaryan Co Ltd* (1894) 2 SLT 149; *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45.

[9] *Kelner v Baxter* (1866) LR 2 CP 174, 184, *per* Erle CJ; *Natal Land and Colonization Co Ltd v Pauline Colliery & Development Syndicate Ltd* [1904] AC 120, 126, *per* Lord Davey.

[10] *Tinnevelly Sugar Refining Co Ltd v Mirrlees Watson and Yaryan Co Ltd* (1894) 2 SLT 149.

[11] *Kelner v Baxter* (1866) LR 2 CP 174.

[12] J P Hambrook, "Pre-Incorporation Contracts and the National Companies code: What does Section 81 Really Mean" (1982) 8 *Adel LR* 127.

[13] (1866) LR 2 CP 174

[14] *Marbelstone Industries Ltd v Fairchild* [1975] 1 NZLR 529, 542, *per* Mahon J; *Power v Nathan* [1981] 2 NZLR 403, 409, *per* Vautier J; *Elders Pastoral Ltd v Gibbs* [1988] NZLR 596, 601–603, *per* McGechan J. In *Marbelsone Industries*, Mahon J expressed the view at 542 that the presumption was "irresistible". However, in *Elders Pastoral*, McGechan J observed that while there can be such a presumption of some strength, it would be wrong to say that the presumption is "irresistible" or "irrebuttable" (at 603).

when the contract was made, it is harder to impose personal liability on the person(s) who executed the contract in the name of the company. In both *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45 [1954] 1 QB 45 and *Black v Smallwood* [1966] ALR 744, where the pseudo directors had wrongly believed the company to be in existence and had therefore subscribed the name of the company on a contract, and added their own signatures underneath, the contract was held to be a nullity. The contract in this situation was held to be a contract purportedly made by the company itself, rather than one made by the person executing the contract on behalf of the proposed company.[15] The function of the signatures of the pseudo directors in *Newborne v Sensolid*[16], as it was held, was just to confirm the signature of the company.[17]

4.008 **Personal liability difficult to impose as company intended to be principal of the contract.** The basis of the courts' decisions in both *Newborne v Sensolid*[18] and *Black v Smallwood*[19] appears to be that the real principal of the contract was the company and the pseudo directors were acting only in their ministerial capacities. The true test on the liability of the pseudo directors in this situation may still be the real intention of the parties. It is possible to argue that the third party contractor and the purported director made the same mistake on the existence of the company when the contract was executed, which means that the company, not the purported director, was intended to be the principal of the contract. In *Phonogram Ltd v Lane* [1982] QB 938, Oliver LJ said that His Lordship was not convinced that the common law position depends on the narrow distinction between a signature "for and on behalf" and a signature in the name of the company.[20] The question, His Lordship held, was "what is the real intent as revealed by the contract."[21]

4.009 **Intention of parties critical to determining liability.** Mahon J's decision in *Marbelstone Industries Ltd v Fairchild* [1975] 1 NZLR 529 appears to have been based on the same view. His Lordship suggested that an alternative way of achieving the same result in a situation similar to that in *Newborne v Sensolid*[22] is to impute a mutual intention to all signatories that the contract was to be made with the company alone where all signatories mistakenly believed that the company was existent.[23]

2.2 Liability where the contract is a nullity: breach of warranty of authority

4.010 **Parties may still be held liable for breach of warranty even if not personally liable under pre-incorporation contract.** That an "agent" or pseudo director is not personally

[15] *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45, 51, *per* Lord Goddard CJ; *Black v Smallwood* [1966] ALR 744, 749, *per* Barwick CJ, Kotto, Taylor and Owen JJ; 749–750, *per* Windeyer J. See also *Hawkes Bay Milk Corp Ltd v Watson* [1974] 1 NZLR 236.

[16] [1954] 1 QB 45.

[17] *Ibid*, 51, *per* Lord Goddard CJ.

[18] [1954] 1 QB 45.

[19] [1966] ALR 744.

[20] *Phonogram Ltd v Lane* [1982] QB 938 at 945.

[21] *Ibid*.

[22] [1954] 1 QB 45.

[23] *Marbelstone Industries Ltd v Fairchild* [1975] 1 NZLR 529, 542.

2. Rules on Internal Governance: Articles of Association

2.1 The legal nature of articles of association

5.025 **Company's regulations on internal governance.** Traditionally, the articles of association have constituted the company's "rule book". As such, the articles set out regulations on the internal governance of the company. The purpose of the articles is to provide for the allocation of profit, risk and control within the company.[32] The articles determine the ways in which the powers of the company are exercised, including allocation of powers to particular corporate organs.[33] The articles may deal with members' rights in relation to the distribution of the company's profits. Under Cap.622, the articles of association still perform this role, although in addition the articles now also perform the role of the former memorandum of association in setting out basic information about the company for outsiders (as discussed in the previous section).[34]

5.026 **Statutory contract between members *inter se* and member and company.** In Hong Kong, as in the United Kingdom and some other jurisdictions of British extraction, a company's constitution is a statutory contract between individual members *inter se* and between individual members and the company. This is made clear by Cap.622 s.86:

> "(1) Subject to this Ordinance, a company's articles, once registered under this Ordinance or a former Companies Ordinance –
>
> (a) have effect as a contract under seal –
> (i) between the company and each member; and
> (ii) between a member and each other member; and
>
> (b) are to be regarded as containing covenants on the part of the company and of each member to observe all the provisions of the articles.
>
> (2) Without limiting subsection (1), the articles are enforceable –
> (a) by the company against each member;
> (b) by a member against the company; and
> (c) by a member against each other member.
>
> (3) Money payable by a member to the company under the articles –
> (a) is a debt due from the member of the company; and
> (b) is of the nature of a specialty debt."

5.027 **Reasons for contractual approach.** There are some historical and practical reasons for the adoption of the contractual approach to the company constitution. In the 19th

[32] See Farrat, fn 10 above, 95.
[33] E.g., Table A, reg.82.
[34] See also Chapter 3 in relation to the contents of articles of association.

century, the contract was a favourite analytical tool. Also, making a contract had been the only way of forming or joining any company under the common law.[35] The constitution of the deed of settlement companies in the 19th century was the deed, which was a contract among members. The Joint Stock Companies Act 1844 (UK) provided, for the first time, for the registration of deed of settlement companies. The constitution of a company registered under the 1844 Act was still the deed, which was an actual contract.[36] The memorandum of association and articles of association were introduced to replace the deed under ss.7 and 10 of the Joint Stock Companies Act 1856. Sections 7 and 10 made it clear that both the memorandum and the articles bound the company and shareholders contractually.

2.2 The enforcement of articles of association

2.2.1 *Who can enforce the constitution?*

The company and its members

5.028 **Company and members.** Section 86 states in clear terms that the constitution is enforceable between the company and each individual member and among each member *inter se*. Thus the company could enforce a provision of the articles that required disputes between the company and its members to be referred to arbitration,[37] and a shareholder was able to enforce a provision in the articles on dividend payments against the company.[38] An example of enforcement by a member of his rights under the articles against a fellow member is *Rayfield v Hands* [1960] Ch 1, where reg.11 provided that a member who intended to transfer shares should inform the directors, "who will take the shares equally between them at a fair value". The directors were also members, as the articles required them to hold shares in the company. The plaintiff wished to transfer his shares and sought a declaration that the three directors were bound to purchase his shares because of the effect of reg.11. Vaisey J granted the declaration, holding that reg.11 was binding on the directors in their capacity as members.[39]

5.029 **Not all clauses can be enforced by company against members and vice versa, eg clause only applies to members *inter se*.** It should be noted that not all clauses in the articles can be enforced by the company against its members and *vice versa*.[40] For example, where a provision in the articles only applies to matters between members *inter se*, the provision may not be invoked by the company in relation to a matter between itself

[35] L S Sealy, "The Enforcement of Partnership Agreements, Articles of Association and Shareholder Agreement" in P D Finn (ed.), *Equity and Commercial Relationships* (LBC, Sydney, 1987) p.89, p.93.
[36] Companies Act 1844, ss.7, 26, see fn 10, 121.
[37] *Hickman v Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch 881.
[38] *Wood v Odessa Waterworks Co* (1889) 42 Ch D 636.
[39] Note that directors are not parties to the statutory contract, but the case of *Rayfield v Hands* illustrates that directors can be bound to the contract in their capacity as members if they also hold shares. However, as discussed below, the constitution is only binding on members in their capacity as members. This restriction was not an obstacle in *Rayfield v Hands*, where the court regarded reg.11 in the articles as involving a relationship between the members and the directors not in their capacity as directors but in their capacity as members of the company (the directors being referred to as "working members" in that context): see [1960] Ch 1, 6. See also para.5.030 below.
[40] For limitations on the ability of minority members to enforce the articles, see Chapter 10.

resolution, over the management of the company's business.[65] The second line of authorities emphasises that the general meeting's power to intervene in management matters is to be determined by the wording of the power-allocation clause.[66]

3.2 The problems with the mainstream authorities

6.027 **Mainstream view that limiting phrase denies general meeting power to exercise control.** Although the first line of authorities represents the received view,[67] it suffers from a number of problems which render this view unconvincing. Firstly, the cases that are normally regarded as authorities for the received view either do not support this view or cannot sustain close analysis. Secondly, the decisions of most of the cases where the general meeting was not permitted to assert its control by ordinary resolutions can be rationalised on alternative doctrinal bases. Thirdly, the received view has been challenged in some more recent decisions.

3.2.1 *Questionable authorities*

6.028 **Criticism of mainstream view authorities.** *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame*[68] is normally regarded as one of the leading authorities representing the dominant view.[69] That case, however, does not say that the general meeting can never intervene by ordinary resolution even if the division of powers article of the company gives such a power to the general meeting. The ratio of Co MR's decision is that where the management powers of the directors are subject to general meeting's control by "extraordinary resolution", the powers of the directors can be altered only by an extraordinary resolution, not an ordinary resolution.[70] In other words, the *Cunningham* case actually supports the view taken by the second line of authorities.

6.029 *Quin & Axtens v Salmon*[71] is also treated as a leading authority representing the received view.[72] While a House of Lords case, Lord Loreburn's short decision in that

[65] For examples, see *The Gramophone and Typewriter Ltd v Stanley* [1908] 2 KB 89 at 105–106, *per* Buckley LJ; *John Shaw and Sons (Salford) Ltd v Peter Shaw and John Shaw* (1935) 2 KB 113 at 134, *per* Greer LJ; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* (1988) 4 BCC 542.

[66] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34 (this case is often regarded as seminal case for the first line of authorities but, as will be pointed out below, this is incorrect and the ratio of the case has been misunderstood in a number of well-known decisions); *Marshall's Valve Gear Co Ltd v Manning Wardle & Co Ltd* [1909] 1 Ch 267; *Dowse v Marks* (1913) 13 SR (NSW) 332; *Tam Kam-yip v Yau Kung School* [1986] 1 HKLR 448; *Credit Development Pte Ltd v IMO Pte Ltd* [1993] 2 SLR 370.

[67] Leo Flynn, "The Power to Direct" (1991) 13 *Dublin University Law Journal* 101; Charles Zhen Qu "Some Reflections on the General Meeting's Power to Control Corporate Proceedings" (2007) 36(3) *Common Law World Review* 231.

[68] [1906] 2 Ch 34.

[69] See *The Gramophone and Typewriter Ltd v Stanley* [1908] 2 KB 89 at 105–106, *per* Buckley LJ; *John Shaw and Sons (Salford) Ltd v Peter Shaw and John Shaw* (1935) 2 KB 113 at 134, *per* Greer LJ; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* (1988) 4 BCC 542. See also R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (14th edn, LexisNexis Buttherworths, Sydney, 2010) 226.

[70] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34 at 42.

[71] [1909] AC 442.

[72] See R P Austin and I M Ramsay, *Ford's Principles of Corporations Law;* see fn 69.

case is of limited value as a binding precedent, as the judgment does not sustain close analysis,[73] and it is difficult to identify a precise principle underlying the decision.[74]

6.030 The third case that has often been cited as an authority for the mainstream view is *John Shaw and Sons (Salford) Ltd v Peter Shaw and John Shaw*.[75] In that case, certain directors purported to authorise the company to commence proceedings against the Shaw brothers (who were also directors in the company). The defendant Shaw brothers raised various defences to the action, including an argument that the proceedings were unauthorised because the general meeting had passed a resolution to discontinue the proceedings. Greer LJ stated:

> "[i]f powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove".[76]

6.031 Greer LJ's judgment in *Shaw*, however, should not be taken as a strong authority on the law of division of powers. His Lordship's above-quoted observation was *obiter dictum* as the defendant Shaw brothers succeeded in the case on different grounds. Moreover, Greer LJ's judgment on the general meeting's power of control was not based directly on a review of authorities. The only authority His Lordship cited was the 11th edition of *Buckley on Companies*. The relevant passage in *Buckley* states:

> "... And it appears now to be established that under an article in the present form [article 67 of Table A], whatever effect is to be given to the words 'to such regulations, being not inconsistent with the aforesaid regulations or provisions as may be prescribed by the company in general meeting', *these words do not enable the shareholders, by resolution passed at a general meeting without altering the articles, to give directions to the directors as to how the company's affairs are to be managed, nor to overrule any decisions come to by the directors in the conduct of its business, even as regards matters not expressly delegated to the directors by the articles.*" (emphasis added)[77]

6.032 The learned authors of the 11th edition of *Buckley* cited *Cunninghame* and *Quin & Axtens* as authorities for their view cited above.[78] However, neither of those cases actually support the proposition contained in the italicised words in the preceding paragraph. The reason why *Cunninghame* does not do so was discussed above.[79] Why does *Quin & Axtens* not support that proposition either? In that case,

[73] See Charles Qu "Some Reflections on General Meeting's Power to Control Corporate Proceedings" (2007) 36(3) *Common Law Review* 23.

[74] *Tam Kam-yip v Yau Kung School* [1986] 1 HKLR 448 at 455, *per* Sir Alan Huggins V.-P.

[75] [1935] 2 KB 113.

[76] [1935] 2 KB 113 at 134.

[77] Buckley, H B, Baron Wrenbuy, et al., *The Law and Practice under the Companies Acts: Containing the Statutes and the Rules, Orders and Forms to Regulate Proceedings* (11th edn, Stevens, London, 1930) 723.

[78] Buckley, H B, Baron Wrenbuy, et al. op cit 723, note (r).

[79] See para 6.028.

of all directors.[127] The reasonableness of the notice depends on the circumstances in which the notice was given. The test of reasonableness appears to be whether the notice is given early enough to enable directors to attend.[128] Thus, where the director's office is five minutes' walk from the venue of the board meeting, a notice of less than ten minutes may be sufficient where the director is available,[129] whereas a few hours' notice may be insufficient where one of the directors cannot be reached until at least the next day, as he or she is overseas.[130] Where there is evidence that the purpose of giving other directors short notice is to make a pre-emptive strike on a scheduled board meeting and to entrench the position of the notice giver as a director, the meeting called through such short notice will be invalid.[131]

7.060 **Model articles: time and place.** The Model Articles require the notice to indicate the proposed date and time of the meeting, and where the meeting is to take place.[132]

7.061 **Generally no need to state nature of business to be transacted.** As a general principle, there is no need to state the nature of business to be transacted in the notice.[133] The rationale behind this rule is summarised by Lindley LJ in *La Compagnie de Mayville v Whitley*:[134]

> "It is not uncommon for directors conducting a company's business to meet on stated days without any previous notice being given either of the day or of what they are going to do. Being paid for their services – as they generally are, it is their duty to go when there is any business to be done, and to attend to business whatever it is."

7.062 **Subject to considerations of reasonableness.** This rule, however, is subject to the overriding consideration of reasonableness in all circumstances. As Deputy Judge To points out in *SEG Investment Ltd v SEG Intl Securities (HK) Ltd*, "[i]t is not a rule without qualification. If it were, some directors at a meeting may, upon finding it opportune to do so, pass any resolution which they know would not be passed had other directors been present at the meeting. . . . The result would be a state of anarchy".[135]

7.063 **Whether some notice required if business important or extraordinary.** Deputy Judge To was of the view that the rule applied only where the business to be transacted at the meeting was ordinary business. His Lordship believed that if the business to be transacted at the meeting was important or extraordinary, some notice of the nature

[127] *Bell v Burton* (1993) 12 ACSR 325, 329, *per* Tadgell; *SEG Investment Ltd v SEG Intl Securities (HK) Ltd* (unrep. HCMP 4211/2003, [2005] HKEC 1633, [11]).
[128] *Broadview Commodities Pte Ltd v Broadview Finance Ltd* [1983] HKLR 384, 388.
[129] *Browne v L Trinidad* (1887) 37 Ch D 1.
[130] *Re Homer District Consolidated Gold Mines Ex p Smith* [1888] 39 Ch D 546. Note, however, that Table A reg.100 provides that it is not necessary to give notice to any director for the time being absent from Hong Kong. There is no equivalent of this provision in the Model Articles.
[131] *Yick Hok Wing v Chan Yook Ming* [1997] 1 HKC 49.
[132] Model Articles (private companies) art.9(2); Model Articles (public companies) art.7(4).
[133] *La Compagnie de Mayville v Whitley* [1896] 1 Ch 788; *Kwok Shun On v Wong Sai Wing* [2001] 3 HKLRD 61.
[134] [1896] 1 Ch 788, 797.
[135] *SEG Investment Ltd v SEG Intl Securities (HK) Ltd* [2005] HKEC 1633, [13]).

of the business to be transacted at the board meeting must be given. The level of the need to state the nature of the business in the notice, His Lordship added, should be proportional to the level of importance of the business.[136]

7.064 **Voluntary winding-up by board.** The facts in *SEG Investment Ltd v SEG Intl Securities (HK) Ltd* involved a purported board resolution for winding-up. A special feature of the law on voluntary winding-up under Cap.32 is that it is possible for the board, as distinguished from the shareholders themselves, to initiate a members' voluntary winding-up.[137] A voluntary winding-up initiated by directors under s.228A has the same effect as a members' voluntary winding-up provided under Cap.32 s.228. As Deputy Judge To observed in *SEG investment*, if a s.228 winding-up required a notice of 21 days specifying the intention to propose the resolution as a special resolution, it cannot be the law that the safeguards provided in the case of a voluntary winding-up be completely dispensed with where the winding-up is initiated by directors.[138]

7.065 **Failure might suggest avoiding opposition of co-directors.** Deputy Judge To's view on the need for stating in the notice the nature of the business to be transacted at the board meeting is supported by *Re Homer District Consolidated Gold Mines*, where North J held that a failure to state in the notice what was to be done at a board meeting may suggest that the aim of the directors who sent out the notice was to secure the passing of a resolution that would bind the company through getting rid of the opposition of their co-directors.[139] The resolution to be deliberated at the meeting in that case was on the allotment of shares to an external party; the allotment of which had been ruled out in the previous board meeting attended by all the directors.

7.066 **Notice when director absent.** If a director is beyond physical reach and has the board's permission to be absent from office, it is unnecessary to send notice to the director, as a notice requiring the director to attend a board meeting would be wholly inconsistent with the permission given.[140] Under Table A, reg.100, it is unnecessary to give notice to a director who is, at the time, absent from Hong Kong. This provision is not reproduced in the Model Articles since the giving of notice to persons outside Hong Kong is not difficult under modern communication technologies (and since meetings can be held without the need for every person to be present at the one location[141]).

5.3 Quorum

7.067 **Quorum generally 2; if director has interest he is not counted under Model Articles.** For companies adopting the Model Articles or Table A, the quorum for transacting business at board meetings is two, unless the directors have determined otherwise.[142] Where a director is interested in a transaction, arrangement or contract

[136] *SEG Investment Ltd v SEG Intl Securities (HK) Ltd* [2005] HKEC 1633, [13].
[137] Cap.32 s.228A. For a more detailed discussion on this topic, see Chapter 19.
[138] *SEG Investment Ltd v SEG Intl Securities (HK) Ltd* [2005] HKEC 1633[14].
[139] *Re Homer District Consolidated Gold Mines Ex p Smith* [1888] 39 Ch D 546, 550.
[140] *Halifax Sugar Refining Co v Franklyn* (1890) 59 LJ Ch 591.
[141] See para.7.098 below.
[142] Model Articles (private companies) art.11; Model Articles (public companies) art.9; Table A reg.102.

(UK) Ltd v Fielding,[29] Lewison J declined to follow that approach, taking the view that the facts in the *Yukong* case indicated that the person was more of a *de facto* director than a shadow director. Lewison J held that the mere fact that a person is a shadow director of a company does not mean that fiduciary duties will be imposed on him or her, although his Lordship accepted that where the shadow director takes on a role beyond indirect influence to assume control of a company asset, then fiduciary duties will be imposed in respect of the use of the asset. But despite *Ultraframe*, the better view is that, because of the actual control and influence of a shadow director over the company, the general law duties of directors should apply to shadow directors to the extent of their control and involvement in the company's activities.[30]

8.018 **Cap.622: duty of care applies to shadow directors.** For the new statutory duty of care, the Ordinance expressly applies the duty to shadow directors.[31]

1.3.4 *Corporate directors*

8.019 **Body corporate subject to same duties as natural persons.** A director which is a body corporate will also be subject to the same duties as directors who are natural persons. Bodies corporate can be *de facto*[32] or shadow directors,[33] and would also be subject to directors' duties to the extent that such duties apply to *de facto* or shadow directors, respectively. In some circumstances, the directors of a corporate director could also be regarded as *de facto* or shadow directors of the company in which the corporate director is a director,[34] and in this situation the first-mentioned company could be subject to duties owed to the last-mentioned company.

1.3.5 *Executive officers*

8.020 **Executive officers owe fiduciary duties but not as extensive as directors unless senior.** Both executive and non-executive directors are subject to the duties of directors. Executive officers or senior managers who are not directors are arguably also subject to the fiduciary and common law duties similar to that of directors. Under the common law, employees of a company owe a duty of care to the company in carrying out their

[29] [2005] EWHC 1638, [1279]–[1290].

[30] This view is supported in Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (Sweet and Maxwell, 8th ed. 2008) 485; John De Lacy, "The Concept of a Company Director: Time for a New Expanded and Unified Statutory Concept?" [2006] *Journal of Business Law* 267, 295. For a critique of *Ultraframe* on this question, see also D D Prentice and Jenny Payne, "Directors' Fiduciary Duties" (2006) 122 *Law Quarterly Review* 558. See also *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3211, 3238 where Thomas J of the New Zealand High Court held that a shadow director can owe a common law duty of care to the company. However, the relevant statutory definition of "director" in the New Zealand legislation included shadow directors (Companies Act 1955 (NZ) s.2, as amended by the Companies Amendment Act 1982; the 1955 Act is now repealed; *cf* Companies Act 1993 (NZ) s.126) and Thomas J's view that it would be appropriate to impose common law duties on shadow directors was made by way of analogy with the treatment of such persons as directors generally under the Companies Act.

[31] Cap.622 ss.465(5).

[32] See *Aktieselskabet Dansk Skibsfinansiering v Wheelock Marden & Co Ltd* [1998] 3 HKC 153; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1.

[33] *Re Hydrodan (Corby) Ltd* [1994] BCC 161.

[34] As for the tests to determine whether this would be the case, see Chapter 7.

functions.[35] Employees also owe fiduciary duties to the company,[36] although the scope and nature of the duties of employees would not be coextensive with that of directors. But the situation is arguably different for employees who are executive officers. In the Canadian decision of *Canadian Aero Services Ltd v O'Malley*,[37] it was held that two persons appointed as president and executive vice-president of the company had responsibilities as senior officers and were in "top management" rather than "mere employees", and as such owed a more exacting duty to the company similar to that owed by directors to the company. Persons within the statutory definition of "manager"[38] could well be regarded as occupying a fiduciary position similar to directors, but in any particular case the extent to which a senior manager or officer would be subject to fiduciary duties comparable with a director will depend on the nature of the position held and the responsibilities attaching to the position in the company concerned. Imposition of fiduciary duties on senior executives similar to those of directors can be justified on the basis that such officers in large public companies may exercise greater management power than the non-executive directors who might only meet as a board a number of times per year.[39]

8.021 **Duty of care owed by officers.** Although the statutory duty of care in Cap.622 s.465 will apply to directors, executive officers would be under a common law duty of care, whether pursuant to contract or tort.

1.4 To whom are the duties owed?

8.022 **Owed to company.** Directors' fiduciary duties and the duty of care are owed to the company such that the company is the proper plaintiff to bring proceedings against a director for breach of duty.[40]

8.023 **Not owed to members except in special circumstances.** Directors' duties are not owed to the members individually,[41] but there may be special circumstances where directors will owe fiduciary duties to individual members directly pursuant to the general principles on fiduciary relationships.[42] This may be the case where directors act as the shareholders' agents in selling their shares.[43] It is also arguable that directors can

[35] *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555 (HL).

[36] *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296.

[37] [1974] SCR 592.

[38] Under Companies Ordinance (Cap.622) s.2, "manager" means a person who, under the immediate authority of the board of directors, exercises managerial functions. Managers, so defined, are "officers" within s.2 of the Ordinance. Compare the definition of "officer" in s.9 of the Corporations Act 2001 (Aust) and the persons held to be officers in *Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72; *Australian Securities and Investments Commission v MacDonald (No 11)* (2009) 256 ALR 199 (general counsel and chief financial officer of company).

[39] E.g., see Melvin A Eisenberg, "The Duty of Corporate Directors and Officers" (1989–1990) 51 *University of Pittsburgh Law Review* 945, 949–950; John C Coffee, "Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response" (1977) 63 *Virginia Law Review* 1099, 1110, 1142. See also Corporations and Markets Advisory Committee, "Corporate Duties Below Board Level" (April 2006), available at the CAMAC website: <http://www.camac.gov.au>.

[40] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189. See Chapter 10.

[41] *Percival v Wright* [1902] 2 Ch 421; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258, 288.

[42] *Peskin v Anderson* [2001] 1 BCLC 372, 379.

[43] *Briess v Woolley* [1954] AC 333 (HL); *Allen v Hyett* (1914) 30 TLR 444 (PC).

8.3 Restitution of company's property

8.165 **Restitution of company property received in breach of fiduciary duty.** Where a director has received property of the company in breach of fiduciary duty, the company is entitled to recover the property from the director who is regarded as a constructive trustee of the property.[384] As a constructive trust is imposed, the ordinary principles of tracing in equity can apply.

8.4 Disgorgement of profits or benefits

8.166 **Account of profits for breach of fiduciary duty.** The remedy of account of profits enables the company to obtain any profits a director has made in breach of fiduciary duty. Thus, for example, where directors have made a gain from usurping a corporate opportunity in breach of either the conflict rule or profit rule, the director is required to pay the amount of the gain to the company.[385] The liability to account arises irrespective of whether the company has suffered any loss.[386]

8.167 **Account of profits personal remedy but constructive trust imposed if profited from misuse of company assets.** The remedy of account of profits is a personal remedy and not a proprietary one, and so, for example, the company would not be entitled to obtain an asset *in specie* acquired by the director by misusing corporate funds but would only be entitled to an equitable account.[387] However, where a director has profited from a misuse of company assets or has obtained funds or assets by misappropriating a corporate opportunity, a constructive trust is imposed on the property attained by the director in breach of fiduciary duty. For example, in *Bhullar v Bhullar*,[388] a constructive trust was imposed on the land acquired by the directors in breach of the conflict rule, and orders were made requiring a transfer of the property to the company.[389] The imposition of a constructive trust again means that the company's remedy is a proprietary one and tracing is possible. Where a fiduciary obtains a bribe in breach of duty, a constructive trust is also imposed on the money obtained.[390]

8.168 **Allowance to director for time, skill and financial contribution.** Where a director has obtained assets or made a profit from misappropriating a corporate opportunity, the court can grant allowances to the director for the time, skill and financial contribution he or she made in obtaining the assets or profit.[391] In cases where the fiduciary carries on an ongoing business as a result of the taking advantage of a business opportunity in breach of duty, it may sometimes be appropriate to put a cap on the duration for which an account of profits is ordered.[392]

[384] *Guinness Plc v Saunders* [1990] 2 AC 663 (recovery of unlawful remuneration); *J J Harrison (Properties) Ltd v Harrison* [2002] 1 BCLC 162 (Eng CA).

[385] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL); *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296.

[386] *Ibid.*

[387] *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd* [2012] Ch 453.

[388] [2003] 2 BCLC 241.

[389] See also *Boardman v Phipps* [1967] 2 AC 46; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

[390] *Attorney-General (Hong Kong) v Reid* [1994] 1 AC 324 (PC).

[391] *Boardman v Phipps* [1967] 2 AC 46; *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296.

[392] *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296.

8.169 **Limits to account of profits where contract affirmed or right to rescind.** Where a director has obtained a profit in selling property to the company, it seems that there are limits to the possibility of the company obtaining an account of profits if the contract is affirmed by the company or the right to rescind is otherwise lost. If the contract is not rescinded, then an account of profits is not available unless the director had obtained the goods as trustee for the company or was already a director and a fiduciary to the company in respect of his or her acquisition of the goods.[393] In *Man Luen Corp v Sun King Electronic Printed Circuit Board Factory Ltd*,[394] the directors were required to account to the company for the profits they received for the sale of raw materials to the company, although there was no rescission of the contract. There was no discussion in the judgment on the limitations on the availability of an account of profits, but the decision is consistent with the general principle as the directors had resolved at a board meeting of the company to set up their own firm for the purpose of supplying goods to the company and the directors can be regarded as having acquired the goods in a fiduciary capacity *vis-à-vis* the company.

8.5 Equitable compensation

8.170 **Equitable compensation for losses suffered by company.** For breach of fiduciary duty by a director, the court has power[395] to order equitable compensation to compensate for losses suffered by the company as a result of the breach.[396] For example, in *Menno Leendert Vos v Global Fair Industrial Ltd*,[397] the Court of First Instance ordered equitable compensation to remedy the company's losses as a result of directors wrongfully selling the company's property at a gross undervalue. It was not possible to seek recovery of the property itself as the property had subsequently been disposed of to third parties who took in good faith for value.

8.171 Equitable compensation can only be granted for losses caused by the breach, namely the losses which would not have occurred but for the breach, or losses which, on a common sense view of causation, were caused by the breach.[398] The measure of equitable compensation is not assessed on precisely the same basis as common law damages, and so the compensation recoverable for breach of fiduciary

[393] See *Burland v Earle* [1902] AC 83, 99; John McGhee (ed.), *Snell's Equity* (Sweet and Maxwell, 32nd ed. 2010) para.7-054; and see also the cases on promoters discussed at Chapter 2.

[394] [1981] HKC 407.

[395] The power arises pursuant to the court's inherent equitable jurisdiction (*Nocton v Lord Ashburton* [1914] AC 932) or pursuant to High Court Ordinance (Cap.4) s.17 (derived from the Lord Cairns' Act 1858 (UK)).

[396] *Menno Leendert Vos v Global Fair Industrial Ltd* (unrep.HCA 4200/1995, [2009] HKEC 1952); *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598; *DEG-Deutsche Investitions und Entwicklungsgesellschaft mbH v Koshy* [2004] 1 BCLC 131, [142]–[147].

[397] (unrep., HCA 4200/1995, [2009] HKEC 1952), [460]. See also *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd* (2009) 12 HKCFAR 417.

[398] *Akai Holdings Ltd v Kasikornbank PCL* (2010) 13 HKCFAR 479, [151]–[152] (CFA); *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296.

is not required to circulate a statement if the members' rights to circulation are being abused or are being used to secure needless publicity for defamatory matter.[149] Whether a statement is "defamatory" depends on the common law meaning of the term, namely whether the meaning of the statement has a tendency to lower the plaintiff in the estimation of the ordinary reasonable reader.[149] The word defamatory for present purposes does not mean that the statement was one which, if it were the subject of a suit in defamation, would result in a win for the plaintiff. In deciding whether a statement is defamatory, one looks only to the meaning of the statement, not to the availability of the defences.[150]

4. Proceedings

4.1 Quorum

4.1.1 *The meaning of quorum*

9.065 **Quorum minimum number of participants required to constitute valid meeting.** A quorum is a minimum number of participants who must be present to constitute a valid meeting.

4.1.2 *The requirement*

9.066 **Quorum for general meeting two unless articles provide otherwise.** Unless articles provide otherwise, the quorum required for a general meeting is two members present in person or by proxy.[151] Where the company has only one member, the quorum is that member in person or by proxy.[152] If the only member of the company is itself a body corporate, that member present by its corporate representative also constitutes a quorum of a general meeting of the company.[153]

9.067 **Cap.622 does not specify time after which meeting to be regarded as inquorate due to insufficient members but MA states half an hour from time appointed for meeting.** Cap.622 does not specify the time after which the meeting is regarded as inquorate due to insufficient members arriving. Under the Model Articles, if a quorum is not present within half an hour from the time appointed for the meeting, then the meeting shall be dissolved where it was called through a members' requisition, and in all other cases the meeting is adjourned to the same day in the next week (or to another day that the directors determine).[154] If at the adjourned meeting a quorum is not present within half an hour from the time appointed for the meeting, the member or members present are deemed to constitute a quorum.[155]

[148] Cap.622 s.583.
[149] *National Roads and Motorists' Association v Snodgrass* (2002) 42 ACSR 622, [10].
[150] *Ibid.*, [11].
[151] Cap.622 s.585(3); Table A reg.55.
[152] Cap.622 s.585(3).
[153] Cap.622 s.585(2).
[154] Model Articles (private companies) art.42(1); Model Articles (public companies) art.46(1); Cap.32 Table A reg.53.
[155] Model Articles (private companies) art.42(2); Model Articles (public companies) art.46(2). The equivalent provision in Table A reg.56 refers to the "members" present being a quorum: see *Re China Star Enterprise Hong Kong Ltd* [2012] 5 HKLRD 290, discussed above at para.9.006.

4.1.3 *Loss of quorum*

9.068 **Quorate meeting may lose quorum if one or more members leave before meeting concluded.** An otherwise quorate meeting may lose its quorum when one or more of the members leave before the meeting is concluded. This possibility raises the question as to the validity of a resolution passed after the meeting has lost its quorum. The question will need to be answered by reference to the wording of the quorum regulations in the company's constitution. The common law rule is that for the meeting to be valid, a quorum must exist from the time when the meeting proceeds to business to the conclusion of the meeting.[156] This common law rule has been incorporated in the Model Articles.[157] Where the company's articles only state that no business shall be transacted at any general meeting unless a quorum is present at the time when the meeting proceeds to business, a quorum is only required at the beginning of the meeting and a quorum is not required when a vote is taken.[158] Where, however, the loss of quorum results in the presence of only one member when the vote is taken, no valid decision can be taken at the meeting, even if the quorum regulation in the articles does not require the quorum to exist at all times through to the conclusion of the meeting.[159]

4.1.4 *Courts' power of calling meetings and deemed quorum*

9.069 **Court has power to call meeting in certain situations.** As discussed previously, in certain situations, the court has the power to call a meeting even if the number of the members attending the meeting does not constitute a quorum.[160]

4.1.5 *Joint shareholders*

9.070 **Common for company to send notice of general meeting to joint shareholder first named in register of members: senior joint holder.** It is common for a company's articles to provide that the notice of a general meeting is to be sent, in the case of joint shareholders, to the joint holder first named in the register of members in respect of shares (the senior joint holder),[161] and the voting power at a general meeting is to be exercised by the most senior joint holder who votes.[162]

9.071 ***Re Transcontinental Hotel* case: joint shareholders can be individually counted for quorum purposes if articles so provide.** Joint shareholders can be individually counted for voting or quorum purposes if this is required as a result of a proper interpretation of the company's constitution. In *Re Transcontinental Hotel Ltd*,[163] the memorandum, which was subscribed by W and ICF, stipulated that the total capital of the company was to be issued as fully paid up to FHF, ICF, W and G. Shares were duly issued to the four persons as joint shareholders. A provision in

[156] *Henderson v Louttit* (1894) 21 R (Ct of Sess) 674; *Ball v Pearsall* (1987) 10 NSWLR 700.
[157] Model Articles (public companies) art.43; Model Articles (private companies) art.39.
[158] *Re Hartley Baird Ltd* [1955] Ch 143.
[159] *Re London Flats Ltd* [1969] 1 WLR 711.
[160] See para.9.022 above.
[161] E.g., Cap.32 Table A reg.133.
[162] Cap.622 s.589; Cap.32 Table A reg.65.
[163] [1947] SASR 49.

10.006 **Choosing appropriate action depends on whether wrong to company or member personally.** The appropriate action which a member should take depends in the first instance on whether the wrong is one that is done to the company or to the member personally. The distinction between the two is not always clear.[5] However, where a corporate right is infringed, then an individual member can generally only seek redress by a derivative action (or rely on the statutory injunction in Cap.622 Pt.14 Div.3). If a personal right is infringed, then the member may possibly pursue an action under Cap.622 Pt.14 Div. 2 (unfair prejudice) or any available common law actions. The same facts may involve infringement of both the rights of the company and personal rights of members.[6] The appropriate action that the member should take in such a situation depends on what type of remedy or order the member wishes to seek. For example, if the remedy sought is compensation to the company, then it is the company's right which is to be vindicated, and so a member can only proceed by way of a derivative action.

10.007 **Members' remedies ensure good corporate governance.** The law of members' remedies can be seen as one of the tools for ensuring good corporate governance in companies.[7] The conferral of legal rights and remedies on members to address wrongdoing in a company constitutes the members as an external control mechanism.[8] Aside from members' collective powers exercisable in general meeting, the conferral of remedies for individual members empowers members in their role of monitoring the company's controllers and of enforcing governance standards and legal duties on managers.

10.008 **Members' remedies can be used to resolve disputes.** In the case of closely held private companies where the members are often also the directors, the law of members' remedies also serves the function of providing mechanisms to resolve disputes between the company's proprietors. Thus members' remedies can be utilised for the purpose of dealing with breakdowns in the relationship between the proprietors by allowing them to part ways (such as via the remedy for winding up on just and equitable grounds) or for otherwise enabling proprietors who are locked-in[9] the company to exit the company on fair terms (such as via the unfair prejudice remedy).

5 See para.10.100.

6 For example, an allotment of shares for the purpose of diluting existing shareholdings amounts to a wrong to the company (breach of directors' fiduciary duties which are owed to the company) but has also been accepted by the courts as infringing personal rights of the existing shareholders.

7 See generally SCCLR, *Corporate Governance Review: A Consultation Paper on Proposals Made in Phase I of the Review* (July 2001) at [12.06]–[12.07]; Robert Ian Tricker, *Corporate Governance: Principles Policies and Practices* (2nd edn, Oxford University Press, Oxford 2012), p.89–95; Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (Cambridge University Press, Cambridge 2013), 98–99; Christine Mallin, *Corporate Governance*, 4th edn, (Oxford University Press, Oxford 2013), 77–79; Jin Zhu Yang, 'The Role of Shareholders in Enforcing Directors' Duties: A Comparative Study of the United Kingdom and China: Part 2' [2006] *International Company and Commercial Law Review* 381; Alex Lau, John Nowland and Angus Young, 'In Search of Good Governance for Asian Family Listed Companies: A Case Study on Hong Kong' [2007] *Company Lawyer* 306.

8 Simon S H Ho, *Corporate Governance in Hong Kong: Key Problems and Prospects* (Hong Kong, Centre for Accounting Disclosure and Corporate Governance School of Accountancy Chinese University of Hong Kong 2003) 3, 49–53.

9 There may not be any market for the shares of a private company, and so it can be difficult for a shareholder to find a willing buyer to acquire his or her shares.

2. The Rule in *Foss v Harbottle*

10.009 ***Rule in Foss v Harbottle: two limbs.*** The rule in *Foss v Harbottle*[10] imposes certain restrictions on the ability of members to seek legal redress for wrongdoing that occurs in a company. There are two limbs to the rule:

- the proper plaintiff principle; and
- the irregularity principle.[11]

2.1 Proper plaintiff principle

10.010 ***Proper plaintiff: where wrong to company then it is proper plaintiff.*** Under this principle, where directors have breached their duties owed to the company or where any person has infringed any rights of the company, the proper plaintiff to bring an action against the wrongdoer is the company.[12] In other words, the company is the person who is entitled under the law to seek legal redress against infringements of the company's rights. In *Foss v Harbottle*, two shareholders sought to bring an action against the directors for breach of directors' duties owed to the company. The court held that the shareholders did not have standing to institute the proceedings.

10.011 **Usually power to institute legal proceedings conferred on board of directors.** Which corporate organ has the authority to institute legal proceedings in the name of the company will depend on the allocation of powers in the company's articles of association.[13] Usually, the power is conferred on the board of directors. When the directors make a decision to commence legal proceedings, then the directors' decision is regarded as the company's decision.[14]

10.012 **Exceptions to proper plaintiff principle: derivative action.** There are, however, exceptions to the proper plaintiff principle. Under both the common law and the Companies Ordinance, an individual member may be entitled to institute proceedings on behalf of the company in particular circumstances. Such an action is referred to as a derivative action and is discussed below beginning with paragraph 10.016.

10.013 **Situations falling outside scope of proper plaintiff principle.** There are also situations which fall outside of the scope of the proper plaintiff principle in *Foss v Harbottle*. Where a member has a personal right of action conferred under the common law or under the

10 (1843) 2 Hare 461, 67 ER 189. For discussion of *Foss v Harbottle*, see further K W Wedderburn, 'Shareholders' Rights and the Rule in *Foss v Harbottle*' [1957] *Cambridge Law Journal* 194, [1958] *Cambridge Law Journal* 93; Stanley Beck, 'The Shareholders' Derivative Action' (1974) 52 *Canadian Bar Review* 159; R R Drury, 'The Relative Nature of a Shareholder's Right to Enforce the Company Contract' (1986) *Cambridge Law Journal* 219.

11 Some cases proceed on the basis that the two limbs are in substance the same (e.g. *MacDougall v Gardiner* (1875) 1 Ch D 13, 22–23, 24–25, 27; *Edwards v Halliwell* [1950] 2 All ER 1064, 1066), but the better view is that the two limbs are separate (see *Browne v La Trinidad* (1887) 37 Ch D 1, 10, 17; *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] Ch 204, 210 (Eng CA); *Re Hong Kong Sailing Federation* [2010] 1 HKLRD 801, [50]; Stanley Beck, 'The Shareholders' Derivative Action' (1974) 52 *Canadian Bar Review* 159, 165, 189).

12 See, *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370, 390.

13 See Chapter 6.

14 Likewise where the general meeting has the power to institute legal proceedings in the name of the company.

example, the US or European countries would need to comply with the IFRS as well as the HKFRS. HKICPA has in the last decade undertaken a convergence programme so that the HKFRS converge with the IFRS. For most companies, compliance with the HKFRS now means compliance with the IFRS.[42]

11.037 **Financial Reporting Framework and Financial Reporting Standard for SMEs.** The convergence of the HKFRS with the IFRS means that the requirements imposed are more exacting than necessary for smaller companies. Accordingly, HKICPA in 2005 issued a Financial Reporting Framework and Financial Reporting Standard for use by small-sized and medium-sized entities ("SME-FRF & FRS"). Companies to which the SME-FRF & FRS applies can accordingly opt for less onerous reporting standards instead of complying with the HKFRS.

3.4.7 *Revision of financial statements*

11.038 **Revision of financial statements.** If the directors discover that the financial statements do not comply with the Companies Ordinance when the financial statements have already been sent to members,[43] the directors can seek to revise the financial statements and make necessary consequential revisions to the directors' report or summary financial report: Cap.622 s.449.[44] Detailed provisions on the revision of financial statements and reports are set out in the Companies (Revision of Financial Statements and Reports) Regulation, made pursuant to Cap.622 s.450.[45]

11.039 **Warning to Registrar of revision if statements already forwarded.** If the financial statements to be revised have already been forwarded to the Registrar under Cap.622 s.664,[46] the company must, within seven days after the directors decided to revise the financial statements, deliver to the Registrar a warning statement in the specified form that the financial statements will be so revised: Cap.622 s.449(3).[47]

11.040 **Revision voluntary but if defective offence committed; and for listed companies effectively compulsory.** Revision of the financial statements under s.449 is voluntary in the sense that the directors are not compelled under the provision to revise the financial statements. It is the directors' choice. However, the Financial Reporting Council has power to effectively require directors of listed companies to exercise their powers under s.449 to revise defective accounts.[48] Also, if the financial statements do not comply with the Companies Ordinance, then an offence can be committed under s.379 if the defective financial statements are laid before the company in general meeting. If the financial statements have been revised in accordance with s.449 and the regulations, then the Companies

[42] Subject to compliance with IFRS 1 – First-time Adoption of International Financial Reporting Standards.
[43] If the financial statements have not been sent to any person, there is nothing to prevent the directors from correcting any errors and to approve the corrected financial statements and have the corrected financial statements be treated as the company's financial statements for sending to members and laying before the company in general meeting etc.
[44] Cap.32 s.141E.
[45] Cf. the Companies (Revision of Accounts and Reports) Regulation, previously made under Cap.32 s.359A(3)-(6).
[46] See para.11.056 below.
[47] Cap.32 s.141E(3).
[48] Financial Reporting Council Ordinance (Cap.588) ss.49 and 50.

Ordinance has effect with respect to the revised statements as if the revised statements were, as from the date of revision,[49] financial statements of the company in place of the original financial statements.[50] The revised financial statements are regarded as the company's financial statements prospectively only and not retrospectively, and so persons can still be liable for any contraventions of the Companies Ordinance which have already taken place before the date of revision of the financial statements.

3.5 Corporate groups: consolidated financial statements

11.041 **Must give true and fair view of company and subsidiaries as whole.** Holding companies are required under Cap.622 s.379(2) to prepare consolidated financial statements.[51] The consolidated financial statements must give a true and fair view of the financial position of the company, and all the subsidiary undertakings,[52] as a whole as at the end of the financial year, and must give a true and fair view of the financial performance of the company, and all the subsidiary undertakings, as a whole for the financial year.[53] Effectively, the statement of comprehensive income and statement of financial position must be prepared on a group basis. The consolidated financial statements must also comply with Sch.4 and other requirements of Cap.622, as well as applicable accounting standards.[54]

11.042 **Individual and group accounts.** Under the predecessor Cap.32, a holding company must prepare both individual accounts for itself and group accounts.[55] The requirement for individual financial statements is not required under Cap.622; however, an individual statement of financial position for the holding company needs to be included in the notes to the holding company's consolidated financial statements.[56]

11.043 **Where holding company is subsidiary it need not prepare consolidated financial statements.** Where a holding company is itself a wholly owned subsidiary of another body corporate, then that holding company need not prepare consolidated financial statements.[57] Where a holding company is a partially owned subsidiary of another body corporate, consolidated financial statements are also not required if the directors of the partially owned subsidiary have notified its members of this intention and no members have required the preparation of consolidated financial statements.[58]

[49] On the meaning of "date of revision", see Companies (Revision of Financial Statements and Reports) Regulation s.2(1).
[50] Companies (Revision of Financial Statements and Reports) Regulation s.10.
[51] Cap.32 s.124.
[52] For the definition of "subsidiary undertaking", see Cap.622 Sch.1.
[53] Cap.622 s.380(2).
[54] Cap.622 s.380(3), (4). These subsections refer to "financial statements", which means both annual financial statements of a company and also the consolidated financial statements: Cap.622 s.357(1).
[55] Cap.32 s.124.
[56] Cap.622 Sch.4 Pt.1 s.2.
[57] Cap.622 s.379(3)(a). See s.357(3) for the definition of wholly owned subsidiary. For Cap.32, see s.124(2)(a).
[58] See Cap.622 s.379(3)(b).

2. General rules of attribution. These are rules which are equally applicable to natural persons, namely principles of agency law.

3. Special rules of attribution. Where the above principles of attribution are not appropriate for determining how a particular law applies to companies, it is necessary for the court to fashion a special rule of attribution to determine whether the act or mental state of a particular individual should be attributed to the company for the purposes of that particular law. This is a matter of interpretation of the substantive rule of law in question. If the rule is intended to apply to companies, then one asks the questions: how was it intended to apply, and whose act (or knowledge or state of mind) was for this purpose intended to count as the act etc. of the company? Where the law is contained in a statute, the issue is determined as a matter of statutory interpretation, taking into account the language of the statutory provision and its content and policy.

12.098 ***Lennard's Carrying Co* case.** In *Lennard's Carrying Co v Asiatic Petroleum Co*,[199] the relevant statutory provision provided that an owner of a ship would not be liable for "any loss or damage happening without his actual fault or privity" where any goods taken on the ship are lost or damaged by reason of fire. Accordingly, liability was based on primary liability of the company and vicarious liability would not be covered. A cargo of benzine on board of a company's ship was lost by a fire caused by the unseaworthiness of the ship in respect of the defective condition of her boiler. The managing director of another company which managed the ship on behalf of the ship-owning company was at fault. Viscount Haldane LC considered that for the company to itself be at fault, there must be a person who can be regarded as a "directing mind and will of the company", such as the board itself, or a person who has authority comparable with that of the board given to him under the articles. The House of Lords attributed the managing director's fault as the company's personal fault and the company was held liable, on the basis that the company failed as a matter of evidence to discharge its burden of showing that the managing director was only a servant or agent.[200] Lord Hoffmann in the *Meridian* case interpreted Viscount Haldane's approach as one involving the application of a special rule of attribution based on an interpretation of what the statutory provision required.[201]

12.099 **"Directing mind and will" can distract from purpose of rules of attribution.** Although the concept of the "directing mind and will" of a company is still cited by judges and commentators when dealing with the question of attribution, Lord Hoffmann had observed in the *Meridian* case that such anthropomorphism distracts from the purpose of rules of attribution.[202] It is well to heed Lord Hoffmann's observations. Focus should be on construction or interpretation of the substantive rule

[199] [1915] AC 705; applied in *Wong Hing Faat v Hong Kong and Yaumati Ferry Co Ltd* [1992] 1 HKC 497.
[200] The memorandum and articles were not put in evidence and the managing director also did not give evidence.
[201] *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, 509.
[202] *Ibid.*, 509–510.

to see how it should be applied to achieve the purpose of the rule, rather than dwelling on the "metaphysics" of a company.[203]

12.100 **Individual director's or board' knowledge.** Where the board's knowledge is to be attributed to the company under the primary rules of attribution, the knowledge of a single director would not be regarded as the company's knowledge where the other directors do not possess that knowledge.[204] As the decision of a majority of directors is a decision of the board, then it seems that the collective knowledge or intentions of the majority should be sufficient for attribution of that state of mind to the board. Where attribution is on the basis of a special rule of attribution, it is possible to treat an individual director's knowledge as the company's for the particular purposes at hand.[205]

12.101 **Concept of aggregation can be applied.** It also seems to be possible to apply the concept of aggregation in the civil context, such that acts or knowledge of different persons can be combined together and attributed to the company.[206] Thus, where the elements of a tort cannot be established against any individual in a company but can be established against the company by attributing the acts of separate individuals to the company, then the company will be liable.[207] However, aggregation is not possible for the purpose of establishing a fraudulent or dishonest intent on the part of a company.[208]

12.102 **Circumstances conduct or state of mind not attributed; *Hampshire Land* principle - agent's knowledge not attributed when relates to his own fraud.** There are circumstances where a person's conduct or state of mind would not be attributed to the company by reason of the person's fraud perpetrated on the company. Under the *Hampshire Land* principle, the knowledge of an agent will not be attributed to the principal when the knowledge relates to the agent's own fraud against the principal or other breach of duty in respect of conduct directed at the principal.[209] This principle is applied as the principal is the victim, and it would be irrational to impute the agent's knowledge to the principal in a way that would prejudice the principal (for example by preventing the principal from being able to recover for the loss by reason of notice of the agent's wrongdoing). However, it appears that in the corporate context, the principle does not apply where all the owners and controllers of the company are complicit in the fraud (such as where the agent is the single shareholder or director of

[203] See [1995] 2 AC 500, 511. However, in *Stone & Rolls Ltd v Moore Stephens* [2009] 1 AC 1391, Lord Walker considered that the concept of "directing mind and will" will still be useful in particular contexts, such as where the company has only a single shareholder or director ([134]–[135]).
[204] *Powles v Page* (1846) 3 CB 16, 136 ER 7; *Red Sea Tankers Ltd v Papachristidis* [1997] 2 Lloyd's Rep 547.
[205] In the pre-*Meridian* case law, this was held to be appropriate where the individual director is regarded as the directing mind and will in the circumstances of the case: *El Ajou v Dollar Land Holdings Plc* [1994] 1 BCLC 464.
[206] *Entwells Pty Ltd v National and General Insurance Co Ltd* (1991) 5 ACSR 424.
[207] *W B Anderson and Sons Ltd v Rhodes (Liverpool) Ltd* [1967] 2 All ER 850.
[208] *Macquarie Bank Ltd v Sixty-fourth Throne Pty Ltd* [1998] 3 VR 133.
[209] *Re Hampshire Land Co* [1896] 2 Ch 743; *Moulin Global Eyecare Trading Ltd (in liq) v Commissioner of Inland Revenue* [2012] 2 HKLRD 911, [24], CA; *Stone & Rolls Ltd (in liq) v Moore Stephens* [2009] 1 AC 1391, [43], *per* Lord Phillips, and see also the discussion of Lord Walker at [137]–[168]. Where the fraud is against a third party but there is an incidental breach of duty to the company, the agent's knowledge could still be attributed to the company where the company has benefitted from the conduct: see *Beach Petroleum NL v Johnson* (1993) 115 ALR 411, 574.

Equitable treatment of shareholders

15.024 **Reduction must affect all shareholders of equal standing in similar manner.** The reduction must affect all shareholders of equal standing in a similar manner, but where the reduction treats certain shareholders differently from their equals, the court may still confirm the reduction if those who are not treated equally have consented to the reduction.[41] The court will decline to confirm the reduction if it is unjust or inequitable to shareholders who do not consent to the proposal.[42]

15.025 **Treatment of different classes conform to rights of different classes arising on a winding-up.** Equitable treatment of different classes of shareholders generally requires that the reduction conform to the rights of the different classes that would arise in a winding-up.[43] For example, where preference shareholders have priority as to return of capital in a winding-up (but no right to participate in surplus assets), then (i) a return of capital in excess of the company's wants should involve paying off the preference holders first;[44] but (ii) where the reduction involves a cancellation of shares to reflect the company's losses, then the ordinary shares should be cancelled first.[45]

15.026 **Reduction not unfair if consistent with reasonable expectations of shareholder in particular class.** A reduction will not be unfair if it is consistent with the reasonable expectations of a shareholder of the class in question, having regard to the risks which the shareholder must be taken to have assumed when he or she acquired the shares of that class.[46] There is no unfairness if the scheme involves no more than the realisation of such a risk. It has been held that it has always been a characteristic of preference shares that the holders are at risk of their hopes of participating in future profits being frustrated by a liquidation or a reduction of capital, and so there is nothing unfair in a company reducing its capital by cancelling preference shares and returning the capital paid up on those shares to the holders.[47] Moreover, in a situation where the preference shareholders have a priority to return of capital in winding-up, an earlier return in a reduction of capital simply gives effect to the preference shareholders' rights to return of capital before ordinary shareholders.[48]

15.027 ***Re Holders* case: proposed reduction unfair to preference shareholders as fell short of compensating them for disadvantages of share cancellation.** In *Re Holders Investment Trust Ltd*,[49] the proposed reduction involved a cancellation of 5 per cent cumulative redeemable preference shares of £1 each, redeemable at par on 31 July 1971, and allotting to the holders the same nominal amount of 6 per cent unsecured

[41] See *Re Jupiter House Investments (Cambridge) Ltd* [1985] BCLC 222, 224; *British and American Trustee and Finance Corp Ltd v Couper* [1894] AC 399.
[42] *British and American Trustee and Finance Corp Ltd v Couper* [1894] AC 399, 406.
[43] *Bannatyne v Direct Spanish Telegraph Co* (1886) 34 Ch D 287.
[44] *Prudential Assurance Co Ltd v Chatterly-Whitfield Collieries Ltd* [1949] AC 512.
[45] *Re London and New York Investment Corp Ltd* [1895] 2 Ch 860; and see also *Re Quebrada Railway Land and Copper Co* [1889] LR 40 Ch D 363.
[46] *Re Hunting Plc* [2005] 2 BCLC 211, [23].
[47] *Re Northern Engineering Industries Plc* [1994] 2 BCLC 704; *House of Fraser Plc v ACGE Investments Ltd* [1987] 1 AC 387, 392–393; *Re Hunting Plc* [2005] 2 BCLC 211.
[48] *House of Fraser Plc v ACGE Investments Ltd* [1987] 1 AC 387, 392–393; *Re Hunting Plc* [2005] 2 BCLC 211, [27].
[49] [1971] 2 All ER 289.

loan stock repayable in 1985–1990. The court held that the proposed scheme was unfair to the preference shareholders. Although there was an increase in the interest rate from 5 per cent to 6 per cent, that advantage fell substantially short of compensating the preference shareholders for the disadvantages, in particular the postponement of the date of repayment.

15.028 **Where reduction involves variation of class rights then ss. 176-184 of Cap.622 must be complied with.** Where the reduction of capital involves a variation of class rights, then the requirements in Cap.622 ss.176–184[50] should be complied with. However even if the requisite approvals of the members of the class have been obtained, the court still has discretion not to confirm the reduction.

15.029 **Reasons why provisions must be complied with.** In *Re Holders Investment Trust Ltd*,[51] the parties were in agreement as to the following principle: that if the reduction has been approved in a class meeting, then the burden of proof is on the opponents to the reduction to show that the reduction is unfair, but if the reduction has not been approved in a class meeting, then the burden is on the company to prove that the reduction is fair. The first limb of that proposition can be accepted. However, it is not clear that the second limb is correct under the current law. The second limb indicates that notwithstanding the absence of approval at a class meeting, the court can still confirm a reduction of capital that varies class rights. At the time of the above decision, procedures for alteration of class rights were only contained in the articles (the original English equivalent of Cap.622 ss.176–184 not being enacted until 1980), and it can be accepted that, in that context, the statutory power to reduce capital can override requirements in the articles for class meetings. However, under Cap.622 s.180(1),[52] requirements in the articles for variation of class rights are given statutory footing, such that the Ordinance mandates variations to conform with requirements in the articles or, in the absence of such requirements, in accordance with the requirements in Cap.622 s.180(3). Although Cap.622 s.226 does not itself require class meetings to be held, there is no reason to read s.226 as overriding s.180. The better view is that both ss.226 and 180 need to be complied with in the case of reductions of capital which vary class rights. In any event, it has been said that where there will be different treatment of different classes, the reduction of capital should proceed by way of a scheme of arrangement (Cap.622 Pt.13) where the statutory provision gives greater protection to minority shareholders; the court should not encourage the weakening of those protections by confirming reductions of capital where class approvals have not been obtained.[53]

Proper explanation

15.030 **Must be full and frank disclosure to shareholders about reasons for reduction.** There must be full and frank disclosure of information to shareholders so that they can make an informed choice. There must be proper explanation of the reduction and the

[50] Cap.32 s.63A.
[51] [1971] 2 All ER 289.
[52] Cap.32 s.63A(4).
[53] See *Re Robert Stephen Holdings Ltd* [1968] 1 All ER 195, 196.

case, there were insufficient restrictions placed on what the chargor could do with the proceeds of the book debts. Since the chargor could freely withdraw money from the account, then it was considered to be a floating charge.[98]

3.2.3 *Disposition of assets subject to a floating charge*

17.085 **Company has implied licence or power to dispose of assets in ordinary course of business.** The core feature of a floating charge is the ability of the company to dispose of the charged assets free of the charge. The company is treated as having an implied licence or an implied power to dispose of the property while carrying on its business in the ordinary course.[99] For example, transactions for sale[100] or lease[101] of assets can be within the scope of the implied licence. Also, unless the floating charge instrument provides otherwise, the company would be entitled to grant a later charge (e.g. a mortgage or fixed charge) having greater priority than the floating charge.[102] Transactions can be valid even though they are not usually entered into as part of the company's business, so long as the transaction was undertaken in the course of maintaining the company's business as a going concern.[103] Transactions would be outside the implied licence if, for example, the transaction amounts to a disposal of the substantial undertaking of the company with a view to ceasing operation as a going concern;[104] the transaction is designed to defeat the chargee's security to benefit other creditors;[105] or the transaction involves a fraudulent dealing.[106]

17.086 **Transaction outside company's implied licence does not necessarily crystallise floating charge.** A transaction outside the implied licence does not necessarily crystallise a floating charge: see further below on "crystallisation". However, if the circumstances also give rise to crystallisation (such as where the transaction also involves a cessation of the company's business), then the assets would pass to the disponee subject to the crystallised charge.[107]

17.087 **Where no crystallisation notice of breach of implied licence determines whether disponee takes property subject to chargee's interest.** If there is no crystallisation, whether the disponee takes the property subject to the chargee's interests depends on whether the disponee has actual or constructive notice of the breach of the implied licence.[108] Notice of the existence of the floating charge without notice that the disposition is inconsistent with the charge is not enough to defeat the claims of a disponee who takes the legal interest in the assets.[109] It is possible for a charge instrument to expressly delineate the types of dispositions that would be valid[110] such that the scope of the company's licence to deal with the assets is narrower than the implied licence.[111] However, a disponee who takes the legal interest in the assets will only take subject to the chargee's interests if the disponee has notice of the restrictions in the charge.[112]

17.088 **Chargee can obtain injunction or appoint receiver if there is potential breach of company's implied licence to deal with assets.** In all cases where there is a proposed transaction that would breach the company's licence to deal with the assets, the chargee can obtain an injunction to restrain the transaction[113] or can appoint a receiver to protect the assets.[114] Such action by the chargee would also have the effect of crystallising the charge: see below.

3.2.4 *Crystallisation of a floating charge*

Meaning and events of crystallisation

17.089 **Process of crystallisation converts floating charge to fixed charge.** When a floating charge crystallizes, the charge attaches specifically to, and becomes a fixed charge over, all the items of assets within the class of assets charged which the company owns at the time of crystallisation. The process of crystallisation converts the floating charge into a fixed charge as at the time of crystallisation.

17.090 **When crystallisation occurs.** The existence of a floating charge is premised on the company continuing to operate as a going concern and to carry on business in the ordinary way.[115] Accordingly, crystallisation occurs in the following situations:

- Upon the court making an order for the compulsory winding-up of the company.[116] The mere fact that a petition is presented for compulsory winding-up does not crystallise the charge.[117] Also, the charge is not crystallised simply because a provisional liquidator is appointed before a court order for winding-up.[118]

[98] The House of Lords overruled the decision of *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep. where a similar charge had been held to be a fixed charge. For a subsequent decision applying the principles in *Re Spectrum Plus*, see *Re Beam Tube Products Ltd* [2006] BCC 615. On *Spectrum Plus* generally, see Alan Berg, "The Cuckoo in the Nest of Corporate Insolvency: Some Aspects of the *Spectrum* Case" [2006] *Journal of Business Law* 22; Duncan Henderson, "Problems in the Law of Property after *Spectrum Plus*" (2006) 17 *International Company and Commercial Law Review* 30; David Capper, "*Spectrum Plus* in the House of Lords: the Victory of Substance over Form in Personal Property Security Law?" (2006) 6 *Journal of Corporate Law Studies* 447.

[99] *Re Florence Land and Public Works Co, Ex p Moor* (1878) 10 Ch D 530, 540–541; *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979, 993.

[100] *Re Florence Land and Public Works Co, Ex p Moor* (1878) 10 Ch D 530, 541.

[101] *Dempsey and National Bank of New Zealand Ltd v Traders' Finance Corp Ltd* [1933] NZLR 1258.

[102] *Re Colonial Trusts Corp, Ex p Bradshaw* (1879) 15 Ch D 465, 472; *Cox Moore v Peruvian Corp Ltd* [1908] 1 Ch 604.

[103] *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1983) 8 ACLR 422 (company which dealt in agricultural equipment disposed of some of its second-hand tractors to a financier in exchange for a reduction in an outstanding debt; it was held that the disposal was valid).

[104] *Hubbuck v Helms* (1887) 56 LJ Ch 536. As the company ceases business, the charge would actually crystallise: see para.17.090 below.

[105] *Hamilton v Hunter* (1982) 7 ACLR 295.

[106] *Taylor v M'Keand* (1880) 5 CPD 358.

[107] *Fire Nymph Products Ltd v The Heating Centre Pty Ltd (in liq)* (1992) 7 ACSR 365, 379.

[108] See, e.g., *Hamilton v Hunter* (1982) 7 ACLR 295.

[109] *English and Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700; *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1983) 8 ACLR 422, 427.

[110] See, e.g., *Governments Stock and Other Securities Investment Co Ltd v Manila Rly Co Ltd* [1897] AC 81; *Re Crompton & Co Ltd* [1914] 1 Ch 954.

[111] If the restrictions go so far as to deprive the charge of the incidents or features of a floating charge, then the court may characterise the charge as a fixed charge rather than a floating charge.

[112] *English and Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700; *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* (1983) 8 ACLR 422, 427. See further para.17.203 below.

[113] See *Re Borax Co, Foster v Borax Co* [1901] 1 Ch 326; *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366, 377–378.

[114] *McMahon v North Kent Ironworks Co* [1891] 2 Ch 148.

[115] *Governments Stock and Other Securities Investment Co Ltd v Manila Rly Co Ltd* [1897] AC 81, 86.

[116] *Wallace v Universal Automatic Machines* [1894] 2 Ch 547.

[117] *Re Victoria Steamboats Ltd* [1897] 1 Ch 158.

[118] *Re Obie Pty Ltd* (1983) 8 ACLR 439.