whether in regard to dividend, voting, return of capital, or otherwise as the company may from time to time determine. Classes of shares are discussed in Chapter 3.

II. PAYMENT FOR SHARES

Introduction

2.007 It will be shown later[34] that the doctrine of capital maintenance was a fundamental principle of company law from the early days. A company's capital was sacrosanct and not allowed to be returned to shareholders. The capital was a source to which creditors could resort in the event of the liquidation of the company. The fact that the capital might have been lost through trading did not deter the courts or the legislature from establishing detailed rules as to maintenance of capital, and one aspect of that doctrine was that the company must receive at least the nominal value of the shares. This rule does not survive the abolition of nominal value. But it is still necessary that a proper price be paid for shares (otherwise the directors may be liable for breach of fiduciary duty) and the prohibition against issuing shares at a discount still applies.[35]

Payment in Cash or Non-cash Consideration

2.008 Shares may be issued at any price which the directors decide may be obtained for them.[36] With the abolition of par value, the concept of issuing shares at a premium is no longer applicable. If the company receives less than the price fixed for shares, then it has issued shares at a discount, which is prohibited.

Cash means actual cash or a cheque or the release of a liability of the company for a liquidated sum.[37]

The payment for the shares must be cash or non-cash consideration. Non-cash consideration means consideration in strict contract principles, so past services is not good consideration for the allotment of shares.[38] An allotment of shares on consideration of the debt due to the founding members for pre-incorporation expenses is good consideration,[39] as is allotment of shares in consideration of a retainer of the allottee for future services at a fixed sum.[40]

Valuation of Non-cash Consideration

2.009 Where the company accepts non-cash consideration, such as a factory and equipment of a business formerly run as a partnership, it may not be easy to determine whether a proper price has been paid for the shares.

[34] See [2.029].
[35] See [2.012].
[36] See *Hilder v Dexter* [1902] AC 474 (HL); see also *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd* [1904] AC 648 (HL). In determining the price, the directors must act in the best interests of the company. The issue of undervaluing the shares sometimes arises in the context of initial public offering, where the over subscription may suggest that the price was too low. But it is difficult to prove.
[37] See *Re Jones Lloyd & Co Ltd* (1889) 41 Ch D 159; see also *Park Business Interiors Ltd v Park* [1992] BCLC 1034. There was no equivalent in any of the former COs nor is there in the current CO of the definition of "cash consideration" in the UK legislation (See CA 1985, s.738(2); CA 2006, s.583(3)).
[38] *Re Eddystone Marine Insurance Co* [1893] 3 Ch 9 (CA Eng).
[39] *Park Business Interiors Ltd v Park* [1992] BCLC 1034.
[40] *Gardner v Iredale* [1912] 1 Ch 700.

Fortunately, the courts rarely interfere. They will not inquire into the value of the non-cash consideration so long as the company honestly regards the consideration given as fairly representing the price of the shares.[41] However, it sometimes may be apparent from the terms of a contract that the value put on the non-cash consideration is extravagant, in which case the court will treat the transaction as an issue of shares at a discount[42] and require the shareholders to pay the balance of the full price of the shares[43] or treat the shares as only partly paid.

Return of Allotment

When a company limited by shares makes any allotment of shares, it must within one 2.010
month thereafter deliver to the Registrar of Companies a return of allotment in the specified form,[44]ie Form NSC1. Where shares are allotted for a non-cash consideration, the return must state the particulars of the contract for sale or for services or other consideration for the allotment.[45] On default in complying with these requirements, the company and every responsible person of the company who is in default will be liable to a default fine and, for continued default, to a daily default fine.[46]

Registration of Allotment

A company must register an allotment of shares as soon as practicable and in any event 2.011
within two months after the date of the allotment, by entering in the register of its members the information referred to in s.627(2) and 627(3) of the CO.[47]

Shares Issued at a Discount

At common law, issuing shares at a discount, ie at less than their nominal value, was 2.012
prohibited.[48] The predecessor CO permitted issue at a discount subject to certain restrictions and with the sanction of the court where shares of the same class have already been issued and the company was entitled to commence business at least one year before the issue.[49]

The CO has a general prohibition of commissions, discounts and allowances.[50] Section 148 of the CO provides for permitted commissions, and s.149 allows capital to be applied in writing of certain expenses and commissions.

[41] See *Re Ooregum Gold Mining Co of India v Roper* [1892] AC 125, 137 (HL); see also *Re Wragg Ltd* [1897] 1 Ch 796, 830–831 (CA Eng); *Re Innes & Co Ltd* [1903] 2 Ch 254 (CA Eng); *Re White Star Line Ltd* [1938] Ch 458 (CA Eng).
[42] For issue of shares at a discount, see [2.012]. Issue of shares at a discount is still generally prohibited under CO, s.147.
[43] *Hong Kong and China Gas Co Ltd v Glen* [1914] 1 Ch 527.
[44] CO, s.142(2)(a). The return must include a statement of capital (CO, s.201) as at the date of the allotment.
[45] CO, s.142(2)(b). See also s.142(2)(c), 142(2)(d) and 142(2)(e) of the CO. For extension of time for delivery of the return, see CO, s.142(4)–142(7). See also *Re China Unicom (Hong Kong) Ltd* (HCMP 2106/2015, 22 September 2015, [2016] 2 HKC 343); *Re Poly Property Group Co Ltd* (HCMP 3154/2015, 15 December 2015, [2016] 4 HKC 169); *Hong Wei (Asia) Co Ltd v Registrar of Companies* (HCMP 1418/2016, 13 July 2016, [2016] HKCU 1741) (relevance of issue of default summons).
[46] CO, s.142(3). For responsible person, see CO, s.3 and FN 47.
[47] CO, s.143(1). For contravention see CO, s.143(2). CO, s.3 (Responsible person) makes an officer and shadow director liable if he or she authorizes or permits or participates in a contravention or failure.
[48] *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL).
[49] CO, s.50(1) and 50(2).
[50] CO, s.147.

III. INCREASE OF CAPITAL

Power of Company to Alter Share Capital

2.013 A limited company may alter its share capital in any one or more of the following ways.[51]

The company may: (a) increase its share capital by allotting and issuing new shares in accordance with Part 4; (b) increase its share capital without allotting and issuing new shares, if the funds or other assets for the increase are provided by the members of the company; (c) capitalise its profits, with or without allotting and issuing new shares; (d) allot and issue bonus shares with or without increasing its share capital; (e) convert all or any of its shares into a larger or smaller number of shares; and (f) cancel shares—(i) that, at the date the resolution for cancellation is passed, have not been taken or agreed to be taken by any person; or (ii) that have been forfeited.[52]

A limited company may alter its share capital as referred to in (e) or (f) of [2.013] only by resolution of the company.[53] Such resolution may authorise the company to exercise the power: (a) on more than one occasion; and (b) at a specified time or in specified circumstances.[54] If shares are cancelled under (f) in [2.013], the company must reduce its share capital by the amount of the shares cancelled.[55] For the purposes of Part 5 (Transactions in relation to Share Capital) of the CO, a cancellation of shares under s.170 of the CO is not a reduction of share capital.[56] A limited company's articles may exclude or restrict the exercise of a power as conferred by s.170 of the CO.[57]

Exercise of the Power

2.014 These powers may be exercised in general meetings[58] or, where appropriate, using the written resolution procedure.[59] Generally, under express regulations the appropriate resolution is an ordinary resolution.[60] If the articles do not provide for increase of capital, it will be necessary to amend the articles to so provide.[61] The notice convening a meeting to consider a resolution to increase the capital should state the amount of the proposed increase.[62] The currency of the increase need not be the same as that of the original capital.[63]

Where the articles provide for increase of capital, those provisions must be observed if the increase is to be valid and effective.[64]

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51 CO, s.170(1).

52 CO, s.170(2).

53 CO, s.170(3). CO, ss.140 and 141 contain provisions requiring a resolution of the company for an allotment of shares. Those sections may be relevant to an alteration of share capital referred to in (a), (c) and (d) in [2.013]. In any conversion under CO, s.170(2)(e) the proportion between the amount paid and the amount, if any, unpaid on each reduced share must be the same as it was in the case of the share from which the reduced share is derived; see also CO, s.170(5).

54 CO, s.170(4).

55 CO, s.170(6).

56 CO, s.170(7). For reduction of capital see s.2.016 et seq.

57 CO, s.170(8).

58 See Chapter 5 [5.019], et seq.

59 CO, s.548.

60 And for Model Articles, see Companies (Model Articles) Notice (Cap.622H, Sub.Leg.) (public companies), Sch.1 art.87 and (private companies) Sch.2 art.69.

61 CO, s.87. For amendment of articles see Chapter 1 [1.016] et seq.

62 CO, s.171(2)(b); see also *MacConnell v E Prill & Co Ltd* [1916] 2 Ch 57.

63 CO, s.172(1); see also *Re Scandinavian Bank Group plc* [1988] Ch 87.

64 See *Tsao Chin Lan v Tin Ka Kung* [1995] 2 HKC 671 (CA).

Notice of the alteration of capital (other than for an increase of capital) must be given to the Registrar of Companies in the specified form NSC11 within one month of the alteration.[65]

Fettering the Company's Power to Increase the Capital

The power to increase capital can be abused. In private companies where there is con- 2.015
flict between members, capital is often increased and an issue of new shares made, in order to cause a dilution in the shareholding of the opposition. Dilution is a common complaint in unfair prejudice cases.[66]

So it is not uncommon in private companies, and joint venture companies in particular, for the articles or a separate shareholder agreement to provide for unanimous approval for an increase of capital.[67] A company cannot fetter its statutory powers, so if such a restriction appears in the articles[68] or in a separate shareholder agreement to which the company is a party, the restriction will not be binding on the company. However, the restriction may be binding on those shareholders party to the agreement (but not shareholders not party to the agreement, unless they adhere to the agreement in some manner),[69] so that, for example, it might be possible to obtain an injunction against a shareholder who was intending to vote contrary to what had been agreed or even damages for breach of contract, if loss could be proved. The Hong Kong courts seem to have gone further in deciding that not only can the company not fetter its statutory rights, but neither can members fetter their statutory powers.[70]

IV. REDUCTION OF CAPITAL

Maintenance of Capital Doctrine

This doctrine of the maintenance of the capital of a company has already been men- 2.016
tioned[71] and more will be said about it later.[72] A company's capital was sacrosanct and not allowed to be returned to members. The reduction of the capital of a company falls within this principle, but, in order to contrast the topic of reduction with the topic of increase of capital just discussed, reduction of capital will be dealt with now.

Reasons for Reduction

A company may wish to reduce its capital for a variety of reasons, but the most com- 2.017
mon situation in the past was where the company had suffered a permanent loss of

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65 CO, s.171(1). The notice must include a statement of capital; see CO, ss.171(2)(c) and 201. For non-compliance under s.171 and 171(4) of the CO.

66 See *Tseng Yueh Lee Irene v Metrobilt Enterprise Ltd* [1994] 2 HKC 684; see also *Ng Yat Chi v Max Share Ltd* [2001] 1 HKLRD 561 (CA), affirmed (2001) 4 HKCFAR 299.

67 *Russell v Northern Bank Development Corp Ltd* [1992] 1 WLR 588 (HL).

68 For the contractual effect of the articles, see CO, s.86.

69 *Russell v Northern Bank Development Corp Ltd*, FN 67.

70 See *Re Greater Beijing Region Expressways Ltd* [1999] 4 HKC 807; see also *Muir v Lampl* [2005] 1 HKLRD 338; *Re Team Y & R Holdings Hong Kong Ltd* [2016] 3 HKLRD 778; appeal dismissed (CACV 6/2017, HCMP 3136/2016, [2017] HKEC 1532); application for leave to appeal to CFA dismissed (CACV 6/2017, [2017] HKEC 2533).

71 See [2.007].

72 See [2.029].

capital through trading losses and the market value of its shares was less than their par value, so that the company could not raise further capital.[73]

The reverse situation is where a company has an excess of capital. This may happen where there is legislation applicable to the company's business requiring a certain capital ratio[74] and the company is giving up that part of its business where a minimum capital is required.[75]

With the comparative relaxation of the rules relating to purchase of own shares by a private company,[76] in many instances a private company will prefer to purchase its own shares, rather than go the reduction route.

Prohibition, Subject to Ordinance

2.018 Except as provided in the CO, no company limited by shares or limited by guarantee and having a share capital[77] shall reduce its share capital in any way.[78] This reflects the capital maintenance principle expounded in *Trevor v Whitworth*.[79]

However, subject to any provision of the company articles that prohibit or restrict the reduction of the company's share capital,[80] a company limited by shares[81] may reduce its share capital under Division 3 of Part 5 of the CO in any way,[82] by one or other of the two procedures specified in the CO. But a company may not reduce its share capital, if, as a result of the reduction, there would no longer be any member of the company holding shares other than redeemable shares.[83]

Section 210 (Permitted reductions of share capital) of the CO provides some examples of the types of reduction: (1) A company may extinguish or reduce the liability on any of its shares in respect of share capital not paid up.[84] (2) A company may, either with or without extinguishing or reducing liability on any of its shares, (a) cancel any paid-up share capital that is lost or unrepresented by available assets[85] or (b) repay any paid-up capital in excess of the company's wants.[86]

The three specified methods of reduction are without prejudice to the expressed power to reduce capital "in any way". A combination of two or more of the specified ways may be used.

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[73] Not being able to issue shares at a discount (see [2.012]), or pay dividends (dividends are only payable out of profits available for distribution, see CO, s.297. A distribution by way of reduction of capital is an exception; see also CO, s.290. See also [2.018] for the types of reduction referred to in CO, s.210.

[74] As in the securities industry, see Securities and Futures Ordinance (Cap.571) (SFO); see also SFO, s.145 and Securities and Futures (Financial Resources) Rules (Cap.571N, Sub.Leg.).

[75] Note that there is no minimum capital required under the Money Lenders Ordinance (Cap.163): see *Re Shun Sing Finance Co Ltd* (HCMP 2518/2006, [2007] HKEC 699), where the company was giving up lending on unsecured loans and therefore needed less capital.

[76] See [2.031].

[77] Since 13 February 2004, a company cannot be formed as, or become, a company limited by guarantee with a share capital as prescribed in CO, ss.9 and 66.

[78] See generally on the prohibition *Hill v Permanent Trustee Co of New South Wales Ltd* [1930] AC 720 (PC).

[79] (1887) 12 App Cas 409 (HL).

[80] CO, s.210(3).

[81] And guarantee companies with a share capital incorporated before 13 February 2004 (see FN 77).

[82] CO, s.210(1); see also *Ex p Westburn Sugar Refineries Ltd* [1951] AC 625, [629] (HL). Note that CO, s.211, adds a new procedure of special resolution supported by a solvency statement.

[83] CO, s.210(2).

[84] Since most shares are nowadays fully paid up on issue (see [2.005]) this situation is not common.

[85] As indicated in [2.017], this is a common situation.

[86] The examples are based on the methods approved in *Poole v National Bank of China Ltd* [1907] AC 229 (PC).

Permitted Reduction of Share Capital

The two procedures for a company to reduce its share capital are: (a) by special resolution supported by a solvency statement or (b) by special resolution confirmed by the court.[87] 2.019

Procedure (a) was introduced by the CO, s.215 et seq and is based on the Companies Act 2006 (UK), ss.642–644. Since this new procedure is likely to reduce the number of applications to the court to confirm a reduction,[88] it will be dealt with first. The concept of a solvency statement made by director as an alternative to a court application for confirmation of a transaction by the company is not new to the CO. It existed under the predecessor CO in s.47F in the context of the giving of financial assistance and in s.49K of the predecessor CO in the context of redemption or purchase of own shares of a private company out of capital. The concept has been extended in CO to other situations.[89]

Solvency Test

A company satisfies the solvency test in relation to a transaction if: (a) immediately after the transaction there will be no ground on which the company could be found liable to be found to be unable to pay its debts; and (b) either (i) if it is intended to commence the winding up of the company within 12 months after the date of the transaction, the company will be able to pay its debts in full within 12 months after the commencement of the winding up; or (ii) in any other case, the company will be able to pay its debts as they become due during the period of 12 months immediately following the date of the transaction.[90] 2.020

Solvency Statement

A solvency statement in relation to a transaction is a statement that each of the directors making it has formed the opinion that the company satisfies the solvency test in relation to the transaction.[91] In forming an opinion for making a solvency statement, a director must: (a) inquire into the company's state of affairs and prospects; and (b) take into account all the liabilities of the company (including contingent and prospective liabilities).[92] 2.021

A solvency statement must be in the specified form (Form NSC17); must state: (i) the date on which it is made; (ii) the name of each director making it; and (c) must be signed by each director making it.[93]

Reduction of Share Capital by Special Resolution Supported by Solvency Statement

All directors of the company must make the solvency statement.[94] 2.022

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[87] CO, s.211.

[88] See Companies Registry Annual Report 2014–15 p.28, 133 out of 141 reductions were by the new out–of-court procedure.

[89] CO, s.204.

[90] CO, s.205.

[91] CO, s.206(1).

[92] CO, s.206(2).

[93] CO, s.206(3).

[94] CO, s.216(1).

The special resolution for reduction of share capital must be passed within 15 days after the date of the solvency statement.[95]

If the special resolution is proposed as a written resolution,[96] a copy of the solvency statement must be sent to every member of the company at or before the time when the proposed resolution is sent to them.[97] If the special resolution is proposed at a meeting, a copy of the solvency statement must be made available for inspection by members at the meeting.[98]

As regards a written resolution, a member of the company holding shares to which the resolution relates is not an eligible person for voting on the resolution.[99] Where the resolution is proposed at a meeting, the resolution is not effective, if any member holding shares to which the resolution relates exercises the voting rights carried by any of those and the resolution would not have been passed if the member had not done so.[100] These restrictions do not apply in the case of a reduction that applies equally to all issued shares in the company.[101]

Publication of Notice

2.023 If the special resolution for reduction of share capital is passed, the company must publish a notice in the Gazette stating that the company has approved a reduction and other information set out in s.218 of the CO including that a dissentient member or a creditor of the company can within five weeks of the date of the resolution apply to the court to cancel the resolution.[102] The company must also publish a notice to the same effect in at least one specified Chinese language newspaper and one specified English language newspaper or give written notice to that effect to each of its creditors.[103] There is also provision for inspection of the resolution and the solvency statements.[104]

Application to Court for Cancellation by Members or Creditors

2.024 Application for cancellation of the special resolution to the Court of First Instance is made by originating summons in the expedited form.[105] A member, who has not consented to or voted in favour of the special resolution, or a creditor of the company may apply.[106] The application must be made within five weeks of the date of the

[95] CO, s.216(2). For precedents of such resolution, see John Brewer, *The Law of Hong Kong Companies* (Sweet & Maxwell, 3rd ed, 2017) p.162; *The Encyclopaedia of Forms and Precedents* (5th ed, 2011 Reissue) Vol.10(1), Form 213 et seq. *Palmer's Company Precedents* (17th ed, 1956) is still very useful in Hong Kong, because, despite the current CO and Civil Justice Reform, this text is closer to Hong Kong's current position, Part I, Form 519. For where a company's powers are fettered, eg unanimity is required for a reduction of capital, see [2.015].

[96] For written resolutions signed by all members see Chapter 5 [5.131] et seq of this text.

[97] CO, s.216(3). For a precedent, see *The Encyclopedia of Forms and Precedents* (5th ed, 2011 Reissue) Vol.10(1), Form 211.

[98] CO, s.216(4). For form of notice to general meeting see *The Encyclopedia of Forms and Precedents* (5th ed, 2011 Reissue) Vol.10(1), Form 212.

[99] CO, s.217(1).

[100] CO, s.217(2) and 217(3).

[101] CO, s.217(5). For offence if share capital is reduced in contravention of the CO, see CO, s.212. For liability of members following reduction of share capital, see CO, s.213. A reserve arising from a reduction of share capital is to be regarded for the purposes of Part 6 of the CO as realized profit; see also, CO, s.214.

[102] CO, s.218.

[103] CO, s.218(3).

[104] CO, s.219.

[105] Rules of the High Court (Cap.4A, Sub.Leg.), O.102 r.2; see also CO, s.58(1). For a useful Procedural Table see *Atkin's Court Forms* (2nd ed, 2010 Issue) Vol.8(4), 303–309.

[106] CO, s.220(1)–220(3).

special resolution.[107] The company must give notice to the Registrar of Companies in the specified form (Form NSC18) within seven days after the application is served on the company.[108] If no application is made to the Court, the company must deliver a return in specified form (Form NSC19) to the Registrar of Companies no earlier than five weeks or later than seven weeks after the date of the resolution.[109] If the Court confirms or cancels the special resolution,[110] the company must deliver to the Registrar of Companies a return in the specified form (Form NSC19) and the Registrar must register the return.[111]

The reduction takes effect when the return under either s.224 or 225 of the CO is registered.[112]

Reduction of Share Capital Confirmed by Court

The alternative to reduction of share capital by special resolution supported by solvency statement is reduction by special resolution confirmed by order of the Court of First Instance confirming the reduction. 2.025

Application to the Court

Application to the court for an order confirming a reduction is made by petition presented by the company.[113] The petition will set out, amongst other things, the history of the company, the initial or current capital, the distribution of the shares, the company's creditors, the regulation in the articles authorising the reduction, the convening of the meeting to pass the resolution, the explanation of the proposed reduction to the shareholders, the nature and effect of the reduction, how any creditors are to be protected, and the voting on the resolution.[114] 2.026

As is usual in most situations where the originating process is by petition, the petition must set out all the relevant facts. The supporting affidavit/affirmation cannot be used to make good deficiencies in the petition itself. The supporting affidavit/affirmation will have exhibited to it all the relevant documents relating to the company and the background and terms of the proposed reduction, including the notice to creditors of the proposed reduction and consents to the reduction.[115]

Where the reduction requires confirmation by the court and involves a diminution of members' liability in respect of unpaid share capital or where paid-up capital is

[107] CO, s.220(1).

[108] CO, s.220(4)(b).

[109] CO, s.224.

[110] CO, s.222.

[111] CO, s.225.

[112] CO, s.215(2).

[113] CO, s.226. The petition is listed under High Court Miscellaneous Proceedings (HCMP).

[114] For precedents see *Brewer*, 167–168; *Atkin's Court Forms* (2nd ed, 2010 Issue) Vol.8(5), Form 104 et seq (the Claim Form in *Atkin* will need adaptation to petition form); see also *Palmer's Company Precedents* (17th ed) Part I, Form 520. If the balance sheet of the company recorded an accumulated loss which reduced available capital, this was the amount of share capital for the purposes of the reduction, so the reduction should have been structured in two parts. See *Re Fok Ying Tung Ming Yuan Development Co Ltd* [2016] 2 HKLRD 292.

[115] For precedents see *Atkin's Court Forms* (2nd ed, 2010 Issue) Vol.8(5), Form 108 et seq; for notice to creditors see *Brewer* p.163. These witness statements in *Atkin* will need adaptation to affidavit/affirmation form. Prior to the abolition of nominal value (see [2.002]), it was usual for the company to offer an undertaking that any bad debts recovered would be paid into a share premium account. Under the CO, the equivalent undertaking is not to treat debts recovered as realized profits distributable as dividends until all the creditors have been paid; see also *Re CNT Security Group Ltd* [2014] 4 HKLRD 659.

offence.[140] In the course of a proceeding for the prosecution of an offence, the court may also make a disqualification order if it thinks fit whether or not any person applies for such an order.[141]

The maximum period of disqualification that can be made under s.168E of the CWUO is 15 years (if order made by the Court of First Instance), 10 years (District Court) or 5 years (magistrate).[142] Where a disqualification order is made by a magistrate, the Official Receiver, or the liquidator or past or present member or creditor of the company affected can apply to the Court of First Instance for a longer period of disqualification.[143] Where the court by which the person was convicted has not made a disqualification order, it is also possible for a separate application to be made to the Court of First Instance under s.168E of the CWUO seeking a disqualification order; however, the court will refuse the subsequent application if it amounts to an abuse of process.[144] The court must ask itself whether it would be manifestly unfair to a party or would otherwise bring the administration of justice into disrepute amongst right-thinking people to allow the proceedings to continue.[145] Fairness to the defendant meant that he should not be exposed to the same claim on multiple occasions by different litigants unhappy with the outcome of the earlier claim.[146]

Where a disqualification order has been made under s.168E of the CWUO as part of the sentence in criminal proceedings, that in itself does not prevent the institution of that s.168H proceedings for a disqualification order on the grounds of unfitness; and it is only in rare cases where the s.168H proceedings would amount to an abuse of process, because of the existence of a very substantial overlap between the matters taken into account in the criminal proceedings and the matters to be taken into account in the civil proceedings, that it would be appropriate to deny relief under s.168H of the CWUO.[147] Similarly, the fact that no disqualification order was made in the criminal proceedings does not mean that proceedings cannot subsequently be brought under s.168H of the CWUO.[148]

Persistent Breaches of Ordinance: s.168F of the CWUO

6.026 Section 168F of the CWUO gives the court power to make a disqualification order against a person who has been persistently in default in relation to provisions of either the CO or CWUO requiring any return, account or other document to be filed with, delivered or sent, or notice of any matter to be given, to the Registrar. Under s.168F(2) of the CWUO, a person is conclusively proved to be persistently in default where the person has been adjudged guilty of three or more defaults in relation to the abovementioned provisions in the five-year period ending on the date of the application for the disqualification order. A person is "adjudged guilty" of a default if the person has been convicted of the relevant offence or the court has made an order in relation to a default under CWUO, s.279 (order requiring liquidator to make returns, etc), CWUO, s.302 (order requiring receiver to make returns, etc), or CWUO, s.306 or CO, s.898 (order requiring officers to comply with CWUO or CO, as the case may be).[149]

[140] CWUO, s.168P(2)(b).
[141] CWUO, s.168P(4).
[142] CWUO, s.168E(3).
[143] CWUO, s.168E(4).
[144] *Secretary of State for Business, Innovation and Skills v Weston* [2014] BCC 581, [38], [39].
[145] *Secretary of State for Business, Innovation and Skills v Weston* [2014] BCC 581, [39].
[146] *Secretary of State for Business, Innovation and Skills v Weston* [2014] BCC 581, [51].
[147] *Official Receiver v Chan Kwong Hung* [2006] HKCU 2009.
[148] *Secretary of State for Trade & Industry v Rayna* [2001] 2 BCLC 48, 57–60; *Official Receiver v Chow Huen Chun Crispin* (7 December 2004, HCMP 5002/2003, Kwan J), [19].

Section 168F(2) of the CWUO does not provide an exclusive ground for showing that a person was persistently in default of the relevant provisions, and so even if a person has not been convicted of the relevant offences, other evidence can show that the person was persistently in default.[150]

In *Director of Corporate Enforcement v McGowan*,[151] the dictionary meaning of "persist" was referred to as:

> ... to continue firmly or obstinately in a state, opinion, purpose, or course of action, esp. against opposition,

with the court adding:

> To persist is to do more than to continue, although repetition is involved. It implies an element of determination.[152]

In that case, the directors were held to have been persistently in default where they had failed to file annual returns for the company for 13 years.

The Court of First Instance has jurisdiction to make an order under s.168F of the CWUO.[153] It is also possible to apply for an order before the magistrate in the proceedings for prosecution of the person in respect of the relevant default.[154] Application for an order may be made by the Registrar of Companies, Official Receiver, Financial Secretary, or by the liquidator or any past or present member or creditor of any company concerned.[155] In the course of a proceeding for the prosecution of an offence, the court may also make a disqualification order whether or not any person applies for such an order.[156]

The maximum period of disqualification under s.168F of the CWUO is five years. In *Director of Corporate Enforcement v McGowan*, above, the court noted that the type of persistent and flagrant failure by the directors in that case would ordinarily warrant the making of a disqualification order, but the court declined to do so in that case on the basis that a disqualification order is not punitive but protective and that a disqualification order in the present circumstances would serve no useful purpose but would disrupt the ongoing business of the company.[157]

In *Re Civica Investments*,[158] the court held that longer periods of disqualification should be reserved for cases where the defaults and conduct of the person have been of a serious nature, for example, where defaults have been made for some dishonest purpose, or wilfully and deliberately, or where they have been many in number and have

[149] CWUO, s.168F(3).
[150] *Director of Corporate Enforcement v McGowan* [2008] IESC 28, [2008] 4 IR 598 (Supreme Court, Ireland).
[151] [2008] IESC 28, [2008] 4 IR 598, [37] (dealing with Companies Act 1990 (Ireland) s.160).
[152] *Director of Corporate Enforcement v McGowan* [2008] IESC 28, [2008] 4 IR 598, [37] (dealing with Companies Act 1990 (Ireland) s.160).
[153] See CO, s.2 for the definition of "court".
[154] CWUO, s.168F(4).
[155] CWUO, s.168P(2)(a) and 168P(2)(b).
[156] CWUO, s.168P(4).
[157] The two directors were husband and wife in a small private company with 12 employees. The following circumstances were relevant: that the breaches were remedied by the directors filing all outstanding returns; and an accountant replaced one of the two original directors under a restructuring to avoid repetition of the defaults.
[158] [1983] BCLC 456 (on the comparable English provision).

not been substantially alleviated by remedial action and convincing assurances that they will not recur in the future. In that case, there had been 298 separate defaults in respect of filing of accounts and annual returns. The court imposed a disqualification order for a period of one year, noting that a longer period would have been imposed if the defaults had not been substantially remedied. The court though emphasised that each case must depend on its own facts.[159]

Fraud or Breach of Duty in Respect of Company in Winding-Up: ss.168G and 168L of CWUO

6.027 Where the court has declared a person to be liable for the debts or liabilities of a company under CWUO, s.275 for fraudulent trading, the court may make a disqualification order against the person (CWUO, s.168L). The court can make the order on its own initiative. Where, in the course of winding-up, it appears that a person is guilty of an offence of fraudulent trading under this s.275 (whether the person has been convicted or not), the court can also make a disqualification order under s.168G of the CWUO. Here, the application can be made by the Official Receiver, the Financial Secretary, or any past or present member or creditor of the company.[160] Also, in the course of a proceeding for the prosecution of an offence, the court may make a disqualification order whether or not any person applies for such an order.[161]

Section 168G of the CWUO is wider than s.168L in that under this s.168G(1)(b) of the CWUO, the court can also make a disqualification order against a person where, in the course of winding-up, it appears that the person has been guilty, whilst an officer[162] or liquidator[163] of the company or receiver or manager of its property, of any fraud in relation to the company or of any breach of his duty as such officer, liquidator, receiver or manager.

In both ss.168L and 168G of the CWUO, the relevant court for making the order is the Court of First Instance.[164]

The maximum period of disqualification under both provisions is 15 years. The courts divide this into three brackets: the top bracket, over ten years, is for serious cases; the middle bracket, six to ten years, is for serious cases which did not merit the top bracket; and the minimum bracket, five years or less, is for relatively not very serious cases.[165]

Unfit Directors of Insolvent Companies: s.168H of the CWUO

6.028 The court must make a disqualification order against a person if it is satisfied that:

- the person is or has been a director[166] of a company which has at any time become insolvent[167] whether whilst he or she was a director or subsequently; and

[159] See *Re Arctic Engineering Ltd (No 2)* [1986] 2 All ER 346 (accountant had failed to lodge returns as a liquidator; there was persistent default but court declined to order disqualification in the circumstances).
[160] CWUO, s.168P(2)(b).
[161] CWUO, s.168P(4).
[162] "Officer" includes a shadow director under CWUO, s.168G(3); and see also CWUO, s.2 for definition of "officer".
[163] For example, involving disqualification of a liquidator, see *Re Well Bond Group Ltd* [2008] 5 HKLRD 147; see also *Official Receiver v Chan Kin Hang Danvil* [2012] 4 HKLRD J3, CA.
[164] CWUO, s.2 definition of "court".
[165] *Re Well Bond Group Ltd* [2008] 5 HKLRD 147.
[166] Director includes shadow director (CWUO, s.168H(3)).
[167] Under s.168H(2) of the CWUO, a company becomes insolvent if (a) the company goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding-up; or (b) a receiver of the company is appointed.

- his or her conduct as a director[168] of that company (alone or taken together with his conduct as a director of other companies)[169] makes him or her unfit to be concerned in the management of a company (CWUO, s.168H(1)).

Applications under s.168H of the CWUO are made to the Court of First Instance,[170] and may be made by the Financial Secretary or the Official Receiver if it appears to be in the public interest that a disqualification order should be made.[171] The liquidator of a company being wound up or a receiver of a company must report the matter to the Official Receiver (who may then report to the Financial Secretary) if it appears to the liquidator or receiver that s.168H(1) of the CWUO is applicable to a person.[172]

In determining whether a person is unfit to be concerned in the management of a company, the court must have regard to the matters listed in Sch.15.[173] These include breaches of duties by directors, misapplication of company property or money and the extent of the director's responsibility for the company's failure to comply with specified provisions of the CO (relating to the company's registers,[174] keeping of minute books and accounting records,[175] filing of annual returns[176] and preparation of the company's financial statements).[177] For insolvent companies, further matters are listed, including the extent of the director's responsibility for the insolvency or for the company's failure to supply goods or services paid for or for the company's entry into transactions or preferences voidable under CWUO, s.182 or 266, and failure by the director to comply with specified statutory provisions in the winding-up.[178]

The courts are entitled to take into account factors other than those specified in Sch.15 of the CWUO whether or not the conduct involves a breach of directors' duties.[179] A director will be held to be unfit if the conduct of the director, viewed cumulatively and taking into account any extenuating circumstances, had fallen below the standards of probity and competence appropriate for persons fit to be directors of companies. Directors have been held to be unfit not only for having committed fraudulent or intentional breaches of fiduciary duties [180] but also for breaches of duties not involving dishonesty.[181] If there have been only minor breaches though, then the

[168] Conduct as a director of a company that has become insolvent includes the person's conduct in relation to any matter connected with or arising out of the insolvency of the company (s.168H(2)).
[169] For the scope of relevance of the person's conduct as directors of other companies, see further *Re Citrend Services Ltd* [2008] HKLRD 279, CA.
[170] Section 2 of the CWUO definition of "court".
[171] CWUO, s.168I(1). Section 168I(2) of the CWUO sets a time limit of four years from the commencement of winding-up or the day on which the receiver vacated office (as the case may be), although the court can grant leave for applications outside that period.
[172] CWUO, s.168I(3). See also the Companies (Reports on Conduct of Directors) Regulation (Cap.32J, Sub.Leg.).
[173] CWUO, s.168K(1).
[174] CO, ss.335, 336, 341, 342, 627, 628, 630, 641, 642(1), 643, 645, 648, 649(1), 650 and 652; predecessor CO, ss.81, 95, 96, 158 and 158A.
[175] CO, ss.373, 374, 377 and 619; predecessor CO, ss.119A and 121.
[176] CO, ss.662 and 664; predecessor CO, ss.107 and 109.
[177] CO, ss.387 and 429; predecessor CO, ss.122 and 129B.
[178] These are: CWUO, ss.190 (statement of affairs), 211 (delivery of property to the liquidator), 228A (special procedure for winding-up), 241 (meetings of creditors in voluntary winding-up), 274 (proper accounts not kept) and 300A (information where receiver or manager appointed).
[179] *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113.
[180] For example, *Re China Talent International Development Ltd* (HCMP 4189/2002, [2004] HKEC 468); *Re Hoida Industrial Co Ltd* [2004] 1 HKLRD 744; *Re Regal Motion Industries Ltd* [2005] 1 HKLRD 461.
[181] For example, *Official Receiver v Li Ping Chung* (HCMP 511/2003, [2004] HKEC 1516); *Re Looe Fish Ltd* [1993] BCLC 1160 (allotment of shares for improper purposes though director acted honestly).

court would not conclude that the director is unfit.[182] Simply making a bad commercial judgment would not render a director unfit to manage companies, but a director will be held to be unfit if there is incompetence or negligence in a very marked degree.[183]

For example, disqualification orders were made in *Re Peregrine Holdings Ltd, Official Receiver v Philip Leigh Tose*,[184] where the directors' serious incompetence in monitoring the company's lending business and in failing to ensure there were risk management and internal auditing procedures to assess credit risk had led to the company's collapse in the 1997 Asian financial crisis. In line with the duty of care imposed on all directors (whether executive or non-executive), non-executive directors who do not carry out their monitoring or supervising role cannot escape a finding of unfitness by having delegated or relied on others in the company.[185] Isolated failures to comply with statutory filing obligations might not be sufficient to show that a director is unfit,[186] but persistent failures can lead the court to conclude that a director is unfit.[187] Whilst previous cases serve as guidance, they do not operate as precedents and each case depends on its own facts.[188]

Where a director is held to be unfit and the court is satisfied with all the matters in s.168H(1) of the CWUO, the court must make a disqualification order. There is no discretion whether to order disqualification. The minimum period of disqualification is 1 year, and maximum period is 15 years.[189] The division of the period into three brackets, discussed above for CWUO, s.168G, is also applicable in relation to s.168H.[190] In setting the periods of disqualification, the courts are to have regard to the purpose of disqualification, namely protection of the public from persons whose past record as director shows them to be a danger to creditors and others.[191] However, deterrence to protect the wider interests of the public is also relevant, but not punishment.[192]

Examples of cases falling within the minimum period (one to five years) include failure to prepare annual accounts,[193] failure to comply with statutory filing obligations[194] and breaches of directors' duties not involving fraud or intentional wrongdoing.[195] Cases involving intentional wrongdoing have been considered to fall in the middle bracket (six to ten years)[196] or at least at the high end of the minimum bracket.[197] Cases involving fraud or deception fall at least in the middle

[182] *Re Time Utilising Business Systems Ltd* [1990] BCLC 568; *Re Cladrose Ltd* [1990] BCLC 204.
[183] *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113; *Re Citrend Services Ltd* [2008] HKLRD 279; *Re Stylands Holdings Ltd* [2011] 1 HKLRD 96; *Secretary of State v Lubrani* [1997] 2 BCLC 115.
[184] (HCMP 112/2002, 8 October 2004) (Kwan J, CFI).
[185] See *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113, 124.
[186] *Re ECM (Europe) Electronics* [1992] BCLC 814; *Re China Talent International Development Ltd* (HCMP 4189/2002, [2004] HKEC 468), [55].
[187] *Re Wealth Property Agency Co Ltd* (HCMP 5157/2001, [2003] HKEC 168), [25]; *Re Hoida Industrial Co Ltd* [2004] 1 HKLRD 744, 751.
[188] *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113.
[189] CWUO, s.168H(4).
[190] For example, *Re Citrend Services Ltd* [2008] HKLRD 279, 288, CA; *Re Styland Holdings Ltd* [2011] 1 HKLRD 96.
[191] *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113, 123.
[192] *Re Hoida Industrial Co Ltd* [2004] 1 HKLRD 744, 752.
[193] For example, *Re Emperor Hotel Management Co Ltd* [2002] 3 HKLRD 805.
[194] For example, *Re Wealth Property Agency Co Ltd* (HCMP 5157/2001, [2003] HKEC 168).
[195] For example, *Re Peregrine Holdings Ltd; Official Receiver v Philip Leigh Tose* (HCMP 112/2002, 8 October 2004) (Kwan J, CFI) (negligence). But breaches by directors of listed companies could be regarded as being more serious and can fall within the middle bracket even though there is no fraud: *Re Styland Holdings Ltd* [2011] 1 HKLRD 96; *Securities and Futures Commission v Cheung Keng Ching* [2011] 4 HKC 453.
[196] For example, *Re Wealth Property Agency Co Ltd* (HCMP 5157/2001, [2003] HKEC 168).
[197] For example, *Official Receiver v Cheung Gin Hung* [2005] 1 HKLRD A1.

bracket.[198] Mitigating factors can be taken into account,[199] such as cooperation with the liquidator,[200] admission of the allegations before trial,[201] age,[202] health,[203] the length of time that the director has been in jeopardy[204] and the fact that the person has already served a prison sentence for the same conduct.[205] However, each case depends on its own facts and previous decisions do not operate as precedents.[206]

Disqualification of Directors after Investigation of a Company: s.168J of the CWUO

Inspectors may be appointed by the Financial Secretary to investigate in a company's 6.029
affairs,[207] or the Financial Secretary may require the production of documents or information from a company.[208] If it appears to the Financial Secretary from the inspector's report or from the documents or information obtained that it is expedient in the public interest that a disqualification order should be made against any person who is or has been a director or shadow director of any company, the Financial Secretary may apply to the court for such an order (CO, s.879(6)). The court may make a disqualification order if it is satisfied that his or her conduct in relation to the company makes him or her unfit to be concerned in the management of a company (CWUO, s.168J(1)). Section 168K and Sch.15 of the CWUO, and the principles discussed above would be relevant in determining the question of unfitness in s.168J of the CWUO.

The maximum period of disqualification under CWUO, s.168J is 15 years.[209]

Miscellaneous Matters

Scope of Disqualification Order

The order for disqualification that a court can make is an order that the person must 6.030
not, without the leave of the court:

- be a director of a company;
- be a provisional liquidator or liquidator of a company;
- be a receiver or manager of a company's property; or
- in any way, whether directly or indirectly, be concerned or take part in the management, formation or management of a company (s.168D(1) of the CWUO).

"Management" is not confined to actions at the level of the board, and can cover the making of decisions as to the direction of the company, even though the decision is

[198] For example, *Re Hoida Industrial Co Ltd* [2004] 1 HKLRD 744; *Re Regal Motion Industries Ltd* [2005] 1 HKLRD 461.
[199] *Re Westmid Parking Services Ltd* [1998] 2 All ER 124.
[200] *Re Peregrine Holdings Ltd; Official Receiver v Philip Leigh Tose* (HCMP 112/2002, [2004] HKEC 1214).
[201] *Re Peregrine Holdings Ltd; Official Receiver v Philip Leigh Tose* (HCMP 112/2002, [2004] HKEC 1214); *cf Re Yan Chim Kee Co Ltd* (HCMP 407/2004, [2005] HKEC 514).
[202] *Re Yan Chim Kee Co Ltd* (HCMP 407/2004, [2005] HKEC 514).
[203] *Official Receiver v Cheung Gin Hung* [2005] 1 HKLRD A1.
[204] *Re Citrend Services Ltd* [2008] HKLRD 279.
[205] *Re Regal Motion Industries Ltd* [2005] 1 HKLRD 461.
[206] *Re Citrend Services Ltd* [2008] HKLRD 279, 289, CA.
[207] CO, Part 19 Division 2.
[208] CO, Part 19 Division 3.
[209] CWUO, s.168J(2).

subject to approval by a higher officer. However, carrying out predetermined policies is not regarded as management, even if the person might be described as a "manager" who is in charge of a branch or division.[210]

Leave to Manage Companies

6.031 A person who is the subject of a disqualification order may apply for leave of the court to be involved in management of a company or otherwise participate in a company in one of the ways prohibited under s.168D(1) of the CWUO. See also s.168Q(1) of the CWUO. The application for leave could be made during or immediately after the actual disqualification proceedings.[211]

Where the disqualification order had been made on application by the Financial Secretary, the Registrar, the Official Receiver or a liquidator, the relevant applicant must appear at the proceedings for leave and call the attention of the court to any matters which seem to him or her to be relevant, and may himself or herself give evidence or call witnesses.[212] In deciding whether to grant leave, the court would take into account factors including on the one hand, the need for protection of the public, and on the other hand, the need of the disqualified person to earn a living or the need of a company to have the work done by the disqualified person for the purposes of its business.[213] The court may grant leave subject to conditions.[214]

Contravention of Disqualification Order

6.032 If a person acts in contravention of a disqualification order, the person commits an offence and is liable to imprisonment for a maximum of two years and to a maximum fine of $150,000.[215] If a disqualified person is involved in the management[216] of a company in contravention of a disqualification order, the person would be personally liable for debts and liabilities of the company incurred at a time when that person was involved in the management of the company.[217]

Where a person involved in the management of the company acts or is willing to act on instructions given by a person whom he or she knows to be disqualified, the firstmentioned person would also be personally liable for the debts or liabilities of the company incurred at a time when he or she so acts or was willing to act.[218]

Foreign Companies

6.033 "Company" in Part IVA of the CWUO is defined[219] to include both Hong Kong companies and registered non-Hong Kong companies,[220] and also any other company

[210] *Cullen v Corporate Affairs Commission (NSW)* (1988) 14 ACLR 789; *Commissioner for Corporate Affairs v Bracht* [1989] VR 821; *Re Campbell* [1984] BCLC 83.
[211] *Secretary of State v Worth* [1994] 2 BCLC 113.
[212] CWUO, s.168Q(2).
[213] *Secretary of State v Barnett* [1998] 2 BCLC 64; *Re TTL Realisations Ltd* [2000] BCC 998.
[214] *Re Gibson Davies Ltd* [1995] BCC 11; *Re Majestic Recording Studios* [1989] BCLC 1; *Re Clenaware Systems Ltd, Harris v Secretary of State for Business, Innovation and Skills* [2015] BCC 283.
[215] CWUO, s.168M and Sch.12.
[216] A person is involved in management if the person is a director of the company or if he is concerned, whether directly or indirectly, or takes part, in the management of the company; see also CWUO, s.168O(4).
[217] CWUO, s.168O(1)(a) and 168O(3)(a).
[218] CWUO, s.168O(1)(b) and 168O(3)(b).
[219] CWUO, s.168C(1).
[220] CWUO, s.2(1).

incorporated outside Hong Kong which is carrying on or has carried on business in Hong Kong and which is capable of being wound up under the CWUO.[221] The effect of the extension of the disqualification provisions to such foreign companies means, for example:

- where a director of a Hong Kong company has been involved in running such a foreign company, his or her conduct with respect to the foreign company can be relevant in determining whether the director's conduct comes within the provisions setting out the grounds for disqualification;
- a person who is director of such a foreign company can also be the subject of a disqualification order under s.168D of the CWUO; and
- a person who has been disqualified under s.168D of the CWUO will also be disqualified from acting as a director, etc of such a foreign company.

Procedural Matters

Section 168P(1) of the CWUO and the Companies (Disqualification of Directors) Proceedings Rules (Cap.32K, Sub.Leg.) (CDDP Rules) apply to applications for dis- 6.034
qualification orders other than applications made in the course of a proceeding for the prosecution of an offence.

The applicant for an order must give at least ten days' notice of the intention to seek an order to the person against whom the order is sought.[222] Applications for an order are made by originating summons and the Rules of the High Court (Cap.4A) (RHC) will apply accordingly.[223] The CDDP Rules deal with other matters relating to the application, service of the summons, the filing of evidence, date of hearing of the application and time of commencement[224] of any disqualification order that is made.[225] Under s.168P(1) of the CWUO, the person against whom a disqualification order is sought may appear and himself or herself to give evidence or call witnesses. On the hearing of any application made by the Registrar, the Official Receiver, the Financial Secretary or a liquidator, the applicant must appear and call the attention of the court to any matters which seem to him or her to be relevant, and he or she may also give evidence or call witnesses.[226] The standard of proof is on the balance of probabilities as the proceedings for a disqualification order are civil proceedings.[227]

[221] This category of foreign company is caught by reason of s.168C(1)(b) of the CWUO which refers to unregistered companies carrying on or which have carried on business in Hong Kong. For the concept of "unregistered companies"; see CWUO, s.326.
[222] CWUO, s.168P(1).
[223] CDDP Rules, r. 3.
[224] CWUO, s.168D(1) states that the period of disqualification commences from the date of the order, and CDDP Rules, r.10 provides that unless the court orders otherwise, the disqualification order takes effect at the beginning of the 21st day after the day on which it is made. The effect is that r.10 suspends the effect of the order such that the disqualification period commences after the 21 days; see also *Secretary of State for Trade and Industry v Edwards* [1997] BCC 222; *Re Continental Assurance Co plc* [1997] BCLC 48.
[225] See also the Companies (Disqualification Orders) Regulation (Cap.32K, Sub.Leg.) for obligations of specified officers of the court to notify the Registrar of the making of disqualification orders or the grant of leave.
[226] CWUO, s.168P(3).
[227] *Re Copyright Ltd; Official Receiver v Chan Chun Yan* [2004] 2 HKLRD 113, 123–124.

The courts allow the use of what is referred to as the *Carecraft* procedure, which originated from *Re Carecraft Construction Co Ltd*,[228] to enable the court to deal with the application summarily in order to reduce the time and cost of the proceedings. Under this procedure, the parties can provide the court with a set of agreed facts and an agreed period of disqualification. If the court accepts that a disqualification order as proposed is appropriate, then the court can make an order for the agreed period (or a different period if the court determines appropriate). If the court considers that the agreed facts are insufficient for disqualification, then the applicant can pursue the application via a full hearing, otherwise the court would dismiss the application.

Where a disqualification order is made by a master, any appeal against the order should be made to a judge of the Court of First Instance and not the Court of Appeal.[229]

Public Examinations

6.035 Under s.168IA of the CWUO, the Official Receiver may apply for a public examination of a person if the Official Receiver is of the opinion that a *prima facie* case exists against a person that would render him or her liable to a disqualification order under that Part IVA of the CWUO. On such an application, the court may direct the person to attend before the court to be publicly examined as to the conduct of the business and affairs of a company or as to his or her conduct and dealings as a director.

Listed Corporations: Securities and Futures Ordinance

6.036 In the case of listed corporations, disqualification orders can also be made under s.214(2)(d) of the Securities and Futures Ordinance (Cap.571) (SFO) upon the application of the Securities and Futures Commission (SFC). The ground for a petition under s.214 of the SFO is that the affairs of the business or affairs of the corporation have been conducted in a manner that is oppressive or unfairly prejudicial to its members; involving defalcation, fraud, misfeasance or other misconduct towards its members; or resulting in its members not having been given all the information with respect to its business or affairs that they might reasonably expect. The court may order a person wholly or partly responsible for the business or affairs of the corporation having been so conducted must not, without leave, be a director or liquidator of a corporation, or receiver or manager of a corporation's property or business; or in any way, directly or indirectly, be concerned, or take part, in the management of a corporation. The order for disqualification can extend to unlisted companies.[230]

The maximum period of disqualification under s.214 of the SFO is 15 years.[231] For example, of cases involving disqualifications under SFO, s.214, see *Securities and Futures Commission v Fung Chiu*[232] and *Securities and Futures Commission v Cheung Keng Ching*.[233] The *Carecraft* procedure can also be adopted for disqualification applications under s.214 of the SFO.[234]

228 [1994] 1 WLR 172. See *Re Emperor Hotel Management Co Ltd* [2002] 3 HKLRD 805.
229 See RHC, O.58 r.1(1) and *Official Receiver v Brown Colvin Morton* [2019] 2 HKLRD 166.
230 *Re China Best Group Holding Ltd* [2016] HKEC 1220.
231 There is no minimum period under the SFO; see also SFO, s.214(2)(d) and *Re First China Financial Network Holdings Ltd* [2015] 5 HKLRD 530, [6].
232 [2009] 6 HKC 423 ("misconduct" within CO, s.214 includes breach of directors' duty of care).
233 [2011] 4 HKC 453, CA. See also *Securities and Futures Commission v Li Hejun* [2017] 4 HKLRD 785; *Re Freeman FinTech Corp Ltd* [2018] 1 HKLRD 320; *Securities and Futures Commission v Fan Di* [2018] HKCFI 346.
234 *Securities and Futures Commission v Fung Chiu* [2009] 2 HKC 19.

The SFC has a duty to act fairly in disqualification proceedings under SFO, s.214 and ordinarily may be required to disclose to the person sought to be disqualified the information and documents the SFC had obtained from the investigation of the impugned transactions that are relied on in the disqualification proceedings.[235]

VII. LOANS TO DIRECTORS AND SIMILAR TRANSACTIONS

Loans

The equitable fiduciary duty would prevent companies from providing loans to their directors without approval of the members or without authorisation under the articles. The predecessor CO had been amended in 1984[236] to introduce provisions imposing stricter regulation of loans because of the potential for abuse—for example, loans provided on uncommercial terms or as disguised gifts, with amounts not repaid to the company. 6.037

The restrictions in predecessor CO are reformulated to some extent under Part 11 Division 2 of the CO. Section 500 of the CO prohibits a company[237] from making a loan to any of its directors[238] or any director of its holding company. The prohibition also extends to the giving of guarantees or security by the company in connection with loans made by the third parties to the director. A major change to the law under the CO, compared with the former provisions in the predecessor CO, is that instead of an outright prohibition, all companies are permitted to provide loans to its directors if there is approval by the members.[239] The requisite approval is referred to as "prescribed approval" in the provisions,[240] and the conditions that need to be satisfied before there is "prescribed approval" are set out in CO, s.496. Broadly, there are notice requirements, and an ordinary resolution would be sufficient. For public companies, and also subsidiaries of public companies,[241] there must be disinterested voting.[242] For example, if the loan is given to a director, then any votes of that director that he may have as a member are disregarded. Disinterested voting does not prevent connected entities (other than nominees) from voting though (unless the loan, etc is given in favour of that connected entity).

Where the loan (or guarantee or security) given by a company is in favour of a director of the holding company, then prescribed approval must be given by both the

235 *Securities and Futures Commission v Wong Yuen Yee* [2017] 1 HKLRD 788.
236 The prohibitions were introduced into the CO in 1984 pursuant to recommendations in the Second Report of the Companies Law Revision Committee on Company Law (April 1973) paras.7.32–7.35.
237 "Company" means a company incorporated under the CO or its predecessors; see also CO, s.2(1). Previously, the prohibition in the predecessor CO, s.157H (repealed) applied not only to companies incorporated under the CO but also any body corporate incorporated in Hong Kong and having its shares listed on the Hong Kong Stock Exchange; see predecessor CO, s.157H(10) (repealed). The position under the current CO is altered since it is thought that additional requirements for listed companies should be dealt with under the listing rules instead of the CO.
238 The provision also covers shadow directors; see CO, ss.484 and 491.
239 The member approval exception previously only applied to private companies under the predecessor CO, s.157HA(2) (repealed).
240 CO, ss.500 and 502.
241 These are referred to as "specified companies" in CO, s.496, with the term defined in that previous s.491 of the CO.
242 CO, s.496(2)(b) and 496(5).

roles that companies play in commerce and society today, and the significant sums of money invested in companies nowadays, significant economic and social harms to shareholders, creditors, employees and others could arise as a result of mismanagement of companies. Directors are seen as having a responsibility to ensure good corporate governance in companies to minimise such harms.[270] However, in setting the appropriate standards, the law needs to strike the right balance, because the imposition of overly stringent duties on directors can potentially stifle entrepreneurship and business innovation by discouraging risk-taking and increasing business costs.[271] The law must recognise that directors operate in a commercial environment where some business risk is inevitable.

Sources of Duty

6.046 The duty of care originally arose under both equity and the common law.[272] The equitable duty is derived from the duty of care imposed on trustees. However, the equitable duty is not a fiduciary duty as such,[273] since the duty has nothing to do with the position of disadvantage or vulnerability on the part of the company and is not specifically concerned with the fiduciary aspect of the relationship between a director and the company.[274] Under the common law, the duty arose in the tort of negligence.[275] For executive directors under a service or employment contract, the duty can also arise either as an express or implied term of the contract.

With the enactment of the CO, the duty of care of directors is now set out as a statutory duty. The question of codification of directors' duties has been topical for some time.[276] Major common law jurisdictions including the United Kingdom[277] and Australia[278] have set out directors' fiduciary duties and the duty of care in legislation. In the absence of consensus in Hong Kong on the need for codification of directors' duties generally, the government proposed to leave the duties to be governed by the general law.[279] The one exception is in relation to the duty of care of directors, where a

[270] See, for example, *Daniels v Anderson* (1995) 16 ACSR 607, 656–668; Paul Redmond, "The Reform of Directors' Duties" (1991) 15 *University of New South Wales Law Journal* 86, 109–110; Paul Spink and Stephen Chan, "The Hong Kong Company Director's Duty of Skill and Care: A Standard for the 21st Century?" (2003) 33 HKLJ 139; *Report of Committee on the Financial Aspects of Corporate Governance* (London, 1992) (Cadbury Report).

[271] See, for example, Michael J Whincop, "A Theoretical and Policy Critique of the Modern Formulation of Directors' Duty of Care" (1996) 6 *Australian Journal of Corporate Law* 72; Douglas M Branson and Low Chee Keong, "Balancing the Scales: A Statutory Business Judgment Rule for Hong Kong?" (2004) 34 HKLJ 303.

[272] *Permanent Building Society v Wheeler* (1994) 14 ACSR 109, 155; *Daniels v Anderson* (1995) 16 ACSR 607, 652–668; *Base Metal Trading Ltd v Shamurin* [2005] 1 WLR 1157, [19].

[273] *Kao Lee & Yip v Koo Hoi Yan Donald* [2003] 3 HKLRD 296, 311–313; *Permanent Building Society v Wheeler* (1994) 14 ACSR 109, 157–158; *Bristol and West Building Society v Mothew* [1998] Ch 1 (Eng CA). See also William M Heath, "The Director's 'Fiduciary' Duty of Care: A Misnomer" (2007) 25 *Company and Securities Law Journal* 370; but for the contrary view, see Antony Goldfinch, "Trustee's Duty to Exercise Reasonable Care: Fiduciary Duty?" (2004) 78 *Australian Law Journal* 678; Justice Heydon, "Are the Duties of Company Directors to Exercise Care and Skill Fiduciary?" in Simone Degeling and James Edelman (eds.), *Equity in Commercial Law* (Lawbook Co, 2005).

[274] *Permanent Building Society v Wheeler* (1994) 14 ACSR 109, 158.

[275] *Daniels v Anderson* (1995) 16 ACSR 607.

[276] See SCCLR, "Corporate Governance Review: A Consultation Paper on Proposals Made in Phase I of the Review" (July 2001) 11–16; Financial Services and Treasury Bureau, "CO Rewrite Consultation Paper on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges" (April 2008) 16–23.

[277] Companies Act 2006 (UK), ss.170–181.

[278] Corporations Act 2001 (Aust), ss.179–190.

[279] Financial Services and Treasury Bureau, "CO Rewrite Consultation Conclusions on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges" (April 2008).

statutory statement of the duty (in CO, s.465) was adopted to clarify that the standard of care imposes minimum objective standards on all directors.

Standard of Care

Directors will not be in breach of duty simply because there has been some error in 6.047
their judgment which leads the company to suffer a loss.[280] Directors will only be liable if they have been negligent.

There are two broad aspects to the duty of care. First, directors must take due care when making decisions or taking positive action on behalf of the company. Here, in determining whether directors have exercised reasonable care, it appears that it would be legitimate for the director to balance the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.[281] Secondly, the duty of care involves oversight or monitoring of the company's affairs such that there can be a breach of duty arising from negligent omissions.[282]

Standard Under the General Law

The care a director is required to take is "reasonable care", which has been described 6.048
as the degree of care an ordinary man might be expected to take in the circumstances on his or her own behalf,[283] or the degree of diligence, care and skill which ordinarily prudent persons would exercise under similar circumstances.[284]

There has been debate as to the precise standard of care under the general law.[285]

In *Re City Equitable Fire Insurance Co Ltd*,[286] Romer J considered that a director need not exhibit in the performance of his or her duties a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience.

In *Re Brazilian Rubber Plantations & Estates Ltd*,[287] Neville J stated that a director:

> ... may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance.

These and other early English decisions[288] are thus regarded as giving rise to an essentially subjective standard of care, such that a director is required to:

> ... do only as much as one might fairly expect of someone as stupid and as incompetent as the director happens to be.[289]

[280] *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.

[281] *Vrisakis v ASC* (1993) 11 ACSR 162, 212; *Permanent Building Society v Wheeler* (1994) 14 ACSR 109, 159.

[282] See [6.050].

[283] *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.

[284] *Daniels v Anderson* (1995) 16 ACSR 607, 666.

[285] See generally Stefan H C Lo, "Courts and Corporate Governance: Development of the Common Law in Light of Policy Objectives" (2006) 14 *Asia Pacific Law Review* 75, 84–93.

[286] [1925] Ch 407.

[287] [1911] 1 Ch 425, 437.

[288] For example, *Turquand v Marshall* (1868–69) LR 4 Ch App 376; *Re Cardiff Savings Bank (Marquis of Bute's Case)* [1892] 2 Ch 100.

[289] Ross W Parsons, "The Director's Duty of Good Faith" (1967) 5 *Melbourne University Law Review* 395, 395.

(b) by a member against the company; and

(c) by a member against each other member. …

The purpose of s.86 of the CO is to give every member of a company a personal right to sue to enforce the terms of the constitution of the company. This is a statutory exception to the rule in *Foss v Harbottle*.[28] Accordingly, a minority shareholder can have a cause of action against the company if the latter enters into a transaction in contravention of its objects clause because the objects clause is part of the constitution. In practice, however, a minority shareholder may find the remedy provided by s.86 of the CO fraught with uncertainties: (i) *First*, there is an element of incompatibility between ss.86 and 116(5) of the CO; and (ii) *Second*, the remedy provided by this s.86 of is vulnerable to be overridden by other provisions of the CO.

Incompatibility between ss.86 and 116 of the CO

9.010 It is submitted that s.86 of the CO only operates to regulate, *inter alia*, the internal contractual relationship between shareholders and the company: it does not involve the rights and obligations of a third party which has an external element. Where a third party is involved, s.116 of the CO will come into play to determine the validity of the transaction.

Section 116(5) of the CO envisages a scenario where a company enters into a transaction in contravention of its objects clause, such a transaction can still be possibly valid. That s.86 of the CO, however, allows a shareholder to enforce the terms of the constitution, including the objects clause. It would be difficult to see how a shareholder is able to enforce the objects clause if a transaction, though it contravenes the objects clause, is nevertheless protected by s.116(5) of the CO. If a shareholder is allowed to enforce the objects clause against the company under s.86 of the CO, the transaction will be invalidated and the third party dealing with the company cannot be protected by s.116(5) of the CO. Where this s.116(5) is to prevail, the remedy provided by s.86 of the CO is as equally limited as that under those ss.116(3) and 116(4) of the CO.

Vulnerability of the CO, s.86 Remedy

9.011 Although s.86 of the CO creates a contract under seal between members of the company *inter se* and between members and the company, the terms of the constitution of the company can be altered by majority shareholders against the wish of minority shareholders.[29] A company may by special resolution alter (or abandon) its objects clause.[30] Although minority shareholders (those holding not less than 5% in aggregate of the number of issued shares) in a private company may apply to the court to oppose the alteration of the objects clause,[31] the Court is inclined to give effect to the special resolution authorising the alteration of the objects clause as long as the special resolution is duly passed and the alteration is in the interest of the company (a

[28] At common law, when a wrong is done to a company or when a company's rights are infringed, the company itself is the proper plaintiff to sue the wrongdoer to enforce its rights. A shareholder generally is not allowed to sue the wrongdoer on behalf of the company. This is known as the rule in *Foss v Harbottle* (1843) 2 Hare 461 or the "proper plaintiff" principle.

[29] The articles can be altered by ordinary or special solution pursuant to ss.87 and 88 of the CO.

[30] CO, s.89.

[31] CO, ss.89(5) and 91.

subjective test) because "rule by majority" is still a cardinal principle of company law. If the interest of the minority shareholders is adversely affected by the alteration of the objects clause, the Court will probably order the majority shareholders to purchase the shares of the dissentient minority if it is feasible.[32]

If s.86 of the CO does not provide an effective remedy, a disgruntled minority shareholder may commence proceedings against the company for "unfair prejudice" under ss.724–725 of the CO. The fact that the transaction has been ratified or approved by majority shareholders will not prevent the minority shareholder from bringing the proceedings. However, such proceedings will not affect the validity of the transaction already entered into. In making any judgment or order, the court will probably also consider whether or not the majority shareholders were acting for proper purposes in the interest of the company when they ratified or approved the transaction. If the majority shareholders were acting for proper purposes and the minority shareholders suffered financial loss as a result, the court is likely to order the majority shareholders to purchase the shares of the minority shareholders in the company at a fair price or award damages to the minority shareholders whose interest has been unfairly prejudiced by the company's entering into the transaction in question.

It is unclear if a minority shareholder can still maintain a derivative action against the directors under common law on the ground of *ultra vires*. Traditionally, an *ultra vires* act of the company is one of the exceptions to the rule in *Foss v Harbottle*[33] since an *ultra vires* act could not be ratified even by unanimous votes of all members of the company.[34] However, since the changes introduced by the Companies (Amendment) Ordinance 1997,[35] an *ultra vires* act has become voidable (as opposed to void) and ratifiable. It is submitted that an ordinary resolution passed in the general meeting is sufficient to ratify the *ultra vires* act (as discussed above). These changes may bar an individual shareholder from commencing a derivative action on the ground of *ultra vires*, because, if the alleged wrong is a transaction which might be made binding on the company by a simple majority of the shareholders, no individual shareholder is allowed to maintain an action in respect of that matter as an exception of the rule in *Foss v Harbottle*.[36] It will also be interesting to see if a minority shareholder can rely on the statutory derivative action provisions in the CO.[37]

A Third Party Dealing with the Company

There are two scenarios.

Where the Third Party Is Not Aware of the Restrictions of the Objects Clause

Section 120 of the CO provides that a person shall not be taken to have notice of 9.012
any matter merely because of its being disclosed in articles kept by the Registrar or a return or resolution lodged with him. This provision effectively abolishes the doctrine of constructive notice in connection with the objects clause. Thus, a third party

[32] CO, s.91(6).

[33] (1843) 2 Hare 461; see also FN 28.

[34] See *Ashbury Railway Carriage & Iron Co Ltd v Riche* (1875) LR 7 HL 653.

[35] (3 of 1997) which came into effect on 10 February 1997.

[36] See *Edwards v Halliwell* [1950] 2 All ER 1064.

[37] See ss.731–738 of the CO. For further discussion of statutory derivative actions, in particular how they will operate under the CO, see [10.047] onwards of S Lo and C Qu, *The Law of Hong Kong Companies* (Sweet & Maxwell, 3rd ed, 2018).

IV. DEALING WITH DIRECTORS AND THE RULE IN *TURQUAND'S* CASE

9.017 Although the doctrine of *ultra vires* has been abolished since February 1997 and a company may generally enter into any contract like an individual, such a contract can only be valid if the person (or persons) purporting to act for the company is (or are) duly authorised or deemed to be duly authorised by the company to do so.

Dealing with Directors

Overview

9.018 The management of the business of a company is usually delegated to the directors. They are the agent of the company and they have the power to act on behalf of the company. Subject to the provisions of the CO and the constitution of the company, they may exercise all powers of the company.[45] However, their power is not unlimited (although the capacity and power of the company itself is now almost unlimited) and is subject to the following restrictions:

(i) They can only act collectively through the board of directors as an organ of the company. An individual director (except a managing director) cannot act as an agent of the company unless he or she is authorised to do so by the board;

(ii) Their act only binds the company if such act is carried out in accordance with the provisions of the constitution of the company; and

(iii) Subject to the protections available to a third party dealing with the directors, the act of directors (even though it complies with the constitution of the company) can be invalidated if such act is carried out for improper purpose or as a result of irregularity on the part of the directors.

A third party dealing with a company may sometimes find it difficult to ascertain whether the transaction in question is duly authorised by the company even if he has examined the provisions of the constitution of the company before he enters into the transaction with the company. For example, they are not in a position to compel the directors to prove that the shareholders have endorsed the transaction in question or insist on inspecting the minutes-book of the company. For this reason, the law provides some protection to an outsider who deals with the company in good faith.

Statutory Indoor Management Rule

9.019 The CO introduces a statutory indoor management rule. Section 117 of the CO provides:

> (1) Subject to section 119, in favour of a person dealing with a company in good faith, the power of the company's directors to bind the company, or authorize others to do so, is to be regarded as free of any limitation under any relevant document of the company.

[45] See, for example, Model Articles (Cap.622) for private companies limited by shares art.2, under this subsidiary legislation.

> (2) For the purposes of subsection (1) –
>
> (a) a person deals with a company if the person is a party to any transaction or any other act to which the company is a party;
>
> (b) a person dealing with a company is presumed, unless the contrary is proved, to have acted in good faith;
>
> (c) a person dealing with a company is not to be regarded as acting in bad faith by reason only of the person's knowing that an act is beyond the directors' powers under any relevant document of the company; and
>
> (d) a person dealing with a company is not required to inquire as to the limitations on the power of the company's directors to bind the company or authorize others to do so.
>
> (3) This section does not affect any right of a member of the company to bring proceedings to restrain the doing of an act that is beyond the directors' powers.
>
> (4) Proceedings must not be brought under subsection (3) in respect of any act to be done in fulfilment of a legal obligation arising from a previous act of the company.
>
> (5) This section does not affect any liability incurred by the directors, or any other person, by reason of the directors' exceeding their powers.
>
> (6) In this section – relevant document (有關文件), in relation to a company, means –
>
> (a) the company's articles;
>
> (b) any resolutions of the company or of any class of members of the company; or
>
> (c) any agreements between the members, or members of any class of members, of the company.

The statutory indoor management rule is a new provision and does not appear in the predecessor CO. This provision provides greater protection for outsiders than the Common Law Rule in *Turquand* discussed below and can be expected to largely, but not entirely, supersede the same. The main reason is that the statutory indoor management rule only attempts to protect an outsider dealing with the directors of a company. If an outsider is not dealing with the directors, he can only rely on the Common Law Rule in *Turquand*. This happens, for example, when the board is inoperative (due to a deadlock between hostile directors or failure to form a quorum at the board meeting), the shareholders in general meeting can replace the board to pass a resolution to enter into the transaction in question.[46] Good faith is the

[46] See Lo and Qu, *The Law of Hong Kong Companies* (Sweet & Maxwell, 3rd ed, 2018) [12-083] and the briefing notes to the new Companies Ordinance at http://www.cr.gov.hk/en/companies_ordinance/docs/briefingnotes_part03-e.pdf. These new provisions are based on ss.40–42 of the UK Companies Act 2006. Where the board

touchstone[47] under s.117 of the CO and is to be presumed:

> "… unless the contrary is proved". A person is not to be regarded as acting in bad faith: "by reason only of the person's knowing that an act is beyond the directors' power …".

This can be contrasted with the position under the *Rule in Turquand* which does not apply if the person dealing with the company is aware of the irregularity. However, it appears that s. 117 of the CO does not protect an outsider who enters into a transaction with the company in suspicious circumstances. Although s.117(2)(d) of the CO provides that a person dealing with a company is not required to inquire as to the limitations on the power of the company's directors to bind the company, it is unclear whether the outsider can rely on this section if he is put on inquiry as to the authority of the directors. This may happen for example, if the outsider is aware that there are two camps of directors (appointed by two hostile groups of shareholders) and the transaction is supported by only one camp of the directors. This issue of "suspicious circumstances" may overlap with the concept of "good faith". An outsider is presumed to be dealing with a company in good faith under s.117 of the CO and he is entitled to believe that the directors of the company have the authority to enter into the transaction with him. The outsider is still regarded as acting in good faith even if he knows that the directors may not have the authority to approve the transaction in question as long as there is no other improper act on the part of the directors or other suspicious circumstances. However, the outsider may lose the shield of "good faith" if his belief in the authority of the directors is dishonest or irrational (which includes turning a blind eye and being reckless).[48]

It also appears that the protection under s.117 of the CO does not cover the case of forgery. It is possible that the position of an outsider dealing with a company in good faith will not be protected if the directors produce a forged board resolution to cause the company to enter into the transaction in question. In such circumstances, the directors are not simply acting beyond their power (which *may be* covered by s.117 of the CO), but committing a fraud (which *may not be* covered by s.117 of the CO).

It should be noted that s.117 of the CO only protects an outsider dealing with a company in good faith. It does not absolve the liability of the directors from acting beyond their power. In other words, even if it is not be feasible for a shareholder to restrain the entering into the transaction (which exceeds the directors' power) between the company and an outsider, it is still possible to hold the directors liable for damages if the shareholder can prove that he suffers financial loss as a result of the transaction in question.

Nor does s.117 of the CO protect a party dealing with a company if that party is an "insider" as opposed to an "outsider". Section 118 of the CO provides that if a director of a company enters into a transaction with his company, he is not entitled to rely on the protection under that s.117. For example, a director enters into a transaction with

of directors is ineffective or not acting, the management power which has been delegated to the board under the articles reverts to the shareholders, namely, company in general meeting. See *Miracle Chance Ltd v Ho Yuk Wah David* [1999] 3 HKC 811.

[47] *Ford v Polymer Vision Ltd* [2009] 2 BCLC 160, [73].

[48] *LNOC Ltd v Watford Association Football Club Ltd* [2013] EWHC 3615 (Comm), see [88] and [89] on the determination of "good faith" on the basis of the UK Companies Act, s.44(5). The judge cited the approach adopted by the Hong Kong Court of Final Appeal in *Thanakharn v Akai Holding Ltd* (2012) 13 HKCFAR 479.

his own company and the transaction is approved by other directors of the company beyond their actual authority. In such circumstances, the director (who is a party to the transaction) cannot rely on the presumption of good faith under s.117 of the CO. The transaction is voidable at the instance of the company. Of course, the transaction can be valid if it is subsequently affirmed by the company (CO, ss.118(2) and 118(3)(d)).

As s.118 of the CO, covers the dealing between a director and his own company, it should be read in conjunction with Part 11 of the CO – Fair Dealing by Directors.

Section 119 of the CO provides that, subject to certain exceptions, then that previous s.117 does not apply to "exempted companies", that is, charitable companies. In other words, if an outsider is dealing with an exempted company, the best course of action for him is to ensure that the directors of such a company have actual authority to enter into the transaction in question by checking the articles of the exempted company or the resolution properly passed by the shareholders of the exempted company.

The Rule in *Turquand's* Case/Indoor Management Rule

Under common law, a person contracting with a company (ie dealing with the board 9.020 of directors or any representative of the company authorised by the board) in good faith is generally entitled to assume that the company's internal procedures required to give effect to the transaction have been duly complied with, and he is not required to make further inquiries. This is known as the rule in *Turquand* (*Royal British Bank v Turquand* (1856) 6 E & B 327) or the *indoor management rule*.

In *Turquand*, two directors signed a bond issued by the company to borrow £2,000. Under the company's deed of settlement, the directors were authorised to borrow on bonds on behalf of the company but only on such sum as had been authorised by a general resolution of the company. The company alleged that the borrowing was invalid on the ground that the requisite general resolution passed by the company was insufficient because it did not specify the amount to be borrowed and as a result, the directors were not properly authorised to borrow the £2,000 in question. The court held that the company was bound by the bond notwithstanding that the resolution did not specify the sum to be borrowed. The court was satisfied that on the face of the deed of settlement, the directors had established that they had the authority to sign the bond and a party dealing with the company could therefore assume that the resolution (as required under the deed of settlement) had been duly passed.

The rule in *Turquand* was followed and elaborated in a line of subsequent authorities. In *Mahony v East Holyford Mining Co*,[49] the House of Lords held that the bank was entitled to rely on cheques signed by two directors and the secretary of the company (whose power to sign the cheques was permitted under the articles) even though they had not been properly appointed. Lord Hatherley provided further guideline to define the operation of the rule:

> … when there are persons conducting the affairs of the company in a manner which appears to be perfectly consonant with the articles of association, then those so dealing with them, externally, are not to be affected by any irregularities which may take place in the internal management of the company…. For instance, when a cheque is signed by three directors, they are entitled to assume

[49] (1875) LR 7 HL 869.

that those directors are persons properly appointed for the purpose of performing that function, and have properly performed the function for which they have been appointed.[50]

In *County of Gloucester Bank v Rudry Merthyr*,[51] a mortgage executed under seal was held to be binding on the borrower company notwithstanding the fact that the board meeting of the company which authorised the execution of the mortgage was inquorate (the meeting was attended by two directors whilst the quorum should be three). The articles of the company did not fix the quorum but provided that the quorum of the board meeting was to be determined by the board. The board had made a regulation that a quorum of three directors should be necessary for the validity of their acts. The English Court of Appeal held that as between the company and the mortgagee, who had no notice of the irregularity, the execution of the mortgage was valid. In the judgment of Lindley LJ:

> … Here the directors may make any quorum they like –it may be two, or it may be three … The mortgage in question is under the seal of the company, signed by two directors, and countersigned by the secretary … If a person looked at the deed and looked at the articles he would not see anything irregular at all; he would be at liberty to infer … that if the directors had appointed a quorum they appointed the two who signed that deed … [52]

What is clear from the authorities discussed above is that whilst a third party dealing with a company is affected by the provisions (or restrictions) of its articles, he or she is not bound to inquire further into the internal affairs of the company. For example, if the directors can only enter into a transaction upon authorisation of an ordinary resolution passed by the company, the third party, when provided with the ordinary resolution, is entitled to assume that all the internal procedures (such as appointment of directors, convening of the general meeting and passing of the ordinary resolution by the requisite majorities) have all been properly carried out.

The rule has been extended to cover the situation where the directors are allowed to act on behalf of the company upon the sanction of the company by an ordinary resolution but no such ordinary resolution has been produced. For example, where the articles provide that the directors can only borrow a certain amount of money with the previous sanction of the company by an ordinary resolution, the lender can hold the company liable for the loan even if the ordinary resolution is not produced to the lender. The lender is not required to enquire whether the borrowing has been duly endorsed by the company. The lender is entitled to assume that all the company's internal procedures required to give effect to the transaction have been duly complied with unless he or she has notice of any irregularity. Thus, the rule in *Turquand* has been developed to mitigate the harshness of the doctrine of constructive notice so that a lender, for instance, will not be caught by the absence of the ordinary resolution in a loan transaction with the company.[53] The rule has also been extended to cover the absence of a board resolution in some cases. Thus, if a party holding the debenture of the company believes that the board has authorised the company to issue the

[50] (1875) LR 7 HL 869, 894 (Lord Hatherley).

[51] [1895] 1 Ch 629.

[52] *County of Gloucester Bank v Rudry Merthyr* [1895] 1 Ch 629, 636.

[53] *Fountaine v Carmarthen Railway Co* (1867–1868) LR 5 Eq 316.

debenture, he can enforce the debenture even if there is in fact no board meeting held to authorise the issue of such debenture provided that the holder had no notice of any irregularity in the issue of the debenture.[54]

If a party seeks to rely upon the rule in *Turquand*, it normally must be pleaded in the pleadings and that the rule is one of mixed law and fact.[55]

Exceptions to the Rule

The operation of the rule in *Turquand* is, however, not without restrictions. The rule does not apply if: 9.021

(i) the person dealing with a company knows that there are some irregularities in the internal affairs of the company;

(ii) the nature of the transaction or the circumstances leading to the transaction are so suspicious that the person dealing with the company is put on inquiry; or

(iii) the transaction is procured by forgery.

Also the rule only protects outsiders, it does not apply to insiders of the company. Each of these restrictions will be discussed below.

Knowledge of Internal Irregularity

The rule in *Turquand* does not apply if the third party has actual knowledge of the internal irregularity of the company. For example, a third party cannot rely on the *prima facie* value of an ordinary resolution if he knows that the quorum of the general meeting of the company had not been satisfied when such resolution was purportedly to be passed. Under the ordinary rules of agency, the law may impute to a principal knowledge relating to the subject matter of the agency which the agent acquires whilst acting within the scope of his authority.[56] Thus, a bank may be deemed to have knowledge of the internal irregularities of the borrower company (eg the board meeting of the borrower company authorizing such borrowing was inquorate) if the solicitors acting for the bank have learnt such irregularities in the course of preparing the legal documents to give effect to the borrowing. Under such circumstances, the bank cannot rely on the rule in *Turquand* even if such irregularities are only known to its solicitors, but not to the bank itself.[57] 9.022

At common law, a person dealing with directors must look into the constitution and any other information of the company (which is registered or filed and can be accessed at the Companies Registry) to ascertain whether the directors indeed have the powers which they are purporting to exercise. If they fail to do so and the directors act beyond their powers under the company's constitution, the third party would be deemed to have notice of the irregularity on the part of the directors and would not be able to bind the company.

[54] *Duck v Tower Galvanizing Co* [1901] 2 KB 314.

[55] *Pacific Foundation Finance Ltd v Fairyoung Holdings Ltd* [1999] 3 HKLRD 153, 157 (Mortimer VP).

[56] See P Watts, FMB Reynolds and W Bowstead, *Bowstead and Reynolds on Agency* (Sweet & Maxwell, 20th ed, 2014) Chapter 8.

[57] See *Bank of East Asia v Labour Buildings Ltd* (HCMP 769/2002, [2007] HKEC 1957).

The following two examples will demonstrate the operation of the rule in *Turquand* in this respect:

(i) If the articles authorise the directors to borrow money on behalf of the company upon an ordinary resolution of the company, the company will be bound notwithstanding that no resolution authorising the loan has been passed where the lender (acting in good faith) relies on the authority of the directors under the articles and advances the loan to the company.[58] Since an ordinary resolution is not required to be filed at the Companies Registry, the lender would not be able to find out whether or not the ordinary resolution has indeed been validly passed. Even if it has not been validly passed, a third party entering into a transaction with a company in good faith will not be affected by the internal irregularities of the company as long as the transaction is permissible under the constitution of the company; and

(ii) Where the articles authorise the directors to borrow money on behalf of the company upon a *special resolution* of the company, the company would not be bound if no such special resolution has been passed even if the lender advances the loan in good faith and relies on the authority of the directors under the articles.[59] This is because a special resolution must be filed at the Companies Registry within 15 days of its passing[60] and the lender in such circumstances would be deemed to have constructive notice that such special resolution has not been passed by the company.

The position is now somewhat complicated by s.120 of the CO which provides that a person shall not be taken to have notice of any matter merely because of its being disclosed in the articles kept by the Registrar or a return or resolution lodged with him.

It appears that this statutory protection is wider than the common law protection under the rule in *Turquand* because it also covers the absence of special resolutions. In other words, if under the articles, a special resolution is required to authorise the transaction, a third party dealing with the company can assume that the required special resolution has been duly passed by the company even if in fact no such special resolution had been passed. They will no longer be adversely affected by constructive notice in connection with the filing of a special resolution.[61] However, as discussed above, the exact scope of operation of s.120 of the CO is not clear. It is quite clear that if a third party has actual knowledge that the transaction is not authorised by the required special resolution, they are not entitled to rely on s.120 of the CO. If they do not have actual knowledge but are put on inquiry by suspicious circumstances as to the authority of the board of directors, it is unclear whether they are bound to enquire if the transaction has been authorised by the company in accordance with its constitution.

One of the side effects of s.120 of the CO is to *remove the onus of a third party to check* the constitution of a company before they enter into a transaction with the company. At common law, where the articles of the company prohibit the directors from entering into a particular type of transaction, a third party cannot rely on the rule in

[58] See *Royal British Bank v Turquand* (1856) 6 E & B 327; see also *Fountaine v Carmarthen Railway Co* (1867–1868) LR 5 Eq 316.
[59] *Irvine v Union Bank of Australia* (1877) 2 App Cas 366 PC.
[60] See s.622 of the CO.
[61] See *Irvine v Union Bank of Australia* (1877) 2 App Cas 366 PC.

Turquand to bind the company if they enter into such a transaction with the directors (it makes no difference whether or not the third party has checked the articles before they enter into the transaction because they are deemed to know the existence of such a restriction). Under s.120 of the CO, they would not be deemed to know the existence of such a restriction and would not be caught by such restriction unless they have actual knowledge (or probably have been put on inquiry by suspicious circumstances) of the limitation of the directors under the articles. If a third party cannot rely on this s.120 because he has actual knowledge of the restriction on directors' power, it is still possible for him to rely on that s.117 of the CO. As discussed above, s.117(2)(c) of the CO provides that a person dealing with a company is not to be regarded as acting in bad faith by reason only of the person's knowing that an act is beyond the directors' powers.

Suspicious Circumstances

When there are unusual circumstances that ought to arouse the suspicion of the outsider, the rule in *Turquand* may not apply. Whilst it is not possible to give specific guidance as to the circumstances in which the nature of a transaction will be such as to put a person dealing with a company upon inquiry, these circumstances may include the possible absence of a quorum, the absence of notice of a meeting and lack of ratification, non-disclosure of interests of directors,[62] or abuse of power by the directors. 9.023

In *Rolled Steel Products (Holdings) Ltd v British Steel Corp*,[63] a director procured the company to execute a guarantee in favour of a third party for the personal benefit of the director (as opposed to the benefit of the company). The third party was aware of the impropriety on the part of the director. The English Court of Appeal held that the third party could not enforce the guarantee against the company. Slade LJ's judgment sets out the legal position:

> In the absence of notice to the contrary, the lenders would thus have been entitled to assume, on the authority of the principle in *Turquand's* case, and on more general principles of the law of agency, that the directors of the borrowing company were acting properly and regularly in the internal management of its affairs and were borrowing for the purposes of the company's business … However, a party dealing with a company cannot rely on the ostensible authority of its directors to enter into a particular transaction, if it knows they in fact have no such authority because it is being entered into for improper purposes. Neither the rule in *Turquand's* case nor more general principles of the law of agency will avail him in such circumstances …[64]

In *Re Moulin Global Eyecare Holdings Ltd*,[65] the lender entered into a loan agreement with a company secured by a debenture comprising a floating charge over the property of the company. The debenture was executed in accordance with the sealing provision of the company but the Court of Final Appeal held (affirming the judgments of the Court of First Instance and Court of Appeal) that the lender was not entitled to enforce

[62] *Re Akai Holdings Ltd (No 2)* (2010) 13 HKCFAR 479.
[63] [1985] 2 WLR 908 (CA).
[64] *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1985] 2 WLR 908, 292.
[65] (2009) 12 HKCFAR 621.

participants to levy a charge on investors for payment into the compensation fund. The specific amount of levy is the same as that imposed under the Levy Rules discussed earlier.[471]

Fidelity Fund for Exchange Participants

10.115 As the default of licenced intermediaries may also affect exchange participants who may be the counterparties of the defaulted party, exchange participants may also insure their potential losses against a Fidelity Fund that is maintained by the Exchanges.[472] Each exchange participant may deposit an amount of HK$50,000 with the Exchange to become a member of the Fidelity Fund. Exchange participants not insured with the Fund must provide a guarantee of up to HK$2,000,000.[473] The Fund would be paid out upon default of an exchange participant in accordance with the claims procedures the Exchanges impose.

VI. REGULATION OF MARKETS

10.116 The regulation of markets consists of two aspects: (i) one is the *ex ante* regulation of market-places so that the market-places allowed to operate satisfy a certain standard of operational fitness and credibility and (ii) the second aspect is the regulation of abusive conduct on market-places so that investor confidence will not be diminished. Investor confidence is regarded as key to the maintenance of a vibrant capital investment product.[474] As investor behaviour is not an exact science,[475] and the loss of investor confidence would bring about serious consequences to market trading, liquidity and may have systemic effects on the Hong Kong economy, regulation of market misconduct has been given a serious boost in the new SFO provisions.

Regulation of Market Misconduct

10.117 "Market misconduct" is defined under s.245 of the SFO to refer to insider dealing, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, and stock market manipulation. This is a great leap forward in Hong Kong's combat against abusive market behaviour, as Hong Kong had only a rather weak insider dealing law until the SFO came into force.

All market misconduct would attract administrative sanctions before a Market Misconduct Tribunal, and they would be initiated by the Financial Secretary. They would also be criminal offences, under Part XIV of the SFO, and civil enforcement could also be carried out against them. Therefore, flanked by many routes of enforcement against market misconduct, Hong Kong is emerging to be in line with international standards where investor protection is concerned.

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[471] See Rules of Exchange, Chapter 11 ("Transaction and Investor Compensation Levies").
[472] Rules of Exchange, Chapter 9.
[473] Rules of Exchange, rr.912 and 921.
[474] BS Black, *The Legal and Industrial Preconditions for Strong Stock Markets* (Stanford Law School Working Paper No 179, 2001).
[475] R Prentice, "Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for its Future" (2002) 51 Duke LJ 1397.

More recently, the SFC identified inadequate internal control procedures as one type of market misconduct. In 2010, the SFC fined two Merrill Lynch subsidiaries $450,000 for "systems and controls failings" after a managing director mis-marked a trading book of illiquid securities from December 2007 to October 2008 and illicitly gained access to the bank's computer systems and changed the pricing parameters on a book of exotic options. The false marks inflated the value of the trading book by about $25 million, concealing its actual loss. However, the SFC found that Merrill Lynch (Asia Pacific) and Merrill Lynch Futures (Hong Kong) did not have adequate internal control procedures in place to prevent fraud or dishonest activity related to the trading book, which indicated that the senior management had failed to adequately manage the risk, and the systems and controls fell short of those expected. Meanwhile, the SFC recognised that Merrill Lynch's misconduct was not intentional and the bank had taken remedial steps to address the compliance weaknesses.[476] This case appears to suggest that the adequacy of internal control procedures, no matter whether they do help prevent fraud, does trigger the SFC's scrutiny when it comes to investigate the case. The rationale is that inadequacy of internal control procedures proves the senior management's lack of skill, knowledge or experience in risk management, which may contribute to the fraudulent activities. As the SFC pointed out in a statement after the penalty decision, "the proper implementation of an effective risk management framework could have enabled Merrill Lynch to detect the mis-marking earlier".[477]

In the global economic downturn, SFC, being concerned that choppy market conditions may push some firms to the edge of failure, stepped up inspections of trading floors and asset management houses. SFC's figures for inspections of licenced financial firms for the six months to the end of September 2011 indicated that it carried out 157 "risk-based onsite inspections", up 37.7% from one year earlier. SFC increased surveillance of brokerages and fund managers to check their trading positions, to ensure that client money is safeguarded, to ensure financial firms comply with rules and do not engage in excessively risky behaviour. These actions aim at maintaining the viability and financial soundness of licenced financial intermediaries and managing financial risks faced by the industry. The SFC also flagged in its 2011–2012 budget that it planned to boost the size of its supervision team so that it could inspect high-risk or impact firms in a more frequent manner.[478]

Insider Dealing

Definition

Insider dealing is defined in s.270 of the SFO in the form of a list of various situations in which insider dealing occurs. Basically, an insider dealer is: 10.118

(a) a connected person to a listed corporation "connected" being defined in ss.247 and 248, as a director, employee, substantial shareholder, a person who occupies a position that gives him access to relevant information in relation to the corporation, a person connected with another corporation but has access to the relevant information by virtue of a transaction, a person previously connected with the corporation within six months of the insider

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[476] R Cookson, "HK Watchdog Slaps Fine on Merrill Units", *Financial Times* (1 June 2010) 18.
[477] See FN 476.
[478] Reuters, "Financial Regulator Steps up Inspections", *South China Morning Post* (14 January 2012), B2.

dealing, or any public officer or officer or employee of a self-regulating entity such as the exchange who receives any relevant information to the corporation;

(b) a person who is contemplating or has contemplated making a takeover offer for the corporation; and

(c) a person who has received relevant information directly or indirectly from a connected person in (a) or a person in (b).

The act of inside dealing would be:

(i) a person in (a) above deals with the listed securities of the corporation, related corporations or any of their derivatives;

(ii) a person in (a) above procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(iii) a person in (a) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal;

(iv) a person in (b) deals as above;

(v) a person in (b) procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(vi) a person in (b) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal;

(vii) a person in (c) deals as above;

(viii) a person in (c) above procures another person to deal as above, having actual or reasonable knowledge that the other person would deal;

(ix) a person in (a), (b) or (c) procures another person to deal as above, having actual or reasonable knowledge that the other person would deal, in a stock market outside Hong Kong or a stock market that is not recognised; or

(x) a person in (a), (b) or (c) discloses relevant information directly or indirectly to another person, with actual or reasonable knowledge that that other person would either deal as above, or procure another to deal, in a stock market outside Hong Kong or a stock market that is not recognised.

The definition of insider dealing is the same under both the civil and criminal regimes. The range of insiders is fairly wide and tippees are covered. However, this range is arguably circumscribed as the original connection with a person connected to the corporation or to a person who may have been contemplating a takeover offer for the corporation, must be made. Thus, any person who may have come into some price-sensitive information, in a situation where there is no connection to the corporation, to any connected person, or potential takeover offeror, would not be regarded as an insider. Thus, primary tippees would be covered but secondary tippees may not be covered.

The regulation of insider dealing is generally accepted to be necessary to maintain investor confidence.[479] However, there have been contrary writings to suggest that insider dealing has no effect on market confidence or development,[480] or that insider dealing actually benefits the market as it is nonetheless a release of price-embodied information into the market, hastening the efficient capital market to reflect the information.[481] Even if there is no statistically proven link between the regulation of insider dealing and actual capital market growth in any jurisdiction, the lack of such regulation is likely to raise concerns as the international community is largely in favour of such regulation.[482]

The following will examine the SFO provisions in detail to understand how each element of insider dealing is established.

"Relevant Information"

The "relevant information" that is crucial to any of the acts described in (i)–(x) above 10.119
is defined in s.245 of the SFO as specific information which is not generally available to accustomed or likely investors, and would materially affect the price of the listed securities, in respect of the following:

(1) the corporation;

(2) a shareholder or officer of the corporation; or

(3) the listed securities of the corporation or their derivatives.

Each of the elements "specific", "not generally available", and "material" have been discussed in Insider Dealing Tribunal reports of Hong Kong.

"Specific"

First, the element of "specific" in the definition of "relevant information" begs the 10.120
question of what "specific" is, and is it opposed to "general"? How "specific" must "specific" be? The Insider Dealing Tribunal in respect of *Re Hong Kong Parkview Group Ltd*[483] thought that "specific" related to single, individual items of information of some significance, such as a potential takeover offer, or potential acquisition or disposal. It did not refer to the general superior working knowledge of the officers and employees of the corporation. The Tribunal in *Re Chevalier (OA) Ltd*[484] also agreed that "specific" had to refer to major or dramatic matters. The bulk of information that investment advisers may be privy to but not the general public, would also not fall within "specific".[485] However, "specific" did not require that all the details relating to

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[479] B Hannigan, *Insider Dealing* (Kluwer, 1988).
[480] E Ferran, *Building an EU Securities Market* (Cambridge University Press, 2004) which suggested that the EU Insider Dealing Directive had no effect on EU market developments.
[481] HG Manne, *Insider Trading and the Stock Market* (Free Press, 1966).
[482] For example, IOSCO (International Organisation of Securities Commissions) conducts annual Internet Surf Days to survey member regulators' jurisdictions in respect of regulatory efforts made to maintain market confidence. Such core regulatory efforts include fraudulent solicitation of investors, fraudulent or misleading release of information, and insider trading. See IOSCO Technical Committee, *Press Release on Second Annual International Surf Day* (June 2001), on IOSCO's website, http://www.iosco.org/news/pdf/IOSCONEWS19.pdf.
[483] Dealing took place between 13 and 16 August 1993, report of 5 March 1997.
[484] Dealing between 26 April and 5 July 1993, report of 10 July 1997.
[485] Insider Dealing Tribunal in relation to Public International Investments Ltd, dealing between November and December 1992, report of 5 August 1995.

fact or law. It gathered expert and professional evidence on whether a piece of information regarding top-up placements and the likely placee would be price-sensitive and relied on expert opinion to conclude on the materiality of the information. If the Tribunal regarded "materiality" as a question of fact, this is unusual as the well-established American approach on defining materiality treats the exercise of determining materiality as a question of law. Although the Tribunal is quasi-judicial in nature, it is still perhaps right to maintain a distinction between the finding of fact and interpretation of law. But it may be argued that the nature of information that may affect price of securities is a sophisticated subject, and expert evidence could be conclusive on the matter, bringing the issue of materiality more like one of fact dependent on the expert evidence in each case. The question of how to interpret materiality, and whether it is a question of fact or law may become more important in the future, as criminal and civil enforcement could be taken in court against insiders, and judges would have to face these issues. Before 2003, insider dealing was dealt with as an administrative transgression under the exclusive jurisdiction of the Insider Dealing Tribunal.

Mental Element

10.123 The *mens rea* element of the insider in sub-ss.(a) and (b) of that s.270 of the SFO, as listed in [10.118], would be knowledge of the nature of the relevant information, and where disclosure is made to another to facilitate the acts in (iii), (vi) or (x) in [10.118], there is a further layer of *mens rea* that the person who discloses should have knowledge or reasonable cause to believe in the other person's acts. The *mens rea* relevant for the person in that sub-s.(c) would be both the knowledge of the nature of the information, as well as the knowledge or reasonable cause to believe that the information came from a person in (a) or (b). See [10.118] for the definition of insider and insider dealing.

Where there is only provision of knowledge and not reasonable cause to believe, it seems that actual knowledge would be required to be established. The argument could be made that as the provision stipulates actual knowledge in relation to the nature of inside information, since the nature of inside information is itself very arguable, as the above analyses on the elements of "specific", "not generally known" and "material" show, then it would be difficult to prove that a person knows for sure that a piece of information is inside information, since the nature of inside information is itself difficult to ascertain. This is also the case with the legislation in Singapore, and this author has commented in another article that it is puzzling why constructive knowledge should be left out. The consequence would be that the prosecution has to prove actual subjective knowledge which is very difficult because the defendant can always deny such knowledge.[498] In the Australian case of *R v Evans and Doyle*,[499] when the defendants dealt with the securities of the corporation about which they had obtained inside information, they thought that the information was already made public by the press release they initiated 30 minutes before the dealing took place. The defendants pleaded that they did not know that the information was not made public yet. On the facts, the trial judge found that the plea was not true. But the judge did not comment on whether an innocent mistake as to the nature of the information, could negative

[498] CH Yu, "Australian Influences in the Insider Trading Laws in Singapore" (2002) *Singapore Journal of Legal Studies* 574.

[499] [1999] VSC 488.

actual knowledge of the nature of the information. But an innocent mistake would have to negative actual knowledge, as actual knowledge of the nature of the inside information would never have existed.

There could be potential pitfalls with requiring only actual knowledge of the nature of inside information.

Exceptions to Insider Dealing

Directors, Liquidators, Receivers and Trustees in Bankruptcy

Sections 271–273 of the SFO provides for the exceptions from insider dealing. The 10.124
common exceptions for underwriters, would-be directors, liquidators, receivers and trustees in bankruptcy are present.

Innocent Insider

Section 271(2) of the SFO exempts a corporation from insider dealing if the actual 10.125
persons who dealt, had no knowledge of the inside information, although some directors or employees might have had the information. Thus, if a director who has relevant information orders an innocent subordinate to deal, the director's liability would attach to himself personally and not be attributed to the corporation.

Absence of Mental Element

Section 271(3) of the SFO exempts an insider if the trade does not include the purpose 10.126
of securing a profit or avoiding a loss for himself. This provision is heavily criticised by one commentator,[500] who argues that profit has still been made or loss avoided at others' expense when the inside information was used in trade. Thus, market integrity has still been compromised whether the subjective intention of the trader was to profit himself or not. However, as insider dealing is also a crime, *mens rea* is an important fundamental principle, and this exception could be argued as negativing the *mens rea* to commit market misconduct. This interpretation is supported by the recent case of *Henry Tai*[501] as the court stated that the lack of "intention" was crucial to the success of the defence, and one of the factors showing a lack of intention could be if the insider had no choice but to sell shares.

One may argue that the insider without *mens rea* should be punished because of the effect that market integrity has been somewhat breached. Such argument uses a strict liability form of reasoning which needs stronger policy justification. It may well be argued that market integrity maintenance itself is a strong policy justification, however, market confidence can generally withstand some imperfections, and even scandals may not result in a financial crisis. Thus, it would be submitted that s.271(3) of the SFO does provide a worthy exception.

Agents and Off-exchange Transactions

Further, persons who deal without the requisite knowledge or deal as agents are
exempt, and persons who dealt off-exchange with each other, both having the requisite 10.127
knowledge, are also exempt. This is probably premised on that, off-exchange dealings

[500] K Lynch, "Stock Market Crises and Insider Dealing in Hong Kong: The Need for Regulatory Reform" in R Wacks (ed), *New Legal Order in Hong Kong* (Hong Kong University Press, 1999) 237, 274.

[501] *Henry Tai Hon Leong v Insider Dealing Tribunal* [2005] HKEC 1740.

between entities who may be in a superior knowledge position to market participants does not affect the listed price of securities and there is no misuse of informational advantage.

Personal Representatives, Trustees and Persons Exercising Rights under Options

10.128 Sections 272 and 273 of the SFO exempts certain personal representatives and trustees who have dealt based on advice obtained good faith, and persons exercising rights under options.

Permission from a relevant compliance unit to deal in shares would not absolve a person's liability for insider dealing if the permission is obtained dishonestly and fraudulently. In *HKSAR v Du Jun*,[502] there was evidence that the defendant had not told the truth of his holding of the relevant insider information to the compliance department when applying for permission to deal in the relevant shares. Consequently, the defendant was not allowed to shield his dishonesty behind the approval he managed to obtain from the compliance department, which he would not have received had he gave the full and complete disclosure of the facts.

Other Laws and Rules Governing Insider Dealing

The Rules Governing the Listing of Securities on the Hong Kong Stock Exchange

10.129 The Listing Rules seek to protect investors against improper use of confidential information by insiders, by inter alia, imposing a general obligation on the listed company to disclose to the market price sensitive information.[503] The Main Board Listing Rules also impose restrictions on dealings by a director in the securities of his or her company.[504] The director of a listed company is also under a duty to ensure that the employees of the company who are likely to be in possession of unpublished price sensitive information are subject to the same dealing restriction.[505]

The Code of Conduct Module of the Supervisory Policy Manual Issued by the Hong Kong Monetary Authority

10.130 The Code of Conduct sets out the minimum standards of codes of conduct that the Hong Kong Monetary Authority expects an authorised institution to adopt. These include prohibition of staff members from dealing in the shares or securities of any listed company when in possession of privileged or price sensitive information not generally known to the public.

The Code of Conduct for Persons Licenced by or Registered with the SFC

10.131 The Code of Conduct imposes an obligation on the persons licenced by or registered with the SFC to implement and maintain measures appropriate to ensuring compliance with the relevant law, rules, regulations and codes administered or issued by the SFC, the Hong Kong Stock Exchange (if applicable) and the requirements of any other regulatory authority that apply to a licenced or registered person.[506]

[502] (DCCC 787/2008).
[503] Listing Rules, r.13.09.
[504] Listing Rules, Appendix 10.
[505] Listing Rules, Appendix 10, para.13.
[506] Code of Conduct for Persons Licenced by or Registered with the SF, para.12.1.

These rules and laws indicate that a properly prepared and communicated compliance system may be the best defence against insider dealing. In order to ensure the effectiveness of the compliance system, the institutions must communicate well with and provide training for employees on how to identify and handle inside information what laws are applicable to the handling of inside information; common insider dealing problems and how to avoid them; and what to do if an employee suspects insider dealing has happened or is about to occur.

Educating employees on how to handle inside information is critically important. In *HKSAR v Lam Kar Fai, Allen*,[507] convictions were obtained against an investment banker and a fund manager. The investment banker was convicted for providing information on the possible takeover transaction involving a listed company to a fund manager through coded emails even though he only overheard his colleagues' conversation and was not involved in the takeover deal directly. The fund manager then purchased the shares of the listed company on behalf of a fund managed by his company and for himself. He then sold shares for profit after the acquisition was announced. The investment banker did not profit from the information but his wife made an indirect profit due to her interest in the fund. Both the investment banker and the fund manager were sentenced to terms of imprisonment though both pleaded guilty, and were imposed with fines equivalent to the profits attributable to the insider dealing. The court felt that the facts were serious enough to warrant imprisonment. The fund manager committed the offence in his professional capacity while the investment banker abused his position as an employee. The fund manager's licence was also revoked by the SFC so that he is unable to carry on certain regulated activity. Further, the fund manager was banned from re-entering the industrial sector for life. In this case, it is worth noting that the court rejected the notion that the infrequency of criminal prosecution in respect of insider dealing could give rise to any reasonable expectation of no prosecution or no imprisonment for the offence.

Enforcement against Insider Dealing

There are three ways of enforcing against insider dealing, the first, an administrative penalty imposed by the Market Misconduct Tribunal, the second, a criminal conviction and penalties and the third, civil enforcement by aggrieved persons. 10.132

Administrative Penalty Regime

First, the administrative penalty regime is a continuation of the enforcement regime under the repealed Securities (Insider Dealing) Ordinance (Cap.395). The repealed Cap.395 Ordinance contains an exclusively administrative enforcement regime whereby an insider dealing tribunal may be set up following the initiative of the Financial Secretary to investigate as well as punish insider dealing. The current SFO now provides for criminal and civil enforcement as well, but it may be anticipated that the administrative penalty regime that has been the dominant regime before would possibly continue to remain the most important means of enforcement. 10.133

[507] (DCCC 919, 921 and 922/980).

Initiating Market Misconduct Proceedings

10.134 Under the SFO, the Financial Secretary may initiate a case before a Market Misconduct Tribunal which shall be presided by a judge and two other members not being public officers. A presenting officer appointed by the Secretary of Justice would conduct the case against the alleged insider.[508] The role of the Tribunal continues to be of an inquisitorial nature,[509] and the Tribunal may find whether market misconduct has taken place, who the responsible persons may be, and the amount of profit made or loss avoided from such misconduct. The role of the SFC would be to report any likely market misconduct to the Financial Secretary in order to initiate the case.

Orders by Market Misconduct Tribunal

10.135 The Tribunal may impose one or more of the following orders on the insider:[510]

(a) disqualification as director, manager, receiver or liquidator, as the case may be;

(b) a prohibition order, not exceeding five years, that disallows the insider from dealing in any investment product, whether securities, futures, leveraged foreign exchange, derivatives or collective investment schemes;

(c) an order that the person shall not perpetrate any market misconduct again;

(d) disgorgement of profit gained or loss avoided;

(e) costs and expenses of the Government and the SFC; or

(f) an order that the appropriate body take disciplinary action against the insider.

Changes under the SFO Compared with Insider Dealing Ordinance

10.136 The SFO has changed the law under the repealed Ordinance somewhat. Under the repealed Ordinance, the Insider Dealing Tribunal could order the insider the pay a penalty not exceeding three times the profit gained or loss avoided,[511] in excess of the disgorgement that would be ordered. The penalty serves a deterrent effect. It remains to be seen if the removal of the deterrent penalty may make any difference to the level of investor protection in Hong Kong. It may be argued that order (c) above which is an order not to perpetrate market misconduct could be used as a deterrent, as a breach of that order could result in either a financial penalty not exceeding the amount which is the greater of HK$10 million or three times the amount of the profit gained or loss avoided by the insider dealer[512] or a criminal conviction with a fine up to HK$10 million and a 10-year imprisonment.[513] Furthermore, the prohibition from dealing, which is new to the SFO, could also serve as a painful punishment for the insider.

[508] SFO, ss.251–252.
[509] The inquisitorial nature of the Tribunal is discussed in Lynch (FN 26) at n265.
[510] SFO, s.257.
[511] Securities (Insider Dealing) Ordinance (Cap.395) (Repealed), s.23.
[512] SFO, s.194(2).
[513] SFO, s.303(1).

Calculating the Amount of the Profit Gained or Loss Avoided

In terms of calculating the amount of profit gained or loss avoided, the *Insider Dealing Tribunal v Shek Mei Ling*[514] has provided some clarification of how the computation should be done. In most circumstances, the profit gained by an insider should be the difference between the purchase and sale price of the shares. Where the issue in question is loss avoided, then it should be the difference between the purchase price of the shares and the market value of the shares at the date the inside information became known and that the market has had a reasonable amount of time to digest the information. The loss avoided would more likely than not be a notional figure. In *Shek Mei Ling*, the insider sold the shares before the information went public, and the sale price of the shares was thus different from and lower than the price of the shares after the information was publicised. The Insider Dealing Tribunal sought to calculate the amount of profit gained by taking the difference between the purchase price of the shares and the price of the shares on the date the information went public. However, the Court of Final Appeal disagreed and said that if the insider bought shares on inside information and sold the shares before the information became public, then the amount of profit gained had to be actual profit made, ie the actual difference between the purchase and sale prices. 10.137

Other Exceptional Circumstances Affecting the Share Price

The Court of Final Appeal even opined that it was possible to look at whether any other exceptional circumstance may have affected share price other than the inside information in question, and that could affect the degree of effect the inside information had on the share price. This is *obiter dicta* as there was no such circumstance in the *Shek Mei Ling* case. This regard for any other circumstance was seen however in a more recent *Re HKCB Bank Holding and HK China Ltd*.[515] It has been criticised that other circumstances should not negate or reduce the liability of an insider as the insider has still done an act that breached market confidence.[516] However, as there is no case to date that deals specifically with whether the existence of other circumstances may negate the effect of the inside information on share price and thus let the insider off the hook, it remains to be seen how this issue may be dealt with if it arises. 10.138

Order Against Officers

The SFO imposes a duty on every officer of a corporation to put in place reasonable measures to prevent the firm from engaging in insider dealing,[517] and failure to do so may give rise to civil sanctions[518] including disqualification as a director and prohibition from dealing in securities for a period not exceeding five years. The Tribunal may also make an order against an officer of a corporation who failed to take adequate measures to prevent insider dealing from being undertaken by the corporation.[519] It is uncertain what "adequate" measures would be. One possibility is the use of Chinese 10.139

[514] [1999] 1 HKLRD 879.
[515] *Insider Dealing Tribunal v Shek Mer Ling* [1999] 1 HKLRD 879.
[516] AYM Tam, "Financial Orders Under Subsections 23(1)(b) and (c) of the Securities (Insider Dealing) Ordinance—Insider Dealing Tribunal v Shek Mei Ling" (2000) 30 HKLJ 22.
[517] SFO, s.279.
[518] SFO, s.258.
[519] SFO, ss.258 and 279.

The new FIL can be seen as a strong signal sent by the Chinese government to the global community that it remains an attractive investment destination. The new FIL emphasises the protection of foreign investors' rights and interests, limits the government's right to intervene in reporting, and clarifies the full implementation of pre-entry national treatment and negative list.[206] In terms of foreign investment supervision, on the one hand, the FIL highly emphasises the importance of administrative agencies in formulating negative list. However, from the current negative list, there are still many areas that prohibit or restrict foreign investment, and there is a big gap with developed countries. In the ongoing BITs negotiations between China and the US and the EU, the specific content of the negative list is always the focus of disputes between the parties, especially the clarity of the negative list, the distribution of power between the central government and local governments, and the negative list for specific industries. Some scholars also believe that clarifying the negative list is a difficult point in the negotiation of BITs between China and the US.[207]

On the other hand, although the foreign-funded review mechanism established by the FIL clearly defines the position of restricting the administrative power of the government, the provisions still have great ambiguity, and there is also great uncertainty in the specific interpretation and application, which reduces foreign country investors' expectations of investment risks and make them still afraid of investing.[208] Generally speaking, the FIL is not only a summary and effective integration of China's foreign investment legislation in the 40 years of reform and opening up, but also a recitation of internationally accepted investment standards in the basic position of the Party Central Committee to continue to promote reform and opening up. In particular, the pre-entry national treatment, the supervision of the negative list as the core, and the legislation of specific measures such as the protection of intellectual property rights demonstrate the basic position of China to continue to promote investment liberalization and facilitation. The new FIL is a big step forward China's investment liberalization.

In short, from the perspective of China's foreign investment legislation for 40 years since the reform and opening up, it has experienced a system build-up from scratch, highlighting the basic position of constantly restricting the government's regulatory power and safeguarding the interests of foreign investors,[209] and showing the country's "leaving" gesture. However, this "leaving" is not sufficient in terms of speed, scope and strength, especially in terms of national treatment, MFN status, and intellectual property protection,[210] and the standards expected by developed economies such as the US and the EU. From the policy direction of 2018, China has begun to pay attention to reforms in the above-mentioned areas, and it continues to highlight the trend of continuing to push the country's "leaving" both at the legislative and administrative levels.

[206] FIL, arts.3 and 4.

[207] See J Huang, *Challenges and Solutions for the China-US BIT Negotiations: Insights from the Recent Development of FTZs in China*, (2015) 18(307) *Journal of International Economic Law* 318–319.

[208] FIL, art.35.

[209] C Chen, *The Liberalisation of FDI Policies and the Impacts of FDI on China's Economic Development*, in *China's 40 Years of Reform and Development* (R Garnaut, L Song and C Fang eds, ANU Press 2018), [612].

[210] See G Wang, *China's Practice in International Investment Law: From Participation to Leadership in the World Economy*, (2009) 34(575) Yale Journal of International Law 577.

VIII. CORPORATE NAMES

13.046 Since a company is an artificial person, it can be only identified by its name. An LLC is required to indicate its legal status in its name, for example, whether it is a company limited by shares.

Formula of Naming a Chinese Company

13.047 Investors will need to choose a Chinese name for the FIEs. With the exception of those prescribed by relevant laws and regulations,[211] the name of all enterprises in China should be composed of, in sequence, the following parts: (i) geographical designation for the local jurisdiction in which the FIE is established, followed by (ii) a chosen trade name (usually all or part of the investor's trade name), (iii) an indication of the FIE's industry, and then (iv) by the form of organization (such as Beijing [a Wholly Foreign Owned Enterprise (WFOE) trade name] Aluminium Manufacturing Co, Ltd).

However, exceptions are permitted. Where the trade name of a single or majority foreign investor (without geographic designation) is used in the Chinese name of the FIE, the geographical designation may come after the foreign investor name in the formula rather than at the beginning. Depending on local practice, "China" may be included in the name of the FIE if the foreign trade name includes a geographic designation (such as [US Widgets] (China) Beijing Aluminium Manufacturing Co, Ltd).

Further, if an FIE has registered capital of not less than RMB 50 million or the equivalent in foreign currency, the FIE may dispense with any geographical designation in its Chinese name (such as [WFOE trade name] Aluminium Manufacturing Co, Ltd) if specially approved by the SAIC. This name should be registered with the SAIC or its local branch at the appropriate level and shown on the business license of the WFOE. Upon the SAIC's approval, a company may use a company name without a "location" if the company is approved by the State Council or registered with the SAIC or if the registered capital of the company is not less than RMB50 million. The company name does not have to indicate the industrial sector if the business scope of the company covers five or more types of business industry or the company's registered capital is more than RMB100 million.

Statutory Restrictions on Naming a Company

13.048 A company name must conform to statutory rules concerning sequencing of characters, content and prohibition on the use of certain words, numerals and characters.[212] The trade name in a company name shall include at least two Chinese characters. A foreign investor needs to use its trade name in Chinese as the SAIC will not approve and register any company name in any foreign language.[213] However, a foreign investor's trade name in a foreign language may be protected according to the Paris Convention for the Protection of Industrial Property.[214]

[211] The major regulations include the Implementing Measures on the Administration of Enterprise Names, which provide clear guidelines for naming companies as well as some dispute settlement procedures.

[212] Administration of the Registration of Enterprise Names Implementing Procedures 2000, art.6.

[213] SAIC's Notice on the No Verification and Approval of Enterprise Names in Foreign Languages, issued by the SAIC on 19 January 1999, art.1.

[214] Implementing Measures on the Administration of Enterprise Names, art.34 Paris Convention for the Protection of Industrial Property.

Foreign investors do not have complete freedom to select the Chinese name of the proposed FIE. Chinese law and practice impose certain naming conventions and requirements. As a general principle, the Chinese name of an FIE should not begin with Chinese characters denoting "China", "State" or "international", and the English name of the FIE typically also cannot include such designations either since the English name (although not subject to approval and registration) usually is translated literally in accordance with the Chinese characters.

Local SAIC's approval is also necessary for those companies which use the local administrative region's name as part of the company name. There are various statutory rules and provisions which prohibit the use of certain words in company names. For instance, a company name shall not use the expressions or words that would impair national or social public interests constitute a fraud or cause some misunderstandings to the public. A company is not allowed to use the name of a foreign country (region) or international organization, the name of a political party, the administration authority or social group.

Translating a Chinese Company Name

As a purely practical matter, of course, an FIE, particularly a WFOE, will usually have 13.049
a foreign language (English) name which will be consistent with its Chinese equivalent. The foreign language name is not required to be registered with the registration authority and is not shown on the business license. An enterprise also has the option of placing the name of the administrative region between the trade name and the form of organization.

As the English translation of the Chinese company name is not entered into the company registry and serves as reference only, the WFOE may as a practical matter deviate somewhat from the registered Chinese name when using an English name translation for letterheads, name cards, marketing purposes, etc.

Prior to submission of the application for the establishment of an FIE, the applicant must obtain preliminary approval of the FIE's name. SAIC will then decide whether to approve the application within 10 days of the receipt of the application and, if approved, issue a *Notification of Preliminary Approval on the Enterprise Name*. An approved name is reserved for six months. To secure permanent use of the name, an enterprise must complete its establishment and apply for the registration of its establishment with the SAIC within the reservation period.

For companies doing business in China, the proper selection and use of Chinese language trade names is becoming increasingly important. The great majority of Mainland Chinese cannot read or write Romanised scripts and can only identify companies and their products solely by their Chinese trade names. Most foreign companies have put much effort into developing trade names with good connotations. Other companies have left it to their agents in Hong Kong or Taiwan to develop their trade names, which can cause immense problems, particularly when a name that sounds good in Cantonese or Hokkien does not have the same sound or connotations in Mandarin. There are three basic strategies that companies use to choose appropriate Chinese language trade names. These are transliteration, translation and development of a distinctive Chinese trade name. You would need to consider the best approach to choose the Chinese name of the WFOE.

An FIE is permitted to establish branches in other parts of China, but this must be approved on a case-by-case basis and stated in the business license. Note that establishment of manufacturing branches in other jurisdictions outside of the jurisdiction in which the WFOE itself is approved and established may prove difficult. Branches of an FICE must be approved by the original local approval authorities and the approval authorities in the jurisdictions of the branches.

Protecting a Business Name as a Trade Name

13.050 The investors may consider protecting the corporate name by registering the trade name as the trade mark in China. Under Chinese law, a trademark is valid for a period of 10 years but can be renewed in the six month period preceding its expiry. A trade name may not be protected as a trademark when the mark is the same as, or similar to, an existing mark or a mark that has been preliminarily examined and approved with respect to the same or similar goods.[215] A mark may be unregistrable if it is indistinctive or misleading to the public.[216] A trademark may not be registrable if it copies or imitates a well-known mark. This is also the case even if the well-known mark has not been registered in the PRC but the application is made for the same class of goods.[217]

IX. CAPITAL RULES

13.051 The corporate capital rule under Chinese law is very different from that in other jurisdictions such as Hong Kong, England and the United States where the capital rule is based on the concept of shares.

Under Chinese law, the concepts of authorised and issued capital are not used. Instead, the concept of "registered capital" is used in corporate finance. Registered capital refers to the equity contributed by the shareholders in cash or in kind to capitalise the company. The shareholders then share the profits and bear the losses of the company in proportion to their respective equity contribution percentages.

Capital Rules under FIE Laws

13.052 The registered capital rule is applied to domestic LLCs and FIEs differently. To FIEs, the concept of registered capital must be used together with the concept of total investment, which refers to the total sum of registered capital and debt which is required to finance the enterprise.

Minimum capitalization is determined by law based on a ratio between the registered capital and total investment to ensure the project is adequately capitalised.[218] The statutory ratios of registered capital to total investment are set forth in Table 3.[219]

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215 PRC Trademark Law, art.28.

216 PRC Trademark Law, arts.10 and 16.

217 PRC Trademark Law, art.13.

218 PRC regulations contemplate that an enterprise will have foreign investment enterprise status so long as the foreign ownership percentage is not less than 25% of the total registered capital. Foreign investors can invest less than 25% of the equity in a Chinese-registered company, but such investment vehicles do not qualify as FIEs or for the favourable tax and foreign exchange treatment.

219 See Provisional Regulations on the Ratio between the Registered Capital and Total Investment of Sino-foreign Equity Joint Ventures, issued by the SAIC in 1987.

great uncertainty after they became effective and this confusion was not dealt with until the SAIC, the MOFOCM, the SAFE and the General Administration of Customs issued the Implementing Opinions on Certain Issues Regarding Application of Laws on Administration of Examination, Approval and Registration of Foreign Invested Companies in April 2006. Given the fact that the previous amendments to the Company Law made in 2005 were applied to FIEs, it may be safe to assume that the 2013 amendments may also be applicable to FIEs.

The new amendments to the Company Law do not automatically apply to FIEs. FIEs are subject to laws and regulations governing incorporation and operation of FIEs in addition to the Company Law. Without corresponding changes to the FIE Law, it is difficult to apply new amendments to the Company Law to FIEs because corporate finance rules are so different under these two regimes. As the 2013 Company Law delegates the power to the shareholders to decide the capital contribution schedule of the company in the AOA, it is technically difficult for the shareholders of JVs to exercise such powers without going through the current approval/registration procedures. In the process of setting up a JV, investors are bound by the approval authority when negotiating and drafting the shareholders' agreement and AOA. The SAFE, in its scrutiny of the cross-border flow of funds regulated under the capital accounts, may also take the opportunity to examine the feasibility of an agreement reached by the shareholders with respect to the amount of subscribed capital and the capital contribution schedule. In other words, the objective of freeing shareholders from burdensome minimum registered capital rules is difficult to apply in practice to FIEs. Whether the newly amended corporate finance rules in the 2013 Company Law are applicable to FIEs eventually rests with the Chinese legislature.

The new amendments to the Company Law are a positive development, as the lower minimum capital requirements are likely to encourage private funds to enter into China's economy. These changes are technically irrelevant to foreign investors as these rules are not applicable to FIEs. However, these rules are relevant in the sense that they will further imbalance the corporate "playing field" in favour of domestic companies by loosening restrictions such as minimum capital investment. These changes give Chinese investors a much easier route to incorporation in comparison with foreign investors for FIEs. Hopefully, these imbalances created by the 2013 Company Law will be addressed in future changes to FIE Laws. It remains to be seen how these rules will ultimately affect the approval process of FIEs.

It is worth noting that some new amendments to the 2013 Company Law have already been implemented in the Shanghai (China) Free Trade Zone and applied to both domestic enterprises and FIEs registered in the zone.

In August 2013, the State Council officially approved the establishment of the Free Trade Zone in Shanghai. The new pilot free trade zone has been touted as the successor to the special economic zone set up in Shenzhen in the 1980s by Deng Xiaoping when he embarked on a series of market experiments. The free trade zone spans 28.78 square kilometres in Waigaoqiao, Yangshan port and Pudong districts in Shanghai. The Chinese government is trying to introduce its own ambitious reforms. The new free trade zone is viewed by the business community and analysts as the Chinese government's most important policy move for economic reform in more than a decade. This zone will be used as a controlled laboratory to experiment with loosened regulations on key economic reform initiatives ranging from interest rates to foreign

investment approvals. If the desired result can be achieved, the zone will spark wider market reforms.

The State Council in September 2013 outlined the policies for the Free Trade Zone in the Framework Plan for China (Shanghai) Pilot Free Trade Zone. The Shanghai Municipality Government promulgated the Administrative Measures for the China (Shanghai) Pilot Free Trade Zone (the Administrative Measures), effective as of 1 October 2013 as well as five pieces of administrative measures related to the establishment of the Free Trade Zone.[225] The Free Trade Zone formally started to accept applications for the filing of enterprises.

According to the Administrative Measures and the Several Opinions of the SAIC on Supporting the Development of the China (Shanghai) Pilot Free Trade Zone (Gong Shang Wai Qi Zi No. [2013] No.147), a company registration system is adopted, on a pilot basis, in the Free Trade Zone. This system has the following key features.

Capital Subscription System

13.053 Unless the actual payment of registered capital of certain companies is otherwise prescribed by laws or administrative regulations, the SAIC office in the Free Trade Zone only registers the amount of registered capital or total equity capital subscribed for by all the shareholders (promoters) of a company instead of the paid-in capital. The shareholders are free to agree with each other on their respective amount of subscribed capital contributions, the method of payment, the period of capital contribution and record these agreements in the company's AOA.

The shareholders are responsible for the authenticity and legality of their payments of capital contributions. A company shall make public the amount of capital contribution subscribed for each of its shareholders, or the number of shares subscribed for, by each of its promoters, the method and period of capital contribution, as well as the actual payment of capital contribution through the market player credit information disclosure system. The disclosure system is put in place to strengthen the supervision of companies within the Free Trade Zone. The Free Trade Zone's SAIC office can make public the information of enterprise registration, filing and supervision, and companies can make public their annual reports and approval certificates procured in connection with specific qualifications.

Registration System for "Business Licenses Before Permits"

13.054 Except for the prior licensing matters for enterprise registration as prescribed by laws, administrative regulations or the decisions of the State Council, companies incorporated within the Free Trade Zone may engage in general production and business activities after applying for registration and obtaining a business license from the relevant SAIC. This is a significantly relaxed approach compared to the business scope

[225] Administrative Measures for Filing of Foreign Investment Projects of China (Shanghai) Pilot Free Trade Zone (Hu Fu Fa [2013] No.71); Administrative Measures for Filing of Outbound Investment Projects of China (Shanghai) Pilot Free Trade Zone (Hu Fu Fa [2013] No.72); Administrative Measures for Filing of Foreign-invested Enterprises of China (Shanghai) Pilot Free Trade Zone (Hu Fu Fa [2013] No.73); Administrative Measures for Filing of Outbound Investment in Setting Up of Overseas Enterprises of China (Shanghai) Pilot Free Trade Zone (Hu Fu Fa [2013] No.74); and Special Administrative Measures (Negative List) on Foreign Investment Access to the China (Shanghai) Pilot Free Trade Zone (2013) (Hu Fu Fa [2013] No.75).

rule (or the traditional objective rule in some common law jurisdictions) adopted in the Company Law, under which every business entity must act within its business scope as set out in its business license. FIEs, like all other legal entities in China, have a limited scope of approved operation as set out in the business license to be issued by the SAIC or one of its competent lower-level branches. It is generally not possible to obtain a general scope of business for an FIE in China.[226] Where the company wishes to engage in business activities involving prior licensing matters, it may then apply with the competent authorities for relevant licenses or approval documents within the Free Trade Zone.[227]

One of the key reforms in the Free Trade Zone is changing the existing pre-approval system for foreign investment to a filing system with the administrative committee in the Free Trade Zone, for an FIE to be established in the Zone (except for the industrial sectors in the negative list).[228] The filing system saves transaction costs involved in the investors' interaction with the local authority. Where special licenses or approvals are still required, foreign investors are not allowed to engage in full-fledged businesses until special permits/licenses are obtained.[229] China's National Development and Reform Commission and MOFCOM released the 2017 version of the Catalogue for the Guidance on Foreign Investment Industries (the Catalogue) on 28 June 2017. The 2017 version Catalogue introduces a negative list nationwide specifying the industries in which foreign investment is restricted or prohibited and opens a variety of new industrial sectors to foreign investment, creating appealing new opportunities for investment.[230]

Since March 2012, the SAIC has implemented a pilot business registration reform in Zhuhai and Shenzhen. A new business license has been used since March 2013. The new business license will add an "Important Notice" column providing directions to check the business scope, registered capital, operation period, items subject to administrative approval, annual report and supervision, etc., which are normally stated on the current business license. This information will be posted on the SAIC's website in pilot cities and accessible by the public. Consequently,

[226] The approved business scope is typically restricted to a specific category of manufacturing or service based on the contents of the feasibility study report. FIEs are still typically manufacturing operations. FIEs intended primarily to import products for resale were prohibited until recently and now are permitted in certain jurisdictions only after heavy scrutiny and under stricter regulation. A large number of FIEs are restricted to be a re-investment vehicle for other China investments.

[227] Reply on Approving the Trial Application of New Business License in the China (Shanghai) Pilot Free Trade Zone (Hu Gong Shang Wai Qi Zi [2013] No.148) (26 September 2013); Provisions of the Shanghai AIC on the Administration of Registration of Enterprises in the China (Shanghai) Pilot Free Trade Zone (Hu Gong Shang Wai (2013) No.329), promulgated on 21 October 2003 and implemented on 1 October 2013.

[228] The negative list is similar in concept to the US's mooted Trans-Pacific Partnership Agreement, which places more than 200 restrictions on investments in 18 industries, including media and publishing, real estate and telecommunications. It is apparent that the negative list should be shortened. Regulators encourage business players to offer ideas and solutions to revise the negative list.

[229] Decision of the Standing Committee of the National People's Congress on Authorizing the State Council to Temporarily Adjust the Administrative Examinations and Approvals of Relevant Legal Provisions in the China (Shanghai) Pilot Free Trade Zone (promulgated on 30 August 2013 and implemented on 1 October 2013) Notice on Authorizing the China (Shanghai) Pilot Free Trade Zone Branch of Shanghai Administration for Industry and Commerce the Administrative Authority for Registration of Foreign-invested Enterprises (24 September 2013).

[230] A Chipman Koty and Z Qian, "China's 2017 Foreign Investment Catalogue Opens Access to New Industries", 11 July 2017, China Briefing, available at http://www.china-briefing.com/news/2017/07/11/.

a company's business license is no longer the only source of information for the general public. The public can check the basic information online. This increase in transparency is an integral part of the public information system of a modern economy and may be rolled out nationwide in due course. Several provinces including Liaoning, Shanxi and Hunan have taken the lead in carrying out the reform since 2014. Enterprises registered in Shanghai Free Trade Zone are to use the new version of the business license too.

Although economists portray the zone as a unique experiment, authorities still scrutinise investors' intentions and ask applicants the reasons why they want to come to the zone. There is a mismatch between high expectations in the investment community and low regulatory transparency. Shanghai officials report that companies in the free trade zone receive business licenses in as little as four days, down from the 29 days it normally takes now. However, as also reported by western media, when an investor registers a company, he must propose a corporation name with three Chinese characters. The company registry (the SAIC) may reject the choices if any two of the characters appearing in the name of another registered company in Shanghai. It is reported by the Shanghai government that 36,314 applicants were dealt with by the licensing office in the first month of the Free Trade Zone, including 3,172 people checking on potential names. Yet only 218 companies were registered in that time. The registration also requires a business address while the landlord may offer a "virtual" address at the price of US$3,380. The registration procedure seems similar to that for setting up regular companies in non-free-trade zone.[231] This information suggests uncertainty in the implementation of and rules governing the free trade zone, and may ultimately discourage it from reaching its objectives.

Annual Report Disclosure System

13.055 The current annual enterprise inspection system has been changed to an annual report disclosure system by the SAIC within the Free Trade Zone. Companies within the Free Trade Zone, within the prescribed period of time each year, need to submit their respective annual reports to the relevant SAIC via the market player credit information disclosure system, and announce the same to the public, which should be accessible to all the entities and individuals. The companies are responsible for the authenticity and legality of their annual reports. In addition, a list of enterprises with abnormal operations shall be prepared by the SAIC, and companies that fail to disclose annual reports within the specified time limit shall be recorded by the market player credit information disclosure system.

On 30 August 2013, the fourth session of the Standing Committee of the 12th National People's Congress of the PRC authorised the State Council to temporarily suspend (for a trial period of three years) the application of various administrative approvals with respect to foreign investment within the Free Trade Zone (except those sectors included in the negative list). These administrative approvals can be found in the Law on WFOEs, the Law on Sino-Foreign Equity Joint Ventures and the Law on Sino-foreign Cooperative Joint Ventures and are listed in Table 5:

[231] JT Areddy, "Name Game in Shanghai Trade Zone", *The Wall Street Journal*, 12 December 2013, A11.

Table 5: Suspended Approvals in Shanghai Free Trade Zone

	WFOE	EJV	CJV
Establishment	X	X	X
Division, merger or other major alteration	X		
Term of business	X		
Extension of term of business		X	X
Dissolution		X	
Major amendments to the agreements, contracts, AOA			X
Entrustment given to others to carry out operations and management			X

Accordingly, the Standing Committee of the People's Congress of Shanghai Municipality issued the Decision on Temporarily Adjusting the Application of Relevant Local Regulations of Shanghai Municipality in the China (Shanghai) Pilot Free Trade Zone (for a trial period of three years) on 26 September 2013 to suspend the implementation of the Rules of Shanghai Municipality on the Examination and Approval over FIEs with respect to foreign investments outside the Negative List within the Free Trade Zone. The decisions of two standing committees have provided legal support for replacing the previous approval procedures with filing procedures within the Free Trade Zone.

Apart from the above, the Shanghai Municipal Government and the SAIC have promulgated a series of supporting regulations and policies, before and after the inauguration of the Free Trade Zone, in support of the goals outlined in the State Council's Framework Plan for China (Shanghai) Pilot Free Trade Zone.

Further Reforms of FDI Regulatory Regime

China's Standing Committee of the National People's Congress adopted a resolution (The Resolution) on 3 September 2016 to abolish the current examination and approval regime applicable to the establishment of most FIEs in China. The MOFCOME published a set of draft measures to implement the change on the same day.

According to the Resolution, certain provisions of the EJV Law, the CJV Law, the WFOE Law and the Law on Protection of Taiwanese Investment in Mainland China will be amended with effect from 1 October 2016.

These amendments provide that an FIE may be established by way of mere filing with the relevant foreign investment authority so long as the industry in which it engages is not subject to any special access restriction imposed by the State. The State Council will issue a "negative list", which may be adjusted from time to time, to set out the industries in which FIE establishment must be examined and approved under existing laws and regulations.

The amendment under the Resolution has the significant effect of extending the pilot scheme from the free trade zones to nationwide. The more relaxed "filing" requirement will replace the "examination and approval" procedures in the formation and change of key particulars of FIEs.

MOFCOM on 3 September 2016 issued a draft of the Interim Measures on Administration of Filing for the Establishment of Filing for the Establishment of and Change in FIEs for the implementation of the NPCSC amendment. The Consultation Draft was for public consultation in September 2016.

Key points listed in the Consultation Draft include:

(1) The filing procedure can be completed within 30 days after the incorporation of the FIE or upon the occurrence of the change of company particulars;

(2) The PRC authorities will tighten post-investment supervision. If an FIE or its investor fails to duly complete the filing procedure, or if it conducts business in a sector under the "negative list" without pre-approval or in which foreign investment is prohibited, or if it fails to cooperate with the relevant authorities' supervisions, penalties and other punishment such as public disclosure of the non-compliance may be imposed; and

(3) The information of the ultimate controller of the FIE and any subsequent change must be filed with MOFCOM.

The Resolution is likely to trigger a major systematic reform in China's regulatory regime of FDI. It is possible that other government authorities that regulate FDI including the SAIC, and the SAFE may have to streamline their administrative roles in regulating FDI. These developments represent a major milestone moving towards a simplified regime for regulating FIEs and FDI in China.

Minimum Capital Rule under the Company Law

13.056 The Company Law relaxes some rules governing company capital.

Unlike FIEs, the minimum registered capital rule applies to domestic LLCs. The minimum registered capital has been lowered from RMB 500,000 to RMB 30,000 (in the case of a limited liability company)[232] and from RMB 10 million to RMB 5 million (in the case of a company limited by shares)[233] although a higher amount can apply where there are specific rules to that effect.

The minimum number of promoters required to establish a company limited by shares is reduced from 5 under the old rule to 2.

The Company Law 2005 removed the old rules linking the minimum registered capital to the industrial sector. However, a flat minimum capital threshold, much higher than RMB30,000 or RMB 5 million, is set differently to the companies engaging in more specialised industrial sectors such as securities, banking and insurance. The investors need to consult various laws and regulations in order to ascertain the applicable capital requirements.[234]

The 2013 Company Law reforms the paid-in capital system. The current minimum (or paid-in) capital rule is abolished. The paid-in capital of a company is no longer required to be registered on the company's registry, but it still must be recorded on the register of shareholders of the company. After 1 March 2014, the Company Law makes it possible to incorporate without registered capital. As a

232 Company Law, art.26.
233 Company Law, art.81.
234 Securities Law, Commercial Banking Law and Insurance Law.

General Manager

Typically, the management organization in an EJV comprises a general manager, one or more deputy general manager(s) and department heads.[297] CJVs and WFOEs, on the other hand, should have one general manager.[298] The general manager and deputy general managers are appointed by the board of directors, except that the EJV Law requires the nomination of the general manager and deputy general manager to be made by the JV parties, respectively,[299] and the WFOE Law requires that the general manager be appointed by the board of directors or the legal representative (if the WFOE does not have a board of directors). 13.078

Traditionally, the general manager is in charge of the overall operation of the FIE, while the deputy general manager may play an overall supportive role or simply be tasked with a particular area of responsibility. The general manager, although not necessarily a director, has enormous power in connection with the day-to-day operations of the JV including but not limited to the implementation of the resolutions of the board of directors, and dismissal of the management personnel reporting to the general manager.[300] Other responsibilities may be provided in the AOA or required by the board of directors. The general manager is accountable to the board. In a JV, if the foreign party is to be relied upon for operational expertise, the foreign party likely would insist that the general manager be nominated by it.

The deputy general manager(s) will then be nominated by the other party in a JV. Usually, a JV has at least one deputy general manager who assists the general manager in specific matters, eg financial control or production. As these managers are responsible for the on-site control over day-to-day business operation of JVs, careful consideration of the structure and composition of the management organization is required to safeguard the investors' interest in their investment in the JV.

Duties of Directors and Managers under FIE Laws

The FIE Laws provide few provisions concerning the duties and responsibilities of directors and managers. For example, in an EJV, the general manager and the deputy general manager are prohibited from concurrently serving as the general manager and the deputy general manager of another entity and from participating in the activities of another entity that is in competition with the EJV.[301] The general manager, the deputy general manager and any other senior management personnel may be terminated if they are found to be corrupt or in serious neglect of their duties.[302] Similar rules are also applicable to the general manager, the deputy general manager or other senior management personnel in a CJV.[303] Nevertheless, similar rules were not codified in the WFOE Law or its Implementing Rules. 13.079

It is safe to apply the Company Law to FIEs (including FIECLSs) so that the directors and managers in these FIEs would be subject to the duties and responsibilities of directors and managers prescribed by the Company Law. As far as the majority of

[297] EJV Law, art.6 EJV Law Implementing Rules, art.35.
[298] CJV Law, art.12; CJV Law Implementing Rules, art.32, WFOE Law Implementing Rules, art.16.
[299] EJV Law, art.6.
[300] EJV Law Implementing Rules, art.36; CJV Law Implementing Rules, art.32.
[301] EJV Law Implementing Rules, art.36; CJV Law Implementing Rules, art.40.
[302] EJV Law Implementing Rules, art.36; CJV Law Implementing Rules, art.41.
[303] CJV Law Implementing Rules, art.34.

FIEs in form of LLCs is concerned, they should also be subject to the Company Law unless the FIE Laws provide relevant "specific provisions".[304] Given the fact that the FIE Laws are generally silent on the imposition of fiduciary duties on directors and managers, the Company Law should govern FIEs on these matters.

The Company Law 1994, among other things, addresses corporate elements of limited liability companies. The Company Law 1994 elaborates on director and manager obligations in the LLCs (eg no disclosure of company secrets, no competition with the company's business, no misappropriation of company funds, no acceptance of bribes) and directors and managers of JV companies are bound by these provisions.

However, the application of the Company Law to the FIEs in respect of the duties and responsibilities of directors and managers is problematic. Take a few examples. Directors and managers are prohibited by the Company Law from taking any position in another company that is in the same type of business as that of the company in which they serve as directors or managers.[305] Investors of an FIE, however, often assign or appoint experienced managerial personnel from their respective entities to serve on the board of directors of, or take managerial positions in, the FIE. The investors often have various transactional arrangements with the FIE such as licensing intellectual property rights to the FIE, and entering into service or supply agreements with the FIE. Therefore, the director appointed by the investor to the FIE may be involved in the same transaction on both sides and can be easily involved in a conflict of interest transaction. Based on the above analysis, it appears that the wholesale application of the provisions in the Company Law on the duties and responsibilities of directors and managers to directors and managers in the FIEs may cause practical difficulties to the business operations of FIEs. Therefore, the lack of specific provisions in the FIE Laws does not necessarily trigger the application of the Company Law. Rather, the FIEs may be ideally left to its own regulatory regime, which recognises the investing parties' active participation in the FIE's business operation and leaves the investing parties to contractually agree on the terms and conditions in the JV contracts and AOA through private negotiation.

Without doubt, some rules relating to the duties and responsibilities of directors and managers in the Company Law should apply to directors and managers in the FIEs in order to ensure a better corporate governance system. These duties and responsibilities include:

(1) Not entering into any direct business dealing with the FIE without the approval of the board of directors;

(2) Not embezzling the funds of the company or lending the funds of the FIE to himself;

(3) Not depositing the funds of the FIE in an account in his own name;

(4) Not using his position and power in the FIE to accept bribes or other illicit gains or to take possession of the property of the company; and

(5) Not owning and operating on his own any business in competition with the FIE.[306]

[304] Company Law, art.18.
[305] Company Law, art.61.
[306] Company Law, arts.59 and 60.