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Preface to the 14th Edition

The purpose of this book is to provide students with an introduction to company law in Hong Kong. This textbook is intended to provide a general purpose explanation and covers the requirements of the company law syllabuses of the major professional and examining bodies in Hong Kong.

The book has no footnotes, most of the cases discussed are reported, and I have endeavoured to explain company law in terms which are concise but not too far removed from the ordinances governing companies conducting business in Hong Kong. The intention of these practices is to provide students with an accurate yet readable account of company law in Hong Kong and to enable closer study of the ordinances. Students are advised to obtain a copy of the most recent edition of the ordinances for use in conjunction with this text.

Since the publication of the 13th edition, a new *Companies Ordinance* (Cap 622) has been enacted. This Ordinance was brought into force on 3 March 2014 with just one exception – the paperless process of holding and transferring of shares and debentures. These provisions will be brought into force once the relevant rules are finalised. Readers will therefore still need to be wary of the date when the remaining provisions become effective. Some of the previous *Companies Ordinance* (Cap 32) provisions remain in force and that Ordinance has been renamed as the *Companies (Winding Up and Miscellaneous Provisions) Ordinance* (Cap 32).

The modernisation of Hong Kong's company law involved the Standing Committee on Company Law Reform (SCCLR), the Companies Registry, the Financial Services and Treasury Bureau, the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Company. Their focus was the enhancement of the legal regime that applies to all companies conducting business and raising finance in Hong Kong.

In recent years there have been a large number of company law cases, not only in Hong Kong but also in other common law jurisdictions – Australia, New Zealand, and the UK. Some important company law cases have also been heard by the Judicial Committee of the Privy Council. Students are advised to refer to the relevant law reports, especially the Hong Kong Law Reports and Digest (HKLRD) and the Hong Kong Cases (HKC). It should be noted that, to date, the Courts are generally still dealing with issues arising under the former Cap 32.

This edition not only endeavours to provide students with updates of the law but also tries to meet the criticisms and suggestions with which the generally favourable response to the earlier editions was met – and I thank those who have made comments and suggestions. I am also grateful to my students, past and present, for their questioning interest and to my husband, parents, friends and editors who have helped in innumerable ways.

V.S.

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s 268 520–522
s 269 485, 513, 514
s 270 513, 514
s 271 544, 545
s 272 544
s 273 545
s 274 249, 317, 545
s 275 8, 269, 312, 314, 510–512, 522
s 276 9, 512, 522
s 277 545
s 278 492, 525
s 278A 492
s 279 312, 502
s 280 490, 524, 526
s 283 541
s 284 502, 539
s 285 541
s 286 358, 359
s 287 495, 503
s 290 543

Part VI
s 297 235
s 297A 235
s 298 235
s 298A 235, 238
s 299 236
s 300 239
s 300A 236, 239
s 300B 236, 237
s 301 239
s 302 239, 312

Part VII
s 306 312

Part X
s 326 464, 504–506
s 327 504–506
s 327A 504–506
s 328 504, 506
s 329 504, 506
s 330 504, 506
s 331 504, 506
s 331A 504, 506

Part XII
s 342 108, 122
s 342A 108, 122
s 342AA 108, 122
s 342B 108, 122
s 342C 68, 108, 122
s 342CA 108, 122
s 342CB 108, 122
s 342CC 108, 122
s 342D 108, 122
s 342E 108, 122
s 342F 108, 122
s 343 108, 122

Part XIII
s 351 80

Part XIIIA
s 360B 30
s 360C 545

Schedules
Schedule 3 22–24, 112, 114–118, 122, 132, 201
Schedule 4 24, 131
Schedule 12 80
Schedule 15 313
Schedule 17 108, 111, 115, 122, 130, 132
Schedule 18 111, 115–118
Schedule 19 121
Schedule 20 117, 118
Schedule 21 116–118
Schedule 22 123

Subsidiary legislation
Cap 32H 467, 478, 492, 494, 499, 505, 509, 532, 533, 540
Cap 32L 119

1 The Nature of a Company

This text is concerned for the most part with the law relating to companies incorporated in Hong Kong. The process of incorporation may be achieved by various methods, but registration under the *Companies Ordinance* (Cap 622), facilitated by the Hong Kong Companies Registry, is by far the most typical.

Hong Kong's first *Companies Ordinance* was enacted in 1865 and was based upon the UK *Companies Act 1862*. In 1933 it was revised and designated as Cap 32 and in 1995 the authentic Chinese text was published. It was continuously and substantially revised by a series of amendment ordinances to take account of the changing practices in the commercial world and in particular the key principles of transparency, which require disclosure of corporate transactions, and accountability. The revisions were often similar to those introduced in other common law jurisdictions, such as Australia, Canada, Malaysia, New Zealand and Singapore, all of which adopted the UK corporate model.

Despite the revisions, the *Companies Ordinance* (Cap 32) became increasingly outdated and a major reform was undertaken resulting in the *Companies Ordinance* Cap 622. This new Ordinance came into force on 3 March 2014 but certain Parts of Cap 32, notably those concerned with prospectuses, disqualification of directors and winding-up, have been retained and that ordinance is now renamed the *Companies (Winding up and Miscellaneous Provisions) Ordinance*, Cap 32.

For ease of reading, references to particular sections in this text are generally noted as being in either 'Cap 622' or 'Cap 32', without mention of the words *Companies Ordinance* or *Companies (Winding up and Miscellaneous Provisions) Ordinance.*

The *Companies Ordinance* (Cap 622) applies to all companies incorporated in Hong Kong. In other words, it applies to existing companies as well as to companies incorporated on or after 3 March 2014, s 17. The new Ordinance does contain some major changes to the law and so there are a large number of transitional provisions. They are listed in Sch 11 of Cap 622 but are generally beyond the scope of this text. Here the focus will be on Cap 622 and the provisions now contained in Cap 32. Significant changes and possible developments will be noted. Changes in terminology, as and when former provisions, or terms, arise in cases will also be noted.

The word 'company' is often used to describe an association of persons who have some common objectives whether as a business, a partnership, a club or some other form of association. So, the word 'company' may be used as part of the name of a business even though it has not been through the process of incorporation. But, throughout this text, the use of the word 'company' generally means a company formed and registered (i.e., incorporated) under the

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Companies Ordinance (Cap 622) or an existing company (i.e., a company formed and registered under a former *Companies Ordinance* (Cap 32)). This meaning is the same as the definition in Cap 622 s 2(1).

The *Companies Ordinance* also concerns the registration of companies that are incorporated overseas and establish a place of business in Hong Kong. Such an entity is described as a *registered non-Hong Kong company*. A company incorporated overseas is governed by the laws in the place where it is incorporated but if it is registered here it is also bound by certain Parts of the *Companies Ordinance* (*see* Chapter 3). Such companies are now commonplace in Hong Kong and often referred to as 'overseas' companies.

In some parts of the text you will find the term 'body corporate'. This term is generally used to distinguish an incorporated body from a natural person, partnership or an association. It is defined by Cap 622 s 2(1) to include a company incorporated in Hong Kong and a company incorporated overseas. You will find the term 'body corporate' is used in the definition of an *associated company* (*see* 1.4) and in many other provisions. This extends the scope of a provision to include related companies, i.e., companies in the same group, no matter where their place of incorporation is. Many of the provisions concerning fair dealing by directors are extended to include a body corporate and/or an associated company (*see* Chapter 13) as are the provisions concerning control of a company and remedies for abuse (*see* Chapter 15). Extending the provisions to include a body corporate is also a means to ensure that the principles stated in the Ordinance are not easily avoided.

A relatively small number of companies are formed by an ordinance passed for the specific purpose of their creation. For example, the Kowloon-Canton Railway Corporation was formed by the *Kowloon-Canton Railway Corporation Ordinance* (Cap 372). This method of incorporation is appropriate when the company plays a significant role in the community, but it would be totally impractical as a method for incorporating commonplace trading and commercial associations and other non-commercial associations, such as clubs, seeking to be incorporated.

In this chapter, we are generally concerned with the various forms of incorporated company and the immediate consequences of incorporation under Cap 622. The creation of a separate legal body and the consequences of incorporation are discussed in 1.1, and the concept of limited liability in 1.2. Companies are then compared and contrasted with partnerships in 1.3. The exceptional circumstances when the Court will lift the 'corporate veil' to look at the reasons for forming a company or the motivation for its activities are considered in 1.4. The distinctions between public and private companies are identified in 1.5 and, finally, the essential requirements for listing securities on Hong Kong Stock Exchange are outlined in 1.6.

1.1 The separate legal entity

A company is a legal entity distinct from its members. It has legal personality and is often described as an 'artificial person' or a 'body corporate'. The consequences of creating such a body were clarified by the House of Lords (UK) in the celebrated case concerning Mr Salomon, his family and a company which they had formed.

In *Salomon v Salomon and Co Ltd* (1897) UK, Salomon had for many years carried on business as a boot manufacturer. His business was solvent when he converted it into a company. Salomon, plus his wife and 5 children, subscribed to the memorandum (*see* Note 1), and the business was sold to the company for £39,000. Of this, £9,000 was paid in cash, and 20,000 shares were allotted to the subscribers (*see* Note 2) as fully paid at £1 each; the balance of £10,000 was treated as a loan by Salomon to the company, and he was given debentures secured by a charge on the company's assets.

After a depression, the company went into liquidation. The assets were sufficient to satisfy the secured debentures, but the unsecured creditors, with debts amounting to £7,000, received nothing.

It was held that Salomon was entitled to be paid before the unsecured creditors. The company was duly registered and was not an agent of or trustee for Salomon but a separate legal entity. Salomon could therefore contract with and be a secured creditor of the company. The court also held that Salomon had not defrauded the creditors or the shareholders, and that any profit he made by selling his business to the company was fully disclosed and approved by the shareholders (*see* 2.1).

Lord Macnaughten explained: 'The company is at law a different person altogether from the subscribers to the memorandum; and although it may be that after incorporation the business is precisely the same as it was before and the same persons are managers and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Ordinance.'

Note 1: The 'memorandum' is obsolete and articles are now the single constitutional document (*see* 2.3 and 2.4).

Note 2: A subscriber to a company's constitution is now termed a 'founder member' (*see* 2.3).

Not only is a company a separate legal entity, having formed a company and sold property to it, such property belongs to the company and not to its members or creditors.

In *Macaura v Northern Assurance Co Ltd* (1925) UK, Macaura was the owner of a timber estate. He sold all the timber to a sawmill company in consideration of the allotment to him of 42,000 fully paid £1 shares. Macaura was also an unsecured creditor of the sawmill company. After the sale, he effected insurance policies in his own name covering the timber against fire. Two weeks later, almost all the timber was destroyed by fire. Macaura claimed on the insurance policies.

It was held that Macaura had no insurable interest in the timber, as he and the company were separate legal entities. His claim was disallowed because the timber was owned by the company. Lord Sumner explained: 'Macaura owned almost all the shares in the company and the company owed him a good deal of money, but neither as creditor nor as shareholder could he insure the company's assets.'

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The cases of Salomon and Macaura were considered by the Hong Kong Courts in relation to a claim that a company was a trustee or *alter ego* (another personality) of its shareholders, as opposed to it being a separate legal personality.

> In *Good Profit Development Ltd v Leung Hoi* (1993), GPD's only asset was a house in Kowloon. L claimed that he had made an oral agreement with the directors and shareholders of GPD to buy all of their shares. It was accepted that GPD was not a party to this agreement and that the directors had not acted as agents of the company. L alleged that either GPD was a trustee, holding the house on trust for the directors and shareholders, or that GPD was the *'alter ego'* of the directors and shareholders.
>
> It was held that a company does not hold property as an agent or trustee of its members or directors. A company is a separate personality and is not the *alter ego* of its members. The agreement to purchase the shares in GPD had nothing to do with GPD itself, there being no privity of contract, and there was no cause of action against GPD (*see also* 1.4).

The principles established in the case of Salomon have also been applied to deal with the question of a person acting for and in relation to a company in various capacities.

> In *Lee v Lee's Air Farming Ltd* (1961) PC, Lee formed a company to carry on his business of spreading fertilisers from the air. He held 2,999 of the 3,000 shares issued by the company, was appointed sole governing director by the company's articles, and was employed at a salary as its chief pilot. Lee was killed in an aircraft crash while flying for the company. If he was a 'worker', his widow was entitled to be paid compensation under the New Zealand *Workers' Compensation Act*. The lower Courts held that Lee could not be a 'worker' when he was in effect also the employer.
>
> The Privy Council held that there was a valid contract of service between Lee and the company, and so Mrs Lee was entitled to compensation. Lord Morris of Borth-y-Gest said: '... the active aerial operations were performed because the deceased was in some contractual relationship with the company. That relationship came about because the deceased was one legal person willing to work for and to make a contract with the company which was another legal entity . . . nor were any contractual obligations invalidated by the circumstances that the deceased was the sole governing director in whom was vested the full government and control of the company. Always assuming that the company was not a sham then the capacity of the company to make a contract with the deceased could not be prejudiced merely because the deceased was the agent of the company in its negotiation.'

Effect of incorporation

So, it is well-established at common law that a company is a *persona* at law; it is an artificial person with a separate legal personality. It will continue to exist despite a change of owners (members) and it is not affected by either their death or their bankruptcy. This means that it has perpetual succession and will continue to exist until it is finally wound up and dissolved.

Section 73 of Cap 622 provides that on and after the date of incorporation the company's members are a 'body corporate' with the name stated in its certificate of incorporation. It also states that the body corporate has perpetual succession.

Section 115 states that a company has the capacity, rights, powers and privileges of a natural person of full age. It states also that a company may do any act that it is permitted, or required to do, by its articles or any Ordinance or rule of law, and that it has power to acquire, hold and dispose of land. So, a company can make contracts, take legal action, be sued, and own property as a natural person. It can also commit crimes and torts.

A company must have a registered office in Hong Kong to which all communication and notices may be addressed, s 658(1). This provision ensures that there is some place where contact with a company, albeit a legal person, may be made.

The effect of incorporation will be considered further in Chapter 2. But from the outset it is important to appreciate the significance of a company's name. A company obviously cannot sign a contract as a natural person. A company may have a common seal with its name engraved on it in legible form, but a seal is not obligatory (*see* 2.3). Otherwise, a company may enter into a contract by the actions of its agents i.e. its directors and employees. If a contract requires a signature, it may be executed on the company's behalf by having it signed by 2 or more directors (or one director if the company only has one director). It may be expressed to be signed on behalf of a company by the words 'for and on behalf of . . . Co Ltd.'. But other words may be used. The signed document has effect as if it had been executed under the company's common seal, s 127.

A company is required to disclose its name and to display its name in accordance with the *Companies (Disclosure of Companies Name and Liability Status) Regulation* (Cap 622B). These regulations are made under s 659. Criminal consequences may follow for failure to make the required disclosures (*see* s 660). The regulations require that a company must display continuously its registered name in legible characters at its registered office and every business venue of the company that is open to the public. If the location is the registered office or business venue for more than 6 companies, a registered name may be displayed by an electronic device for 15 seconds in every 4 minutes or within 4 minutes of a request through such a device to display it (*see* Cap 622B, reg 3).

A company must also state its registered name in legible characters –

- in any communication document, meaning any business letter, notice or other official publication of the company;
- in any transaction instrument, including any contract or deed, bill of exchange, promissory note, endorsement, cheque, order for money or goods, signed, or purporting to be signed by or on behalf of the company, or any consignment note, invoice, receipt of letter of credit of the company; and
- on any website of the company (*see* Cap 622B, reg 4).

An officer of the company will be personally liable to the holders if he signs or authorises the signing, on the company's behalf, of any bill of exchange, promissory note, endorsement, cheque

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5 Share Capital

This and the following 3 chapters are concerned with a company's share capital. The relevant provisions are generally to be found in Parts 4 and 5 of Cap 622 and Part II of Cap 32.

Part 4, ss 134–202, contains 8 Divisions and is concerned with various aspects of a company's share capital. It deals with the nature of shares, allotment and issue of shares, commissions and expenses for agreeing to subscribe for shares, transfer and transmission of shares, replacement of lost share certificates, alteration of share capital, classes of shares and merger relief. Some of these aspects of share capital will be considered in this chapter and most of the others in Chapter 7.

The order of topics in this chapter does not follow their order in Part 4. This is because some of the topics are more relevant after studying the methods of raising share capital. Part II of Cap 32 concerns issuing a prospectus and other methods of raising share capital and is considered in Chapter 6. This may appear to be disjointed but in relation to public companies, raising capital is not only a matter of company law but also of securities law. In the future, we may see these provisions contained in the *Securities and Futures Ordinance* (Cap 571) or a stand-alone ordinance.

Part 5, ss 203–289, concerns transactions in relation to share capital, reduction of capital, share redemption and buy-backs, and financial assistance for acquisition of a company's own shares. These topics are all covered in Chapter 8.

The Model Articles for public companies arts 61–99 and those for private companies arts 56–79 (*see* Cap 622H) concern shares and distributions. Some of these articles will be mentioned in this and the following 3 chapters. Chapter 9 deals specifically with the distribution of profits and assets.

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Proposing to issue share capital

You may recall from Chapter 2 that, if a company intended to be formed is to have a share capital, its Incorporation Form must contain a 'Statement of Capital and Initial Shareholdings', s 68(2). This Statement is prescribed in Cap 622 Sch 2 s 8, and requires the following details –

- the total number of shares that it proposes to issue;
- the total amount of share capital to be subscribed by its founder members;
- the amount to be paid up and the amount to remain unpaid on the total number of shares that it proposes to issue on its formation (*see* 5.1 – paying for shares);
- if the share capital is to be divided into different classes of shares, certain details for each class including (a) the total number of shares, the amount of share capital to be subscribed by founder members and the amount paid up and remaining unpaid; and (b) the details of the voting, distribution and redemption rights (*see* 5.3 – classes of shares); and

- in respect of each founder member, the number of shares that it proposes to issue to each of them and the total amount of share capital to be subscribed by each of them on its formation.

A new company, with the exception only of a company limited by guarantee, must include the above details in its Incorporation Form. Most of these details **must** also be stated in its articles, the only exception being the details concerning the voting, distribution and redemption rights applying to a class of shares (i.e., bullet 4, point b), s 85(1). Its articles **may** also state the maximum number of shares that a company may issue, s 85(2), but stating such a maximum is not a requirement.

Issued share capital v paid up share capital

A Statement of Capital and Initial Shareholding requires detail of the number of shares to be issued and the amount paid up on those shares. It is important to clearly distinguish between these 2 items. A company's *issued share capital* is simply the total number of shares which the company has actually issued; whereas the *paid up capital* is the amount paid (or regarded as paid). In many cases, shares are issued fully paid in the form of cash consideration. This means that the 'issue price' has been fully paid in the form of money to the company. But not all shares are issued fully paid. The consideration may be something of value other than cash and shares may also be credited as paid up, as in a bonus issue (e.g., an issue of shares financed out of distributable profits).

A company's paid up capital clearly provides more meaningful information about its financial position than its issued share capital. It should be noted that if any official document of a company, i.e., a notice, advertisement, circular or other official publication, states its issued share capital, the document must also state, with no less prominence, its paid up capital. If a company fails to comply with this provision, the company, and every responsible person of the company, commit an offence, s 202.

Statement of capital

After incorporation, details concerning a company's issued share capital and its paid up capital are often required to be delivered to the Registrar. Such details must now be contained in a standardised *'statement of capital'*. The content of a statement of capital is prescribed by s 201 and includes 'the amount paid up or regarded as paid up ... on the total number of issued shares'. This statement will be considered further in 5.2.

The focus of this chapter is the nature of share capital and the provisions that concern its issue and allotment. The nature of shares and payment for them is considered in 5.1, and the power to allot shares in 5.2. Classes of share capital that a company may create and the variation of those rights are considered in 5.3 and 5.4. The alteration of the share capital is discussed in 5.5 and re-registration of an unlimited company as a company limited by shares in 5.6. This chapter concludes in 5.7 with a review of the requirements concerning a company's annual return. The detailed requirements of this return are found in Part 12, ss 662–665, but it is helpful to appreciate its content from the outset of studying company law.

5.1 The nature of shares and payment for shares

In *Borland's Trustee v Steel Bros & Co Ltd* (1901) UK, Farwell J explained that a share is the interest of the shareholder in the company measured by a sum of money for the purpose of liability in the first place and of interest in the second.

The price a shareholder pays, or agrees to pay, for a particular share is termed the 'issue price'. Shares no longer have a nominal (face) value (*see* s 135). In terms of Farwell J's explanation, it is now the issue price that determines liability – if it has already been paid, a shareholder will generally incur no further liability for the company's debts.

The 'interest' that Farwell J referred to is the shareholder's investment in the company which hopefully will result in a return in the form of dividends. Dividend, if declared, will be paid in respect of each share – shares measure a person's interest in a company.

Part 4 s 134(1) states that a share (or other interest of a member) in a company is personal property. In legal terms, property is either 'real property', such as land or buildings, or 'personal property'. Share certificates are 'chattels' whereas the underlying share is a type of personal property termed a 'chose in action', meaning that a share comprises rights that are enforceable.

The total amount of share capital that a founder member agrees to subscribe must be stated in the articles and this creates a contract. This contract, like other contracts, needs good consideration. Once a company is formed, any contract for the purchase of its shares will similarly be binding only if it is supported by good consideration. The general law of contract applies. Essentially, the consideration must not be past and it must be sufficient in law, but it need not be adequate.

> In *Re Eddystone Marine Insurance Co* (1893) UK, a company resolved to allot £6,000 of fully paid shares to its directors and shareholders, and a contract was made agreeing to allot the shares in consideration of their past services and expenses in forming the company and establishing the business. The contract was registered and the shares allotted. The company soon afterwards went into liquidation.
>
> It was held that the directors and shareholders were liable to pay for the shares as there was no consideration in money or money's worth for the allotment, past services being no consideration.

Consideration may be in the form of cash, but it may also consist in the sale of property to the company or performing services.

Non-cash consideration

The Statement of Capital and Initial Shareholdings required to be contained in an Incorporation Form and a company's articles must state the amount to be paid up, or *to be regarded as paid up*, on the total number of shares that the company proposes to issue on its formation. The phrase 'regarded as paid up' refers to any non-cash consideration for the shares. This may be property such as goods or land, or it may be in the form of services. In any case, especially in the case of services, the issue that arises is their value to the company.

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If there is a contract for specific property or services to be given to a company in payment for shares, the Court will generally not inquire into the adequacy of the consideration.

> In *Re Wragg Ltd* (1897) UK, the goodwill, stock-in-trade, and property of a business were sold to a company for £46,000, of which £20,000 was to be paid in fully paid shares. The stock-in-trade was shown in the company's books at £11,000 less than the sum allocated to it in the agreement. The company went into liquidation and a misfeasance claim was made against the directors to obtain payment for the shares.
>
> It was held that the agreement could not be impeached for fraud and therefore the adequacy of the consideration could not be looked into.

However, if the contract is fraudulent or shows on the face of it that the consideration is illusory, the allottee is liable to pay for the shares.

> In *Hong Kong and China Gas Co Ltd v Glen* (1914) UK, G agreed to sell a concession to the company in return for an immediate allotment of 400 fully paid shares and an allotment of 20 per cent of any future increase of capital.
>
> It was held that the agreement was good in so far as it obliged the company to allot 20 per cent of any future increase of capital, but void in so far as it relieved G from paying for the shares. It was apparent that the value of the concession bore no relation to the amount of the shares.

The lack of an inquiry into the true value of non-cash consideration received by the company in return for an allotment of shares undermines the 'maintenance of capital' concept. The only safeguard is the requirement to disclose the relevant contract in the company's return of allotment (*see* below). There is also a limited disclosure requirement in a company's annual return (*see* s 664 and the Sch 6 requirement for an annual return to contain 'particulars relating to members and share capital of the company').

Partly paid shares

When a company allots shares and agrees to receive only part of the issue price on allotment, the shares are said to be *partly paid* and the unpaid amount is the company's *uncalled capital*. A company may only issue its shares partly paid if it is authorised to do so by its articles.

Section 200 provides that, if authorised by its articles to do so, a company may (a) make arrangements on the issue of shares for a difference in the amounts and times of payment of calls on the shares; (b) accept the whole or part of the amount remaining unpaid, although no part of that amount has been called up; and (c) pay a dividend in proportion to the amount paid up on each share.

The Model Articles for private companies art 56 (*see* Cap 622H) states that 'No share is to be issued unless the share is fully paid'. But the articles of a private company may provide otherwise.

If a company does issue its shares partly paid, the shareholder is liable to pay the balance when the company makes a call. The Model Articles for public companies arts 70–78 (*see* Cap 622H) provide that the directors may make calls upon the members in respect of amounts unpaid on their shares. However, a call notice –

- must not require a member to pay a call that exceeds the total sum unpaid on that member's shares;
- must specify when (but at least 14 days after the notice) and how any call is to be paid; and
- may permit or require the call to be paid by instalments (i.e., a contractual obligation to pay on specified dates).

Before receiving any call, the notice may be revoked or postponed as the directors decide. A call is deemed to have been made when the directors' resolution authorising the call is passed. If a member fails to pay a call, he/she is liable to pay interest at a maximum rate of 10 per cent (the directors may waive the interest, in whole or in part), and his/her shares may be forfeited. Notice of intended forfeiture must be served on the member concerned.

If the member then fails to pay the call and the directors resolve to proceed to forfeit, he/she will cease to be a member, but he/she remains liable for the call until the company sells the shares and receives payment in full from some other person.

5.2 Allotment and issue of shares

The term 'allotment' is used in relation to a company issuing shares as opposed to a person acquiring shares from an existing member of the company. The agreement to allot the shares is between the company and the allottee.

The allottee becomes a member of the company when his/her name is entered on the register of members. The process of allotting shares, as distinct from issuing them, has been clarified for the purposes of UK tax legislation.

In *National Westminster Bank plc v Inland Revenue Commission* (1994) UK, irrevocable applications to purchase shares were followed by letters notifying the successful applicants that they had been allotted shares and would in due course receive the certificates. The letters were sent on 12 March 1993 and the shares registered on 2 April. The question arose as to whether the shares had been 'issued' before 16 March 1993 because UK tax law entitled a taxpayer to relief in respect of such shares.

It was held by the House of Lords that shares are issued when an application has been followed by an allotment and notification and is completed by entry on the register. The term 'issue' means something distinct from allotment and imports that some further act has been done whereby the title of the allottee has become complete.

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Directors' power to allot shares

Part 4 Div 2 ss 140–146 are concerned with the allotment and issue of shares. The key provision is s 140. Section 140(5) provides that, as a general rule, the directors of a company may only exercise a power to allot the company's shares if they have approval in advance given by resolution of the company. Otherwise, the directors have no such power. A director commits an offence if he/she knowingly contravenes, or authorises or permits contravention of, this provision.

In *Tsao Chin Lan v Tin Ka Kung and others* (1995), TCL and her husband were the only members and directors of a company, Tin's PVC Compound Co Ltd. In 1981, unbeknown to TCL, her husband issued and allotted 400 shares to his brother and to his 3 sons. TCL learnt of the issue and allotment a few days after her husband's death in 1983. TCL began proceedings in 1991 to challenge the validity of the issue and allotment. There were no minutes of the meeting (if any) held to approve the allotment and the return of allotment (*see* below) was signed only by TCL's husband.

It was held that it would be inequitable and iniquitous after such delay to allow TCL to succeed and to rectify the company's register, on the basis that she was guilty of laches. Mayo JA expressed the view: '. . . the allotment was irregular and had TCL made the company a party to the litigation, and applied to the Court for rectification of the company's register within a reasonable period of time, some appropriate form of relief would have been forthcoming.'

The general restriction on allotment extends to granting rights to subscribe for shares and rights to convert any security into shares (i.e., options), but does not apply to an allotment in the 4 situations stated in s 140(2) –

- a rights issue, i.e., an allotment of shares (or grant of rights) under an offer made to the members in proportion to their shareholdings (note – an offer is not required to be made to a member whose address is in a place where the offer is not permitted);
- a bonus issue, i.e., an allotment of shares (or grant of rights) to the members in proportion to their shareholding;
- an allotment of shares to a founder member in relation to the shares he/she has agreed to take by signing the company's articles; or
- an allotment of shares made in accordance with a grant of a right to subscribe for, and to convert any security into, shares and complying with s 141.

The approval process

The approval given to the directors to allot shares or to grant rights is governed by s 141. The company must give approval in advance by passing a resolution. An ordinary resolution is sufficient.

The approval may be unconditional or subject to conditions and may be given for –

- a particular exercise of the power, or
- general exercise of the power.

10 Debentures and Charges

Companies invariably seek loans to finance some of their transactions. Borrowing may be the only option for a private company that already has 50 members (*see* s 11) and wants to keep its private status. Borrowing may be in the form of a single loan or multiple small denomination loans. In the former case, it is the provisions governing the creation of registration of charges (security) that are likely to be more relevant; whereas in the latter case, the provisions concerning registration of the loan transaction and registration of charges will often apply. The Model Articles in Cap 622H contain no provisions on the subject of borrowing.

The former Model Articles (former Cap 32 Table A) art 81 provides that the directors may exercise all the powers of the company to borrow money; to charge (i.e., use as security) all or part of its property, undertaking and uncalled capital; and to issue debentures, debenture stock, convertible debentures, and other securities; with the proviso that the amount borrowed cannot exceed the nominal amount of the company's issued share capital unless the borrowing is sanctioned by the company in general meeting. This article may still be relevant to a company incorporated under the former Cap 32.

Debentures are now governed by Part 7 (ss 307–332), and charges are governed by Part 8 (ss 333–356). Certain provisions in Part 8 apply specifically to a registered non-Hong Kong company that creates a charge on property in Hong Kong, or acquires property in Hong Kong that is subject to a charge. Whether the company is incorporated in Hong Kong or is a registered non-Hong Kong company, the registration requirements are broadly the same. However, in this chapter, you will find the key provisions applying to a registered non-Hong Kong company in a separate part, so that they are more readily accessible to those focusing their studies on non-Hong Kong companies (*see* Chapter 3).

The first 2 parts of this chapter concern the nature and various types of debentures (10.1), and the register of debenture holders (10.2). Security granted for their issue is considered in 10.3. Registration of charges is explained in 10.4, and the registration requirements with regard to non-Hong Kong companies in 10.5. The question of the priority of charges is considered in 10.6. Finally, we shall consider the appointment of receivers and managers in 10.7.

10.1 The nature of debentures

A debenture is a document used by a company to evidence a loan, and the debenture holder, the person who provides the loan, is a creditor of the company. The payment of interest and repayment of the loan are not conditional on the company making a profit. On the due date as stated in the terms of issue of the debenture, the company has an obligation to pay.

Section 307 does not actually define a debenture. But it states that, in relation to a company, the term *debenture* includes bonds and any other debt securities of the company, whether or

not constituting a charge on the assets of the company, and generally includes debenture stock (*see* below).

The term *debenture* includes a single debenture issued by a company as evidence of a large loan, whether secured or unsecured. For example, a mortgage of land by a company is a debenture: *Knightsbridge Estates Trust Ltd v Byrne* (1940) UK. But the term also includes a series of small nomination loans issued by a company as debentures, or as company debenture stock. A series of debentures and debenture stock may be issued as unsecured or secured.

The issue of debentures

A single debenture is the product of private negotiations between the company and the lender, but a series of debentures or debenture stock will be issued when a company is looking to the public for a loan. It should be remembered that a private company is prohibited by s 11 from inviting the public to subscribe for shares or debentures of the company (*see* 1.5). However, in contrast with the restriction on the number of members, a private company may have any number of creditors.

When debentures are issued in a series to a large number of subscribers, a clause in the debentures will state that they rank equally (*pari passu*) without preference or priority. This statement enables the company to regard a large number of creditors as a 'class'; within that class, the debenture holders have equal rights, and the class may be given security (*see* 10.3).

Debenture stock avoids the problems created by a series comprising a vast number of small nomination debentures. It is a loan fund; the stock is divided among the lenders, and it may be subdivided and transferred in any fractions as the holders wish. Certificates are issued declaring the holder to be entitled to a definite sum that is described as the nominal value; the lender may have actually 'paid' (lent) more or less than that nominal value.

If a company issues a prospectus inviting subscriptions for debentures, that prospectus must comply with most of the provisions considered in Chapter 6, except that there is no minimum subscription requirement. Cap 32 s 42 applies only to a share capital. Cap 32 Sch 3 para 26 also requires a prospectus to indicate whether such debentures are unsecured or secured, and the particulars of any guarantee, including the name and address of any guarantor.

A contract with a company to take up and pay for any debentures of the company may be enforced by an order for specific performance, s 330.

Types of debenture

Debentures can be broadly categorised in the following ways –

Registered or unregistered

A company is not required to register all the debentures which it issues, but the similarities between a shareholder and a holder of a series of debentures or debenture stock prompted the requirement for a register of such holders. The provisions governing a company's register of debenture holders (*see* below) are similar to those applying to its register of members (*see* 7.5 and s 627).

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Debentures may also be issued in the form of unregistered bearer debentures. They are transferable by delivery and, depending on their terms of issue, may constitute negotiable instruments: *Bechuanaland Exploration Co v London Trading Bank* (1898) UK. The company undertakes to pay the debenture debt and the interest to the holder of such a debenture.

Secured or unsecured

A company generally has the capacity, rights and powers of a natural person of full age and so may borrow money and grant security for such loans. A company's capacity and powers may be restricted by its articles, but such restrictions will generally not affect the validity of a company's transactions (*see* 2.5).

In the case of an unsecured loan, if a company fails to pay the interest due or to repay the loan, the debenture holder can only reclaim his/her debt as a general creditor of the company. If a loan is secured, the debenture holder can look to his/her security for repayment. So, if a company has secured the issue of a series of debentures on its printing machinery, the money owed to the debenture holders may be paid out of the proceeds of sale of that machinery.

Redeemable, irredeemable, or perpetual

Redemption is the process of a company repaying a loan to the lender. Debentures may be issued on the terms that the company is bound to redeem them on a specified date or that a certain number of them will be redeemed by 'drawings' (i.e., lot) each year. A company may reissue redeemed debentures (*see* below).

If debentures are described as irredeemable or perpetual, or if they are redeemable on the happening of a remote event, or redeemable only on the expiration of a long period of time, they are valid despite the fact that equity generally prohibits the postponing of redemption of a loan beyond a reasonable period of time. The perpetuity rules do not apply to such debentures or make them invalid, s 327.

If the company issues debentures with no fixed date for redemption, the terms of issue may in fact provide the holders with a right to insist on redemption if the company fails to pay any interest due or in the case of some other default. In the event of the company being wound up, the debentures will be redeemed.

Convertible or inconvertible

Debentures may be convertible at the holder's option into fully paid ordinary shares at a specified price (which may be less than the market price). The option to convert may be exercised at a specified date or within a certain period.

Convertible debentures have become more popular in recent years. From the investor's point of view, a convertible debenture (bond) is attractive because it not only provides a fixed rate of income, but it can also be converted into shares at a fixed price. The investor can thereby benefit from any increase in the market value of the shares above that fixed price. If the share price drops, the bond holder still gains a fixed income from the bond.

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Reissue of redeemed debentures

The power to reissue redeemed debentures is governed by s 328. Where a company has redeemed any debentures, it has the power to either reissue the same debentures or issue new ones as replacements unless (a) a provision to the contrary (express or implied) is contained in the company's articles or in any contract made by the company; or (b) the company has, by passing a resolution or any other act, shown its intention that the debentures are to be cancelled, s 328(2).

On a reissue, the person entitled to the debentures has, and is deemed always to have had, the same priorities as if the debentures had never been redeemed. The reissue is not to be regarded as a new issue for the purposes of any limit on the amount or number of debentures to be issued, but is to be regarded as a new issue for the purposes of stamp duty. If reissued debentures are given as security for a loan and they appear to have been stamped, the lender may give the debentures in evidence in any proceedings for enforcing the security unless the lender had notice or, but for his/her negligence, might have discovered that the debentures were not stamped, s 328(3)–(7).

If a company deposits debentures to secure advances from time to time on a current account, the debentures are not to be regarded as having been redeemed only because the account of the company has ceased to be in debit, s 329.

Trust deed

When a company issues a series of debentures or debenture stock, whether or not the debentures or the stock are secured, a trust deed may be drawn up vesting the legal ownership of the debentures in trustees. The debenture holders are then the equitable beneficiaries of a trust which is administered by those trustees.

The trust deed will contain a covenant by the company for payment of the principal money lent and interest, provide for meetings and the procedure for serving notices on the debenture holders or debenture stock holders, and give the trustees the power to appoint a receiver if the company defaults in payment or is otherwise in breach of the agreement (*see* 10.7).

Where the debentures or debenture stock are secured, the trust deed will vest title to the security in the trustees and specify the events on which the security is to become enforceable. It will also contain covenants by the company for the insurance and repair of the security; the trustees will ensure that such covenants are observed.

Liability of trustees for debenture holders

A provision in a trust deed securing an issue of debentures (or a contract with such holders secured by a trust deed) is void to the extent that it exempts a trustee, or indemnifies him/her, against liability for breach of trust in failing to show the degree of care and diligence required of the trustee, having regard to the provisions of the trust deed conferring him/her with any powers, authorities or discretions, s 332(1).

However, s 332(1) does not invalidate –

- a release otherwise validly given in respect of anything done, or omitted to be done, by a trustee before the giving of the release;
- a provision in a trust deed enabling such release from liability given by a majority of at least 75 per cent in value of the debenture holders present in person or by proxy (if proxies are permitted) at a meeting summoned for the purpose, and applying in relation to specific acts or omissions or on the trustee dying or ceasing to act; or
- a provision in force on 31 August 1984 entitling a trustee to an exemption from liability, or an exemption or right to be indemnified under such provision.

The benefit under a provision in bullet 3 above may be given to present and future trustees of the deed, or to any named trustee if that benefit is given by a resolution passed by a majority of at least 75 per cent of the debenture holders present in person or by proxy (if proxies are permitted) at a meeting summoned for the purpose in accordance with the trust deed, or, if there is no such provision, summoned in a manner approved by the Court.

A debenture holder or the trustee for all debenture holders is entitled, on request and payment of a fee, to be provided with a copy of any trust deed or any other document securing the issue of debentures (*see* 10.2 below and s 310).

Meeting of debenture holders

Section 331 provides that holders of debentures which form part of a series ranking equally (*pari passu*) and debenture stock, unless excluded by the debentures, the trust deeds or other documents securing the issue of the debentures, may apply to the Court for a meeting of the debenture holders. Such an application may be made by the holders (alone or jointly) of at least 10 per cent of the value of the company's debentures. A higher percentage may be provided for in the debentures, the trust deeds or other relevant documents. The purpose of such a meeting is to give directions to the trustee for the debenture holders.

10.2 Register of debenture holders

The register of a company's debenture holders is one of the several registers that a company is required to keep. A company's register of shareholders was discussed previously (*see* 7.5) and the register of charges will be discussed later in this chapter. The regulations made under Cap 622I s 657 govern the keeping of, the right to inspect and the provision of copies of the registers and related documents (*see* 14.6).

Section 308 provides that if a company issues a series of debentures, or any debenture stock, that are not transferable by delivery (i.e., bearer debentures), the company must keep a register of the holders, either in English or Chinese, that includes the following information –

- the name and address of each holder;
- the amount held by each holder;
- the date on which each person is entered on the register; and
- the date on which any person ceases to be a holder.

The register must be kept either at the company's registered office or at a place prescribed by the regulations made under Cap 622I s 657. If the register is kept at a place other than its

registered office, the company must notify the Registrar of the place at which it is kept. The notice must be delivered to the Registrar within 15 days after the register is first kept at that place, and within 15 days after any change in the place where it is kept (other than a change of address of the company's own registered office), s 309.

If a company fails to keep a register of debenture holders as required by s 308, or keeps a register at a place that contravenes s 309, the company, and every responsible person of the company, commit an offence, ss 308(3) and 309(5).

Branch register

If a company issues outside Hong Kong a series of debentures, or debenture stock, that are not transferable by delivery, it may, if authorised by its articles, keep there a branch register of debenture holders who are resident there. The company must give the Registrar a notice within 15 days after beginning to keep such a register, stating the address where the branch register is kept, s 312.

A branch register must be kept in the same manner as the principal register of debenture holders. A duplicate must be kept at the place at which the principal register is kept and, within 15 days after an entry is made in the branch register, the company must transmit a copy of the entry to its registered office and update the duplicate of the branch register. The duplicate is regarded for all purposes of Cap 622 as part of the principal register, s 313.

The debentures registered in the branch register must be distinguished from those in the company's principal register, and no transaction in respect of those registered in the branch register may, during the continuance of that registration, be registered in any other register, s 314.

A company may discontinue a branch register. All entries in the register must then be transferred either to some other branch register kept by the company in the same place or to the company's principal register. It must, within 15 days after the discontinuance, give a notice to the Registrar, informing the Registrar of the discontinuance and the register to which the entries have been transferred, s 315.

Inspection of the register

The right to inspect the register and to request certain copies of the register is governed by s 310. The regulations made under s 657, Cap 622I must also be complied with (*see* 14.6). A member of a company and a registered debenture holder is entitled, on request made in the required manner and without charge, to inspect the register of debenture holders. Any other person is entitled to inspect on request made in the required manner and on payment of a prescribed fee.

A member, debenture holder and any other person may request a copy of the register, or any part of it. And a debenture holder or a trustee for all debenture holders of a company may request a copy of any trust deed or other documents securing the issue of the debentures. These rights to a copy of the register and certain documents require payment of a prescribed fee, s 310(4)–(5).

Closing the register

A company may, on giving notice, close the register of debenture holders, or any part of it, for any periods not exceeding a total of 30 days each year. In the case of a company having any of its debentures listed on a recognized stock market, notice must be given in accordance with the

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that irregularities in matters affecting internal management can be regularised by the majority shareholders in a properly convened meeting, so long as it would not constitute a fraud on the minority (*see* 15.6).

KEY SECTIONS

- s 548 – written resolutions – *see* 14.1
- s 563 – ordinary resolution – *see* 14.2
- s 564 – special resolution – *see* 14.2
- s 566 – members' request for a general meeting – *see* 14.3
- s 568 – members' power to call a general meeting at the company's expense – *see* 14.3
- s 570 – power of the Court to call a general meeting – *see* 14.3
- s 571 – notice requirement for a general meeting – *see* 14.3
- s 576 – contents of notice for a general meeting – *see* 14.3
- s 578 – resolution requiring special notice – *see* 14.3
- s 580 – members' power to request circulation of a statement – *see* 14.3
- s 585 – quorum at general meetings – *see* 14.4
- s 591 – right to demand a poll – *see* 14.4
- s 596 – right to appoint a proxy – *see* 14.4
- s 606 – representation of a body corporate at a meeting – *see* 14.4
- s 610 – requirement to hold AGM – *see* 14.5
- s 615 – members' power to request circulation of resolution for AGM – *see* 14.5
- s 620 – member's right to inspect records kept by the company – *see* 14.6
- s 622 – registration of certain resolutions – *see* 14.6

15 Control and Remedies for Abuse of Control

A company has 2 controlling bodies – its directors and its members. In Chapters 12 and 14, we have looked at the provisions governing meetings and resolutions passed by these 2 bodies. But the question we have yet to fully address is whether it is the directors or the members who have 'the final say', on the company's behalf, in respect of a particular decision.

In the case of a private company with one member who is also the company's only director, there will obviously be no conflicting views or decisions. But, whenever there are different persons in the roles of director and member, there needs to be an understanding of which controlling body is entitled to make a particular decision. In 15.1, we examine the principles which determine whether it is the directors or the members who are so entitled.

Whenever a group of people are required to make a decision, issues of fairness come to the fore, and the tenet generally employed is that the view of the majority will prevail. In 15.2, we consider this concept of majority rule in so far as it relates to running a company, and take an overview of the various ways in which Cap 622 endeavours to protect companies' and members' interests. Protection is found throughout the Ordinance, but the key provisions are to be found in Part 14 of Cap 622.

Part 14 essentially provides remedies for –

- unfairly prejudicial conduct, in Div 2 (ss 723–727);
- conduct in breach of Cap 622 and breach of duty – an injunction, in Div 3 (ss 728–730);
- misconduct – a derivative action, in Div 4 (ss 731–738); and
- lack of information – an order for inspection of records or documents, in Div 5 (ss 739–743).

The first 3 remedies are considered in 15.3–15.5. In the following part of this chapter, 15.6, the situations in which a member may bring a personal or representative action to enforce contractual rights against a company, and a member's right to bring an action on behalf of a company (given that the wrongdoers are in control of a company) – *a common law derivative action* – will be explained. An order for inspection of documents is considered in the last part of this chapter, 15.7.

15.1 Control of a company

The general powers of managing a company are usually vested in its directors. Directors take decisions collectively. In practice, this collective group of directors is usually termed 'a board'. The extent to which the board of directors may manage the company without interference from the company's members has been the subject of a number of cases. The company's own articles are, however, critical in this regard; they may specify that certain powers are to be exercised by the company in general meeting, or that particular decisions require the approval of certain members.

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Under Cap 622, there are model sets of articles called the 'Model Articles' (*see* Cap 622H). You will recall from Chapter 2 and s 80 that, if a company is incorporated without registering articles, then the Model Articles that are for the time being in force will form its articles (or will apply in so far as its articles do not exclude or modify the Model Articles). Cap 622H Schedule 1 applies to a public company limited by shares and Sch 2 to a private company limited by shares. Under the former Cap 32, there were model sets of articles – in particular, Table A, which concerned a company limited by shares. Table A contained a provision that is similar to s 80, so a company incorporated before 3 March 2013 (i.e., an 'existing company') without registering articles will have Table A as its articles.

Whilst the focus of this textbook is Cap 622, in relation to the control of a company, it is important to know whether an existing company had registered articles in the process of incorporation and, if it did not, we also need to know the date of its incorporation. This is because Table A was amended in 2004. But it must also be appreciated that an existing company may since have made amendments to its articles and so deviate from the relevant model.

Companies incorporated before the 2004 amendment

If an existing company was incorporated under the former Cap 32 before February 2004, and adopted Table A as its articles, then Table A art 82 provided that the directors could exercise all powers of the company not required, by the Ordinance or the articles, to be exercised by the company in general meeting. If the directors acted within the powers given to them by this version of art 82 (or by some similar article), the Courts generally upheld the view that the directors were not bound to obey resolutions passed by shareholders at a general meeting.

In *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) UK, the articles of the company contained an article similar to the former Cap 32 Table A art 82 (HK) except that it was stated to be 'subject to such regulations as might be made by the company by extraordinary resolution'. The majority of shareholders arranged a sale of the company's undertaking and requisitioned a meeting, at which an ordinary resolution was passed requiring the directors to seal the contract.

It was held that the articles constitute a contract, by which the members agree that the directors will manage the company. Unless and until their powers were curtailed by an extraordinary resolution or an alteration of the articles, they could ignore resolutions of the general meeting on matters of management. The directors were not bound to obey the resolution of the general meeting.

In *Salmon v Quin and Axtens Ltd* (1909) UK, the articles contained an article similar to the format Cap 32 Table A art 82 (HK), and also provided that no resolution of the directors to acquire or dispose of property was to be valid if A or S (the company's 2 managing directors) dissented. The directors resolved to acquire property but S dissented. An ordinary resolution to acquire the property was passed at an extraordinary general meeting (EGM).

It was held that the ordinary resolution was inconsistent with the articles, and that the company was restrained from acting on it. (This decision was approved by the House of Lords, reported as *Quin & Axtens Ltd v Salmon* (1909)).

The division of power between the board of directors and the shareholders was clearly stated by Greer LJ in *John Shaw and Sons (Salford) Ltd v Shaw* (1935) UK: 'A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by the directors; certain other powers may be reserved for the shareholders in general meeting. If the powers of management are vested in the directors, they and they alone can exercise those powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering the articles, or, if the opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove.'

This explanation, and the UK cases discussed above, were reviewed by Harman J in *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* (1989) UK where he held that, given the company concerned had adopted [the former Cap 32 Table A art 82 (HK)], the jurisdiction to conduct the business of the company was vested in the board of directors, and the shareholders in general meeting could not intervene.

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Companies incorporated under Cap 32 after the 2004 amendment

The former Cap 32 Table A art 82 was revised in February 2004 to provide that the directors' general power of management is subject to directions given by a special resolution of the shareholders. This was done with a view to strengthening the role of shareholders and providing them with a means to control the board, otherwise than by removing directors from office.

Companies incorporated under Cap 622

The Model Articles (Cap 622H) now provide, in relation to both public and private companies, that subject to Cap 622 and the Model Articles, the business and affairs of the company are managed by the directors who may exercise all powers of the company, Model Articles for public companies art 2(1) and those for private companies art 3(1). Also, the members may by special resolution direct the directors to take, or refrain from taking, specified action, Model Articles for public companies art 3(1) and those for private companies art 4(1). The former is described as the *directors' general authority* and the latter as *members' reserve power*.

Powers to be exercised by members in general meeting

The directors' general power to manage a company is subject to Cap 622 and to the Model Articles (Cap 622H). This means that certain decisions, as specified in Cap 622 or Cap 622H, may require the approval of the company's members in the form of either an ordinary or a special resolution.

Cap 622 requires shareholder approval for matters concerning, for example –

- **The company's constitution**: alteration of articles, s 88; alteration of objects (if any), s 89; and change of name, s 107.
- **The company's capital**: the directors' power to allot shares, s 141; a variation of class rights, s 180; reduction of capital, ss 211, 215 and 226; listed companies buying back their own shares, under a general offer or on a recognised stock market or otherwise, ss 238–240;

unlisted companies buying back their own shares, s 244; companies redeeming or buying back shares out of capital, s 258; giving financial assistance for acquisition of own shares, ss 284–285; and arrangements and reconstructions, ss 673–674.

- **The auditors**: the appointment and removal of the auditors, ss 396 and 419.
- **The directors**: the appointment and removal of directors, ss 460 and 462; and approving payments to directors for loss of office and retirement, s 518 and ss 521–523.

You will recall that the company's own articles may also specify that certain powers must be exercised by the company in general meeting. Thus, certain decisions may require the passing of an ordinary or a special resolution albeit there is no such requirement in Cap 622.

Reversion to the general meeting

There are also circumstances when the general power of management may revert, at common law, to the general meeting. If the board of directors is unable or unwilling to act, if it proposes to act beyond its powers and is seeking approval for such action, or if it has acted in breach of its fiduciary duties, the members in general meeting may decide on the action to be taken.

Where the board is unwilling or unable to act

If the board of directors cannot or will not exercise the powers vested in it, the general meeting may do so.

In *Barron v Potter* (1914) UK, the 2 directors of the company were not on speaking terms. The company's articles provided that the quorum at directors' meetings should be 2; an effective board meeting could not therefore be held. A shareholder requested a meeting at which additional directors had purportedly been appointed. The company's articles provided that the power to make such appointments was vested in the directors.

It was held that, in view of the deadlock between the 2 original directors, the power to appoint additional directors reverted to the general meeting and so the appointments were valid.

In *Marshall's Valve Gear Co Ltd v Manning, Wardle and Co Ltd* (1909) UK, M was the majority shareholder and managing director of a company formed to exploit an invention which he had patented. On the board, he was outvoted on a proposal to sue the defendant company for infringing his patent, the other 3 directors being interested in the defendant company. In spite of the opposition of his co-directors, M brought an action to prevent the infringement.

It was held that M, as the majority shareholder, had a right to bring the action. Neville J said: '. . . I ought not to interfere with the progress of the present action, because it is brought with the approval of the majority of the shareholders of the company . . . the majority of the shareholders in the company at a general meeting have a right to control the action of the directors, so long as they do not affect to control it in a direction contrary to any of the provisions of the articles which bind the company.'

In *Alexander Ward and Co Ltd v Samyang Navigation Co Ltd* (1975) UK, a company registered in Hong Kong, which had no directors and had not held a general meeting for more than 2 years, was owed money by a Korean company. A summons for payment of the debt was issued on behalf of the company by Ward and Irons (who were not authorised to act as its agents), and when the company went into liquidation, the liquidator ratified the acts done on behalf of the company by Ward and Irons.

It was held that although no directors had been appointed to manage the company, it did not follow that the company was unable to exercise its powers of management. Any act within the company's powers could still be undertaken on its behalf, and be ratified by the company at a later date. Recovery of a debt due to the company was such an action. The company had thus been a competent principal throughout the period in question and, through the liquidator, had been able to validate retrospectively the action brought in its name by Ward and Irons.

It is, however, important to distinguish a situation where the company in general meeting is exercising powers which might otherwise have been exercised by a board of directors, had the board been effective, from a situation where the company in general meeting is attempting to usurp the powers of a board which is effective: *Miracle Chance Ltd v Ho Yuk Wah* (1999).

Where the board seeks approval for acts beyond its powers

The board may seek the approval of the general meeting if it has acted or proposes to act beyond its powers but within those of the company. The members may authorise such an act.

In *Grant v UK Switchback Railways Co* (1888) UK, the articles of the company disqualified any director from voting at a board meeting in relation to any contract in which he/she was interested. The directors of the company agreed to sell the company's undertaking to X Ltd despite the fact that they were its promoters. A general meeting of shareholders was held, and it passed an ordinary resolution approving and adopting the agreement to sell, and authorising the directors to carry it into effect.

It was held that the company's articles prevented the directors from binding the company to the contract but there was nothing to prevent the company from entering into such a contract, and that the company could ratify the unauthorised act of the directors by an ordinary resolution.

In subsequent decisions, however, directors seeking approval for acts which were beyond their powers but within the company's powers (i.e., *intra vires*) have required the unanimous agreement of the company's members. In *Salomon v Salomon* (*see* 1.1), the Court considered a sale to the company at an overvaluation, and concluded that a company is bound in a matter which is *intra vires* the company by the unanimous agreement of its members. Also, in *Express Engineering Works Ltd* (1920) UK, it was held that the unanimous, though informal, agreement of all of the company's members bound the company.

In *Re Horsley and Weight Ltd* (1982) UK, 2 of the company's 5 directors held all issued shares of the company. They purchased a pension policy for a fellow director who was retiring. The purchase was *intra vires* the company, but it was an unauthorised act of the board of directors because it lacked the board's consent or the consent of the shareholders in general meeting. It was held that the assent of the 2 directors to obtaining the policy had the effect of ratifying the transaction.

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Modification of the compulsory winding-up provisions

The provisions applying to registered companies being wound up by the Court apply also to unregistered companies being wound up under Cap 32 Part X, with the following modifications –

- A 'contributory' is generally defined by Cap 32 ss 170–174 (*see* 20.1), but in the case of an unregistered company, the term is extended to include every person who is liable to pay (or to contribute to the payment of) any debts or liability of the company, or the costs of winding-up for the adjustment of the rights between members, Cap 32 s 328.
- The provisions regarding staying actions and proceedings between the presentation of a winding-up petition and a winding-up order (*see* 19.3) extend to actions and proceedings against any contributory of an unregistered company, Cap 32 s 329.
- Where the Court makes an order for winding up an unregistered company, no action can be proceeded with, or commenced against, any contributory of the company in respect of any debt of the company, except by the leave of the Court, Cap 32 s 330.

KEY SECTIONS

Cap 32

s 177 – grounds for a winding-up petition – *see* 19.1

s 178 – inability to pay debts - ground for a petition – *see* 19.1

s 179 – application for winding-up – *see* 19.2

s 180 – powers of the Court on hearing a winding-up petition – *see* 19.2

s 182 – dispossession of a company's property after commencement of winding-up - void – *see* 19.3

s 184 – 'commencement' date of winding-up – *see* 19.3

s 186 – action stayed on winding-up order or appointment of a provisional liquidator – *see* 19.3

s 190 – statement of the company's affairs – *see* 19.5

s 193 – appointment of provisional liquidator – *see* 19.3

s 194 – appointment of liquidator – *see* 19.5

s 199 – powers of liquidator – *see* 19.7

s 206 – committee of inspection – *see* 19.5

s 209A – Court's power to order winding-up as a creditors' voluntary winding-up – *see* 19.6

s 221 – Court's power to examine on oath – *see* 19.6

s 227A – winding-up with a regulating order – *see* 19.8

s 227F – summary procedure for winding-up by the Court – *see* 19.4

ss 326–331A – winding up unregistered companies (Part X) – *see* 19.9

20 The Assets of a Company Available for Distribution

In this chapter, we are concerned with the collection of money and property. The liquidator is under a duty to realise the assets of the company, and if those assets are insufficient to pay its debts, he/she may call upon the members of the company to contribute to the extent that their shares are not fully paid.

In 20.1, we shall consider the definition of a contributory, a contributory's liability, and the compiling of the lists of contributories, while the process of collecting the company's assets is discussed in 20.2. Finally, the provisions dealing with 'onerous property' – property which is unsaleable – are considered in 20.3.

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20.1 Contributories

The term 'contributory' means every person liable to contribute to the assets of a company in the event of its being wound up, and includes any person alleged to be a contributory, Cap 32 s 171. Thus, the holder of fully paid shares is a contributory because all members are liable to contribute. There are, however, limits on that liability, and whether a person is in fact liable to contribute will be determined in the course of the winding-up.

Liability of a company's members

In the event of a company being wound up, every past and present member is liable to contribute to the assets of the company to an amount sufficient to pay –

- the company's debts and liabilities;
- the costs, charges and expenses of winding-up; and
- for the adjustment of rights between the members, Cap 32 s 170(1).

This statement of liability is qualified in relation to companies incorporated with limited liability –

- In a company limited by shares, no contribution is required, from any past or present member, which exceeds the amount, if any, that is unpaid on his/her shares, Cap 32 s 170(1)(d).
- In a company limited by guarantee, no contribution is required which exceeds the amount which was undertaken to be contributed in the event of the company being wound up, Cap 32 s 170(1)(e).
- Any sum due to a member by way of dividend is not a debt of the company in a case of competition between himself/herself and a creditor, but may be taken into account in the final adjustment of the rights of contributories among themselves, Cap 32 s 170(1)(g).

- In a company limited by guarantee which has a share capital (such a company cannot now be formed; *see* 1.2), in addition to the amount undertaken to be contributed in the event of a winding-up, the members are also liable to contribute to the extent of any sums unpaid on any shares they hold, Cap 32 s 170(3).

A past member will not be liable if he/she ceased to be a member one year or more before the commencement of the winding-up, Cap 32 s 170(1)(a), or in respect of the debts and liabilities of the company contracted after he/she ceased to be a member, Cap 32 s 170(1)(b). Furthermore, he/she will only be liable if it appears to the Court that the existing members are unable to satisfy the contribution required to be made by them, Cap 32 s 170(1)(c).

When a company is registered as unlimited and re-registers as limited (*see* 5.6), special provisions apply to the liability of the members of the company –

- A past member who was a member at the time of re-registration is liable to contribute to the assets of the company for the debts and liabilities contracted before re-registration, if the winding-up commences within 3 years of the re-registration, Cap 622 s 133(2).
- If none of the existing members was a member at the time of re-registration, a person who was a past or present member at the time of re-registration may be liable to contribute, Cap 622 s 133(3)–(4).
- There is no limit on the amount which a person who was a past or present member at the time of re-registration is liable to contribute, Cap 622 s 133(5).

Liability of a company's directors

Under the former Cap 32, a director of a limited liability company could undertake to be personally liable for the debts of the company to an unlimited amount. There is no such provision in the present Cap 32 and Cap 622. A director who has undertaken such liability, in addition to his/her liability (if any) to contribute as an ordinary member, is liable to make a further contribution as if he/she were a member of an unlimited liability company, Cap 32 s 170(2). In these circumstances, a director is regarded as a contributory. However, a past director is not liable to make such a further contribution if he/she ceased to hold office for one year or more before the commencement of the winding-up, or in respect of any debt or liability of the company contracted after he/she ceased to hold office. Subject to the company's articles, a director is not liable to make such further contribution unless the Court deems it necessary, Cap 32 s 170(2)(c).

Liability of a contributory

The liability of the contributory creates a specialty debt due from the time when the liability commenced. Thus, any action for the debt may be commenced within 12 years of the liability commencing (as opposed to 6 years for a simple contract). But the debt only becomes payable when a call is made, Cap 32 s 172. Calls can only be made to raise a sum sufficient to pay the company's debts and liabilities; the costs, charges and expenses of the winding-up; and for the final adjustment of rights between contributories, Cap 32 s 213 (*see* below).

If a contributory dies before or after he/she has been placed on the list of contributories, his/her personal representative is liable in the course of administering the contributory's estate and is regarded as a contributory, Cap 32 s 173(1). If a contributory becomes bankrupt before or after being placed on the list of contributories, his/her trustee in bankruptcy will represent him/her for the purposes of the winding-up and will also be regarded as a contributory, Cap 32 s 174.

List of contributories

The list of contributories, which must be settled by the Court, Cap 32 s 210, or by the liquidator, Cap 32 s 226, as soon as possible after the winding-up order is made, is in 2 parts: the A list and the B list. The A list consists of the members of the company at the commencement of the winding-up (i.e., present members). The B list consists of persons who were members within a year before the commencement of the winding-up, and is often not settled at all; it is only settled if it appears that the A list contributories are unable to satisfy their contributions. However, if it appears to the Court that it will not be necessary to make calls or adjust the rights of contributories, it may dispense with this requirement.

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The procedure for compiling the list of contributories is laid down in the *Companies (Winding-up) Rules* (Cap 32H). The liquidator must –

- appoint a time and a place for the settlement of the list, which must contain a statement of the address of, and the number of shares attributed to, each contributory, the amount called up, and the amount paid, r 68;
- give notice in writing, of the time and place appointed for the settlement of the list, to every person he/she proposes to include in the list, r 69; and
- on the day appointed for settlement of the list, hear any person who objects to being settled as a contributory, and, finally, settle the list, r 70.

Both the Court and the liquidator have the following powers –

- To rectify the register of members if necessary, Cap 32 s 210.
- To order any contributory to pay any money due from him/her (not including any calls) to the company, Cap 32 s 212(1). In the case of unlimited liability companies and directors who have unlimited liability (*see* above), any amount owed by the company to the member or director on any independent contract may be set off against the debt, Cap 32 s 212(2).
- To make calls on all or any of the contributories (to the extent of their liability) to pay the debts and liabilities of the company; the costs, charges and expenses of the winding-up; and for the adjustment of the rights of the contributories, Cap 32 s 213. When all creditors of the company are paid in full, any money due from the company to a contributory may be allowed as a set-off against subsequent calls, Cap 32 s 212(3).
- To adjust the rights of the contributories among themselves, and distribute any surplus among the persons who are entitled, Cap 32 s 218.
- To order any contributory to pay the amount due into a specified bank account, Cap 32 s 214.

These powers are granted to the liquidator by Cap 32 s 226, but to rectify the register of members or to make calls, he/she must first obtain the special leave of the Court. Alternatively, he/she may seek the sanction of the committee of inspection to make the calls.

20.2 Collection of the company's assets

The Court must cause the assets of the company to be collected, Cap 32 s 210(1), and may, at any time after making a winding-up order, require any contributory who is on the list, and any trustee, receiver, banker, agent or officer of the company, to pay, deliver, convey, transfer or surrender to the liquidator any money, property, books and papers to which the company is *prima facie* entitled, Cap 32 s 211. The Court may also order any purchaser or other person who owes money to the company to pay the amount due into a specified bank account, Cap 32 s 214. These powers may be delegated to the liquidator, Cap 32 s 226.

There are a number of provisions in the Ordinance which, in the event of a company being wound up, enable the liquidator to add to the company's assets and thus swell the amount of money available to pay its creditors or to return to members.

Personal liability in the event of fraudulent trading

If, in the course of a winding-up, it appears that the business of the company has been carried on with an intent to defraud its creditors, any person who knows that the business has been carried on in that manner may be personally liable for the debts or other liabilities of the company, as the Court may direct, Cap 32 s 275.

The fact that the company has paid one creditor knowing it could not pay all of its creditors may not amount to 'carrying on business with the intent to defraud', if the directors genuinely believe that the company will be able to satisfy all of its creditors in the future. In *Re WC Leitch Brothers Ltd* (1932) UK, the Court clarified the meaning of 'carrying on business with intent to defraud'. Maugham J said: 'If a company continues to of carry on business when there is to the knowledge of the directors no reasonable prospect of the creditors receiving payment of their debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud ...' However, in *Re Patrick and Lyon Ltd* (1933) UK, Maugham J said: 'I will express the opinion that the words "defraud" and "fraudulent purpose", where they appear in the section in question, are words which connote actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame.'

In *Re White and Osmond (Parkstone) Ltd* (1960) UK, Buckley J said in the course of his judgement: 'There is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet all its liabilities as they fall due. What is manifestly wrong is if directors allow a company to incur credit at a time when the business is being carried on in such circumstances that it is clear the company will never be able to satisfy its creditors. However, there is nothing to say that directors who genuinely believe that the clouds will roll away and the sunshine of prosperity will shine on them again and disperse the fog of their depression are not entitled to incur credit to help them to get over the bad time.'

The Hong Kong Courts have reviewed these and many other cases concerning Cap 32 s 275 in *ADS v Wheelock Marden & Co*. This case first came before the Court in 1989 when Jones J held that, in order to succeed in a claim for fraudulent trading, actual dishonesty is an essential element. It must be shown that the persons involved in carrying on the company's business –

- actually intended to defraud creditors or to achieve a particular fraudulent purpose; or
- were reckless as to whether the carrying on of the business would result in the creditors being defrauded.

Wheelock Marden had argued that, on the facts, there was no case to answer, but the Court held that ADS had established a cause of action. Wheelock Marden appealed (reported as *Wheelock Marden and Co Ltd v ADS* in 1990), but it was held that the points of claim appeared to establish a case inviting investigation under Cap 32 s 275. The case was eventually heard by the Court of First Instance in 1997.

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In *ADS v Wheelock Marden & Co* (1997), ADS claimed that Wheelock Maritime International (WMI), a subsidiary of Wheelock Marden, obtained 2 loans from ADS at a time when the persons responsible for managing WMI knew that there was no reasonable prospect of the loans being repaid. This was denied largely on the grounds that Wheelock Marden (the holding company) would support WMI – it had done so in the past and there was genuine belief that it would continue to do so.

The Court of Appeal (1998) upheld the decision of the trial judge, agreeing that the persons responsible for managing WMI had not been fraudulent. But the decision was not unanimous. Le Pichon J, in her dissenting judgement, explained that the trial judge found 'an unjustified albeit honest chasing of the rainbow'. She added, 'I have some difficulty in understanding how a chasing that is unjustified can at the same time be honest if it amounts to gambling with a creditor's money or putting it at substantial risk. In terms of moral turpitude, it is no different from enriching oneself at a creditor's expense'.

In 2000, the Court of Final Appeal upheld the decision of the Court of Appeal on the question of fraudulent trading (reported as *ADS v Brothers*). Lord Hoffman explained that 'It is well-established that [Cap 32] s 275 requires proof that someone carried on the business of the company with fraudulent intent and that the other directors sought to be held liable were knowingly party to the fraud ... the question whether the person carrying on the business was fraudulent was subjective in the sense that he personally must have been dishonest' (p519/20 of CFA [2000] 1 HKC 511). In response to Le Pichon's judgement, he explained that the directors must honestly believe there was a reasonable prospect that the company would be able to pay the debts which it incurred. But the fact that the likelihood of survival was objectively low was not inconsistent with honesty (p528).

A person will be liable under Cap 32 s 275 only if he/she is 'a party to the carrying on' of a business.

In *Re Maidstone Buildings Provisions Ltd* (1971) UK, it was held that a company secretary, who knew that the company was insolvent but failed to advise the company's directors that it should cease trading, was not 'party to the carrying on of the business' with intent to defraud creditors. Pennycuick V-C said: 'The expression "party to the carrying on of a business" is not, I think, a very familiar one but, so far as I can see, the expression "party to" must on its natural meaning