



S T E P

Companies Bill Team
Financial Services Branch
Financial Services and the Treasury Bureau
15/F Queensway Government Offices
66 Queensway
Hong Kong

24 March 2010

Dear Sir

Submission on the Draft Companies Bill – First Phase Consultation

We refer to your Consultation Paper in relation to the first phase of the Companies Ordinance Rewrite.

We thank you for the opportunity to participate in this consultation and apologise for the delay with our submission. The Society of Trust and Estate Practitioners (“STEP”) has reviewed the consultation documents. We only wish to comment on three aspects of the draft Companies Bill as they are most relevant to trustees. Our comments relate to Part 10 and Part 17 of the draft bill, being the proposals relating to:

- A. restriction of corporate directorship in private companies (Part 10 – Clauses 10.3 to 10.5),
- B. indemnities for directors (Part 10 – Clauses 10.15 to 10.18), and
- C. Non- Hong Kong Companies (Part 16).

PART 10: DIRECTORS AND SECRETARIES

A. Clauses 10.3 to 10.5 in relation to Restricting corporate directorship in private companies

The Relevant Draft Clauses

1. Clause 10.3 of the Consultation Draft of the Companies Bill (“CB”) provides that a company with one member who is also the sole director can appoint a reserve director who can act upon the death of the director.

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2. Clause 10.4 of the CB restricts the use of corporate directorship for public company and private companies within a listed group. This clause is a restatement of current law as per section 154A of the *Companies Ordinance* ("CO").
3. **Clause 10.5** of the CB proposes to restrict corporate directorship in private companies by requiring a private company (other than one within the same group of a listed company) to have at least one director who is a natural person.

Comments

4. We do not support proposed draft Clause 10.5 for the reasons set out below.
5. The CO was amended in 2003 to allow a private company to have a single director with the introduction of section 153A. This simplification was a welcome modernisation of Hong Kong companies law and many companies have made use of this simplification to have single director board. However, together with the proposed Clause 10.5, it means that where a private company has a single director board, the sole director will, in the future, have to be an individual.
6. Trustees are of the view that this proposal is not practical for trust structures that involve Hong Kong companies. Indeed, Trustees are of the view that the proposal will drive businesses away from choosing Hong Kong companies whenever they can avoid doing so.
7. It is common for trustees to hold trust assets through the use of special purpose vehicle ("SPV") in the form of corporate entities. This is because, for professional trustees in any jurisdiction, it is often inefficient, sometimes illegal, and oftentimes potentially risky for a trustee to directly own the underlying investments or assets of a trust. In cases where an SPV is used, it is often a trustees' duties to nominate a director/determine the directorship of the board of the SPV. For SPVs that are pure holding vehicles, it is then advisable for the parties to opt for a single directorship board (if such is permitted by law, as is now the case for Hong Kong companies) as this keeps corporate procedures simple, and administrative costs minimal.
8. Operationally, where the trustee is an independent trust company, a corporate director, (with a number of persons authorised to act on behalf of the corporate director company,) is undoubtedly much more appropriate than an individual director for the following reasons.
 - (a) Aside from death of a director (which is a scenario contemplated by Clause 10.3 with the nomination of reserve director), there are a host of circumstances when an individual could be rendered unable or unfit to act as a director, e.g. because of illness, of becoming mentally incapacitated, etc. Any such circumstance will render the board of a Hong Kong company with a single individual director paralysed to act.
 - (b) In addition, in today's international commerce, business travel is the norm. Indeed, any travel commitments, be it for business or leisure, of individuals within the trustee business would render it difficult for any individual to maintain their directorship duties for the SPVs concerned.¹ A corporate director, where a number of individuals can be appointed as signatory on behalf of the corporate director company, is a simple and practical means of conducting business.
 - (c) There can be personal liability issues that would render the office of directorship unpalatable to individuals who are merely employees of trustee companies, particularly in conjunction with the proposal to limit indemnity (refer below comments). As for appointing the office bearers or senior management staff of the

¹ The provision relating to alternate director under Clause 10.528 of the CB/ section 153B of the CO only goes part way to alleviate this practical difficulty; and is subject to the articles of a specific company authorising such appointment.

trustee company to act as sole directors of underlying holding companies, then the practical issues of individual's accessibility are outlined in (a) and (b) above.

- (d) There will be the administrative burden of formally appointing and removing directors every time there is a change in the employment relationship between the trustee company and the individual directors concerned.
9. If Clause 10.5 is introduced, many companies will end up not using single directorship board or will simply avoid using Hong Kong companies altogether. In the trust industry's case, our view is that even 2 directors board would probably not resolve the commercial and practical ineffectiveness highlighted above. In the event that one individual cannot act, quorum or majority decisions cannot be made. It follows that to use a Hong Kong company, one would necessarily need to default to 3 directors board to effectively operate the company. This would add an additional layer of administration, and therefore additional costs, to operate a HK company. This means that for all the reasons stated in paragraph 9, especially for independent trust companies, coupled with the additional administrative and inherent operating costs of using a HK company, corporate service providers and professional trustees may well avoid using HK companies for their clients and suggest alternative off-shore companies that are simpler and cheaper to operate and maintain. The flow-on effect of this is that not only would there be a direct loss of revenue from the reduction in the use of Hong Kong companies, but also a reduction of business and revenue for professionals servicing Hong Kong companies for part of their business and revenue, such as lawyers (dealing with HK company law and litigation, arbitration and mediation within the HK legal jurisdiction), accountants (dealing with HK accounting, audits, tax filing, etc), corporate service providers (providing company secretarial, nominee shareholder/director, registered office services, etc), and other related services.
10. Paragraph 2.9 of the Consultation Paper referenced anti-money laundering and counter-terrorist financing concerns as a rationale of excluding corporate directors to private companies. To this end, we note that the companies that are used for corporate directorship in the professional trustee industry would, like the trustee companies, usually be subject to the AML rules under HKMA (in the case of corporate directors provided by bank trustees) or other relevant professional regulatory bodies (e.g. the law society in the case of corporate directors provided by law firms).
11. In the event that the Consultation concludes on the need for clause 10.5 of the CB without exception, we request the government to consider enlarging the circumstances under which a reserve director can be appointed under Clause 10.3 of the CB so that (a) any individual director of any private company (rather than only to company with one member who is also the director) can be allowed to appoint a reserve director, and (b) the reserve director can act in circumstances other than death of the director; e.g. on the director becoming mentally incapacitated, missing, etc.

Concluding comments

12. In short, we do not support the proposed clause 10.5 of the CB in its current form. If Clause 10.5 is introduced, trustees would be forced to (a) choose not to use Hong Kong incorporated companies whenever possible, or (b) appoint more than 1 director to Hong Kong incorporated companies thereby clearly undercutting the simplification introduced by section 153A of the CO. We therefore request that the proposal be removed or that an exception be introduced for corporate directors that are themselves owned, managed and operated by Trustees or other corporate service providers.

B. Clause 10.15 to Clause 10.18 in relation to Indemnities for Directors

Comments

13. As trust companies frequently provide nominee directors of companies owned by trusts or for beneficial owners of shares held on bare trusts (where the trust company also acts as nominee shareholder), some trustees are concerned by any erosion of their ability to take an indemnity from their clients in return for agreeing to act as directors of the company.
14. In the context of trust companies and nominee directorships it is necessary to strike a balance between protecting the company where things have gone wrong, and preventing over wide indemnities; and encouraging a diverse pool of high quality directors provided by trust companies and other corporate service providers in the market. (This is recognized in the UK Department of Trade and Industry White Paper on company law reform)

Legislative background

15. The Companies Ordinance rewrite proposes reforms, which will very broadly follow the modernizing reforms made in the UK with the UK Companies Act 2006. Under the current Companies Ordinance a company is prohibited from exempting or indemnifying a director against any liability for negligence, default, breach of duty or breach of trust in relation to the company of which he is the director. The proposed reforms seek to extend this prohibition to cover indemnities provided by related companies.

Insurance and legal costs

16. Companies will still be allowed to purchase directors and officers (D and O) insurance, except against any liability arising from any fraudulent act or fraudulent omission on the part of the director. (The underlined words are not included in the UK Companies Act 2006.)
17. In our experience of insurance policies, the insurer is likely to withdraw cover if there is any accusation of an offense of dishonesty. We had some concerns that a trust company director might be accused of a fraudulent act or omission which might not be dishonest (though admittedly this seems unlikely). e.g. The Hong Kong statutory offense of fraud under Section 16A of the Theft Ordinance does not mention dishonesty but it does require an intent to defraud (defined as a deceit which will induce another person to make an act or omission which will result in benefit to somebody other than the party deceived, or prejudice to any person other than the deceiver). Hong Kong retains the Common Law offense of conspiracy to defraud which is in effect a general dishonesty offense.
18. Moreover, Clause 10.17(2) of the CB permits the company, despite the exception in Clause 10.17(1) (the exception relating to fraudulent act or omissions), to take out insurance for the director against any liability incurred in defending proceedings (civil or criminal) for negligence, default, breach of duty or breach of trust in relation to the company or an associated company of which he is a director. Does this include proceedings which allege fraud? This is unclear: it may be intended that, subject therefore to any practice by the insurance company in withdrawing cover, if the director is accused of fraud, he will be able to use the insurance to fund the legal costs of the defense. Given the increase in allegations of fraud in modern litigation, this would be desirable.
19. A company is also permitted (Clause 10.18) to grant an indemnity to a director against liability incurred by him to a third party. This may not cover liability for criminal fines or regulatory penalties, or any liability in defending criminal proceedings in which is convicted, simple proceedings brought by the company or an associated company where judgment is given against the director, or an application to the Court for relief where the Court refuses (under

Section 358 of the existing Companies Ordinance or Section 20.10 or 20.11 of the CB – application by a person in defending proceedings for negligence, default, breach of duty or breach of trust for relief where it appears to the Court that he has acted honestly and reasonably having regards all the circumstances including those of his appointment).

20. A company can therefore pay the director's legal costs up front, provided that he will have to reimburse them if he is convicted in criminal proceedings or judgment is given against him in civil proceedings brought by the company/an associated company.. Alternatively, it seems to us that insurance could cover these costs. **On the present drafting it seems that if it is paid by the insurance company, this would be without reimbursement but this is not clear.**

Indemnities from shareholders?

21. It seems that, in the context of nominee directorships, there is nothing in the proposed legislation to prevent the shareholders of the company from providing indemnities to directors, or agreeing to limit their liabilities. It appears that indemnities from shareholders of a company would not fall within the evil which the legislation is intended to prevent, namely using the company's assets to indemnify the director against his own breach of duty; this is consistent with Clause 10.22 which permits ratification if approved by the members.

Concluding comments

22. We have no major comments on this part of the legislation. However from the point of view of the professional trustee company it would be desirable to have:
- (a) some clarification of the ability to allow shareholders to grant indemnities (where the company can not grant an indemnity);
 - (b) clearer wording in Clause 10.17 (2) as to whether an insurance policy will be able to cover the costs of defending allegations of fraud or dishonesty; and
 - (c) some clarification of whether insurance taken out against third party liabilities – see Clause 10.18 - need not be reimbursed.

C. PART 16: NON-HONG KONG COMPANIES

23. In the context of registering non-Hong Kong companies, we would also like to put forward a proposal for the government to consider allowing for corporate redomiciliation/ migration.
24. This could reduce the cost of doing business internationally and is a useful tool when the overseas country of registration changes the conditions under which companies operate, becomes prohibitively expensive, or introduces changes to tax regimes.
25. For corporate migration to operate, corporate redomicile must be permissible under the laws of the jurisdiction of incorporation as well as the jurisdiction to which the company wishes to move. Corporate redomicile is permissible in many countries including but not limited to the Ireland, Switzerland, Isle of Man, Jersey, the BVI and Cayman Islands.
26. Allowing for non-Hong Kong companies to redomicile to Hong Kong will make Hong Kong a more competitive jurisdiction and reduce cost for maintaining corporate structure.
27. The other aspect of this would be to also allow Hong Kong companies to redomicile overseas.
28. We recommend for the government to consider this proposal.

We thank you for giving us the opportunity to offer our comments.

Yours faithfully



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