

## PART 11

### FAIR DEALING BY DIRECTORS

#### Introduction

1. Part 11 covers fair dealing by directors and deals with particular situations in which a director is perceived to have a conflict of interest. It governs transactions involving directors or their connected entities which require members' approval (namely loan transactions, long-term service contracts, substantial property transactions and payments for loss of office), and covers disclosure by directors of material interests in transactions, arrangements or contracts.
2. Part 11 introduces a definition of "connected entity" and introduces new statutory provisions requiring members' approval for director's long-term employment and for substantial property transactions entered into by a company. It also restates relevant sections of the CO, namely sections 157H to 157J (prohibition of loan transactions with directors and other persons), sections 163 to 163D (requirement for company's approval for loss of office payments to directors) and section 162 (disclosure by directors of material interests in contracts) with some changes.

- The significant changes to be introduced under this Part are highlighted below:
  - (a) Expanding the prohibitions on transactions to cover a wider category of persons connected with a director;**
  - (b) Introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities;**
  - (c) Repealing the criminal sanction provisions in section 157J of the CO;**
  - (d) Extending the application of the prohibitions on payments for loss of office;**
  - (e) Requiring members' approval for a director's employment exceeding 3 years and requiring a company to keep directors'**

**service contracts available for members' inspection;**

- (f) Requiring members' approval for substantial property transactions;**
- (g) Requiring disinterested members' approval in the case of public companies; and**
- (h) Widening the ambit of disclosure currently under section 162 of the CO.**

### **Significant Changes**

- (a) Expanding the prohibitions on transactions to cover a wider category of persons connected with a director**

#### *Background*

3. At present, there are individual sections in the CO which extend the application of the relevant prohibition provisions to persons connected with a director. For example, in the case of loan transactions, section 157H(8) and (9) of the CO extends the references to "director" in section 157 to a spouse, child and step-child (including illegitimate child) under the age of 18, and specified categories of trustees and partners, and section 157H(2)(c), (3)(c) and (4)(c) extends the prohibition provisions to a company in which a director holds a controlling interest. We consider that the current references are not comprehensive enough to cover all parties who are closely associated with directors. Taking into account similar provisions in the UKCA 2006<sup>1</sup>, we consider it necessary to expand the prohibitions on transactions to cover a wider category of persons connected with a director.

#### *Proposal*

4. In Part 11, there are a number of prohibitions on transactions with an entity connected with a director or past director. In particular, a public company must not make a loan or quasi-loan etc. to, or enter into a credit transaction etc. as creditor for, a connected entity (**Clauses 11.18 and 11.19**), and a company must not make payment to a connected entity for a director's loss

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<sup>1</sup> Sections 252 to 255 of the UKCA 2006.

of office (**Clauses 11.37 to 11.39**). **Clauses 11.2 to 11.4** provide that an entity connected with a director or past director of a company means:

- (a) a family member;
- (b) an associated body corporate;
- (c) a specified category of trustees;
- (d) a specified category of partners.

5. The categories of person classified as “connected entity” are broader than those currently under the CO. For example, **Clause 11.3** defines “family members” to cover a director’s child, step-child and adopted child of any age whereas under the CO, only a director’s child and step-child under the age of 18 are caught. The proposed definition in **Clause 11.3** also covers any other person (whether of a different sex or the same sex) with whom the director or past director lives as a couple in an enduring family relationship.

**(b) Introducing new exemptions from prohibitions on loans and similar transactions in favour of directors and connected entities**

*Background*

6. The decision whether to make a loan is normally taken by the directors. Section 157H of the CO prohibits, subject to certain exceptions, a company from entering into any direct or indirect loan transactions in favour of its directors, directors of its holding company or any of their connected persons. These rules are intended to protect shareholders and creditors. However, there are situations in which the prohibitions may not serve any meaningful purpose. For example, where the directors hold all or a majority of the shares and creditors are not prejudiced. There are exemptions from prohibitions under section 157HA of the CO which apply to all companies.<sup>2</sup> In addition, a private company, which is not a member of a group which includes a listed company, is exempted from the prohibitions if the loan transaction is approved by shareholders in general meeting.<sup>3</sup>

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<sup>2</sup> Exceptions for intra-group transactions (section 157HA(1)), funds to meet company expenditure incurred (section 157HA(3)(a)), home loan (section 157HA(3)(b)), hire or lease on not more favorable terms (section 157HA(3)(c)) and ordinary business transactions (section 157HA(6) and (7)).

<sup>3</sup> Section 157HA(2) of the CO.

7. The exceptions are fairly complex. Members' approval is a simple method of ensuring compliance but is currently applicable only to private companies not associated with a listed company. The narrow application of the members' approval exception is arguably too restrictive. For example, private companies owned by majority shareholders of a listed company cannot rely on the exception even though they might not be regarded as a member of the listed group under the Listing Rules.<sup>4</sup> To facilitate business operation, there is a case to extend the members' approval exception to all other companies. Nevertheless, the new exemption would have to contain appropriate safeguards for minority shareholders. In the case of public companies, we propose that the transactions must be approved by disinterested members (see section (g) below). As regards private companies within the same group of a listed company, we ask in Chapter 8 of the Consultation Paper whether they should also be subject to the requirement of disinterested members' approval.

*Proposal*

8. **Clauses 11.16 to 11.20** provide generally that a company must not make a loan, a quasi-loan or enter into a credit transaction in favour of a director of the company or of its holding company without the prescribed approval of members.<sup>5</sup> The prohibitions are extended to persons connected with a director (connected entities) in the case of public companies.
9. Two new exceptions from prohibiting a company from making a loan are also introduced :
- (a) exception for small loan, quasi-loan and credit transaction (**Clause 11.21**);
  - (b) exception for funds to meet expenditure, incurred or to be incurred by a director, on defending proceedings or in connection with an investigation or regulatory action (**Clauses 11.23 and 11.24**).

These new exceptions are subject to conditions as to financial limit and requirements as to repayment.

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<sup>4</sup> c.f. the terms "group" and "subsidiaries" as defined in Chapter 1 of the Main Board Listing Rules. "Group" means the issuer or guarantor and its subsidiaries, if any, and "subsidiaries" includes the meaning attributed to "subsidiary undertaking" in the 23rd Schedule of the CO and any entity which is or will be accounted for and consolidated in the audited consolidated accounts of another entity as a subsidiary pursuant to the applicable financial reporting standards.

<sup>5</sup> "prescribed approval of members" is defined in clause 11.11.

(c) **Repealing the criminal sanction provisions in section 157J of the CO**

Background

10. Section 157J of the CO provides for criminal sanction where there is a breach of section 157H (prohibition of loans, etc., to directors and other persons) and imposes the penalty of a fine and imprisonment. The liability extends to the company and directors who wilfully permitted or authorised the transaction and other persons who knowingly procured the company to enter into the transaction.
11. In the UK, the UKCA 2006 decriminalised the provisions which restrict loans etc. to directors and connected persons. The criminal sanction was therefore abolished. The rationale is that there is a danger of over-deterrence if criminal sanctions are attached to general directors' duties of loyalty rather than closely defined wrongdoing, and that enforcement of such duties should be a civil matter for the companies.<sup>6</sup> We agree with the rationale.

Proposal

12. We are of the view that the civil consequences under **Clause 11.29** are sufficient and the criminal sanction provisions in section 157J of the CO should be repealed.

(d) **Extending the application of the prohibitions on payments for loss of office**

Background

13. It is unlawful under sections 163 to 163D of the CO to make payments to directors or past directors of a company, as compensation for loss of office or as consideration for retirement from office, without the company's prior approval. However, since the provisions only apply to payments to directors or past directors of the company, there are concerns that such payments can be made indirectly via other parties, thus defeating the purpose of the prohibition provisions.

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<sup>6</sup> UK Company Law Review Steering Group, *Modern Company Law: Completing the Structure* (November 2000), paragraphs 13.4 and 13.36.

### Proposal

14. We consider there is a need to plug any loophole in the case of payments via other parties by extending the loss of office payment provisions to include:
  - (a) payment to an entity connected with a director or past director of a company or of its holding company (**Clause 11.32(3)**);
  - (b) payment by a company to a director of its holding company (**Clause 11.37(2)**).
15. Section 163A of the CO only applies to situations where a payment for loss of office is made to a company's director or past director in connection with a transfer of a company's undertaking or property. **Clause 11.38(2)** extends the provisions to include a transfer of the undertaking or property of the company's subsidiary.
16. Section 163B of the CO only applies to a payment for loss of office made to a company's director or past director in connection with certain types of transfers of shares as provided in section 163B(1). By virtue of **Clause 11.32(1)** (definition of "takeover offer" for Division 3)<sup>7</sup> and **Clause 11.39(1)**, the prohibitions in connection with a share transfer are extended to include all transfers of shares in a company or in its subsidiary resulting from a takeover offer.
- (e) **Requiring members' approval for a director's employment exceeding 3 years and requiring a company to keep directors' service contracts available for members' inspection**

### Background

17. At present, there is no provision in the CO requiring members' approval for long-term employment of a director or requiring a company to keep directors' service contracts available for members' inspection. There is a risk that directors may arrange for themselves long-term employment with their companies which entrenches them in office or makes it too expensive for the company to remove them from office before their contract expires (as the director might be entitled to damages for the company's breach of

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<sup>7</sup> "Takeover offer" means a takeover offer within the meaning of Part 13 of the Companies Bill, draft clauses of which will be released for consultation in the second phase consultation for the Companies Bill.

contract arising from the early termination). Also there is a lack of transparency in relation to directors' service contracts.

### Proposal

18. **Clause 11.50** requires the approval of the members of a company and / or of its holding company for any contracts under which the guaranteed term of employment of a director with the company, or of employment of its holding company's director within the group, exceeds or may exceed 3 years.
19. **Clauses 11.52 and 11.53** require a company to keep available directors' service contracts, or a written memorandum of terms of any such contract if the contract is not in writing, for members' inspection and copying. Non-compliance with these provisions will be an offence. The company and every responsible person will be liable to a fine.

### **(f) Requiring members' approval for substantial property transactions**

#### Background

20. There is currently no specific provision in the CO which requires members' approval for a company to enter into a transaction for the purchase of a major asset from a director or the sale of such an asset to a director. In the UK, provisions requiring members' approval were introduced by the Companies Act 1980 in response to reports of fraudulent asset stripping by directors. The SCCLR has recommended the enactment of provisions based on the relevant sections in the UK.<sup>8</sup>

#### Proposal

21. **Clause 11.59** provides that a company shall not enter into arrangements where it acquires a substantial non-cash asset from or sells such an asset to a director of the company or of its holding company or a person connected with such directors, unless with the approval of the members of the company and / or of its holding company. However, the arrangement may be entered into by the company conditional on such approval being obtained.

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<sup>8</sup> Sections 190 to 196 of the UKCA 2006 (formerly under sections 320 to 322 of the UK Companies Act 1985). See SCCLR, *Annual Report 2003 / 2004*, pages 14 to 16.

The company is not subject to any liability by reason of a failure to obtain the members' approval for the conditional arrangement.

22. Non-cash asset is defined in **Clause 11.55** to mean any property other than cash and any reference to an acquisition of a non-cash asset includes the creation or extinction of an estate or interest in, or a right over, any property and also the discharge of a liability of any person, other than a liability for a liquidated sum.
  23. **Clause 11.56** sets out the thresholds for triggering the operation of the substantial property transaction provisions. For a private company or a company limited by guarantee, the value of a non-cash asset is substantial if it exceeds 10% of the company's asset value and is over \$100,000, or exceeds \$1,500,000. For a public company, the value is substantial if it exceeds 10% of the company's asset value and is over \$750,000, or exceeds \$10,000,000.
- (g) **Requiring disinterested members' approval in the case of public companies**

Background

24. Currently, except for some specified transactions<sup>9</sup>, there is no provision in the CO restricting members' rights to vote or requiring members to abstain from voting in relation to transactions in which they have an interest. For listed companies, the Listing Rules provide generally that, when a transaction or arrangement of an issuer is subject to shareholders' approval under the provisions of the Listing Rules, any shareholder that has a material interest in the transaction or arrangement shall abstain from voting on the resolution approving the transaction or arrangement at the general meeting.<sup>10</sup>
25. The SCCLR has recommended disinterested members' voting for connected transactions to ensure procedural fairness. The recommendation does not apply to private companies.<sup>11</sup>

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<sup>9</sup> Sections 49BA(1)(c) and (5), 49D(4) and (6), 49E(2) and (3), 49F(2) and (3), 49L(2) (purchase or redemption of the company's own shares) and 163D(4)(c) (payment to director for loss of office or retirement) of the CO.

<sup>10</sup> The chapters of the Listing Rules which deal with notifiable transactions and connected transactions impose additional requirements relating to abstention from voting by interested persons at a general meeting.

<sup>11</sup> SCCLR, *Annual Report 2003 / 2004*, pages 14, 15, 25 and 26.

## Proposal

26. **Various clauses in Divisions 2 to 5**, which set out the requirements for members' approval for the four types of prohibited transactions covered by Part 11<sup>12</sup>, have incorporated the disinterested members' voting requirement for public companies.<sup>13</sup> The clauses provide that if the company concerned is a public company, the resolution of such a company is passed only if every vote in favour of the resolution by the interested members is disregarded.
27. Whose voting right shall be restricted will depend on which type of prohibited transaction is in issue. In general, the members whose right may be restricted include the following categories of person :
- (a) the relevant director;
  - (b) the relevant connected entity;
  - (c) the recipient of the payment for loss of office, if he is not the relevant director;
  - (d) a person who makes the takeover offer and his associates, where a payment for loss of office is made in connection with a share transfer;
  - (e) in the case of a resolution for affirming a transaction that contravenes Part 11 (where the company elects to adopt the transaction despite the contravention), any other directors of the company who authorised the contravening transaction;
  - (f) any person who holds any shares in the company concerned in trust for the above categories of person.

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<sup>12</sup> The types of transactions are (a) loans, quasi-loans and credit transactions; (b) payment for loss of office; (c) directors' service contracts; and (d) substantial property transactions.

<sup>13</sup> Clauses 11.11(2) and (5); 11.31(1) and (4); 11.34(2), (4) and (5); 11.48(2) and (4); 11.57(2) and (5); and 11.62(1) and (4) of the CB.

(h) **Widening the ambit of disclosure currently under section 162 of the CO**

Background

28. Section 162 of the CO requires a director, who has a material interest, directly or indirectly, in a contract or proposed contract with the company, to disclose to the board of directors the nature of such interest at the earliest meeting of directors that is practicable. We are of the view that the current application of the section is relatively narrow and there is a need to widen the ambit.

Proposal

29. **Division 6 (Clauses 11.63 to 11.67)** restates the provisions of section 162 of the CO which are modified to be in line with those of other common law jurisdictions such as the UK and Australia,<sup>14</sup> and to widen the ambit of the section as follows:
- (a) the ambit of disclosure is widened to cover “transactions” and “arrangements” instead of just “contracts” (**Clause 11.63(1) and (2)**);
  - (b) for a public company, the ambit of disclosure is widened to include disclosure by a director of any material interest of entities connected with him (**Clause 11.63(2)**);<sup>1</sup>
  - (c) a director is required to disclose the “nature and extent” of his interest instead of just disclosing the “nature” of his interest (**Clause 11.63(1) and (2)**);
  - (d) the disclosure requirements are extended to shadow directors (**Clause 11.66**).

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<sup>14</sup> SCCLR, *Corporate Governance Review by the Standing Committee on Company Law Reform – A Consultation Paper on Proposals made in Phase I of the Review* (July 2001), paragraph 7.11.

<sup>15</sup> Clause 11.63(5)(a) contains an exception providing that a director is not required to declare an interest if he is not aware of the interest or the transaction in question.