Cliffnotes | Business Associations 2005

Contents

Partnership

Steps in Analyzing a Partnership Case

1. **Look at the Legislation**

   The express provisions in the Partnership Ordinance are the first place to look – *Cameron v Murdoch* [1986].

2. **Identify potential partnerships in the case**

   Such a relationship is described in s3 as: "the carrying on of a business in common with a view of profit" by 2 or more (corporate) persons. This can be referred to as a partnerships agreement where agreement is express or inferred from conduct.

   - Elements: business, in common, view of profit.
   - A business can be the setting up of a business before actual trading as in *Miah v Khan* [2000 HoL] where it was held that any commercial activity that could be undertaken by an individual could be undertaken by a partnership too. The context was embarking on a venture on which they have agreed (the restaurant). The date of the agreement to enter business cannot be the date a partnership commences and the date when the business actually starts business are both inconclusive.

   S4 gives further details as to what is probably not a partnership.

   - Joint tenancy or co-ownership of a profit-generating object is not partnership - *French v Styring* [1857]:

     > "It in truth amounts to no more than a contract between two tenants in common, whereby the one agrees, in consideration of certain things to be done by the other, to abstain from exercising his rights in respect of the chattel held by them in common. It is no more a partnership than if two tenants in common of a house agreed that one of them should have the general management, and provide funds for necessary repairs, so as to render the house fit for the habitation of a tenant, and that the net rent should be divided between them equally".

   - Sharing of gross returns (as opposed to gross profits) is not enough;
   - Sharing gross profits is prima facie evidence – *Cox v Hickman* [1860]; but without further proof:

     A debtor getting back his loan is not a partner;

     A contract for the remuneration of a servant by a share of the profits is not adequate;

     The dependant of a deceased partner receiving a portion of the profits is not adequate;

   A person can be a partner although he does not, and is not allowed to, take part in management – *Pooley v Driver* [1877]. The dormant partner does not even need to contribute any capital – ibid. A "salaried partner" may, depending on the circumstances, be either a partner or an employee – *Stekel v Ellice* [1973].

   In every case the court must look at the substance of the relationship between the parties and not the mere label attached to the relationship in order to ascertain whether the person is a partner (*Pooley* and *Stekel*) or a lender (as was in *Mollwo, March & Co. v Court of Wards* [1872]) or an employee (as in *Walker v Hirsch* [1884]). Ultimately, the question is: "are you carrying on business together with your partners?" or, where an alleged partner is a dormant partner, "are the partners carrying on business also on your behalf?"

There is no single test and there is no advantage to restrict the circumstances which raise a partnership. The test of involvement is not conclusive –see, e.g., dormant partners. The receipt of share of profits criterion is also not conclusive because it would discourage investors to rescue companies by taking a variable interest by reference to profit levels.

3. **Dealing with suspicious relationships**

- A **Salaried Partner** receives a salary as remuneration and is held out to the world as being a partner with his name on notepaper, etc.
  In *Kao Lee & Yip v Edwards* [1993 CA], the defendant did not take part in the management nor engage the credit of his firm. He did not have to contribute to the capital and was not entitled to a share of the profits. The litigation concerned the applicability of a restrictive covenant. The judge here distinguished an applied restrictive covenant in *Bridge v Deacons* on the basis that in this case, the defendant as a salaried partner had no equal bargaining power and there was no mutuality between the parties regarding the restrictive covenant. Mutuality would exist when the restrictive covenant bound all parties because an early senior-retiring partner could undermine the business of a new partner by taking his clients with him. It is not so in this case.
  In *Kao Lee & Yip v Koo* [1994 CA], the term 'equity partner' was material to decide whether a restrictive covenant should be applied. The equity partner's terms were greatly subordinate to the founding partners and so, not only was there no mutuality, the restrictive covenants were for the benefit of the founding partners only.
- Individuals who **hold themselves out** as partners may be liable to those who, upon reliance of such, give credit to the firm. According to s16, holding out applies to people who represent themselves or knowingly let themselves be represented as a partner.
- **Retiring partners** are also a problem. By virtue of s19, retiring partners may still be liable for pre-retirement debts. He may be discharged, however, when there is some agreement between himself and the newly constituted firm and the creditors or the course of dealing between the new firm and the creditors infers agreement. According to s38, all apparent members of the old firm will be treated as still being members of the firm by the creditor until he has notice of the change. Notice posted on the Gazette will only be notice to those who had no previous dealings with the firm.
  New partners do not automatically become liable for pre-joining debts.
- Check the legislation for other possible provisions for retirement, contract duties, continuation and so on.

High Court Rules Order 81 allows actions to be pursued in the name of the firm for convenience.

Partnership Property:

If the partners originally co-owned land and purchased new land to be used for like purpose, that new land will belong to them as co-owners as well.

Whether any piece of property is partnership property is a matter of fact. Where there is no express provision, the courts will only determine it as partnership property to give business efficacy that which has happened – *Miles v Clarke* [1953]. In that case, business efficacy did not require that the shop be partnership property. Instead, the consumable goods were deemed partnership property as they were shared and indistinguishable.

Liability of Partners:

S7: Partners are agents for each other and their actions, in the usual course of business, bind the firm unless:

The 3rd party knows he has no authority; *or*
Does not know or believe him to be a partner.

Also see *Mercantile Credit v Garrod* where it was found that the plaintiff did not know that the dealer had no authority (cannot trade cars) and he knew him as a partner. The issue was whether the transaction was within the usual course of business. It was HELD that it was to be determined from the facts (in this case, car trading was in a garage's usual nature. The conduct of the people involved and past conduct will also be scrutinized). Objective standard – would a reasonable man not told of any authority issue raise an enquiry for the business?

See also s10 where firm may not be bound by the acts of the partner if the third party has knowledge of this agreement.

Note that the 3rd party does not need to know anyone else in the firm to have them be made liable for his immediate contact's debts.

S10: Is a more specific form of s7 relating to *internal agreements.*

S16: A partner may hold himself out when he represents himself or knowingly lets himself be represented as a partner of the firm; and that representation is relied upon by the creditor.
Carelessness is not sufficient to make the non-partner liable. He must know of the false representation – *Tower Cabinet v Ingram* [1949]. In that case, notepaper with the ex-partner's name was used in a transaction conflicting with an agreement that the partnership should notify others that the ex was no longer interested in the firm. He was 'shown to the world' with neither authorization or knowledge – he was not 'held out'.

Mere appearance of a person's name in the Registry does not amount to holding out – *Bishop v Tudor Estates* [1952].

Be careful of switching notepaper in a case, because when old notepaper is used, names of new members are not represented to the 3rd party.

A person not 'held out' as such may nonetheless be an apparent member in the eyes of a third party. TREAT s16 and s38 SEPARATELY.

S38: Where a person deals with a firm after a change in its makeup, he his entitled to treat all apparent members of the old firm (apparent to him) as still being members until he has notice. Members can be 'apparent' from the slightest hint: a sign, notepaper, indirect information, etc. – *Tower Cabinet v Ingram*.
Notice by Gazette is notice only to those without prior dealings with the firm.
Retirement of a person not known by the plaintiff to be an 'apparent' member of the firm restricts his liability for the relevant partnership debts after retirement.

S12: The entire partnership is liable for any tort committed by a partner in the usual course of business or with the authority of his co-partners where damage is caused to someone outside the firm.

Company Personality

Companies are liable for all its debts. Its shareholders/members, however, are only liable to the extent of their capital contribution.

Why is this so? The bigger a company is, the harder it is to manage a company if all are given equal management rights. Investment and financing is encouraged and risks are reduced.

Cite *Salomon v Salomon* [1897 HoL] for the principle that a company is a **legal entity separate** from its members. Creditors have full notice that they are dealing with a limited liability company (it follows that creditors reasonably without notice are not bound). Anything that purports to say a company under the sole control of one man is not a separate creature in law is misleading. This will hold unless there is fraud, misrepresentation, deceit, express agency or trust.

Cite *Macaura v Northern Assurance* [1925 HoL] for the proposition that **companies can hold property**. This was a case where it was said that a company, having brought out insurance to cover another company's property, had no legal, nor equitable insurable interest in that property since destroyed (without additional arrangements) since the property belonged to that other company.

Cite *Foss v Harbottle* [1843] for the proposition that a company shall bring legal proceedings in its own name. No other 'person' can be the **proper plaintiff**.

As a separate entity, a **company can hire employees and enter into contracts**. In *Lee v Lee Ltd.* [1960 PC], it was held that an employee contract is not vitiated because he himself was an agent of the company in the negotiation and creation of the contract as managing director. It was thus possible for Lee to contract with the company as they were separate entities.

Lifting the Corporate Veil

This term is specifically used when the courts decide that the offending company is not a separate legal entity using the exceptions noted in *Salomon v A Salomon & Co. Ltd*. The loose term is when the courts place liability on the member behind the company whilst recognizing the existence of separate legal entities (both may be charged).

Lifting by Common Law

Lifting the corporate veil by common law is some form of equitable remedy ??? and is not generally used. Even if an individual is in sole control of a company, the veil will not be lifted – Salomon. CF *Liu Sow Keng* where the directors (and the transferee of the business) were charged with joint and several liability. This was because in *Liu Sow Keng*, the directors had received dividends from the transferor company and the transferee company had ceased trading. The *Salomon exceptions* include: misrepresentation, fraud, and deceit of a third party.

On Running a Business in a Locality

Cite *Re FG (Films) Ltd.* [1953] for a weak argument on agency or sham. Agency is very unlikely because there is no common law presumption that a company acts as agent for its members and agency cannot be inferred from control. The mostly American company tried to register a film as British. It could be argued that the American film company was trying to escape the existing obligation to have the film made by UK people in general. A giant façade in general on the specific facts.

See also *Re Brauch* [1978 CA UK] where it was held that in order to establish that the debtor had 'carried on business in England', within s4(1) of the English Bankruptcy Act 1914 (a bankruptcy jurisdiction now repealed), it was **not sufficient to show that he had been running his company's business in England, even if he was the sole beneficial shareholder and in complete control** (complete control was also seen in *Salomon v Salomon*). Rather, the court needs to find that he had been **carrying on personal capacity a business of his own** in England independently of that of the companies (albeit his *modus operendi* involved the use of the companies as vehicles for achieving his business objectives). This was found since he was personally in the business of promoting companies (setting up companies), finding suitable sites for development and financing his purchases; he then caused the properties to be vested in companies – per Lord Goff.

Agency

Agency is rarely successful as an argument for lifting the veil. Agency is not generally presumed and mutual intention is a core element that is established as a matter of facts. Where a company is formed to carry some form of businesses, it is usually not the case that its controllers intend it to be an agent for their actions.

In *Yukong Line v Rendsburg* [1997], Toulson J acutely provides: either express or implied consent between the agent and the principle is necessary. Ordinarily, the intention of someone conducting trade through the vehicle of a one-man company is quite the opposite.

On Perpetuating a Continuing Breach of Contract

Cite *Gilford Motor Co. v Horne* [1933 CA] for the proposition that **escaping an obligation**, or **perpetuating a continuing breach of contract** through the use of a company will not be tolerated by the courts. The defendant had covenanted not to solicit the plaintiff's customers. He formed a company to do so. The veil was lifted as the company was a façade. In this case, both director and company were charged with legal liability and it can be seen that the concept of separate legal entities was not dismissed.

In *Jones v Lipman*, Lipman entered into contract to sell his house to the plaintiff. Lipman then tried to avoid the sale by transferring the property to a company he formed and also controlled. Specific performance was ordered against both the company and Lipman (realizing the separate nature of the company).

Similar is *HKSAR v Leung Yat Ming* [1999], where the defendant covenanted not to use housing subsidiaries to pay for property-purchases. He formed a company to buy the property and rented the property from it, effectively paying the company's purchase through his housing subsidiaries. The courts held that the company was a sham and lifted the veil.

On Legislative Intent and Evasion/Avoidance

Cite *China Ocean Shipping Co. v Mitrans Shipping Co. Ltd.* [1995 CA] in revolt of the single economic entity argument propounded by Lord Denning in *DHN Food Distributors*. We are concerned with the law, not economics – *Adams v Cape Industries* [1990 CA] and *Bank of Tokyo Ltd v Karoon* [1986]. The courts do not lift the veil just because a corporate structure has been used to reduce risk/potential liability as it is actually the intention of the law that this can be done.

There had been **no evasion of liability** in this case. The plaintiffs chose to deal with a limited company without guarantee. The defendant company did not have any original liability to evade. It is the entire aim of the legislation that people can reduce their risks and invest more in commercial interests. The law operates to **preserve legal obligations** and none had arisen here.

Also relevant is *Bakri Bunker Co. Ltd. v The Neptune* [1986 HC]. Here, the courts held that a system to limit liability is acceptable by law. Here also, the plaintiff had no liability before the offending contract, hence with the 'system' already in place, he was not escaping liability as opposed to having merely limited potential liability.

On Justice

Justice in itself is a necessary yet APPARENTLY NOT sufficient factor to lift the corporate veil. *Creasey v Benchwood Motors* [1993] has often been misunderstood to say that the exercise to lift the veil is to achieve justice. As stated by Nazareth VP in *China Ocean Shipping*, *Creasey* should be interpreted to mean that the exercise is one that can achieve justice, but if misused, could cause injustice. The principles of *Salomon* hold in each and every case unless the courts can somehow fit the facts to the exceptions noted above.

On Economic Realities (Holding Companies and Subsidiaries)

In *Smith, Stone and Knight* [1939], Atkinson J tried to formulate rules for establishing agency in the case (or more specifically, on the particular facts).

(1) Were the profits treated as those of the parent company?
(2) Were the persons conducting the business appointed by the parent?
(3) Was the parent the head and brain of the trading venture?
(4) Did the parent govern the adventure and decide on capital issues?
(5) Were profits made by the parents skill and direction?
(6) Was the parent in constant control?

Atkinson obviously looked heavily to control, but what if *Salomon* were decided on these principles, surely it would have been decided differently, see: *Yukong Line*. This decision must be constrained to particular facts, namely: the newly acquired business must be run in exactly the same way; profits should be treated as profits of the parent; subsidiary operating on behalf of the parent?

Contrary to looking at veil-lifting factors expounded by *Salomon*, one can look at *DHN Food Distributors Ltd.* [1976]. The liberal Law Lord, Denning, shocked the world by applying 'economic realities' to the situation, saying that the group was virtually a partnership. A group of companies would thus be treated together for the purpose of its general accounts, balance sheet, and profit and loss account. There is evidence that in this case a dollar loss to PII would result in a dollar loss to the balance sheet or profit of PIH i.e. its holding company.

This was rejected (not expressly overruled, but nonetheless severely doubted) by the higher court in *Woolfson v Strathclyde RC* [1978 HoL]. Subsequently, no case has ever tried to resurrect this rule – *Adams v Cape Industries*, affirmed by *China Ocean Shipping*.

Lifting by Statute

Lifting by statute can be technically said not to be disregarding the company as a separate identity but more to direct liability to a person or group despite recognizing the company is a separate entity.

S93(5): If any person of a company: uses a fake seal where the company's name is not properly engraven; issues any business letter, publication or credit papers where the name is not properly mentioned; or issues any invoice where the company name is not properly mentioned – that person shall be liable to the extent of the improper use of the name.

The rationale is based on the presumption that limited companies should only be protected if their creditors have knowledge of the nature of business they are dealing with. If the company business is falsified, there is no way for the creditor to really know the risk he is taking.

S344A(6): If a dormant company trades, all shareholders and directors shall be personally liable for debts arising from that transaction.

Since a dormant company is exempt from certain reporting obligations, it is unfair for a dormant company to trade. Creditors are not as well informed as they should be under HK company law. This is a strict liability offence.

S275(1): If the business of the company had been carried out with the intent to defraud its creditors or for any fraudulent purpose; and the company in the course of winding up, the court may, if it thinks proper to do so, declare the knowing parties to be personally liable for debts as the company may direct.

Fraud requires intent/dishonesty to be proved. That is a difficult standard. Actual dishonesty involving notions of fair trading among commercial men amounting to real moral blame – *Re Patrick Lyon Ltd.* and *R v Grantham* [1984]. Fraud, according to Peter Gibson, J in *Baden, Delvaux and Lecuit v SG* [1983], involves: actual knowledge; willfully shutting one's eyes to the obvious; willfully or recklessly failing to make inquiries that an honest and reasonable man would make; or knowledge of the circumstances which would indicate the facts to an honest and reasonable man or put him on inquiry.

Lack of commercial judgment or gross negligence will not suffice.

Because of this difficulty, proposals to make directors liable for insolvent trading have been made.

Company Constitution

Companies must have this – s4, 9, 11, Companies Ordinance.

S23(1) states that it is a contract under seal between the company and each member and each member and each other member. Under s23(1A), the memorandum once registered is enforceable by the company against members and by members against the company and each other member.

Memorandum of Association

The contents of the memo are stipulated in s5.

Name (with limitations)
Registered office address in Hong Kong
Objects clauses ← -- -- --
Capital clause
Liability clause

Name

The company's name is its main identity and under s20-22C, the name cannot be too similar to existing names, statutory bodies, offensive, etc.

The name cannot be misleading so in *The Association of Certified Public Accountants of British v Secretary of State of Trade and Industry* [1997], the offending name implied CPA whereas no one inside it was actually certified. It was therefore misleading and they had to change names.

Pre 1997 Ultra Vires Doctrine

Any act ultra vires the company's memo is void. Contracts entered into not consistent with the objects in the memo would be unenforceable.

All pre-1997 companies were mandated to put their objects onto the memorandum. Now, non-charity, etc. companies may decide not to do so.

This obsolete requirement was thought to protect investors by setting out the business nature, hence risks of the business. Contracts entered into ultra vires its memo cannot be ratified nor approved by a General Meeting. Third parties would not be able to enforce these contracts since they were taken to have constructive notice of the objects in the memo. The memo thus restricted the power of the company to act in various ways.

Ashbury Railway Carriage and Iron Co. Ltd. v Riche [1875 HoL]: the objects of the company stated that it would build railway carriages but it entered into a contract to purchase concessions to purchase railways. That contract was deemed void by the court and was thus unenforceable.

Consequently, memo drafters began to draft object clauses more widely, encompassing many forms of business transactions, but they could not cover them all.

Re Introductions

Re Introductions [1970 CA]: the company borrowed money for pig breeding. Its objects stated the business nature was tourism, but inter alia, borrowing money. The objects stated each object was to be read independently. The company went bankrupt and the bank sought to enforce the contract, relying on the clause.

> HELD: The CA read the object to borrow money as a power and that power was used for ultra vires business, therefore since the bank actually knew of the purpose, the contract was ultra vires and unenforceable.
>
> > QUALIFIED by *Rolled Steel*: the bank knew that the borrowed moneys were to be used outside the objects. Thus they knew that the borrowing was an abuse of powers. With this knowledge, the borrowing cannot be enforceable.

Conclusion

TEST: Related to object clause (not mere powers)?

Transaction done in good faith?

Transaction in best interests of company?

Differentiating Powers and Objects

Differentiating them is essential because powers written in the objects clause are just express powers supplementing powers which are implied to allow the company to attain its various objects. As a rule (*Rolled Steel*), powers cannot exist on their own and only serve to support other objects in the clause. The first 1-3 paragraphs are to be treated as the main clauses – *Anglo-Overseas Agencies Ltd*.

Rolled Steel

Rolled Steel Products Ltd. v British Steel Coroporation [1986 CA]: the company memorandum stated that it could give guarantees and grant security as the directors deemed expedient for the furtherance of the company's objects.

R granted security for S's obligations to B over its property for a director's benefit and all R and B shareholders knew of this. When R failed to make payment, B sued it. R brought an action on the grounds that the guarantee was ultra vires.

The trial judge held that since B knew that the transactions were not to the benefit of R, the guarantee was unenforceable.

> HELD: The CA held that the transaction was not ultra vires and should be enforceable though it was not enforced on other grounds. The court likened the situation to trustees who conveyed property in breach of trust. If the transaction falls within the powers of the company, the transaction is not void if the trustees had merely abused their power. Aside from an injunction, the members' remedy

lies against those who have wrongly caused the company to abuse the company's powers. If the transferee had notice of the abuse of power, he could be taken as a constructive trustee.

→ The power to give guarantees was not exercised to further the objects of the company. That power was not ultra vires the company, but since its exercise was an abuse of power, and the 3rd party had notice of that, the guarantee was unenforceable.

The critical distinction is between acts done in excess of powers (notice comes into play) and excess of capacity (wholly void). Shareholders may choose to ratify an abuse of power but may not ratify an act outside the capacity of the company.

Ultra vires acts therefore only cover acts done without capacity. Things it cannot do as opposed to things it shouldn't do.

Step 1: determining the objects of the company (as opposed to powers). Not all objects mentioned may be objects and some may be powers on their true construction. Even separate object clauses may not elevate power clauses into true objects. An ultra vires act is void and consequently, it is irrelevant whether any third party had notice.

Conclusion

A business object has many powers. If a power is abused (not done according to the objects) and the third party knows of this, that transaction will be void. If the proposed abuse of power is discovered by shareholders quickly, they will be able to restrain it. If they discover it later, their action lies against the abusers of powers.

Use this in conjunction with *Re Introductions*.

Powers in the 7th Schedule must be taken into account in Hong Kong. These are specific powers and will be construed as such if they are presented in the object clauses of a company.

Object Clauses post 1997

S5A: Companies may do anything permitted by law.

S5B: Companies that state their objects shall abide by them although acts done in contravention are not invalid. Members may bring proceedings to restrain the doing of the act.

S5C: Constructive notice of articles or memorandum no longer applies. Actual notice, however, of abuses of power or acts against company objects does apply.

Articles of Association - Enforcement

Articles may be registered by companies limited by shares, and shall be registered by companies limited by guarantee or unlimited – s9.

Table A is adopted if articles are not registered or if register, insofar as they do not modify or exclude Table A provisions. In *Grant Trade Development Ltd. v Bonance International Ltd.*, it was held that exclusions shall only be valid where stated clearly.

Remember that s23 has the articles bind the company and its members; constituting a binding contract between the shareholders and the company as well as between each individual member – *Wood v Odessa Waterworks Co*.

Therefore when the articles state that dividends will be paid in cash, members may seek an injunction to prevent the company from passing out bonds. Similarly when the articles contain an arbitration clause, frustrated members are bound to seek redress through arbitration should they seek to institute some action against the company – *Ng v HK Football Association* [1994].

By alteration, the terms of the contract may be changed against the wishes of a minority member.

Traditionally, the type of right enforceable by members are rights by way of their capacity as members as opposed to rights in the capacity of a director, auditor, employee… outsider rights.

Hickman v Kent [1915]: A right given by an article to a person may not be enforced against the company if that right is not in the capacity of a member (e.g. as solicitor, director, promoter).

A member cannot enforce an outsider right.

Eley v Positive Government SLA [1876]:

Eley included a clause in the AA stating that he was to be the company's lawyer. He brought an action against the company when it did not hire him.

> HELD: Although at the time of the action, Eley was a shareholder, he was enforcing outsider rights. Action dismissed.

Beattie v E&F Beattie Ltd. [1938 CA] defendant v plaintiff

The plaintiff member brought an action against the defendant member/director, Beattie, in the name of the company for breach of duty. The defendant relied on the articles for the action to be referred to arbitration.

> HELD: The dispute involved the company and the director in his capacity as such (not as a member). The director tried to rely on the arbitration clause, consequently, in his capacity as director. He was not relying on it to enforce a right common to himself and other members.
>
> > COMMENT: Had he tried to enforce that right in his capacity as shareholder, the result may have been different. See *Salmon v Quin* [1909] where the managing directors sought out their rights to veto company acts as members and not as outsiders even if indirectly, outsider rights were enforced as well.

Rayfield v Hands [1960]

The Articles stated that any member intending to transfer shares shall inform the directors who will take them equally and at fair value. The plaintiff wished to transfer his shares but the directors refused to take them.

It was said that the relationship was between the plaintiff member and the directors as members.

Relying on the case of *Re Leicester Country Club*, Vaisey J said that directors cannot divest themselves of their character as members of the company.

Where the AA terms are embodied into a separate express or implied contract, rights which may originally have been determined as outsider rights may be enforced – *Re New British Iron Co*.

More contentiously, Wedderburn's article tha: "a member can compel the company not to depart from the contract with him under the articles, even if it means indirectly enforcing outsider rights vested in either third parties or himself, if he sues qua member and not qua outsider," has been supported in *Ram Kissendas v Satya Charan Law* [1949 PC].

In that case, the ratio did not go further than to say if an outsider is given rights, which under the article can only be taken away by special procedure (2/3 majority special resolution), the company, at the suit of a shareholder will be prevented from acting in breach of the special procedure.

Membership in a Company

Membership provides the legal basis to exercise important rights and obligations, e.g. notices, dividends, voting, appointing directors, etc.

Members can be corporate (subsidiary relationships) or natural persons. Companies must have > 2 members, or, if they are 1-member companies, after 2003 amendments, section 4 CO was amended and companies may have 1 member.

Becoming a Member

Section 28 defines a member as a person who:

1) agrees to become a member; and
2) whose name is entered into the Member Register, see: *Max Share Ltd*.

There are 4 ways to become a member:

S28(1): Subscribers to the memorandum are deemed to have agreed to become members and their registration will be entered into the Member Register.

S28(2): Other persons who later agree to become members and whose name is entered into the Register will become members.

S65: Transferees of shares need to be registered by the directors of the company. Transfers may be in breach of preemption clauses – *Hurst v Crampton Bros Ltd* (below).

. The personal representative or estate may become a member through transmission on the member's death.

In practice, s28(1) mainly deals with the formation of a private company or original promoters of public companies. These people must work closely to establish the company. S28(2) deals with allotment (share issues) by the company, where the company seeks to increase share capital through selling more shares. Whoever agrees to buy those shares will become members of the company.

The Member Register

The register is official and is prima facie evidence of any matters under the ordinance – s96, 102 and *Re NBA Football Club Ltd*. (below). Registration confers legal title to the person whose name is registered – *Max Share Ltd*.

Share Certificates

A share certificate is given supplementing and proving a member's title to shares – s70(1) and s71.

Restrictions on Share Transfer

Preemption Clauses

Shares are private property and can thus are freely transferable. S65 provides that shares are transferable subject to AA. Public companies are not too much of a concern. However, s29(1) limits membership of private companies to 50.

Private companies therefore, should have restrictions regarding the transfer of shares. The intention is to facilitate closed ownership. Most private companies mandate that shares must first be offered at reasonable value to any existing member – **preemption clause**. Any member desiring to transfer shares shall give notice to all other members. This way, shares are kept closely held. Violations see s23, directors of the company have absolute discretion to refuse the transfer by not registering the transferee's name.

Hurst v Crampton [2002]: a shareholder executed a share transfer in Oct 1998 by transferring 400 shares to his nephew. His transfer was notified to the nephew and the shareholder died. The issue was: "who should own the 400 shares?". A shareholder who owned just 1 share of the company filed a lawsuit and said that the transfer should be void as it violated the AA preemption clause.
The executor argued that the clause shouldn't apply as there was no transfer and only transmission (equitable transmission of equitable interest). The trial judge agreed.

> HELD: The CA allowed the appeal: the deceased was in breach and the transfer was voidable because of the violation of the clause. There is no business meaning to read 'transferred' as 'registered'. In business, signing a contract means a transfer and entitled other members to take action to stop it. Procedurally, the process of becoming a member is not completed until an entry is made to the Register. The law maintains great importance to the maintenance of the Companies Register – S95. The register is prima facie evidence of any matter.
>
> > CONCLUSION: a transmission does not arise out of the mere fact of death if the shares were indeed actually transferred to a party before death.

NBA Football Club Ltd.

The aggrieved member thought he owned 2000 shares of the company. 1000 issued by the company and 1000 sold by a 3rd party. In fact, the meeting had a procedural defect and the resolution to issue new shares was actually invalid. This lead to the issue of shares being invalid. However, his name was still entered into the Register.

> HELD: On his petition, the CA held that he was a member by virtue of being in the Register. He bought shares – equity. The company should be responsible for the Register. Furthermore, there was a long delay in which the company failed to take any action; it was estopped from denying his ownership.

Max Share Ltd.: A company had 2 shareholders. A company majority holder and Ng the minority shareholder. Ng became bankrupt and his creditor Choy obtained his shares from a public auction. The directors tried to evict the minority by refusing to register Choy. Indeed, the directors do have the discretionary power. The debtor filed a petition for winding up the company under s168A – since the company's affairs were managed in such a biased manner, they could wind up the company. The majority petitioned to strike out the claim on the ground that neither Ng nor Choy had any standing – Choy's name had not been registered and Ng was bankrupt and his shares no longer 'belonged' to him – he held his shares for somebody else.

HELD (CA, CFA): Choy had indeed no standing, but Ng was still a member and entitled to file the petition. The CFA affirmed this. CJ restated s28 requirements. The unanimous court held that Ng's rights as a member remained intact, including the protection of his shares and holding in trust for Choy. By registration, a person gets legal title of his shares.

Register Rectification

The court has the discretion to remove or add names to the Register. It is an equitable remedy – s100(1)

Re Sussex Bridge Co.:

Plaintiff purchased shares and asked company to put his name on the Register. By mistake, his name was not entered. Later, the company was liquidated for reorganization, requiring members' approval. P sent in his disagreement, which the liquidator disregarded, as his name was not on the Register. P petitioned and the court held that the Register would be rectified.

Re Data Express [1987]:

The company stored the Register in a computer file, which was subsequently lost. The court had to treat the company with an erroneous Register. The court authorized the company to reenter all the shareholders into the Register.

Re HKC Gas Co. [1999]:

Some shares were under the name of D. D deposited the shares with P, a securities firm. The shares were stolen by T. P settled with D. P petitioned to the court asking if the shares were discovered later, who should be the owner? Future rectification of the Register was allowed in that case – D, would of course, have to repay monies through settlement.

Share Certificates

S70(1) CO requires companies limited by shares to complete and have ready for delivery, share certificates with the company's seal, within 2 months of the transfer.

The certificate serves as prima facie evidence of the holder's title. Failure to comply is an offence subject to legal liability. A share certificate enables the company to ascertain the identity of its members and allows it to register the transfer or transmission.

Share certificates issued to individual shareholders are different from the Register, which is an official record kept in the company. Register is a contractual relationship between member and company. The certificate is an information document. Final determination of rights and obligations depends on the Register.

S102: certificates serve as prima facie evidence for matters on it. Therefore, the company has legal duty to issue a correct version of it – it may be liable for any loss arising from that document's errors. A member may go to the court to force it to issue a certificate – s70(2).

The company is responsible for any loss arising from any error on the certificate so it may be estopped from saying what it stated was not right.

Burkinshaw v Nicholls:

A party was estopped from calling on the shares of another because he had a certificate that certified he had paid for the shares in full (in fact, he had not).

Re San Francisco Rail Co.:

B – A – C

B purchased shares from A, who in turn provided his certificate to B. B was registered as a new member. Later it was found that A was not the true owner, having stolen the shares from C by forging a transfer and sending in a stolen share certificate. The company, without negligence or fraud, issued a certificate to A.

The transfer should be void since C was still the lawful owner.

> HELD: C's name should be restored as he was the rightful owner of the shares. B's title was not better. Although B had rights against A, the company had to compensate B for removing his name from the Register. The company was liable to compensate B for the value of the shares at the time of B's removal.

Forged certificates, however, should not bind the company – *Ruben v Great Fingall*.

Capacity

The relationship between a company and a member is contractual. As such, shareholders under 18 hold a voidable contract – which are binding on the infant unless he repudiates the contract before reaching 18 years of age. Whilst an infant may avoid further obligations after repudiation, money paid is usually not recoverable unless there has been a total failure of consideration. Courts are unwilling to find this.

In *Steinburg v Scala*, an infant applied for shares which she was duly allotted. She paid the amount due. She did not receive any dividends, nor did she exercise any rights attached to her shares. She repudiated the contract while she was still an infant seeking to recover monies paid.

> HELD: She cannot recover the money because there was no total failure of consideration. She had obtained what she had bargained for, despite that she received no tangible benefit from the purchase.

Under 18.

Companies may be members.

Law requires memo and AA to allow legal persons to become members. A company as a member, may only be represented by an authorized person – s115(1).

A subsidiary is not allowed to be a member of its parent – prevent insider dealing (set offs, etc.).

A member begins to be entitled to enjoy rights. 4 categories.

1. member's fundamental rights – notice, dividends, residual rights, appoint directors…
2. obligations: nature of company. Unlimited companies have members face potential unlimited liability. Limited by shares have to pay for all shares
3. internal relationship: once a person joins as member, there is a relationship – s23. All provisions will be treated as a binding contract on the member between the company and other members.
4. Membership may also be governed by other laws. Securities law, insolvency law…

Share Classification

s63 allows companies to divide share capital into different classes subject to memo or AA.

Share classification. Different classes have different rights and obligations. Equitably, same class shares should be the same.

S57A(2) stipulates that where shares are classified, every share certificate shall contain a statement specifying the class, value and voting right.

Rationale

Different companies have different situations. Legally, there are 3 major reasons: raise capital without dispersing too many rights and control.

Preferred shares: possibly better off situation – fixed dividends paid first. Accumulated shares if company has no profits, dividends are accumulated. Fixed percentage shares: – limit profit giveouts.

Controller wants arrangement to concentrate control. Lower-class shares with fewer voting rights are issued to raise capital but reduce control.

Safeguard minority interests. If they vote together, the majority will win. Positive discrimination as solution: 2 classes. Both classes must consent to important issues for it to pass.

Someone must be responsible for the debts – ordinary shares.

Where new shares are issued in the same class, the only change is the entitlement of dividends. Other rights are not affected.

General Meetings

Annual General Meetings

Procedure

Mandated by s111(1), CO.

1st AGM to be held within 18 months of incorporation.

Subsequent AGMs to be held within 15 months of each other and every business calendar year.

The registrar may indicate a time period greater than 15 months – s111(1).

The time and place for the meeting is usually decided on by the directors – art. 49, Table A.

Note, however, given modern technology standards, a physical meeting is not mandated if a resolution in writing is signed by or on behalf of all the members of the company who at the date of the resolution would be entitled to attend and vote at such meeting – s116B.

Default of Procedure

The court has the discretion to call a meeting and give other directions, e.g. directing that one member present in person or in proxy constitutes a valid meeting despite the usual law requiring two – s111(2).

The company and any officer become liable to a fine – s111(5).

*Agenda

The normal course of discussion involves the company's finances (profit & loss accounts, balance sheet) – s122, director and auditor reports, (re)appointment of directors – arts. 96-98, t-A, appointment and remuneration of auditors (not dismissal) – s131, and recommendation on any dividend – art. 115, t-A.

Members are thus allowed to exercise their right to not-reappoint directors who come up for re-election.

However, ordinary and special resolutions may be raised at any AGM with the requisite notice. Members may propose their own resolutions since although EGMs provide a similar forum, it is not guaranteed that they are actually held.

Member-proposed Requisitions

Shareholding Eligibility

Such members must hold at least 2.5% of the total voting rights or a collection of 50 members whereby the average holding per member is $2,000 – s115A(2).

Notice

Subject to s115A, it is the duty of the company, on a member's proposal, to give members of the company entitled to receive notice of the AGM, notice of resolutions intended to be moved at the AGM. For other meetings, a 5,000 word limit applies – s115A.

Costs

Such members must also bear reasonably sufficient costs, to be tendered along with the requisition at the registered office of the company – s115A(1) and s115A(4)(b).

Shareholders have to pay so to avoid abuse of their powers, since what an individual thinks is totally subjective and they are not subject to fiduciary duties to do what is best for the company. Directors don't have to pay because they owe a fiduciary duty to shareholders and must work for the company to the best of their ability. They may be sued if they act otherwise.

Notice Period

Requisitions requiring resolutions must also be given at least 6 weeks in advance. Other requisitions may be submitted 1 week before the meeting. Also, where an AGM is called for a date ≤ 6 weeks after a proposal has been deposited in the company's registered office, the proposal, though not deposited in the required time, shall be deemed to have been properly deposited – s115A(4)(a).

The underlying policy encourages members to participate in company affairs so they may put their own agenda forward and remove sole power from a handful of directors.

Enforcement

Meetings shall include requisitions that have notices, and notice shall be deemed to have been given despite any accidental omission in the giving of it.

Extraordinary General Meetings

Any meeting other than an AGM is an EGM – art. 51, t-A.

Who Shall Convene EGMs

Directors

Directors may convene an EGM whenever they think fit – art. 51, t-A, especially where the approval of member is required for any matter, e.g. changing the company name.

Shareholders

On Demand / Requisition

To enable members' views to be heard, the company must convene an EGM on the demand of members with at least 5% paid-up-capital with voting rights – s113(1). Upon receiving the demand, the directors are to summon a meeting in the 21 days following and actually hold the meeting within the next 28 days.

Demand → 21 days for preparation → 28 days to hold meeting

If the process is not followed, at least half the requisitionists may convene a meeting by themselves with reasonable costs paid by the company, recoverable from fees payable to defaulting directors – s113(3), (5). Insufficient notice means that the meeting has not been duly convened – s113(6).

Convening meetings themselves

If the AA do not provide otherwise, two or more members holding at least 10% of the issued share capital value; or at least 5% of the total number of members may call a meeting – s114A(1)(b).

2 members shall be a quorum – 114A(1)(c).

This number may also convene an AGM if the requisite number of directors are unavailable in Hong Kong. This provision is impractical in large corporations.

Liquidators, Official Receivers, Auditors

A liquidator, upon receiving a resolution of the contributories and creditors, or a written request of 10% in value of the contributories and creditors, may summon a meeting – s200(2).

Any auditor who resigns has the right to demand the directors to convene an EGM to consider reasons connected with his resignation – s140B(1).

The Court

Impracticability

The court comes into play when it decides that it is impracticable to call/hold/conduct a meeting pursuant to the AA or normal rules governing meetings. It may then order: a meeting to be called, held and conducted in a manner it thinks fit; and may give directions as it things expedient, including a direction that one member present in person or by proxy shall be deemed to constitute a valid meeting – s114B.

In the UK, the court used a s114B equivalent to change the way a meeting was conducted for fear of causing a riot – *British Union for the Abolition of Vivisection*.

Hong Kong is strict in its use of discretion.

HK Estates v San Imperial [1980]: an official receiver requisitioned the directors to convene a meeting under s113. He intended to replace the board with his nominees. However, before the 21 days of notice period expired, he applied to the court under s114B equivalent to convene a meeting. After his application, however, the directors indeed held a meeting.

HELD: it was practicable to hold a meeting and refused to exercise discretion.

Cheng v Chan [1993 CA]: Cheng challenged Chan's beneficial interest in the shares that he held and refused to attend a meeting that required him to fulfill the quorum. D tried to use 114B to have the court convene the meeting.

HELD: until the ownership issue had been resolved, it would be unjust to convene any meeting pursuant to s114B.

Standard Chartered Equitor v George Zee [1995 HC]: the majority shareholder died and the trustee had to liquidate his assets. He did not like the directors and he used 114B to try to convene a meeting where he would remove the directors.

HELD: the court looked at the trust deed and saw that the trustee was not authorized to do anything other than sell property. It was *ultra-vires* of him to do anything related to the company, plus if the directors did anything wrong, he could refer the issue to court. Ultimately, the meetings would lead to an unjustified removal of the directors.

Minorities and Absence at Meetings

Where the courts used this power, it was to prevent a minority shareholder from using the quorum provisions as a veto power:

Re Opera Photographic [1989]: A meeting was requested by a majority shareholder. An earlier attempt was rendered inquorate by the minority shareholder's refusal to attend.

HELD: the general right to have a quorum in a general meeting cannot be regarded as a class right attached to the shares of a minority shareholder. The meeting, under a s114A equivalent, was convened by the court.

If that power is an entrenched class right, however, that consideration does not apply.

Harman v BML Group [1994 CA]: the shareholders held A and B classified shares. There was a shareholder agreement that quorum rights were entrenched.

HELD: the court has no right to override the quorum rights so entrenched, conferring a veto power on the holder of B shares to prevent the holding of company meetings.

Mansfield Coatings v Springfield Coatings [1995 HC]:

HELD: the court shall not override any shareholder agreement, however informal, reached between the shareholders on the management and control of the company.

Unfair Prejudice, etc.

Despite that the bias of directors may be unfair to minority shareholders, courts have chosen to hold meetings:

Re Success Plan Ltd [2002 CFI]: Directors nominated by the monitory shareholder refused to attend meetings, rendering them inquorate.

> HELD: the possibility that unfair prejudice might result from a court-ordered meeting is a matter that the court would take into account as it would not lend its hand to the commission of any unfairly prejudicial acts against shareholders. However, the fact that such a petition had been presented would not defeat an application for a court-ordered meeting in all circumstance – *Re Whitchurch Insurance Consultants Ltd* [1993].
>
> If ALL the resolutions sought to be passed were clearly oppressive, the court would not assist the requisitor. (This says nothing if SOME of the resolutions sought to be passed are oppressive).
>
> The courts have no knowledge or right to decide on the parties' substantive rights. Judges are not businessmen.
>
> Should any director not act in the interests of the company, they may be personally liable for breach of fiduciary duties. Should any shareholders take any actions that would be oppressive to other shareholders, the prejudiced shareholders would be entitled to present petitions for unfair prejudice or for a just and equitable winding up of the company.
>
> The court's purpose is just to get the company out of its "frozen state". Private companies are supposed to work closely together and courts will exhibit much more judicial restraint when dealing with private companies.

The Procedure in Summary

To petition the court under s114B, the plaintiffs first have to show that a meeting is impracticable.

> To do that, the courts may take into account: the quorum; entrenched minority rights; ownership disputes; and trustee authority.

After impracticability has been discovered, the court will see whether to exercise its discretion or not.

> In doing so, the court decides whether: unfair prejudice might result; (all) oppressive resolutions; and shareholder agreement.

Although the court may decide on the parties' substantive rights, it will usually not do so, since judges are not businessmen. Directors are personally liable for any breach of their fiduciary duty to act in the best interests of the company, and should any shareholder take actions that would be oppressive to other shareholders, the prejudiced shareholders would be entitled to present petitions for unfair prejudice or for a just and equitable winding up of the company.

Analysis taken from *Re Success Plan Ltd.* [2002 CFI].

Meeting Procedure

Meeting Notice

Notice Period

The period of notice is:

> 21 days for an AGM – s114(1);
>
> 21 days for a meeting about a special resolution – s116(1);
>
> 14 days for a meeting not for the passing of a special resolution – s114.
>
> 28 days / Special notice is to be given where auditors are appointed or removed – s132(1) in conjunction with s116C.

See art. 52, t-A for similar provisions.

SFC v Stock Exchange HK [1992]: HELD: for s116(1) regarding EGM notice, the requirement for 21 days' notice means 21 *clear* days, i.e. 21 days add one day for sending the notice, one day for receiving the notice and one day for holding the meeting. Other days may be added, e.g. public holidays.

The AA may provide for longer periods only – s114(1), (2).

Exception where all members entitled to participate and vote agree to shorter notice – s114(3).

Notice is served personally or not more than 48 hours after posting of a notice properly addressed, prepaid and prepared – art. 132, t-A.

All members must be 'notified' whether voting or not unless specified by the AA – s114A(1). All members, persons entitled to a share by transmission and company auditors are entitled to notice – art. 135, t-A.

Content of Notice

The notice must specify the place, day and time of the meeting; nature of any special business (defined in s114C(7) to mean things not normally discussed, e.g. dividends, finances, reports, appointments, etc.)

Generally, the notice shall disclose all necessary details to enable the shareholder to decide whether to attend the meeting.

Chung v Sze Yap SS Co. [1931 full court]: Re-confusing notice. The offending notice sought confirmation of 'such resolutions previously adopted'. It actually sought to mean certain resolutions concerning the director's poor performance. The validity of the resolutions confirmed by the meeting referred to by the offending notice was challenged.

HELD: the notice was bad since it did not give a shareholder fair indication of what he would be called upon to confirm in the meeting and so, the resolutions passed there become invalid. The only safe way is to circulate the actual words of the resolutions passed.

Re Moorgate Mercantile Holdings [1980] HELD: s116 equivalent requires the entire contents of a special resolution to be set out in the notice convening the meeting.

Musselwhite v CH Musselwhite & Son Ltd. [1962]: Accident in not giving shareholder notice of meeting. EXPAND HERE

Defective notice can be cured after realization of defect by a written consent of all members – *Re Pearce Duff* [1960].

Quorum

2 members or more constitute a valid quorum – s114A, but the AA may specify the need for more (binding contract).

A 1-man company needs only him to constitute a quorum – s114AA.

The quorum shall be constituted within 30 minutes of the scheduled time – art 56 tA.

Voting

Entitlement

Without further deliberation, all members shall be entitled to vote unless he has sums payable in respect of shares – art. 64, t-A onwards.

Proxies are appointed by members entitled to attend and vote in meetings to vote in place of the member. The proxy shall have the member's rights in the meeting – s114C. Notices should state clearly that proxies may be appointed else, the company and any officers are liable to a fine – s114C(3).

Methods

A vote by a show of hands lets every voting member have one vote. This is used for uncontroversial issues – art. 64 t-A.

A vote on a poll means that every share gets one vote. This is used for more major issues – art. 64, t-A.

A second vote, should votes be equal, may be cast by the chairman – art. 62, t-A.

In *Re Horbury Bridge Coal* [1879], a resolution needed a decision. A vote by show of hands would enable the minority shareholders to win (they had more people but fewer voting rights); but a vote on a poll would enable the majority shareholders to win.

HELD: It was inappropriate to vote on a show of hands on that important issue.

The Chairman

Any member elected by those present at a meeting may be chairman thereof – s114A(1)(d), but it will usually be the chairman of the board, selected by directors – art. 57, t-A.

The chairman, in the case of equal-side voting, may cast the decisive vote – art. 62, t-A.

In *Might SA v Redbus Interhouse* [2004], 28.5% holding shareholders called a meeting to fire the board. The chairman, by the AA, was to chair the meeting. The plaintiffs argued that there was a conflict of interest since he-who-was-to-be-removed, was to chair the meeting.

HELD: There is no conflict of interest since there is no requirement that the chairman be neutral. Further, he is bound by fiduciary interests.

Different Types of Resolution

Ordinary Resolutions

Ordinary resolutions only need a simple majority.

Special Resolutions

Special resolutions need a 75% majority – s116(1), no less than 21 clear days' notice – s116(1), and registration within 15 days of passing – s117.

Notification period exception where at least 95% shareholders of total nominal share value agree. For voluntary winding up proceedings, pursuant to s228(1)(b), at least 7 days notice is required.

Special Resolutions typically include:

Altering objects and articles	Changing a company name	Removal of a director
Rendering the liability of directors unlimited	Approving the assignment of office by a director	Resolution that the company be wound up
Resolution to voluntarily wind up the company		

Irregularities

Irregularities may arise where an issue cannot be voted upon by directors, but they agree on a decision anyway. Or other articles and procedures are not followed.

Minor irregularities in meeting proceedings may be excused – art. 52 t-A.

Irregularities may be cured by unanimous agreement – *Tsao Chin Lan v Tin* [1995]. If all entitled members agree on an issue, that decision becomes binding despite the absence of a company meeting. In *Parker & Cooper v Reading* [1926], it was held that where a transaction is intra vires and honest, especially if it is for the benefit of the company, it cannot be upset if all members assent.

Irregularities may be deemed to have been adopted by a long course of acquiescence. In *Tsao* (above), the plaintiff waited 8 years after having known of an allotment given by her husband to the defendants. It was HELD in that case, that the doctrine of *laches* applied, and it was too late for the plaintiff to uphold her challenge to it.

Proper Plaintiff Rule (Foss v Harbottle)

The proper plaintiff to bring an action against majority shareholders or directors where the conduct of the company or general meetings is concerned, is the company itself. This is because the company had been wronged, not individual shareholders.

Board of Directors

S2(1) defines a 'director' broadly. It includes directors de jure and de facto, managing directors, shadow directors (a person in accordance with whose instructions the directors of a company have been accustomed to act), reserve directors and both executive (full-time) and non-executive (independent) directors.

According to the Cadbury Report, non-executive directors are preferred as they bring independent judgment to the company. Their caliber and numbers should thus be sufficient to give them weight in decision making. Compensation should be through fees and not share options or pensions. Their ability to receive information is important. They should be selected by an independent nomination committee and their terms shall be set out forthright.

Number of Directors: Public: 2, Private: 1 –s153(1).

Michell & Hobbs (UK) Ltd. v Mill [1996]. ???

Board of directors may delegate its powers to an individual director or a committee of directors according to its articles – arts. 104 (delegation to committee of director(s)), 109 (delegation to managing directors), 111 (conferring powers to managing directors).

Appointment

Articles of Association – Table A

The general power to appoint is vested in members in general meetings – arts. 77 (initial naming in AA), 96 (The company may from time to time by ordinary resolution change the number of directors), and 99 (filling in vacancies or adding directors by ordinary resolution).

In public companies, each director is to be appointed by separate motions and resolutions. This is to prevent entire cabinets from being nominated or otherwise. Unanimous agreement by all members may choose another method. Resolutions passed in contravention of s157A(1) shall be void by (2).

Directors may be empowered by the articles to fill any casual vacancy and to appoint additional directors – art. 97. Directors so appointed shall be eligible for re-election. This is subject to, and does not conflict with the appointment powers of members in general meetings – *Barron v Potter* [1914].

Each company must keep a register of its directors (including shadow directors) with certain particulars – s158.

Slight **defects** in appointment will not affect the validity of the acts of the director concerned – s157 and art.107 t-A.

Morris v Kanssen [1946 HoL]:

C and S wanted to get rid of the other shareholder – K.
C and K were the only directors.
C modified the board's minutes to make S a director.
The company failed to hold its AGMs and its directors vacated office.
C and S held a purported meeting to appoint M as director.
C, S and M held a board meeting to allot shares acquired by M.

HELD: There was actually no appointment, let alone any defect at all. The 'appointment' was a nullity.

Qualification

Mature age – s157C; sound mind – art. 90(d); share ownership – s155; not a body corporate – s154A; not an undischarged bankrupt – s156(1).

Removal of Directors

Retirement by resignation through notice – s157D(1), art.90 T-A.

Retirement by rotations – art. 91.

Members may participate in the removal of a director before the end of his term.

Removal by ordinary resolution – s157B(1).

Removal by special resolution – art. 98 t-A and s157B. s157B(5) protects members in that no share may have weighted voting rights so no share may have a greater number of votes on a resolution for removing a director.

Removal by written requests of co-directors.

Lee Tak Samuel v Chou Wen Hsien [1984 PC]

Removal by the written request of all co-directors must be done in a bon-fide manner. However, to hold that bad faith on the part of any *one* director vitiates notice to resign would introduce into the management a source of uncertainty unintended by members of the company.

To give business sense to art.73(d), it is necessary to construe the article strictly according to its terms without any qualification. Otherwise, the company may be brought to a halt pending the resolution of any dispute raised.

Meetings of the Board

Directors meet when they think fit – art. 100 t-A. These meetings are much less formal than general meetings and the procedures are governed by the articles and rules conjured up by the board. Where a director is absent from Hong Kong, he may legally not receive notice for these meetings.

A meeting does not include a mere physical coincidence unless they are aware that the occasion is to be a meeting – *Pestch v Kennedy* [1971] and *Bently-Stevens v Jones* [1974].

Meetings may not have to be convened if a written resolution is signed by all directors – art.108.

Unanimous decisions can be made without meetings – *Runciman*,

Notice: Due notice must be given otherwise the meeting may be deemed irregular. Of course, the AA or the board may provide fixed times for meetings. Notice may be given verbally unless otherwise required and within a reasonable time before the meetings. In *Broadview*, it was held that notice must be given sufficiently early to enable directors to attend. 'sufficiently early' depends on the facts of every case. In the particular case, the plaintiff had no excuse apart from saying that the notice was short. Evidence pointed out that he had plane tickets to Hong Kong, he had in fact business to attend there. It was held that notice was sufficient as it had not been proven that it was not sufficient.

Art.100 states that notice need not be sent to directors outside HK. If the result is that a director is not notified, the meeting and its resolutions may be deemed irregular, but that does not stop outsiders from transacting business as the company is bound by the IMR/Turquand rule. Such irregularities may be subsequently ratified.

Quorum: 2 directors unless otherwise specified by art.101. A one-man company shall provide the company with a written record of the director's decision within 7 days after the decision is made.

Where the quorum falls below that stated in the AA or otherwise agreed, continuing directors may only act for the purpose of increasing their number or summoning a general meeting – s153(5) and art.102.

Voting: Each director gets one vote and issues shall be voted upon by majority – art.100. Chairman gets the power vote.

Conflict of Interest

Since a quorum is composed of directors entitled to vote on a particular issue, a director with a conflict of interest + prohibition by the AA, should not be entitled to count as quorum nor vote on the issue – art.86(2). S162 mandates disclosure of directors of material interests in contracts despite that they are not entitled to vote. Directors have a common law fiduciary interest to ensure that their personal interests do not conflict with those of the company. Compliance with s162 may not necessarily absolve directors of liability. In *Man Luen Corp*, it was held that s162 only supplemented the common law.

If this rule renders the meeting inquorate, the articles permit the company to ratify a 'biased' meeting though a general meeting.

Insurance Scheme

Provided by s165, 2003 amendments.

Disqualification

*Division of Powers: Board and General Meetings **

The relationship between the board and members is a contractual one governed by the articles which determine the extent of the powers conferred on the board.

The general approach (textbook) is that company management powers are usually vested in the board and art.82 provides that directors may exercise all powers not confined to a general meeting.

Things that a general meeting have the sole right to determine include: amendment of the company's constitution, changing company's capital, and the common law right to ratify a director's breach of fiduciary duty.

Extent of Member's Control over the Board

Pre-2003 amendment art.82 Table A	Post-2003 amendment art.82 Table A
Company business shall be managed by directors; and	Subject to the ordinance, constitution and any direction given by special resolution,
Directors may exercise all powers of the company … not required to be exercised by the company in a general meeting.	The business shall be managed by the directors who may exercise all the powers of the company.
Subject to any article, provision or statute or regulation prescribed by the company in general meetings.	No alteration of the constitution and no direction shall have retrospective effect.

The contentious point with the old article (still in use) is the "subject to…" limiting clause. In solving such a problem, the issue is:

1) To determine whether the issue is one that arises in the course of management of the company and coming squarely within the duties of the directors.
2) Whether art.82 confers 2 powers on the directors
    a. Power to manage the business of the company; and
    b. Power to exercise all powers of the company not required to be exercised by the general meeting.

    In the *Yau Kung School case*, the court rejected this 2-power argument holding that the article conferred only powers which were relevant to the management of the business.
3) Subject to (2), whether the limiting words "subject to any regulation prescribed by the company" apply to both or the second power.
4) What does "regulation" mean?

    It should probably mean articles.

In the commonwealth states, there has been a long line of cases that say that the management of the company is the sole ambit of the directors. No general meeting may interfere with that power short of a special resolution to change the company's articles.

In Hong Kong, there was a contentious court of appeal case *(Tang Kam Yip v Yau Kung School [1986 CA])* where a minority judge (Sir Alan Huggins VP) stated obiter, that: provided that an ordinary resolution is not inconsistent with another article, there is no reason why it should not bind the directors in the management of the business. In *Yau Kung School*, Huggins held that if s.82 conferred just one power, (a) above, then the directors in that case had no power to do what they did. Only if (a) and (b) are taken together do they confer a power on the directors to do everything. A two-part construction would mean that the powers if the directors (b) would be subject to the limiting restriction. He also said that cases which held that the general meeting could not usurp the power of the directors were distinguishable on the facts. He agreed with In re Standard Bank of Australia that the words "directors may exercise all the powers of the company" to supplement the fact that directors were to manage the company's business. As such the limitation applied to the whole clause.

However, the same court through Rogers JA stated obiter in *Miracle Chance Ltd v Ho Yuk Wah, David [1999]*, that management powers vested with the board cannot be usurped by shareholders in a general meeting. This would change if the board was not functional and there was a deadlock – consistent with the commonwealth authority – management powers would be reverted to shareholders. He relied on *Breckland Group Holdings*.

There are contrasting obiter opinions in Hong Kong and the law is not settled.

According to the old art.82, companies can, through general meetings, prescribe provisions that control what powers directors have.

Since the UK case of *Automatic Self Cleansing Filter Syndicate v Cuninghame*, English courts have held that, if the board is capable of functioning, members cannot interfere with management through a general meeting. (the court in *Cuninghame* took support from the fact that the AA provided that directors could only be removed by special resolution.) since the board could only be removed by ¾ majority, it would be silly of the decisions could be changed by only a basic majority.

It has been held that each of the two separate organs should be regarded as autonomous in themselves and members cannot usurp the powers which, by the articles, are reserved by the directors any more than the directors can usurp the powers vested in the AA in the members – *John Shaw & Sons v Shaw*.

HOWEVER, commentators have said that those decisions can be distinguished on the facts. They say that if due weight is given to art.82, it ought to be construed as giving members the power to override the autonomy apparently conferred on the directors. This view is supported by a first instance decision of *Manning*, which said that members can control directors' actions through ordinary resolution as long as it did not contravene the AA.

Severe doubt has been cast against *Manning [1909]* since *Breckland Group Holdings [1989]* held that the reasoning must be that interference in the general meeting must be by way of special resolution.

In HK, the supreme court in *Re Commonwealth Printing Press* held that the board has exclusive powers to manage the company subject to a deadlock situation entitling its members to intervene. Similarly, in *Broadview*, it was held that members cannot, short of changing the AA, usurp the management powers of directors. The court distinguished *Manning* on the ground that the board in this case sanctioned the proceedings with one director who did not and he was in a position of conflict as well. However, in *Manning*, the 3 directors out of a board of 4 had declined to sue a company in which they were interested in. it might not have been just to disallow the members to change their management practice by simple majority.

In *Breckland*, it was held that where matters are confided by the articles to the conduct of business by the directors, it is not a matter where the general meeting can intervene short of special resolution.

Briefly that either:

The directors have free reign of any management on the company's behalf until the articles are changed by special resolution; or

Directors are subject to ordinary resolution that may change their practice.

Structure of Corporate Governance

Traditional View

The general meeting was the supreme organ of the company.

The board of directors was only the agent of the company subject to the control of its members in a general meeting – *Isle of Wight Railway v Tahourdin* [1883 CA].

The New Approach

The division of powers between the board and the general meeting should be governed by the AA as the contract by which all members have agreed that the board alone shall manage the company's business.

The focus of the new approach is on the separation of business management powers of the directors from member-functions. Efficiency and fairness must be balanced.

Special Concerns in HK

Family control poses legal obstacles to fair dealing, transparency and effective supervision.

Dealing with a Company

Companies have to strike a balance to protect both members and outsiders.

A company is created to facilitate business.

Members are protected from the abuse of power by directors.

Outsiders/3rd parties must know how to deal with a company so that contracts are honored.

How will companies be bound when they sign a contract?

The ultra-vires doctrine has been abolished. The strict constructive notice doctrine has been abolished also.

Therefore uutsiders do not have to worry about object clauses and capacity, etc.

What if a company signs a contract which is *within capacity*, but with procedural problems, e.g. contract not approved by the board, no authority, etc.?

2 Ways to Bind Companies

s32 of the Companies Ordinance says that contracts may be written or made by parol and a company may be contractually bound in one of two ways:

Common Seal

Written contract to which a company's common seal is affixed – s32(1)(a) bind the company. The seal shall be metallic upon which its name is engraved in legible characters – s93(b). The seal shall only be used by the authority of the directors – t-A arts. 84, 114.

> The directors shall provide for the safe custody of the seal, which shall only be used by the authority of the directors or of a committee of the directors authorized by the directors in that behalf, and every instrument to which the seal shall be affixed shall be signed by a director and shall be countersigned by the secretary or by a second director or by some other person appointed by the directors for the purpose.

However, a company can amend the number of signees in the AA, see: *Grand Trade v Bonance International*.

Persons contracting under the authority of the company

Contracts in writing signed by people under a company's authority on behalf of a company bind the company – s32(1)(b).

Amendment: art.82: company management shall be exercised by the board.

CAPACITY:	Whether company is *capable* of making certain contracts (illegality, etc. but see ultra-vires doctrine).
AUTHORITY:	Whether the company can *properly* do this.

Effect of the Requirements to Bind

A person dealing with a company was deemed to know everything about the company – all the documents are registered and considered public knowledge. This constructive notice rule has been statutorily abolished by s5C.

Directors know what is going on inside the company yet outsiders will have little idea. Strict application of the constructive notice doctrine imposed difficulties and led to injustice and harsh results – *Perfectime Ltd. v Ko*. Since 1997, courts have imposed a reasonable person standard on outsiders. Constructive notice is not deemed with published documents.

Indoor Management Rule (Turquand Rule)

FACTS: directors borrowed money from the bank on the company's behalf, affixing company seal to provide security for the borrowing. According to the articles, any borrowing needed to be approved by its members.

> ARGUMENT: The company tried to claim that the loan was not enforceable. No resolution was ever adopted. The bank <u>should shoulder its own loss for not making enquiries</u>.

HELD: the bank was bound to read the articles, but they were not bound to do any more. Even if the bank did indeed read the AA, they would know such resolution was needed. BUT from such a reading, they would not know whether such a resolution had been adopted or not.

The bank has a right to infer that the resolution had been passed.

There is thus no need to investigate the management of the company beyond the obvious,

This rule protects outsiders dealing with a company in good faith without knowledge of any internal irregularities.

Statute s5 provides for the abolition of the constructive notice doctrine since 1997.

Outsiders may assume that a company's internal requirements and procedures have been duly carried out.

Implications

Outsiders are not required to investigate into the internal management matters of the company. If a decision that a company should enter into an obligation purported to be authorized by the board, the company is bound.

t-A article 81 – company finances (borrowing, mortgaging, debentures…) depends on the directors. Delegating power of companies. Article 82 is more general.

Re Hampshire: AA said directors could borrow to the limit of its paid-up capital. Any larger amount had to be passed through resolution. The company borrowed in excess. A general meeting was in fact held to allow the borrowing but due to the defective notice, the approving resolution was invalidated and borrowing could not proceed properly.

HELD: Nonetheless, the loan was valid. The lenders know of the internal restrictions bur under the IMR, the outsider is entitled to assume that the internal procedures have been complied with.

Exceptions to the Indoor Management Rule

Forgery

If a document is forged, it does not have any legal effect and is a nullity. The IMR only applies to internal irregularities, not nullities. As a result, forged documents that purport to represent compliance with internal rules, etc. do not bind the company.

Hua Rong

FACTS: L provided a loan to D, who had 3 directors. D1 signed the loan agreement on behalf of the company, affixing the company seal. When D1 negotiated, she showed L a purported resolution. D defaulted in the loan. D2 testified that there was never a meeting. The purported resolution was forged.

HELD: The court refused to grant relief to P. Forged documents are a nullity and cannot bind the company

Northside (High Court, Australia): 1 director and his son signed the loan agreement on behalf of the company. The director told the company that the second signee was authorized to do so. The second signature was forged. When reviewing the authorities, the court said that the rule was not final nor settled. The IMR could not apply to this situation. Nullities are not irregularities.

Strict Forgery and Falsified Documents *

The court in *Northside* differentiated between cases of strict forgery and cases of falsified documents.

In strict forgery, the seal and/or the signatures of the main contract are forged. As such, the document is a nullity and cannot be enforced.

Falsified documents contain real director signatures and authentic seals, but the authority upon which they rely on is forged. The court in *Northside* sought to say that such transactions are not nullities and may be enforceable by application of normal agency theory: if there was no ostensible authority, it would be a forgery, but if there was apparent authority, (holding out by the company), then the IMR rule applies and the outsider can deal with the company as if all internal management rules had been complied with – the company would be estopped from denying his authority.

Actual knowledge

If the outsider actually knows that certain internal procedures had not been complied with, he may not be entitled to rely on the IMR.

Pacific Foundation: D borrowed money from L. Based on the instruction of Chen (a managing director), L did not give money to D but sent it to a third company directly. D got into financial trouble and L called for the loan. Only part was repaid. The plaintiff sued the borrower for the balance. The major defence was that Chen had no authority to enter into the loan agreement with the lender and absolutely no authority to send money to someone else.

Chen had an interest in the other company. He should have disclosed this under the AA, but he did not. Further, D alleged that Chen was not a director, rendering the meeting quorum invalid. More importantly, L knew of Chen's personal interest, so D argued that L should have actual knowledge of this arrangement and should not be able to rely on the IMR to enforce the loan.

> HELD: Although L knew of Chen's personal interest, every member of the board also knew Chen's personal interest. Any disclosure would not make a difference. In these circumstances, P was entitled to assume that the interest had been disclosed. (if the articles so requires, Chen should follow the law!). Would the failure to disclose provide a defence? » NO.

Defect apparent from the face of the documents (Constructive notice)

If the irregularity is *so apparent* that the outsider *should* notice, then the IMR shall not apply.

Pre-1997 constructive notice: *Irvine v Union Bank*: the company's articles provided that the director could borrow up to half of the company's paid-up capital. The director borrowed more than the limit. A special resolution would be necessary. The directors failed to get the resolution passed. The IMR could not be applied because it was obvious that no such special resolution was passed as it had not been registered with the registrar. (constructive notice rule applied at that time).

Suspicious situations (current law)

Northside: documents showed that the company held nothing apart from a piece of land. The request to borrow money and transfer to another company was highly suspicious.

> HELD: Borrowing for the benefit of another would put the bank on inquiry. As such, since the bank borrowed money in full (reasonable) knowledge of the risks, the bank is unable to use the IMR rule to its favour.

Five judges expressed different views.

1. bank had actual knowledge, bank should be estopped from enforcing the law.
2. forgeries are nullities that cannot bind the company.
3. suspicious circumstances.

No matter what approach, the result is the same.

2 directors could not get along. The AA required 2 signatures. Checks often had 1 signature only.

One day a director appeared with a lady to get money. The lady was his wife but was presented as a director. The company sued the bank to recover the money.

It was clearly suspicious. On past dealings, you know of the company's problems. You cannot rely on a single person's representation!

If the bank did not make any inquiry, the bank is liable.

Rule applies only to outsiders but directors may use it sometimes

Because these exceptions operate on the basis of 'knowledge' of the company's activities, insiders are generally barred from taking advantage of the IMR – see: *Howard v Patent Ivory* and *Morris v Kanssen*. Directors have been recognized as an exception, but only in exceptional cases. In *Hely-Hutchinson*, he director could not get any access to information (as part of his deal) and when he tried to enforce his guarantees and indemnities, the company argued they were void since the person who gave it to him was not authorized to do so. It was HELD: that he could use the IMR rule to enforce is rights because a director is treated as an 'insider' only if the transaction with the company was so intimately related with his position as director that he has no excuse to not know the power limitations of the persons with whom he dealt with.

Agency Rules to Protect Outsiders

The rule is that an agent can only act within his 'authority'.

A company is bound if a contract is entered into by its agent on its behalf with either actual or apparent authority.

Actual Authority

Actual authority may be express or implied – agency agreement between agent and company. The 3rd party need never know of this contract. In *Freeman & Lockyer*, Diplock, LJ stated that the scope of the agreement is a factual matter that can be ascertained by applying ordinary principles of construction of contracts, including express words, trade jargon, practice and course of business between the parties.

Apparent Authority

Apparent authority is harder. It occurs where the principal has placed the agent in a position where an outsider would generally regard him as having authority to enter into transactions.

It involves a representation by the principal made to the contractor. It may not even involve the agent himself, although he is generally aware of this.

Representation commonly involves conduct by persons with actual authority to permit the agent to act in some way in the conduct of the principal's business with other persons.

If in the case of a company, the board, who has the 'actual' authority to manage the company, permits the agent to also manage the company. Then the company, by virtue of the board, represents to all persons dealing with the agent, that he has the authority to manage the business.

This apparent authority operates as an estoppel to prevent the principal from asserting that he was not bound by the contract.

Freeman: The company had 4 directors. According to its articles, it should have appointed a managing director to look at the overall operations. The company never did. When the director functioned as if he was an MD, he signed a contract with some workers to do some construction work for the company. The contract was known by all other directors and no one raised any objections. Once work was done, the directors said no one was appointed to authority.

HELD: the director held himself out and no one raised any objections.

TEST to determine ostensible authority formulated by Diplock, LJ in *Freeman*.

1) Representation to the contractor of the agent's authority.

By the person who had actual authority to manage the co.'s business. (E.g. a representation by the board that the agent has such authority).

2) Actual reliance on the representation by the outsider.

3) There are no restrictions in the memo or AA that deprive the capacity to enter uinto such contracts, or to delegate authority.

Zanda Investments: key person was a secretary to the director. Nonetheless, he was appointed as an alternative director. No specific power was delegated. The secretary indorsed certain checks from the company's account. Later, the company sued the bank to recover the checks.

Issue: whether the person had apparent authority to endorse all the money.

HELD:

1. No apparent authority – alternate directors had no authority to endorse checks, which was a management function.
2. AA did not delegate any powers.
3. No holding out situation.
4. No representation.

Apparent authority depends on course of dealing.

Had Zanda not been contributory negligent, since there was no apparent authority, the banks would have to return the money – the indorsement was invalid.