CU Review Autumn/Winter 2007

The Commercial Unit, Civil Division
The Department of Justice

What's inside

Notes:

Editorial

This Autumn/Winter 2007 Review features seals. We acknowledge gratefully Campos Cheng's happy marine mammal and "Some Gleanings of Oriental Wisdom" by Nury Vittachi in "The Shanghai Union of Industrial Mystics" (please see page 2).

Since the Spring 2007 Review one marathon has entered its final stages, namely the approval of the acquisition by the Mass Transit Railway Corporation Limited (M) of significant interests in the Kowloon Canton Railway Corporation (K) by a large majority (253,800,897 votes/82.9%) of minority shareholders voting at an Extraordinary General Meeting of M. Government and Government interested parties were not entitled to vote in view of their interest in both seller and buyer, i.e. K and M. The CU's involvement began in 2002 with the legal implications for a feasibility study conducted by Government. In 2004, the then Secretary for Transport announced 5 key parameters for acquisition including a fare adjustment mechanism and job security for front-line staff. In April 2006, a non-legally binding Memorandum of Understanding was signed. In June 2007, the Rail Merger Ordinance was enacted 11 months after First Reading, and in August 2007, a number of key transaction documents including a Service Concession Agreement were signed conditionally by M and K. K's bondholders' consent was obtained in October 2007. The Secretary for Housing and Transport published a notice in the Gazette on 26 October 2007 to designate 2 December 2007 as the commencement date of the Merger Ordinance. Our Spring 2007 Review contains further information on this transaction.

This Review contains the first of two important Court of Final Appeal cases on contract formation and a topical article on investing in HKEx.

In our Summer 2007 Review, we briefly described the work of the three CU teams. The background of the 22 Counsel in the CU is now briefly summarised on page 7 together with our requirements of Counsel. In addition, CU has two Contract Legal Executives to assist with research and preparation of some of our core contractual tenders and consultancies, and with the CU Review. Counsel are assisted by 4 PSs and a (too) small pool of secretaries. We are currently engaging two additional Counsel and one night secretary.

CHARLES BARR

Sealing a Document

What is a Seal?

A seal is an impression or a mark, attached to a document, expressing an authorisation or agreement. Originally a seal was a daub of wax into which an impression was made. In modern times, the wax seal is replaced by a paper seal (usually but not necessarily red in colour) adhering to the document.

Personal seal

A document under seal i.e. a deed must be signed by the party or parties to it or by other(s) who have been authorised to do so by a power of attorney (which also must be under seal).

A document is presumed to have been sealed by an individual if it:

(i) describes itself as a deed; or

(ii) states that it has been sealed; or

(iii) bears any mark, impression or addition intended to be or to represent a seal or the position of a seal

(Conveyancing and Property Ordinance (Cap. 219), section 19(2)).

"Sign" includes, in case of a person unable to write, the affixing or making of a seal, mark, thumbprint or chop (Interpretation and General Clauses Ordinance (Cap. 1), section 3).

In the United Kingdom, a deed executed by an individual must make clear on its face that it is intended to be a deed, whether by describing itself as a deed or otherwise; and must also be validly executed (usually by signature) by the individual.

Company seal

A company (formed and registered under the Companies Ordinance (Cap. 32)) may have two types of seals: common seal and official seal.

The common seal of a company shall be a metallic seal on which it shall have the name of the company engraved in legible characters (Cap. 32, section 93(1)(b)).

An official seal, an exact copy of the common seal, may be kept for use outside Hong Kong (Cap. 32, section 35(1)).

Subject to compliance with the company articles, a deed is deemed to have been duly executed by a company if the deed purports to bear the seal of the company *affixed* in the presence of and *attested*:

(i) by its secretary or permanent officer and a director of the company; or

(ii) by 2 directors of the company

(Cap. 219, section 20(1)).

Where a person is empowered to execute a deed by a corporation, he may execute the deed as agent by signing the name of the corporation or his own name and by affixing his own seal (Cap. 219, section 20(2)).

In the United Kingdom, the new execution provisions are in sections 43 to 47 of the Companies Act 2006, which will come into force in October 2008. A deed has to be executed under the common seal or "validly executed" by the company. "Validly executed" means signed on behalf of the company by:

(i) two authorised signatories i.e. directors or secretary (if the company has one); or

(ii) a director in the presence of a witness who attests the signature.

The Shanghai Union of Industrial Mystics

"In a lake city in the fifth century, a rebel warlord named Xie killed the king and took his palace. He searched for the ring bearing the royal **seal** but could not find it. He tore the building to dust but it was not there. His men even searched the stools of the young princes in case one of them had swallowed it. But they had not.

The judges ruled that since no one had the royal seal, the land could have no king. Darkness settled on the kingdom.

The princes lived in the dust with only the birds to talk to. One year later, the eldest prince turned up at the court with the seal and the judges proclaimed him king. The judges asked him where he had hidden it.

He said : 'I did not hide it. I put the ring with the seal on the foot of the bar-headed lake goose. Every year the geese fly five thousand miles away for the winter. But they always return to their original homes.'

Blade of Grass, even people who live in the dust can get friends in high places, and sometimes unexpected ones."

("Some Gleanings of Oriental Wisdom" by Nury Vittachi)

Statutory body and corporation's seal

Where any Ordinance constitutes a board, tribunal, commission, committee or similar body having perpetual succession and a common seal, execution of a document with such common seal should be:

(i) affixed by the chairman of such body or by any member appointed by the chairman for that purpose; and

(ii) authenticated by the signature of the chairman or such member

(Cap. 1, section 53).

Where an Ordinance incorporates a corporation sole, the sealing requirements are usually specified by the incorporating Ordinance. For example, section 39A(4) of Police Ordinance (Cap. 232) provides that the affixing of the corporate seal to a document executed by the corporation (namely, Commissioner of Police Incorporated) is not valid unless authenticated by the Commissioner or a police officer designated for the purpose by the Commissioner. Section 39A(3) of Cap. 232 provides that a document requiring authentication by the corporation is sufficiently authenticated if it is signed by the Commissioner or by any police officer authorized to do so by the Commissioner.

Public seal

As regards a document executed with the public seal of the HKSAR and other seals not mentioned above, the common law requirement of sealing applies. However, the requirement has been interpreted by the courts very liberally. A circle printed on the document containing the letters "L.S." (i.e. *Locus Sigilli* meaning *the place of the seal*) will suffice. One may not deny that a document simply expressed to have been "signed, sealed and delivered" by the signatory was already sealed.

For a document signed, executed and made by any public officer on behalf of the Government, it is sufficient to name the office held by such public officer (naming such public officer is unnecessary in law but preferable in practice). Then the public officer shall be deemed to be a party thereto as if such public officer were a corporation sole with perpetual succession (Cap. 1, section 59).

When is a seal needed?

- A deed may be unilateral and is required when provided by statute or when it is intended to create an enforceable obligation without a bilateral contractual relationship. Examples are deeds assigning real estate or intellectual property interests or deeds creating a guarantee or indemnity obligation.

- A contract without consideration (i.e. without any price in the form of money or money's worth) becomes enforceable if it is executed as a deed with a seal. But the equitable remedies such as specific performance (a court-ordered remedy that requires precise fulfilment of a contractual obligation when monetary damages are inadequate) are not available for a deed without consideration. Examples are third party guarantees or undertakings.

When is a seal not needed?

A seal is not needed for "simple" contracts with consideration, for example, tender contracts and consultancy agreements.

Practical Tips

Proper execution of a deed under seal:

- Always ensure that the words "signed, sealed and delivered" are included in the execution clause.
- Always ensure that the names and the capacity of the signatories are clearly stated in the execution clause.
- Express amendments to a deed under seal must be done by a deed under seal.
- For an individual:
  - Execution is by a personal signature.
- For a company:
  - Refer to section 20(1) of Cap. 219 and otherwise in accordance with its articles.
  - Check minutes of Board meeting to ensure person(s) proposing to affix the seal and attest to it is/are authorised by the company to do so.
  - Check the requirements of the company's articles.
  - Pay attention to these details.
- For a board, tribunal etc. constituted by statute as a body corporate:
  - Refer to section 53 of Cap. 1.
- For a statutory corporation:
  - Refer to the sealing provision(s) in the respective Ordinance.
- For a government department:
  - Refer to section 59 of Cap. 1.

BOYCE YUNG

Investing in Hong Kong Exchanges and Clearing Limited (HKEx)

HKEx is most likely to be on market watchers' list of most outstanding stocks of the year. Just look at how its share prices rocketed in the last few months. That aside, there are other matters relating to the local bourse that are worth noting.

Is HKEx a pure commercial enterprise?

HKEx has a *de facto* monopoly in operating the only stock exchange, futures exchange and their related clearing houses in Hong Kong. Recognizing such key strategic position of HKEx in the local financial market, the legislation provides for certain public duties and functions of the bourse. These statutory duties override any contractual, common law or equitable duties that may be owed by HKEx to its shareholders.

Under the Securities and Futures Ordinance (Cap. 571) (SFO), HKEx must ensure as far as reasonably practicable an orderly, informed and fair market in the trading of stocks and futures contracts, and in clearing and settlement arrangements. It also has the statutory duties to ensure prudent risk management and compliance by the two exchanges and the clearing houses with all lawful requirements.

Unlike other ordinary commercial enterprises, legislation requires HKEx to act in the interest of the public and to give regard to the investing public's interest. If there is a conflict between public interest and the commercial or other interest of HKEx, the former will always prevail and HKEx must give effect to public interest.

As an additional safeguard, if the Securities and Future Commission (SFC) is satisfied that a conflict exists (or may exist) between the interests of HKEx and the proper performance of its functions under the SFO, the SFC may direct HKEx to take the necessary steps to remedy the conflict of interest.

Legislation requires HKEx to act in the interest of the public and to give regard to the investing public's interest

Who is a "Minority Controller"and what are the restrictions?

A "Minority Controller" is a person who alone or jointly with his associate(s) has an interest in more than 5% of the voting rights of HKEx.

Under section 61 of the SFO, a person must obtain the SFC's written approval before he becomes a Minority Controller. If an approved Minority Controller increases its interest in HKEx, the SFC's further approval is required. Criminal sanctions are imposed for a contravention of any of these requirements. In addition, the SFC may declare the votes cast by a person who contravenes any of these requirements to be void and direct him to take necessary steps to cease to be a Minority Controller within a specified period. Such person may not exercise any rights as the shareholder of HKEx except for the purpose of ceasing to be a Minority Controller.

It is a criminal offence if a person fails to take the steps directed by the SFC. The SFC may require that the shares concerned be transferred to its nominee. It may also apply to the Court of First Instance for an order to sell the shares.

The SFC must not approve a person to be a Minority Controller or to increase his interest in HKEx unless it is satisfied that the interest of the public or the investing public will be served and that it has consulted the Financial Secretary (FS).

If approval is given by the SFC, it may impose conditions on the approval. A failure to comply with any such conditions will attract criminal and civil sanctions similar to those set out above.

Is there any disclosure requirement in investing in HKEx?

A person who acquires 5% or more of the shares of HKEx has the statutory duty to notify HKEx and the Stock Exchange of Hong Kong Limited (Stock Exchange) within 3 business days after the date on which his shareholding reaches the 5% threshold. The same duty arises if such person disposes of the shares or if, having maintained his shareholding at a minimum of 5%, there is a subsequent change in the percentage level of his interest or the nature of his interest.

The disclosure must contain the prescribed particulars set out in section 326 of the SFO. This

includes the name and address of the acquirer, the date of acquisition of the shares and the number of shares acquired.

Failure to comply with the disclosure requirements constitutes a criminal offence.

Who may appoint the directors of HKEx?

Under section 77 of the SFO, if the FS is satisfied that it is in the interest of the investing public or the general public to do so, he may appoint not more than half of the total number of directors of HKEx's board (excluding the CEO) (Government Directors). Neither the Government nor the FS needs to hold any shares in HKEx in order to make the appointment. The rest of HKEx's board members are elected by the shareholders.

The Government Directors are appointed primarily to represent the public and market interests. One might question whether this would put the Government Directors in a difficult position where their duties to the public conflict with their duty to act in the best interest of HKEx. Such conflict is unlikely to arise since HKEx's **statutory** duty to act in interest of the public always prevails over its other interests. The Government Directors' primary duty to the public therefore coincides with that of HKEx's duty.

Government's investment recently in HKEx

The Government has recently increased its stake in HKEx to 5.88% through the Exchange Fund. Under the Exchange Fund Ordinance (Cap. 66), the FS may, with a view to maintaining Hong Kong as an international financial centre, use the Exchange Fund as he thinks fit to maintain the stability and the integrity of the monetary and financial systems of Hong Kong.

This increase in the Government's shareholding in HKEx has sparked off a controversy as to whether the Government Directors qualify as independent non-executive directors (INEDs) under the Listing Rules. The basis for the contention is that the Government now holds more than 5% of HKEx's shares.

The Listing Rules require the board of directors of a listed corporation to comprise at least 3 INEDs. The Stock Exchange is the authority to assess the independence of a non-executive director. In making the assessment, it will take into account a number of indicative factors. None of the factors is conclusive but the independence of a director will be called into question if he holds more than 1% of the listed corporation's shares. A note in the Listing Rules states that "*[a] candidate holding an interest of 5% or more will normally not be considered independent*". If a person is appointed on the listed corporation's board to protect the interest of an entity whose interest is at variance with the corporation's shareholders as a whole, this may indicate a lack of independence.

The directors of HKEx subsequently voted on and confirmed the independence of the Government Directors. It is difficult to see how the Stock Exchange will come to a view different from that of its parent company.

Perhaps one should note that it is the Government, not the Government Directors, which holds 5.88% of HKEx's shares. When elaborating on the method for calculating the 1% threshold, the notes to the Listing Rules do not refer to the shareholding of an associate of the director.

We have pointed out above that the Government Directors are appointed to represent the interest of the public and the market, not that of the Government.

Another related issue is whether the Government needs to obtain the SFC's approval to become a Minority Controller and to disclose its shareholdings as required under the SFO. These provisions do not bind the Government but voluntary disclosure has been made by the Government.

FS may appoint not more than half of the total number of directors of HKExs board

ADA CHEN

Contract formation:
New World Development Co. Ltd. & Others v Sun Hung Kai Securities Ltd. & Another
(2006) 9 HKCFAR 403

Background

This is one of two important and recent Court of Final Appeal Cases on contract formation. A contract is a legally binding agreement between two or more parties. A number of key ingredients must be present in order to form a contract. These key ingredients **include** an intention to create legal relations (contrast, for example, an agreement with your dependent child: "ice-cream in exchange for going to bed now") and certainty of terms (contrast, for example, an agreement to agree where nothing is agreed and everything remains at large).

Facts

In April 1990, the Plaintiff (P) and IGB entered into a joint venture agreement (the JV) to develop two hotels in Malaysia. The JV was to be carried out through a company, GUP.

In April 1990, by an oral contract between P and the Defendant (D), D, which was aware of the essential features of the JV, agreed to indirectly participate in the JV by D contributing 50% (initially) of the investment P was making in the JV for a share in returns accruing to P. D had undertaken to reimburse P for D's proportionate share of all joint JV payments made by P, comprising payments by way of subscription for shares in GUP, shareholders' loans and expenses advanced to GUP, and had paid a total of $35.3 million towards this. D however remained indebted to P for unpaid sums totalling more than $80 million. D appealed to the Court of Final Appeal arguing a number of points including:

(a) on the evidence, the parties lacked the necessary intention to create legal relations;

(b) alternatively, any agreement reached was so uncertain or incomplete that it could not in law constitute an enforceable contract.

What the Court of Final Appeal decided

Intention to create legal relations

(1) The CFA decided that parties reaching an express agreement of a commercial character were presumed to intend it to have legal effect unless the contrary was shown. The burden was on the party who asserted that no legal effect was intended, and was a heavy one. In deciding whether the burden had been discharged, the courts would be influenced by the importance of the agreement to the parties, and by the fact that one of them acted in reliance on it, as in this case. (***Rose & Frank Co v JR Crompton & Bros Ltd & Others*** [1923] 2 KB 261, ***Edwards v Skyways Ltd*** [1964] 1 WLR 349 applied.) Here, D fell far short of discharging this heavy burden.

Uncertainty and incomplete argument

(2) An agreement might fail for uncertainty where the parties had expressed themselves in language that was too uncertain, vague or unintelligible to make their agreement legally enforceable. But courts would do their best if satisfied that there was an ascertainable and determinate intention to contract, to give effect to that agreement. They would not be deterred by mere difficulties of interpretation. The courts would endeavour to find practical meaning in commercial agreements and were reluctant to strike down as too vague and uncertain agreements which businessmen had made and acted upon. (***Hillas & Co Ltd v Arcos Ltd*** (1932) 43 L1 L Rep 359, ***G Scammell & Nephew Ltd v Ouston*** [1941] AC 251 applied.)

(3) For there to be a good contract there must be a concluded bargain and a concluded contract was one which settled everything that was necessary to be settled and left nothing to be settled by agreement. But an agreement was not incomplete merely because it left something which still had to be determined. **It was often possible for the court to discern in the parties' agreement the intended principles, criteria or machinery, express or implied, for determining specific contractual rights and liabilities without requiring the parties to arrive at further agreement.** (***May & Butcher Ltd v R*** [1934] 2 KB 17, ***Foley v Classique Coaches Ltd*** [1934] 2 KB 1 applied.)

(4) Here, the oral contract for D to discharge its proportionate share of P's obligations in the JV and to enjoy its proportionate share of its returns was contractually certain and complete, enabling D to determine, without further agreement with P what its obligations were and what rights it enjoyed. As to uncertainty, there was no difficulty in ascribing a precise and definite meaning to what it was the parties had agreed. **As to being incomplete, simplicity should not be mistaken for incompleteness.** D's argument that the oral contract was incomplete or uncertain since, at the time of that contract, P and IGB had yet to agree on their mutual obligations regarding the JV was rejected. This confused the JV agreement and the oral contract. The parties were NOT contracting for D to participate in the JV and therefore uncertainty of the terms of the JV was not fatal to the terms of the oral contract in issue as between P and D.

Practical Tips

Here is a summary of the law with practical guidance :

- There must be an intention to create relations; parties reaching express agreement of a commercial character are presumed to intend it to have legal effect and in consequence courts are reluctant to strike down agreements which those in business had made and acted upon.

- There may be no agreement (and therefore no contract) if the language used was too uncertain, vague or unintelligible. Simplicity however should not be mistaken for incompleteness, and the court may be able to find in the agreement reached principles, criteria or machinery, express or implied, for determining specific rights and liabilities.

Always minimise the risk of uncertainty and incomplete agreements (and therefore litigation) by expressly stating all rights and liabilities in the agreement. Minimise what you leave to chance. Careful pre-contractual consideration and negotiation are still critical. Do not rely on the Court finding or "discerning" in the agreement a formula or mechanism for making terms certain and complete.

CHARLES BARR

(CU Editor's underlining throughout).

More about Counsel in the Commercial Unit (CU)

"To measure the man measure the heart .....". Well, yes; but experience informs us that the following are (also) important:

- in recruitment and retention, Counsel should have and demonstrate **relevant** commercial law knowledge **and** experience;
- skills acquired in related disciplines (such as Master of Business Administration and Master of Economics), in second or further law degrees (such as Master of Laws) and in presentations (such as lecturing and publication) increasingly add value;
- the work of CU requires a balanced combination of:
  - ♦ commercial relevance or "nous";
  - ♦ academic ability and knowledge;
  - ♦ relevant experience; and
  - ♦ attention to detail
  - – the difficulty lies in the balance;
- teams of CU Counsel are required on major or significant matters. Team skills are therefore important;
- "lateral hires" i.e. recruiting partners and very senior lawyers from law firms in a relevant commercial law discipline is not usually possible and CU must therefore concentrate on "organic" development. From experience it takes 7 – 8 years to develop the knowledge and appropriate level of experience in major specialised areas of commercial law work.

So how do we measure up?

A statistical review of all 22 Counsel in CU has recently been conducted :

- The 22 Counsel have in total 394 years of legal experience after qualifying as solicitors and/or barristers (some are dually qualified). On average each Counsel therefore has 17.9 years of legal experience. If a total of two Counsel with the most (46) and least (8) number of years of legal

experience are excluded from statistical assessment, the average is 17 years.

- The 22 Counsel have in total 170 years of experience in private practice and/or the private sector. On average each Counsel therefore has 7.6 years of experience in private practice and/or the private sector. (Some Counsel have experience in both private practice and in-house private sector.) If a total of two Counsel with the most (20) and least (0) number of years of experience in private practice and/or in-house private sector are excluded from statistical assessment, the average is 7.4 years.
- 5 Counsel have published in one or more legal text books or periodicals.
- 6 Counsel have lectured and/or tutored at University or College of tertiary education.
- 14 Counsel have a total of 27 second or further degrees or qualifications (in addition to a first degree and qualification as solicitor or barrister). These second or further degrees or qualifications include Master of Business Administration (1), Master of Laws (5), Master of Economics (1), Master of Arts (1), legal qualifications in England and Wales, New South Wales, Australian Capital Territory and Singapore, as well as admissions to the Bars of New York and California.
- In CU, the ratio of directorate posts to non-directorate posts is 1:6+. This is believed to be close to the ratio commonly found in major private sector law firms as between partners and solicitors assisting partners.

CHARLES BARR

Court take realist view of corporate personality: *Beckett Investment Management Group Ltd and Others v Hall and Others* [2007] IRLR 793

If asked what is the most significant case for commercial lawyers, the answer would probably be ***Salomon v Salomon & Co.*** [1897] A.C. 22. This case established the principle that a company has a separate legal entity, separate from its shareholders and promoters. This is sometimes called the shield or veil of incorporation. Inroads into this separate corporate entity principle are few compared with examples of its application. However, in two major situations, the Court has been inclined to pierce the shield or veil of incorporation, namely:

(i) fraud or improper conduct, and

(ii) under express statutory provisions.

Other than these two situations, it is difficult to predict whether the Court will pierce the shield or veil. The Court will do so where "justice requires". The following is an example of where "justice requires", namely where the Court takes a realist view of corporate personality.

In ***Beckett Investment Management Group Ltd and Others v Hall and Others*** [2007] IRLR 793, the Court of Appeal in England, in construing a promise in restraint of trade (i.e. a non-compete promise) between a holding company of a corporate group and its employees who provided services through subsidiary companies within the group, rejected a purist approach to corporate personality in favour of one which had regard to the realities of big business, taking the group as being one concern under one supreme control.

In this case, the defendants were financial advisers employed by the holding company of the Beckett group. The holding company did not provide any financial advice to anyone. Financial advice was provided through subsidiary companies within the group.

In their employment contracts with the holding company, the defendants promised not to provide advice to clients of "the company" of a type provided by "the company" in the ordinary course of business for a period of 12 months after their employment contracts had terminated.

After their employment came to an end, the defendants formed a new company and provided financial advice to clients of the Beckett group. The holding company sued the defendants for breach of the promise.

At first instance, the judge held

that the term "the company" in the promise was to be narrowly construed as "the holding company of the Beckett group". As the holding company did not provide any financial advice to anyone but simply acted as a holding company, the judge held that the restriction in the promise was of no practical utility to the holding company and that the defendants had not breached the promise. The holding company appealed to the Court of Appeal in England.

The Court of Appeal allowed the appeal and rejected the judge's narrow construction. The Court emphasized that the defendants had been employed within the group for some time and that they were well aware of the structure of the group and the respective roles of the holding company and its subsidiary companies. The Court of Appeal followed the Privy Council's decision in ***Stenhouse Australia Ltd v Phillips*** [1974] AC 391, at 404, in which Lord Wilberforce rejected the purist approach and considered that "the subsidiary companies were merely agencies or instrumentalities through which the appellant company directed its integrated business". The Court of Appeal held that the term "the company" in the promise was to be construed as "the Beckett group" and that the defendants had breached the promise.

Some relevant quotations can be extracted from this case for example :

(i) "interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract";

(ii) "Agreements in restraint of trade, like other agreements, must be construed with reference to the object sought to be attained by them";

(iii) "Lord Denning MR in ***Littlewoods Organisation Ltd v Harris*** [1977] 1 WLR 1472 CA, at 1481 : 'The answer is, I think, the law today has regard to the realities of big business. It takes the group as being one concern under one supreme control.' ";

(iv) "In ***Stenhouse Australia Ltd v Phillips*** [1974] AC 391 PC … Lord Wilberforce rejected the purist approach 'technically attractive though it may appear'. In the circumstances of that case, he considered that : 'the subsidiary companies were merely agencies or instrumentalities through which the appellant company directed its integrated business'. These words resonate in the present case.".

Practical Tips

Although unpredictable in application, this case shows that, where "justice requires", the Court will have regard to the realities of big business and take a corporate group as one concern under one supreme control.

Justice **<u>may</u>** require this where, for example :

- one party has made a mistake in a contract which is known to the other or which the other seeks to take advantage of; or
- rectification of a mistake may be appropriate; or
- an employee has been guilty of sharp practice or breach of his duty of fidelity to the employer, not necessarily amounting to fraud or improper conduct; or
- severance of an unenforceable provision is appropriate.

However, it seems unlikely that the Court would go so far as to find that a holding company or the group is liable for the breach of obligations of subsidiary companies in contracts where the holding company or group is not a guarantor. Accordingly, when the Government enters into contract with a subsidiary company of a corporate group, it is still necessary for the Government to obtain a parent company guarantee or a performance bond, or to use some other devices such as the agency or trust concept to ensure that the Government can go against the substantial parent company in order to secure performance.

YUNG LAP YAN

Editor's Note – The ***Beckett Case*** is also important for affirming the threefold test in ***Sadler v Imperial Life Assurance*** [1988] IRLR 388 HC for severing i.e. removing an unenforceable provision.

The New Financial Reporting Council Ordinance – A step towards enhancing corporate governance

The Financial Reporting Council (FRC) was established on 1 December 2006 as a result of the enactment of the Financial Reporting Council Ordinance (FRCO) on 13 July 2006. The FRC has been modestly funded with HK$10 million annually for recurring expenses in its first 3 years plus an additional HK$20 million in reserves. FRC is funded by the Companies Registry, the Securities and Futures Commission (SFC), the Hong Kong Institute of Certified Public Accountants (HKICPA) and Hong Kong Exchanges and Clearing Limited (HKEx). Since its commencement on 16 July 2007, FRC has received 7 complaints, 5 of which are under review as at 29 September 2007. Ocean Grand Holdings, one of last year's high profile corporate failures, will continue to be handled by HKICPA since the acts, the subject of the complaint, occurred before commencement of FRC. In future, similar cases will be handled by FRC.

Why FRCO?

Corporate scandals in the United States and suspected cases of false financial reports of listed companies in Hong Kong have caused considerable public concern in recent years. Although HKICPA may discipline its members, it lacks sufficient investigative powers. As a result, Government proposed to set up the FRC and to equip it with powers to investigate into audit irregularities and non-compliance with relevant requirements in the financial reports of companies (whether incorporated in Hong Kong or not) and collective investment schemes that are listed in Hong Kong (listed entities).

Who are FRC members?

The FRC shall consist of not more than 11 members: the Registrar of Companies (ROC) or her representative; CEO of the FRC; 3 members each nominated by the SFC, HKICPA and HKEx and at least 4 and not more than 6 other appointed members. The majority of FRC members must be non-accountants.

To equip FRC with powers to investigate into audit irregularities and non-compliance with relevant requirements in the financial reports of companies

Currently, there are 10 members. Ms Sophia Kao, now the Chairperson of the Women's Commission, has been appointed as the Chairperson. The former Director of Accounting Services (February 1999 to October 2003) , Mr M.T. Shum is the CEO.

What types of audit irregularities can FRC investigate?

The FRC may investigate into irregularities committed by:

- auditors of listed entities in auditing their accounts; and
- reporting accountants of listed entities in the course of listing.

In this regard, the FRC will take over the investigation functions of the HKICPA.

What types of non-compliance in financial reports can FRC enquire?

The FRC may enquire into suspected non-compliance with legal, accounting or regulatory requirements in the financial reports of listed entities. These requirements include:

- those provided in the Companies Ordinance (Cap. 32) (CO);
- the standards of accounting practices issued or specified under the Professional Accountants Ordinance (Cap. 50);
- the International Financial Reporting Standards; and
- the Listing Rules issued by the Stock Exchange of Hong Kong Limited (Stock Exchange).

What powers does FRC have?

The FRC's investigation powers in relation to **audit irregularities** are modelled on those currently possessed by the SFC for investigating companies listed in Hong Kong. They include:

- require production and explanation of records and documents relating to audit irregularities; and
- require persons to attend before the FRC investigator to answer questions.

Any failure to produce the required documents or to answer questions is a criminal offence. However, if the

person claims that the required explanation might tend to incriminate him, the requirement and the explanation are not admissible in evidence against the person in criminal proceedings except for perjury.

The FRC's powers in relation to audit irregularities are wider than those currently enjoyed by the HKICPA or the police.

The FRC enjoys similar enquiry powers in relation to defective **financial reports**.

Furthermore, if a person fails to comply with the above requirements in the course of an investigation/enquiry, the FRC may apply to court to compel compliance with the requirements, and to punish the person as if he had been guilty of contempt of court.

What follows the investigations/enquiry?

The FRC only performs an investigation function; it does not have any disciplinary powers.

During or after an investigation, the FRC may refer any audit irregularity or defective financial reports to the HKICPA for disciplinary action. It may also refer it to the SFC, the Stock Exchange, the police or other relevant law enforcement agencies.

What about defective financial reports?

In addition, the FRC may require the directors of the listed company or the manager of the listed collective investment scheme to revise the financial report or take such other remedial action as the FRC thinks fit. Where the director or manager fails to comply, the FRC may apply to court for an order to compel compliance with those accounting requirements that are specified in the CO. The FRC will not seek court orders to compel compliance with accounting or non-legal requirements.

The FRC may refer any audit irregularity or defective financial report to HKICPA for disciplinary action

Can companies voluntarily revise their accounts?

The FRCO has also amended the CO by allowing voluntary revision of accounts. Where accounts have already been sent to the company members or other persons who are entitled to be sent a copy for the purpose of an annual general meeting but it appears to the directors that the accounts did not comply with the CO, the directors may revise the accounts with regard to those aspects that did not comply with the CO. This also applies to an overseas company where its accounts have been delivered to the ROC for registration.

Will auditors/accountants be afraid to whistle-blow?

Accountants and auditors are often the first persons to be aware of any suspected corporate fraud or misconduct. They have hesitations about informing or cooperating with the law enforcement agencies because of the risk of being sued by the listed entity for breach of the duty of confidentiality and other civil liability such as defamation. In scrutinising the Bill, some legislators were also concerned about protecting the anonymity of the whistle-blowers. The FRCO deals with the above concerns by:

- giving statutory immunity from any civil liability to those auditors or reporting accountants who communicate in good faith to the FRC any information or opinion on any suspected audit irregularity or defective financial reports; and
- giving a witness in any civil or criminal proceedings, Market Misconduct Tribunal proceedings or HKICPA disciplinary proceedings a right not to disclose the name and address or any information that would tend to lead to the discovery of the name or address of the informer and any person who has assisted the FRC in its investigation or enquiry.

It is hoped that with extensive investigation powers and despite the modest funding, FRC would be able to live up to its pledge to maintain independence, preserve transparency, uphold efficiency, and reinforce accountability.

BEVERLY YAN