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Assessing the Impact of the New Hong Kong Companies Ordinance on Charitable Institutions

The new Hong Kong Companies Ordinance (Cap. 622) (New CO) came into effect on March 3, 2014, with the aim to enhance corporate governance, ensure better regulation, facilitate business and modernize the law. As the New CO essentially replaces an 80-year-old regulatory framework, the changes have far-reaching effects for companies, their directors, officers and other stakeholders.

The impact also will be felt by registered charitable institutions incorporated as Hong Kong companies limited by guarantee (CLGs).[1] While there is no single governmental body or piece of legislation regulating Hong Kong charities, these entities and their directors and officers need to consider the myriad ways in which the New CO may affect their operations.

About CLGs

Institutions established "exclusively for charitable purposes" may apply for tax-exempt status under Section 88 of the Inland Revenue Ordinance, which offers certain legal and economic privileges.

The distinguishing features of a CLG are that it has no share capital (*i.e.*, there is no investment or ownership concept, as that is considered inappropriate for charities) and the liability of its members is limited to the amount they are willing to contribute (*i.e.*, guarantee) in the event of the company's winding up; this usually is a nominal figure. A CLG offers separate legal personality, but compliance with the Companies Ordinance is required.

New CO Impact on Directors and Other Officers

The New CO raises the bar on corporate governance requirements, especially in terms of the enforcement regime and standard of care expected of directors. The new provisions may be particularly relevant to directors of charities incorporated as CLGs who play a passive role or who have limited business experience.

Responsible Person. Historically, certain offenses under the Companies Ordinance, such as the failure to properly prepare and circulate annual financial statements, exposed both companies and their directors, shadow directors,[2] managers and company secretaries (officers) to liability, and only those officers who knowingly and willfully authorized or permitted the default were called to account (termed "officers in default").

Under the New CO, the term now used is "responsible persons" (which includes directors), and reckless acts (or omissions), as well as intentional contraventions, failures and willful blindness by responsible persons can result in liability. The New CO also expands liability to officers who participate in the breach (not just those who authorize

1 Hong Kong charities also may be formed by statute, charitable trust or operate as an unincorporated body (*e.g.*, a society). Foreign corporate charities also may operate in Hong Kong and register as a "non-Hong Kong company" under the Companies Ordinance. These types of charities/bodies are not covered in this article.

2 A shadow director is someone who is not appointed to the board, but a person in accordance with whose directions or instructions the directors, or a majority of directors, are accustomed to act.

or permit it). From a practical perspective, every responsible person should be vigilant regarding the CLG's regulatory obligations under the New CO, as we may see more prosecutions brought against complacent officers under the New CO.

Duty of Care, Skill and Diligence. Directors have important duties and responsibilities embodied in statute, case law and the company's memorandum and articles. The New CO clarifies (and arguably expands on) one of these duties: a director's duty of care, skill and diligence, which previously was enshrined in case law. The new test requires acts of a director (as well as a shadow director) to be judged both objectively and subjectively. A director's conduct now will be compared to a standard that would be exercised by "a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company" (New CO, Section 456(2)(a)).

In other words, the New CO mandates a minimum standard of care, skill and diligence that cannot be significantly reduced to accommodate someone who, for example, has limited corporate or management experience. This may be relevant to founder-governed charities or charities with inexperienced board members. To address these new rules, inexperienced directors may consider additional training or mentoring; and charities themselves may consider appointing more qualified personnel to the board to add support and enhance corporate governance.

The other fiduciary duties owed by directors (*e.g.*, duty to act in good faith) remain enshrined in case law and the Companies Registry has issued a revised Guide on Directors' Duties, which is a useful overview of the case law and statutory duties owed by directors of Hong Kong incorporated companies.

Additional Director Considerations. Other New CO changes that may affect directors (including directors of CLGs) include:

- A director's duty to disclose to the board any material interest he/she has in a contract or proposed contract that is significant to the company, has been expanded to cover "transactions" and "arrangements." Disclosure should include the nature and extent of the interest;
- A "business review" will need to be incorporated into the annual director's report, unless the CLG qualifies for the reporting exemption in Part 9 (discussed further below). The business review requires analytical and forward-looking information;
- Penalties imposed on the aforementioned "responsible persons" have been increased (*e.g.*, the fine for failure to lodge an annual return is now HK$1,000 per day);
- A director's right to be indemnified by the company's assets for liabilities to third parties has been confirmed, subject to important exceptions (*e.g.*, the indemnity cannot cover criminal fines, regulatory penalties and defense costs where a director is guilty of an offense or a judgment is given against him/her). It is a good idea to have this indemnity agreed between the director and the company contractually (even if already contained in the articles), but any such agreement must be disclosed in the director's report and a copy of the agreement kept at the company's registered office (refer to the indemnity provisions in the New CO CLG Model Rules (as discussed below) for drafting suggestions); and
- an acknowledgement that a company may purchase director's insurance for liabilities incurred by directors for actions such as negligence, default, breach of duty or breach of trust (except fraud) (and liability for defending proceedings related to such). Given that the assets of a charity may be limited (and thus the protection offered by a company indemnity is reduced), director's insurance is generally recommended.

New CO Impact on the Corporate Entity

There are a range of measures in the New CO that clarify, streamline and modernize Hong Kong corporate law from a CLG's perspective. These can be put into two broad categories: compliance obligations[3] and matters of procedural convenience.

Compliance Obligations. Important changes include:

Separate Category. CLGs now are classified as a separate category of "company," eliminating the question of whether a CLG is a private company under the Companies Ordinance. This in turn clarifies matters such as the requirement to publish financial statements and the availability of simplified financial reporting. A CLG must have two directors and cannot have a corporate director. A legacy private company limited by guarantee with a corporate director or less than two directors has until early September 2014 to comply with the new rules.

Accounting Reference Period. The accounting reference period (ARP) is a new concept and is the period by reference to which the company's financial statements are to be prepared. It is important for a CLG to ascertain the time period of its first ARP (First ARP), as the requirements under the New CO regarding preparation of financial statements, simplified reporting, holding an annual general meeting (AGM), laying/sending financial statements and filing the annual return (among others) start applying from the date of the First ARP onwards.

The First ARP begins on the day immediately following the end date of the company's accounts for the financial year immediately before the commencement of the New CO and ends 12 months after. As the New CO commenced on March 3, 2014, a CLG with a March 31 year-end would have as its First ARP the period April 1, 2014, to March 31, 2015; a CLG with a December 31 year-end would have as its First ARP the period January 1 to December 31, 2015. Each 12-month period thereafter constitutes an ARP (unless the reporting period is amended).

Timing of AGMs, Reporting Documents and Annual Returns. A CLG that has not dispensed with the requirement to hold an AGM now must conduct such a meeting within nine months of the end of its ARP. (Previously an AGM had to be held in each calendar year.)

A CLG's directors still are required to lay before the company's AGM the reporting documents (*e.g.*, audited annual financial statements, director's report and auditor's report), so the changes to AGM timing will affect a charity's reporting schedule. If the AGM has been dispensed with, the reporting documents must be sent to every member within nine months of the end of the ARP.

A CLG also must continue to file an annual return, but the timing requirements have changed slightly. A CLG must file within 42 days of the company's "return date" and the return date is the date nine months from the end of each ARP. The reporting documents laid before the AGM (or sent to members) need to be attached to the annual return, and it is a critical filing for a CLG. Breaching this duty will expose the company and its responsible persons to criminal penalties.

Simplified Reporting. A "small company limited by guarantee" can qualify for simplified reporting if its annual revenue does not exceed HK$25m. Termed as "companies falling within the reporting exemption," they still need to prepare a director's report and financial statements and have those financial statements audited, but they will be exempt from the following requirements:

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3 There are other compliance obligations under the New CO that are not discussed here, for example: disclosure of the company's name on business premises and communications; rules regarding written resolutions; threshold for demanding a poll; keeping and inspection of company records; rights and obligations of proxies; matters regarding the audit and auditor; and deregistration and changes to statutory forms. The Companies Registry has issued detailed briefing notes on the key changes.

- to disclose auditor's remuneration;
- for the financial statements to give a "true and fair view" (*e.g.*, the assets do not require revaluation at fair value);
- to include a "business review" in the directors' report; and
- for the auditor to express a "true and fair view" opinion (instead they will opine as to whether the financial statements have been "properly prepared").

The intention is that the financial statements of these companies will be prepared in compliance with the Small and Medium-sized Entity Financial Reporting Framework and Standards issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). These accounting standards are a briefer and simpler set of accounting requirements and disclosures compared to the HKICPA's full set of standards.

Although voluntary, adopting simplified reporting could be advantageous to smaller charities and should be discussed with their accountants and auditors. However, the company's articles may expressly require the accounts to give a "true and fair view" (this was the language used in the predecessor ordinance) and therefore the articles must be amended before taking advantage of simplified reporting. Potential obstacles to amending the articles are discussed below.

From a practical perspective, a charity may decide not to switch to simplified reporting if it believes donors will place more weight on a "true and fair view" audit opinion than a "properly prepared" audit opinion.

To date, the Inland Revenue Department (IRD), Companies Registry and HKICPA have not issued any guidance or commentary on the application of simplified reporting to Hong Kong corporate charities. CLGs and their directors will want to keep abreast of any developments by these organizations.

Matters of Procedural Convenience. The New CO offers numerous provisions designed to streamline and modernize corporate procedures. Many of these are not automatic and require the entity to elect or seek approval to adopt them. Furthermore, if the new provisions run contrary to the company's articles, the articles will also need to be amended.

While other companies (especially those that are closely held) can amend their articles quite easily, a CLG has two potential obstacles: the IRD (because it wants to be notified of any changes and obtaining a response could take months); and, for those with a large (legally registered) member base,[4] obtaining the 75 percent consent threshold to amend their articles could be difficult. From our discussions with the IRD, there are no plans to fast-track New CO "procedural" amendments for existing CLGs. Thus, each charity will need to decide whether the advantages of modernizing its procedures outweigh the time and cost of doing so.

Abolition of Memorandum of Association. Unlike most for-profit entities, which have the powers of a natural person, charities must have a confined set of objects/powers drafted into their memorandum of association in order to meet the IRD's requirements. The New CO abolishes the memorandum of association, which means these provisions in a CLG's memorandum are "deemed" to be incorporated into the articles of association (along with other relevant provisions in the memorandum, such as the company's name, its limited liability and the guarantee clause). There is no requirement to amend

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4 References in the New CO and this article to "members" are members in the legal sense, *i.e.*, those who are entered into the legal register of members (and are therefore liable to guarantee the allocated amount if the company is wound up). This is different from the supporters or donor base, who may "join" and support the company, but who are not "members" in the legal sense.

the articles, but the officers and senior managers of CLGs should be aware of the change so they can correctly interpret the document.

Common Seal Becomes Optional. The common seal is the metallic instrument that is "pressed" onto a red seal sticker (in contrast to a "chop", which is a rubber seal used for administrative convenience). A common seal is optional under the New CO (and deeds can now be signed without affixing the seal), but this is "subject to the articles." In other words, if the CLG's articles require that a seal must be held (a common provision in CLG articles), this must continue to be honored, or the articles amended, notwithstanding the relaxation under the New CO.

Dispense With AGM. The flexibility to dispense with an AGM has been well-received, especially for smaller companies that feel burdened by this requirement. Single-member companies are automatically exempt. Dispensation requires unanimous member approval (either in meeting or in writing), which may be difficult to achieve for CLGs with a large membership base. The matter is further complicated by the fact that many companies will have provisions in their articles mandating the holding of an AGM and discussing the procedural requirements. These provisions will need to be amended before an AGM can be dispensed with by obtaining the necessary member support.

Dispensing with the AGM in no way relieves a company from its obligations to properly prepare, circulate and file audited annual financial statements.

It has always been possible (subject to a company's articles and other than for decisions regarding removal of directors and auditors), to dispense with a physical meeting (including an AGM) by passing a unanimous written resolution. The New CO includes clearer procedures for doing this, but CLGs also must check the requirements in their articles.

Obtaining Section 88 Status in the Future

The New CO (in subsidiary legislation) provides a set of example articles of association for a company limited by guarantee, termed "Model Rules," which contemplate the various procedural and compliance points contained in the New CO. These make a good starting point for the preparation of new (or revised) articles for CLGs. Those wishing to apply for Section 88 status will need to modify the Model Rules to meet IRD requirements (*e.g.*, prohibiting remuneration to directors, restricting distribution of profits to members, stating that surplus assets will be distributed to an institution with similar charitable objectives on winding up etc.).

Looking Ahead

The Law Reform Commission's 2013 report on the law and regulatory framework relating to charities may lead to future reform for charities in Hong Kong. For now, CLGs need to rely on and comply with the New CO.

While parts of the New CO may appear daunting, CLGs should focus their immediate attention on the higher standards of corporate governance expected of their officers as well as their financial reporting and regulatory filing obligations (both in terms of scope and timing). Many of the other changes relevant to CLGs may offer procedural convenience and modernization, but may not necessarily require immediate attention, or be feasible given that (in some instances) they may require CLGs to amend their articles.