EAST ASIA TRANSNATIONAL
International Commercial Lawyers
Hong Kong and Auckland, NZ.
www: transnational. co. nz

Auckland
Ph: 64-09-4764471/4764472
Fax: 64-09- 4764473
Mobile: 027-2733331
tjbrears@transnational.co.nz

Hong Kong
Ph: 852-25262077
Fax: 852-28450354
Mobile: 94481338
jcll@ioffice-hk.com

INTERNET NEWSLETTER- July 2007

Issue 18.

In this Issue:

(1) Employment- the latest amendments to the Employment Ordinance- need to change payroll systems.

(2)

(3) Company/Corporate/Contract issues

(a) inability of Company to conduct business due to disappearance of shareholder;

(b) need for allotment of shares by Directors- observance of section 57B;

(c) Oral contracts on the telephone- immediately binding and not subject to later documentation by lawyers- Bear Stearns case in London.

(4) Tax

a. Judicial Review to fight the IRD;

b. Latest Update and Re- issue of IRD Departmental Notes (No. 10) on Salaries Tax;

(5) Trusts

a. Trustee's right of Indemnity- the risks to a corporate Trustee and its Directors;

b. Topical issues in British Virgin Islands.

(6) Securities and Licensing

a. an update of SFC supervisory requirements on Investment Advisers;

b. the right to sue over a" grey" market trade- latest case in Hong Kong.

Employment.

The latest amendments to the Employment Ordinance- need to change payroll systems.

Coming into force on the 13/7/07 was the Employment (Amendment) Ordinance 2007. Those employers who are unaware of it should become acquainted with it as soon as possible, as it changes the basis of the calculation of statutory benefits to a formula based on the ' daily average' of the wages earned by an employee over the preceding 12 months in lieu of the average daily wage for the last wage period.

The new provisions will mean the manner of calculation of benefits and payments such as wages in lieu of notice, damages for wrongful termination, end of year payments, maternity leave pay, sickness allowance, holiday pay and annual leave pay will be different.

It will also mean that the following periods, and the wages therefrom, should be ignored:

any period therein for which the employee was not paid his wages or full wages by reason of:

- maternity leave, rest day, sickness day holiday or annual leave
- leave taken by agreement;
- employer not providing any work on a normal working day;
- absence from work due to incapacity for which compensation is payable under the Compensation Ordinance

There is no definition of " full wages".

The amendments have been driven by the Lisbeth case where sliding scale commission was held by the Court of Final Appeal not to be ' daily wages'. Commission is now included as a result of the amendment.

There are many difficulties over interpretation of the new provisions, and practical issues arise; for instance those employers who employ part time or hourly paid employees may not know what their " full wages " are. In addition, the period over which daily or monthly averages must be calculated is 12 months ' immediately prior to the date of sick leave, annual leave etc. It is not now the prior 12 month wage period.

Company/Corporate/Contract issues

(a) Inability of Company to conduct business due to disappearance of shareholder.

It sometimes happens that because of the disappearance or recalcitrance of a shareholder in a two shareholder Company it proves impossible for a shareholder to hold a shareholders meeting to conduct essential business. However, it should not be forgotten that a remedy is provided in section 114B of the Companies Ordinance where on a simple court application the Court can authorize the passing of a special resolution at an EGM. In a recent Hong Kong case the Court had no difficulty in approving and passing a special resolution on proof that the other shareholder had failed to collect notices and could not be located.

(b) Need for allotment of shares by Directors- observance of section 57B;

It is sometimes overlooked that under the Hong Kong Company Ordinance unless Directors are authorised by the shareholders in general meeting they are not able to pass a board resolution to allot new shares. The exercise of this function by Directors in most commonly seen in the public company arena where shareholders usually give the Directors a mandate at an AGM under section 57B of the Companies Ordinance to issue or allot up to 10% of the authorised capital of the Company for the next 12 month period.

However, the legislation also applies to a private company and without shareholder authorization it may be prove inconvenient and hold up new capital raising if the required mandate is not in place, particularly where

the company is not a family company and shareholders live in diverse locations.

(c) Oral contracts on the telephone- immediately binding and not subject to later documentation by lawyers

Unless it is in the broker and security area most clients would have thought that agreeing the terms of a transaction by telephone and making some terms subject to agreement later in a contract to be prepared by legal advisors would mean that no contract came into existence until the later contract was prepared and signed. Also, the absence of what might appear to be a completion date might well have been thought an essential term possibly avoiding the legal formation of a contract unless it was agreed subsequently.

However the dangers of making agreements by telephone was demonstrated by a recent UK case of **Bear Stearns PLC and Forum Global Equity Ltd**. There a London Court found that a legal contract had been formed by telephone between the brokers of each firm. Bear Stearns were successful in arguing that an agreement to purchase part of the bonds of Parmalat (a failed Italian Company) at a deep discount on a completion date to be agreed and on terms to be set out in contracts to be prepared by the legal advisers to the parties had been breached by Forum when they subsequently refused to complete the transaction. The fact that no completion date had been agreed was held not to prejudice the oral agreement already reached.

Although there were special issues in the above case that might not arise in the average dealing between non –broker parties, it should be borne in mind that, under normal contract law principles, it is open to the parties to say that, in effect" we have made our agreement and all that remains is to document it" While this might mean that matters such as the date of completion and the currency of settlement had still to be agreed, a court can find, as it did here, that the parties had agreed that some issues were capable of being dealt with later, and that matters of detail and the terms of the legal contract were simply added to record a transaction that has already been consummated.

The lesson to be learned is that if you do not wish to commit yourself to an oral agreement made on the telephone make it clear that any

arrangements are subject to contract that and there is to be no deal until legal advice is taken and a satisfactory written contract negotiated and signed.

TAX

(a) Judicial Review to fight the IRD;

In the recent High Court case of **Wong Yu Rolly V the IRD** there was some discussion on what remedies a taxpayer might have in the face of dilatory and inexcusable delays on the part of the IRD to take action on possible settlement negotiation suggested by the Court.

The Court suggested that a tax payer has a right to complain to the Ombudsman if the IRD fails to respond to settlement offers. In addition, the court proceedings that had been adjourned can be re- opened and continued.

While in the present case the Judge held that the delay thus far by the IRD (some two months) to respond was dilatory, it was not a delay as to allow Judicial Review of the decision or inaction of the IRD. However, it was implicit in the judge's comments that there were delays and actions by the IRD that might be subject to Judicial Review.

All too often the IRD has strung out tax investigations and litigation to unacceptable lengths and it timely to bear in mind that the tax payer has the remedy of Judicial Review available in some circumstances as well as a right to ask the Ombudsmen to look into the matter to see if the IRD is fulfilling its statutory obligations.

(b) Latest Update and Re- issue of IRD Departmental Notes (No. 10) on Salaries Tax;

The IRD has now replaced and updated its interpretation notes No. 10 (dated 1987) relating to salaries tax. The notes are updated as at June 2007.

In the revised notes case law and some interpretative provisions and practices have been updated but the majority of the notes follow the earlier notes. However, the following matters appear worthy of comment:

(i) Much of the notes deal with the issue of whether there is Hong Kong employment and re- iteration of the principal in the Goepfert case that where the services are rendered is not relevant;

(ii) The IRD will in the future insist on a copy of an employment contract where non- Hong Kong employment is claimed;

(iii) If the Employer is in Hong Kong it is unlikely non- HK employment will be agreed to notwithstanding services are rendered outside HK or the contract is signed outside HK;

(iv) The residence of a Company will be determined by the place with Board meetings took place, if those board meetings deal with essential decision making matters;

(v) Minutes of Board meetings, job descriptions of persons controlling non-HK controlled companies would need to be produced;

(vi) Other than situations where it can be established that the employee performs all services outside Hong Kong, is not resident in HK and is not paid directors fees from a HK employing entity, it will be rare that exemption from HK tax can be claimed.

We have mentioned in past Newsletters that formation of non -HK employment needs considerable thought and documentation and structure are vital issues.

TRUSTS

(a) Trustee's right of Indemnity- the risks to a corporate Trustee and its Directors;

Many clients may have settled domestic or offshore trusts using a corporate entity (eg- a BVI company) as Trustee of the Trust. The Director and shareholder of that Trustee company may be the settlor, but very often is a friend or relative. Usually the Trustee company will only hold passive assets such as shares in underlying companies and will not actively trade. However, Directors of such Trust companies should be aware of potential liabilities or what might happen if the Trustee company

was required to give a security, enter into a trading contract, or was sued by a creditor.

The general law in this area can be summarized as follows:

(i) if a trustee company has incurred liabilities in the performance of the Trust the trustee is entitled to be indemnified against those liabilities out of trust property;

(ii) a Director of a Trust, if sued personally, would have recourse under normal company law principles to the trust assets by way of indemnity;

(iii) However, a Director of a Trust company which traded recklessly and incurred liabilities in excess of the assets of the Trust might well face legal action personally for running an insolvent company. In Australia, Companies legislation provides that in the absence of trust assets the Director of a Trustee entity is personally liable for the debts of the Company. No such provision exists under Hong Kong legislation, but the risk cannot be discounted;

Certain steps can be taken by Directors of Trust Companies to alleviate any risks. These are:

(a) avoid trading situations;

(b) if a trading situation exists, make sure that an exemption clause is built into the contract to the effect that the Trust entity enters into the transaction as a trustee and that its liability is limited to the assets of the Trust;

(c) at all times when dealing with banks in a lending situation make sure that trustee status is revealed, because if it is not, the Bank's claim on the assets of the Trust may come in ahead of the beneficiaries; in that event there may be no right of indemnity;

(d) if a director of a trustee entity make sure a simple nominee agreement exists reflecting that the share in the company and the role of director is as nominee for the Trust;

(e) most important of all, have the settlor of the Trust sign an indemnity agreement in favour of not only the trustee entity but also any directors so that in the event of obligations arising that are not covered by the Trust assets losses can be recouped from the settlor personally.

(b) Developments in British Virgin Islands Trust Law

The British Islands legislature has recently gazetted new legislation applicable to private, as opposed to public, trust companies. This legislation will bring BVI into line with other tax havens which have allowed private trust companies restricted powers to operate in family and other situations. We will deal with this legislation in a subsequent Newsletter.

SECURITIES AND LICENSING

(a) An up date of SFC supervisory requirements on Investment Advisers

Licensed Investment advisers have often complained about the standards of compliance required under the Code of Compliance ("Code") but it seems that the SFC is determined to intrude even more in their supervisory role if the contents of a recent report are to be believed. The Report of Findings of Second Round of Thematic Inspection of Licensed Investment Advisers was released on the 31/5/07 ("Report") and contains a summary of what the SFC believes are unsatisfactory practices found in a survey of Investment Advisers ("IAs")and some indication of future policy.

Although the Report identifies number of areas where there were failures to comply with the Code, two may be highlighted, showing as they do the high duty of care that the SFC requires.

The first failure was in the area of Product due diligence. It is clear that the SFC expects IA's to have an in depth knowledge of the Product and to have conducted a timely market survey of market and financial information before recommending the Product. Further, the Report say that IA's will be expected to have due diligence systems and procedures in place and to have reviewed Products before allowing

sales staff to promote the Products. In addition, the SFC say that it expects that IAs will spot inconsistencies between offering documents and marketing materials, a typical example being a description of a Product as being suitable to conservative investors with low risk tolerance whereas the offering memorandum says that the investment was only for those who afford to lose their entire investment.

As well, material errors in offering material or contradictory material from a product provider is expected to be picked up on by the IA.

Finally, the Report makes it clears that reliance on material in prospectus's offering circulars etc is not enough; investigations by the IA on their own account and a record of the results are recommended.

The second area commented on in the Report was the requirement to know the client. In the Report (and in the SFC FAQ on suitability obligations of IAs') the fact that under the Code there are positive obligations to seek information was mentioned and emphasized. It seems clear the SFC expects the IA to collect information that includes investment knowledge, investment horizon, risk tolerance (including loss of capital) and capacity to make regular contributions. Information is expected to be updated.

Two other matters may be mentioned briefly.

One is disclaimer documentation which says that the IA did not recommend or advise over the Product but only executed an order. That documentation may not be treated as bona fide by the SFC. Evidence of proper advice and evidence that properly documented disclosure material and advice was give to the client may have to produced with suitable waivers. The suspicion will be that it is likely impossible for a client to sign such a disclaimer without having received some advice. The SFC says it will be reminding clients that they should not sign disclaimers of this nature.

The other matter is commission and its disclosure to clients. While some IAs make disclosure of receipt of commission or soft dollar benefits from product providers, others do not. The SFC says in the Report that it is currently reviewing the issue and may consider making disclosure mandatory.

In summary, more intrusive controls and guidelines from the SFC seem likely. The Code and the Guidelines (Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC) apply to all IA's and while a breach of the Code might be expected to be the more serious offence, there is a statement in the Report that breach of the Guidelines may be treated on the same basis.

(b) The right to sue over a "grey" market trade- latest case in Hong Kong

In a recent High Court decision of **Woo Hing Keung Lawrence V CEF Brokerage Ltd** some guidance on the legalities affecting a trade on the "grey" market was given. There are no guidelines on the subject of "grey" market trades put out by the Stock Exchange and there had been no case decisions to date.

The facts of the case involved a short seller of China Telecom stock who instructed his broker to short sell the stock on the grey market. The buyer defaulted, Mr. Woo having made a correct call that the market would fall, as it did due to the Asian financial crisis at the time. As Mr. Woo was suing the broker (a broker is bound to honour a trade if a counterparty defaults) a key issue was whether the broker was bound to cross the order on the Exchange on the first day of trading or whether the position was different in a "grey" market trade.

The Court held:

(a) there was no liability to cross the trade;
(b) there was no Stock Exchange rule or any term in the broker documentation that the broker was liable for the defaulting third party;
(c) there was no market practice rule protecting the client;
(d) Mr. Woo could sue the third party who had defaulted;
(e) The broker might be sued in negligence if he failed to keep records of the grey market trade.

In summary, for the general public there are can be considerable risks in entering into a "grey" market trade before an IPO.

CHINA

(a) Update on tax arrangement between Hong Kong and the PRC;

The China State of Administration of Taxation has issued a Notice clarifying the Arrangements between the PRC and Hong Kong for the avoidance of Double Taxation. Amongst the issues clarified are:

(i) Hong Kong companies that engage in production, supervision, management or sales in relation to processing arrangements will be deemed to have a permanent establishment in China;

(ii) If a Hong Kong resident sells an equity interest in a PRC company then the gain on the disposal is taxable at the rate of 25% if the seller has ever owned 25% or a greater interest in such company (no matter if the interest held is greater or lesser than 25% at the time of disposal).

(b) New Safe Rules affecting offshore special purpose companies

China's State Administration of Foreign Exchange ('Safe") has issued new rules for registration of foreign exchange by residents of the PRC. Under the rules any citizen who acquires an interest in an offshore financing vehicle for the purpose of overseas financing of a domestic company.

This measure may have far reaching consequences on the current registration procedures, and the list of accounts, information and details of the controlling shareholders of the PRC company are extensive.

Disclaimer: The above Newsletter and information contained in it is for general information only and not intended as legal advice.

Copyright: East Asia Transnational July 2007. The contents of these notes/draft document are for the exclusive use of the clients to whom they are addressed and copying and unauthorized circulation is prohibited

EAST ASIA TRANSNATIONAL