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Issue 22

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1(a). Mediation- the advantages

Most commercial clients will be well aware of Arbitration clauses placed in agreements, but the possibility of mediation as a substitute method of determining disputes and its advantages is not so well recognized. A mediator can be appointed to assist and act as a kind of chairman or facilitator of the negotiation process. The mediator has no power to make a decision but rather sifts through information and can communicate separately with each party in an endeavour to try and reach a compromise agreement. Parties do not need to be represented by lawyers although lawyers may play an important role on advising what documentation needs to be produced. Parties may sit in separate rooms with the mediator going between them in an endeavour to broker an agreement. Advantages are that costs are normally much less than a formal arbitration and the mediator can be anyone that the parties mutually select.

A well drawn mediation clause will normally adopt a set of mediation rules (the HKIAC has appropriate rules) but there should be default provisions in case mediation is not mutually agreed (or no mediator can be agreed) and recourse to formal Arbitration is needed. A mere reference in an agreement to mediation without more is not legally enforceable.

1 (b) **Signature of Documents- " virtual signings"**

This note is intended as a brief reminder to commercial clients on the practice of completing documents by adding new pages to an existing document and relying on a pre- signed signature page to cover the whole document. In a recent case a dispute arose and the Court held that there is no presumption that unsigned pages formed part of the document and that normally parties intend that pages of an agreement are to signed or formally authenticated in some way.

Employment

2 (a) **Update on PCCW case.**

In an earlier Newsletter we dealt with PCCW and Aitkin. PCWW had sought an injunction to enforce the usual confidentiality and trade secrets restrictions in DMA's employment contract, but, in addition, an order that DMA be restrained completely from using any information at all he had been privy to on the basis that he was in the same position as legal adviser who has acted for a competitor and must keep all discussions completely confidential (not merely trade secrets).

The Court of Final Appeal, particularly Lord Hoffman, upheld the lower Court and re- affirmed that information carried in the head of an employee and based on past business experience with an employer, so long as not trade secrets, may be used by the employee in a future job. This view accords with the well known rules established in such cases as Faccienda Chicken, and it is to wondered why PCCW wasted the time and money on an appeal.

2(b) **Termination- a brief summary of the main grounds**

In a tough economic climate a brief summary of the grounds that an Employer can terminate under the Employment Ordinance (" EO") may be timely. Termination is never easy and it is important to get it right.

(i) Termination Generally: Termination is usually by notice under the employment contract, either a payment in lieu of notice, notice as in the contract or as implied under the EO, or can be " garden leave" notice where the employee is dismissed on full pay to serve out the notice.

(ii) Calculation of payments:

(a) The EO now defines commission as wages;
(b) The average of all wages paid to the employee over

the last 12 months of employment must be used as the starting base for calculations.

(c) Unless specifically made discretionary, there is a presumption that an end of year payment is included in wages;

(d) Upon termination, accrued annual leave entitlements, wages in lieu of notice, compulsory bonuses, plus other claims must be paid in 7 days;

(e) Under section 31Q of the EO after two years of service, dismissal of an employee is assumed to be redundancy, 2/3rds of wages as redundancy pay may be due;

(f) Note that with bonuses, mere labeling as a discretionary bonus may not be good enough if there is proof of regular payments of bonuses pursuant to a scheme. It would pay for an employer to be seen to actually exercise a discretion. Concise criteria for payment of bonuses is recommended lest employees in the same position complain of non receipt of a bonus as compared with a colleague.

(g) Dismissal with a settlement agreement is a good option if the termination has been contentious. Restraints of trade and waiving of future rights may be appropriate. An agreement may assist the clarification of the tax treatment of the payment. A recent case held that a payment made under an agreement as an ex - gratia payment was not taxable so long as it was not dressed up and included payments in lieu of notice, garden leave etc.

(iii) Unreasonable dismissal is covered by section 32A(1) where an employee has been in the job over two years. Defences can include, conduct, qualifications, redundancy and other reasonable grounds. Where dismissal is because of a desire to avoid payment of contractual bonuses, good grounds for dismissal will be needed.

(iv) Where employers employ international employees in Hong Kong it is possible some are employed under the law their home jurisdiction. Care will be needed to see which law applies as the dismissal principles under the Hong Kong EO will not be appropriate to countries where pre- termination conferences are needed followed by special notices of dismissal. Expatriate allowances and air fares may be involved in a dismissal.

3. **Tax:**

3(a) **Hong Kong Double Tax Treaties**: The Government was to Gazette on the 26/6/09 amendments to the IRO to enable Hong Kong to adopt the latest international standard for exchange of information in a comprehensive avoidance of double taxation agreement.

Amendments are necessary because under the IRO the IRD cannot collect any tax information unless it is for domestic tax purposes.

For Hong Kong domestic tax payers the amendment is of little interest. However, in the wider international commercial and trust community those who have companies in Hong Kong will no doubt carefully consider not only whether Hong Kong is appropriate but whether structures set up will have the Hong Kong Company as the taxpayer and if so, who will be the shareholders and directors.

We are not suggesting that evasion of tax in another country should be condoned, but fishing expeditions by the IRD from other countries are time consuming and expensive at both ends. Much will depend on which countries Hong Kong will sign double taxation agreements with. Historically, Hong Kong has had little interest in seeking comprehensive double tax agreements because Hong Kong's source and territorial tax system meant Hong Kong companies did not pay tax on profits earnt offshore. However, as many of Hong Kong's trading partners have are in favour of treaties, it seems the Hong Kong Government is anxious to oblige. Hong Kong has concluded treaties with Belgium in 2003, Thailand in 2005, China in 2006 and Luxembourg in 2007.

3 (b) **Datatronix Tax case- an update**: The Datatronic taxpayer lost the third round of litigation when the IRD were successful in the Court of Appeal on the 15/7/09. The case is important and we now summarise how the Court of Appeal arrived at its decision.

A short fact summary first. It will be recalled from our last Newsletter that DSC (the PRC subsidiary) was a manufacturing company owned by Datatronic HK(DHK). DHK sold materials to DSC, DSC manufactured the products and then sold them to DHK. The prices were not at arms length but profits were recorded in the books of both companies. DHK provided know how to DSC and handled processing agreements.

Basically DHK argued that DSC was its manufacturing agent, DHK was therefore a manufacturer and was engaged in import processing in China and that under the IRD DIPN 21 rules on apportionment it was entitled to claim that 50% of the HK profits of DHK were sourced in China.

The Court of Appeal held that section 14 of the IRO, and the usual source of profits rules applied to the situation and the IRD DIPN 21 rules had no force of law or did not apply.

The Court upheld the Commissioner and held that all DHK's profits were sourced in Hong Kong. Its reasons were:

(a) the source of the profits was the sale of the products purchased from DSC, and all sales took place in Hong Kong. DHK had sold material to DSC and then bought back the finished products for re- sale;

(b) The true source of the profit was not the import processing operation and the associated technical assistance;

(c) DSC was not an agent of DHK. Goods were bought and sold between them as independent parties and situations like that were excluded under the IRD DIPN 21 rules. Arguments by DHK that the sale arrangements were solely for customs purposes were rejected;

(d) the IRD DIPN 21 rules apply to contract processing, not import processing.

(e) statements in the ING Barings case that profits of one company cannot be allocated to another company in a Group were approved;

In summary, DHK adopted the wrong strategy and structure in dealings with its subsidiary DSC. Quite clearly, if it had provided the raw materials and technical assistance at a fee and clearly appointed DSC its agent, the 50% exemption no doubt would have been available under the IRD DIPN 21 rules or on application of general principles under section 14 of the IRO.

3(c) **TIEA and BVI**. Due to the widespread use of BVI Companies it is worth reminding clients that the Government of the British Virgin Islands will be signing TIEA's (Tax Information Exchange Agreements) with a number of countries in the OECD.

A TIEA does not require the BVI Government to reveal any information about a given taxpayer unless there is a formal request. If there is a request it cannot be a "fishing expedition" but must be specific and related to the tax affairs of the taxpayer. Grounds for BVI not produce the information are provided for but are limited.

Given that the usual BVI Company does not carry on business in BVI and there are no accounts etc, it is hard to see what information other than who the Director and Shareholder of the Company are would be available to be disclosed by the Registered Agent. And the Memorandum of Understanding signed between BVI and other countries exempts communications between a client and a lawyer.

BVI has signed TIEA's with the USA, Australia and the UK. TIEAs' are close to being signed with New Zealand, and the Nordic Council (Denmark, Norway etc)

4. International

(a) **Annual filing of Foreign Bank Account Reports for US taxpayers**.

There has been some publicity and seminars in HK concerning this new requirement from the US. We do not propose to go into the matter in any depth as we do not practice US law. However, as the application of the new rules may have the potential to effect non - US citizens we summarise the effect of the new rules as we understand them.

(i) the form to be completed relates to a taxpayers interest in a bank account and is not a tax return;

(ii) it is a financial interest in a bank account owned and or controlled by a US citizen that must be reported;

(iii) the rules will come into effect next year as the old rules will apply this year;

(iv) the rules are very wide ranging and cover a person acting as an agent of a US taxpayer, a partner ship interest of over 50%; a trust in which the US taxpayer has a beneficial interest as a beneficiary of over 50% or receives 50% of the income;

(v) a trust bank account where the trust has a trust protector;

Clearly those non -US citizens who control accounts, trusts, entities and funds held on behalf of US taxpayers will have to carefully examine what obligations they may have under the new rules. We will be looking into the issue further and will report in subsequent newsletters.

(b) **FDI Rules Vietnam:** These have just been announced and may of some interest to potential investors from Hong Kong.. We will cover in subsequent issues.

5. Trusts

(a) **Liability of Co- Trustees**: Recent case law has highlighted the risks in trustees entering into contracts on behalf of a trust without limiting personal liability. The usual rules based on obvious contractual principles means that personal liability to a third party may be only be negatived if there is a standard clause in the contact disclosing that the trust is the contracting entity, and that liability is limited to the assets of the trust.

What of the position of a trustee where his co- trustee enters into a contract personally on behalf of the trust without any limitation ? Is the trustee also liable personally because of the acts of his co- trustee ? A recent case confirmed that there is no general principle that a trustee can bind his co – trustee personally without that trustee's signature as well to the unlimited contract.

The case highlights the need for co - trustees to have operating procedures in place over signature of contracts. Notwithstanding that the trustee may have personal liability there should be a right of indemnity to the Trust assets which beneficiaries and the settlor may well be unhappy about where one trustee was able to incur a liability without the signature of his- co – trustee.

(b) **Fraud on a Power**: Fraud on power may seem to professional trustees (and other non- professional trustees) a somewhat academic issue and not a matter of great importance in the administration of a trust.

Trustees will no doubt take professional advice where the issue might arise, and we do not wish to deal in detail with what can be a complex issue. However, it would be as well for trustees to at least be aware of the circumstances where such an issue might arise so as to ensure that the terms of the Trust Deed are observed and that the correct procedures undertaken when it is intended to make an advance to a beneficiary with the intention of benefiting other beneficiaries who were not originally beneficiaries under the main Trust Deed.

The starting point is the recognition of the general principle that a power of appointment under a trust is for the purpose of the Trustee making a decision on who will take the Trust Funds whereas a power re- settlement in a Trust Deed (usually, but not always in older trusts, explicitly set out in the Trust Deed) allows the Trustees to establish new trusts for the Trust property, the beneficiaries of which are usually the same as the existing beneficiaries, but not always.

An example may demonstrate the difficulties that may arise and constitute fraud on power. A is a beneficiary but wishes to benefit a non- beneficiary of the Trust be setting up a new trust. Can A do so ? Obviously A can do so, because under the usual discretionary power of appointment granted to Trustees, the Trustee may advance the Trust Funds to A as a beneficiary. A may then establish a new fund with those funds whose beneficiaries are different from those under the original Trust Deed. Obviously gift duty and value added taxes may apply to the transaction in jurisdictions such as UK, Australia and NZ, but not in Hong Kong, which has no gift taxes or value added taxes.

On the other hand, an attempt to achieve the same result by a power of re-settlement may well fall foul of the provisions in the Trust Deed either because the terms of re- settlement in the Trust Deed do not allow re- settlement with new beneficiaries, or if there is no power of re- settlement, use of the power of advancement in the Trust Deed when the term of the power does not allow. That and may constitute unauthorized use of the power also.

<u>In summary, recent case law in UK and NZ has established that the Courts will hold Trustees to account if they have proceeded to make advances under the wrong power or exceeded existing powers, usually by delegating powers which they are not able to do. Careful planning to benefit non- objects and set up new trusts for them is necessary in all cases.</u>

(c**) Liability of Directors of PTC's**:Use of a offshore or other companies as PTC's where the settlor, or more commonly family or friends, hold the shares and the directorship, is widespread;

The liability of such directors and shareholders has been considered in UK and recent NZ cases and it may be useful to summarise the general principles that apply to the position that the Director/shareholders hold.

(i) has a Director of a PTC liability to a beneficiary of the Trust or creditors of the Trust ? Generally the case law is that the Director owes no such liability, whether fiduciary of otherwise;

(ii) However, where there is evidence that a Director has assisted or possibly closed his eyes to a dishonest breach of trust, the Director may have some liability;

(iii) Alternatively, there may be a " dog leg" claim against the Director on the basis that the actions of the Director have caused loss to the Company as Trustee of the Trust

In summary, Directors of PTC's can derive some comfort from the general law, but would be wise to have the usual indemnities direct from settlors and have indemnities in the Trust Deed that not only cover the Company but also its Directors. Except in cases of dishonesty this should provide sufficient protection but if greater protection is required, insurance can be taken out.

6. **China:**

(a) **Cash Flow into and out of China**: We do not practice China law but often have to consider its application when advising on structures that involve a Hong Kong company and investment in FIE's in China.

The real problems are two fold; the difficulty of extracting cash from China FIE's and the restriction on how capital and loans are invested in a PRC FIE ot other entity.

It is clear that careful planning is required to balance the twin objectives of contributing as little as possible to paid up capital when capitalizing new set up FIE's and the other objective of avoiding a situation where the FIE is left short of liquidity in an expansion phase. PRC law allows staged payments of capital with 15% within 90 days and the balance in cash in two years. However, access to this capital is difficult and it is effectively locked in.

Payment by the offshore subsidiary to the FIE in return for sale of products, IP rights, services is a quicker method of financing.

Investor should consider use of foreign currency loans as a means of dealing with cash flow problems. Loans must be registered and approved by SAFE.

Inter company loans and intra- group lending in China is difficult and loans can only come from banks.

Extracting cash from FIE's in China is difficult because of limitations on dividend distribution and restriction on transfer of cash equivalent to depreciation. Use of a loan from an offshore subsidiary may allow easier repatriation, and, in addition, outbound loans from a FIE to an offshore borrower as long as the offshore borrower is wholly or partially owned subsidiary of the onshore lender.

In summary, investment in and extraction of capital from an FIE remains a complex and beaurocratic exercise requiring considerable pre-planning if financial difficulties are to be avoided for both the investor and the FIE.

(b) **China Transfer Pricing Regulations**: China has transfer pricing regulations of some complexity and any group that has subsidiaries in China and sales between those subsidiaries and other group companies must observe quite detailed conditions and reporting requirements.

We do not intend to delve into the complexities of the regime in this Newsletter, but a few observations may be made which may be of use to those companies having group operations.

Related party transactions are identified by:

(i) shareholding percentages between group companies, whether 25% owned or controlled;

(ii) debts owed by one company to another;

(iii) percentage of senior management appointed by another enterprise;

(iv) purchase of raw materials is under the control of another enterprise;

(v) other control methods;

Every company subject to the rejime must prepare a transfer pricing system and PRC companies must file details of transfer pricing transactions.

OECD transfer pricing methods are used in China and include the different formulas, such as Resale price method, uncontrolled price method, profit split methods etc.

All companies dealing with China and with inter- group transactions would be well advised to become familiar with the transfer pricing regulations before and as part of pre-planning to invest in China.

7. Duty of care on Financial Advisers in Hong Kong.

Claims against financial advisers have been rife in many jurisdictions as a result of the market meltdown and the investigation of the products sold to the public, such as Lehman Brothers minibonds.

It is perhaps timely to briefly summarise the obligations and duty of care owed by Financial Advisers in Hong Kong.

(i) The starting point is the Client Agreement under the Code which must be signed by each client of a Financial Adviser in Hong Kong before any advise can be given or dealings undertaken;

(ii) An integral part of the investment process is establishment, as set out in the Client Agreement, the level of risk that the investor can tolerate;

(iii) In the case of Susan Field V Barber Asia the Court had no difficulty in holding a financial adviser guilty of negligence when an in-experienced investor was persuaded to invest in a product involving borrowing in one currency to invest in another. The basis of the liability is that the financial adviser has undertaken to provide special services for reward and the investor had relied on that advice.

(iv) Use of a Client Agreement and setting out the risk profile and nature of the investment will usually provide some defence to the Financial Adviser, as warnings to the investor required by the SFC under the Code are clearly given. However, claims might still be made if information provided was incorrect or oral advice contradicted what is in the Client Agreement;

(v) A difficult area is where the Financial Adviser argues that he was not giving advice but merely handing over say a brochure on an investment. In other words, the Financial Adviser says he has not been engaged to give advice and was only a ' salesman". Much will depend on the facts, but in at least two cases, JP Morgan V Springwall and NMFM v Citibank the Courts in UK have held that a duty of care still arises so as to impose an obligation on the adviser not to recommend high risk products detailed in brochures or other material. Proof of knowledge that the advisers know that the investor is making important investment decisions may trigger the duty of care;

<u>The only safe course of action for financial advisers is to be extremely care ful to record correct details in the Client Agreement, to keep records of all conversations and correspondence, and where there is doubt about the investor, to deliver a final pre- investment letter to the investor making it clear that the risks have been discussed and the investment is to proceed.</u>

8. **<u>Australian and New Zealand expatriates- pre- migration, tax, trust and investment issues</u>**

As we advise many Australia and NZ investors (as well as other clients who wish to use the opportunities available) in our next issue we will deal with some of the more common planning issues, including:

(i) the Australian temporary residents exemption waiving tax on offshore income;

(ii) the NZ equivalent;

(iii) the Australian offshore superannuation fund procedure;

(iv) the NZ offshore trust regime;

(v) the NZ foreign settlor trust system- using NZ as a tax haven;

(vi) use by any offshore investor of a NZ offshore finance Company registered in NZ- now authorized by the Securities Commission in NZ- the ability to offer outside NZ investor banking and investment services enabling collection of deposits, investment and management services etc.

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