EAST ASIA TRANSNATIONAL

International Commercial Lawyers

NEWSLETTER – MARCH 2001

The following Newsletter, which will be on out Website in the next month, contains some interesting and varied topics, which we believe will be of interest to our clients. Some topics have been covered in detail, and may raise further issues on which you require additional information. Please do not hesitate to contact us if you have any queries.

Apart from our main articles on financial assistance to buy shares, you will find below comments on securities law, Internet (see details on new OECD decision on tax of Websites), trademarks, Trusts (can a wife "bust" a Trust ?), the liability of co- directors for negligent acts of the Managing Director, share options as an inducement for staff, and avoidance of tax on severance payments. There is also comment on HK Estate Duty planning- the Shiu Wing case.

Financial assistance from a company to buy its own shares- is this possible, and how does it work ? Is it dangerous for Directors of the target company to do it ?

We particularly mention this in depth article on a topic not so well known in Hong Kong, but of very great importance. Our article deals with HK legislation which allows a Buyer to obtain a loan from a target company on security of its assets to fund the price of the shares- sound to good to be true ? We suggest the subject deserves closer study, as the legislation allows for some interesting and novel methods to fund a share purchase of a private or public company, while at the same time, creating some very dangerous traps that have even caught out some listed companies overseas.

FINANCIAL ASSISTANCE FOR THE ACQUISITION OF SHARES.

With some Hong Kong companies, particularly "dot coms", in financial difficulty more attention may have to be focused on the needs of a purchaser who wishes to buy the Company or its assets, with the added "sweetener" of some finance provide by the Vendor, give that the Banks are unlikely to be interested in providing the required finance.

Traditionally a company was not able to give financial assistance to a Buyer to purchase its shares, but changes to the law in recent years have made it easier to give such assistance, and may have opened up some additional planning opportunities.

It may therefore be of interest to our clients if we summarise some of the legal issues that arise where say a Vendor decides to sell shares in a HK company but the Buyer requires

the Vendor and/or the Company to provide financial assistance to the Buyer on security of the assets of the Company.

An associated issue is whether there are advantages in the Vendor(s) procuring the Company to sell its assets, rather than the shares, with the Company making a Loan to the Buyer on security of the assets sold.

Advantages/Disadvantages in offering shares or assets of Company as security for loan

The Buyer could offer security in the form of a pledge/mortgage over the shares to a lender, but the shares offer weak security because:

(a) if the Buyer defaults, the lender must either cause the Company to sell all its assets and go into liquidation, or alternatively, the lender must find a buyer for the shares. In a liquidation, even an unsecured creditor ranks ahead of the lender. While a security over the shares of a listed company may offer better security, the shares of a private closed company are obviously one of the worst types of security available;
(b) The Buyer will probably fund payments on the Loan from dividends/income from the company, and a failure of the Company will inevitably lead to a default under the Loan;
(c) The Buyer is also in a position of control to strip the Company of cash by distributions, high salary payments, increase in borrowing, or by plain bad management.

A lender who finances the Buyer will almost always prefer to take security over the assets of the Company rather than shares. As an example, in order for the Buyer to acquire the shares of the Company, the Company could issue a guarantee in support of a loan to the Buyer, but as additional security, the lender might well take security over the assets of the Company in the form of a second debenture allowing the lender to take control of the Company and liquidate it should there be a default.

While on the face of it, this appears a simple commercial transaction, under section 47A of the Companies Ordinance (Chapter 32 Laws of Hong Kong) financial assistance, whether directly, or indirectly, by the Company allowing the Buyer to acquire shares in the Company is stated to be unlawful and punishable by a fine or imprisonment, with both the Company and its Directors being liable. Section 47B goes on to further define " financial assistance" which includes a gift, guarantee, loan, indemnity etc or any other assistance where the " net assets" of the Company are reduced to a material extent, or where the Company has no net assets.

General Principles:

Brief mention my be made at this stage as to the reasons for the prohibitions mentioned. Companies are generally prohibited from giving financial assistance for the acquisition of their own shares on the basis that to do so will reduce the assets of the company available to creditors. The prohibitions have existed throughout Commonwealth Law, but not in the USA. In the UK the Greene Committee first recommended legislation on the basis that it would deter persons dealing with the Companies own shares, and then, some 30 years later, the Jenkins committee in UK re – confirmed the rule on different grounds, namely the unequal allocation of costs and benefits allowing a purchaser of shares to acquire all the benefits through ownership, with a loss to the Company since the Buyer has invested no funds of his own.

To take a simple example of the most blatant financial assistance;

Example 1

Party A causes Company B to lend him HK$1,000,000.00 to buy shares in Company B, or declares a cash dividend of say HK$250,000.00 to assist A's purchase. The effect on the creditors of the Company is substantial; in the case of the loan, while a loan of HK$1,000,000.00 will represent an asset to the Company in its balance sheet, in reality the fortunes of Party A are tied up with the success of the Company , and if it fails, A will likely not be able to pay back the loan. If a dividend, then there is again an immediate diminution in the value of the Company assets.

Another example using a different structure would be:

Example 2

Party A as owner of the shares in Company B enters into an arrangement with the Buyer pursuant to which A procures that the Company issues shares to the Buyer for HK$250,000.00, and then buys the shares of A in a share buy back for HK$1,000,000.00. While it is true that the only difference between this and a straight loan is that the Company has not received a loan as an asset, the true difference is that the Company has issued partly or fully paid shares to the Buyer, and thus type of transaction clearly puts the creditors of the Company at risk in the same way as in Example 1.

Much planning went into schemes to avoid the draconian application of the old rules in company legislation (a breach rendered the transaction void, and there were penalties and sanctions) but wide dissatisfaction resulted in amendments allowing a company to provide financial assistance to a Buyer of shares subject to certain conditions being met.

Relaxation of Rules for Unlisted Companies

Section 47E now provides that an unlisted Company may give financial assistance for the acquisition of its shares or, if it is the subsidiary of an unlisted company, its holding Company's shares if:

(a) the assistance does not reduce the Company's net assets, or if it does, the assistance is provided out of distributable profits; and
(b) the majority of the Directors make a statutory declaration stating, amongst other things, that in their opinion there will be no ground on which the Company could then be found unable to pay its debts, and either, (i) if it is intended to wind up the Company in 12 months, that the Company will be able to pay all its debts within 12 months of the beginning of the wind up, or (ii) in any other case the Company will be able to pay its debts as they fall due in the following 12 months.

In the case of a listed company the test is solely a balance sheet test; assistance may only be given if the either the net assets of the Company are not reduced, or if they are, then the financial assistance is provided out of distributable profits.

In summary, it will be clear that the " balance sheet" test will be critical in all cases of financial assistance where a private company is involved.

{ and the definition of net assets as modified in section 47E(2) and of financial assistance in section 47B (3) (b) means that situations in the examples where a direct loan might be given, or a guarantee in favour of the Buyer are caught by the legislation. Without these changes in definitions, it would be possible for the loan in Example 1 to be given lawfully, as it would qualify as an asset in the balance sheet, whereas the definition makes it clears that a reduction in net assets as set out in the balance sheet immediately before the assistance must come from distributable profits. Similarly, a guarantee give in the favour of the Buyer, while not effecting the balance sheet initially, is caught by the wording and definitions in clause 47B(3)(b) which include discharging a future liability.}

CAN A COMPANY GIVE A DIRECT LOAN OR GUARANTEE TO A PURCHASER OF ITS SHARES ?

Based on the balance sheet test, it seems possible that a private company can give a direct loan to a Buyer of its shares provided the principal of the loan, and the interest thereon, together with any costs incurred by the Company in giving the loan, are re-payable by the Buyer and the loan is otherwise a valid security. This is on the basis that the loan constitutes an asset of the Company,and while, as seen above, the asset may well be of doubtful worth, such a result seems possible given that the wording in section 47E (2) { referring to the definition of "net assets" in section 47D (2) (a)} refers to the net assets of the Company " immediately before the financial assistance is given" Accordingly, a proper loan agreement prepared in advance of any declaration and special resolution may well not breach the balance sheet test, although obviously timing is but one factor that Directors will have to take into account.

Similarly with a guarantee. While it seems likely that the Directors would deem it prudent to retain on its books a contingent liability which it may or may not have to meet, it is far from clear whether the right of indemnification which the Company would have

against the Buyer as borrower is, or should, similarly to be counted as an asset. On established accounting principles there is no reason why it should not be. There is also an issue of whether a non- recourse loan given by the Company qualifies as a liability (where security is taken over company property, but does not constitute a personal liability on the Company)

A decisive factor for Directors will be whether they are able to make the required declaration that the Company is and will be solvent, and whether , in the case of loans or guarantees to a Buyer, they are confident that they have reasonable grounds for making the declaration. A subsequent failure of the Company and an inability for the Company to meet its commitments may well trigger fines or imprisonment for Directors who make a declaration recklessly and without good grounds for doing so. Further comment on this important issue is set out below.

ARE THERE WAYS AROUND THE BALANCE SHEET TEST ?

(1) Revaluation of Assets

If there are difficulties in meeting the balance sheet test, or the Directors are fearful of making a declaration based on the present balance sheet of the Company, an obvious solution would be to revalue the Company's assets. An example will illustrate the advantages.

Example 3

A owns all the shares in Company B. The Company's balance sheet shows HK$1,000,000.00 in assets, of which HK$800,000.00 are liabilities (HK$500,000.00 of which are secured) and HK$200,000.00 are shareholders funds.

Party B as buyer wishes to purchase all of A's shares for HK$500,000.00 and has a cash sum of $200,000.00 to put towards the purchase. B wants A or a third party bank to lend him the balance of HK$300,000.00 on the basis of a guarantee from the Company securing the loan of $300,000.00, and the lender wants the Company's guarantee to be secured by a second debenture over the Company's assets. Such a guarantee would increase the liabilities of the Company from HK$800,000.00 to HK$1,100,000.00 even assuming that it was a non- recourse guarantee. If the Company however revalues its assets from HK$1,000,000.00 to $1,100,000.00 no breach of the balance sheet test would arise.Provided the re-valuation is reasonable, no questioning of it by a liquidator should be possible, as the parties have in effect simply agreed on a new value for the assets of the Company as reflected in the sale price of the shares.

(2)Timing of payment of dividends and instalment payments to purchase shares

It will sometimes happen that there is a sale of shares with finance being provide to the Buyer in two tranches; the first payment may be a dividend, but a later payment may be in the form of financial assistance from the Company in the form of a loan or guarantee.

The following example will demonstrate the potential problem:

Example 4

In example 3 assume that a sale of shares has been agreed for $500,000.00 with the Party B as Buyer paying an immediate cash deposit from his own funds of HK$250,000.00, with an additional $100,000.00 in one weeks time from a dividend declared by the Company in favour of B.The balance of $150,000.00 will be due in one years time by the Company issuing a guarantee to a Bank in Hong Kong who will fund the Buyer, and the Bank will take a security over the assets of the Company.

If the dividend is declared within one week as agreed, then provided the Directors feel the payment will not affect the solvency of the Company, the Company will be left with HK$900,000.00 in assets comprising liabilities of $800,000.00 and shareholders funds of $100,000.00. However, it will be apparent that without a revaluation of its assets, the Company is unable to provide the financial assistance of $150,000.00 which would increase liabilities to $950,000.00 and leave assets at $900,000.00. If however the financial assistance of $150,000.00 was provided before the dividend was paid, the balance sheet test appears to be complied with; liabilities will be increased to $950,000.00 but assets are still $1,000,000.00.If the dividend of $100,000.00 is to be paid later, and after the financial assistance, whether it can be paid will depend on the balance sheet of the company and whether the right of indemnification against B can be counted as an asset.

GRATUITOUS CASH ADVANCES TO A BUYER

The position over a cash advance is clear, and Directors can make such an advance out of distributable profits so long as they pass the required special resolution, and are in a position to make what is in effect a declaration of solvency of the Company.

Nor is there objection to advances to employees for a share purchase scheme.

Definition of "Net Assets" in balance sheet test

As has been seen, fundamental to the balance sheet test and the ability of the Company to give financial assistance to a Buyer is the classification of loans, guaranties and other financial assistance in the balance sheet, whether they are categorized as contingent assets or liabilities, and what allowances and values in respect of such assets and liabilities the Directors must, or should, place in the balance sheet of the Company.

It should be noted that in some Commonwealth and other countries a distinction is made between an asset such as an indemnity or loan receivable from a Buyer who has befitted from a loan of guarantee from the Company, and other assets unrelated to the financial assistance to a Buyer. The rationale for this is referred to above; it is obviously likely that a right of indemnity that a Company has against a Buyer may be viewed as an asset of

doubtful value, and its exclusion as an asset that can be credited in the balance sheet is logical.

However section 47D (2) makes it clear that the definition of " net assets" means the difference between the aggregate of the company's assets and the aggregate of its liabilities as stated in the Company's balance sheet before the financial assistance is given. Given that definition, it seems clear that a right of indemnity or a contingent asset may be credited in the balance sheet. It is abundantly clear that a loan or guarantee given as financial assistance may be classed as a liability with some qualifications as to amount, as section 47D (2) (b) appears to cover such amounts that the Board of Directors may allow for or retain to cover a liability such as a guarantee, which of course may never be called upon.

If the way is clear for a contingent asset such as a right of indemnity to be included as an asset then technically financial assistance could be extended to a Buyer in every case, as there would be no diminution in the net assets of the Company.

However, Directors will doubtless be reluctant, save where the Buyer has been able to give the most safe and secure indemnity to the Company, to make a declaration of solvency where the Buyers indemnity is involved. To make such a declaration where the Buyers fortunes are tied up with the Company's performance may , in certain circumstances, be very risky, and obviously the worth of the Buyer and the prospects of the Company must be carefully evaluated.

Traps for the Unwary.

An Australian case shows that apparently innocent commercial arrangements can fall foul of legislation prohibiting financial assistance to a Buyer purchasing the company's shares. In the case there four shareholders in a listed company. One shareholder (A) was to be bought out and to assist in such arrangements three of the shareholders entered into an agreement to arrange for the company itself to issue attractive options allowing members of the public to effectively acquire the shares of A , although the arrangements did not amount to A simply selling it shares at a discount.Although the method and documentation were complex, the effect, as argued by those opposing the option sale arrangement, was that the company itself, by sponsoring the option arrangement for the public to take options below their real worth, was in effect granting financial assistance and was reducing its asset base by the action taken. The case turned on whether in fact what had been done amounted to a reduction in the capital of the company in terms of the Australian legislation, and although the court held that it did not, the case shows that care must be exercised where the company may in any indirect way be providing illegal finance to a Buyer of its shares.

Summary:

For purchasers wishing to arrange finance to acquire the whole or a substantial stake in the issued share capital of a company, financial assistance from the target company may

well offer an attractive alternative to traditional sources of finance. The laws relating to financial assistance are no longer a legal minefield, and more companies should consider structuring transactions of the type mentioned where the Directors of the target company feel they are in a position to make the declarations required.

Employment Law Issues:

(a) **Share Options to employees as remuneration – what advantages** ?

Share options are rights or options are usually granted by an Employer to a Director or senior executives as part of a performance based remuneration package. While Listed Companies in Hong Kong are restricted in the discounts they may offer on share options (although the new G.E.M. has allowed some relaxations) private companies are under no such restrictions.

The advantages of share options as a remuneration package are:

(i) for an Employer there is the opportunity to give the Employee an incentive to stay with the Employer for period of time with the inducement of a vesting of the right to take up the option shares in say 2, 3 or 5 years time.

(ii) Private companies are free to offer a large discount on the market value of the shares, and fix what is known as the " strike price" at an attractive level calculated to give the Employee what may be a significant and immediate cash sum as income when the option is exercised and the shares sold at current market values.

(iii) There is an ability to "stagger" the times when the options may be exercised, with either the whole of the shares being made available in say 3 years, or say 20% each year over 5 years.

(iv) In recent years the real incentive for an Employee comes from the possibility of the Employer Company being involved in an IPO. Other factors may also intervene, such as a sale of the Company, and events such as these may accelerate the vesting of the options.

(v) An Employer Company may prefer to set up an Employee share option through a Trust, and as an exception to the general rule that a Company cannot finance the purchase of its own shares, may offer finance on concessionary terms. However, that type of arrangement is more commonly known as a share purchase scheme, and may not necessarily offer finance to purchase share options.

(vi) In certain circumstances the Employer may wish to consider offering shares with no voting rights to protect against block voting, and as well, there may well have to be written into the agreement with the Employee restrictions against selling the shares if the Employee left the Company. Sanctions because of dismissal and the loss of the rights to share options must also be considered.

(vii) Tax issues on the establishment and granting of share options must also be carefully considered by the Employer and Employee. The general rule is

that the gains from the exercise of the option and subsequent sale of the shares, whether those shares are shares in the Employer Company, or an associated, or non associated company, constitute income and are subject to salaries tax. It must also be noted that the income or gain is deemed to be derived for tax purposes when the option is exercised, and not when the shares are sold. Planning to avoid the tax may be possible in certain areas, such as establishing that the options were acquired in the course of normal investment activity and not as a consequence of employment, proof that the option was granted and exercised outside Hong Kong, and the establishment of an argument that there was no nexus between the actual granting of the option outside Hong Kong and the employment services rendered by the Employee in Hong Kong. Intervention of an offshore trust which takes up the options may also offer limited planning opportunities.

Summary:

Share options offer many advantages to both Employer and Employee, but there is a need to set up the arrangements in a proper service agreement which recognizes that there are a number of other issues to address apart from the terms of the options granted.

(b) Taxation of redundancies – can it be avoided ?

The payment of incentives, “golden handshakes”, “ garden leave”, gratuities and redundancy or severance payments to Employees may or may not be taxable under the Salaries tax provisions in Hong Kong and much will depend on the application of a very simple principle of taxation law; that a payment must essentially be for services rendered if it is to be subject to Salaries Tax.

So far as taxation of severance and redundancy payments is concerned, they have been typically exempt from tax on the basis that when the person is dismissed due to redundancy the payment made to him or her is not a reward for past services or services in the future, but rather a payment to compensate him or her for loss of office. The character of the payment and how, when, and in what circumstances it is payable are all relevant factors. If structuring or paying a severance payment, the following points should be noted:

(i) Compensation for loss of office, and salary in lieu of notice, generally are not taxable, but the way they are negotiated and set out in an employment contract can be critical; in some HK cases they have been held to be deferred remuneration calculated at the outset of an employment contract.

(ii) A genuine calculation and pre- estimate of damages, such as 6 months entitlement to wages, established by some preliminary

correspondence and later enshrined in an employment contract should not be taxable.

(iii) No mention should be made in a severance payment that the payment in any way relates to a payment not to compete with the Employer, as such a payment would be taxable.

(iv) Payments made to an Employee to agree to a change in the terms of employment should not be calculated on long service principles, as they may then be taxable as relating to past employment, or an inducement to stay.

(v) Long service payments made under the Employment Ordinance have not normally been subject to salaries tax by the IRD, although authority for this seems questionable.

(vi) Timing of a severance payment may be important. In a recent case an employee dismissed from a HK company in April, and paid a severance payment, was re- employed by a subsidiary company in mid May. The Board of Review confirmed non -taxability of the payment on the basis that the real negotiation of the new contract did not take place until well after the separate event of the dismissal and they were not connected.

(vii) Finally, although not in all cases determinative of the issue, careful negotiation, definition and calculation of the severance payment, and written confirmation to the Employee that the payment relates to redundancy for loss of office, will all be useful in any argument with the IRD over the status of the payment.

Summary:

Employer and Employees should always consider the tax implications of the arrangements they make if a severance payment is to be made, and document the arrangements in advance of the proposed payment.With planning there is no reason why such payments should be subject to tax.

Trusts:

(a) Resettlement- what does this mean, and why do it ?

To those clients not overly familiar with Trusts, the term " resettlement" may mean nothing, but it nevertheless is an important power that is usually open to the Trustees of a Trust, and may indeed be of substantial use to the Settlor of a Trust in certain circumstances.

As the names implies, resettlement means a change in the terms of the Trust, usually when the Trustees separate part or all of the assets of the Trust and set up a separate Trust under powers given to them in that behalf under the Trust, or it may be that the existing beneficiaries are excluded and new beneficiaries added. As well, the actual

terms of the Trust as it applies to the separated assets, or the new beneficiaries, may be different from the original Trust.

Obviously, the Trust Deed must give the Trustee powers to undertake a resettlement, and the powers involved can be conferred under traditional powers commonly seen in Trust Deeds, such as powers of appropriation, appointment, addition and exclusion of beneficiaries, advancement, variation of a trust, and a specific power of resettlement in the body of the Trust Deed.

These powers can be very useful. As an example, a person called B is named as a beneficiary to whom the Trustee may advance funds. B becomes bankrupt, or becomes a problem, perhaps wasting money and generally acting in an unstable manner. The Trustee then exercises a power of advancement of part of the Trust assets to B for life, with entitlement to income only, but with the capital to the children of B on his death, even though the children were not contemplated or mentioned as beneficiaries under the Trust Deed. This is a type of resettlement which can be undertaken so long as the advance is for the benefit of B.

By contrast a power of appointment in favour of B will not enable a settlement for the children of B, as a power of appointment is strictly construed, but it will enable the Trustee to set up a new trust, on different terms, for the benefit of B.

It would also be possible for the Trustee to establish a new Trust, appropriate part of the Trust assets,and declare that a new set of trusts would apply to that property, perhaps even in another jurisdiction. Such a power is essential where, for example, Government legislation or civil unrest in the Trust jurisdiction force the Trustee to move the property and/or the situs of the Trust to a more friendly country.

There can be however a fine line between a simple variation of a Trust and resettlement of a Trust, and this is of critical importance where the assets of the Trust are situated in a jurisdiction where taxes may apply to them. If what happens in a variation is that there is only a variation pursuant to an express power, or a power of appointment is exercised to appoint a new beneficiary, this does not involve a disposition from one taxpayer to another, and that is not a resettlement.

On the other hand, a new settlement of the Trust’s assets on a new trust, or a substitution of existing beneficiaries with a new beneficaries unrelated in any way to the original class, would in all probability be deemed a resettlement.

The tax issues that may arise from a settlement will in all cases depend on the legislation of the jurisdiction in which the assets are situated, but some of the common issues that might arise would be as follows:

(i) Stamp duty- as an example, an offshore trust in BVI, with shares in a HK land owning company, substitutes a new class of beneficiaries under the Trust, with two only of an original six beneficiaries included in the new substituted

class. If the transfer is deemed to be a transfer from a trust to beneficiaries then there is an exemption under the HK stamp duty Ordinance {section 27 (5)} However as there is arguably a partial change in the "beneficial" ownership of the shares in the Company stamp duty may be payable.

(ii) Depreciation – if a trust owns assets that have been depreciated,then a resettlement may trigger a disposal of those assets, which may in turn create a taxable situation; under most jurisdictions, depreciation recovered is taxable. Planning may involve an actual sale of the property to the new Trust at a value designed to give the best result to both sides.

(iii) Capital gains taxes- clearly the legislation in some jurisdictions may catch certain resettlements.

(iv) VAT and GST- For various goods and services taxes, a Trust is defined as a taxable entity and deemed transfers of assets in a resettlement may create input and output tax issues.

(v) Gifts- although normally any distribution or appointment of assets to beneficiaries would not be deemed a gift in most jurisdictions, it is by no means clear that all resettlements are necessarily gift free in some jurisdictions.

With the typical Hong Kong offshore trust the stucture involved, and the tax system in Hong Kong, resettlement should not give rise to many tax issues, but where assets are in other jurisdictions tax is an issue that should be looked at closely before any resettlement is undertaken.

Summary:

Resettlement will be rare, but if undertaken may create complex tax and other issues where the assets are situated, and require advice in different jurisdictions.

(b) Trust busting- rights to attack a trust settlement- the claim by the wife/husband- can resettlement avoid claims ?

We propose to deal with this issue only briefly, as in many instances the laws of the jurisdiction in which the claimant resides will govern whether there are rights for a husband of wife to pursue an action against the Trustee and/or the Settlor of the Trust.

We are assuming that the Settlor Mr. A sets up a Trust in say BVI which holds shares in a number of Hong Kong companies, and a Company in Australia. Mr. A is a Co – trustee with a BVI professional Trustee. The wife B is a discretionary beneficiary. There is a break- up. Most of A's assets are in the Trust, and a Promissory Note in favour of the husband for HK$5,000,000.00 has been partially gifted off- HK$1.00 Million is still owing. The terms of this debt provide that if anyone other than Mr A becomes the owner of the debt then the repayment date of the debt will be for 50 years interest free instead of upon demand as it is now. As well, there are some creditors of Mr. A who are also pressing for payment. Mr.A is also a trustee for a Trust in which he and his wife and

children are beneficiaries, and funds in his name only and under his control have been inserted into the BVI Trust.

In relation to Matrimonial Property Claims by the wife:

1. Most commonwealth countries have Matrimonial Property legislation allowing the Courts to set aside dispositions taken with a view to defeating a claim or a future claim by a spouse. Accordingly, if it is established that Mr.A transferred assets to the Trust to defeat claims by B, then the transfer of assets could be avoided by the court, especially if Mr.A was to call in his debt from the Trust and thereby reduce the assets further.
2. Courts may well however consider the effects of voided disposition if its affect is to prejudice the interests of the beneficiaries of the Trust.
3. The Court is unlikely to avoid the transfer where third parties have acquired assets from the Trust in good faith and for valuable consideration, and have altered their position based on the acquisition of assets.
4. It does not help the case of Mr. A that he is a Co –trustee, as a Court will not be inclined to accept settlements associated with a spouse as necessarily having been made in good faith.
5. Hong Kong legislation, while allowing a court jurisdiction to alter a settlement (not defined under the legislation, but presumably applying to a trust settlement), appears to contain no specific provisions allowing avoidance of a transfer to a Trust. In addition, there is no automatic presumption under HK law that spouses share matrimonial property on a 50/50 or any other basis and we are not aware of any case where a transfer to a trust by a spouse has been avoided by a court on the basis that there was an attempt to defeat a claim or future claim by the other. On the other hand, property under the name or control of one spouse, which belongs to or has been the subject of a financial contribution by the other spouse, may well be the subject of an avoidance order where it has been transferred to a Trust with avoidance as an obvious intention.
6. The Court will very likely entertain an action against Mr. A under the common law action of deceit in respect of funds belonging to wife and beneficiaries under the other Trust, which he has put into the BVI Trust.

In relation to claims by creditors:

(a) In Hong Kong and other commonwealth countries the Courts will always enforce legislation which prohibits transfers of property undertaken with the intention of defeating creditors.
(b) If Mr A can prove he was solvent at the time he made the transfers to the Trust he may have some prospect of avoiding an invalidation of the transfer of property to the Trust at the suit of the creditors. It has been difficult to prove fraud where

the debtor was solvent at the time of transfer of the assets to the Trust.

(c) Intent of Mr. A is however important, and the action he took in making the debt a very undesirable asset was not honest in the context of a debtor and creditor relationship. A court may well avoid the transfer on this basis.

(d) Investigations by the wife B may be made as a kind of auditing exercise to pick up errors in the transfer of assets to the Trust, conflicts of interest, sham trust possibilities etc. Some examples of this might be:

(i) has the property been properly transferred to the Trust ?

(ii) As Mr. A is a co –trustee of the Trust, is the Trust properly constituted or is in merely a sham with Mr. A in total control of the trust assets.?

(iii) Are real beneficiaries named, or are there non charitable objects ?- if there are such defects the trust may fail.

(iv) If Mr. A is bankrupted in Hong Kong, assets he has in Hong would be subject of attack as would the shares in Australia, and it is likely that the transfers of the shares to the BVI Trust would similarly liable to attack as an arrangement to defeat creditors.

Summary:

In the Hong Kong context, and assuming that the Settlor is solvent, and using his own money and assets, with no provable intention to defraud a spouse or creditors, possible claims against transfers of assets to the Trust may be difficult, but care is needed to ensure that the transfers of assets has been properly documented, that the Settlor is not a trustee or beneficiary of the Trust, and that the Trust is undertaken for proper commercial and personal reasons.

(c) **Resettlement**

Let us assume that Mr. A, prior to any claims from a spouse or creditors, arranged for the BVI Trust to set up a new Trust in the Cayman Islands by means of a new Trust, with different beneficiaries, including a company in which he is the major shareholder, and the new trust is settled with a cash advance of one half of the cash held by the BVI trust pursuant to a specific power of resettlement in the Trust Deed. The Caymans trustee then invests in a 50/50 joint venture property development in London with obligations on the Caymans trust to come up with further funds for development. Can the spouse claim that this transfer was void as an attempt to defeat her claims ?

On this situation it would be very difficult, short of establishing a sham trust, to trace the resettlement monies, as Mr.A himself has not personally been involved in the transfer of assets, and there is the other problem that third parties, for value, have claims against assets bought from the Caymans trust. Those claims are probably valid. However, the transfers of assets in the jurisdiction of the claimant will remain subject to attack., and many countries, particularly the USA, have been active in active in assuming jurisdiction over assets that although in the Trust name, are within the country where the claimant is situated.

Summary:

Resettlement, where the Settlor is solvent, and the Trustee independent, and there is, on the face of it, legitimate commercial reasons for the resettlement, offers a means for a settlor to distance assets from a future matrimonial property claim. However, conduct by the Settlor spouse that suggests dishonesty and a desire to distance assets from creditors or a spouse, may well still attract the attention of the Courts who have not been slow to look through trust arrangements where justice to spousal and creditor claims is seen to be necessary.

Internet:

New OECD Rules for the sites of ISP for tax purposes.

The decision of the 30 nation OECD and its subsequent announcement on proposed laws relating to taxation of Web Sites and Servers has substantial implications for all business's and Internet Service Providers (ISP). Although the effects of some aspects of the announcement are still uncertain, the main thrust of the new policy to be adopted by all (with one or two exceptions) countries is to define when the presence of a Website or a server in another country results in a taxable presence in that country. Important points to note are:

(i) the OECD decision does not require new legislation in member countries and the policy applies immediately. This means all business involved in trading electronically would be wise to consider their position as soon as possible.

(ii) In essence, the new policy states that a business that sells its products or services from Website on a server that it owns or rents in another country then it could have a taxable presence in that country.

(iii) Any business deemed to have a presence would therefore have to file tax returns in that country and pay tax there.The absence of any assets or income in that country may not be a bar to recovery by a determined IRD which might

obtain a judgement for the tax and seek to enforce it under any double tax treaties the country may have with member states.

(iv) It is also clear that where web based service providers, such as ISP's, who may use servers in other countries to provide services such as website hosting, will be deemed to have a taxable presence where the server is located.

(v) There is still opportunity to establish a server in some OECD countries, not all of which agreed with what was a majority decision by the OECD. As an example, the UK was a dissenting voice in the discussions and the UK appears keen to attract E-commerce. UK as a site for a server may still be a viable option, although an ISP operating from a UK base with a server in another country would be caught by the OECD policy.

(vi) The policy will still depend on a new definition of " permanent establishment" to be finalized by the OECD technical group,and until that is done the true scope of the new policy will not be known.

(vii) It is clear that a business that relies on an ISP in another country to host its site will not itself have a taxable presence in that country.

(viii) For many business's the OECD policy can obviously easily be avoided. Many countries such as Hong Kong, have a territorial basis for their taxation system and the concept of " permanent establishment" is unknown. Jurisdictions such as Hong Kong, and other offshore tax havens, are likely to benefit from business's and ISP's simply moving servers to non OECD countries with territorial tax systems which do not automatically tax an entity based on physical presence.

Summary:

ISP's and those involved in internet commerce should watch developments carefully, and it is clear that a review of the location of existing and future Websites and the tax implications involved should be undertaken immediately.

Napster- the current position and issues

Napster was a file sharing service started by a 19 year old University student which provided a search engine for to locate MP3 music files on the Internet as well as a mechanism for retrieving and playing those files. Law suits were filed against Napster by the Recording Industry of America (RIAA) principally based on alleged breaches of copyright, and copyright piracy. Although in the initial stages RIAA had mixed success, latest developments suggest that it will be successful in having the Napster site shut down

The legal basis for the challenge to Napster appeared to present no difficulties. It was based on an allegation of simple copying of existing material in which copyright exists. The application however of copyright law to new processes has never been easy. It is not as easy to say that someone has copied music on to disk when the music is not in readable format like an extract from a book. Indeed, court decisions (one in America concerning tunes on piano rolls in early 1900) have held that some reproductions might not automatically infringe musical compositions. Nor has it always been easy for owners of

software to allege that there has been copyright infringement by third parties absent blatant copying of manuals and other written material ancilliary to the digital content of a disk.

Although copyright law may continue to provide a remedy to owners of original material, it is hard to see how the owners of original music compositions or any other body representing them can control and monitor sharing and trading of files between individuals through such distribution centers such as Freenet.

Summary:

It has been well said that “ the Internet is a giant copying system” and this process seems likely to continue. The music industry and other business’s had better get used to the idea and adapt to it, because effective control mechanisms relative to copied material easily accessed on the Internet seem well nigh impossible.

Copyright and Trademark Law

(a) Possession of material an offence- use in a business- new tough copyright provision in Hong Kong.

Having mentioned the Napster decision it is perhaps timely to refer to an amendment to the laws of copyright in Hong Kong which will take place in early April 2001. In April the Intellectual Property (Miscellaneous Amendments) Ordinance 2000 will come into force, the most important provision of which is to make it an offence to (with both civil and criminal liability) possess copyright infringing materials.

This extends the existing law significantly, as whereas before actual use of the materials in a business needed to be established, now simple possession is enough. Many examples of this could be quoted, but perhaps the simplest one is the situation where the licence to use software has expired. Nor is it necessary to deal in the offending articles as the main purpose of the business; simple possession of illegal material will be sufficient.

Quite clearly it will be important to be able to say what is copyrighted material and what is not. Unlike patents and trademarks, which are registered, copyright exists in every expression of an idea which has been reproduced into written or a tangible form, and applies to literary, dramatic, musical and artistic works, and includes computer software, sound recordings, films etc. It is the expression of the idea that is protected, not the idea itself. As an example, a speaker may address a meeting, but unless it is recorded, he will have no copyright in the speech, whereas a reporter or radio station that records or reports the address, will have copyright in that report.

(b) Distinctive- how a name qualifies to be registered as a trademark

With the advent of the Internet and the ability of persons to illegally copy a person's name, ideas, and Website content and to disseminate it internationally, it may become more important to seek to protect the name of a business or product by a registered trademark that is able to be registered internationally if need be. A trademark confers greater protection than simple copyright, and in recent court cases the owner of a registered trademark has usually managed to defeat the claims of those attempting to register pre –emptive Websites under well known brand names.

To those contemplating registration of a trademark we offer the following brief summary of the requirements to be met. It is a complex topic and the law is not always easy to understand. The following is only a basic introduction to some leading principles.

For the Trademark Registry in Hong Kong to accept an application to register a trademark, the main criteria is whether the name is "distinctive" and adapted to distinguish the services or product from other traders, and if it is not distinctive, has it nevertheless been so adapted to distinguish by the prior use of the service or product.

Whole volumes of decisions could be reproduced dealing with why some names have been regarded as distinctive and some not. It is clear however that:

(i) invented words have a much greater chance of registration than words in every day use.

(ii) Words used must not refer to the character and quality of the services or goods, or be " laudatory". The reason for this is that such words are usually in everyday use, and if subject to trade mark would make it an offence for other traders to use such words in normal day to day commerce. As an example, a word such as " perfect" and " easy" will rarely, if ever, be accepted for registration notwithstanding some prior use. Fine shades of meaning however may mean the difference between a word being held to be purely descriptive ("tastee – freeze" for ice-cream) or merely having an emotive meaning ("Tub Happy" as meaning the effects of the Tub) or having a meaning that was capable of many different interpretations but unlikely to be used by traders in every day use ("Eurovogue" conjuring up an image of Europe relative to clothing)

(iii) Surnames and names of geographical origin will usually not be regarded as distinctive.

(iv) Signs which have become customary by trade use will not be distinctive. As examples, numbers, dollar signs and striped toothpaste.

(v) The Trade Mark Registry may accept a name for registration under Part B of the Registry under a less stringent test that the mark is " capable of " distinguishing services or goods from the operations of other traders, although the protection afforded is slightly less than a registration under part A.

Enough has been said to show that in some cases it will be difficult to decide whether the name will be distinctive, and evidence of substantial prior use may well be the deciding factor in a number of cases.

Summary:

When contemplating registration of a name as a trademark, take some professional advice first, as the Trademark Registry may not approve the name you require, and much time and cost may be avoided if a more distinctive name is possible.

Securities Law

(a) Comments by the Law Society on the new bill

Earlier comments by the Law Society on some of the more objectionable points of the new Securities and Futures Bill produced worthwhile changes. The Law Society has made further comments on the latest " blue bill" which show that there are still inconsistencies and potential problems despite improvements. A copy of the comments produced in full is on the Law Society Website, and we do not intend to reproduce the comments here. To those involved in the securities field we would however highlight the following issues:

(i) whereas under the existing Ordinance the SFC was restricted to approving advertisements, invitations etc relative to investment products, now there is power to a approve the investment product itself.

(ii) The so called " professional investor" exemption is still unsatisfactory and the new definition has arguably narrowed the existing definition.

(iii) An overseas director in charge of a local firm in Hong Kong is not able to supervise operation in Hong Kong without being licenced, which may be quite impractical in some instances.

(iv) The SFC will still have wide powers to make rules relative to dealing practices which carry criminal sanctions, and as these powers appear not to be authorize by the Ordinance, they represent a very wide and unjustified extension of powers to the SFC.

(v) Misrepresentations are dealt with severely as a criminal offence, although carelessly or negligently made. Given that criminal offences usually require proof of intention, this wording, if it remains in the final bill, seems quite unjustified on general principles.

Summary:

It is to be hoped that the submissions made by the Law Society will be actioned, as substantial amendments are still required before brokers in Hong Kong will feel comfortable with the new bill.

Company Law

Co-Directors- liability for the acts of a Managing Director. Can other directors ignore the acts of the MD if negligence is involved and/or regulatory infringements ?

Directors of listed and private companies have all experienced situations where a Managing Director ('MD') has been appointed and perhaps has tended to act in a dictatorial, secretive, and perhaps reckless manner thus giving concerns about the lack of consultation and possible breaches of regulatory provisions or worse. It may therefore be useful to summarise just what the legal responsibilities of the co-directors are, and whether they may be in breach of their responsibilities as Directors if they do nothing and meekly aquiese in what is happening.

First, a brief comment about the role of an MD. Modern Articles of Association usually empower the Board to appoint one of their number to be the MD, and invariably the MD will be appointed under a service contract for a specified period, but subject to the terms of the Articles, which are deemed to be incorporated in the Service Contract. The Board has the power to confer on the MD any of the powers exercisable by Directors on such terms as they see fit, but equally, as this is delegated authority, the Board can withdraw it.

Assuming the MD has therefore been appointed under a Service Contract and given wide powers to manage the Company, are there any limits to his authority, and what are is the legal position of the Co- directors ('Remaining Directors') if the powers of the MD have been exceeded, and possibly the MD has committed both regulatory and criminal breaches. ?

The following points may be noted:

(i) The MD is under the same obligation as any other Director under the general law that he or she must not enter into a transaction that is illegal under the law nor a transaction that is ultra vires the powers of the Company. Such breaches give rise to an action by the Company and its shareholders to recover any losses. Although it is possible that the Company by special resolution can absolve and pardon the Director(s) from breaches, it is unlikely that such illegal acts as making secret profits, breaches of company legislation, payment of dividends out of share capital, misappropriation of company property by theft or negligence, illegal financial assistance to buy the company's shares could be subject of absolution by the Board.

(ii) In cases where an MD has been delegated wide responsibility to manage the Company under a Service Contract, the duty of care which the Remaining Directors are under is substantially less than if there was no MD. Similarly, where the Board delegates authority to some of its members to undertake certain tasks; the Remaining Directors may assume that cheques put in front of them to approve, or securities that need to be obtained from investments, have in fact been properly issued or obtained as the case may be, and they do not have to closely supervise or watch the situation.

(iii) Difficult issues may arise where the Remaining Directors become aware of improper or the negligent actions of the MD or staff under their control, and the Courts have held that although each case must be assessed on its own merits; Directors who become aware of improper or negligent actions of one of their number may not escape their own negligence and subsequent liability for losses unless they reveal the situation to the Board as a whole or the shareholders at the earliest opportunity.

(iv) If a listed company, the onus on the Remaining Directors may be higher, as channels and procedures exist under the Listing Rules for director to alert non executive " watch dog" directors of nay concerns, or they may advise the regulatory authorities.

(v) In general, in the absence of bad faith and the securing of improper profits from company dealing, the MD is not generally liable for making wrong or even negligent decisions in every day business dealings on behalf of the Company, and even if a decision taken by the Board results in losses to the Company, all the Directors would likely have no personal liability in a claim by the Company, Shareholders or creditors. However, if the MD continued to incur new liabilities on behalf of a Company that was insolvent the Remaining Directors may have some liability to a Liquidator later if their behavior amounted to fraudulent trading, especially if they had stood by watching behavior by the MD that amounted to fraud on the creditors of the Company.

Summary:

The Remaining Directors can be at risk where an MD is involved in improper conduct or risky trading. They would be wise to ensure that they keep abreast of what the MD is doing, and on becoming aware of improper conduct, they should immediately call a Board meeting to lay their concerns on the table, and if they gain no satisfaction from that action, call an EGM so that all shareholders and any regulatory authorities can be made aware of the situation. Failure to act may involve the personal liability later at the suit of the Company or a Liquidator.

ESTATE DUTY IN HONG KONG

The Shui Wing Case - HK Estate Duty planning now easier ?

On the 12/7/2000 the Court of Final Appeal (Hong Kong's highest Court) in **SHIU WING LTD AND THE COMMISSIONER OF INLAND REVENUE** allowed an appeal by an offshore Trust in Manx against an assessment of estate duty on Hong Kong on alleged gifts of Hong Kong property made by a Settlor in Hong Kong to offshore Trusts controlled by the Settlor's family.

The case has important implications for those contemplating establishment of an offshore Trust to own Hong Kong assets, and where the saving of Estate Duty is one of the purposes of setting up the structure. In particular, the cases Ramsay and Furniss & Dawson, the principles of which had struck down some English tax planning schemes, and allowed others, were examined in detail and observations made as to their applicability in the context of a complex scheme, one of the effects of which was of save millions of dollars of HK estate duty. The scheme involved can be categorized as one of the " Macao Round Robin" schemes where there is a circular paper trail of money setting up transactions outside Hong Kong.

The legal issues and facts are too involved to deal with in detail in this brief note, but the following points should be noted;

1. The principles of the Ramsay case are part of Hong Kong Law, but are not a doctrine, rather an aide in construction of a tax statute, particularly where a transaction can be characterized as artificial and explicable only on the basis of tax avoidance.

2. There must be a pre- ordained series of transactions, or a composite transaction which may or may achieve a commercial business end.

3. There must be intermediate steps in planning that are wholly artificial and relate to avoidance of tax only.

4. If the two above factors are present, then the inserted artificial steps are to be disregarded and the end result examined in light of the tax statute in question.

5. The Court in the present case, having found that intermediate steps were indeed artificial, found that the end result was that the gifts of property, having taken place in Macao, were not gifts in Hong Kong and therefore not assessable.

6. Nor was the " associated operations" concept under the Estate Duty Ordinance held to be of any assistance to the IRD, as the court held that there were no gifts in Hong Kong created by associated operations; all gifts were made in Macao.

7. It was apparently accepted that there were no controlled companies in terms of the Estate Duty Ordinance involved in the transaction. Where transfers of assets to a company has taken place there is a risk that the assets themselves will still attract duty if there has been a reservation and receipt of benefits in the last three years prior to death.

For future planning, we may deduce:

(a) that transfers that take place for valid consideration, and were intended and intellectually possible, cannot be ignored. On the face it, it seems at first sight difficult to distinguish the case from others where actual transfers took place of assets into the name of other entities(as in Furniss and Dawson), but apparently Furniss and Dawson can be distinguished on the basis that there was an initial tri-partite agreement which documented the scheme, and indeed the holding of the shares in the UK company by the offshore vehicle was a fleeting occurrence, not permanent, and gave no control, thus making it possible to hold that the end result was that that nothing had changed, and the tax statute in question still applied.

(b) It would also appear it is not possible, although disregarding the intermediate steps in a tax driven transaction, to give any part of the transaction a different character other than how it was legally constituted originally, and for that reason attempts by the HK IRD to argue that the transfers of property were conditional gifts were not permitted.

(c) Planning in the future may still have to be undertaken with considerable care as we believe there are still several areas of concern if the structure employed in the Shiu Wing case is adopted carte blanche in planning schemes: We mention:

(1) there may have to be an absence of any written or underlying agreement or understanding at variance with the documentation, which may allow the Ramsay principle to be applied, leading to a re-characterization of the transaction resulting in the application of a tax statute.
(2) the concept of “ associated operations” was not examined in detail, and it may be that any transfer through a third party and in effect a gift would still be caught.
(3) we believe that the IRD are unlikely to allow the Shiu Wing principle to be slavishly applied, and that anti-avoidance legislation is not impossible.

(4) the costs of establishing a Shiu Wing structure would be considerable, and we believe there is much to be said for simply gifting assets and debts to Trusts and taking the risk that death will not occur within the 3 year time limit, although in some cases this approach may be impracticable.

Summary:

(a) Notwithstanding the result of the case, it is clear that estate duty planning remains a complex exercise which should be only be undertaken with care, and preferably not as an exercise dedicated solely to avoidance of duty or tax.
(b) Save with very large estates, we question whether planning as in Shiu wing is practical or cost effective.
(c) Establishment of a Trust should focus on asset protection and orderly family succession to the Settlor's assets, and there should be comprehensive correspondence which can establish that those objectives are paramount, and that estate duty planning is an incidental matter.In all cases the Settlor must not be in a position to appoint himself as a beneficiary under the Trust.
(d) Structures should be kept simple and where possible, transfers of assets should be direct to a Trust, and not through intermediate structures.

DISCLAIMER:

While the contents of the above Newsletter are believed to reflect the current law, no guarantee is given that in all cases the comments made and examples given are necessarily correct and no responsibility is assumed for the consequences of any party undertaking any action on the basis of what is written in this Newsletter without prior written advice from us on the factual situation involved.

EAST ASIA TRANSNATIONAL

March 2001

INTERNET COMMUNICATIONS CANNOT BE GUARANTEED TO BE SECURE OR ERROR-FREE AS INFORMATION COULD BE INTERCEPTED, CORRUPTED, LOST, ARRIVE LATE OR CONTAIN VIRUSES. THE SENDER THEREFORE DOES NOT ACCEPT LIABILITY FOR ANY ERRORS OR OMISSIONS IN THE CONTEXT OF THIS MESSAGE WHICH ARISE AS A RESULT OF INTERNET TRANSMISSION.

NEW ZEALAND OFFICE
36 Penguin Drive, Murrays Bay, Auckland 1310
New Zealand
Phone: (09) 4764471 or 4764472
Fax: (09) 4764473
Email: tjbrears@transnational.co.nz
Web Site: www. transnational.co.nz

Hong Kong Office
Suite 1501 & 1503
Chinachem Tower
34-37 Connaught Road
Central
Hong Kong

Please see our new Web Site at www.transnational.co.nz which includes details of our charges, contact information and latest Newsletters. Note new E-Mail address which is: tjbrears@transnational.co.nz