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@xtra.co.nz

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

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1. CORPORATE AND COMMERCIAL

Duty of stock broker to its client.

The Australian Federal Court decision of Eric Preston Pty Ltd ("EPP") v Euroz Securities Limited ("Euroz") dealing with the relationship between a stockbroker and its client provides an instructive summary of the law. The general principles would almost certainly have application in Hong Kong.

The facts, in brief, were that the Plaintiff EPP initially traded under margin facilities but later switched to a securities lending facility where ownership of the shares were vested in the lender. The lender became insolvent and EPP suffered substantial losses which it sought to recover from its stockbroker Euroz. The basis of the claim by EPP against Euroz was that:

(a) Euroz had agreed to give financial advice and had assumed a duty of care; and

(b) Euroz had been guilty of misrepresentation in that it was alleged that Euroz had said the later margin facility was the same as the original facility where beneficial ownership of the shares was still vested in EPP and that the share portfolio was safe because for the lender to become insolvent the share market would have to fall over 20% in one day.

On the first issue the Court found that there was no express or implied agreement for Euroz to provide financial advice and that under the general law stockbrokers are only under a duty to execute orders and not duty bound to give advice unless these duties are added to or varied by a special agreement or the circumstances of the case.

Of more interest was the Court's findings on the second issue that there was no misrepresentation by Euroz just because it had passed on to EPP written assurances by the lender that its financial position would not be at risk unless the stock market fell over 20% in one day and that it was unlikely that the marker would fall 20% in one day. In essence, the Court decided Euroz was not the source of the information and had not endorsed it in any way.

Comment: For stock brokers and financial advisers in Hong Kong the case carries some lessons, particularly where information from other parties concerning underlying securities or assets is passed on to clients in situations where there is the possibility of an allegation that what may be negligent advice was endorsed by the adviser. Appropriate warnings would be justified.

*2. **TAX**:*

(a) New Advance Ruling from HK IRD- waiver of loans and whether write off is taxable:

In Advance Ruling No.47 just released the HK IRD ruled that a HK company (" HK Co") that had accumulated substantial trading losses and was in a " negative equity" situation was not assessable for profits tax on the release and waiver by another company (" Lender Company") of substantial loans and advances made to HK Co by Lender Company.

As it is quite a common situation in HK for HK companies to be capitalized by unsecured loans and advances from a parent or other companies this ruling provides a useful reminder of the tax issues involved and the way the IRD has interpreted the relevant sections of the IRO.

In its ruling the HK IRD held:

(i) The waived or " gifted off " amount of the loans advanced by Lender Company to HK Co were not profits derived in the ordinary course of business conducted by HK Co and therefore the HK IRD concluded that section 15 (1) (c) of the IRO had no application. That section deems grants, subsidies or similar financial assistance received by a person carrying on a trade or business as chargeable receipts;

(ii) Nor did section 15(2) of the IRO apply since no claims had been made by HK Co for taxable deductions in respect of the loans in its accounts. That section imposes tax on debts subsequently released where they have been subject to taxable deductions;

(iii) The HK IRD also held that sections 61 and 61A did not apply and that the waiver of the loans was not tax avoidance.

Comment: We have considerable reservations concerning the HK IRD's interpretation or application of section 15 (1) (c) as one would have thought it was arguable the waiver of loans was indeed connected with the carrying on of a business since the rationale of the write off was to allow HK Co to continue to trade. However, as no claims for deductions had been made clearly section 15(2) did not apply and that seemed the more critical issue determining non –assessment. Write offs of parent company loans to subsidiaries needs to be carefully planned and other methods in structuring a write off may be desirable.

(b) Avoidance of Double Taxation Arrangement (" Arrangements") between PRC and Hong Kong- 183 day rule queried in Legislative Council

On the 23/11/11 an issue of interpretation of the 183 day rule was raised in question time. Essentially it was an issue of whether days not worked such as week- ends and sight- seeing days are counted in calculations as to whether a person has spent 183 days in a 12 month period in the " other state" so as to become tax resident for tax purposes.

The questioner raised the issue of why week -ends and non -working day should be counted as part of the 183 day period and whether the HK Government had plans to amend the Arrangement and relax the rule.

The comments made in reply, set out below (but edited), are a useful summary of the current position under the Arrangements and comment on different approaches adopted by some counties in relation to " frontier workers". We have underline the important points.

In reply the Secretary for the Treasury stated (we have omitted non – relevant comments)

(i) "As the relevant provisions of "The Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income" (the Arrangement) provides that "the recipient is present in the Other Side for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned", the Hong Kong and the Mainland tax authorities have to refer to the "days of stay" and not the "actual working days" in determining a person's tax liabilities in the other side under the Arrangement. This "days of physical presence" method is a correct interpretation of the provisions under the Arrangement. It is also the method commonly adopted by other tax jurisdictions and consistent with the

standard used by the Hong Kong Board of Review in determining the tax liabilities of a person;

(ii) According to international practice, a day during any part of which, however brief, the taxpayer is present in a tax jurisdiction counts as a day of presence in that jurisdiction. Hence, a same-day trip or a stay of less than 24 hours in the Mainland is counted as a day of presence. This interpretation about the counting of days is consistent with the decision of the Hong Kong Board of Review;

(iii) We have raised the suggestion of relaxing the 183-day threshold with the State Administration of Taxation. After discussions, both parties consider that the 183-day threshold should not be changed as it is an international standard which has been effectively applied. Furthermore, it has taken into account and balanced the tax interests of the resident and the source jurisdictions;

(iv) According to our understanding, some European countries have special tax provisions for frontier workers. Pursuant to these provisions, frontier workers only have to pay tax to the government of his place of residence and not to the government of his place of work. These provisions usually cover definitions on frontier cities (e.g. the distance from the border) and frontier workers (e.g. the frequency of travel between the two countries), as well as allocation of financial resources (e.g. the government of the place of residence of the frontier workers has to make financial compensation to the government of the place of work);

(v) As Hong Kong's taxation system is based on the territorial principle, Hong Kong residents' income derived from the Mainland is not subject to tax in Hong Kong. The proposal of introducing special tax provisions for frontier workers will therefore lead to double non-taxation of the income. Besides, it is difficult to determine the coverage of the exemption area and to define frontier workers on an objective basis. Hence, the proposal requires careful deliberations."

3. ***TRUSTS***

Clause exonerating liability for gross negligence upheld in Privy Council Case

The Privy Council sat for two full days last December to hear the appeal by Spread Trust Company Ltd against Hutcheson and others before overturning decisions of the Royal Court of Guernsey and Guernsey Court of Appeal and ruling.

The case itself concerned the effect of a clause in long-established Guernsey trust deeds seeking to exonerate the trustees from certain liabilities, including gross negligence. The trust was established before statutory legislation was brought in which prevented trustees from building exoneration of this type into the trust deeds.

It was argued for the beneficiaries that the trustees were in breach of trust for not diversifying investments

The Privy Council has effectively ruled that trustees can be exonerated from their own gross negligence. The Privy Council effectively followed English law in this area (*Armitage v. Nurse*. is the leading UK case on the subject)

The Privy Council decision covers some very important and complex issues of trust law that have significance not only for professional trustees and legal practitioners in the Channel Islands but also in the United Kingdom and elsewhere.

Comment: There are some trust practitioners who argue that *Armitage v. Nurse* goes too far and certainly most Trust Deeds do not allow a Trustee to escape liability for fraud or gross negligence.

Our own practice when preparing Trust Deeds is to ensure that in larger trusts an investment adviser is appointed. In that case, the Trustee cannot usually be liable for losses. Nor do the Trustees have liability in respect of the activities of directors of underlying companies and such exemption clauses have also been upheld by the UK courts.

However, Trustees should always bear in mind that their overall fiduciary duty is to preserve the trust funds for the benefit of the beneficiaries and we do not recommend (and clients will not accept) clauses in Trust Deeds that seek to exempt professional trustees from completely ignoring the management of underlying assets in trust funds

4. CHINA

Although we are not licensed to practice China law we endeavour to keep up with important developments which may be of interest to our clients and we deal with selected PRC legal firms where necessary.

(a) Use of variable interest structures in China:

For some years investors in China have used what have been known as variable interest structures ("VIS") to invest in trading and manufacturing ventures in China. Such structures have the advantage of avoiding the beaurocratic and capital intensive equity joint ventures and WOFE very often used by foreign investors.

One example of what may be called a VIS is to have say a substantial listed company in Hong Kong (" HK Co") with a WOFE owned by itself in the PRC to set up and manage a business in the PRC under its own name pursuant to a HK joint venture agreement with a HK or foreign party (" HK investor"). HK Co effectively manages and owns the venture in the PRC for the HK investor. HK Co pays HK investor, who has no presence in the PRC, the profits of the PRC business less management fees payable to HK Co. Payment is made in Hong Kong.

More common is the kind of VIS where HK investor, through a non- Chinese entity, exerts contractual control over a PRC based operating entity so that from an accounting perspective the profits from the PRC operating entity are consolidated into the accounts of the non- Chinese entity.

To set up VIS a subsidiary in China is set up as a wholly owned subsidiary of the foreign non- Chinese parent. The China subsidiary then enters into a number of contracts with a local Chinese company holding the necessary Chinese operating licenses in the business to be operated. Typical of the contracts entered into are a services contract, trademark and IP agreement and charge over and option to buy the shares in the local Chinese company.

Comment: While in some industries the VIS structure has worked, in others it has not and there are risks the owners of the local Chine operating company will breach the contractual arrangements and take over effective ownership and control of the company. High profile examples of the GIS structure not working are Alibaba, Bhudd Steel and Gigamedia.

(b) Protection of Trade Secrets in China:

Although registration of a trademark in the PRC is well recognized as being one of the important steps in an IP protection programme in the PRC, less well known is that China has developed laws to protect trade secrets in the PRC. This is set up under the Anti- Unfair Competition Law ("ACUL").

To enforce protection measures and remedies for unless use of trade secrets (widely defined in the ASUL) adequate confidentiality measures must be taken, such as labeling, adopting passwords, having confidentiality agreements in place and limiting access to machinery and factory locations.

Owners of trade secrets can pursue administrative or judicial remedies which involve fines up to RMB200,000 and orders for return of trade secrets and damages for loss of profits.

Comment: While remedies under ACUL are welcome and a valuable right to have where trade secrets have been stolen, enforcement suffers from the lack of an effective injunction procedure and the lack of the legal remedy of discovery available in HK and other western jurisdictions. Accordingly, good documentation and proof of ownership of trade secrets is essential.

5. EMPLOYMENT LAW ISSUES IN HONG KONG:

(a) Hong Kong case clarifies criteria for classification of person as an independent contractor:

In Leung Suk Fong Peggy v The Prudential Assurance Society the Court of First Instance held that an insurance agent was not an employee but an independent contractor. This appears to be the first time in Hong Kong that the status of an insurance agent acting on a " free lance " basis has been examined and one wonders if the HK IRD will be so willing accept such a classification.

In making it decision the Court applied well known principles of law to establish the legal basis of the relationship. In summary:

(i) It was common ground that the defendant had no restrictions on where, when, how and how often the claimant performed her work. The Court found that the defendant, by asking the claimant to attend training sessions and meetings and to use leaflets and proposals developed by the defendant, only had control over the quality of the claimant's work. Such control was necessary to ensure that the claimant's performance would meet the standard required as the defendant's agent, and was not control over her as an employee;

(ii) The claimant had no fixed monthly salary and her monthly income fluctuated depending on the number of insurance policies she was able to sell. She also had to pay for her own travelling expenses and contribute a small sum to share her up-line manager's secretary's salary. If any of the claimant's client withdrew an insurance policy, she might need to reimburse the defendant the medical examination fees for the client. TheCourt found that the claimant had to bear considerable risks financially in performing her work, which was inconsistent with an employee's status.

(iii) The claimant agreed that the defendant did not provide work to her but she had to look for her own business and clients. The Court found that this was a strong factor militating against any suggestion of an employment relationship.

(iv) The Court found that although the defendant provided the claimant with office accommodation, furniture and use of computer and fax machine, this was only for the convenience of the claimant and other agents. What mattered was that the defendant's office was not the claimant's principal place of work where she solicited her business.

(v) It was clearly stated in the claimant's tax return that she was not an employee. The Court found that although the defendant contributed to the claimant's occupational retirement scheme, this was a "wholly neutral" factor because the defendant could have contributed no matter whether the claimant was its employee or not.

Comment: Other than clarifying the employment position of a free lance insurance agent the case may have wider implications for those who wish to trade through what was previously called a " service company". The " service company" legislation under section 9A of the IRO sets out similar criteria for determining whether a person is controlled by an employer and provided a person can satisfy the tests there is no reason why use of a service company, in the right circumstances, cannot be justified. The writer had a tax case some years ago where the HK IRD were not prepared to treat an insurance agent as an independent contractor in similar circumstances and one wonders whether other agents, provided they have appropriate consultancy agreements in place, may not seek independent contractor status for tax purposes if they have not already done so.

(b) Springboard Injunctions for breaches of Restraint of Trade Restrictions

One the most vexed issues in Hong Kong employment law is the common situation of a senior employee leaving existing employment, taking away client lists and starting a new business in competition with his or her previous employers using his knowledge and existing clients as a base to start the new business.

In order to protect the business, an employer should enter into a contract of employment with each of its employees containing valid and enforceable confidentiality clauses clearly defining the confidential information it seeks to protect. As well there should be valid and enforceable restrictive covenants to restrict an employee from competing against his/her employer and soliciting its employees and customers.

However, it should be noted that restrictive covenants should go no further than necessary to protect the legitimate interests of the business of the employer and should be reasonable in all the circumstances of the business of the employer.

If a former employee breaches his/her confidentiality obligations or his/her post-termination restrictions, a former employer may commence legal proceedings against the former employee for breach of contract and claim damages. The problem is that this may not be an adequate remedy if a former employer wants to immediately stop the former employee from continuing to use the confidential information or trade secrets to set us his/her own business. The former employee may have a client list.

Rather than simply trying to take a case for damages, which may be lengthy and expensive, a better option for the former employer is to prevent that employee from dealing with those clients and to stop the employee from using the employer's confidential information and trade secrets.

An immediate remedy that may be available is what is known as a springboard injunction. The policy behind this is to put the possessor of the confidential information under a special disability and create a level playing field. In Hong Kong, springboard injunctive relief may be confined to cases in relation to misuse of confidential information and trade secrets. Springboard injunction relief is an order granted by the Court which prevents a former employee from gaining an unfair advantage or a "head start" by using his/her former employer's confidential information or trade secrets in his/her new business.

The relief granted depends on the facts of each case. The Court may make an order restraining the former employee from dealing with those clients for a certain period of time and should direct the former employee to return the misappropriated confidential information. The general principles applicable to springboard injunctions were set out in the UK case of UBS Wealth Management (UK) Ltd and another v Vestra Wealth LLP [2008] EWHC 1974 (QB).

Comment: Few employers review their employment contracts in relation to restraint of trade provisions but such a review may be desirable to update old restraint of trade provisions in relation to key employees. Restraints that are too wide may not be enforceable and confidential information may not be adequately defined in light of business developments.

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