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1.**Bearer Shares- chattel or chose in action?**

It was common in the days when Hong Kong had estate duty to hear some clients say that they could divest themselves of the ownership of shares by giving them to someone else or lodging them for safekeeping with a family member outside Hong Kong. By this magical piece of planning estate duty issues and possible tax on the profits of an offshore company would supposedly disappear.

However, in a recent case in Hong Kong which involved delivery of a suitcase containing bearer shares to an intended transferee, analysis by he judge showed that treating a bearer share as a chattel transferable by delivery is a simplistic approach and, depending on the terms of the Articles of Association, is certainly not the true legal position. The learned judge held that shares in a company, whether bearer shares or registered shares, are not chattels. They are legal choses-in-action. Share certificates, the pieces of paper evidencing the issue of and title to the shares, are chattels. They may be sold or pledged or made the subject of a gift as may be any other chattels. The requirements for proof of a gift of share certificates, of the pieces of paper, would, in principle, be the same as for any other chattels. But an effective gift, or sale or pledge, of the share certificates could not by itself vest in the transferee the legal title to the shares themselves. The transfer would entitle the transferee, as against the transferor, to the benefit of the transaction, whatever that might be, and to retain the share certificates accordingly, but in order to perfect the legal title of the transferee to the shares notice to the company of the transfer would, in principle, be necessary. The rights of a shareholder as against the company depend upon the articles of the company but, subject to that, would be expected to include the right to notice of company meetings, the right to vote at company meetings, the right to receive a dividend if a dividend were declared, the right to participate in any capital distribution, and so on. None of these rights could be enforced by a transferee against the company unless the legal title to the shares had vested in the transferee, or, perhaps, unless an order giving effect to the rights were made in an action in which the legal owner was a party.

In summary, any transfer of bearer shares, if intended to be a gift or sale etc, must be attended by the necessary intention to make a gift or transfer. At that stage, equitable ownership of the shares may vest in the transferee but it will not be legal ownership until the necessary notice to the company has been given.

2. **Derivative actions- can a shareholder in a listed company sue for alleged losses in respect of defaults committed by the management of subsidiary ?**

To the average shareholder in a listed company (or a private company) the legal issue of whether he or his company could sue for what is assessed as a personal loss on share value or loss of income from the company or an underlying subsidiary reflected in the accounts of the holding company might seem a complex, impossible and possibly esoteric and academic exercise.

Yet in a recent case in the Hong Kong Final Court of Appeal (Waddington V Playmates International & Others) Lord Millet considered this very situation where Waddington as shareholder in the holding company sued for personal losses in the holding company resulting from alleged improper actions carried out by the directors of an underlying subsidiary.

At first instance, in an admirable judgment, Barma J found that in the derivative action brought by Waddington on behalf of Playmates Holdings Limited ("Playmates"), the holding company, (and against the holding company) the claims advanced were merely reflective of the alleged losses of Playmates' sub-subsidiaries Profit Point Limited ("Profit Point") and Autoestate Properties Limited ("Autoestate") and therefore precluded by the reflective loss doctrine authoritatively explained in *Johnson v Gore Wood & Co*. He rejected the argument that the case falls within an exception to that principle and concluded that in so far as Waddington's claim was for reflective losses, it was liable to be struck out.

However, he held that a minority shareholder in a holding company may as a matter of law be allowed to bring proceedings, by what has sometimes been called (conveniently, although somewhat inaccurately) a "multiple derivative action", on behalf of a wholly owned sub-subsidiary which has the cause of action, in circumstances where the alleged wrongdoer is effectively in control at every level of the corporate chain. He therefore held that a derivative action by Waddington (a shareholder in Playmates) brought on behalf of Profit Point and Autoestate is in principle available.

Lord Millet confirmed the principles mentioned above, emphasizing that a shareholder like Waddington is prevented from suing for a personal loss in its own name on the basis that Waddington would be recovering at the expense of the holding company, its creditors and other shareholders. It is the company (in this case either Profit Point Autoestate) which is allowed to recover, not Waddington.

3. **Shareholder/Joint Venture Agreements- which pricing mechanism on exit of shareholder ?**

Parties to a shareholder or joint venture agreement are free to negotiate the price of shares on the exit of a shareholder and what is finally agreed may depend on the strength of the parties negotiating positions.

Broadly speaking, there is no exit formula that is perfect and much depends on the nature of the business the company is involved in and whether a pre- set formula is appropriate or whether the value of the shares, in absence of agreement, is better fixed by an expert valuer on a fair market basis. As well, an exit formula to apply on a breach of the agreement by one party should not be fixed so as to provide an incentive for one party to breach the agreement to take advantage of a compulsory acquisition by other shareholders at a favorable valuation. While pre- set formulas are possibly more popular, future circumstances are difficult to predict and formulas may not work fairly at the time.

A summary of the various formulas available may be useful. It is open to the parties to select that may be appropriate in the circumstances. It is desirable to use two alternate formulas with the higher being the one applicable but with a minimum lower price.

(a) sale price shall be the greater of (a) (multiple x EBIT- Debt x ownership interest; or (b) shareholders funds x ownership interest.

An issue with this formula is the treatment of goodwill.

(b) Third party determination of the price in the absence of agreement- usually by an expert, possibly the auditors. It is possible for the agreement to provide guidelines for the valuation, although this might hinder the valuer.

(c) Put option- a right granted to a shareholder to require another shareholder to buy its shares at a certain price and at a certain time;

(d) Call option- a right granted to a shareholder to require another shareholder to sell its shares at a certain price and at a certain time.

(e) Drag along right- where a selling shareholder to a third party wishes and is able to compel another shareholder (s) to also sell their shares to that third party.

(f) Tag along right- where a shareholder can " tag along" with another shareholder who is selling to a third party. The shareholder having the right can effectively join in the transaction if it wishes.

(g) Buy sell Agreement- not technically a price mechanism, but where shareholders take out term life cover on each other to provide a buy out fund for the surviving shareholders to acquire shares from the deceased shareholders estate at a fixed price.

(h) Deadlock mechanisms. Exit mechanisms typically cover situations where there are defaulting shareholders or voting deadlock occurs. Some options are as follows:

(i) Liquidation- the possibility of a fire sale price may encourage

shareholders to resolve the dispute;

(ii) Russian roulette- may be OK if parties are of similar wealth. Means that either party may offer their shares to the other at a certain price and the recipient party then must either purchase at that price or sell his shares to the offeror at that price.

(iii) Shoot out- where one party advises the other that is wishes to buy its shares on specified terms, and if the other also wishes to buy, both parties participate in an open auction. The highest bidder purchases the other parties shares.

4. **Default by a US joint venture partner- what is the legal position ?**

In the current climate there may be HK entities who are parties to joint venture/shareholder agreements where the US party may go bankrupt. A common situation is where the HK party may manufacture using IP rights owned and licensed by the US party.

We do not practice US law, but from research we have had access to it is possible to briefly mention some of the more pressing issues that a HK party must consider.

(a) IP rights- we understand the position is unaffected by the bankruptcy of the parent assuming the IP rights are owned by a US subsidiary;

(b) The administrator of a bankrupt estate or company may affirm or disavow the contract- any remedy may be worthless if the contract is not confirmed;

(c) The position with licenses seems unclear, but it may be that the license can be kept if payments continue to be made;

(d) Control of the joint venture where a US party is bankrupt will depend on whether the US administrator affirms or disavows the contract;

(e) Guarantees- generally the HK party may be in a difficult position where there have been joint and several guaranties by joint venture parties as recovery against the US bankrupt party may prove impossible.

In summary, HK parties will need to look first at existing joint venture and shareholder agreements carefully to see whether the agreement covers bankruptcy and the respective rights of the parties. Remedies may then depend on US law and what the administrator in the US wishes to do.

5. **Employment Law**

(a) **Confidential information- what may an ex - employee disclose ?**

In a recent case in the Court of Appeal (PCCW v DM Aitkin and CSL) the limits of protection for confidential information obtained by an employee and senior executive who has moved to

an opposition firm was examined in great detail.

The brief facts were that Mr. Aitkin ("DMA") was employed by PCCW and was privy to confidential discussions and briefings from senior London councel relating to court action over regulatory issues. He then left the employment of PCCW and moved to CSL, supposedly to take up a position unrelated to regulatory issues. On PCCW finding out that DMA was in fact engaged with its rival CSL in the very regulatory issues he had been discussing while with PCCW, including its future regulatory strategy, PCWW immediately not only sought an injunction to enforce the usual confidentiality and trade secrets restrictions in DMA's employment contract, but an order that DMA be restrained completely from using any information at all that he had been privy too 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). Councel for PCCW sought to apply the principles in the Bolkiah case in UK (involving the Sultan of Brunei) where KPMG were restrained from acting for another party on the basis that had received information in the analogous position of a lawyer and could not be allowed to use any of that information.

The Court of Appeal rejected the proposition for forward by PCCW and held that DMA was in no way in the same position as a lawyer (even though he was qualified as one) and that the law as well understood in the Faccenda Chicken case would apply; that is, only true trade secrets can be protected, but not information falling short of a trade secret which is taken away by the employee, learnt on the job and retained in his head.

The case will go on appeal to the Court of Final Appeal.

For those clients wishing to protect strategy secrets and other information that might be useful to a competitor, the best course of action (rather than relying on confidentiality provisions alone) is to mark all sensitive written material as confidential and part of the IP rights and trade secrets of the firm, and more importantly, as said in Faccenda Chicken case, to try and restrain the employee from working for a competitor for a suitable period of time and using the sensitive material. Where material has been found to be sensitive and important to a firm (as in the present case) restraints of trade for periods of up to 6 months or longer may be enforced by the Courts if the restraints are reasonable.

(b)**Confidentiality of information on execution of ICAC search warrant- recent case summary**.

In a recent case (RBSA Corporate Services ICAC/Sec for Justice) the court dealt with a situation where a legal firm running a separate corporate services operation claimed legal privilege (and alleged illegality of the warrant) against an ICAC search warrant issued under Mutual Legal Assistance in Criminal Matters Ordinance (Cap. 525).

The court firmly rejected the argument that the warrant was illegal because the search was conducted on the premises of a legal firm and with a lawyer present, as it was not restricted to documents protected by legal privilege, and

documents for which privilege was claimed were sealed and put aside from other documents which had been seized for the purposes of checking if funds had been channeled through certain offshore companies from the Philippines.

The case is useful for its observations on solicitor and client legal privilege where the ICAC is concerned and it is clear that the ICAC are under a duty not to seize or read documents where a claim of privilege is made and must seal these documents in the presence of a lawyer. However, mere possession by a law firm of documents mixed up with other documents does not always guarantee privilege. In addition, it is clear that not all documents will be subject to privilege; as an example, documents lodged with lawyer for safekeeping and unconnected with the claim in question or not representing notes and confidential correspondence relating to a claim may not escape seizure. The case also confirms the wide powers granted to the Government under the Mutual Legal Assistance in Criminal Matters Ordinance where countries who are parties to the treaty in question will allow search warrants to be issued in relation to a number of matters, some of which may not technically be criminal and might include tax evasion. The only safe place for confidential material to be stored is outside Hong Kong given the wide powers enjoyed by the ICAC.

6. **Tax**

(a) **Compensation of loss of office and whether taxable- does the wording in an employment contract change the character of the payment ?- latest case summary;**

In a recent High Court decision (Fuchs v Commissioner of Inland Revenue) the taxpayer sought to overturn a decision by the IRD that payment of a double salary and the average of 3 years past bonuses was subject to salaries tax, although in terms of the employment contract it had been structured as a severance payment in the event that the employee was terminated before the expiry of the contract.

Under HK tax principles, well accepted by the IRD, severance payments for loss of office unconnected with the rendering of services and compensatory in nature are not normally subject to salaries tax.

Notwithstanding that both payments were arguably compensation for loss of office, the Court held that:

(i) on a true construction of the contract, the bonus element was income as it had been included as an inducement to enter the contract, but more importantly was a payment calculated on what was due to the employee if he had remained in employment.

(ii) by contrast, the double salary payment was unconnected with services because it was calculated on a multiplier basis, was called compensation, was not referable to work done under the contract, would not have been payable if the contract had continued (the bonus would have been) and finally, it was an arbitrary payment to soften the blow of unemployment. Accordingly, the payment was not taxable.

The case demonstrates that considerable care is needed when drafting termination and severance provisions. If the bonus element has been added in as a set figure and added to the double salary to form one single payment it is very likely that the single payment would have been treated as whollycompensatory. Reference to existing mechanisms to calculate what might have been paid if the employee had stayed will, it seems, characterize the payment as income paid to the employee for acting as or being an employee.

(b) **Source of profits- nature and structure of manufacturing operations in China owned/controlled by HK taxpayer will determine whether HK profits tax applies and whether apportionment will apply- recent case summary;**

In an important case decided earlier this year (Commissioner of Inland Revenue V Datatronic) the High Court examined:

(i) the scope and application of the IRD's interpretation notes DIPN 21 which determine whether a HK company sourcing product from a PRC associated and/or controlled entity can claim a 50/50 split of trading profits for profits tax in HK as between HK and the PRC on the basis that the HK company is involved in the manufacturing in the PRC;

(ii) what constituted the PRC entity a mere sub- contractor, in which case, no apportionment of profits would be possible on the basis that all the HK company was doing was buying product on an arms length basis, and was not involved in manufacturing. An essential ingredient of a sub- contracting operation would be where raw materials were merely sent to the factory on consignment, rather than sold outright;

(iii)whether the form of the arrangements and documentation was the important issue, or whether the substance of the arrangement was the more vital factor.

The facts were somewhat complex but in essence the HK company adduced evidence to prove that it wholly controlled the PRC company and that this entity was not an agent. Of importance were that:

(a) the PRC entity kept separate accounts;
(b) the HK taxpayer provided designs to the PRC entity;
(c) raw materials were purchased from the HK taxpayer;
(d) purchases from third parties were procured by the HK taxpayer;
(e) the PRC entity was carrying on import processing and paid processing fees to the HK taxpayer.

In answer to the key issue of whether the HK taxpayer was involved in manufacturing in the PRC through its PRC controlled entity, the Court rejected the IRD contention that, because the form of the documentation referred to sales of raw materials and purchase of the product by the HK taxpayer, this showed that the PRC entity was a simple sub- contractor. The Court said that the substance of the transaction showed that the purchases were not at arms length

and that because of the factors in (a) to (e) above, it was clear that the HK taxpayer was intrinsically involved in the PRC manufacturing operation and was entitled to claim that 50% of the profits under the DIPN 21 concession were sourced in the PRC. The Court also confirmed the principle decided in earlier UK cases that, irrespective of the IRD guideline ruling in DIPN21, apportionment of profits is in principle possible although not mentioned in the Inland Revenue Ordinance.

Any parties structuring manufacturing arrangements in the PRC would do well to read the provisions of DIPN 21 carefully and take advice on the form and substance of the arrangements between a HK taxpayer and an associated PRC manufacturing entity. The difference between a sub-contracting arrangement and a manufacturing arrangement is spelt out in DIPN 21 but it is clear that these guidelines are not entirely comprehensive and may admit of more than one interpretation. It is advisable that the form of the arrangement follow the substance of what is happening lest the IRD have an excuse to examine the whole transaction.

(c) **Hong Kong signs Double Taxation Agreement with Vietnam- brief details;**

On the 16/12/08 Hong Kong signed with Vietnam an agreement for the avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. In brief:

(i) But for the new treaty profits earnt by Vietnamese residents would be subject to both HK and Vietnamese tax and likewise with Vietnamese companies operating branches in HK. Now a credit will be allowed in Vietnam for HK tax paid;

(ii) Royalties paid to HK residents from Vietnam previously subject to a 10% withholding tax will now be subjected to a lower rate of 7%;

(iii) As with most double tax treaties business carried out through a permanent establishment will be taxed by the county in which the business is situated;

(iv) Arrangements over shipping and airline profits are also covered;

(v) Notably, the definition of " permanent establishment" includes a building site assembly or installation project only if the activity lasts longer than 6 months, and also includes services conducted for more than 180 days in a 12 month period;

(vi) There are provisions allowing exemption of agents as constituting permanent

establishments but also provisions deeming companies to have permanent establishments where agents have authority to conclude contracts.

Given the importance of Vietnam as a manufacturing base the new treaty is to be welcomed. HK is making efforts to conclude a network of double tax treaties with major trading partners and has concluded treaties with Belgium in 2003, Thailand in 2005, China in 2006 and Luxembourg in 2007. We have full text of the treaty which is available to those who wish to have a copy.

(d) **The current inquisitorial attitude of the HK IRD- a summary of danger areas to avoid:**

For some years we have been retained by clients who are involved with tax investigations by the HK IRD. As some clients will know, the IRD has become increasingly active in the area of increased field audits and the pursuance of alleged tax due from a wide range of business and trading activities conducted by both local HK companies and associated offshore companies. The IRD seem determined to pursue tax at any cost and for any length of time notwithstanding there are good grounds for objection or the possibility of actual recovery of the tax is remote. No one is immune from an audit and it is better to be prepared for one if at all possible.

It may assist clients if we summarise some danger areas where we have seen the IRD focus their attention. We suggest that any trading or business activity in these areas be monitored carefully to see that the correct trading structure is in place or if it is not, to ensure some review takes place so as to alleviate the risk of an audit and/or recovery of alleged unpaid tax and penalties.

The following situations are danger areas:

(i) the use of a HK company to own overseas assets. Potential liability includes stamp duty on a sale of shares in the HK company, allegations that on the sale of the asset the profits had source in HK, that the assets were trading assets and not on capital account. If the transaction can be structured using an offshore company so much the better;

(ii) Loans made by HK companies to overseas entities where interest may be assessed as having a source in HK;

(iii) Attempts to run offshore profits through offshore companies when the offshore company is centrally managed and controlled in HK or has its share registry in HK;

(iv) While the IRD accept that an offshore subsidiary may have overhead expenses, appointment of an overseas director , proper records of expenses and detailed board minutes will assist;

(v) Inadequate documentation between a HK trading entity and its PRC associate recording the control of the PRC entity- failure to do that may prejudice a 50/50 claim for apportionment of profits;

(vi) Employment of staff or consultants who do work offshore and claim that this income is non- taxable is a fertile source of litigation. There are so many complications that we cannot list them all. Some issues are directors fees (nearly always taxable notwithstanding the director does not reside in HK), the 60 day rule (part days counted as full days), how services are rendered overseas(even an atom of work carried on in HK may prejudice the arrangement), the need for dual contracts (one for overseas work and one for HK work), share options (the need to structure them so that they are paid to a consultant and not an employee);

(vii) The dangers of a section 76(1) demand from the IRD on a HK firm who pay compensation to an offshore employee who is assessed as owing tax by the IRD;

(viii) Reporting consultancy income to the IRD as salary by mistake thus creating a huge problem for a consultant who may also be a director. Always consider dual contracts for director fees that may be taxable and a separate consultancy contract for other offshore services.

(ix) Any transactions where invoicing is carried out through HK. All these transactions are being examined by the IRD. Keep activities of the re- invoicing HK company to " post box" status and have all contracts signed and invoices prepared outside HK by duly appointed offshore agents.

We have more detailed information sheets on a number of the above issues and will make these available upon request. We are available to advise on structures and draft appropriate documentation.

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