



Corporate governance for private companies: when does it matter



Produced
in partnership
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In Hong Kong, corporate governance guidelines apply to private companies that meet certain criteria.

Slotine co-authored an article with LexisNexis detailing the scope of private companies that these guidelines apply to, what the core principles laid out in the Companies Ordinance (Cap 622) (CO) are, the HKIOD Guidelines and Toolkit on Corporate Governance for SMEs in Hong Kong, and the rules and guidelines for listed companies, too.

Here is an extract from that article explaining which private companies corporate governance guidelines are most relevant for.

Three possible criteria are reviewed below to identify those private companies for which corporate governance are likely to be most relevant:

- categories 3 and 4 SMEs as defined by the HKIOD
- private companies which do not fall within the reporting exemption
- private companies whose shareholders are considering to enter into a shareholders' agreement

CATEGORIES 3 AND 4 SMEs AS DEFINED BY THE HKIOD

The Hong Kong Institute of Directors (HKIOD) refers to the term 'SMEs' for small and medium enterprises, for which it has elaborated five categories, from category 1 (skillful entrepreneur) to category 5 (companies listed on the stock exchange bound by the listing rules). Companies which fall within category 3 and category 4 as defined by the HKIOD are definitely most concerned by corporate governance.

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Category 3 SMEs are described as follows in the 3rd edition of the HKIOD Guidelines on **Corporate Governance** for SMEs:

“Once a company has several shareholders it becomes necessary to consider their rights, and it may be important to demonstrate that the company offers attractive investment possibilities. Additional shareholders bring additional responsibilities: Articles of Association, and a representative board of directors, will probably be necessary. The need to satisfy other shareholders means that the accounting and control systems will have to be more reliable, and since in larger companies, planning and risk management will become more important, the relevant systems will be more sophisticated. In these companies the legal obligations of the entrepreneur, and the practical needs of the business, will be more complex and onerous.”

The same guidelines describe Category 4 SMEs as:

“These companies have a substantial number of shareholders, and as a consequence, there is a separation of ownership from control and the board has a responsibility to act in the interests of the company as a whole. The board must be accountable to the shareholders and it must hold management accountable to it. Not only must all the **governance** systems needed by category 3 companies be developed to a greater degree of sophistication but additional mechanisms will be required. The composition of the board, its harmony and teamwork, communications with shareholders, the functions of the board and its relationship with management will all take on a greater importance.”

PRIVATE COMPANIES WHICH DO NOT FALL WITHIN THE REPORTING EXEMPTION

Hong Kong companies which do not meet the exemption criteria set out in the box below, are required to prepare a business review as part of the directors' report. In practice, subject to exchange rates fluctuations, directors of companies with an income /total asset above USD 13 million and 100 employees or more are expected to prepare such unless their shareholders agree not to at a qualified majority with no objection.

The content of this business review is set out in Schedule 5 to the CO, and summarised below:

- an analysis using financial key performance indicators
- a discussion on:
 - the company's environmental policies and performance, and
 - the company's compliance with the relevant laws, and regulations that have a significant impact on the company, and
- an account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company and on which the company's success depends

The content of this report is destined to increase the accountability of the board to the members as well as a first step towards **corporate** social responsibility awareness for private companies (CSR).

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PRIVATE COMPANIES WHOSE SHAREHOLDERS ARE CONSIDERING TO ENTER INTO A SHAREHOLDERS' AGREEMENT

Shareholders agreement are contracts entered between all or some members of a company and generally the company itself in order to reinforce or alter the provisions of the law with regards to **corporate governance**, as well as other provisions regarding transfer of shares, restrictive covenants, exit or deadlock situations. Typical provisions regarding **corporate governance** include (for the purpose of illustration only):

- increased access to information for members
- increased reporting duties of the managers
- reserved matters for the board
(list of decisions which can only be decided by the board)
- reserved matters for the members
(list of decisions which can only be decided by the members)
- additional rules for the organization of board meetings
(delay for notice, content of notice, quorum, qualified majority rules)
- additional rules for the organization of general meetings
(delay for notice, content of notice, quorum, qualified majority rules), etc

It is good practice to amend the articles of association of a company to include the **corporate governance** provisions of the shareholders agreement, in order to ensure third parties' information as well as increase the weight of such provisions as articles of association are 'quasi-deed' according to Hong Kong law.

In Hong Kong, a company's constitution is a statutory contract between individual members inter se and between individual members and the company. Once a company's articles are registered, they have effect as a contract under seal (section 86(1) of the Companies Ordinance (Cap 622)):

- between the company and each member, and
- between a member and each other member

The articles are to be regarded as containing covenants on the part of the company and of each member to observe all provisions of the articles. They are enforceable (section 86(2) of the Companies Ordinance (Cap 622)):

- by the company against each member
- by a member against the company, and
- by a member against each other member.

To understand what these corporate governance guidelines entail and how to implement them in your company, please see the rest of the article on Lexis Advance @ Hong Kong Practical Guidance.

AUTHOR'S BIO - MAËVA SLOTINE

Maëva founded Slotine in 2016 after being admitted in Hong Kong, France, and England & Wales. Since beginning her career in 1998, she has gained extensive experience on numerous multinational cases globally, focusing on mergers and acquisitions, private equity transactions, foreign direct investments and corporate governance matters.