M&A Primer: Board Representation of Minority Investors in Hong Kong Companies

Minority investors in companies will often wish to secure board representation so as to ensure that the company in which they have invested is managed in a manner satisfactory to themselves. Whilst it is easy to secure a right to appoint a director, it is more difficult under Hong Kong law to ensure that the appointee is not removed if relations with the majority shareholder sour. In this article, we examine the relevant legal issues following the introduction of the new companies legislation earlier this year.

Private equity funds and other investors taking a non-controlling interest in a company will often wish to secure a seat on the board of directors to protect themselves. In so doing, their legal advisers will often recommend that they enter into a shareholders agreement which will expressly provide for a right on their part to appoint a specific number of directors. However, such a contractual provision by itself may be ineffective to secure their commercial interests.

DIVISION OF POWERS

The underlying assumption is that the board of directors manages the affairs of the company and therefore, by securing one or more board seats, the investor will be able not only to observe how the company is being managed but to take an active role in influencing or controlling how the company is managed. Whilst standard articles of association for companies do in fact provide for the affairs of the company to be managed by the directors:

- The articles may restrict the scope of the board's power to manage the company (*e.g.* by reserving certain matters to the shareholders).

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Indeed, in the model articles of association for private companies limited by shares under the Companies Ordinance ("**CO**"), the shareholders may, by special resolution, direct the directors to take, or refrain from taking, specified action. A minority shareholder who secures board representation may therefore wish to consider the need, whether in the articles or the shareholders agreement, to restrict the majority shareholder(s) from bypassing the board or from passing certain types of shareholder resolutions.

- Where the board is unable or unwilling to act (*e.g.* the board is deadlocked or unable to form a quorum), the shareholders in general meeting may act in lieu of the board. A minority shareholder who secures board representation may therefore wish to consider how deadlock at the board level should be resolved and, if it cannot be resolved, how and what role the shareholders will play in resolving the deadlock. This may in turn require consideration of what should happen in the event that the shareholders are deadlocked.

APPOINTMENT

The CO does not provide for how directors are to be appointed save to say at s. 460 that:

- For a public company (or a company limited by guarantee), a motion at a general meeting for the appointment of directors must be made by separate resolutions unless the shareholders have unanimously agreed otherwise. In other words, it is not normally possible to consolidate a slate of directors into a single resolution to be presented to shareholders for voting.
- Any provision in the articles of association for the automatic re-appointment of a director in default of another appointment is void.

As a result of the absence of specific statutory provisions, the means of appointing directors is a matter for the articles of association. In this regard, under the CO, the model articles of association for a private company limited by shares provide for directors to be appointed by the shareholders by ordinary resolution or by the directors to fill a vacancy (*e.g.* a director needs to be appointed as a result of the resignation of another director). On this basis, a minority shareholder may wish to include in the shareholders agreement a provision that shareholders should vote their shares to ensure that each person nominated by the minority shareholder in accordance with the agreement is appointed as a director.

The weakness in relying on such a provision alone is that if shareholders breach the agreement and refuse to appoint a director duly nominated by the minority shareholder, the minority shareholder's only remedy is to sue for a breach of the agreement. In the interim, pending a court ruling, as a matter of company law, his nomination is ineffective. Accordingly, it is often desirable to entrench the right to appoint a director into the articles of association so that any nomination becomes effective immediately as a matter of company law.

Personal Rights of Appointment

It is possible for the articles to provide for a specific person to have the right to appoint a director. However, if the person is not a shareholder, he may be unable to enforce his right. This is because the articles of association constitute a contract between the company and its shareholders alone and thus, is likely to be enforceable only as between the shareholders and as between the company and the shareholders.

If the articles provide for a right of a person to appoint a director and that person holds that right in his capacity

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as a shareholder, the right will constitute a class right and accordingly, may benefit from statutory protection as regards variation of class rights.

Different Classes with Different Director Rights

Specific articles enabling persons to appoint directors however, are generally not transferrable. Accordingly, a common method for securing board representation is to divide the company's share classes into different classes with each class having a right to appoint its own director(s). Each investor holds a different class corresponding to its right of appointment.

REMOVAL

Any mechanism for appointing a director must consider the removal of the director. In this regard, as with the appointment of directors, the CO does not provide for circumstances in which directors will automatically retire. So, for example, the CO does not mandate that directors retire at each annual general meeting.

However, the CO , s. 462(1) provides that a company may, by an ordinary resolution passed at a general meeting, remove a director before the end of the director's term of office, despite anything in its articles or in any agreement between it and the director. For investors in companies who have negotiated board representation, given this statutory procedure, a concern is how such investors prevent the removal of the director appointed by them.

It is not possible to simply provide either in the articles or in a shareholders agreement that the company will not remove any director so appointed. Such a provision is likely to be unenforceable on the basis that a company cannot, whether in its articles or otherwise, fetter its statutory powers. For the same reason, a provision in the shareholders agreement that the shareholders will not vote to remove any director so appointed may be unenforceable if the shareholders agreement is regarded as operating otherwise than as a mere personal contract between them. This may arise in Hong Kong, for example, where the shareholders agreement binds all present shareholders and provides that all future shareholders must adhere to it. This is a more restrictive position than that under some other common law jurisdictions and suggests that in Hong Kong, to entrench board representation, it may be necessary to rely on class rights set out in the articles to supplement those in the shareholders agreement and possibly to flaw the shareholders agreement so that future shareholders need not adhere to it. A possible approach is for the shareholders agreement to require unanimous shareholder consent for the admission of a new shareholder and to provide that any shareholder may refuse consent if the new shareholder does not agree to adhere to the shareholders agreement.

Different Share Classes

Under the statutory procedure, an ordinary resolution at a general meeting may be used to remove a director. In this respect, the CO, s. 563 provides that an ordinary means a resolution that is passed by a simple majority and a resolution at a general meeting is passed by simply majority if it is passed by a simple majority of the total of the number of shareholders who, being entitled to do so, vote. On this basis, it seems likely that a director can be entrenched by (i) establishing multiple classes of shares with each class having the right to vote to appoint or remove its own directors, (ii) issuing to each investor a separate class of shares, and (iii) providing that each class shall have no right to vote in respect of the appointment or removal of directors for another class.

[W]hilst it is possible to create a class of shares which holds a greater number of votes generally compared other classes of shares, it is not possible to create a class of shares which holds a greater number of votes than other classes of shares only as regards resolutions to remove a director.

Weighted Shares

Whilst in some common law jurisdictions it is possible to establish weighted shares carrying super voting rights in respect of resolutions concerning the removal of directors, the CO, s. 462(7) provides that no share on a poll may carry a greater number of votes than it would carry in relation to the generality of matters to be voted on at a general meeting of the company. Thus, whilst it is possible to create a class of shares which holds a greater number of votes generally compared other classes of shares, it is not possible to create a class of shares which holds a greater number of votes than other classes of shares only as regards resolutions to remove a director.