

Newsletter No. 99 (EN)

A Hong Kong Company's Board of Directors, Functions and Liabilities

May 2009

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This Memorandum should provide an extract of the functions, the powers and duties as well as the liability of the board of directors of a limited company in Hong Kong. For the purpose of this memo only the conditions of private companies are elaborated. The stricter and more complex rules concerning public and especially listed companies are solely covered in footnotes.

1. Structure of a limited company

To understand the board of directors correctly, one has to have a look at the structure of a limited company in Hong Kong.

A Hong Kong company basically consists of two parties

- The shareholder respectively the owners (in Hong Kong also called members (Section 28 Companies Ordinance (Chapter 32)1) and
- The board of directors which is composed of the company's directors (s.153 and following)

Principally every natural and/ or legal person can be a shareholder and/ or a director. The capital that the shareholders have to pay in does at no time actually have to be paid. Only if the board of directors requests the money to be paid in by the shareholders, do they really have to pay it.

There are different types of capital:

- a) **Registered Capital:** The capital which the Memorandum of Association states as capital the company proposes to be registered and divided into shares. (s.5(4) (a)).
- b) **Authorised Capital:** The capital which is declared towards the Hong Kong authorities as fixed amount of the company's total capital.

¹ All other sections, if not labeled differently, are sections of the Companies Ordinance.

- c) **Issued Capital:** The sum of capital, equivalent to the value of the shares that have actually been issued by the company. (It may be lower than the amount of the authorised capital).

- d) **Paid up (or paid in) Capital:** The capital which the shareholders already paid in and made available to the company.

- e) **Outstanding Capital (uncalled capital):** The capital which has been authorised as the company's capital but has not yet been paid in by the shareholders.

- f) **Equity Capital:** The equity capital consists of all capital the company can be liable for. (In case of the company's insolvency, it is mandatory, that the shareholders pay in the outstanding capital).).

- g) **Outside Capital:** Outside capital is the capital, which has been given to the company by non-shareholders (e.g. banks or other financial institutions).

Note: In Hong Kong, no interest has to be paid on the outstanding capital

2. Functions of the board of directors

Initially the general tasks and the rights and duties of a director of the board shall be explained.

2.1. The board's general duties

The board of directors is the company's governing body. Its tasks involve:

- Transferral of decisions to the annual general meeting (AGM);
- Determining long term strategic objectives and policies;
- Appointment of the management, determination of the management structure;

- Supervision of the Management. Taking corrective action, if the long term objectives are not sufficiently executed.
- Reporting to the shareholders about the company's activities.

A board resolution can be passed by the board with a bare majority. Depending on the size of the company some tasks may be delegated to committees or the management. The responsibility stays with the board though.

2.2. Members of the board

According to s. 2 any person occupying the position of a director and fulfilling the respective tasks is regarded as a director, no matter by what name he or she is called. Therefore, even a person who has not been formally appointed as a director (regardless or not of following the formalities is an offence) is treated as a director.

If a person, who is not an officially appointed director of a company, acts like a director towards third parties (external representation of a company), the company will be bound by contracts entered into by him or her, as if this person had the actual authority of a director. This „*Turquand rule*“² serves to protect third parties.

In case, the board continuously acts according to instructions of a person who is not appointed as director, this person is a “shadow director” and therefore also regarded as a director.

All directors on the board share the same responsibility. Yet there are, depending on the articles of association, different positions in the board.

Usually in a company of a certain size a chairman is appointed to ease the work of the board. He presides over the board, conducts its meeting and is the board's representative to the outside. Further on, a managing director is appointed, who, as the top of the management structure, watches over the execution of the company's strategic objectives.

² *Royal British Bank vs. Turquand (1856)*

To fulfill their duties, the chairman and the managing director receive specific rights, which are needed to accomplish their tasks.

It is also possible to combine both positions in one person. Whether this is suitable depends on the respective company.

It is also important to pass a board resolution, which determines who has the banks signing authority for the accounts of the company.

To ease the working procedures, it is also possible to give power of attorney to a member of the board or a third person.

The power of attorney has to cover the following issues:

- Start and end date of the power of attorney,
- Extent of the authority,
- If it is possible to issue sub-authorisations,
- Revocation of the authority (the safest option would be to give the right to revoke the authority at any time to every board member.)

2.3. Powers and duties of a director

Regarding the powers and duties of directors it is necessary to differentiate between private and public companies. The content of this memo only covers private companies.

2.3.1. Private companies

Private companies are companies in which the shareholders have only limited rights to assign shares. The number of shareholders is restricted to fifty and offers to the public to subscribe for shares are prohibited. Concerning private companies the Companies Ordinance as well as the non statutory guidelines have to be considered.

2.3.2. Public Companies

A public company is a company which does not fulfill to criteria mentioned above³.

2.3.3. Powers of a director

The company receives its powers and objectives by law and by it is memorandum of association. These powers are delegated by the articles of association to the board of directors. The powers and duties of the directors are therefore set in the articles of association.

This includes all powers necessary to exercise the duties of the board of directors.

Usually the directors have the right to call board meetings and to be informed about meetings. The proceedings of a meeting, of which not all members of the board were notified properly, are void. To be able to proceed to business a certain quorum is necessary (depending on the articles of association). In a private company with one or two directors, the question of a quorum is not relevant.

It is possible to hold so called „paper meetings“, passing circular resolutions, so the physical presence of the board members is not required.

According to s.119 and s.119A minutes of the meeting have to be taken which afterwards have to be kept in the company's registered office. A failure to comply with this rule is subject to a daily fine.

For the decisions made by the board all directors bear the same responsibility. Once the board has come to a decision, a director is obliged to comply with it.

If a director deems a decision to be commercially unwise, this should be discussed and minuted at the board meeting. Depending on the articles of association the director may have the right to call a board meeting for such purpose. If the director does not have such a right, he can still seek support

³ In the case of a public company the Companies Ordinance contains stricter rules. For listed companies additionally the regulations of the HKEx rules, securities ordinance, securities and futures ordinance have to be considered. For public companies the non-statutory guidelines are also relevant.

from the shareholders to call for an Extraordinary General Meeting (EGM), in order to solve the issue.

If a director however regards a decision not just as commercially unwise but also as unlawful, it is his duty towards the company to take action against it. In doing so he has the possibility to look for internal as well as for external help and support. The company's auditors, the shareholders or the financial secretary⁴ could provide such help.

The directors are entitled to any Information necessary to fulfill their functions. For instance, a director has access to the management accounts and statistical reports to receive information in order to supervise the management and to the plans of projects and budgets to be able to review and determine the company's policy.

To issue shares of the company a director requires, according to s.57B, the permission of a general meeting.

2.3.4. Duties of a director

The directors exercise their rights as fiduciaries of the company. From this fiduciary position arise several duties.

Basic Duties

- He has to act bona fide for the benefit of the company. It may be difficult to define the interests of the company. Both long and short term interests of the company have to be taken into consideration. Also the question, of how to act considering a relation between parent company and subsidiary puts the director in a tense situation. In this case the director owes his duty primarily to the company to whose board he is appointed.

⁴ Concerning public companies, organisations such as the HKEx, the Securities Commissioner or the Panel on Takeover & Mergers come into consideration.

- He has to exercise his powers for their proper purpose. The powers which are given to the director by the articles of association must not be used for other purposes than those intended by the articles of association.

- Conflicts of interests (between his duties as a director, i.e. the company's interest and his personal interests) have to be avoided.
A director must not take personal advantage of the company's opportunities. The court requires a high standard of honesty from fiduciaries. Secret profits, which a director makes in course of his function through the use of a corporate opportunity, which are not disclosed to the company, belong to the company.

The fiduciary position of a director may make it necessary for a director to declare (in case of an existing or possible conflict of interest) his interests to the company. The principle of declaration of interest is supported by s.162 under which a creditor has to disclose his interests in any contract that is significant to the company's business

In the case of existing contracts between a director and the company conflicts of interest are likely to happen. The Companies Ordinance contains complex rules prohibiting the grant of loans or similar transactions in favor of a director or a person connected to a director.

The general rule is that a company may not grant a loan or provide any security in connection with a loan to a director or a company controlled by a director.

A *private* company however can by resolution of a general meeting, grant loans to its directors. Furthermore a company whose ordinary course of business includes granting loans and giving securities is also permitted to grant a loan to its directors as long as this transaction is part of the ordinary course of business. But these exceptions only apply if the total liability of the company under all provisions of security made does not exceed 5% of its net assets.

According to s.161B such loans and similar transactions must be laid before the company in a general meeting.

Standard of care and skill

The standard of care and skills which a director is subjected to whilst fulfilling his duties and tasks is discussed in *RE City Equitable Fire Insurance Co Ltd (1925)*. The court laid down three points, which summarise a director's duty of care.

1. A director, in the performance of his duties, does not need to apply a greater degree of skills than may be reasonably expected from a person of his knowledge and experience. He has to exercise such a degree of diligence as a ordinary man might be expected to apply in looking after his own interests in the particular circumstances.
2. A director is not bound to attend all board meetings, though he ought to attend whenever he is reasonably able to do so. Due to the intermittent nature of his duties he is not obliged to give continuous attention to the affairs of his company.
3. In respect of all duties that may be left to some other official a director is in the absence of grounds for suspicion justified in relying on that official to perform such duties honestly.

In *Secretary of State for Trade vs. Baker (No 6) (1999)* the court elaborated three other points.

1. The directors have both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge of the company's business to enable them to properly discharge their duties.

2. The power to delegate particular functions does not absolve a director from his duty to supervise the execution of the delegated functions.

3. For these duties no universal application can be formulated, the extent of the duty depends on each particular case, including the director's role in the management.

Directors Report

The directors are required to prepare a report at the end of the financial year in respect of the profit and loss of the company for the financial year and the state of the company's business proceedings in accordance with s.129D. This report must be attached to the balance sheet, which is presented to the shareholders at a general meeting. It is also sent to everybody entitled to receive it, 21 days before a general meeting. Prior it has to be approved and signed by the board. All shortcomings whether in signing the report or in fulfilling the requirements of s.129D result in repercussions, such as fines or even imprisonment.

3. The board's liability

According to s.159, it is possible to stipulate an unlimited liability of the directors in the memorandum of association, meaning the amount to which a director can be held liable by the company or third parties in respect of damages is not limited. In a limited company only the liability of the shareholders is limited.

Any exemption or indemnification of a director in the articles of association or the contract with the director against liability for negligence, default, breach of duty or breach of trust is void according to s.165.

Art 137 of Table A of Schedule 1 of the Companies Ordinance (Table A)⁵ makes it possible to indemnify a director against the liability he incurred in defending proceedings against him, in which judgment is given in his favor

⁵ Table A is an annex to the Companies Ordinance, concerning the possible regulations in the company's articles of association. It is not mandatory to adopt Table A. Herein Table A shall serve as guideline.

or he is granted a relief in accordance with s.358. This relief however does not have any effect on the liability of the director. Further protection can be achieved through a directors & officers liability insurance (D&O).

Furthermore the Companies Ordinance provides a number of sanctions in case of noncompliance on the side of the directors, under s.351(2) the sanctions also concern „shadow directors”.

3.1. Internal liability

From *China Everbright-IHD Pacific Ltd vs Ch'ng Poh (2003)* accrues, that in the internal relationship between company and director the director is liable for any loss to the company due to his breach of duty. If a breach of duty is committed by several directors they are jointly and individually liable.

3.2. External liability

As a basic principle, the company as a legal entity is solely liable for debts and obligations to the outside. Consequently a director has no personal liability towards the company's creditors, as long as he clearly acts on behalf of the company. To this principle there are a few exceptions.

If a company in a dormant state in terms of s.344A(1) still subsequently enters into relevant transactions which require to be accounted by s.121, of which the directors know or ought to know, they are under s.344A(6) personally liable for debts and obligations of the company. Where a company commits a criminal offence a director who is in control of the relevant activity may also be indictable. Another case in which directors are personally liable is collateral liability which occurs for example when directors execute a personal guarantee in support of a corporate loan.

For any loss caused to third parties by a breach of duty a director is also personally liable.

4. Insurance coverage

A director may be exposed to accusation of breach of duty and related demands of damages from different sides. Such claims may be made by the shareholders, employees, creditors, authorities and auditors. Insurance coverage against such accusations can be achieved with a directors and officers liability insurance (D&O). A D&O and is usually subscribed by the company for its directors and covers damages and defence costs.

S. 165 renders void any provision exempting or indemnifying a director. This also concerns a director's insurance coverage. A D&O which the company subscribes for the director, indemnifies him for costs that arise due to his liability. However, s.165(3) gives the company the possibility to provide insurance coverage for it is directors against liability as well as coverage for defense costs in respect of all negligence and breaches of duty save fraud in relation to the company or third parties. Hence a company can cover a director against liability; solely a cover against liability caused by fraud is not possible. The majority of demands for D&O indemnity in Hong Kong are for the advancement of defense costs in litigation. Providing this coverage causes no problems under the Companies Ordinance.

5. Appointment/Removal of a director

Further it shall be elaborated how a director is appointed into his office and how he can be removed from it. The possibility of disqualification of a director either by the board or by court shall also be explained.

5.1. Appointment

Both appointment and removal of the directors are proceeded in an annual general meeting or an extraordinary general meeting. The procedure under which the directors are appointed is determined in the articles of association. Usually the first directors are named in the articles or in the statement of the first directors, signed by the subscribers of the memorandum of association. Thereafter the directors are appointed by a general meeting. According to Art 97 of Table A, the directors shall have the right to appoint a director any time. The articles of association normally assign the right to appoint direc-

tors to the board. The appointment then has to be approved by a general meeting. A formal confirmation should be issued to any newly appointed director, which states who was when and with what function a member of the board.

5.2. Removal

A director may be removed under the relevant provisions of the company's articles of association. In s.157B which cannot be excluded neither by the articles of association nor by contract the Companies Ordinance governs the removal of directors. Under s.157B a director can be removed by an ordinary resolution of the members of a general meeting.

To ensure that a director cannot keep his office against the will of the majority of shareholders no shares may carry higher weighted voting rights on a resolution to remove a director than it would carry in a resolution on general matters.

A notice of the intention to come up with such a resolution, must be given to the company at least 28 days prior to a general meeting. Afterwards the company must immediately send a copy to the concerned director not less than 21 days before the meeting a copy to its members.

The director concerned has the right to speak at the meeting. He is also entitled to communicate his point of view to the members of the meeting in written form or read it out at the meeting.

The removal of a director under s.157B, does not affect any right the director might have in respect of compensation or damages due to his removal from office.

5.3. Disqualification

The disqualification of a director is possible either by virtue of the provisions of the articles of association or the Companies Ordinance.

Depending on the articles this may be the case if a director becomes of unsound mind or bankrupt, fails to attend board meetings on a regular basis or is asked by all other directors of the board to resign.

A number of reasons for the disqualification of a director can be found in Art. 90 of Table A.

According to s.156 it is an offence, punishable with a fine and imprisonment, to act as a director if a person is undischarged bankrupt.

Under s.168C to s.168S the court may and under some circumstances issue a disqualification order against a person, for a specified period of time ranging from 1 to 15 years. This order prevents a person from acting as director, liquidator or manager of a company or to be directly or indirectly concerned with the formation or management of a company.

The grounds upon which a person may be disqualified are among others if a person is convicted for an indictable offence in connection with the formation, management or liquidation of a company.

The person is also disqualified if he or she persistently fails to fulfill the requirements set by the Companies Ordinance in respect of documents that have to be send to the registrar.

Furthermore a disqualification is declared if it appears to the court that the person has been guilty of an offence under s.275 which covers fraud in the detriment of the creditors in relation to the liquidation of a company or any other form of fraud or breach of duty towards the company.

Another reason for disqualification is given, if the court deems the person's conduct during the insolvency of a company makes the person unfit to be concerned in the management of a company.

If after investigation the financial secretary thinks it is indicated and in public interest, he may apply for a disqualification order against a director or shadow director.

Under s.168M to s.168N it is an offence and punishable by fine or imprisonment not to comply with a disqualification order. This does not only concern the person against whom the disqualification order was issued but also the company and its officers if they are found to be in contravention of the disqualification order. A person who is involved in the management of a company in contravention of a disqualification order or a person, who

knowingly acts on the instructions of a disqualified person is according to s.168O liable for all debts that incurred to the company during that period of time.

6. Resignation of a director

According to s.157D a director may resign from office any time, given that the articles of association or the director's contract do not provide otherwise. It has to be kept in mind, that following *Glossop vs Glossop (1907)* upon giving notice of the resignation it becomes immediately effective and cannot be withdrawn. In *Latchford Premier Cinema Ltd vs Ennion (1931)* it was held that this was even the case if the resignation was given verbally.

In accordance with s.157D the resignation has to be sent to the registered office in written form. Afterwards the company has to notify the registrar to comply with s.158 about the resignation of the director.

The office of a director also ends by rotation. Art. 92 of Table A provides that the directors who are due to retire in every year shall be those who have been longest in their office since their election. A director who vacates his office due to rotation is eligible for re-election.

7. Consequences of the removal/resignation

If a director is removed under s.157B by a general meeting, his compensation or damages for the loss of office are not affected.

Depending on the director's contract the removal may cause some costs for the company. In principle the damages, in case of fixed term contract, are calculated according to the salary which would have been paid during the remaining time until expiration of the contract.

In case the contract stipulates the remuneration per day or per year, the director is entitled to an appropriate part of his annual salary, when his office ends. In *Healy vs Francaise Rubastic SA (1917)* the court ruled that the director was even entitled to this payment, if the reason for the vacation was the misconduct of the director.

Bona fide payments to a director as compensation for breach of contract or as pension in respect of past services, do not need to be approved by a general meeting.

If however, the company makes a payment by way of compensation for loss of office or in connection with retirement from office, the approval by a general meeting is under s.163 necessary. According to s.163A to s.163D the approval is also required, if the payment is made in the form of a transfer of property or shares.

In respect of retirement benefits and pensions it has to be considered that the company has no power to take any actions which are not in its own interest or for its own benefit. Therefore the payment of pensions has to be covered by the company's objectives, defined in the articles of association. If companies adopt Table A, the directors may, according to its Art. 89, pay a gratuity or pension on retirement to any director on behalf of the company.

8. Conclusion

This short summary can only provide a brief introduction into the provisions concerning the board of directors in private companies. The aim of this summary is merely to illustrate the fundamental principles which all limited companies have in common. Depending on the type of the company and the circumstances of the particular case, the regulations and judicature may be far more complex than described in herein and have to be adjusted to the respective company.

Annex 1

P O W E R O F A T T O R N E Y

TO WHOM IT MAY CONCERN

[.../name of the company],

a company incorporated under the laws of the Hong Kong SAR and having its registered office located at [...] (hereinafter referred to as the "PRINCIPLE") is desirous to appoint a person as its true and lawful attorney with powers as described below, being empowered to manage the interests, activities, programs and affairs of the PRINCIPLE in such manner as it deems fit, and in particular to appoint and remove attorneys and to delegate to this person powers and authorities of the PRINCIPLE.

The PRINCIPLE does hereby makes, constitutes and appoints

Mr. [...], born on [...]

Holder of [.../nationality] Passport No. [...]

currently residing at [...] (hereinafter referred to as "ATTORNEY") to be the PRINCIPLE's true and lawful attorney, and to act as such in full compliance with the policy of the PRINCIPLE and any decisions and instructions given by the Board of Directors of the PRINCIPLE and/or the managing director of the PRINCIPLE and any other restrictions contained in this Power of Attorney:

1. To act as the GENERAL MANAGER of the PRINCIPLE and to direct, manage and/or superintend the PRINCIPLE's business affairs in Hong Kong and in Mainland China, and to employ and discharge employees, purchase, take on by lease or otherwise acquire and hold office space and procure supplies, materials and equipments needed for the business of the PRINCIPLE.

Any purchases in the name of the PRINCIPLE exceeding per case in total EUR [...] (says: EUR [...]) shall require the prior written approval of at least one director of the PRINCIPLE.

2. To conclude proceedings, negotiate, execute and deal with any Hong Kong government ministry, department, office and/or other governmental authority, and secure necessary permits, licenses and/or concessions for the business of the PRINCIPLE as well as execute and certify corresponding documents.
3. To endorse or deposit to the PRINCIPLE's credit in bank's cheques, drafts, monies, notes, and other evidence of value; to draw and sign cheques against such deposits for such moneys as may be necessary from time to time in the transaction of business.
4. To commence, file, prosecute, defend and carry to completion of all actions or legal proceedings at all levels in the Hong Kong courts or before other tribunals and Hong Kong governmental organizations which the PRINCIPLE may have,

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both civil and criminal, involving any parties, including bankruptcy and liquidation proceedings against any natural or juristic person, and if, in the discretion of the ATTORNEY, it seems wise, to settle or compromise, refer to arbitration, or take such other steps as may be suitable in the foregoing, including the power to receive money or properties from any court, governmental organization, administration tribunal or natural juristic person.

5. To accept bills of exchange, borrow money by loan or overdraft, pledge the credit of the PRINCIPLE, encumber the property of the PRINCIPLE as security thereof in the way of pledge, mortgage, or hypothecation, to issue trust receipts and execute agency agreements.
6. To substitute and appoint an Attorney or Attorneys to perform any of the purposes aforesaid as the ATTORNEY deems fit and to revoke such appointment in his discretion and to appoint another substitute or other substitutes from time to time.
7. In general and within the boundaries hereof, to do all other acts, deeds, matters and things whatsoever for all or any of the purposes aforesaid as amply and effectively to all intents and purposes as far as the PRINCIPLE might or could have done if he had acted personally.

This Power of Attorney shall be effective

from **[.../its date of execution]**
and shall
expire on **[...]**,

except prolonged in writing by the PRINCIPLE prior to the above expiration date.

IN WITNESS WHEREOF, the PRINCIPLE has caused this Power of Attorney to be executed in its name and on its behalf, and its corporate name and seal to be affixed.

For the PRINCIPLE

Mr. [...]
AUTHORISED SIGNATURE
Director

WITNESS

Mr. [...]
AUTHORISED SIGNATURE
Director

WITNESS

For the ATTORNEY:

MR. **[...]**

WITNESS

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Board of Directors

Annex 2
Appointment Letter

Dear Mr./MS. [NAME],

On behalf of the Board of [COMPANY NAME], I write to invite you to accept appointment as a director of [COMPANY NAME].

It is proposed that, on receipt of your signed consent to act, you will be appointed on the Board until the next Annual General Meeting which is scheduled to be held on [DATE]. The Board intends that you should be nominated for election by the shareholders at that meeting for a period of [DURATION]. At the conclusion of that period you will be eligible for re-election. The composition of the Board is reviewed annually by the Nomination Committee in order to ensure that the membership of the Board is in the best interest of the shareholders. It is normal practice on this Board for directors to serve no more than [NUMBER] terms of [DURATION] each.

The Board schedules regular meetings, usually on [DATE], which last approximately [DURATION]. There is an annual two day board conference and additional meetings may be called to deal with urgent and important matters. The attendance of directors is expected at all board meetings unless leave of absence has been previously agreed with the Chairman. It is expected that each director will serve on at least one board committee. Over the last few years the time spent on their duties by members of the Board has averaged [TIME] per year. No special duties apply to your appointment.

Currently the remuneration of directors is [CURRENCY] [VALUE] per annum, paid monthly in arrears. Additional fees for committee work or other special activities are [CURRENCY] [VALUE]. No retirement benefits are provided. Expenses incurred in the discharge of a director's duties may be reclaimed by submission of a written claim which should be sent to the [PERSON RESPONSIBLE] and countersigned by the Chairman.

The Company indemnifies directors and pays part of the premium for a Directors' and Officers' Liability Insurance Policy. A copy of the arrangements is enclosed.

The directors have agreed to be bound by the enclosed Board Protocol which covers such matters as the duties of directors, confidentiality, and access to expert advice at the company's expense, contracts between directors and company executives, the handling of conflicts of interest and the positions of the Chairman and the Company Secretary. You will note that if a director should breach the Protocol he would be expected to resign.

A copy of the Company's Memorandum and Articles of Association, a list of the other directors with brief CV's and a copy of a company organization chart are attached for your information.

Yours sincerely,
[NAME]

Chairman

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We hope that the Information provided in this brochure was helpful for you. If you have any further questions please do not hesitate to contact us.

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