

## PART 5

### TRANSACTIONS IN RELATION TO SHARE CAPITAL

#### Introduction

1. Part 5 of the CB contains the provisions concerning “Capital Maintenance” (reduction of capital and purchase of own shares (“buy-backs”)) and related rules (financial assistance). The capital maintenance doctrine was first developed in the mid-19th century in the UK. The premise of the doctrine is that creditors provide credit on the basis of an express or implied representation by the company that consideration received for shares (the share capital) shall be applied only for the purposes of the business and that it shall not be returned to the shareholders except in a winding up after all creditors have been paid.
2. In the public consultation conducted during June to September 2008, we asked whether changes should be introduced to the current rules. Having regard to the comments received<sup>1</sup>, the CB will introduce reforms to streamline and rationalize those rules which are commonly considered as unduly complex, ill-targeted for their intended purpose or somewhat overtaken by their exceptions.
3. In Chapter 2 of this Consultation Paper, we seek comments on the option of abolishing the prohibition on financial assistance for private companies, as an alternative to the rules on financial assistance proposed in Divisions 2 and 5 of this Part.

- The significant changes to be introduced under this Part are highlighted below:
  - (a) Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part;**
  - (b) Introducing an alternative court-free procedure for reduction of capital based on a solvency test;**

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<sup>1</sup> FSTB, *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009), paragraphs 30 to 51 (available at [http://www.fstb.gov.hk/fsb/co\\_rewrite](http://www.fstb.gov.hk/fsb/co_rewrite)).

**(c) Allowing all companies to purchase their own shares out of capital, subject to a solvency test; and**

**(d) Allowing all types of companies (whether listed or unlisted) to provide financial assistance, subject to the satisfaction of the solvency test and certain specified procedures.**

## **Significant Changes**

**(a) Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part**

### *Background*

4. Under Part II of the CO a solvency test is provided for in respect of:

(i) buy-backs of its own shares out of capital by a private company; and

(ii) financial assistance by an unlisted company for the purpose of an acquisition of shares in the company or its holding company.

For (i), the solvency test has to be satisfied according to the requirements set out in section 49K(3), (4) and (5). For (ii), the solvency test has to be satisfied according to the requirements set out in section 47F(1)(d) and (2). Both of these solvency tests are based on cash flow alone. However, they are not exactly the same. The main differences are:

(i) the solvency test under section 47F(1)(d) seems to have an additional limb under section 47F(1)(d)(i) which provides for the situation where the company intends to commence winding up within 12 months of the date of the proposed financial assistance<sup>2</sup>; and

(ii) under section 49K(5), the solvency statement has to be accompanied by an auditor report<sup>3</sup>.

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<sup>2</sup> It states that if it is intended to commence the winding up of the company within 12 months, that the company will be able to pay its debts in full within 12 months of the commencement of the winding up.

<sup>3</sup> The auditor report should state that:

- the auditor has inquired into the company's state of affairs
- the auditor is not aware of anything to indicate that the opinion expressed by the directors in the statement is unreasonable in all the circumstances.

5. As the solvency test will be applied to transactions involving a reduction of capital, buy-back or financial assistance, we consider that a uniform solvency test would result in consistency of the law. A uniform adoption of the approach of section 47(F)(1)(d) can give clarity and certainty on how the solvency test may apply in different scenarios.
6. As to the auditor's report, we take the view that the issues that need to be considered in determining whether the company would satisfy the solvency test involve forward-looking business judgments and so auditors would not be in a better position than the directors in ascertaining the company's solvency. Directors would be expected to have reasonable grounds in forming their opinion as to the company's solvency, and should be left to decide in any given case whether professional assistance is needed. Requiring an auditor's report in every case would add expense and delay for relatively little gain. We therefore do not propose to retain the requirement of attaching an auditor's report to the solvency statement.

#### Proposal

7. **Clause 5.2** provides that a uniform solvency test will be applicable to all three categories of transactions - reduction of capital, buy-backs and financial assistance. **Clause 5.3** sets out the content of the uniform solvency test, which in substance, re-enacts section 47F(1)(d). **Clause 5.4** provides for the making of a solvency statement. A solvency statement in relation to a transaction is a statement that each of the directors making it has formed the opinion that the company satisfies the solvency test in relation to the transaction. In forming his opinion, a director must inquire into the company's state of affairs and prospects and take into account contingent and prospective liabilities of the company. The solvency statement must be in the specified form and be signed by each director making it.
- (b) Introducing an alternative court-free procedure for reduction of capital based on solvency test**

#### Background

8. At present, the CO only allows reduction of share capital by a court sanction procedure, save for the re-designation of the nominal value of shares to a lower amount (sections 58 to 63 of the CO). Shareholders must agree by

special resolution. In determining whether to approve the reduction, the court will consider various factors, including whether the reduction is equitable between shareholders and whether creditors' interests are safeguarded.

9. We will introduce a court-free procedure based on the solvency test, as an alternative procedure to the current rules. The new procedure should be faster and cheaper and can be utilised by all companies.

### Proposal

10. **Subdivision 2 of Division 3** provides for a court-free procedure for reduction of capital, subject to compliance with the solvency test. The key features of the process include:
  - (a) all the directors signing a solvency statement in support of the proposed reduction of capital (**Clause 5.12**);
  - (b) the company obtaining members' approval by a special resolution (**Clauses 5.11 and 5.13**);
  - (c) the company publishing notices with relevant information in the Gazette and newspapers<sup>4</sup> and registering the solvency statement with the CR (**Clause 5.14**);
  - (d) any creditor or non-approving member of the company may, within 5 weeks of the date on which the resolution is passed, apply to the court for cancellation of the resolution (**Clauses 5.16 to 5.18**). During this 5-week period, the company must make available the special resolution and solvency statement for the members' and creditors' inspection (**Clause 5.15**); and
  - (e) the company must deliver after the 5-week period (but no later than 7 weeks) to the CR a return in specified form if there is no court application (**Clause 5.20**), or within 15 days<sup>5</sup> after the court makes the order confirming the special resolution or the proceedings are ended without determination by the court (**Clause 5.21**). The reduction takes effect when the return is registered by the CR.

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<sup>4</sup> Instead of publishing notices in newspapers, the company may give written notice to that effect to each of its creditors.

<sup>5</sup> Or such longer period as ordered by the court.

11. **Subdivision 2 of Division 3** is based on sections 49K to 49O, which set out the procedures for a private company to buy-back its own shares out of capital. There is a difference in that the CB provides that the reduction of capital will take effect when the return is registered by the CR under **Clause 5.20** or **5.21**.
- (c) **Allowing all companies to purchase their own shares out of capital, subject to a solvency test**

*Background*

12. The current rules on buy-backs in the CO, which distinguish between financing a purchase out of distributable profits or the proceeds of a new issue of shares and that out of capital, are fairly complex and restrictive. Also, financing by payment out of capital based on a solvency test is currently provided as an exception available to private companies only. We will streamline the rules and allow all companies to fund buy-backs out of capital, subject to a solvency requirement. This procedure is included in the CB as an alternative to the existing rules on buy-backs out of profits or the proceeds of a fresh issue of shares.

*Proposal*

13. **Clause 5.52** provides that a company may redeem or purchase its own shares out of distributable profits, out of the proceeds of a fresh issue of shares or out of capital. However, a listed company will not be allowed to make a payment out of capital in respect of a purchase of its own shares on the stock exchange because it would be impractical for the listed company to follow all the procedures for payment out of capital each time before it purchases its own share in the market.
14. **Clauses 5.53 to 5.61** retains much of the requirements and procedures applicable to the buy-backs by a private company out of capital, and extends it to all companies. Largely the same requirements and procedures will be adopted for the new court-free procedure for reduction of capital in **Subdivision 2 of Division 3**, which are discussed in paragraph 10 above. The main difference is that the company is not required to deliver to the CR a return in specified form after the 5-week period. This is because under **Clause 5.66**, the company will be required to deliver a similar return, which is applicable to all types of purchase/redemption of shares (not just those

financed out of capital) within 14 days after the date on which the redeemed/purchased shares are delivered to the company. The purchase or redemption must be made no earlier than 5 weeks and no later than 7 weeks after the date the special resolution is passed, unless otherwise ordered by the court.

- (d) **Allowing all types of companies (whether listed or unlisted) to provide financial assistance, subject to the satisfaction of the solvency test and certain specified procedures**

### Background

15. Section 47A of the CO imposes broad prohibitions (subject to certain exceptions) on a company and its subsidiaries giving financial assistance for the purpose of acquiring shares in the company. In Chapter 2, we seek comments on the option of abolishing the prohibition on financial assistance for private companies.
16. Assuming that the prohibition on the giving of financial assistance for private companies are still considered necessary, we propose to streamline the financial assistance provisions in a manner similar to the NZCA.

### Proposal

17. The CB retains the current definition of financial assistance in the CO (**Clause 5.70**). It also largely retains the current exceptions to the prohibition in section 47C of the CO (see also paragraph 21 below) and the special restrictions for listed companies in section 47D of the CO (**Clauses 5.73 to 5.78**). It then allows all types of company (whether listed or unlisted) to provide financial assistance, subject to the satisfaction of the solvency test<sup>6</sup> and one of the three procedures set out in **Subdivision 4 of Division 5**.
18. The first which is in **Clause 5.79** provides that a company may give financial assistance if the assistance, and all other financial assistance previously given and not repaid, is in aggregate less than 5% of the

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<sup>6</sup> Unlike the solvency test for reduction of capital and redeem/purchase of own shares where all directors are required to make the solvency statement, the solvency statement for financial assistance is only required to be made by a majority of directors. This is the current position for the solvency test in financial assistance provisions in the CO and we believe having the majority of directors to make the statement should be sufficient as financial assistance is strictly not related to capital maintenance, and a lower threshold is justified.

shareholders' funds. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the day on which the solvency statement is made. Within 15 days after giving the assistance, the company must notify its members the details of the assistance.

19. The second which is in **Clause 5.80** provides that a company may give financial assistance if it is approved by written resolution of all members of the company. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the day on which the solvency statement is made.
20. The third which is in **Clause 5.81** provides that a company may give financial assistance if a notice is given to shareholders regarding the financial assistance. The giving of the assistance must be supported by a solvency statement and the board must resolve that giving the assistance is in the interests of the company. The company must send to each member a notice which contains all information necessary for the members to understand the nature of the assistance and the implications of giving it for the company. The assistance may only be given not less than 28 days after the day on which the notice is sent to the members and not more than 12 months after the day on which the solvency statement is made. **Clauses 5.82 to 5.84** provides that any member of the company or the company may, within the 28-day period, apply to the court to restrain the giving of the assistance.

## **Other Changes**

### **(a) Making changes to the employee share scheme exception to giving financial assistance**

21. The existing section 47C(4)(b) of the CO provides that the prohibition on financial assistance does not apply to employee share schemes. However, the financial assistance is restricted to the provision of money for the purchase or subscription of fully paid shares. We note that section 682(2)(b) of the UKCA 2006 adopts a more flexible approach than the current CO. **Clause 5.76**, which is largely based on the relevant UKCA 2006 provisions, allows all forms of financial assistance if the assistance is

given in good faith in the interest of the company for the purposes of an employee share scheme or the giving of the assistance is for the purposes of enabling or facilitating transactions to acquire the beneficial ownership of shares for the employees. A number of definitions are also added for the purpose of clarity, e.g. “employee share scheme”.

**(b) Standardising the definition of net assets in financial assistance**

22. In section 47B(2) of the CO “net assets” is given “the same meaning as in section 157HA(15)”. The definition in section 157HA(15) includes the concept of “provisions”, which is itself defined in the Tenth Schedule of the CO. The Tenth Schedule will not be retained in the CB. There is another definition for “net assets” under section 47D(2) of the CO (which sets out a special restriction on financial assistance for listed companies). Since the two definitions are in substance the same, the definition set out in section 47D(2) is adopted in **Clause 5.70** for application in **Division 5 of Part 5**. The definition in section 47B(2) is not re-enacted.