

CHAPTER 2

SHARE CAPITAL

Background

- 2.1 This chapter makes a number of proposals on the simplification, rationalisation and deregulation of the share capital rules in the CO. *Share capital* means the money paid into the company (or legally promised as being available on call) by members for shares in the company. The current rules relating to share capital require companies having a share capital to have a par value ascribed to their shares (the requirement for *par value*) and to declare in the constitutional document⁵ the maximum share capital that may be issued (the requirement for *authorised capital*). The rules also require that the capital so raised must be kept in the company, and used for the purposes of its business only, and must not be returned to shareholders except in restricted circumstances (the *capital maintenance rules*)⁶.
- 2.2 Some of the rules relating to share capital are thought to be complex, ill-targeted for their intended purpose and to present unnecessary difficulties to businesses and investors. This has led to questions as to whether their existence is justified, and to the reform (or proposed reform) of the share capital rules by the UK, US, New Zealand, Australia, Singapore and Malaysia.

The Requirement for Par

- 2.3 Par value (or nominal value, as it is also called) is the minimum price at which shares can generally be issued. Currently, companies incorporated in Hong Kong and having a share capital are required to have a par value ascribed to their shares⁷. Each share therefore has a fixed face value that is its par value. If this is \$z, the constitutional document of the company would state the share capital this way:

‘The share capital is \$x divided into y shares of \$z each.’

⁵ Under the current CO, the constitutional documents of a company formed in Hong Kong are the Memorandum of Association and Articles of Association. We will propose in the Companies Bill that a company incorporated in Hong Kong will only be required to have Articles of Association. The Memorandum of Association will be abolished and essential information contained in a Memorandum of Association can be set out in the Articles of Association.

⁶ The capital maintenance rules will be discussed in Chapter 3.

⁷ Section 5(4) of the CO.

- 2.4 There is no essential difference between a share of no par value and one having a par value. Both represent a share, being a fraction or an aliquot part of the equity, but the par value share has attached to it a fixed face value, and the share without par value does not.
- 2.5 Current thinking is mostly that the fixed face value does not serve the original purpose of protecting creditors and shareholders, and may, to the extent that some are led to believe that it provides some protection, even be misleading. The reality is that most creditors, in extending credit, do not rely much, if at all, on the par value; they rely on economic realities. The fact that the shares have a par value of, for example, \$1.00 each would give no indication of the real value of the shares or the company. Indeed these days, the par value is frequently set very low to obviate certain restrictions imposed by the capital maintenance rules. For this reason also, it does not provide a meaningful benchmark against share watering. Requiring new shares to be issued at par does not prevent dilution of the fractions of ownership held by earlier allottees of shares.
- 2.6 There is a growing recognition and acceptance of the validity of no-par value shares, and a clear move towards its adoption in place of par value shares. Retiring the concept of par, it is largely felt, would create an environment of greater clarity and simplicity that would be desirable for the business community generally. Jurisdictions that have adopted no-par shares include Australia, New Zealand and Singapore. The UK and Malaysia are likely to migrate to a no-par system as well, the UK when restrictions in European legislation have been removed, and Malaysia much sooner.
- 2.7 In a public consultation conducted by a consultant commissioned by the FSTB in 2003⁸, a significant proportion of respondents thought that par value had given rise to one or more of the following practical problems:
- (a) ***Unnecessarily complex accounting system***: The capital contributed to a company has to be “split” between a number of different accounts (share capital, share premium, etc.), each of which is subject to

⁸ See Freshfields Bruckhaus Deringer, *Consultation Study Concerning the Implications of Adopting a No-Par Value Share Regime in Hong Kong: Final Report (29 November 2004)*, pp.16-18. The main report is available at www.fstb.gov.hk/fsb/co_rewrite.

different use restrictions, giving rise to an accounting regime which is unnecessarily complex and confusing to operate⁹.

- (b) ***Inhibits raising of new capital:*** If a company's shares have a real value below par, the company cannot issue shares at a discount to par value without seeking the approval of the court or creating a new class of shares.
- (c) ***Unnecessary work for share registries and costs:*** It requires a company wishing to capitalise profits to make an issue of bonus shares which will entail the release of extra paper (share certificates) in the system (unless the shares were dematerialised) but provides no added value to the shareholder.
- (d) ***Misleading to the unsophisticated investor:*** When a monetary value (the par value) is attributed to a share, it tends to deflect recognition of a share for what it really is, a fraction of the equity of the company. This can lead to misconceptions as to the real worth of a share. A share with a par value of \$5.00 being offered for sale by an existing shareholder at \$2.00 may appear to an unsophisticated investor to be a bargain. However, the share might in fact be worth less than \$2.00.

2.8 The SCCLR, which agreed with the views of the majority of respondents of the 2003 consultation, recommended the adoption of mandatory no-par for all companies, subject to further research on the details of the no-par regime and the related capital maintenance issues in the rewrite of the CO¹⁰. The SCCLR has recently considered the details of the no-par regime and reaffirmed its recommendation for introducing the mandatory system of no-par. The mandatory system is preferred because it would be simpler for all concerned. An optional no-par system requires legislating for and administering two parallel legal systems, and brings with it added costs and complexity. It is worth noting that Singapore

⁹ Below is an example of the difference between accounting for share issues under par value ("PV") and no-par value ("NPV") regimes:

Issue of 2 shares at issue price of \$1.50				
(a) Under a PV share regime where the PV of the shares is \$1.00				
Dr	Cash		3.0	
	Cr	Share capital		2.0
	Cr	Share premium reserve		1.0
(b) Under a NPV share regime				
Dr	Cash		3.0	
	Cr	Share capital		3.0

¹⁰ See SCCLR, *The Twenty-First Annual Report 2004/2005*, pp.26-29.

adopted a mandatory system of no-par from 30 January 2006 without any apparent difficulties.

Question 1

Do you agree that Hong Kong should adopt a mandatory system of no-par for all companies with a share capital?

Proposed Mechanics of Change to No-par

- 2.9 Assuming that there is broad support for a move to a no-par regime, we intend to legislate for the conversion to no-par and to have legislative safeguards to ensure that contractual rights defined by reference to par value and related concepts will not be affected by the abolition of par. Providing a statutory deeming provision will save considerable work, expense and time for companies and reduce the possibility of disputes.
- 2.10 We intend to also give companies time to review their documents before the conversion is effected, and would like to invite views as to whether 12 months is appropriate. This is to allow companies to tailor their own changes if they so prefer. Also the deeming provision, whilst effective in a domestic setting, may not necessarily be applied by a foreign court, particularly if the proper law of the contract in question is not Hong Kong law.
- 2.11 Amendment to the CO to legislate for no-par will not affect companies incorporated off-shore as they will continue to be governed by the law of their incorporation. Where there are legislation and rules that apply to these companies, such as the SFO and Listing Rules, these can be amended to accommodate both par and no-par value shares to address the fact that the shares of some of these off-shore incorporated companies could still have par values.

Question 2

Do you agree that a period of 12 months would be reasonable for companies to review their arrangements before migration to no-par? If you think another period more appropriate, please specify what that is and your reasons.

The Issue Price

- 2.12 The abolition of par will remove the minimum price at which shares may be issued, but this does not give directors a completely free hand in setting the issue price. They would still have an overriding fiduciary duty to set that in good faith.
- 2.13 The issue that we have to decide is whether it is sufficient to rely on the directors' fiduciary duty in making issues only on terms that the company receives adequate consideration for the issue (as Australia and Singapore have done), or whether there is a need to legislate more specifically for that duty.
- 2.14 The NZCA requires directors who vote in favour of an issue price to certify that in their opinion the consideration and terms of the issue are fair and reasonable to the company and all existing shareholders. The certificate has to be lodged with the Registrar¹¹.
- 2.15 In South Africa, the issue price of new no-par shares cannot be lower than an amount arrived at by dividing the share capital by the number of issued shares of that class, unless authorised by a special resolution of the company. The directors must provide a report setting out the reasons for the proposed lower issue price¹².
- 2.16 The question whether there is a need to provide for some legislative control on the setting of the issue price depends largely on the efficacy of Hong Kong's governance systems. Where the fiduciary duty system and minority remedies are well developed, there is probably less of a need to compensate for the loss of par value by the provision of a formula for the floor price or legislating an explicit duty to achieve fair value for the benefit of the members as a whole.
- 2.17 The SCCLR has recommended against legislating for any controls.

Question 3

Do you agree that there should not be any legislative control over the setting of the issue price of the no-par shares?

¹¹ Section 47 of NZCA.

¹² Section 82 of the South African Companies Act.

Share Capital and Share Premium

- 2.18 Without par, there will no longer be a need to distinguish between share capital and share premium, and consequently to account for them separately. We propose to provide a legislative deeming provision for the amalgamation of the existing share capital amount with the amount in the company's share premium account (and also capital redemption reserve) immediately before the migration to no-par share capital.
- 2.19 They should then basically become undistributable except in the limited circumstances when share capital is distributable. To avoid hardship to companies which would lose the permitted uses of share premium that they enjoyed prior to the migration to no-par, we propose to preserve substantially the currently permitted uses of the share premium for the amount standing to the credit of the share premium account before the migration to no-par.

Merger and Reconstruction Reliefs

- 2.20 The reliefs relate to share premiums received or receivable upon issue(s) of shares which would otherwise be required to be placed in a share premium account. Where shares are issued at a premium as consideration for the transfer or cancellation of another company's shares in the context of a *merger*, the relief extends to the whole of the premium (section 48C). Where shares are issued at a premium as consideration for the transfer of assets in the context of a *group reconstruction*, the relief is limited to any excess over the base value of the assets transferred (section 48D).
- 2.21 It may be thought that with a no-par system where there is no share premium account, the reliefs as presently conceived would logically be redundant¹³.
- 2.22 Whether Hong Kong should repeal the relief provisions depends on whether the capital maintenance rules are to be preserved. If the existing capital maintenance rules are largely maintained in a no-par value regime (to be discussed in Chapter 3), it would seem unduly harsh to abandon the concept of merger relief entirely, as the full amount of the consideration received for issuing the shares (including the amount that under a par value regime would be labelled as "premium") would be included within

¹³ This is the case if the capital maintenance rules are completely replaced by the distribution rule subject to the solvency test being satisfied.

restricted capital. On the other hand, if merger relief is extended to cover the full amount of the consideration received, then in effect, no restricted capital would be recorded when shares are issued as part of the transaction and hence it gives relief beyond the existing legislative intent of section 48C. Therefore, if the relief is to be retained, it should apply to some parts but not all of the proceeds of the shares. This could, for example, be the amount in excess of the subscribed capital of the acquired company attributable to the shares acquired or cancelled .

Question 4

Assuming the abolition of par value while the existing capital maintenance rules are largely maintained, do you favour:

- (a) The abolition of the merger relief; or**
- (b) Its application to the amount in excess of the subscribed capital of the acquired company attributable to the shares acquired or cancelled; or**
- (c) Some other alternatives (please specify)?**

Please provide reasons.

2.23 In the case of group reconstructions, the existing relief is limited to the excess of the premium over the base value of the assets transferred. If the relief is to be retained, it could be modified to cover the excess of the consideration for the shares over the base value of the assets transferred.

Question 5

Assuming the abolition of par value while the existing capital maintenance rules are largely maintained, do you favour:

- (a) The abolition of the group reconstruction relief; or**
- (b) Its application to the excess of the consideration for the shares over the base value of the assets transferred; or**
- (c) Some other alternatives (please specify)?**

Please provide reasons.

Other implications

- 2.24 We propose that the CO be amended to allow a company in a no-par environment to capitalise profits with or without an issue of new shares. This is one of the advantages of no-par shares.
- 2.25 Bonus shares can continue to be issued notwithstanding that there will no longer be a share premium since in a no-par environment, shares can be issued without transferring an amount to the share capital account.
- 2.26 Companies will continue to be able to effectively consolidate and subdivide shares. Whilst there is no nominal amount to be divided for no-par shares, a similar result to subdivision can be achieved by increasing the number of shares. The process of consolidating shares into a smaller number should be considerably simplified where there are no par values to contend with. The number of shares will just reduce with no visible effect on the share capital.
- 2.27 It is possible to provide for redeemable shares even in a fully no-par environment, and we propose to maintain them. Payment for redeemable shares can continue to be computed by reference to the par value if that was the term of its issue prior to migration to no-par. We propose to facilitate this by legislating that a reference to the par value of a share is to be taken to be a reference to the par value of the share immediately before the migration. For redeemable shares issued after migration to no-par, redemption will be in accordance with the terms upon which the shares were issued.

Question 6

Do you agree with, or have any comments on, the proposals outlined above on:

- (a) Capitalisation of profits with or without an issue of shares;**
- (b) Issuance of bonus shares without the need to transfer amounts to share capital;**
- (c) Consolidation and subdivision of shares; and**
- (d) Redeemable shares.**

Authorised Capital

- 2.28 Authorised capital is the maximum amount, usually specified in monetary terms, that a company is permitted by its constitutional document¹⁴ to raise by issuing shares. Shares can but need not be issued up to the authorised level.
- 2.29 The protection against dilution which authorised capital is thought to provide is far from absolute as most companies are able to increase the authorised capital by an ordinary resolution. As companies are not obliged to and often do not issue shares up to their authorised limit, it would not be a prudent creditor who relies on the authorised capital as a measure of the company's business undertakings.
- 2.30 The UK, Australia, New Zealand and Singapore have all removed the requirement for authorised capital, mostly citing simplification of the processes of capital raising by companies as the reason. They concurrently provided for the deemed deletion of the authorised capital provision from the constitutional documents of the companies.
- 2.31 The SCCLR has also recommended removing the requirement for authorised capital. Nevertheless, companies can still be given the option to retain the provision for authorised capital in the company's Articles of Association¹⁵, or to delete or amend it by resolution. If retained, the authorised capital will be deemed to be specified in terms of number of shares to be issued instead of monetary value.

Question 7

Do you agree that the requirement for authorised capital should be removed?

Question 8

Do you see value in companies having a choice whether to retain or delete the authorised capital from their Articles of Association?

¹⁴ Please see footnote 5.

¹⁵ Please see footnote 5.

Partly Paid Shares

- 2.32 Although not many companies have partly paid shares these days, and its removal may possibly simplify the CO, we have weighed this against the loss to companies of the financing choice of partly paid shares, and do not recommend its abolition. We would however like to know the public's views on whether it sees value in having a choice.
- 2.33 Liability for calls will not be affected by the shares losing their par value. We propose to provide as a matter of legislation that the amount unpaid will be the difference between the issue price and that contributed by the shareholder.
- 2.34 Australia and Singapore distinguished between shares issued before and after the migration to no-par, defining the amount unpaid on the former as that which is unpaid on the par value. This is intended to preserve the distinction in a par value environment between amounts outstanding on the par value (which is covered by statute) and that on the premium (which the liquidator must sue in contract for). We do not propose to distinguish between the shares in this way.
- 2.35 Partly paid shares without a par value can continue to be subdivided. We propose to legislate for the reallocation of the outstanding liability on existing shares to the new shares to maintain the pre-existing ratios.

Question 9

Do you see value in retaining the option of having partly paid shares? Please provide reasons.

Question 10

Do you agree that the amount unpaid on partly paid shares should be defined by reference to the issue price, without a need to distinguish between shares issued before and after migration to no-par?

Question 11

Where partly paid shares without a par value are subdivided, do you agree that there should be reallocation (by legislation) of the outstanding liability on existing shares to the new shares to maintain the pre-existing ratios?