CO Rewrite
重寫《公司條例》

CO Rewrite

Rewrite of the Companies Ordinance

Consultation Paper

Share Capital
The Capital Maintenance Regime
Statutory Amalgamation Procedure

June 2008

Financial Services and the Treasury Bureau
www.fstb.gov.hk

ABOUT THIS DOCUMENT

1. This paper is published by the Financial Services and the Treasury Bureau ("FSTB") to consult the public on legislative proposals to improve various provisions in the Companies Ordinance (Chapter 32) ("CO"). This is the third public consultation on the rewrite of the CO. The first consultation on accounting and auditing provisions in the CO was conducted in 2007. The consultation conclusions are available on http://www.fstb.gov.hk/fsb/co_rewrite. The second public consultation on company names, directors' duties, corporate directorship and registration of charges was conducted in the second quarter of 2008. The consultation conclusions will be published later this year.

2. After considering the views and comments on individual subject areas, we aim to issue a draft Bill for public consultation in mid-2009.

3. A list of questions for consultation is set out for ease of reference after Chapter 4. Please send your comments to us on or before **30 September 2008**, by one of the following means:

   By mail to: Companies Bill Team
   Financial Services and the Treasury Bureau
   15/F, Queensway Government Offices
   66 Queensway
   Hong Kong

   By fax to: (852) 2869 4195

   By email to: co_rewrite@fstb.gov.hk

4. Any questions about this document may be addressed to Mr Nick AU YEUNG, Assistant Secretary for Financial Services and the Treasury (Financial Services), who can be reached at (852) 2528 9156 (phone), (852) 2869 4195 (fax), or nickauyeung@fstb.gov.hk (email).

5. This consultation paper is also available on the FSTB's website http://www.fstb.gov.hk/fsb and the Companies Registry's website http://www.cr.gov.hk.

6. Submissions will be received on the basis that we may freely reproduce and publish them, in whole or in part, in any form and use, adapt or

develop any proposal put forward without seeking permission or providing acknowledgment of the party making the proposal.

7. Please note that names of respondents, their affiliation(s) and comments may be posted on the FSTB's website or referred to in other documents we publish. If you do not wish your name and/or affiliation to be disclosed, please state so when making your submission. Any personal data submitted will only be used for purposes which are directly related to consultation purposes under this consultation paper. Such data may be transferred to other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submission, please contact Mr Nick AU YEUNG (see paragraph 4 above for contact details).

ACKNOWLEDGEMENT

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CONTENTS

ABBREVIATIONS

AGs	Advisory Groups
UK CA 2006	United Kingdom Companies Act 2006
CLRSG	Company Law Review Steering Group (UK)
CO	Companies Ordinance (Chapter 32)
CR	Companies Registry
FSTB	Financial Services and the Treasury Bureau
NZCA	New Zealand Companies Act
SCA	Singapore Companies Act
SCCLR	Standing Committee on Company Law Reform
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Chapter 571)
SMEs	Small and Medium-Sized Enterprises
UK	United Kingdom
US	United States

EXECUTIVE SUMMARY

1. The FSTB launched a comprehensive rewrite of the CO in mid-2006. Two public consultations covering the accounting and auditing provisions of the CO as well as company names, directors' duties, corporate directorship and registration of charges have already been conducted. More information on the rewrite exercise and past consultations can be found at our website: www.fstb.gov.hk/fsb/co_rewrite.

2. The present consultation covers the following issues:

Share Capital (Chapter 2)

(a) To introduce a mandatory no-par value share regime for all companies and provide a period of 12 months for companies to review their arrangements before migration to no-par. We do not propose to introduce any legislative control over the setting of issue price of no-par shares but directors will still have an overriding fiduciary duty to set that in good faith;

(b) To seek public views on whether the merger and reconstruction reliefs should be retained, and if so, its formulation;

(c) To allow the capitalisation of profits with or without an issue of shares and the issuance of bonus shares without the need to transfer an amount to the share capital account. To continue to allow companies to consolidate and subdivide shares and to provide for redeemable shares;

(d) To remove the requirement for authorised capital but give companies a choice whether to retain or delete the provision for authorised capital in their Articles of Association;

(e) To retain the option of having partly paid shares;

The Capital Maintenance Regime (Chapter 3)

(f) To seek public views on whether they agree with the SCCLR's recommendations that -

(i) Hong Kong should not replace the current capital maintenance regime with the solvency test approach to distributions of all forms; and

(ii) As far as reduction of capital is concerned, there is no need to introduce a court-free procedure based on solvency as an alternative to the current court-sanctioned procedure;

(g) To seek public views on whether the existing rules on buy-backs and financial assistance should be streamlined and modified, and if so, what option should be adopted; and

Statutory Amalgamation Procedure (Chapter 4)

(h) To consider introducing a court-free statutory amalgamation procedure in Hong Kong, in addition to the existing court-sanctioned procedure, along the lines of the Singaporean model with some modifications. The proposed court-free procedure will contain a number of measures to protect the interests of relevant stakeholders.

3. The Government will carefully study the comments received during this consultation before taking a final view on the proposals.

4. The final proposals for this and previous rounds of public consultation will be incorporated into the draft Bill for further public consultation around mid-2009. We plan to introduce the Companies Bill into the Legislative Council, tentatively, in the third quarter of 2010.

CHAPTER 1

INTRODUCTION

Background

1.1 This is the third public consultation for the ongoing CO Rewrite exercise. The rewrite exercise aims to modernise our CO to meet more fully the needs of Hong Kong as a major international financial and business centre.

Previous Consultations

1.2 We had consulted the public on accounting and auditing provisions of the CO in 2007. The consultation conclusions for that round of consultation can be found at http://www.fstb.gov.hk/fsb/co_rewrite under "Publications & Press Release".

1.3 The second public consultation on company names, directors' duties, corporate directorship and registration of charges was conducted in the second quarter of 2008[1]. We are in the process of collating feedback on that consultation and aim to publish the consultation conclusions later this year.

Current Public Consultation

1.4 In formulating proposals for this round of public consultation on share capital and the capital maintenance rules, we were assisted by an external legal consultant[2]. We have also benefited from the advice of the SCCLR[3] which plays a key role in advising on all major proposals to reform the CO, as well as that of AG1[4]. The current membership of the SCCLR and AG1 respectively are at **Appendix I**.

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1 The consultation paper can be downloaded from http://www.fstb.gov.hk/fsb

2 Dr Maisie Ooi from the National University of Singapore was appointed the consultant for the consultancy study on the parts of the CO covering share capital, capital maintenance rules, registration of charges, debentures and remaining provisions in Part II of the CO. She is assisted by several experts from the UK and New Zealand.

3 Members of the SCCLR include representatives of the SFC, Hong Kong Exchanges and Clearing Limited and relevant government departments, as well as individuals from relevant sectors and professions such as accountancy, legal and company secretarial. Please see http://www.cr.gov.hk for further information.

4 Members of AG1 comprise representatives from relevant professional and business organisations, academics and members of the SCCLR.

Future Work

1.5 We aim to publish the conclusions for this round of public consultation by early 2009.

1.6 The final proposals will be incorporated into the draft Bill to be issued around mid-2009 for further public consultation. The draft Bill will enable the public to comment on the proposals in a more holistic manner before the Companies Bill is introduced into the Legislative Council, tentatively, in the third quarter of 2010.

Seeking Comments

1.7 We would like to invite public views by **30 September 2008** on the following topics:

(a) Share capital;
(b) The capital maintenance regime; and
(c) Statutory amalgamation procedure.

The key proposals are described in Chapters 2 to 4 below.

1.8 Each chapter starts with a brief background of the relevant issues and our considerations before presenting the details of the proposed changes or amendments. The questions for consultation are set out under different sections in each chapter and a list of all questions for consultation is extracted at the back of this document after Chapter 4.

1.9 As the proposed changes or amendments may have significant implications for companies and different stakeholders including directors, shareholders, investors, creditors and relevant professionals, we would like to invite public comments before drafting the Bill. The comments received will help us ensure that the relevant legislative proposals will suit Hong Kong's unique circumstances.

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 document[5] 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 shares[7]. 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.’

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[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 2003[8], 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

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[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 operate[9].

(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 CO[10]. 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.

<u>Question 1</u>

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.

<u>Question 2</u>

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 Registrar[11].

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 price[12].

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.

<u>Question 3</u>

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 redundant[13].

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 .

<u>Question 4</u>

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.

<u>Question 5</u>

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.

<u>Question 6</u>

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 document[14] 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 Association[15], 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.

<u>Question 7</u>

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

<u>Question 8</u>

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?

CHAPTER 3

THE CAPITAL MAINTENANCE REGIME

Background

3.1 Part II[16] and Part IIA[17] of the CO contain the provisions commonly referred to as the capital maintenance and distribution rules respectively. The latter are not in fact distinct rules but the key statutory provisions embodying the capital maintenance doctrine.

3.2 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 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.

3.3 For the purpose of ***creditor protection***, the CO restricts payment out of capital to shareholders in the following ways:

3.3.1 dividends can only be paid out of distributable profits;

3.3.2 court sanction is generally required for the reduction of capital, except for redesignation of the nominal value of shares;

3.3.3 the purchase by a company of its own shares ("buy-back") may generally only be made out of distributable profits or the proceeds of a new issue, save for certain exceptions; and

3.3.4 financial assistance by a company of the acquisition of its own shares ("financial assistance")[18] is generally prohibited, save for certain exceptions.

3.4 Whilst the principle of capital maintenance has developed principally for

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16 Sections 47A to 48, 48B to 50 and 58 to 62.

17 Sections 79A to 79P.

18 The rules on financial assistance are often regarded as part of the capital maintenance regime although technically they are not necessarily related to the preservation of share capital. If negotiated on proper terms, a financial assistance transaction should not affect the assets of the company and, on whatever terms, is no more likely in itself than any other transaction to infringe the company's capital.

the protection of creditors, the rules also seek to protect shareholders, particularly the minority, from unequal treatment in selective distributions where only some shareholders receive benefits and from dilution of existing shareholders' rights.

The Capital Maintenance Doctrine

3.5 Some have questioned the premise of the doctrine, doubting whether creditors rely on the share capital significantly in practice, as most creditors negotiate and contractually provide for the level of protection that their circumstances require. By definition, non-consensual creditors do not rely on the levels of capital maintained by the companies concerned.

3.6 The capital maintenance principle has become less relevant nowadays. Most companies only have a small issued share capital[19]. Out of a total of over 662,000 live companies incorporated in Hong Kong which have issued capital in Hong Kong Dollars ("HKD") as at end of April 2008, around 80% have no more than HKD10,000 issued share capital and around 36% actually have issued capital of HKD100 or less.

3.7 Some have also considered the capital maintenance rules as unduly complex, often ill-targeted for their intended purpose and somewhat overtaken by their exceptions.

Reform in Other Jurisdictions – the Solvency Test Approach

3.8 Some jurisdictions such as the UK, Australia and Singapore have reformed their capital maintenance rules in recent years, each with some variations to suit their particular circumstances. Some other jurisdictions like the US and New Zealand have moved away from the capital maintenance regime to a general solvency test approach. These changes are summarised in **Appendix II**.

3.9 The theory underpinning the solvency test approach is that the law should focus on the core risk at stake – insolvency of the company – since this is the only condition in which creditors will be left unpaid. All forms of distribution to shareholders including payment of dividends, capital returns and buy-backs are allowed provided that relevant solvency tests are met,

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[19] The CO, like other common law jurisdictions, does not prescribe a minimum capital, therefore allowing companies operational flexibility. This is readily explicable – it would be quite difficult to determine an appropriate level of capital for all companies.

without distinguishing between payment from capital or profits. The argument for this method is that creditors are more concerned with a company's solvency than the preservation of its share capital.

Cash Flow and Balance Sheet Tests

3.10 There are traditionally two types of solvency tests: the cash flow (or liquidity) test and the balance sheet (or net assets) test. The cash flow test basically requires the company to be able to meet all debts as they fall due, whilst the balance sheet solvency test requires that liabilities must not exceed assets. A majority of the directors are typically required to confirm that the tests are met and to sign a solvency certificate as to their opinion. Civil liability is usually provided to give the right of recoupment by the company of the unauthorised distribution from directors or shareholders. In addition, criminal liability is imposed on a director who signs a certificate knowing that it is false or misleading in a material particular[20].

3.11 In Hong Kong, the solvency test is basically a cash flow test, and has been part of the capital maintenance rules (being an exception to financial assistance for unlisted companies and a condition to buy-backs out of capital by private companies) for some time. The details are set out in the relevant sections below.

SCCLR's Recommendations

3.12 The SCCLR has considered whether the general solvency test approach should be adopted in Hong Kong. It has recommended against across the board application of the solvency test to all forms of distribution, mainly for the following reasons:

(a) While the solvency test approach would in theory offer better protection to creditors than the capital maintenance regime, it may give rise to considerable concerns on the part of directors, especially those of SMEs, due to the increase in their potential liabilities;

(b) Directors may have to rely on professional advice more frequently to avoid being held liable for improper distribution and this would increase the cost of running business;

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[20] See, for example, sections 377(1) and 373(4) of the NZCA.

(c) The business sector is likely to find the application of the solvency test to the distribution of dividends objectionable, in particular. The current rules that dividend should be declared out of distributable profit have worked well and provided certainty. Moreover, the civil remedies under the NZCA where payment of a distribution that did not satisfy the solvency test is recoverable in the first instance from the shareholders who have received the payment would also be objectionable to the general investors. It would create great uncertainty to the shareholders in their receipts of dividends[21];

(d) Some features of the present capital maintenance regime may provide better safeguard against improper distribution (e.g. court sanction is required in case of reduction of capital other than re-designation of the nominal value of shares to a lower amount), as compared with relying on a solvency test based on the judgement of directors; and

(e) While using solvency as the principal rule for protection of creditors is appealing in theory, the concerns and potential drawbacks, especially those noted in (a) to (c) above, would outweigh any benefits arising from the adoption of such an approach.

<u>Question 12</u>

Do you agree that Hong Kong should NOT adopt the solvency test approach to creditor protection which applies to all forms of distribution? Please provide reasons.

Options for Reform

3.13 While advising against the adoption of an across-the-board solvency test approach, the SCCLR does not dismiss the possibility of streamlining and rationalising some of the complex capital maintenance rules.

3.14 As noted in paragraph 3.12(c) above, the current rules on distribution of dividends have worked well and no major change is proposed. We would therefore like to invite public views on possible options to streamline or rationalise the rules on reduction of share capital, buy-backs and financial assistance before deciding whether to incorporate them into

21 See section 56(1) of the NZCA. There are however safeguards that shareholders who received the dividends in good faith and who have altered their position can keep their dividends. By comparison, under the US's Revised Model Business Corporations Act, directors are primarily liable for the amount in excess of a lawful distribution.

the draft Bill for further public consultation.

<u>Existing Solvency Test Requirements</u>

3.15 Regardless of whether the reform options (discussed below) are adopted, we would like to have your views as to whether the existing solvency requirement, which is basically a cash flow test, should be replaced with one which combines both cash flow and balance sheet bases of solvency.

3.16 A company that is in a highly liquid state (as where it has cash or assets easily convertible to cash) at a time when its liabilities exceed its assets may satisfy the cash flow solvency test, but not the balance sheet solvency, and consequently the combined tests.

3.17 The NZCA and the US Revised Model Business Corporations Act combine both solvency tests, so that a company must have a positive cash flow and a positive net worth. Jurisdictions that have more recently enacted the solvency test appear to have preferred the combined cash flow and balance sheet approach to solvency. The SCA (has since 30 January 2006) adopted this approach in amending its capital maintenance rules. South Africa chose this approach to solvency when enacting solvency as the measure for distributions in 1999[22]. In Malaysia the Corporate Law Reform Committee has recommended that the New Zealand form of solvency test (the twofold cash flow and balance sheet test) be applied to its proposed reform of its capital reduction, buy-back and financial assistance rules[23].

3.18 The UK applies only the cash flow test of solvency in the non-court sanctioned reduction of capital process and the exception to the prohibition on buy-backs. The Rickford Report[24] concluded that the balance sheet test added little to the cash flow test, and suggested that should the UK move to the solvency approach to distribution, the solvency test should broadly follow that currently applied to capital reductions with supplementary disclosure addressing the accounting net assets balance[25]. The Report considered that the balance sheet test

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22 Section 90 of the South African Companies Act.

23 *A Consultative Document on Capital Maintenance Rules and Share Capital: Simplifying and Streamlining Provisions Applicable to Shares* (June 2005) by the Corporate Law Reform Committee for the Companies Commission of Malaysia, available at www.ssm.com.my.

24 The Rickford Report is a report by an interdisciplinary group established in the UK in May 2003 to review company law on capital maintenance and developing accounting standards. See J Rickford Ed., *Reforming Capital: Report of the Interdisciplinary Committee on Capital Maintenance, (2004) European Business Law Review 919-1027, p.977 in particular*.

25 [2004]European Business Law Review 977

tended to be treated as a mere mechanical application of a calculation of balance sheet net asset value. Such mechanical application of a crude balance sheet test fails to make proper allowance for the quality of a company's assets and liabilities, their volatility and linkage over time and the quality of the company's performance. A surplus on a company balance sheet does not necessarily indicate that a company may prudently distribute that amount, any more than that is the maximum which it would be prudent to distribute.

3.19 The Rickford view has been disputed. Clearly a crude use of the balance sheet test might prevent legitimate distributions but the converse risk that it might allow excessive and imprudent distributions should be met by the cumulative requirement of cash flow solvency. It has also been argued that there is no reliable yardstick which directors could use in order to ascertain to a reasonable degree whether long term liabilities will find their match in future profits under the cash flow solvency test, and that a balance sheet test is also required in order to ensure a 'minimum protection' for long term obligations. This is because balance sheet tests require all liabilities which have accrued to be covered by existing assets on the distribution date, irrespective of the date when payment has to be performed[26].

3.20 We would like to hear public views on whether the combined solvency approach gives a significantly better balance of protection for creditors without undue hardship to companies.

Question 13

Should the solvency test currently used in Hong Kong (which is basically a cash flow test) be modified by including a balance sheet test?

Reduction of Share Capital

3.21 The CO only allows for reductions of share capital by court sanction, save for the re-designation of the nominal value of shares to a lower amount[27]. Shareholders must agree by special resolution, and the court, after settling the list of creditors and considering creditor objections, has to be satisfied

[26] W Schon, 'Balance Sheet Tests or Solvency Tests – or Both?' (2006) European Business Organization Law Review 181, 190-193.

[27] See Sections 58 to 63 of the CO. Section 58(3) and the ancillary provisions introduced by the Companies (Amendment) Ordinance 2003 to allow for re-designation of the nominal value without court sanction will no longer be relevant if Hong Kong moves to a no-par system (see Chapter 2 above).

that alternative protections are in place. In the period of 2005-06 to 2007-08, the number of cases of capital reduction that were subject to confirmation by the court and registered with the CR under section 61 of the CO was on average about 20 each year.

3.22 Some jurisdictions such as Singapore[28] and the UK[29], which also require reduction to be sanctioned by the court, recently introduced a court-free process based on solvency for capital reduction as an alternative procedure which is thought to be faster and cheaper. The UK CLRSG initial proposal was to replace the court-sanctioned procedure with the new process, but it decided in favour of retaining the former in the Final Report. One of the arguments which influenced the decision was that the court's confirmation provides certainty as to the legality of the transaction and therefore still had its value.

3.23 The alternative procedure is restricted to private companies in the UK, as the Second European Community ("EC") Directive was thought to stand in the way of its extension to public companies. In Singapore, it is available to both public and private companies with some differences in the conditions of application. In both the UK and Singapore, the solvency declaration is required to be made by *all* directors. Both have criminal sanctions relating to the solvency declaration.

3.24 The SCCLR does not see a strong need for the introduction of a court-free procedure based on solvency test as an alternative to the current court sanctioned procedure in Hong Kong. Some companies may still prefer the court's confirmation as it provides certainty as to the legality of the transaction. Some creditors may also perceive a solvency declaration by the directors as offering lesser protection for them than the court's oversight. Nevertheless, we would like to hear public views on the need for introducing a court-free procedure for capital reduction as an alternative procedure before taking a final view on the matter.

[28] See Division 3A of Part IV of the SCA, available at http://statutes.agc.gov.sg/non_version/html/homepage.html
[29] See Chapter 10 of Part 17 of the UK CA 2006, available at http://www.berr.gov.uk/bbf/co-act-2006/

<u>Question 14</u>

Do you agree that reduction of capital should continue to be subject to judicial control and there is <u>no</u> need to introduce a court-free procedure as an alternative process in addition to the current rules?

<u>Question 15</u>

If your answer to Question 14 is negative (i.e. you think that an alternative court-free process for reduction of capital should be introduced:

(a) Should it be available to all companies (whether listed or unlisted) or just private companies or private and unlisted public companies; and

(b) Should all directors make the solvency declaration, or is it sufficient for the majority to do so?

<u>Purchase of Own Shares (Buy-backs)</u>

3.25 Under the CO, a company may, subject to meeting certain requirements, purchase its own shares out of distributable profits or the proceeds of a new issue of shares[30]. Buy-backs out of capital are only allowed by (1) private companies to the extent that there are insufficient distributable profits or proceeds of a fresh issue, and subject to meeting certain solvency requirements[31], and (2) by all companies in the four circumstances stipulated in section 49B(4)[32], if authorised by its articles.

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[30] Section 49B of the CO. Where shares are cancelled, the amount by which the company's issued share capital is diminished is transferred to the capital redemption reserve (section 49H). This reserve is to be treated as if it were share capital with the exception that it may be used to pay up fully-paid bonus shares (section 49H(4)). Subject to the move to no-par, there will no longer be a capital redemption reserve and hence no such transfer.

[31] The directors shall make a statement that, having made full inquiry into the affairs and prospects of the company, they have formed the opinion –

(a) As regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts; and

(b) As regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout the year.

[32] The four circumstances stipulated in section 49B are to (1) settle or compromise a debt or claim; (2) eliminate a fractional share or fractional entitlement; (3) fulfil an agreement in relation to an employee share option scheme; and (4) comply with a court order ordering a purchase in respect of either an application to the court by minority shareholders upon an alteration in the company's objects, or an unlisted company providing financial assistance for the acquisition of its shares, or unfairly prejudicial conduct.

The CO requires the cancellation of shares that are bought back[33].

3.26 For private companies to buy-back shares out of its capital, they have to undergo several steps, including (a) obtaining members' approval by a special resolution; (b) the directors filing a statutory form, together with an auditor's report, with the CR that the company will be able to meet the solvency requirement; and (c) publishing notices with relevant information in the Gazette, one English newspaper and one Chinese newspaper. 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[34].

3.27 Buy-backs by listed companies are subject to additional requirements under section 49BA of the CO and the Code on Share Repurchases[35] issued by the SFC and also have to comply with the Listing Rules. Nevertheless, the SFC may exempt any listed company from any of the buy-back requirements in section 49BA[36].

3.28 Any purchase of its own shares by a company is subject to disclosure requirements. A return has to be delivered to the CR within 14 days from the date on which the purchased shares are delivered to the company. In the period of 2005-06 to 2007-08, the CR registered a total of some 560 returns, out of which around 40 were buy-backs out of capital.

3.29 Some jurisdictions have relaxed their rules on buy-backs in recent years. Singapore has since early 2006 allowed buy-backs for all companies (i.e. both private and public companies) from whatever source of funds subject to the solvency requirement[37] and approval by shareholders[38]. Australia similarly allows buy-backs for all companies irrespective of the source of funds provided creditors are not prejudiced. The UK, however, has not made any significant changes to its rules, mainly because the Second EC Directive prevents the extension of the solvency approach to public companies.

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33 Section 49A(4) as extended to buy-backs by section 49B(3).
34 Sections 49K to 49O of the CO.
35 The Code is intended to ensure that persons engaged in buy-back offers act fairly. We will not review the Code as it is beyond the scope of the CO rewrite exercise.
36 See section 49BA(11) of the CO and the Guidelines for the Exemption of Listed Companies from the Share Repurchases Requirements of Section 49BA of the CO issued by the SFC. There are other considerations in the case of listed companies, such as prevention of market manipulation and shareholder protection issues that are mainly tackled by the SFC's Code on Share Repurchases. The Code is beyond the scope of the current rewrite exercise.
37 See section 76F of the SCA.
38 See sections 76C,76D, 76DA and 76E of the SCA.

3.30 The current rules on buy-backs in the CO, which distinguish between purchase out of distributable profits or the proceeds of a new issue of shares and purchase out of capital, are fairly complex. Also, the solvency exception is currently restricted to private companies only. One option for reform is to extend the current solvency exception to public companies so that public companies can fund buy-backs from capital to the extent that there are insufficient distributable profits or proceeds of a fresh issue, subject to meeting the solvency requirements. Another option is to allow all companies to fund buy-backs regardless of the source of funds, subject to a solvency requirement in a manner similar to that of the SCA. This would streamline the rules, but the proposed solvency requirement may add a burden to companies purchasing their own shares out of distributable profits or the proceeds of a new issue of shares.

Question 16

Should the current provisions on buy-backs in relation to protection of creditors be:

(a) retained;

(b) amended to allow public companies (whether listed or unlisted) to fund buy-backs from capital subject to the solvency and other procedural requirements currently applicable to a buy-back out of capital by private companies; or

(c) amended to allow all companies (whether listed or unlisted) to fund buy-backs (regardless of the source of funds) subject to a solvency requirement (in a manner similar to that of the SCA)?

Treatment of Repurchased Shares

3.31 Currently the CO requires all repurchased shares to be cancelled. The UK, Singapore, New Zealand, and a number of states in the US give their companies (in the UK only those listed on a recognised exchange) the option to hold the shares bought back in treasury, so that the shares bought back are not inevitably cancelled. A number of ways to counter the dangers of abuse have been adopted, e.g. prohibiting the sale of treasury shares at 'price sensitive times' and limiting the number of shares that could be held in treasury.

3.32 The question whether Hong Kong should allow the shares of listed companies to be held in treasury has been considered in some detail by the SFC with the issuance of a public consultation paper on the subject in 1998[39].

3.33 In its Consultation Conclusions in July 1999, the SFC decided not to introduce treasury shares and suggested instead to proceed with amending the Listing Rules to enable all listed companies in Hong Kong to expedite the listing of new shares that are reissued following a repurchase and cancellation (described in the document as a 'block listing regime')[40]. This conclusion was reached taking account of the views expressed in the responses to the consultation, which favoured adoption of the block listing regime over treasury shares.

3.34 Nevertheless, we would welcome consultees' views on the need to introduce treasury shares for all companies (including private companies) before taking a final view.

<u>Question 17</u>

Is there a case for legislating for treasury shares for all companies (as in Singapore)?

<u>Financial Assistance</u>

3.35 Section 47A of the CO imposes very broad prohibitions on a company (and its subsidiaries) giving financial assistance to a third party for the purpose of acquiring shares in the company. Certain exceptions are set out in section 47C and special restrictions apply to listed companies (section 47D). Unlisted companies are provided with an additional exception premised upon solvency and subject to a special resolution of the shareholders (section 47E). The solvency test itself is based on cash flow alone[41], but there is also a requirement that the assistance must be

[39] The SFC Consultation Paper on Treasury Shares can be found at http://www.sfc.hk/sfc/html/EN/speeches/public/consult/consultation/treasury%20shares.html

[40] A Consultation Paper on Treasury Shares Consultation Conclusions - Hong Kong July 1999 can be found at http://www.sfc.hk/sfc/html/EN/speeches/public/consult/consultation/conclusion_treasury.html
The proposed block listing regime has not been implemented yet as there has not been strong demand for it in the market and is therefore a low priority item to the Hong Kong Stock Exchange.

[41] A majority of the directors must provide a statement that –
(1) Immediately following the date on which the assistance is proposed to be given, that there will be no ground on which the company could be found to be unable to pay its debts; and either:

provided out of distributable profits to the extent that the net assets are reduced by the assistance[42].

3.36 Although it is clearly important to protect the interest of creditors and minority shareholders against such risks like the company's assets being lost because of the lack of credit-worthiness of the assisted parties, the rules on financial assistance, and the exemptions that are available are so complex that it is generally accepted that they are capable of capturing potentially beneficial, or at least innocuous transactions. As a result, companies may spend a disproportionate amount of time and money structuring transactions in such a way that they do not contravene the prohibition. Although the scope of the prohibition has been whittled away with the addition of exceptions, companies have first to understand all the rules and then identify that an exception applies to them, and determine how it works. Moreover the exceptions, while useful, do not simplify the law as much as is useful.

3.37 The UK CA 2006 has dispensed with the restriction against private companies providing financial assistance. The UK CLRSG took the view that the financial assistance provisions impose unjustified costs on private companies, and proposed that they be repealed. It was also of the view that other protections found in the sphere of directors' duties of fidelity and fairness and the use of powers for proper purposes with a duty of care, as well as minority protection of the shareholders, were adequate to protect creditors and members[43].

3.38 Other jurisdictions have also reformed their financial assistance rules although not going as far as abolishing the prohibition altogether for private companies. The NZCA allows financial assistance with a solvency certification by the directors, and provided that the board has resolved that the company should give the assistance, that it is in the best interest of the company, and that the terms are fair and reasonable to the company[44], and either that:

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(2) If it is intended to commence the winding up of the company within 12 months of that date, that the company will be able to pay its debts in full within 12 months of the commencement of the winding up, or

(3) In any other case, that the company will be able to pay its debts as they fall due during the year immediately following that date.

42 Section 47E(2) of the CO.

43 *Modern Company Law for a Competitive Economy: Developing the Framework* (London: DTI, 2000) 232-234.

44 Section 76 read with section 77 of the NZCA.

(a) There is unanimous shareholder approval[45]; or

(b) The procedures for special financial assistance (where not all shareholders are extended the assistance) are followed[46]; or

(c) The financial assistance does not exceed 5% of shareholders funds[47].

3.39 Singapore has also retained the prohibition, but introduced two additional exceptions premised upon (cash flow and balance sheet) solvency for all companies[48]. Both exceptions require that all directors make a solvency statement in relation to the giving of the financial assistance, and that they resolve (giving full grounds for their conclusions) that:

(a) the company should give the assistance;

(b) it is in the best interest of the company; and

(c) the terms and conditions are fair and reasonable to the company.

The financial assistance may not exceed 10% of the total paid-up capital and reserves of the company (the first new exception)[49] unless there is also unanimous shareholders resolution for the giving of the financial assistance (the second new exception)[50].

3.40 Both jurisdictions have criminal sanctions relating to the solvency requirement.

3.41 There appears to be a case for reforming the financial assistance rules. The question is the direction that such reform should take. For the protection of creditors and minority shareholders, it seems doubtful whether we should go so far as abolishing the prohibition altogether, like the UK has done for private companies. There is probably no compelling reason to follow Singapore in making solvency an additional exception to the prohibition for all companies[51] as this will just add to the length and complexity of the provisions and further confuse the

45 Section 76 of the NZCA.

46 Section 78 of the NZCA, which requires the Board to disclose information with regards to the assistance to each shareholder and certify that the giving of the assistance is of benefit to those shareholders not receiving the benefit.

47 Section 80 of the NZCA.

48 Singapore's Companies (Amendment) Act 2005 which came into effect on 30 January 2006.

49 Section 76(9A) of the SCA.

50 Section 76(9B) of the SCA.

51 It is already an exception under the CO for unlisted companies.

underlying policy of the prohibition. The more streamlined approach adopted in the NZCA seems to be a possible way forward. If there is broad support for reform in a manner similar to the NZCA in this aspect, we will develop the proposal in the draft Bill for further public consultation.

Question 18

Should the current financial assistance provisions be streamlined in a manner similar to the NZCA?

Question 19

If your answer to Question 18 is in the negative, would you prefer instead:

(a) the current provisions be retained;

(b) the prohibition of financial assistance be abolished in respect of private companies (as the UK has done); or

(c) making solvency an additional exception to the prohibition for all companies (whether listed and unlisted) in a manner similar to the SCA?

CHAPTER 4

STATUTORY AMALGAMATION PROCEDURE

Background

4.1 Mergers and amalgamations[52] are not uncommon in Hong Kong. The reasons underlying amalgamation or other forms of corporate reorganisation are generally commercial or economic. At present, Hong Kong law does not provide for a simplified and court-free procedure for amalgamation of companies. Companies intending to amalgamate may, however, resort to the process under sections 166 to 167 of the CO which involves a court-sanctioned scheme of arrangement for companies to make provisions to attend to the interests of their creditors and/or members. The arrangement, when approved by the court, will be binding on all the parties concerned and the court has wide powers to make such orders as are necessary to secure that the amalgamation shall be fully and effectively carried out.

4.2 In practice, the use of sections 166 to 167 of the CO to effect an amalgamation is rare. Apart from the complex procedure involved and high compliance costs, the court's restrictive approach in applying the provisions may also be a disincentive.

4.3 Some common law jurisdictions such as Singapore and New Zealand[53] have adopted, in addition to a court-sanctioned procedure, a court-free statutory amalgamation procedure of corporate entities. The idea of introducing the latter option is to facilitate a streamlined amalgamation process for effecting solvent amalgamations while at the same time protecting members and creditors' rights.

Overseas Precedents

4.4 Under both the Singaporean and New Zealand models, there are two forms of court-free amalgamation procedure, one for intra-group amalgamation, being an amalgamation of a holding company with one or more of its wholly-owned subsidiaries, or an amalgamation of two or more wholly-owned subsidiaries of the same holding company (referred to as "short form amalgamation"), and the other for merger of other

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52 Broadly speaking, a merger may be understood as a combination of two or more companies into a single company, where one survives and the other ceases to exist as a separate business entity. Amalgamation is a legal process by which the undertaking, property and liabilities of two or more companies merge and are brought under one of the original companies or a newly formed company and their shareholders become the shareholders of the new or amalgamated company.

53 Singapore introduced its court-free amalgamation provisions on 30 January 2006 (sections 215A to 215J of the SCA). The Singaporean model was based on the New Zealand legislation (sections 219 to 226 of the NZCA) which took effect on 1 July 1994.

companies (referred to as "long form amalgamation"). The two models are broadly similar although the Singaporean model may be more stringent in certain aspects, including the protection for the stakeholders.

Long form amalgamation[54]

4.5 A long form amalgamation procedure applies where there is a proposed amalgamation of two or more companies not being of the same group of companies. It is commenced by the preparation of an amalgamation proposal setting out the terms of the amalgamation in detail and all critical information relating to it[55]. Each board of the amalgamating companies must pass a resolution opining that the amalgamation is in the best interests of the company and that the amalgamated company will be solvent. The directors who vote in favour of the resolution must also sign a declaration confirming that the relevant requirements have been satisfied[56]. In Singapore, each board of the amalgamating companies has to make a further solvency statement in relation to the respective amalgamating and amalgamated companies. If the amalgamating company is exempt from audit requirements, the solvency statement has to be in the form of a statutory declaration. If not, the statement shall either be in the form of a statutory declaration or be accompanied by a report from its auditor opining that the solvency statement is not unreasonable given all the circumstances[57].

4.6 The board must then send to the members all the relevant information as may be necessary to enable a reasonable member to understand the nature and implications of the proposed amalgamation[58]. In New Zealand, the information must also include a statement setting out the buy-out right of any dissident member[59].

4.7 Newspaper advertisement of the proposal and manner whereby it may be inspected must be posted at least a specified number of days before the meeting or before the amalgamation proposal becomes effective, and copies of the amalgamation proposal must also be sent to the secured creditors[60].

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54 Sections 215B to 215C of the SCA; Sections 220 and 221 of the NZCA.
55 Section 215B(2) of the SCA; Section 220 of the NZCA.
56 Section 215C(2) and (3) of the SCA; Sections 221(1) and (2) of the NZCA.
57 Section 215I(2)(b) of the SCA.
58 Section 215C(4) of the SCA; Section 221(3) of the NZCA.
59 Under section 110 of the NZCA, a shareholder has a minority buy-out right which has no equivalent in the CO or the SCA. Section 110 of the NZCA provides this right to a shareholder who has voted all his share against a resolution of shareholders in favour of exercising their power under section 106(1)(a) (concerning adoption, alteration or revocation of the companies constitution), section 106(1)(b) or section 106(1)(c) (concerning approval of majority transaction and amalgamation respectively). Accordingly, if a shareholder of an amalgamating company casts all the votes attached to his shares against an amalgamation, but the amalgamation is nevertheless approved, he has a buy-out right.
60 Section 215C(5) of the SCA; Section 221(4) of the NZCA.

4.8 The proposal must be approved by a special resolution of members of each of the amalgamating companies at a general meeting[61]. Any creditor or dissident member may apply to the court for relief on the ground of being unfairly prejudiced[62].

4.9 The final step is to lodge the approved amalgamation proposal with the Registrar of Companies for registration, together with a declaration by the directors of the amalgamated company that no creditor will be prejudiced if that company will have a higher proportion of creditors' claims to assets than that of any of the amalgamating companies[63].

4.10 The effect of an amalgamation is that the amalgamated company succeeds to all rights, liabilities and obligations of each of the amalgamating companies[64].

Short form amalgamation[65]

4.11 In the event where the short form amalgamation procedure applies (i.e. a proposed intra-group amalgamation being either an amalgamation of a holding company with one or more of its wholly-owned subsidiaries, or an amalgamation of two or more wholly-owned subsidiaries of the same holding company), certain formal requirements under the long form procedure will be dispensed with, including the preparation of formal amalgamation proposal and some parts of the approval procedure[66].

4.12 In New Zealand, the amalgamation needs only be approved by a resolution of the board of each amalgamating company[67]. The directors voting in favour of the resolution must sign a certificate stating that they are satisfied on reasonable grounds that the amalgamated company will satisfy the solvency test immediately after the amalgamation becomes effective[68]. In Singapore, the approval must be given by a special resolution of each amalgamating company at a general meeting. The board of each company must, before the meeting, make a solvency statement in relation to the amalgamated company and every director who votes in favour of the solvency statement must sign a declaration confirming that all the relevant requirements are satisfied[69].

4.13 All secured creditors of the amalgamating companies must be notified of

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61 Section 215C(1)(a) of the SCA; Section 221(5) of the NZCA.
62 Section 215H of the SCA; Section 226 of the NZCA.
63 Section 215E of the SCA; Section 223 of the NZCA.
64 Section 215G of the SCA; Section 225 of the NZCA.
65 Sections 215D to 215G of the SCA and Section 222 of the NZCA.
66 Section 215D(1) and (2) of the SCA; Sections 222(1) and (2) of the NZCA.
67 Sections 222(1), (2) and (4) of the NZCA.
68 Section 222(5) of the NZCA.
69 Section 215D(5) and (6) of the SCA.

the resolution in advance, though they cannot vote on it. Nevertheless, any creditor may appeal to the court if he considers himself to be unfairly prejudiced by the amalgamation[70].

Considerations

4.14 The current court-sanctioned scheme of arrangement procedure under sections 166 to 167 of the CO is both complex and costly. The introduction of a voluntary, court-free option would simplify the amalgamation process, thereby reducing business costs. The court-free procedure is particularly suitable when the proposed amalgamation is either one which is between a holding company with one or more of its wholly-owned subsidiaries or between two or more wholly-owned subsidiaries of the same holding company, or one which does not involve complex transactions, debt reorganisation or class rights issues. For amalgamations involving such complicated issues, companies should resort to the court-sanctioned procedure.

4.15 The viability of a court-free procedure depends very much on whether there are sufficient built-in measures to protect the interests of relevant stakeholders (e.g. minority shareholders and creditors) and to prevent the procedure from being abused by the management. At the same time, the procedure cannot be made overly complicated, or else it would defeat the purpose of simplifying procedure and reducing costs.

4.16 We propose to introduce a court-free amalgamation regime in Hong Kong along the lines of the Singaporean model which offers greater protection to the stakeholders, except that there would be no need for the report of the company's auditor to be provided together with the solvency statement (see paragraph 4.5). It would likely be difficult for the auditor to give what may amount to a fairness opinion without compromising his professional independence. The key elements of the proposed regime which consists of a short form procedure (for companies within the same group) and a long form procedure (for other companies) are set out in **Table A**.

4.17 One major component of the Singaporean model is to require, for the purpose of the court-free amalgamation, the board of directors to make a solvency statement in the form of a statutory statement[71] in relation to the respective amalgamating and amalgamated companies. The solvency statement is to confirm that –

(a) the amalgamated company will be able to pay its debts as they fall due during the period of 12 months immediately after the date on

[70] Section 215H of the SCA and Section 226 of the NZCA.
[71] Section 215J of the SCA.

which the amalgamation is to become effective; and

(b) the value of the amalgamated company's assets will not be less than that of its liabilities, including contingent liabilities.

4.18 The proposed court-free amalgamation procedure applicable for intra-group amalgamation and merger of other companies, following the Singaporean model, contains a number of measures to protect the interests of shareholders and creditors, for example:

(1) requiring the directors of each of the companies concerned to pass a resolution to confirm that the amalgamation is in the best interest of the company and make statements in relation to the solvency of the amalgamating company and the amalgamated company. It will be an offence for any director who votes in favour of or otherwise causes a solvency statement to be made to do so without having reasonable grounds for the opinion;

(2) requiring disclosure of all relevant matters to the members and notification of the proposal to the creditors not less than 21 days before the general meeting to allow them sufficient time to consider the proposal; and

(3) a remedial right of the members and creditors of the company to apply to the court for relief on the ground of being unfairly prejudiced.

4.19 We consider that there is no need to follow the New Zealand model in providing dissident members with a right to be bought-out[72]. Dissident members would usually be bought out in the negotiation process in any event. A right for minority shareholders to object and to lay an unfair prejudice claim before the court, as set out in paragraph 4.18(3), should offer sufficient protection.

72 See footnote 59 above.

Table A Key Elements of the Proposed Statutory Amalgamation Procedures	
Procedure for "Long Form Amalgamation"	Procedure for "Short Form Amalgamation"
(1) A formal amalgamation proposal setting out all the relevant information to be prepared.	(1) The terms and conditions of the amalgamation must conform with those stipulated in the statute. No formal amalgamation proposal is therefore required.
(2) The board of directors of each amalgamating company to: (a) make a solvency statement in relation to the amalgamated and amalgamating company; and (b) pass a special resolution at a general meeting to approve the amalgamation.	(2) The board of directors of each amalgamating company to: (a) make a solvency statement in relation to the amalgamated company; and (b) pass a special resolution at a general meeting to approve the amalgamation. The resolution is deemed to be an amalgamation proposal that has been approved.
(3) A general meeting to be convened to consider the amalgamation proposal. All relevant information including the amalgamation proposal, copy of declarations, statement of any material interests of directors should be sent to every member of the amalgamating company not less than 21 days before the general meeting.	(3) A general meeting to be convened to consider the amalgamation.
(4) Each director of the amalgamating company, who votes in favour of the resolution, to sign a declaration that, in his opinion, all relevant requirements in relation to the amalgamation have been satisfied together with the grounds	(4) Same as the procedure for the Long Form Amalgamation.

of his opinion.	
(5) A copy of the amalgamation proposal to be sent to each secured creditor of the amalgamating company and a notice to published in the newspaper, not less than 21 days before the general meeting[73].	(5) Written notice of the proposed amalgamation to be sent to each secured creditor of the amalgamating company not less than 21 days before the general meeting.
(6) Shareholders' approval by special resolution.	(6) Same as the procedure for the Long Form Amalgamation.
(7) Any shareholder or creditor may apply to the court for relief on the ground of being unfairly prejudiced. The court may stop the proposal from coming into effect, modify it or direct it to be reconsidered by the amalgamating companies.	(7) Same as the procedure for the Long Form Amalgamation.
(8) Relevant documents to be lodged with the Registrar of Companies. Amalgamation to take effect from the date specified in the certificate of amalgamation issued by the Registrar of Companies.	(8) Same as the procedure for the Long Form Amalgamation.

Question 20

Do you consider that there is a need for Hong Kong to have a court-free statutory amalgamation procedure, in addition to the existing court-sanctioned procedure?

Question 21

If your answer to Question 20 is positive, should the court-free statutory amalgamation procedure be based on the elements outlined in Table A above? If you think that there should be alternative or additional elements, please explain.

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[73] Creditors are not entitled to vote on the amalgamation proposal but they may apply to the court for relief before the amalgamation becomes effective.

LIST OF QUESTIONS FOR CONSULTATION

Question 1 Do you agree that Hong Kong should adopt a mandatory system of no-par for all companies with a share capital?

Question 2 Do you agree that a period of about 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.

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?

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.

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.

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.

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?

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?

Question 12 Do you agree that Hong Kong should NOT adopt the solvency test approach to creditor protection which applies to all forms of distribution? Please provide reasons.

Question 13 Should the solvency test currently used in Hong Kong (which is basically a cash flow test) be modified by including a balance sheet test?

Question 14 Do you agree that reduction of capital should continue to be subject to judicial control and there is <u>no</u> need to introduce a court-free procedure as an alternative process in addition to the current rules?

Question 15 If your answer to Question 14 is negative (i.e. you think that an alternative court-free process for reduction of capital should be introduced):

(a) Should it be available to all companies (whether listed or unlisted) or just private companies or private and unlisted public companies; and

(b) Should all directors make the solvency declaration, or is it sufficient for the majority to do so?

Question 16 Should the current provisions on buy-backs in relation to protection of creditors be:

(a) retained;

(b) amended to allow public companies (whether listed or unlisted) to fund buy-backs from capital subject to the solvency and other procedural requirements currently applicable to a buy-back out of capital by private companies; or

(c) amended to allow all companies (whether listed or unlisted) to fund buy-backs (regardless of the source of funds) subject to a solvency requirement (in a manner similar to that of the SCA)?

Question 17 Is there a case for legislating for treasury shares for all companies (as in Singapore)?

Question 18 Should the current financial assistance provisions be streamlined in a manner similar to the NZCA?

Question 19 If your answer to Question 18 is in the negative, would you prefer instead:

(a) the current provisions be retained;

(b) the prohibition of financial assistance be abolished in respect of private companies (as the UK has done); or

(c) making solvency an additional exception to the prohibition for all companies (whether listed and unlisted) in a manner similar to the SCA?

Question 20 Do you consider that there is a need for Hong Kong to have a court-free statutory amalgamation procedure, in addition to the existing court-sanctioned procedure?

Question 21 If your answer to Question 20 is positive, should the court-free statutory amalgamation procedure be based on the elements outlined in Table A above? If you think that there should be alternative or additional elements, please explain.

Appendix I

List of Members of the Standing Committee on Company Law Reform and Advisory Group 1
(as at 31 May 2008)

The Standing Committee on Company Law Reform

Chairman
Mr Benjamin YU Yuk-hoi, SC, JP

Non-Official Members
Mrs Anne CARVER
Mr Felix CHAN Kwok-wai, MH
Mr Vincent FAN Chor-wah
Mr Peter William GREENWOOD
Mr Stephen HUI Chiu-chung, JP
Ms Teresa KO Yuk-yin, JP
Mr Godfrey LAM Wan-ho
Mr John POON Cho-ming
Ms Edith SHIH
Ms Vanessa STOTT
Mr David Peter Robert STANNARD
Mr Carlson TONG Ka-shing, JP
Mr Paul Franz WINKELMANN
Mr Patrick WONG Chi-kwong

Ex-Officio Members

Mr Andrew John YOUNG	(Securities and Futures Commission)
Mr Paul CHOW Man-yiu	(Hong Kong Exchanges and Clearing Limited)
Mr Edward Lawson Griffin TYLER	(Department of Justice)
Mr Eamonn O'CONNELL	(Official Receiver)
Ms Ada CHUNG Lai-ling	(Registrar of Companies)
Mr Stefan M GANNON, JP	(Hong Kong Monetary Authority)
Mr John LEUNG Chi-yan, JP	(representative of the Secretary for Financial Services and the Treasury)

Secretary
Mr Edward LAU Kar-ning

Advisory Group on Share Capital, Distribution of Profits and Assets and Charges Provisions
(Advisory Group 1)

Chairman
Mr David Peter Robert STANNARD

Members
Mr Stephen BIRKETT
Mr Colin CHAU Yu-nien
Prof Stephen CHEUNG Yan-leung, JP
Ms Ada CHUNG Lai-ling
Ms Julianne DOE
Mr Dennis HIE Hok-fung
Mr Stephen HOPKINS
Ms Roxanne ISMAIL
Mr Simon LAI
Mr John LEUNG Chi-yan, JP
Mr Stefan LO Huoy-cheng
Ms Catherine MORLEY
Prof Philip St John SMART
Mr Lincoln SOO Hung-leung, JP
Mr William TAM Sai-ming
Dr Davy K C WU
Ms Wendy W Y YUNG
Ms Sonia LEUNG

Alternate Members
Mr CHAO Tien-yo
Ms Tina LEE
Mr Richard LEUNG Wai-keung
Mrs Patricia Mary McBRIDE
Mr Emil YU Chen-on
Mr Rimsky YUEN Kwok-keung, SC

Representatives of Government Departments

Mr Edward Lawson Griffin TYLER	(Department of Justice)
Ms Thelma TONG	(Department of Justice)
Ms Feliciana CHEUNG Siu-wai	(Hong Kong Monetary Authority)
Mr William SHIU Wai-chuen	(Land Registry)

Appendix II

Reform in Overseas Jurisdictions concerning Capital Maintenance Rules

UK

1. Reform for public companies in the UK has been largely constrained by European Community ("EC") law. The EC Directives which require capital preservation for public companies are themselves being reviewed. The Interdisciplinary Group on Capital Maintenance established in May 2003 to review company law on capital maintenance in the UK and Europe concluded that the focus of the law on creditor protection should be on maintaining a reasonable expectation of solvency, and not maintaining share capital.

Australia

2. After the 1998 reform to the Australian Corporations Act, financial assistance, capital reductions and buy-backs are generally allowed (with no prescription as to the source of funds) provided that there is no material prejudice to the company, its shareholders, and the ability to pay creditors. The Australian system is therefore also premised upon solvency although there is, unlike the US Revised Model Business Corporations Act 1984 ("MBCA") and New Zealand models, no prescribed formulation for the solvency measure.

Singapore

3. Singapore has introduced solvency as an exception to its financial assistance prohibition, and as an alternative method of reducing share capital. It allows buy-backs to be made (even from capital) provided the company is not insolvent, and does not become insolvent as a result of the purchase.

US and New Zealand

4. The MBCA of the US is arguably the first carefully considered modern treatment of the full solvency test approach. New Zealand followed it with additional safeguards a few years later. It seems that the transition for New Zealand from the strict UK approach on capital maintenance in

1993 to the MBCA solvency test approach has been successful, and has been used as the reference for reform in the UK and Singapore.