

Part 5

Transactions in relation to Share Capital

INTRODUCTION

Part 5 (Transactions in relation to Share Capital) of the new Companies Ordinance (Cap. 622) (“new CO”) contains provisions concerning “capital maintenance” (reduction of capital and purchase of own shares (“buy-backs”)) and related rules (financial assistance by a company for the purpose of acquiring shares in the company or its holding company).

POLICY OBJECTIVES AND MAJOR CHANGES

2. Part 5 contains initiatives that aim at facilitating business operation, namely –

- (a) Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part (paragraphs 4 to 8);
- (b) Introducing an alternative court-free procedure for reduction of capital based on a solvency test (paragraphs 9 to 11);
- (c) Allowing all companies to purchase their own shares out of capital, subject to a solvency test (paragraphs 12 to 15);
- (d) Allowing all types of companies (listed or unlisted) to provide financial assistance for acquisitions of the companies’ shares, subject to satisfaction of the solvency test and certain specified procedures (paragraphs 16 to 20); and
- (e) Relaxing the rules on giving of financial assistance for the purposes of employee share schemes (paragraphs 21 to 22).

3. The details of the above major changes in Part 5 are set out in paragraphs 4 to 22 below.

Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part (Sections 204 to 208)

Position under the Companies Ordinance (Cap. 32) (“Cap. 32”)

4. Under Part II of Cap. 32, a solvency test is provided for in respect of –

- (a) buy-backs of its own shares out of capital by a private company (requirements of the solvency test are set out in section 49K(3), (4) and (5)); and
- (b) financial assistance by an unlisted company for the purpose of an acquisition of shares in the company or its holding company (requirements of the solvency test are set out in section 47F(1)(d) and (2)).

5. Both solvency tests are based on cash flow alone, but there are minor differences between them, as follows –

- (a) for buy-backs, under section 49K(5), the solvency statement has to be accompanied by an auditors’ report; and
- (b) for financial assistance, section 47F(1)(d)(i) has an additional requirement for the solvency statement which provides for the situation where the company intends to commence winding up within 12 months of the date of the proposed financial assistance.

Position under the new CO

6. There is discrepancy in the solvency tests applicable to buy-backs and financial assistance under Cap. 32. It is desirable to adopt a uniform solvency test for buy-backs and financial assistance, and extend its application to the court-free procedure for reduction of capital, for consistency in the law. The new CO adopts the approach for financial assistance set out in section 47F(1)(d) (see paragraph 5(b) above), as it can give clarity and certainty on how the solvency test may apply in different scenarios.

7. Under the new CO, there is no requirement for attaching an auditors' report to the solvency statement. Auditors would not be in a better position than the directors in ascertaining the company's solvency which involves forward-looking business judgments. Directors should be expected to have reasonable grounds in forming their opinion as to the company's solvency and judgment in deciding whether professional assistance is needed. Requiring an auditors' report in every case would add expense and cause delay for relatively little gain.

Key provisions in the new CO

8. **Section 204** provides that a uniform solvency test will be applicable to all three categories of transactions, namely reduction of capital, buy-backs and financial assistance. **Section 205** sets out the content of the uniform solvency test, which in substance, re-enacts section 47F(1)(d) of Cap. 32. **Section 206** provides for the making of a solvency statement by the directors who have formed the opinion that the company satisfies the solvency test in

relation to the transaction concerned. In forming his or her opinion, a director must inquire into the company's state of affairs and prospects and take into account contingent and prospective liabilities of the company. The solvency statement must be made and signed by all directors for buy-backs and reductions of capital, and made and signed by a majority of directors for financial assistance.

Introducing an alternative court-free procedure for reduction of capital based on a solvency test (Sections 215 to 225)

Position under Cap. 32

9. Cap. 32 only allows a reduction of share capital if there is approval by the shareholders via a special resolution and if the reduction is approved by the court (sections 58 to 63). In determining whether to approve the reduction, the court would consider various factors, including whether the reduction is equitable between shareholders and whether creditors' interests are safeguarded. Court approval is not required if the sole purpose of the reduction is to re-designate the nominal value of shares to a lower amount (section 58(3)).

Position under the new CO

10. The new CO introduces, as an alternative procedure, a general court-free procedure based on the solvency test which would be faster and cheaper and can be utilised by all companies.

Key provisions in the new CO

11. **Sections 215 to 225** provide for the said court-free procedure, subject to compliance with the solvency test. The key features of the procedure include –

- (a) all the directors need to sign the solvency statement in support of the proposed reduction (**section 216**);
- (b) the company needs to obtain members' approval by a special resolution (**sections 215 and 217**);
- (c) the company must publish notices with relevant information in the Gazette and newspapers and must register the solvency statement with the Registrar of Companies ("the Registrar") (**section 218**);
- (d) any creditor or non-approving member of the company may, within five weeks after the special resolution is passed, apply to the court for cancellation of the resolution (**sections 220 to 222**). During this five-week period, the company must make available the special resolution and solvency statement for members' and creditors' inspection (**section 219**); and
- (e) the company must deliver after the five-week period (but no later than seven weeks) to the Registrar a return in specified form if there is no court application (**section 224**), or within 15 days after the court makes

the order confirming the special resolution or the proceedings are ended without determination by the court (**section 225**). The reduction of share capital takes effect when the return is registered by the Registrar.

Allowing all companies to purchase their own shares out of capital, subject to a solvency test (Sections 257 to 266)

Position under Cap. 32

12. Under Cap. 32, the general rule is that a company can only buy back its shares using distributable profits or using the proceeds of a fresh issue of shares (sections 49A and 49B). This rule is derived from the capital maintenance doctrine. There is an exception for private companies which may fund a buy-back by payment out of capital based on a solvency test (sections 49I to 49N).

Position under the new CO

13. Under the new CO, all companies are allowed to fund buy-backs out of capital, subject to a solvency requirement.

Key provisions in the new CO

14. **Sections 258 to 266** retain most of the Cap. 32 requirements and procedures applicable to buy-backs by a private company out of capital, and extend them to all companies. The requirements and procedures are similar to the new court-free

procedure for reduction of capital as set out in paragraph 11 above¹. The redemption or buy-back must be made no earlier than five weeks and no later than seven weeks after the special resolution is passed, unless otherwise ordered by the court.

15. **Section 257** prohibits a listed company from making a payment out of capital in respect of a buy-back of its own shares on a recognised stock market or on an approved stock market because it would be impractical for it to follow all the procedural requirements.

Allowing all types of companies (listed or unlisted) to provide financial assistance, subject to satisfaction of the solvency test and certain specified procedures (Sections 283 to 289)

Position under Cap. 32

16. Section 47A of Cap. 32 prohibits a company and its subsidiaries from giving financial assistance for the purpose of acquiring shares in the company. The broad prohibition is subject to certain exceptions.

Position and key provisions in the new CO

17. The rules on financial assistance and the exemptions available under Cap. 32 are fairly complex and there has been general support for reform. **Section 274** retains the definition of financial assistance in Cap. 32. **Sections 277 to**

282 largely retain the exceptions to the prohibition in section 47C and the special restrictions for listed companies in section 47D. The main change under the new CO is to allow all types of companies (listed or unlisted) to provide financial assistance, subject to satisfaction of the solvency test and one of the three procedures set out in **sections 283 to 289**.

18. The first procedure, set out in **section 283**, provides that a company may give financial assistance if the assistance, and all other financial assistance previously given and not repaid, is in aggregate less than 5% of the shareholders' funds. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the solvency statement is made. Within 15 days after giving the assistance, the company must notify its members of the details of the assistance.

19. The second procedure, set out in **section 284**, provides that a company may give financial assistance if it is approved by written resolution of all members of the company. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the solvency statement is made.

¹ There are some differences though, to align the registration requirements with those for buy-backs out of profits. For example, instead of requiring the company to deliver to the Registrar a return in specified form after the five-week period (paragraph 11(e) above), the company will instead be required, under section 270, to deliver a similar return, which is applicable to all types of redemption/buy-back of shares (i.e. not limiting to those financed out of capital), within 15 days after the redeemed or bought back shares are delivered to the company.

20. The third procedure, set out in **section 285**, provides that a company may give financial assistance if it is approved by an ordinary resolution. The giving of the assistance must be supported by a solvency statement and the board must resolve that giving the assistance is in the interests of the company. The company must send to each member at least 14 days before the resolution a notice which contains all information necessary for the members to understand the nature of the assistance and the implications of giving it for the company. The assistance may only be given not less than 28 days after the resolution is passed and not more than 12 months after the day on which the solvency statement is made. **Sections 286 to 288** provide that shareholders holding at least 5% of the total voting rights or members representing at least 5% of the total members of the company may, within the 28-day period, apply to the court to restrain the giving of the assistance².

Relaxing the rules on giving of financial assistance for the purposes of employee share schemes (Section 280)

Position under Cap. 32

21. Section 47C(4)(b) of Cap. 32 provides that the prohibition on financial assistance does not apply to employee share schemes, provided that the financial assistance is restricted to the provision of money for the purchase or subscription of fully paid shares.

Position and key provisions in the new CO

22. **Section 280** allows financial assistance for all types of employee share schemes if the assistance is given in good faith in the interest of the company for the purposes of an employee share scheme or the giving of the assistance is for the purposes of enabling or facilitating transactions to acquire the beneficial ownership of shares for the employees.

TRANSITIONAL AND SAVING ARRANGEMENTS

23. The major changes described in these Highlights apply to activities carried out after the commencement date of the new CO. For activities started under Cap. 32 and in progress when the new CO commences, Cap. 32 provisions will continue to apply (**sections 42 to 47 of Schedule 11** to the new CO).

² A threshold (10%) is present in section 47G of Cap. 32, mainly to minimise frivolous claims.