New Companies Ordinance

Briefing Notes on Part 13

Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back

INTRODUCTION

Part 13 (Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back) of the new Companies Ordinance ("the new CO") contains provisions relating to schemes of arrangement or compromise with creditors or members, reconstructions or amalgamations of companies, and compulsory acquisitions of shares following a takeover offer or following a general offer for a share buy-back.

POLICY OBJECTIVES AND MAJOR CHANGES

2. This Part largely restates the relevant provisions under the Companies Ordinance (Cap. 32) ("Cap. 32"). However the following changes that aim at facilitating business have been introduced –

(a) revising the definitions of "property" and "liabilities" in the provisions for facilitating reconstructions and amalgamations (paragraphs 15 to 17 below);

(b) introducing a new court-free statutory amalgamation procedure for wholly-owned intra-group companies (paragraphs 18 to 22 below);

(c) clarifying the meaning of "takeover offer", "shares already held by the offeror" and "shares to which the offer relates" in a takeover (paragraphs 23 to 27 below);

(d) introducing new provisions to allow a revised offer to be treated as the original offer so long as certain specified conditions are met (paragraphs 28 to 29 below); and

(e) introducing new provisions to allow an offeror in a takeover offer or share buy-back offer to apply to the court for an authorization to give squeeze out notices (paragraphs 30 to 32 below).

3. The "headcount test" for approving a scheme of arrangement that involves a general offer or a takeover offer is replaced with the requirement that the votes cast against the scheme do not exceed 10% of the voting rights attached to all disinterested shares. The test is retained for other schemes but the court is given a new discretion to dispense with the test for members' schemes that retain the test (paragraphs 5 to 14 below).

4. The details of the major changes in Part 13 are set out in paragraphs 5 to 32 below.

Replacing the "headcount test" for approving certain schemes of arrangement with a new test and giving the court a new discretion to dispense with the test for members' schemes that retain the test (sections 673, 674 and 676)

Position under Cap. 32

5. Section 166 of Cap. 32 provides that where a scheme is proposed between a company and its members or creditors or any class of them, the court may order a meeting of the members or creditors or a class of them to be summoned. The section also provides that if a majority in number ("headcount test") representing three-fourths in value ("share value test") of the creditors or members (or classes of creditors or members) present and voting at the meeting agree to the proposed scheme, the scheme shall, if sanctioned by the court, be binding on all members or creditors and the company.

6. The court has the discretion not to sanction a scheme even though it has been approved under both the share value test and the headcount test (for instance, where there is doubt that the process has been unfairly administered, such as where the approval under the headcount test was achieved by share splitting). Nevertheless, the court does not have the jurisdiction to sanction a scheme where the headcount test had not been passed even in the event that share splitting has increased the headcount of members opposing the scheme.

Position under the new CO

7. There were divergent views expressed by the respondents during the public consultation on the draft Companies Bill ("CB") regarding the abolition or retention of the headcount test for members' schemes. In particular, there is concern that the abolition may undermine the protection of the interests of minority shareholders. For public and listed companies, while the Code on Takeovers and Mergers ("Takeovers Code") offers some protection for minority shareholders, it is intended to supplement, but not substitute, the statutory protection in Cap. 32. Rule 2.10(b) of the Takeovers Code stipulates that the number of votes cast against the resolution shall not be more than 10% of the voting rights attached to all disinterested shares, i.e. shares not held by the controlling shareholders or their connected parties.

8. The Bills Committee on the CB of the Legislative Council held in-depth discussions on the headcount test and invited deputations to give views on the test. The majority view among the deputations is to abolish the headcount test. The main concerns are that the test is contrary to the "one share, one vote" principle and it has inherent problems, such as vote manipulation through share splitting and the difficulty to reflect the wish of the overwhelming majority of listed shares held in the names of nominees and custodians.

9. On the other hand, there is also a general consensus that, given the binding nature of these schemes, there should be adequate safeguard to protect the interest of the minority shareholders. If the headcount test is abolished without any replacement safeguard, the only test will be the share value test. In terms of the level of statutory protection for minority shareholders, this is incommensurate with the binding nature of the schemes.

10. To strike a reasonable balance, the headcount test is replaced with a new test based on the concept of the 10% objection rule of the Takeovers Code for certain members' schemes. For other members' schemes that retain the headcount test, the court is given a new discretion to dispense with the test in special circumstances, such as where there is evidence that the result of the vote has been unfairly influenced by share splitting.

11. As for creditors' schemes, the concern for vote manipulation and problems arising from nominee shareholdings do not exist. It is desirable to retain the headcount test to protect small creditors. As it is unlikely for small creditors who oppose a proposed scheme to manipulate the outcome of voting by assigning part of their debts to other persons, there is therefore no need to extend the court's discretion to dispense with the headcount test to cover creditors' schemes.

Key provisions in the new CO

12. **Sections 673 and 674(1)** basically restate section 166 of Cap. 32. **Section 674(1)(c)(ii) and (d)(ii)** gives the court a discretion to dispense with the headcount test for members' schemes that retain the headcount test.

13. **Section 674(2)(a)(ii) and (b)(ii)** sets out the new requirement that replaces the headcount test. It provides that the number of votes cast against the resolution to approve a scheme of arrangement is not more than 10% of the votes attached to all disinterested shares. The new requirement would apply to the following two types of schemes of arrangement –

(a) takeover offer within the meaning of section 674(5); and

(b) general offer for share buy-back within the meaning of section 707.

"Disinterested shares" is defined in **section 674(3)** and basically means shares held by non-interested parties. Parties that may be included as "interested parties" are: (a) the company which makes the buy-back offer and the non-tendering member, plus their associates and nominees; and (b) the offeror and his associates and nominees. The term "associate" is defined in section 667.

14. To address the concern that minority shareholders are reluctant to challenge a scheme in Court because of the potentially huge legal costs, **section 676(5)** provides that a dissenting member may be ordered to pay legal costs only if his opposition to the scheme is frivolous or vexatious.

Revising the definitions of "property" and "liabilities" in the provisions for facilitating reconstructions and amalgamations (section 675)

Position under Cap. 32

15. Section 167(4) of Cap. 32 defines "property" as including "property, rights and powers of every description" and "liabilities" as including "duties". Based on decided cases, a transfer order made under section 167 to facilitate reconstructions and amalgamations is unable to operate to transfer a contract of personal service. As a result, contracts of employment are not transferable under the section.

Position under the new CO

16. Personal rights and duties, which could not have been transferred and assigned unless with the consent of the parties concerned, may be transferred or assigned once a transfer order is made.

Key provisions in the new CO

17. **Sections 668 to 677** basically restate with modifications the provisions on schemes of arrangements in sections 166, 166A and 167 of Cap. 32, except the headcount test (see paragraphs 12 to 14 above). **Section 675** sets out additional powers which the court may exercise to facilitate reconstructions or amalgamations of companies. In particular, **section 675(8)** defines **"**property" as including rights and powers of a personal character and incapable of being assigned or performed vicariously under the law; and rights and powers of any other description. "Liabilities" is defined as including duties of a personal character and incapable of being assigned or performed vicariously under the law; and duties of any other description.

Introducing a new court-free statutory amalgamation procedure (sections 678 to 686)

Position under Cap. 32

18. Under Cap. 32, companies intending to amalgamate have to resort to the procedures under sections 166 to 167 which require court sanction. In practice, sections 166 to 167 are rarely used given the high cost involved.

Position under the new CO

19. A court-free regime for amalgamations is provided in Division 3. To minimise the risk of abuse, the court-free regime is confined to amalgamations of wholly-owned intra-group companies where minority shareholders' interest would normally not be an issue.

Key provisions in the new CO

20. **Sections 680 and 681** provide that an amalgamation may either be vertical (i.e. between the holding company and one or more of its wholly-owned subsidiaries) or horizontal (i.e. between two or more subsidiaries of the same holding company). The board of each amalgamating company must make a statement (i) to confirm that the assets of the amalgamating company is not subject to any floating charge, or if there exists a floating charge, the chargee has consented to the amalgamation proposal, and (ii) to verify the solvency of the amalgamating company as well as the amalgamated company. Details of the solvency statement are set out in **section 679**. The amalgamation proposal must be approved by the members of each amalgamating company by special resolution.

21. As the effect of amalgamation is that the amalgamated company takes the benefits and is subject to the liabilities of the amalgamating companies (**section 685(3)**), this poses a problem when two or more of the amalgamating companies have floating charges subsisting over their respective assets in favour of different security holders. There will be a question of priorities between the competing security holders over the assets of the amalgamated company, which may result in unfairness between the security holders. The written consents of the holders of the floating charges are therefore required (**sections 680(2)(d)(ii) and 681(2)(d)(ii)**).

22. **Section 686** provides that before the effective date of the amalgamation proposal, the court may disallow or modify the amalgamation proposal or give directions, if it is satisfied that giving effect to the amalgamation proposal would unfairly prejudice a member or creditor of an amalgamating company or a person to whom an amalgamating company is under an obligation, on application by a member or creditor of an amalgamating company or such a person. This is to protect the interests of the minority shareholders and creditors in the course of the amalgamating process.

Clarifying the meaning of "takeover offer", "shares already held by the offeror" and "shares to which the offer relates" in a takeover (sections 689, 691, 707 and 709)

Position under Cap. 32

23. Section 168 of Cap. 32, together with the Ninth Schedule to Cap. 32, deal with the compulsory acquisition of shares following a takeover. Section 168 applies, inter alia, where a company makes an offer to acquire all the shares not already held by it in another company on terms which are the same in relation to all the shares to which the offer relates. There are no clear definitions of what would constitute "shares already held by an offeror" and "shares to which the offer relates".

Key provisions in the new CO

24. The meaning of the above terms is clarified in the new CO. **Section 689(1)** defines a takeover offer. First, it must be an offer to acquire all the shares (or shares of any class) in the company except those that, at the date of the offer, are held by the offeror. Secondly, in relation to all the shares to which the offer relates (or all the shares of the class to which the offer relates), the terms of the offer must be the same.

25. **Section 689(3)** provides that "shares that are held by an offeror" include shares that the offeror has contracted, unconditionally or conditionally to acquire, but exclude shares that are subject to a contract which is intended to secure that the holder of the shares will accept the offer when it is made and entered into for no consideration and by deed, for consideration of negligible value, or for consideration consisting of a promise by the offeror to make the offer.

26. **Sections 689 and 691** clarify that shares to which a takeover offer relates may include:

(a) shares that are allotted after the date of the offer but before a date specified in the offer (**section 689(6)**);

(b) shares which the offeror acquires or contracted to acquire other than by virtue of acceptances of the offer during the offer period unless the acquisition consideration exceeds the consideration specified in the terms of the offer (**section 691(2)**); and

(c) shares which a nominee or an associate of the offeror has contracted to acquire after a takeover offer is made but before the end of the offer period, unless the acquisition consideration exceeds the consideration specified in the offer (**section 691(4)**).

27. **Sections 707(1), 707(3) and 709** contain similar provisions in relation to compulsory acquisition powers following a share buy-back offer.

Introducing new provisions to allow a revised offer to be treated as the original offer so long as certain specified conditions are met (sections 692 and 710)

Position under Cap. 32

28. Cap. 32 does not have any provision on revised offers to provide for unexpected changes of circumstances after the making of an offer. As a result, an offeror who wishes to revise his offer will have to make a new takeover or share buy-back offer and address the acceptances received under the old offer.

Key provisions in the new CO

29. **Section 692** provides that a revision of the terms of a takeover offer is not regarded as the making of a fresh offer if the terms of the offer provide for the revision and the acceptances on the previous terms to be regarded as acceptances on the revised terms; and the revision is made in accordance with that provision. **Section 710** contains a similar provision in the case of a share buy-back offer.

Introducing new provisions to allow an offeror in a takeover offer or share buy-back offer to apply to court for an authorization to give squeeze out notices (sections 693 and 712)

Position under Cap. 32

30. Under Cap. 32, there is no mechanism for an offeror to apply for a court order authorising the giving of squeeze out notices for those takeover or buy-back offers which failed to achieve the applicable threshold for giving of such notices because of untraceable shareholders related to the offer.

Position under the new CO

31. A mechanism for an offeror to apply to the court for authorisation to give squeeze out notices in the above situation is provided in the new CO. Such a mechanism has been adopted in the United Kingdom since 1987 and is considered to be practical and useful.

Key provisions in the new CO

32. **Section 693(3) to (7)** provides for the mechanism which will apply if the offeror has been unable to trace the relevant shareholders after reasonable enquiry. The consideration offered must be fair and reasonable and the court may not make an order unless it considers that it is just and equitable to do so having regard, in particular, to the number of shareholders who have been traced but have not accepted the offer. **Section 712(4) to (8)** provide for a similar mechanism in the case of a share buy-back offer.

TRANSITIONAL AND SAVING ARRANGEMENTS

33. Transitional and saving arrangements are set out in **sections 122 and 123 of Schedule 11** to the new CO and are basically as follows :

- Sections 166, 166A and 167 of Cap. 32 and rule 117 of the Companies (Winding-up) Rules continue to apply to an arrangement or compromise if an application was made to the Court for a meeting to be summoned before the commencement of Division 2 of Part 13.

- Section 168(1), (2) and (3) and the Ninth Schedule to Cap. 32 continue to apply to an acquisition offer made before the commencement of Division 4 of Part 13.

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