

CHAPTER 2

FINANCIAL ASSISTANCE BY A COMPANY FOR ACQUISITION OF ITS OWN SHARES

- 2.1 We have streamlined the financial assistance provisions in a manner similar to the NZCA in the CB. The details can be found in the Explanatory Notes on Part 5 and the draft clauses in Division 5 of Part 5 of the CB. We would however like to seek comments on the option of abolishing the prohibition on financial assistance¹¹ for private companies, as an alternative to the said new rules on financial assistance.

Background

- 2.2 Section 47A of the CO imposes a broad prohibition on a Hong Kong company (and its subsidiaries) giving financial assistance to a party (other than the company itself) 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 passing a solvency test and subject to a special resolution of the shareholders (section 47E)¹². One of the purposes of the prohibition is to prevent the resources of a company and its subsidiaries being used to assist a purchaser of the shares in the company which might be prejudicial to the interests of creditors or shareholders not involved in the relevant acquisition.
- 2.3 However, the rules on financial assistance have become so complex and the case law has imposed an increasingly broad interpretation on the prohibition such that companies would have to incur substantial costs and expenses to try to understand the rules so as to ensure that the rules are not violated. In some cases, directors acting in good faith involved in transactions intended for the benefit of the company but unwary of the prohibition may be caught without even knowing that they had violated the law. We believe this is particularly relevant to private companies which have relatively fewer resources and may not always be able to afford the cost of obtaining legal advice.

¹¹ The financial assistance prohibition referred to in this Chapter is the prohibition under the CO against the provision by a Hong Kong company (or any of its subsidiaries) of financial assistance for the purpose of acquiring the shares in the Hong Kong company. This is different from the requirements relating to the giving of "financial assistance" in Listing Rules (e.g. in chapters 13, 14 & 14A), which are requirements imposed on the giving of "financial assistance" in a general sense (e.g. granting credit, lending money, providing security for, or guaranteeing a loan) and not just relating to the acquisition of a company's own shares.

¹² The assistance must be provided out of distributable profits to the extent that the net assets are reduced by the assistance.

- 2.4 The possibility of innocuous transactions being penalised by the prohibition has caused some concern. A case in point is where a payment by a company's subsidiary of a small fee for preparing an accountant's report for a genuine arms length acquisition of its holding company's shares was considered to be unlawful for breach of the rule prohibiting financial assistance¹³. The acquisition was clearly in the shareholders' interest, was not prejudicial to the company, and carried no additional risks for its creditors¹⁴. The directors in this case were found to be in breach of their fiduciary duties to the company and held personally liable to restore the amount of the assistance to the company. As seen in this case, the most difficult area of the financial assistance rules is identifying financial assistance (which may sometimes be referred to as "a trap for the unwary"), rather than what to do about it once it has been identified¹⁵. Indeed, if the fee concerned had been paid by the holding company, no question of financial assistance would probably have arisen¹⁶.
- 2.5 In the topical public consultation¹⁷ conducted in the third quarter in 2008, we asked whether the current financial assistance provisions should be streamlined in a manner similar to the NZCA. While respondents generally considered that the current provisions should not be retained as they are, views were divided on the changes to be introduced, with a slight majority proposing that the current financial assistance provisions should be streamlined in a manner similar to the NZCA. Quite a number of respondents supported the abolition of the prohibition in respect of private companies (as the UK has done) to remove complex and costly procedures.
- 2.6 We have attempted to streamline the financial assistance provisions in a manner similar to the NZCA. The details are set out in Division 5 of Part 5 of the CB and the relevant Explanatory Notes on Part 5. Generally

¹³ *Chaston v SWP Group Ltd* [2003] 1 BCLC 675.

¹⁴ See Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (London: Sweet & Maxwell, 8th edn, 2008), page 347, at paragraph 13 to 30.

¹⁵ See Nigel Davis, "Financial Assistance: Time for a Little Recap and a Lot of Reform", *Hong Kong Lawyer*, August 2007, pages 49 to 55, which discusses the problems associated with the financial assistance rules.

¹⁶ This is because the fees only came within the statutory definition of "financial assistance" because the assistance was of a type which materially reduced the net assets of the company. The subsidiary held few assets and so the fees were relatively significant compared with the subsidiary's assets. But the fees would not have been significant compared with the assets of the holding company. So if the holding company had paid the fees, the assistance would not have been caught by the statutory definition. See Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (London: Sweet & Maxwell, 8th edn, 2008), page 346, at footnote 248.

¹⁷ See FSTB, *Consultation Paper on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (July 2008), paragraphs 3.35 to 3.41 and *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009), paragraphs 48 to 51 (available at http://www.fstb.gov.hk/fsb/co_rewrite).

speaking, a company will be allowed to give financial assistance¹⁸, regardless of the source of funds, subject to satisfaction of the solvency test and compliance with requisite procedures applicable to the following three scenarios where:

- (a) the amount of financial assistance will not exceed 5% of the shareholders' fund (**Clause 5.79**);
- (b) unanimous approval of the shareholders is obtained for the financial assistance (**Clause 5.80**); or
- (c) a notice is given to shareholders regarding the financial assistance and allowing shareholders to object to the court (**Clauses 5.81 to 5.85**).

In each case, the financial assistance must also be in the interests of the company.

2.7 Adopting the New Zealand model does not completely address the issue of the provisions being “a trap for the unwary”, particularly for private companies which have fewer resources and the costs of obtaining legal advice could be a heavy burden for them. While we are open to comments on how the financial assistance rules can be further streamlined, there appears to be grounds for revisiting the option of abolishing the financial assistance rules for private companies. We would like to invite further public views on the option of abolishing the restrictions on financial assistance for private companies before taking a final decision.

Considerations

2.8 We need to strike a reasonable balance between two concerns, namely (a) addressing the problem of a “trap for the unwary”, particularly for private companies; and (b) preserving the protection for small investors, which is particularly relevant to public companies.

2.9 It may be argued that only the abolition option can offer a satisfactory solution to the problem of “a trap for the unwary”, especially for private companies. Streamlining the provisions would simplify the “whitewash” procedures and benefit the well advised, but probably not private companies which may not always be able to afford the costs of obtaining legal advice.

¹⁸ There are certain qualifications and exceptions to financial assistance (such as the principal purpose exception, the distribution of dividends lawfully made, the lending of money in the ordinary course of business or pursuant to an employee share option scheme). Financial assistance within these exclusions or carve-outs are not prohibited, and consequently do not need authorisation via the solvency based procedures in subdivision 4 in Division 5 in Part 5. See subdivision 3 in Division 5 in Part 5 for these exceptions.

- 2.10 Some jurisdictions have opted for abolition of the financial assistance prohibition. The financial assistance prohibition has long been abolished in the United States and a number of provinces in Canada (British Columbia, Alberta, Ontario and Québec). It was repealed in its entirety in the federal Canada Business Corporations Act in 2001. More recently the UK abolished it for private companies. It has been retained for public companies, largely because the Second European Community Directive was thought to stand in the way of a full elimination¹⁹.
- 2.11 In considering whether the financial assistance rules should be abolished for private companies, it is worth mentioning that the prohibition on financial assistance was a statutory development and was not enunciated by the 19th century judges as part of the capital maintenance regime and may not have any impact on the company's legal capital. If a company lends money to someone to purchase its shares, the company's share capital, share premium account and capital redemption reserve²⁰ will not be in any way altered by that loan or by the subsequent purchase of the shares. Nor does the rule on financial assistance necessarily reduce the company's net asset position. If the borrower is able to repay the loan, the company is simply replacing one asset (cash) with another (loan) and possibly the latter will earn the company a higher rate of return²¹.
- 2.12 There are two propositions that we need to consider before deciding whether to keep the financial assistance rules in respect of private companies in the statute. First, can we identify any problem that would not be effectively dealt with by other company law rules? Second, even if a problem or a gap is identified and the only way to deal with this gap is by the financial assistance rules, are we sure that the benefit is not outweighed by the cost of striking down innocuous transactions?
- 2.13 For the first question, it may be argued that the risks posed by unwise or unscrupulous financial assistance are, currently, sufficiently covered by other more targeted legal provisions, such as directors' fiduciary duties and the duty of care, the requirements for exercise of directors' powers for proper purposes and minority shareholder remedies²².

¹⁹ Maisie Ooi, "The Financial Assistance Prohibition: Changing Legislative and Judicial Landscape", [2009] *Singapore Journal of Legal Studies* 135, 142.

²⁰ We proposed in Part 4 of the CB to adopt a mandatory system of no-par for all companies with a share capital, with a transition period of not less than 24 months. Without par, there will no longer be share premium and capital redemption reserve. See Explanatory Notes on Part 4 for details.

²¹ See Paul L Davies, Gower and Davies' *Principles of Modern Company Law* (London: Sweet & Maxwell, 8th edn, 2008), page 342, at paragraphs 13 to 26.

²² This view is shared by the UK Company Law Review Steering Group; see UK Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework* (March 2000), pages 232 to 234.

- 2.14 It should be noted that a number of improvements to be made to these provisions in the CB are being considered. These improvements include:
- (a) codifying directors' duty of care, skill and diligence;
 - (b) enhancing corporate governance such as in the area of connected transactions involving directors and their associates; and
 - (c) enhancing the rules on shareholder remedies, including improving the operation of the unfair prejudice remedy and statutory derivative action²³.

Moreover, we intend to introduce a duty on directors to prevent insolvent trading under the legislative proposals for a corporate rescue procedure²⁴. The insolvent trading provisions, if adopted, will create a substantial disincentive for directors to sanction financial assistance which reduces the company's assets in a way that endangers creditors. When these improvements are in place, there would be a more robust regulatory scheme to tackle the risks currently dealt with by the financial assistance rules.

- 2.15 For the second question, as the UK Company Law Review Steering Group has noted, it seems anomalous to target specifically one possible violation of directors' duties or oppression of minorities, particularly where to do so may well inhibit a range of transactions which do not harm third parties and which benefit the company²⁵. Taking into account the developments mentioned in paragraphs 2.13 and 2.14 above, it follows that there is a strong argument for abolishing the financial assistance rules for private companies. Abolition of the restrictions on financial assistance would result in savings to private companies in time and costs that would be incurred in carrying out the "whitewash" procedure, without adversely affecting the protections for their shareholders and creditors.
- 2.16 The considerations for public companies (including both listed and unlisted public companies) may be somewhat different. When reviewing the CO in 2000, the SCCLR noted that the rationale of the financial assistance provisions was to prevent looting of a company by bidders in leveraged takeovers and that the primary concern was for minority shareholders who

²³ See FSTB, "Chapter 2, Enhancing Corporate Governance", *Consultation Paper on Draft Companies Bill First Phase Consultation* (December 2009), particularly paragraphs 2.4 to 2.7 and 2.22 to 2.24.

²⁴ FSTB, "Chapter 6: Insolvent Trading", *Consultation Paper on Review of Corporate Rescue Procedure Legislative Proposals* (October 2009).

²⁵ See footnote 22, paragraph 7.24 at page 233.

remained in the company after a successful takeover²⁶. As a safeguard for small investors, it seems doubtful whether we should go so far as abolishing the financial assistance rules in respect of public companies altogether. Moreover, the concern about the provisions being “a trap for the unwary” is less relevant to public companies as they should have the resources to obtain legal advice, where necessary.

2.17 There appears to be two possible options for public companies:

- (a) maintaining the status quo, i.e. listed companies would continue to be prohibited from giving financial assistance except for certain exceptions as set out in sections 47C and 47D of the CO (largely equivalent to Subdivision 3 of Division 5 in Part 5 of the CB) while unlisted public companies may give financial assistance subject to a solvency test and a special resolution of the shareholders (section 47E of the CO); or
- (b) adopting the streamlined approach using a solvency test as currently drafted in Division 5 in Part 5 of the draft CB for both listed and unlisted public companies.

We are inclined towards (b). Nevertheless, we would like to listen to public comments before taking a final view.

2.18 On the other hand, if it is considered that financial assistance restrictions are still a useful regulatory tool to protect the interests of creditors and minority shareholders in all public and private companies, comments on whether the draft clauses in Division 5 in Part 5 would achieve the purpose and whether they could be further streamlined are welcome.

Question 1

- (a) Do you agree that the restrictions on financial assistance should be abolished for private companies?**
- (b) If your answer to (a) is positive, which of the following options concerning regulation of listed and unlisted public companies would you prefer –**

²⁶ SCCLR, *The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance* (February 2000), paragraph 9.92. On the other hand, the SCCLR also noted in the Report the defects of the existing provisions: they are cumbersome, difficult to apply and result in unnecessary costs; they sometimes result in the non-completion of transactions which would be economically beneficial; and parties determined to circumvent the current prohibitions can succeed in so doing.

(i) existing rules for listed and unlisted public companies in the CO be retained (i.e. listed companies cannot give financial assistance except for certain exceptions as set out in sections 47C and 47D of the CO while unlisted public companies may give financial assistance subject to solvency test and a special resolution of the shareholders (section 47E of the CO));

(ii) the rules for both listed and unlisted public companies to be streamlined using a solvency test as set out in the draft clauses in Division 5 of Part 5; or

(iii) any other option (please elaborate),

having regard to the need to protect small investors of public companies?

(c) If your answer to (a) is negative (i.e. you believe that private companies should still be subject to certain restrictions on financial assistance), do you have any specific comments on the draft clauses in Division 5 of Part 5? Please elaborate.