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SOLICITORS

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Key Changes under the New Companies Ordinance

Part Two – Share Capital, Transactions Involving Share Capital and Share Transfers

Introduction

The New Companies Ordinance (Cap. 622) (the **New CO**) will come into force on 3 March 2014. Following commencement of the New CO, the current Companies Ordinance (Cap. 32)(the **Old CO**) will be retitled as the "Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)". The core provisions affecting the operation of companies under the Old CO will be repealed, except those provisions relating to winding-up and insolvency of companies and prospectuses.

Charltons is preparing a series of newsletters summarising the key changes to the company law framework under the New CO. In this second newsletter, we discuss the key changes in respect of share capital (in particular, abolition of par value), transactions involving share capital (such as capital reductions, buy backs and financial assistance), and registration of share transfers.

Abolition of Par Value Of Shares

New CO references: section 135 and 170; part 4, division 2 of Schedule 11

Position under the Old CO

Companies incorporated in Hong Kong under the Old CO and having a share capital are required to have a par value ascribed to their shares. Generally, par value is the minimum price at which shares can be issued.

Key changes under the New CO

The New CO adopts a mandatory system of no-par for all Hong Kong companies with a share capital and abolishes the concept of par (or nominal) value of shares. On the commencement of the New CO, a Hong Kong company's shares will have no nominal value. This will apply to all shares, including shares issued before that date. Concepts such as par value, share premium and the requirement for authorised capital will be redundant following the migration to no par, and will be abolished.

The New CO provides that the amount of authorised capital set out in an existing company's constitutional documents is deemed to be deleted.

Schedule 11 to the New CO sets out transitional arrangements and deeming provisions so that existing companies will not need to take steps to change their existing share capital and constitutional documents to reflect the no-par regime, and to ensure that contractual provisions that reference par value and related concepts will not be affected by the abolition of par.

For contracts, resolutions, trust deeds and other documents executed before the commencement date of the New CO, any express or implied reference to par or nominal value will be deemed to be a reference to nominal value immediately before the commencement date of the New CO.

From the commencement date, any amount in the share premium account and any amount in the capital redemption reserve will become part of the company's share capital. The current permitted uses of share premium will be preserved for any such amounts in the share premium account immediately before the commencement date.

The liability of a shareholder for calls on partly paid shares issued before the commencement date (whether the amounts due are in respect of nominal value or premium) will not be affected.

Practical considerations and recommended steps

The migration to no-par should benefit companies by giving them greater flexibility in structuring their share capital. The nature of a share will still be the same whether or not it has a par value, in that a share will still represent a fraction of ownership in a company. The concepts of paid up capital, issued capital and partly paid shares will also still be relevant.

Alteration of share capital

Section 170 of the New CO sets out the various methods by which a company can alter its share capital (other than by redemption or repurchase of shares), including issuing new shares, capitalising profits, issuing bonus shares and effecting a share split or a share consolidation. A company must submit notice of any alteration of share capital to the Registrar of Companies in Hong Kong (the **Registrar**), which notice must include a statement of capital setting out the number of shares in issue and the amount of the share capital.

Issuing new shares for consideration

If a company issues new shares for consideration, then the full proceeds will be credited to the share capital account.

As the concept of par value has been abolished, there is now no minimum price at which shares must be issued, or indeed any statutory control over the setting of the issue price of shares. However, directors will still have an overriding fiduciary duty to set the price in good faith. It may also be necessary to obtain shareholders' approval before issuing new shares, if the shares are not allotted under an offer made to all members of the company in proportion to their holdings (i.e. a rights issue).

Maximum number of shares that may be issued

As the concept of authorised share capital is being abolished, there will be no limit on the number of shares that the directors can issue. However, if shareholders so wish, they can amend the articles of association by way of special resolution to specify a maximum number of shares that may be issued. The maximum number of shares that a company may issue can be changed by way of ordinary resolution.

Issuing bonus shares

When a company issues bonus shares under the "no-par" regime, such shares will have no nominal value, meaning the company is no longer required to transfer an amount to share capital if it issues shares for no consideration, unless it elects to do so (for example, by capitalising profits). Therefore, a company may allot and issue bonus shares either with or without increasing its share capital. Shareholder approval would not be required for a bonus issue, provided the issue is to members of the company in proportion to their shareholdings.

Consolidation and subdivision of shares

Companies will continue to be able to consolidate and subdivide shares. Although 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 can be effected by reducing the number of shares with no visible effect on the share capital.

Amendments to constitutional documents and contracts

Notwithstanding the transitional arrangements described above, companies may wish to review their particular situation to determine if they need to introduce specific changes to company documents (such as the articles of association, contracts and share certificates) to reflect the abolition of the par value regime. Also, while the transitional arrangements provide legal safeguards in respect of contracts that reference par value (and related concepts) under Hong Kong law, they may not necessarily be applied by courts outside Hong Kong, particularly if the governing law of the relevant contract is not Hong Kong law. Such contracts may need to be reviewed to determine whether clarifying amendments should be requested. An example would be a preferential dividend or liquidation preference payable to a holder of preferred shares up to the amount of the nominal value of each share. Such rights are often set out in a subscription or shareholders' agreement, as well as the constitutional documents of the company.

Shareholder Consent for Grants of Options and Other Equity Linked Securities

New CO references: sections 140 and 141

Position under the Old CO

Under the Old CO, directors may only allot new shares (other than rights issues and allotments to founder members) with prior approval of the company in general meeting. However, the Old CO does not require shareholders' approval for the grant of an option to subscribe for shares or a right to convert any securities into shares. Only the subsequent exercise of the option or the right of conversion that would result in an allotment requires shareholders' approval.

Position and key provisions in the New CO

Sections 140 and 141 of the New CO extend the requirement of shareholders' approval for allotments of shares to the grants of rights to subscribe for, or to convert securities into, shares. If approval is given for the grant of the right, there will be no need to obtain further approval of the allotment of shares pursuant to exercise of that right.

Practical considerations and recommended steps

It will be useful for both companies and rights holders to deal upfront with shareholder approval for the granting of the right, rather than dealing with the issue subsequently when the right is exercised, at a time when the shareholding structure may have changed and / or shareholder approval may not be forthcoming for a variety of reasons.

Uniform Solvency Test for Share Capital Transactions

New CO references: sections 204 to 206

Position under the Old CO

The Old CO established solvency tests for share buy-backs out of capital and financial assistance by an unlisted company for the purpose of acquiring its own shares (or the shares of its holding company). The solvency tests were based on cash flow, with minor differences between them. In particular, for buy-backs, the solvency statement has to be accompanied by an auditors' report.

Key changes under the New CO

The New CO establishes a uniform solvency test for buy-backs, financial assistance and reductions of capital. Under section 205 of the New CO, a company satisfies the solvency test in relation to a particular transaction if:

- immediately after the transaction there will be no ground on which the company could be found to be unable to pay its debts; and
- either:
    - ◊ if it is intended to commence the winding up of the company within 12 months after the date of the transaction, the company will be able to pay its debts in full within 12 months after the commencement of the winding up; or
    - ◊ in any other case, the company will be able to pay its debts as they become due during the period of 12 months immediately following the date of the transaction.

Section 206 further requires the directors of a company to make a "solvency statement" to the effect that the directors have formed the opinion that the company satisfies the solvency test in relation to a particular transaction. 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.

Under the New CO, there is no longer any requirement to attach an auditors' report to the solvency statement.

Practical considerations and recommended steps

The uniform solvency test changes described above will apply to activities carried out after the commencement date of the New CO. For activities started under the Old CO and in progress when the New CO commences, the Old CO provisions will continue to apply (sections 42 to 47 of Schedule 11 to the New CO).

Financial Assistance

New CO references: sections 274 to 289

Position under the Old CO

The Old CO prohibits a company and its subsidiaries from giving financial assistance for the purpose of acquiring shares in the company, subject to certain exceptions.

Key changes under the New CO

The New CO retains the definition of financial assistance in the Old CO. The New CO also substantially retains the exceptions to the prohibition in section 47C of the Old CO, such as the "principal purpose exception", distribution of the company's assets by way of dividend or on a winding up, allotments of bonus shares, and reductions of share capital, redemptions and buy-backs in accordance with the New CO. The New CO also retains the special restrictions for listed companies in section 47D of the Old CO, allowing financial assistance only if a listed company has net assets that are not reduced by the giving of the financial assistance or, to the extent such net assets are reduced, the assistance is made out of distributable profits.

All types of companies allowed to provide financial assistance, subject to satisfaction of solvency test and certain procedures

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 following three procedures:

- Procedure 1: financial assistance permitted 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.

- Procedure 2: financial assistance permitted 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.

- Procedure 3: financial assistance permitted if 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 assistance may only be given not less than 28 days after the resolution is passed. 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 assistance.

In each case, the assistance must be given within 12 months after the solvency statement is made.

Employee share schemes

The New CO also relaxes the rules on giving of financial assistance for the purposes of employee share schemes. While the Old CO only allows financial assistance for the purchase or subscription of fully paid shares, section 280 of the New CO 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.

<u>Non-Hong Kong holding companies</u>

The New CO clarifies that a company is not prohibited from giving financial assistance for the purpose of an acquisition of shares in its holding company, if the holding company is incorporated outside Hong Kong.

However, there is no clarification that the giving of financial assistance by a non-Hong Kong subsidiary for the purpose of an acquisition of shares in its Hong Kong holding company is not prohibited. As the definition of "subsidiary" in the New CO is not limited to companies formed and registered under the New CO (referring instead to "body corporates"), the prudent view would be that non-Hong Kong subsidiaries are caught by the prohibition.

Practical considerations and recommended steps

The New CO will facilitate transactions involving financial assistance by abolishing the current complicated whitewash exemption procedure and replacing it with a choice of three approval mechanisms that can be used by both listed and non-listed companies.

Directors do not need to obtain an auditors' report or rely on audited accounts when making a solvency statement to support financial assistance in a particular case. However, directors are still expected to have reasonable grounds in forming their opinion as to the company's solvency. Directors must therefore make due enquiries as to the company's state of affairs and prospects before signing the solvency statement. In some cases, directors may decide that professional assistance (for example, from auditors or financial advisers) is needed. However, the additional expenses and delays in engaging third party advisers may not be appropriate in all cases. Third party advisers may not be in a better position than the directors in ascertaining the company's solvency, which involves forward-looking business judgments. In the resolutions approving the financial assistance, the board should clearly set out its bases for forming the opinion that the company satisfies the solvency test in relation to the particular transaction.

As with the changes relating to the new solvency test for all share capital transactions, the financial assistance changes will apply to activities carried out after the commencement date of the New CO. For activities started under the Old CO and in progress when the New CO commences, the Old CO provisions will continue to apply (section 46 of Schedule 11 to the New CO).

Alternative Court-Free Procedure for Reduction of Capital Based On Solvency Test

New CO references: sections 215 to 225

Position under the Old CO

The Old CO only allows a reduction of share capital if approved by way of shareholders' special resolution <u>and</u> a court approves the reduction (although 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).

Key changes under the New CO

<u>Court-free procedure for capital reductions</u>

While retaining a court-sanctioned procedure for capital reductions, the New CO introduces an alternative court-free procedure based on a solvency test. The main features of the court-free procedure include the following:

- all the directors need to sign the solvency statement in support of the proposed reduction;
- the company needs to obtain shareholders' approval by way of special resolution;

- the company must publish notices in the Gazette and newspapers and must register the solvency statement with the Registrar; and
- any creditor or non-approving shareholder may, within five weeks after the special resolution is passed, apply to the court for cancellation of the resolution.

Treatment of reserves

It is unclear under the Old CO whether reserves created arising from a reduction of share capital can be regarded as distributable reserves. Section 214 of the New CO clarifies that reserves arising from a reduction of share capital may be regarded as realised profits.

Practical considerations and recommended steps

The directors are expected to have reasonable grounds in forming their opinion as to the company's solvency. Directors must therefore make due enquiries as to the company's state of affairs and prospects before signing the solvency statement. In some cases, directors may decide that professional assistance (for example, from auditors or financial advisers) is needed.

Allowing All Companies to Buy Back Shares Out Of Capital, Subject To Solvency Test

New CO references: sections 257 to 266

Position under the Old CO

Under the Old CO, a company can generally only buy back its shares using distributable profits or using the proceeds of a fresh issue of shares. There is an exception for private companies, which may fund a buy-back by payment out of capital based on a solvency test.

Key changes under the New CO

Under the New CO, all companies are allowed to fund buy-backs out of capital, subject to a solvency requirement. Sections 258 to 266 retain most of the Old CO 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 above, and include the following key features:

- all the directors need to sign the solvency statement in support of the proposed payment out of capital;
- the company needs to obtain members' approval by a special resolution of disinterested shareholders passed within 15 days after the date of the solvency statement;
- the company must publish notices in the Gazette and newspapers and must register the solvency statement with the Registrar;
- any creditor or non-approving shareholder may, within five weeks after the special resolution is passed, apply to the court for cancellation of the resolution; and
- the buy-back must be made no earlier than five weeks and no later than seven weeks after the special resolution is passed (subject to any court application by a creditor or dissenting shareholder).

Section 257 of the New CO 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.

Practical considerations and recommended steps

As noted above, the New CO removes the existing requirement for an auditors' report to be prepared when funding a buy-back out of capital. However, the directors are still expected to have reasonable grounds in forming their opinion as to the company's solvency. Directors must therefore make due enquiries as to the company's state of affairs and prospects before signing the solvency statement. In some cases, directors may decide that professional assistance (for example, from auditors or financial advisers) is needed.

Refusal to Register Transfers of Shares or Debentures

New CO references: Section 151(3) and (4)

Position under the Old CO

The Old CO requires a company which refuses to register transfer of shares or debentures to send a notice of such refusal to the transferor and transferee within two months after the transfer was lodged with the company. However, there is no requirement for the notice to be accompanied by the reasons for the refusal.

Position and key provisions in the New CO

Sections 151(3) and (4) of the New CO require companies to give reasons explaining their refusal to register a transfer of shares upon request and within 28 days after receiving the request.

Practical considerations and recommended steps

Section 152 of the New CO retains the provisions of the Old CO that allow a transferee, where a company refuses to register a transfer of shares, to apply to the court to have the transfer registered by the company. A court may, if it is satisfied that the application is well founded, disallow the refusal and order that the transfer be registered forthwith by the company. Generally, however, courts have been reluctant to intervene in the exercise of directors' discretion without clear evidence of bad faith or an improper motive. The requirement to provide reasons for refusing to register a share transfer under the New CO will enhance transparency and help to ensure that directors only exercise their powers for proper purposes.

One area where a refusal to register a transfer of shares may be a significant issue is in the case of an equitable charge over shares, where the charged shares are not registered in the name of the security holder. Following enforcement, the board may refuse to register the transfer of shares into the name of the security holder or a third party purchaser. In such case, the requirement to explain the refusal under the New CO may assist the security holder (if it can be shown the refusal is motivated by bad faith). As an extra precaution, the security holder may insist at the outset that the articles of association are amended so as to remove the directors' discretion to refuse to register a transfer of shares following enforcement of the charge.

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