Appendix

Comments from Hong Kong Institute of CPAs in response to the 3rd Consultation Paper on Rewrite of the Companies Ordinance

Share Capital

Question 1:

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

Yes, in principle, we support the proposal of adopting a mandatory system of no-par for companies with a share capital, for the reasons put forward in the consultation paper.

We would tend to accept that the concept of "par value" of capital does not have any necessary connection with the financial strength of a company and it does not give a clear indication of the real value of the shares or the company. We also understand that, generally, the concept of par value, paid-up share capital, etc. may in practice no longer be relied upon by creditors and shareholders for their protection, and that they would look to other measures for assurance.

However, we believe that there may still be perception by some members of the public that paid up share capital is an important indicator of a company's financial resources, which is given weight by the fact that capital requirements are still imposed on certain companies, such as those in regulated sectors (e.g., authorised institutions, pursuant to Schedule 7 of the Banking Ordinance (Cap.155)). This being the case, if Hong Kong moves to a no-par regime, particularly if the existing capital maintenance regime is substantially altered, a clear and adequate explanation of the background to, and the rationale for, this change needs to be given to the public.

In addition to the more direct legislative changes that would be required if the no-par regime is to apply across the board, other consequential changes would need to be made to legislation, rules and regulations, such as:

a. Securities and Futures Ordinance (Cap. 571) – with regard to determining the percentage level in relation to notifiable interests and short positions (s. 314)

b. Stock Exchange Listing Rules – with regard to the basis for the calculation of the annual listing fee of listed issuers (Appendix 8)

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.

We agree that a reasonable time should be allowed for companies to review their arrangements before migration to no-par.

As mentioned in paragraph 2.10 of the consultation document, such period is "*to allow companies to tailor their own changes if they so prefer*". This may require conducting a general meeting of shareholders to approve relevant changes to a company's constitutional documents. In order to minimise any disruption to existing companies, sufficient time should be allowed for companies to seek shareholders' approval of the relevant changes at an

annual general meeting. As such, we propose that a period of 24 months would be more appropriate.

In addition, it would be helpful, in this regard, if more information could be provided as to the experience of other jurisdictions in this regard, e.g., Australia, New Zealand and Singapore.

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?

If the directors' fiduciary duty in these circumstances relates essentially to ensuring that the company receiving adequate consideration for the issue, as suggested in paragraph 2.13 of the consultation paper, then prima facie, there would seem to be an argument for some degree of control to ensure that the interests of any existing shareholders are also taken into account. However, without more information regarding the rationale for the different approaches adopted in New Zealand and South Africa in relation to equitable treatment for existing shareholders, it is difficult to comment upon these, or other possible options, except to say that the New Zealand approach appears to be more flexible.

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.

The existing capital maintenance rules are regarded as being complex and somewhat piecemeal. However, if the same basic approach is largely retained under a no-par regime, then the concept of merger relief should not be abandoned entirely. Under these circumstances option (b) under question 4 would appear to have merit and should be studied further.

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.

The existing capital maintenance rules are regarded as being complex and somewhat piecemeal. However, if the same basic approach is largely retained under a no-par regime, then the concept of group reconstruction relief should not be abandoned entirely. Under these circumstances option (b) under question 5 would appear to have merit and should be studied further.

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

The views contained in the consultation paper would seem to be reasonable.

(b) Issuance of bonus shares without the need to transfer amounts to share capital

The views contained in the consultation paper would seem to be reasonable.

(c) Consolidation and subdivision of shares

The views contained in the consultation paper would seem to be reasonable.

(d) Redeemable shares

The views contained in the consultation paper would seem to be reasonable.

Question 7:

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

Paragraph 2.29 of the consultation paper states, amongst other things, that the protection against dilution that authorised capital is thought to provide is not absolute, as most companies can increase the authorised capital by an ordinary resolution. Nevertheless, although the protection may not be absolute, the existing requirement for an ordinary resolution, particularly in the case of more-widely-held companies, would still seem to provide some form of check against potential abuses. At the same time, we note that several jurisdictions have removed the requirement for authorised capital, citing simplification of procedures. Under the circumstances, we would suggest that more detailed discussion of the pros and cons of the proposal may be needed before coming to a position.

Question 8:

Do you see value in companies having a choice whether to retain or delete the authorised capital from their Articles of Association?

Notwithstanding our response to question 7 above, were it decided to do away with the requirement for authorised capital, we would see little value in permitting companies to have the option of retaining the provision for authorised capital in their Articles of Association.

Under such circumstances, we would suggest following the approach indicated under paragraph 2.30 of the consultation paper, to provide for the deemed deletion of the authorised capital provision from companies' constitutional documents. Otherwise, sufficient time should be allowed for companies to make the necessary changes in their Articles of Association (e.g., 24 months, as in our answer to question 2 above).

Question 9:

Do you see value in retaining the option of having partly paid shares? Please provide reasons.

We consider that the option of having partly paid shares should be retained. Since partly paid shares and a no-par system are two different concepts, we do not see any need or reason for removing this financing choice for companies.

The option of having nil-paid shares should also be retained (otherwise the concept of trading in nil-paid shares in a rights issue may need some further thought).

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?

We would agree, in principle, to the concept that the amount unpaid on partly paid shares should be defined by reference to the issue price and the amount contributed by the shareholder. However, it would be helpful if more information could be provided on the reason why in Australia and Singapore it was decided to continue to distinguish between partly paid shares issued before and after the migration to no-par, unless it was simply to preserve the existing legal distinction referred to in paragraph 2.34 of the consultation paper.

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?

Yes, we would agree that where partly paid shares without a par value are subdivided, there should be reallocation (by legislation) of the outstanding liability on existing shares to the new shares to maintain the pre-existing ratios.

The same principle should apply where partly paid shares are consolidated.

The Capital Maintenance Regime

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.

In principle, we consider that Hong Kong should adopt some form of "solvency test" approach to creditor protection and that, in the long run, this should apply to all forms of distribution. Members of the Institute's Restructuring and Insolvency Faculty point out that corporate insolvencies rarely, if ever, occur due to the failure of a company to maintain its issued capital and the maintenance of capital alone will not ensure protection for creditors. They see a solvency test as providing a more direct and relevant means of achieving the objective of greater protection for creditors.

At the same time we note the concerns raised by the SCCLR and have the following comments on them:

(a) A solvency test would make directors focus on whether what they were proposing to do was financially prudent and make them more responsible for their actions, which, in principle, should be seen as a positive development. As regards the concern about increasing the potential liabilities of directors of SMEs, in particular, consideration could be given to applying the solvency test only to "large" or listed companies. However, the problem with excluding SMEs is that, as there is no public filing of private company accounts in Hong Kong, creditors dealing with private companies are less protected. For this reason, on balance, we would not favour excluding SMEs.

(b) See the response to (a) above.

(c) It is difficult to argue that a company should be able to pay a dividend in circumstances where it may be unable to pay its creditors. However, given the view reflected in the consultation paper that the existing rules have worked well and provided certainty, one option would be to extend the solvency test to additional forms of distribution but not, at the initial stage, to the payment of dividends, at least not until directors have become more accustomed to the practical application of the test.

(d) Generally, the capital maintenance rules have become outdated, unduly complex and lacking in coherence. Furthermore, companies do not become insolvent as a result of capital reduction.

(e) It is not clear that the concerns and potential drawbacks outlined by the SCCLR, which could in any event be partially addressed, would outweigh the benefits of adopting the solvency test more widely as the principal rule for the protection of creditors. Certainly there are jurisdictions with well-developed company law, where they have taken the view that a solvency test is the most appropriate approach.

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?

Yes, we consider that the existing solvency requirement in Hong Kong, which is basically a cash flow test, should be modified by including a balance sheet solvency test, covering both current and total assets/liabilities, to provide a more comprehensive and objective approach in the assessment of solvency and better safeguards for creditors. In the event of financial difficulties, creditors would also look to the assets on the balance sheet of a company for repayment, and not only to cash flows.

Question 14:

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

No, we do not agree that reduction of capital should continue to be subject to judicial control in all cases. We support the proposal for introduction of a court-free procedure as an alternative process in addition to the current rules, which would reduce the costs of a capital reduction exercise.

We would suggest that a court-free procedure be subject to the following safeguards:

a. approval by shareholders in general meeting, with a solvency declaration made by directors to be put before shareholders;
b. adequate advertising and publicity;
c. written notice to all creditors;
d. provision for appeal to the court by aggrieved creditors and/or shareholders;
e. penalties against directors if they abuse this procedure.

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

We are of the view that, as an alternative, a court-free process for reduction of capital should be available to all companies, whether listed or unlisted. In the case of listed companies, the regulators should be able to investigate cases of alleged abuse. For unlisted companies, aggrieved persons should have recourse to the court. The procedures should be subject to the safeguards indicated in our response to question 14, above.

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

We believe that, for practical reasons, it should be sufficient for a majority of directors to make a solvency declaration, as it may be difficult to arrange for all directors to sign a document without causing delay. For reference, we note that under section 228A of the Companies Ordinance, a majority of directors is sufficient to form an opinion that the company cannot by reason of its liabilities continue its business and to commence a voluntary winding up procedure under that section.

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)?

While we are not aware of any problem with the current provisions on buy-backs, option (b) would give public companies greater flexibility to fund buy-backs. However, if this option is further pursued, we would suggest adopting a standard form of solvency test (for both public and private companies), which, as we indicate in response to question 13 above, should include a balance sheet solvency test.

Question 17:

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

We have no specific view on this.

Question 18:

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

Streamlining the current financial assistance provisions along the lines of the provisions in the New Zealand Companies Act (”NZCA”), as set out under paragraph 3.38 of the consultation paper, merits further consideration. However, if this option is to be pursued, we would suggest adopting a standard form of solvency test, which, as we indicate in response to question 13 above, should include a balance sheet solvency test.

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?

N/A

Statutory Amalgamation Procedure

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?

Yes, we would support the introduction of a simplified, 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.

We would agree that the court-free statutory amalgamation procedure for "Short Form Amalgamation" should be based on the elements outlined in Table A of the consultation paper. As such a procedure would apply to intra-group amalgamations, there would not appear to be any likelihood of outsiders being disadvantaged. Subject to the modification indicated below, we would agree that, as an alternative to the existing court-sanctioned procedure, the court-free statutory amalgamation procedure for "Long Form Amalgamation", applicable to an amalgamation of corporate entities not being of the same group of companies, should be based on the elements outlined in Table A. However, we are not entirely clear why a buy-out provision for minority shareholders that disagree with the amalgamation, as contained in the NZCA, is considered to be unnecessary for Hong Kong. It may not be realistic to assume that dissenting minority shareholders will be bought out as part of the negotiation process and, if they are not, the current proposal puts the onus on them to apply to the court for relief on the ground of being unfairly prejudiced. This could be expensive and make life difficult for minorities while assisting for those who might want to abuse the process. It is suggested, therefore that a buy-out right, as in the NZCA, would provide an added safeguard against abuses for dissenting minority shareholders in a court-free statutory amalgamation procedure.