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Mrs Mary Tang
Bills Committee on
Companies (Amendment) Bill 2002
Legislative Council
Hong Kong

Dear Mrs Tang,

Companies (Amendment) Bill 2002 – Clause 26(c)

As foreshadowed in my letter to you dated 11 October 2002, I am writing to you setting out my view on Clause 26(c) of the Companies (Amendment) Bill 2002.

Section 58(1) of the Companies Ordinance enables a company, subject to the sanction of the Court, to reduce its capital "in any way", including the cancellation of "any paid-up share capital which is lost or unrepresented by available assets" as set out in paragraph (b) of subsection (1). As stated in paragraph 10.3 of "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", one of the main purposes of the provisions for the reduction of capital, which requires the approval of the Court, is to ensure that the capital of a company is maintained for the protection of its creditors.

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It was considered by the Standing Committee on Company Law Reform that when a reduction involves "only… a redesignation of the par value [of the shares] to a lower amount" (emphasis added), the company involved should not be required to go through the cumbersome statutory procedures (paragraph 10.49 of the Report). Thus the Standing Committee recommended in paragraph 10.64 of the Report that Court approval for this particular type of reduction should be dispensed with provided that the four conditions set out in that paragraph are satisfied.

The rationale behind the recommendation, although not explicitly stated in the Report, is that a reduction only of the par or nominal value of the issued and unissued shares of a company, the nature of which is fully discussed in paragraphs 10.13 to 10.21 of the Report, would not affect the interests of its creditors provided that the credit arising as a result of the cancellation of the paid-up capital (being the difference between the existing amount of the fully paid-up issued capital, which is calculated by multiplying the amount of the par value and the number of the shares in issue, and the amount of the paid-up capital after the proposed reduction of the par value of the shares has become effective) would not be distributed to the shareholders, but be credited to the share premium account which can only be used in the restrictive manner prescribed by Section 48B of the Companies Ordinance. This requirement accords with the present practice of the Court that, as a condition for the confirmation of this type of reduction, the excess amount of the paid-up capital, which will be cancelled upon the reduction becoming effective, must be transferred to a "capital reserve account" specifically created for the purpose so that the amount in the account will be preserved as capital, as in the case of share premium, for the protection of the creditors of the company and its distribution to members can only be made upon satisfying the exceedingly stringent conditions imposed by the Court.

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It is important to note that the rule for the maintenance of capital is derived from the fact that when outsiders enter into transactions or deal with a company, it is presumed at law that they have knowledge of, and rely on, the amount of its paid-up capital as disclosed in the public records filed at the Companies Registry. Hence any form of reduction of the capital of a company, whether for eliminating losses or beyond the needs of the company or on any other ground, must be approved by the Court so as to ensure, among other things, that the creditors who have been dealing with the company in the past will not be prejudiced by the reduction of its paid-up capital. For this purpose, it is imperative that the amount of the excess paid-up capital arising from the reduction required to be transferred to the special capital reserve account or, as proposed by the Standing Committee, the share premium account should remain intact and not be eroded. It is on this very basis that the Standing Committee recommended the dispensation with the Court process when the reduction applies solely to the lowering of the par value of the shares but not otherwise.

As a practitioner in this branch of the law for some years, it has been my experience that virtually all the applications to the Court for the reduction of par value in recent years, which coincide with the drastic economic downturn, were made because the trading prices of the shares of the companies on The Stock Exchange of Hong Kong Limited had fallen below their par values (paragraph 10.19 of the Report). This arose as a result of losses suffered by those companies which had the singular effect of depleting part of their paid-up capital. Under such circumstances, the companies were prevented from issuing shares for fund raising purpose because of Section 50 of the Companies Ordinance which prohibits the issuing of shares at a discount to the par value unless the company involved applies to the Court following a procedure which is even more cumbersome and costly than that for a reduction of capital.

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By the use of the word “only” in paragraph 10.49 of the Report when referring to reductions for lowering par values, it is evident that it was not the intention of the Standing Committee that a company whose paid-up capital has been depleted should become a beneficiary of its recommendation. The proper procedure to remedy the situation would be for this type of company first to apply to the Court for a reduction of their paid-up capital to the extent of their depletion by satisfying the Court that that part of the capital had been permanently lost (see paragraph 10.45 of the Report) and then proceed to reduce the par value of their shares in the form of another reduction of capital. If a company whose paid-up capital has been partially lost adopts the procedures envisaged by Clause 26(2) of the Bill to lower the par value of its shares, the amount to be transferred to the share premium account will fall short of that required for the protection of its creditors. As presently drafted, Clause 26(2) of the Bill is grossly defective in a number of aspects, particularly it seems to permit the reduction of the capital of a company <u>for any purpose</u>, including the elimination of losses, without the sanction of the Court provided that the four conditions set out in the provision of the Bill are satisfied. <u>This was definitely NOT the intention of the Standing Committee.</u>

It should be noted that the Report is aimed at the general public and, by necessity, must be in a compendious form. Thus it deals with general principles and its contents, whenever possible, are devoid of any technical details or legal phraseology. In no way should any part of the Report be treated as a substitution for or reproduced as the wording for the Bill or the proposed amendments to the Ordinance. It is regrettable that the draftsman of Clause 26(2) of the Bill, as demonstrated by his wholesale adoption in the provision of the Bill of the wording of the four conditions set out in paragraph 10.64 of the Report, fails to appreciate the mechanics of and the underlying rationale and legal requirements for reductions of capital which inextricably involve certain accountancy concepts.

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I now set out below the defects of the wording of the added sub-section (3) to Section 58 of the Companies Ordinance as contained in Clause 26(2) of the Bill:-

(1) the opening phrase in subsection (3) – "Confirmation by the court of a reduction of the share capital of a company is not required under sub-section(1) if the following conditions are satisfied -- …"

This phrase is highly undesirable and opens the door for all types of reductions, specifically when capital has been lost, to avoid the scrutiny of the Court provided that the four criteria are fulfilled. Notwithstanding the purport of paragraph 18 of the Explanatory Memorandum to the Bill, it totally fails to reflect the intention of the Standing Committee that, even if the four conditions are satisfied, the dispensation with the Court's confirmation is restricted to those reductions the sole purpose of which is to redesignate the par value of a company's shares to a lower amount.

(2) paragraph (b) – "all issued shares are fully paid-up"

Even coupled with the protection afforded by the fourth condition for the transfer of the "reduction" to the share premium account as stated in paragraph (d) of the provision, this requirement will not protect the interests of the creditors in the case of a company whose paid-up capital has been eroded.

Once a shareholder has answered the call of the company and paid up his shares in full, those shares will always be

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described as "fully paid-up" in legal terminology notwithstanding that the whole or part of the paid-up capital might have subsequently been lost by the company. As pointed out above, it is essential in order to protect the creditors that the amount standing to the credit of the capital account of a company which comprises the full value of its issued shares must not be diminished for whatever reason at the time of the reduction, ie. at the passing of the special resolution for the reduction as mandated in Section 58(1) of the Companies Ordinance.

As presently drafted, paragraph (b) of the provision, by omitting any reference to the integrity of the paid-up amount in the capital account, fails to safeguard the interests of the creditors under the circumstances described above. Accordingly, words should be introduced into paragraph (b) to ensure that there would be no depletion to the fully paid-up capital at the time of the passing of the special resolution for the reduction.

(3) paragraph (c) – "the reduction is distributed equally to all shares"

Creditors' interests aside, one of the remaining criteria under common law for the Court's confirmation of a reduction is that the shareholders are treated equally *(re Thorn EMI plc (1988) 4 BCC 698 at 701; re South China Strategic Ltd [1997] HKLRD 131 at 133E-G & re Lippo China Resources Ltd [1998] 1 HKLRD 20 at 23I-24A)*. Indeed, the Standing Committee acknowledged this condition in paragraph 10.45 of the Report where it is stated that one of the two requirements for sanction

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of a reduction is “to ensure fair distribution of the burden of a reduction among shareholders…” (emphasis added) which paragraph (c) of the provision in the Bill intends to reflect.

First, the word “reduction” signifies the act or the process itself and, as such, to “distribute” it “equally to all shares” is awkwardly expressed because it is difficult to conceive that an act or a process can be “distributed” to the shares or their holders regardless of whether equally or not. What was intended by the Standing Committee was that the effects of the reduction on all the shares or their holders should be the same. Secondly, if the word “reduction” has the meaning attributed to it in (4) below, being the excess amount of the paid-up capital thrown up as a result of the reduction of the par value, then it contradicts paragraph (d) of the condition in the Bill that such amount should be credited to the share premium account for protection of the creditors as the juxtaposition of the word “reduction” with this particular meaning against the word “distributed” suggest that the amount is distributable to the shareholders which was never intended to be the case.

As a reduction of capital affects the rights inherent in the shares or those exercisable by their holders, to better convey the meaning of the common law criterion, paragraph (c) of the provision should be replaced by words like “all shareholders affected by the reduction are treated equally” or “the reduction applies to and affects all shares equally”.

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(4) paragraph (d) – "the reduction is credited to the share premium account"

It is clear that the word "reduction" here has a meaning totally different from that in paragraph (c) of the provision as discussed in the preceding paragraph (3). It means nothing more than the credit thrown up or the excess amount of the paid-up capital which is cancelled as a result of the lowering of the par value of all the issued shares. To remove any ambiguity, the word "reduction" should be replaced by words like "any amount arising as a result of the proposed reduction" or to that effect. It is highly unsatisfactory for the same word employed in a statutory provision to carry two totally different meanings.

Yours faithfully,

Winston Poon, QC

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cc. The Honourable Mr Justice Rogers, V.P.,
Chairman of the Standing Committee on Company Law Reform

The Secretary of the Hong Kong Bar Association