Bills Committee on Companies Bill

Part 13 and Part 14 of the Companies Bill

PURPOSE

This paper outlines the major proposals and policy issues in Part 13 (Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back) and Part 14 (Remedies for Protection of Companies' or Members' Interests) of the Companies Bill. It also covers relevant overseas experience and public views received during earlier public consultation on the major proposals and our responses.

DETAILS

2. Details for each Part are contained in the Annexes -

Annex A - Part 13 (Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back)

Annex B - Part 14 (Remedies for Protection of Companies' or Members' Interests)

ADVICE SOUGHT

3. Members are invited to note the contents of the paper and provide their views.

Financial Services and the Treasury Bureau
Companies Registry
2 June 2011

Annex A

Bills Committee on Companies Bill

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 Companies Bill ("CB") 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 PROPOSALS

2. This Part largely restates the relevant CO provisions. However we have also introduced some proposals that aim at facilitating business, namely –

(a) revising the definitions of "property" and "liabilities" in the provisions for facilitating reconstructions and amalgamations (paragraphs 5 to 8 below);

(b) introducing a new court-free statutory amalgamation procedure for wholly-owned intra-group companies (paragraphs 9 to 14 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 15 to 20 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 21 to 23 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 24 to 26 below).

3. This Part retains the "headcount test" for approving a scheme of compromise or arrangement while giving the court a new discretion to dispense with the test for members' schemes in appropriate circumstances (paragraphs 27 to 35 below).

4. The details of the major proposals in Part 13 are set out in paragraphs 5 to 35 below.

Revising the definitions of "property" and "liabilities" in the provisions for facilitating reconstructions and amalgamations (clauses 659 to 666)

Current position

5. Section 167(4) of the CO 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.

Proposal and key provisions in the Bill

6. We propose to enable personal rights and duties, which could not have been transferred and assigned unless with the consent of the parties concerned, to be transferred or assigned once a transfer order is made.

7. **Clauses 659 to 666** basically restate with modifications the provisions on schemes of arrangements in sections 166, 166A and 167 of the CO. **Clause 665** sets out additional powers which the court may exercise to facilitate reconstructions or amalgamations of companies. In particular, **clause 665(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.

Overseas experience

8. Our proposal is in line with section 413 of the Australian Corporations Act 2001 ("ACA").

Introducing a new court-free statutory amalgamation procedure (clauses 667 to 675)

Current position

9. Currently, companies intending to amalgamate have to resort to the procedures under sections 166 to 167 of the CO which require court sanction. In practice, sections 166 to 167 are rarely used given the high cost involved.

Proposal and key provisions in the Bill

10. We propose to introduce a court-free regime for amalgamations. To minimize 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.

11. **Clauses 669** and **670** 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 to confirm that the assets

of the amalgamating company is not subject to any floating charge and to verify the solvency of the amalgamating company as well as the amalgamated company. Details of the solvency statement are set out in **clause 668**. The amalgamation proposal must be approved by the members of each amalgamating company by special resolution.

12. As the effect of amalgamation is that the amalgamated company takes the benefits and is subject to the liabilities of the amalgamating companies (**clause 674**), 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. As the purpose of the new procedure is to introduce a simple and less costly procedure for amalgamation, we therefore exclude companies with floating charges in order to keep the procedure simple and easy to implement (**clauses 669(2)(d) and 670(2)(d)**).

13. **Clause 675** provides that before the effective date of the amalgamation proposal, the court may disallow or modify the amalgamation proposal or give any directions, if it is satisfied that giving effect to the amalgamation proposal would unfairly prejudice a member or a 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.

<u>Overseas experience</u>

14. Our proposal is generally in line with sections 215D, 215H, 215I and 215J of the Singapore Companies Act and sections 222 to 226 of the New Zealand Companies Act 1993, with some modifications to cater for local circumstances.

Clarifying the meaning of "takeover offer", "shares already held by the offeror" and "shares to which the offer relates" in a takeover (clauses 678, 680, 696 and 698)

Current position

15. Section 168 of CO, together with the Ninth Schedule, deals 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".

Proposal and key provisions in the Bill

16. We propose to clarify the meaning of the above terms in the CB. **Clause 678(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.

17. **Clause 678(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.

18. **Clauses 678 and 680** 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 (**clause 678(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 (**clause 680(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 (**clause 680(4)**).

19. **Clauses 696(1), 696(3) and 698** contain similar provisions in relation to compulsory acquisition powers following a share buy-back offer.

Overseas experience

20. Our proposal is in line with sections 974 to 979 of the United Kingdom Companies Act 2006 ("UKCA 2006").

Introducing new provisions to allow a revised offer to be treated as the original offer so long as certain specified conditions are met (clauses 681 and 699)

Current position

21. At present, the CO 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.

Proposal and key provisions in the Bill

22. We propose to introduce provisions on revised offers. **Clause 681** 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. **Clause 699** contains a similar provision

in the case of a share buy-back offer.

Overseas experience

23. Our proposal is in line with section 974(7) of UKCA 2006.

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 (clauses 682 and 701)

Current position

24. Under the CO, 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.

Proposal and key provisions in the Bill

25. We propose to introduce a mechanism for an offeror to apply to the court for authorisation to give squeeze out notices in the above situation. Such a mechanism has been adopted in the United Kingdom since 1987 and is considered to be practical and useful. **Clause 682(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. **Clause 701(4) to (8)** provide for a similar mechanism in the case of a share buy-back offer.

Overseas experience

26. Our proposal is in line with section 986(9) and (10) of UKCA 2006.

Retaining the "headcount test" for approving a scheme of compromise or arrangement while giving the court a new discretion to dispense with the test for members' schemes (clause 664)

Current position

27. Section 166 of the CO 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.

28. 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).[1] 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.

Public consultation

29. During the first phase consultation of the draft CB, we consulted the public on whether the headcount test for members' schemes of listed companies, non-listed companies, and creditors' schemes should be retained, abolished, or retained but giving the court discretion to dispense with the test. There were divergent views among respondents, with more respondents supporting the abolition of headcount test. A summary of the public views on the headcount test is at **Appendix**.

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1 *Re PCCW Ltd*, [2009] 3 HKC 292.

Proposal

30. We note the divergent views expressed by the respondents during the public consultation on the abolition or retention of the headcount test for members' schemes. In particular, we note the market 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[2], we agree that the Code is intended to supplement, but not substitute, the statutory protection in the CO. As a scheme will bind all members and permit the compulsory acquisition of the shares of dissenting shareholders, it would be important to ensure that the interests of minority shareholders are sufficiently safeguarded.

31. The criticism that the headcount test fails to reflect the decisions of beneficial owners of shares under the Central Clearing and Settlement System ("CCASS") may to a certain extent be addressed by the proposed introduction of a scripless market in Hong Kong. As regards the concern that the headcount test attracts vote manipulation, we note the Securities and Futures Commission's advice that there has been no credible evidence to support the suggestion that attempts to manipulate the vote are common.

32. On balance, we believe that there are merits in retaining the headcount test for members' schemes. Nevertheless, to strike a reasonable balance, the court will be 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.

33. As for creditors' schemes, the concern for vote manipulation and problems arising from CCASS do not exist. We consider it desirable to retain the headcount test to protect small creditors. In fact,

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[2] Under the Takeovers Code, there are additional requirements to protect the interests of minority shareholders, including:

(a) under Rule 2 of the Takeovers Code, an independent board committee comprising all non-executive directors who have no conflict of interest in the scheme has to be established to give advice to disinterested shareholders and the committee would seek advice from an independent financial adviser; and

(b) 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.

the headcount test was originally introduced to protect the interests of small creditors in creditors' schemes. 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, we see no need to extend the court's discretion to dispense with the headcount test to cover creditors' schemes.

Key provision in the Bill

34. **Clause 664** basically restates section 166 of the CO. **Clause 664(2)(c)** gives the court a discretion to dispense with the headcount test for members' schemes.

Overseas experience

35. The headcount test has been retained in other common law jurisdictions including the United Kingdom, Australia, Singapore, Bermuda and the Cayman Islands. The proposal to give the court a discretion to dispense with the headcount test is in line with section 411 of ACA.

PUBLIC COMMENTS

36. We have consulted the public on the draft CB in two phases of public consultation held between December 2009 to March 2010 and May to August 2010 respectively. The issue of the headcount test, which was covered by the first phase consultation, is discussed above. The rest of Part 13 was covered by the second phase consultation and we did not receive any substantive comments on the draft provisions.

Financial Services and the Treasury Bureau
Companies Registry
2 June 2011

Appendix to Annex A

Respondents' views on Headcount test received during the First Phase Consultation on the Draft Companies Bill

A total of 144 submissions commented on the subject focusing primarily on members' schemes of listed companies, including 101 from companies (most of which are listed companies), 26 from individuals and 17 from organisations. Views were diverse as to whether the headcount test should be retained or abolished.

Members' Schemes of Listed Companies

2. A total of 124 submissions opted for abolishing the test for members' schemes of listed companies, including those from business and professional bodies like Hong Kong General Chamber of Commerce, Law Society of Hong Kong ("LSHK"), Hong Kong Bar Association ("HKBA"), Hong Kong Institute of Certified Public Accountants ("HKICPA"), Hong Kong Institute of Chartered Secretaries, Hong Kong Institute of Directors ("HKIoD") and the Chamber of Hong Kong Listed Companies. There are also 91 submissions from listed companies supporting the abolition. The main arguments for abolition are –

(a) the headcount test could not effectively reflect the preference/views of beneficial owners, particularly as a very large proportion of shares in listed companies were held by nominees and custodians in the Central Clearing and Settlement System ("CCASS"). While beneficial owners can withdraw their shareholdings from CCASS and become registered shareholders, the process is cumbersome and involves cost;

(b) the headcount test might attract attempts for vote manipulation; and

(c) it is against the one share one vote principle, i.e. giving disproportionate weight to minority shareholders in the scheme approval process.

3. On safeguarding the interests of minority shareholders, most of the above submissions considered that the Code on Takeovers and Mergers issued by the Securities and Futures Commission ("SFC") already provided sufficient safeguards and that any additional safeguards should be dealt with by the SFC through amendments to the Code. Some respondents, including LSHK and HKIoD, highlighted that notwithstanding the abolition, the court still retains the discretion not to approve a scheme in the event of irregularities or where the rights of minority shareholders are at stake.

4. At the same time, some 20 submissions, including those from the SFC, the British Chamber of Commerce, the Association of Chartered Certified Accountants (Hong Kong), the Hong Kong Securities Association and Hong Kong Association of Banks, supported retaining the headcount test. They believed that the headcount test serves as an essential check on the share value test. The existing problem of the headcount test mentioned in paragraph 2(a) above could be overcome by the proposal to pursue a scripless market and that there was no credible evidence indicating that vote manipulation was common. Among these respondents, a majority saw merit in the option of giving the court a discretion to dispense with the test. They considered that it would be a fairer option which allowed the court to intervene in the event of possible abuses of the process. They also considered that it would strike a reasonable balance between protecting the right of the minority shareholders and avoiding giving too much veto power to the minority shareholders.

Members' Schemes of Non-listed Companies

5. Only 49 respondents commented on how to deal with the headcount test for members' schemes of non-listed companies. In general, those who supported the abolition of the headcount test for members' schemes of listed companies tended to support the same for non-listed companies, except for a few like HKBA, which argued that the headcount test should be retained for non-listed companies given that they were not affected by the problems relating to CCASS.

Creditors' Schemes

6. Some 48 respondents commented on the headcount test for creditors' schemes. The majority (33 submissions) preferred abolishing the test. Some of them argued that minority creditors would be able to petition for winding up. On the other hand, 10 submissions including the Hong Kong Confederation of Trade Unions, LSHK, HKBA, HKICPA and several accounting/legal firms supported retaining the headcount test for creditors' schemes, arguing that the test served to protect the interests of small creditors. There are arguments that the position of creditors bore little resemblance to that of shareholders in the context of schemes of arrangement and that the interests of large creditors did not usually align with small creditors.

Annex B

Bills Committee on Companies Bill

Part 14 – Remedies for Protection of Companies' or Members' Interests

INTRODUCTION

Part 14 (Remedies for Protection of Companies' or Members' Interests) of the Companies Bill ("CB") contains provisions relating to the remedies available for protection of companies' or members' interests. These include the unfair prejudice remedy, the statutory injunction order restraining conduct that constitutes contravention of the new Companies Ordinance ("CO"), the statutory derivative action, and the right to seek a court order for inspection of company records.

POLICY OBJECTIVES AND MAJOR PROPOSALS

2. Shareholder remedies provisions were substantially revised by the Companies (Amendment) Ordinance 2004 with a view to enhancing legal remedies available to members of a company. The amendments included –

(a) providing for a statutory derivative action that may be taken on behalf of a company by a member of the company (subsequently extended to cover multiple derivative action through Companies (Amendment) Ordinance 2010);

(b) facilitating members to exercise their rights to obtain access to company records;

(c) empowering the court, on application by an affected person or the Financial Secretary, to grant an injunction restraining any person from engaging in conduct which constitutes contravention of the CO or a breach of his fiduciary or other duties owed to a company; and

(d) improving the unfair prejudice remedy in section 168A of the CO to provide the court with a power to award damages to the members of a company where it was found that their interests had been unfairly prejudiced and to award such interest on the damages as the court thinks fit. The scope of the remedy has also been extended to allow past members (and their personal representatives) of local companies and members and past members (and their personal representatives) of non-Hong Kong companies to commence legal action under that section.

3. Part 14 of the CB mainly restates the existing provisions with improved drafting, while at the same time introduces the following initiatives that aim at fostering shareholder protection, namely –

(a) extending the scope of the unfair prejudice remedy to cover proposed acts and omissions (paragraphs 5 to 8 below); and

(b) enhancing the court's discretion in granting relief in cases of unfair prejudice (paragraphs 9 to 12 below).

4. The details of the major proposals in Part 14 are set out in paragraphs 5 to 12 below.

Extending the scope of the unfair prejudice remedy to cover proposed acts and omissions (clause 713)

Current position

5. Section 168A(1) of the Companies Ordinance ("CO") provides that a member of a company may petition to the court if the affairs of the company are being or have been conducted in a manner unfairly prejudicial to the interests of the members generally or of some part of the members. There is some uncertainty whether, under the current provisions, a member can bring an action for unfair prejudice where a course of action is only at the proposal stage, or where there is only a threat to do or not to do something.

Proposal and key provisions in the Bill

6. We propose to extend the scope of the unfair prejudice remedy to cover proposed acts and omissions. **Clauses 711 to 716** restate the unfair prejudice remedy provisions under section 168A of the CO. **Clause 713(1)(b)** provides that the court may exercise the power to grant remedies under these provisions if there is any actual or proposed act or omission of the company (including one done or made on behalf of the company) which is or would be prejudicial to the interests of the members. The remedies that may be granted by the court under **clause 714** are therefore extended to cover an order restraining the proposed act or requiring the doing of an act that the company has proposed to omit to do.

Overseas experience

7. The proposal is in line with section 994(1) of the United Kingdom Companies Act 2006 ("UKCA 2006") and section 232 of the Australia Corporations Act 2001 ("ACA").

Public consultation

8. During our earlier public consultation on the draft CB, we did not receive substantive comments on the proposal. There was a concern that the provisions on remedies for unfair prejudice to members' interests might lead to a large number of small claims being brought to the court by disgruntled shareholders in small private companies. It was suggested that consideration should be given to promoting alternative methods (outside of the CO) to enable disgruntled shareholders of small private companies to resolve their differences outside of court. While we note the concern, we consider that the provisions are important for shareholder protection. As for alternative dispute resolution channels, we understand that the Judiciary is promoting the use of mediation as an alternative to litigation.

Enhancing the court's discretion in granting relief in cases of unfair prejudice (clause 714)

Current position

9. Section 168A(2) of the CO provides that orders made by the court (other than for payment of damages and interest) must be "with a view to bringing to an end the matters complained of". This prevents the court from granting a remedy which is unable to meet that requirement.

Proposal and key provisions in the Bill

10. We propose to enhance the court's discretion in granting relief in cases of unfair prejudice. **Clause 714** provides that the court may make any order that it thinks fit for giving relief in respect of the matter complained of.

Overseas experience

11. The proposal is in line with section 996(1) of the UKCA 2006 and section 233 of the ACA.

Public consultation

12. There were no substantive comments raised on this proposal.

PUBLIC COMMENTS

13. We have consulted the public on the draft CB in two phases of public consultation held from December 2009 to March 2010 and May to August 2010 respectively. Part 14 was covered by the first phase consultation. The public comments on our major proposals are discussed above. As for the comments on other provisions in Part 14 and our response, they are set out in Appendix III to the consultation conclusions of the first phase consultation of the draft CB issued on

27August 2010[1].

Financial Services and the Treasury Bureau
Companies Registry
2 June 2011

[1] Available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccfp_conclusion_e.pdf .