Bills Committee on Companies Bill
Follow-up actions to be taken by the Administration for the meeting on 3 June 2011

Purpose

This paper sets out the Administration's response to the following issues and views raised by Members at the Bills Committee meeting on 3 June 2011 relating to Parts 6 to 8:-

Part 6 - Distribution of Profits and Assets (paragraphs 1 to 9 below)

(I) A Member enquired about directors' obligations where they become aware of matters affecting the propriety of the payment of a dividend before the dividend is paid (paragraphs 1 to 3); and

(II) A Member suggested that provisions on distribution in-specie similar to those in the Companies Act 2006 of the United Kingdom (UKCA 2006) should be provided for in the Companies Bill (CB) (paragraphs 4 to 9).

Part 7 – Debentures (paragraph 10)

A Member enquired about details of regulation of convertible securities and share options/ subscription warrants in other jurisdictions and Hong Kong.

Part 8 - Registration of Charges (paragraphs 11 to 25)

Members made the following suggestions:-

(I) Charges on cash deposits should be registrable (paragraphs 11 and 12);

(II) Early alert system for registration of charges should be put in place (paragraphs 13 to 16);

(III) Chargees should be responsible for delivering the charge for registration (paragraphs 17 to 20);

(IV) Criminal sanctions for late registration of charges should be removed altogether when the court has granted relief for an extension of time (paragraphs 21 and 22); and

(V) Notification to the Registrar of Companies (the Registrar) of debt satisfaction or release of a charge, etc. under the CB should not be more cumbersome than that under the Companies Ordinance (CO) (paragraphs 23 to 25).

Administration's response

Part 6 – Distribution of Assets and Profits

(I) A Member enquired about directors' obligations where they become aware of matters affecting the propriety of the payment of a dividend before the dividend is paid

According to *Gower and Davies' Principles of Modern Company Law*[1], "the normal practice regarding dividend payments is that a directors' recommendation as to the level of the dividend is an essential part of the dividend-setting process. Whether they should, in the light of their then knowledge, refrain from recommending a dividend will depend on the nature of that knowledge. If they have discovered that the relevant accounts were so seriously inaccurate that they did not in fact give a true and fair view of the state of the company's affairs and its profits or losses at the time the accounts were signed, they clearly should not recommend a dividend, and should withdraw any recommendation they have made; for the dividend, if paid, would be unlawful. If, however, the relevant accounts truly reflected the position as at their date and the only reason why the requisite conditions are no longer met is some calamity occurring thereafter, payment of the dividend would not, seemingly, be unlawful under the statute. Payment in such circumstances might constitute a breach of the directors' fiduciary duties

[1] Paul Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn, 2008) at 295-296.

or an act of wrongful trading, and this is also a situation in which the common law rule prohibiting a return of capital to shareholders might bite."

2. The above views are supported by case law, such as *Re Cleveland Trust plc*[2] and *Peter Buchanan Ltd v McVey*[3].

3. As noted from the extract from *Gower and Davies'*[4], there could be a breach of directors' fiduciary duties or a breach of the capital maintenance doctrine if dividends are paid when they should not have been because of intervening events. It is now well-established that the directors' fiduciary duty to act in good faith in the interests of the company requires the directors to take into account the interests of creditors when the company is insolvent or near insolvency[5]. A payment of dividends when the company is insolvent or which puts the company into insolvency can amount to a breach of duty on the part of the directors, even if the dividends are paid out of profits (*Hilton International Ltd v Hilton*[6]).

(II) A Member suggested that provisions on distribution in-specie similar to those in the UKCA 2006 should be provided for in the CB

4. Section 845 of the UKCA 2006 (**Annex**) provides guidance for distribution in-specie. The section was put in place to deal with concerns raised following the decision in *Aveling Barford Ltd v. Perion Ltd*[7].

5. The decision in *Aveling Barford* concerned the sale of a property by a company (which had no distributable profits) at a considerable

---

2 [1991] BCLC 424.

3 [1955] AC 516.

4 See footnote 1 above.

5 *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd* (2009) 12 HKCFAR 417; *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Nicholson v Permakraft (NZ) Ltd (in liq)* [1985] 1 NZLR 242.

6 [1989] 1 NZLR 442.

7 [1989] BCLC 626.

undervalue to another company controlled by the company's ultimate sole beneficial shareholder. The court held that the transaction was void under the common law as it was an unauthorised return of capital[8].

6. Section 845 of the UKCA 2006 does not disturb the position in *Aveling Barford* and where a company which does not have distributable profits makes a distribution by way of a transfer of assets at an undervalue, there will still be an unlawful distribution contrary to Part 23 of the UKCA 2006[9] (similar to Part 6 of the CB).

7. Section 845 deals with the position where a company does have a distributable profit. It provides that if an asset is transferred by such a company to its members for a consideration not less than its book value, the amount of the distribution is zero. However, if the asset is transferred for a consideration less than its book value, the amount of the distribution is equal to that shortfall (which will therefore need to be covered by distributable profits).

8. It seems from our study that section 845 was put in place in the UKCA 2006 to address a specific concern in the UK. Whilst the *Aveling Barford* case did not decide on the situation where a company that has distributable profits makes an intra-group transfer of assets at book value, there was a concern that as such a transfer of assets at book value may have an element of undervalue if book value was lower than market value, the transaction would constitute a distribution thereby requiring the company to have distributable profits sufficient to cover the difference in value[10].

9. In formulating the CB proposals, we considered, in consultation with the relevant experts, whether to provide for distribution in-specie in the CB in a manner similar to section 845 of the UKCA 2006. However,

---

[8] It was also held that the transaction was void because it was a breach of duty by the directors. The transferee company was merely a constructive trustee and had to account to the transferor company for the profit on the resale of the property. See paragraph 28 and 29 of "*Modern Company Law - For a Competitive Economy - Capital Maintenance: Other Issues*" published by the Company Law Review Steering Group of the UK in June 2000.

[9] See paragraph 1153 of the UKCA 2006 Explanatory Memorandum.

[10] See paragraph 1152 of the UKCA 2006 Explanatory Memorandum.

as section 845 seemed to be addressing a specific concern in the UK, it was considered that whether the CB should have similar provisions would largely depend upon whether the *Aveling Barford* case had given rise to similar concerns in the Hong Kong business community about intra-group transfers. As there were no particularly strong views received from the business sector during the public consultations on the draft CB[11], we decided not to adopt the UK approach to provide for distribution in-specie.

Part 7 - Debentures

A Member enquired about the regulation of convertible securities and share options/ subscription warrants in other jurisdictions and Hong Kong

10. As to the enquiry about the regulation of convertible securities and share options/ subscription warrants in other jurisdictions and Hong Kong, according to our study, other than situations for "offers to the public", there seem to be only a few provisions regulating convertible securities and share options/ subscription warrants, as follows:-

(a) In the UKCA 2006, subject to some exceptions, a company that is proposing to allot equity securities (which includes rights to subscribe for, or to convert securities into, ordinary shares) in the company must offer them to existing shareholders first (that is, on a pre-emptive basis). The basic principle is that a shareholder should be able to protect his proportion of the total equity of a company by having the opportunity to subscribe for any new issue of equity securities[12].

Section 549 of the UKCA 2006 provides that the directors may not allot shares (or grant rights to subscribe for shares or to convert any security into shares) except as provided for in the Act (e.g. with the authorization by resolution of the company).

---

[11] Only two respondents (a law firm and an accounting firm) raised the issue that distribution in-specie should be provided for in Hong Kong in the same manner as in the UK.

[12] Paragraph 866 of the Explanatory Memorandum of the UKCA 2006.

Clauses 135 and 136 of the CB have similar requirements to section 549. The clauses require the directors to obtain shareholders' approval for allotting shares and granting rights to subscribe for, or to convert securities into, shares. The purpose is to enhance protection of minority shareholders against dilution.

(b) In the Australian Corporations Act (ACA), section 170 requires the keeping of a register of option holders (for options over unissued shares). Section 1071H provides for the issue of certificate to a "securities" holder. "Securities" includes share options.

Similar provisions are not found in other comparable common law jurisdictions like the UK and Singapore. Likewise, there is no similar provision in the CB.

(c) In Singapore, no relevant provision is found in the Singapore Companies Act.

Part 8 – Registration of Charges

(I) A Member suggested that charges on cash deposits should be registrable

11. Currently, the prevailing view is that charges over cash deposits created by companies do not require registration as charges over book debts or under any other head of registrable charge[13]. However, whether the deposit is in fact a book debt in the normal sense of a debt due in the ordinary course of business is not entirely beyond doubt and depends upon the particular circumstances of each case. The intention of clause 333(3)(b) of the CB is to put the position beyond doubt that charges over cash deposits are not registrable. The reasons to support this position are as follows:-

[13] Sir Peter Millett at (1991) 107 LQR 679.

(a) charge backs usually mirror the effects of set-off which are not required to be registered;

(b) creditors would not be surprised to find that bank deposits were subject to security interests;

(c) registration of charges over quickly moving transactions and short term assets make registration too burdensome and may impede commercial activities; and

(d) the public will not be misled as bank accounts are generally conducted in secret and the amount a company is in credit is usually not visible to outside creditors.

12. In the 2008 topical "Consultation on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges"[14], the great majority of respondents supported the proposal that a charge over cash deposits should be expressly excluded from registration. There were a few respondents who suggested that a charge over cash deposits in favour of a party other than a depository bank should not be excluded. However, there is difficulty in practice if such a distinction is to be made, which would result in requiring a charge over cash deposits created in favour of, say, a stock broker or investment financier or over a margin deposit or any other financial products resembling a charge over cash deposits to be registrable as a charge over book debts. As pointed out in sub-paragraph (c) above, in a financial market where transactions move very quickly within a very short period of time, registration would be burdensome and may impede commercial activities. Given the foregoing, we consider that all charges on cash deposits should be excluded from the registration requirement.

(II) A Member suggested that an early alert system for registration of charges should be put in place

13. In considering the proposal to shorten the period for delivery to the Registrar of a certified copy of a charge instrument and the prescribed

[14] Financial Services and the Treasury Bureau, *Consultation Conclusions on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges* (December 2008) (Available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/cdrc_conclusion_e.pdf).

particulars from five weeks to one month[15], a Member suggested that the public should be alerted to the fact that there is a charge in respect of the company pending registration shortly after the charge is created.

14. Currently, image records of all the documents registered and kept by the Registrar are available for search through the Integrated Companies Information System (ICRIS) maintained by the Companies Registry (CR). Those who conduct searches on the Companies Register (the Register) can obtain a list of all documents registered, or pending registration, in respect of a company.

15. An early alert system for registration of charges is already in place under the current CO regime. In practice, when a company creates a charge and a Form M1 ("Mortgage or Charge Details") is received by the CR, a new entry will appear at the top in the Document Index of that company to show that a Form M1 relating to a charge in respect of the company has been submitted. As such, the public will be alerted to the existence of a charge document submitted to the Registrar pending registration.

16. After implementation of the CB, the CR will continue to provide this early alert system on charge documents pending registration.

(III) A Member considered that chargees should be responsible for delivering the charge for registration

17. Under the current law, the obligation to deliver the charge for registration is imposed on the company creating the charge and not the charge holder (i.e. the chargee). It is considered that the obligation to register charges should remain with the company. This obligation should be treated in the same way as reporting changes in directors, secretary or other relevant information about the company where the onus is on the company, as it is the company who should have the responsibility to maintain its records up-to-date. Likewise, as the registration of charges is intended to protect third parties against false wealth of the company, it is appropriate for the company to have the duty

[15] Paragraph 23 to 25 of Annex C to the paper on Parts 6 to 8 of the CB (CB(1)2175/10-11(01)).

to register. To protect the integrity of the Register, which is critical for protecting minority shareholders and creditors, etc. it is also appropriate to retain the criminal penalties for non- or late registration to encourage compliance (see paragraphs 21 and 22 below).

18. Whilst in practice in some circumstances it may be the chargee who in fact attends to registration because the economic incentive to register is stronger where the failure to register results in the charge being void against the liquidator and other creditors, it is noteworthy that the charge is not void against the liquidator and other creditors in all circumstances. For example, where a company acquires a property which is already subject to a charge, any delay in registration of the charge would only result in breach of the CB and possible prosecution. In these circumstances there is no incentive for the chargee to effect registration. We therefore consider it appropriate to continue to impose the primary obligation to register charges on the company creating the charge.

19. Although the primary obligation to register a charge will continue to be imposed on the company, where the charge will be void for want of due registration, a "person interested" in the charge is given an option under the CB to register and to claim against the company for the fees incurred in so doing. A person interested will be the chargee (see for example, clauses 334(3) and (7); and 335(3) and (8) of the CB).

20. In the UK[16], a company that creates a charge must deliver the prescribed particulars of the charge, together with the instrument by which the charge is created or evidenced, to the Registrar for registration within the prescribed period. In Australia[17] and Singapore[18], the primary obligation to register details of a charge with the Registrar also remains with the companies creating the charges. Given that and the fact that the current practice and law have not caused any difficulties, we consider that it is appropriate to maintain the status quo.

---

16 Section 860 of the UKCA 2006. Section 860(2) also provides for a person interested to effect registration.

17 Section 263 of the Australia Corporations Act.

18 Section 132 of the Singapore Companies Act.

(IV) A Member suggested that criminal sanctions for late registration of charges should be removed altogether when the court has granted relief for an extension of time

21. In cases of late registration, where the time for registration has already been extended by court orders and the charge accepted for filing, transparency of the company's information has already been achieved and the integrity of the Register maintained. There is no public interest in taking prosecution action in these late filing cases. In the last three years, the CR has not received any complaints in respect of late or non-filing of particulars of a charge, therefore no prosecution has been taken as a result of any complaint against a company for failure to register particulars of a charge under section 81 of the CO.

22. Section 81 of the CO is restated in the CB as clause 336. Under clause 336 of the CB, the company and every responsible person of the company shall be liable for late registration of charges created by them. In other comparable common law jurisdictions like the UK[19], Australia[20] and Singapore[21], there are similar provisions to clause 336 of the CB where the company and every officer of the company shall be criminally liable under the relevant offence provisions if the company fails to deliver the prescribed particulars together with the instruments by which the charges are created or evidenced to the register for registration within the prescribed period. It is desirable to retain clause 336 to achieve a deterrent effect in cases where, for instance, the court does not grant the order for extension of time or grants the order for extension but considers that there are culpabilities on the part of the directors or the company in not delivering the charge for registration within the time limit.

---

19 Section 860(4) of the UKCA 2006.

20 Section 270(2) of the Australia Corporations Act.

21 Section 132(1) of the Singapore Companies Act.

(V) A Member considered that notification to the Registrar of debt satisfaction or release of a charge, etc. under the CB should not be more cumbersome than that under the CO

23. Currently, under the CO[22], an application for registration may be made to the Registrar in a specified form, Form M2 ("Memorandum of Satisfaction or Release of Property from Charge"), supported by evidence of discharge such as Deed of Release when a debt for which a registered charge was satisfied or the property subject to a charge has been released. On registration, only Form M2 will be registered and made available for public inspection while the evidence of the release or satisfaction will be returned to the presentor of the documents.

24. Under clause 344 of the CB, when the debt secured by a registered charge has been satisfied or the property subject to a registered charge has been released, a notification may be made to the Registrar in specified form accompanied by a certified copy of any instrument for the purpose of evidencing the satisfaction or release. On registration, the notification will be registered together with the accompanying certified copy of instrument. Once registered, both the notification in specified form and the certified copy of instrument evidencing the release or satisfaction will be made available for public inspection.

25. In gist, there is no difference in the process of application or notification under the CO and the CB. The only difference relates to the type of documents registered. Under the CO, only the specified form is made available for public search, while under the CB, a certified copy of the instrument will also be made available for public inspection in addition to the specified form, to enhance the transparency of information available to the public.

Financial Services and the Treasury Bureau
Companies Registry
14 June 2011

[22] Section 85, 91(1) and (5) and 304 of CO.

Annex

Companies Act 2006 of the United Kingdom (UKCA 2006)

Section 845 - Distributions in kind: determination of amount

(1) This section applies for determining the amount of a distribution consisting of or including, or treated as arising in consequence of, the sale, transfer or other disposition by a company of a non-cash asset where—

(a) at the time of the distribution the company has profits available for distribution, and

(b) if the amount of the distribution were to be determined in accordance with this section, the company could make the distribution without contravening this Part.

(2) The amount of the distribution (or the relevant part of it) is taken to be—

(a) in a case where the amount or value of the consideration for the disposition is not less than the book value of the asset, zero;

(b) in any other case, the amount by which the book value of the asset exceeds the amount or value of any consideration for the disposition.

(3) For the purposes of subsection (1)(a) the company's profits available for distribution are treated as increased by the amount (if any) by which the amount or value of any consideration for the disposition exceeds the book value of the asset.

(4) In this section "book value", in relation to an asset, means—

(a) the amount at which the asset is stated in the relevant accounts, or

(b) where the asset is not stated in those accounts at any amount, zero.

(5) The provisions of Chapter 2 (justification of distribution by reference to accounts) have effect subject to this section.