

Capital Reduction under the New Companies Ordinance

(Relevant to PBE Paper IV – Business Law and Taxation)

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Introduction

The new Companies Ordinance (“CO”) (Cap.622) overhauled the realm of Hong Kong company law. The changes are extensive and will have a great effect on the structure and various procedures of our corporate administration. Whilst company secretaries, accountants and lawyers are all inundated with the massive amendments, only a handful of them fully understand the full picture behind. Amongst all the changes, the introduction of a new court-free capital reduction process is undoubtedly a milestone. It represented a shift from a compulsory judicial intervention approach into a transparent disclosure paradigm. This article will discuss the basic principles on capital reduction under the new CO with special emphasis on its various procedures and legal requirements.

Capital Maintenance Doctrine

The doctrine of maintenance of capital means that the share capital contributed by the shareholders cannot be paid back to them until the company is wound up. The rationale is for the protection of creditors, where it is assumed that the capital paid by the shareholders shall be available to meet the company’s liabilities. Unlawful return of capital is void under common law. Directors may also attract both criminal and civil liabilities in procuring the company for an unlawful return of capital.

This paramount principle in corporate financing was well illustrated in the leading case *Trevor v Whitworth* [1887] LR 12 App Case 409, where the court held that paid up capital may be diminished in the course of business, but persons who deal with and give credit to a limited company are expecting that the company is trading with a certain amount of capital already paid, and they are entitled to assume that no part of such capital which has been paid into the company will be subsequently paid out. The case abovementioned simply means that return of capital must be restricted, and shall be allowed only in certain limited situations.

There are four major forms on return of capital:

- 1) Reduction of Capital;
- 2) Self-Acquisition of Shares;
- 3) Financial Assistance for the Acquisition of Shares; and
- 4) Payment of Dividends.

We will focus on the Reduction of Capital.

The Forms on Reduction of Capital

Reduction of Capital can be achieved in three forms:

- 1) Returning paid-up capital to shareholders;
- 2) Extinguishing or reducing the liability on unpaid shares; or
- 3) Cancelling any paid-up share capital.

The first form is to make payment directly to shareholders. The second form is to allow holders of partly paid shares to be relieved from their liabilities on the outstanding amounts. The last form is not a direct return of capital, but a reduction of the figure of paid-up capital in the company's accounts.

The Court Sanctioned Approach

Before the advent of the new CO (Cap.622), it is a compulsory requirement that all the capital reduction procedures shall be approved by court (owing to the reason stated above). The court sanctioned procedure still maintained in the new CO (Cap.622). A company, accompanied by a duly passed special resolution, can request the court to approve its application for share capital reduction (Sub div.3 (s.211(b))). The procedure for court confirmation under s.211(b) is similar to the old CO (Cap.32). Though there is no longer a need to have an authorization provision in the articles as required by the old CO (Cap.32). A company can reduce its capital based on the relevant sections in the CO, but the power is still subject to the company's articles (if any) (s.210(3)).

Generally, the following four requirements must be satisfied before a reduction of capital would be approved by the court:

Firstly, the shareholders must be treated equitably. For example, if the capital has been returned proportionately then this requirement shall be prima facie satisfied. Though the court may still confirm the reduction if those who are not treated equally have consented to the reduction (Re Jupiter House Investments Ltd [1985] BCLC 222, 224).

Secondly, the proposal must be fully explained to the shareholders, so that they can make an informed decision. The explanation usually includes the reasons for the reduction (Re South China Strategies Ltd [1996] 4 HKC 182), the possible disadvantage and the interests of the directors involved in the proposal (Re Campaign Holdings Pty Ltd [1989] 15 ACLR 762).

Thirdly, the creditors are entitled to object if the reduction of capital involves either a return of capital to the shareholders or a cancellation of liabilities for unpaid capital (s.226(2), s.227). The court must then settle a list of creditors entitled to object (s.227(2)), and will only make the order confirming the reduction if all of them are willing to give consent or their debts to be fully discharged (s.229).

Fourthly, there must be a discernible purpose for the reduction. It means there must be a clear purpose or some reasons for justification on the reduction which can be demonstrated with evidence to the court (Re Lippo China Resources Ltd [1998] 1 HKC 161). One of the well accepted reason is that the reduction is to return to the shareholders the capital that is in excess of the wants of the company as a result of a scaling down of the company's business operation (Re Fuji Copian [HK] Ltd [2004] HKEC 1298).

The Solvency Statement

The solvency test is an alternative court free procedure first introduced under the new CO (Cap.622). It supposes to be a quicker and simpler method, and it seems to be a much better option for a company which is clearly solvent (a financially healthy company without much need for supervision from court). Though, companies may still free to choose the court confirmation method for the sake of prudence and higher certainty in legality. The procedures in details are:

- 1) The directors to issue a solvency statement (s.216)
- 2) The company to pass a special resolution (s.215)
- 3) Publish a notice concerning the company's approval of the reduction (s.218)
- 4) Both members and creditors have a five weeks period to apply to court in objecting the reduction (s.220)
- 5) The reduction must be registered in the Companies Registry (within 7 weeks after the resolution) if there is no application of objection or the court already approved the reduction (s.223 – s.225)
- 6) The reduction becomes effective upon registration (s.215(2))

Obviously, the solvency statement is the core of the whole episode. In plain English, it is a statement to be executed by each of the directors where they formed the opinion that the company can satisfy the test by fully paying off its debts within 12 months after the reduction in case of winding up; or in any other cases, for any of its debts as they become due in the period of 12 months immediately following the reduction (s.205).

Beside that, the special resolution must be passed within 15 days after the execution of the solvency statement (s.216(2)). Those members related (if it only affects certain members) to the reduction are prohibited to vote (s.217(2)(3)). There will be no restriction on voting if the reduction applies equally to all issued shares. Finally, the notice must be published in the Gazette stating that the company has approved the reduction (s.218(1)). The company must also publish a notice in the newspaper, or alternatively, notify each of the creditors.

Reserves arising from a reduction share capital can be regarded as realized profits and is distributable to shareholders as dividends (s.214).

The Implication of the New Approach

In fact, a similar solvency test also existed in the old CO (Cap.32). A solvency test is provided for a company in buying back its own shares, and financial assistance given by an unlisted companies for the purpose for an acquisition of shares in the company or its holding company. Both solvency tests are based on cash flow alone, and an auditor's report is compulsory in the situation of buying-back.

Under the new CO (Cap.622), there is no need to attach an auditor's report to the solvency statement. The rationale behind is that auditors would not be in a better position than the directors in ascertaining the company's future financial position, as the solvency statement requires forecasting rather than validating.

Indeed, directors are expected to have reasonable grounds in forming their opinions as to the company's solvency. They should carefully enquire to the state of affairs of the company before signing the solvency statement. Though an auditor's report is not compulsory, the directors should always consider to engage professional accountants or other qualified financial advisers in assessing the financial status of the company, especially on its projected financial health after the reduction. That said, for the sake of prudence, the basis for forming the opinion in the solvency statement should be recorded in writing. Finally, the resolution should set out clearly the factors that the directors have taken into account and the reasons for forming their opinions in the solvency statement.