Introduction to company law

ASSIGN BUSTER

Q1.

1. There are the difference between a private company limited by shares and a public company, as following:

Transfer shares

A private company limited by shares is restricted to transfer share according to its articles but a public company is not restricted.

Number of members

For a private company limited by shares, the number of member is limited to 50. However, the number of member of a public company is no limitation.

Subscription

Any invitation to the public to subscribe for any shares or debentures of the company is prohibited in a private company limited by shares. Nevertheless, it does not restrict a public company.

Levels of regulatory regimes

The requirements of a private company limited by shares in the Companies Ordinance are lower than those of a public company. Its annual returns filing with the Companies Registry are less information than ones of a public company. In addition, it does not have to file its accounts with the Companies Registry so that its financial information is not in the public domain. Therefore, the cost of compliance of a private company limited by shares is lower than a public company.

Functions

A private company limited by shares cannot become a listed company since becoming a listed company requires first becoming a public company. Thus, a public company may become a listed company.

Risk

A private company limited by shares is the lack of freedom to exchange shares and the low transparency level of their accounts. It leads to a higher risk investment. Consequently, it is lower level of capital investment. To opposite, a public company is lower risk investment.

(Unit 1 P. 32-33)

2. In this case, it is about the corporate veil between the company and its members. That is to say, it considers whether the rights and liabilities of the company are treated as separate from the rights and liabilities of its members in company law.

Lifting the corporate veil is no guidelines in law but there are many law cases in previous years. Generally, a company is a separate legal entity which its members are legally permitted to hide behind the corporate veil according to Salomon v. A Salomon & Co Ltd [1897] AC 22. Nevertheless, the courts may lift the veil because of obtaining improper advantages, perpetrate fraud or conceal illegal activities. The corporate veil seems a sham or facade so that the courts would lift the veil. For example, the courts determine the criminal responsibility of a company's staff or a director acts dishonestly with the company's property.

In Re H and others (Restraint Order: Realisable Property) [1996] 2 All ER 391, a lot of individuals failed fraudulently to pay more than £100 million in excise duty. Two family companies had the total of owned 100% shares. The government applied a court order to restrain them for dealing with the companies' property and their own property. The Court of Appeal held that it was a prima facie case that the companies had been used for the fraudulent evasion of excise duty. Moreover, it lifted the corporate veil because it treated the companies' property as the individuals' own property.

John suggests that Kelvin sell his shares to Leo who is John's brother. However, Leo is a fresh graduate so that he has no money to pay in Genius Limited. John wants to pay Kelvin HK$700, 000 from the company. After that, John as a shareholder of Genius Limited should receive dividends and then he will use the dividends to set off the sum of HK$700, 000. Therefore, he will transfer the 30% shares to Leo Free of charge. It is improper method because it treats the companies' property as his own property in accordance with the case. He does not have right to use the company's property to set off Leo's liability. At the same, his behavior is unfair for others and David is deprived of his right to buy the shares. Hence, it is an improper advantage.

In conclusion, the property of the company is used to set off Leo's liability and the behavior is illegal. The amount of HK$700, 000 is the company's property, not the members.

(Unit 1 P. 26)

3. In a private company, its shareholders' right is restricted to transfer shares in compliance with its articles. Generally, there is a ' pre-

emptive right' which is a shareholder must firstly provide his shares to other shareholders if he wants to sell and transfer them. After the other shareholders reject, he offers to a third party and cannot provide a discount on the shares. That is to say, the selling price cannot be lower than the amount of selling to other shareholders.

The reason is that a private company is very small scale and there is trust among shareholders. When a shareholder withdraws in the company, hence, the other shareholders have an opportunity to determine whether they accept a new shareholder.

In this case, John should have a prior right over David due to the above reason. Genius Limited is a private company which the articles restrict to transfer shares. In addition, John is the majority shareholder in the company. As a result, Kelvin should comply with its articles and he should first offer his share to John who has a pre-emptive right. If John refuses Kelvin's shares, Kelvin has a chance to sell David which is the third party. However, the selling price cannot be lower than the price of selling to John.

4. Model articles should be read to determine whether directors refuse any transfer of shares. Generally, it allows directors refuse the transfer. The reason is that they can first offer their shares to existing shareholders and the behavior is a pre-emptive right. That is to say, Kelvin should first offer his shares to John.

Except that, directors provide share buy-back that is to offer shares back to the company. In other words, Genius Limited may repurchase Kelvin's shares.

Furthermore, shareholders’ agreements restrict the transfer of shares but it is only suitable for existing shareholders of the company.

To conclude, John can object that Kelvin sell his shares to David because he can choose buy Kelvin’s shares or share buy-back.

Q2.

1. George wants to know whether F&G Limited buy back its own shares. In the past, it was not allowed because of the rule in Trevor v. Whitworth case. However, it is allowed under the new Companies Ordinance, as following:

According to the House of Lords in Trevor v. Whitworth (1887) 12 App Cas 409, it was not permitted that a company could buy back its own shares even if the Memorandum of Association allowed. That is to say, its paid-up capital should be maintained and kept unless:

- it was lost due to ordinary business risks, or
- there has been a reduction of the share capital authorized according to the legislation.

The reason of prohibition of repurchasing a company’s own shares is that it would make the damage of creditors and other abuses. For instance, an entity may pay higher than the market value when there is share buy-back. It leads to dilute the value of the remainder. But the entity pay lower and the value of the remaining shares would increase. At the same time, directors may use this method to enhance the value of their own holdings or to expand their voting power.

In recent years, the rule about capital maintenance is abolished. In other words, share buy-back for all companies is allowed and it subjects to a solvency requirement (CR 2008).

The following share redemption or buy-back may be funded in accordance with the new Companies Ordinance:

- Payment is paid out of a company's distributable profits. (section 257(2)(a));
- There is out of the proceeds of a new issue of shares which is for the purpose of share redemption or buy-back (section 237(2)(b)); or
- There is out of capital if a solvency test is passed. (section 248-266).

It is unlawful for a company or its subsidiaries to give indirectly or directly financial assistance for the purpose of acquisition of its shares in accordance with section 275. Breaking the prohibition leads to the directors in a fine and imprisonment. Under section 274, financial assistance refers to gifts, guarantees, security, indemnities, loans and any other financial assistance. Acquisition means shares transfer and shares subscription.

However, there are the following exceptions:

- the payment of dividends, allotment of bonus shares, distribution of assets in winding-up, reduction of capital confirmed by the court (section 277);
- the ordinary business of the company is lending money (section 279);
- a company in good faith in the interests of the company provides financial assistance for the employee share scheme (section 280); or

- the company provides loans to its eligible employees for the purpose of enabling them to purchase fully paid shares in its holding company or the company (section 281).

Under section 283 to 285, it subjects to solvency test and one of the three procedures, as following:

1. Under section 283, it provides financial assistance if :

- directors pass a resolution to give the assistance;
- those directors make a solvency statement;
- the aggregate amount of the assistance and other financial assistance given under this section not repaid (such as guarantee or security) is less than 5% of the paid-up share capital and reserves of the company; and
- the assistance is given not more than 12 months of the solvency statement.

According to section 283(4), the company has to send a notice and the solvency statement to all members within 15 days after giving the assistance.

2. Under section 284, the assistance is approved by written resolution of all members.

3. Under section 285, the assistance is approved by an ordinary resolution. Directors must show the benefit of the assistance to the company.

To conclude, share buy-back in Franklin Limited is allowed in recent years but there is some above restricted conditions.

(Unit 2 P. 34-38)

2. If F&G wants to reduce its capital, there are two methods for reduction of share capital.

One method is that a company passes a special resolution and applies by petition to the court for an order confirming to reducing share capital under the new Companies Ordinance under sections 226 to 232. On the petition, the court makes the order on any terms and conditions it thinks fit.

In fact, every creditor of the company has a right to reject the reduction of share capital. The court confirms the reduction of share capital when it is satisfied that:

- the creditors' consent is obtained; or
- the creditor's debt or claim is discharged, determines or is secured (section 229).

Another method is a court-free procedure and there are some following criteria:

- All directors make a solvency statement in accordance with section 216.
- Members approves in a special resolution passed within 15 days of the solvency statement in section 216.
- A public notice of the reduction of share capital is published in Gazette declaring the content under section 218.
- A notice is published in one specified Chinese and one specified English newspaper and a written notice to be given to its creditor before the

end of the week after the week in which the special resolution is passed according to section 218(3).

- A copy of the solvency statement is filed to the Registrar for registration.
- The members or creditors of the company have a right to examine the solvency statement and special resolution within five weeks' time.
- If no application of objection is raised by dissentient members or creditors to cancel the resolution, the company can deliver a copy between five and seven weeks after the resolution to the Registrar for registration in accordance with section 224(1).
- The reduction of share capital and the special resolution should take effect when the return is registered.

If a creditor or member objects to the special resolution, the court may cancel or confirm the special resolution and on any terms as it thinks fit under section 222. In order to determine whether the reduction is approval, the court may consider various elements, such as whether the reduction is equitable among shareholders and whether the interests of the creditors in the company are protected (CR 2013a).

The above states the solvency statement which each of directors makes to form the opinion that the company needs to satisfy the solvency test in accordance with section 206(1). The statement should be applied to reduction of share capital, share redemption and buy-back and financial assistance under section 204. In section 205, it states the solvency test is satisfied if:

- immediately after the transaction, the company will be capable of paying its debts; and
- the company will be able to pay its debts within 12 months after the transaction or commencement of winding up.

Given an opinion, a director must ask the company's state of affairs and prospects and take into account all the liabilities of the company in section 206(2), for example, contingent and prospective liabilities.

Besides, a solvency statement is in the specified form, states the date on which it is made and the name of each director making it, and is signed by each director who makes it according to section 206(3).

In conclusion, George can choose either one of the above two procedures to reduce the capital of F&G Limited.

(Unit 2 P. 30-33)