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# Key Changes Under The New Companies Ordinance

## Part Six – Schemes Of Arrangement, Amalgamations And Compulsory Share Acquisitions

### Introduction

The New Companies Ordinance (Cap. 622) (the **New CO**) will come into force on 3 March 2014. Following commencement of the New CO, the current Companies Ordinance (Cap. 32)(the **Old CO**) will be retitled as the "Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)". The core provisions affecting the operation of companies under the Old CO will be repealed, except those provisions relating to winding-up and insolvency of companies and prospectuses.

Charltons is preparing a series of newsletters summarizing the key changes to the company law framework under the New CO. In this sixth newsletter, we discuss key changes impacting on schemes of arrangement, amalgamations and compulsory acquisitions of shares.

### Schemes Of Arrangement: Headcount Test And 10% Objection Test

*New CO references: sections 674, 676*

Position under the Old CO

The Old 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 relevant class). If a majority in number (**headcount test**) representing three-fourths in value (**share value test**) of the creditors or members (or class) present and voting at the meeting agree to the proposed scheme, the scheme will be binding on all members or creditors and the company, provided it is sanctioned by the court.

The court has discretion not to sanction a scheme even though it has been approved under both the share value test and the headcount test. This may occur where, for example, the court considers that the process has been unfairly administered, such as where the headcount test has been satisfied by share splitting.

The court does not have jurisdiction to sanction a scheme where the headcount test has not been passed, even if share splitting has increased the headcount of members opposing the scheme.

Key changes under the New CO

A share value test – requiring members representing at least 75% of voting rights at the meeting to agree to the arrangement – has been retained for all arrangements (including arrangements involving a general offer (i.e. a share buy-back offer) or a takeover offer.

For arrangements involving a general offer or a takeover offer, the headcount test has been replaced with a new test requiring that the number of votes cast against the arrangement is not more than 10% of the votes attached to all "disinterested shares".

Other types of members' schemes will retain the headcount test, but the court will have a new discretion to dispense with the test in a particular case.

The headcount test is retained for creditors' schemes. The court will not have discretion to dispense with the headcount test in the case of creditors' schemes.

If a dissenting member applies to court to challenge a scheme involving a takeover offer or a general offer, the court may only order such member to pay legal costs if his opposition to the scheme is frivolous or vexatious (section 676(5)). A court may also require the company to indemnify a dissenting member against its legal costs if satisfied that the member is opposing the application in good faith (section 676(4)).

Practical considerations and recommended steps

**Court's power to dispense with headcount test**

The court may exercise its discretion to dispense with the headcount test in special circumstances, such as where there is evidence that the result of the vote has been unfairly influenced by share splitting. The court's discretion can be exercised regardless of whether the arrangement has been approved or rejected under the headcount test.

**"Disinterested shares" under 10% objection test**

For the purposes of the 10% objection test, "disinterested shares" means shares held by non-interested parties. "Interested parties" include:

- in the case of a general offer, the company which makes the buy-back offer and a non-tendering member, plus their associates and nominees; and
- in the case of a takeover offer, the offeror and his associates and nominees.

The term "associate" is defined in section 667 to include:

- various family members of an individual offeror / member;
- companies in which an offeror / member is "substantially interested" (e.g. by controlling more than 30% of the voting power);
- if the offeror / member is a body corporate, companies within the same group of companies as the offeror / member; and
- a person (or its nominee) who is a party to an acquisition agreement with the offeror / member to acquire shares or interests in shares to which the offer relates.

**Implications under the Code on Takeovers and Mergers**

The 10% objection test under the CO is broadly in line with the requirements for approving takeovers and privatisations under the Hong Kong Code on Takeovers and Mergers (the **Code**)(Rule 2.10 of the Code). Under Note 6 to Rule 2 of the Code, "disinterested shares" means shares in the company other than those which are owned by the offeror or persons acting in concert with it. The definition of "disinterested shares" under the New CO will overlap with the Code definition to a large extent, but the two definitions are not identical. Accordingly, an offeror should ensure that the 10% objection test has been satisfied both under the CO and the Code (where both apply).

While the rules on schemes of arrangement under the New CO will apply only to Hong Kong incorporated companies, the Code will apply to companies incorporated outside Hong Kong with a primary listing of their equity securities in Hong Kong. This would include, for example, listed companies incorporated in the Cayman Islands, BVI or Bermuda. Such companies will be subject to the Code as well the statutory requirements for schemes of arrangement under the laws of their respective jurisdictions of incorporation.

## Amalgamations: Court-Free Statutory Amalgamation Procedure

*New CO reference: sections 678 to 686*

Position under the Old CO

Under the Old CO, court sanction was required for an amalgamation. This was a costly and time consuming process, meaning that the amalgamation procedure was rarely used in practice.

Position under the New CO

The New CO provides for a court-free regime for amalgamations.

**Conditions for court-free amalgamation**

The conditions for a court-free amalgamation are as follows:

- each amalgamating company must be a Hong Kong incorporated company limited by shares;
- the amalgamation must be of wholly-owned intra-group companies. An amalgamation may either be vertical (i.e. between a 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 the solvency of the amalgamating company as well as the amalgamated company (details of the solvency statement are set out in section 679)
    - to confirm that the assets of the amalgamating company are not subject to any floating charge, or if a floating charge exists, that the chargee has consented to the amalgamation proposal;
- the amalgamation proposal must be approved by the members of each amalgamating company by special resolution; and

- the directors of each amalgamating company must notify secured creditors of the proposed amalgamation and publish a notice of the proposed amalgamation in an English and Chinese newspaper in Hong Kong.

**Court's power to disallow or modify amalgamation proposal**

Section 686 provides that before the effective date of the amalgamation proposal, the court may disallow or modify the amalgamation proposal or give directions, if it is satisfied that giving effect to the amalgamation proposal would unfairly prejudice a member or 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.

Practical considerations and recommended steps

**Effect of vertical amalgamation**

A vertical amalgamation occurs between a holding company and one or more of its wholly-owned subsidiaries. On a vertical amalgamation:

- the shares of the amalgamating subsidiary will be cancelled (without payment or other consideration); and
- the articles of the amalgamated company will be the same as the articles of the amalgamating holding company.

**Effect of horizontal amalgamation**

A horizontal amalgamation occurs between two or more subsidiaries of the same holding company. On a horizontal amalgamation:

- the shares of all but one of the amalgamating subsidiaries will be cancelled (without payment or other consideration); and
- the articles of the amalgamated company will be the same as the articles of the amalgamating company whose share are not cancelled.

**Effect of amalgamation generally**

On the effective date of an amalgamation:

- each amalgamating company ceases to exist as an entity separate from each amalgamated company
- the amalgamated company succeeds to all the property, rights and privileges, and all the liabilities and obligations, of each amalgamating company;
- any proceedings pending by or against an amalgamating company may be continued by or against the amalgamated company;
- any conviction, ruling, order or judgment in favour of or against an amalgamating company may be enforced by or against the amalgamated company; and
- any agreement entered into by an amalgamating company may be enforced by or against the amalgamated company unless otherwise provided in the agreement.

**Tax consequences of amalgamation**

To date, there have been no amendments proposed to the Inland Revenue Ordinance to reflect the new court-free amalgamation procedure, nor has the Hong Kong Inland Revenue provided guidance on the tax consequences of court free amalgamations.

Certain potential tax consequences may be of particular concern (in the absence of clarification):

- certain assets could be regarded as disposed of by the amalgamating companies on the effective date of the amalgamation. As the amalgamated company will not have incurred any costs in acquiring such assets, there may be no cost basis against which to claim depreciation allowances or deductible cost on sale of the relevant assets; and

- tax losses may not be carried over from the amalgamating company to the amalgamated company (although the fact that the amalgamated company assumes all liabilities of each amalgamating company suggests that tax losses arising in one of the amalgamating companies could be offset against the amalgamated pool of taxable profits).

Before carrying out an amalgamation, the relevant companies should also consider any overseas tax issues, for example, whether tax losses or profits will crystallise on amalgamation pursuant to the tax laws of the relevant jurisdiction, or whether a transfer of assets will be deemed to have occurred.

**Stamp duty**

Since a court-free amalgamation under the New CO can only be effected among wholly-owned intra-group companies, any deemed transfer of Hong Kong real estate and shares from the amalgamating companies to the amalgamated company is likely to qualify for stamp duty group relief under section 45 of the Stamp Duty Ordinance.

**Contracts**

Important contracts (such as loan agreements, joint venture agreements and franchise agreements) should be reviewed to determine whether an amalgamation will constitute a breach or event of default under such documents.

**Foreign law issues**

A court-free amalgamation under the New CO may not be recognised under foreign law. The relevant parties should consider obtaining foreign counsel advice in jurisdictions where key assets are located, or in respect of important contracts governed by foreign law.

**Floating charges**

As the effect of amalgamation is that the amalgamated company takes the benefits and is subject to the liabilities of the amalgamating companies, this creates an issue when amalgamating companies have floating charges 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. Accordingly, the written consents of the holders of floating charges to a proposed amalgamation are required (sections 680(2)(d)(ii) and 681(2)(d)(ii) of the New CO).

## Amalgamations: Revising The Definitions Of "Property" And "Liabilities"

***New CO references: section 675***

Position under the Old CO

Under the Old CO, the court had power to make provisions to facilitate reconstructions and amalgamations of companies, including by ordering the transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company.

For this purpose, "property" was defined as including "property, rights and powers of every description" and "liabilities" as including "duties". Based on decided cases, a transfer order made 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 Old CO.

Key changes under the New CO

Personal rights and duties may now be transferred or assigned once a transfer order is made by the court, and the consent of the parties concerned is not required. Section 675 of the New CO, which sets out additional powers which the court may exercise to facilitate reconstructions or amalgamations of companies, 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.

## Compulsory Share Acquisitions: Meaning Of "Shares Already Held By The Offeror" And "Shares To Which The Offer Relates"

*New CO references: sections 689, 691, 707 and 709*

Position under the Old CO

The Old CO included provisions for compulsory acquisition of shares following a takeover, applicable, 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 constitutes "shares already held by an offeror" and "shares to which the offer relates".

Key changes under the New CO

The New CO clarifies 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 with a shareholder which is intended to secure that such shareholder 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 (for example, "irrevocable undertakings" often given by supportive shareholders in a takeover offer) (section 689(3) of the New CO);

- shares to which a takeover offer relates may include:

    - shares that are allotted after the date of the offer but before a date specified in the offer (section 689(6));

    - 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 (section 691(2)); and

- 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 (section 691(4)).

Sections 707(1), 707(3) and 709 contain similar provisions in relation to compulsory acquisition powers following a share buy-back offer.

## Compulsory Share Acquisitions: Revised Offers

*New CO references: sections 692 and 710*

Position under the Old CO

The Old CO does not have any provision on revised offers, so that an offeror who wishes to revise his offer has to make a new takeover or share buy-back offer, and address the acceptances received under the old offer.

Key changes under the New CO

Section 692 of the New CO 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 original offer provide for:
  - the revision; and
  - acceptances on the previous terms to be regarded as acceptances on the revised terms; and
- the revision is made in accordance with that provision.

Section 710 contains a similar provision in the case of a share buy-back offer.

## Compulsory Share Acquisitions: Untraceable Shareholders

*New CO references: sections 693(3) to (7), and 712(4) to (8)*

Position under the Old CO

Under the Old CO, there is no mechanism for an offeror to apply for a court order authorising the giving of squeeze out notices in respect of takeover or buy-back offers which failed to achieve the applicable 90% squeeze out threshold because of untraceable shareholders.

Position under the New CO

Sections 693(3) to (7) of the New CO allow an offeror to apply to the court for authorisation to give squeeze out notices where the failure to achieve the 90% threshold is because the offeror is unable to trace one or more shareholders after reasonable enquiry, and provided the consideration offered is fair and reasonable. 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.

Section 712(4) to (8) provide for a similar mechanism in the case of a share buy-back offer.

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