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## COMPANY LAW

### CORPORATE LAW REFORM COMMITTEE

#### A CONSULTATIVE DOCUMENT

### CAPITAL MAINTENANCE RULES AND SHARE CAPITAL: SIMPLIFYING AND STREAMLINING PROVISIONS APPLICABLE TO THE REDUCTION OF CAPITAL, SHARE BUY BACK AND FINANCIAL ASSISTANCE

APRIL 2007

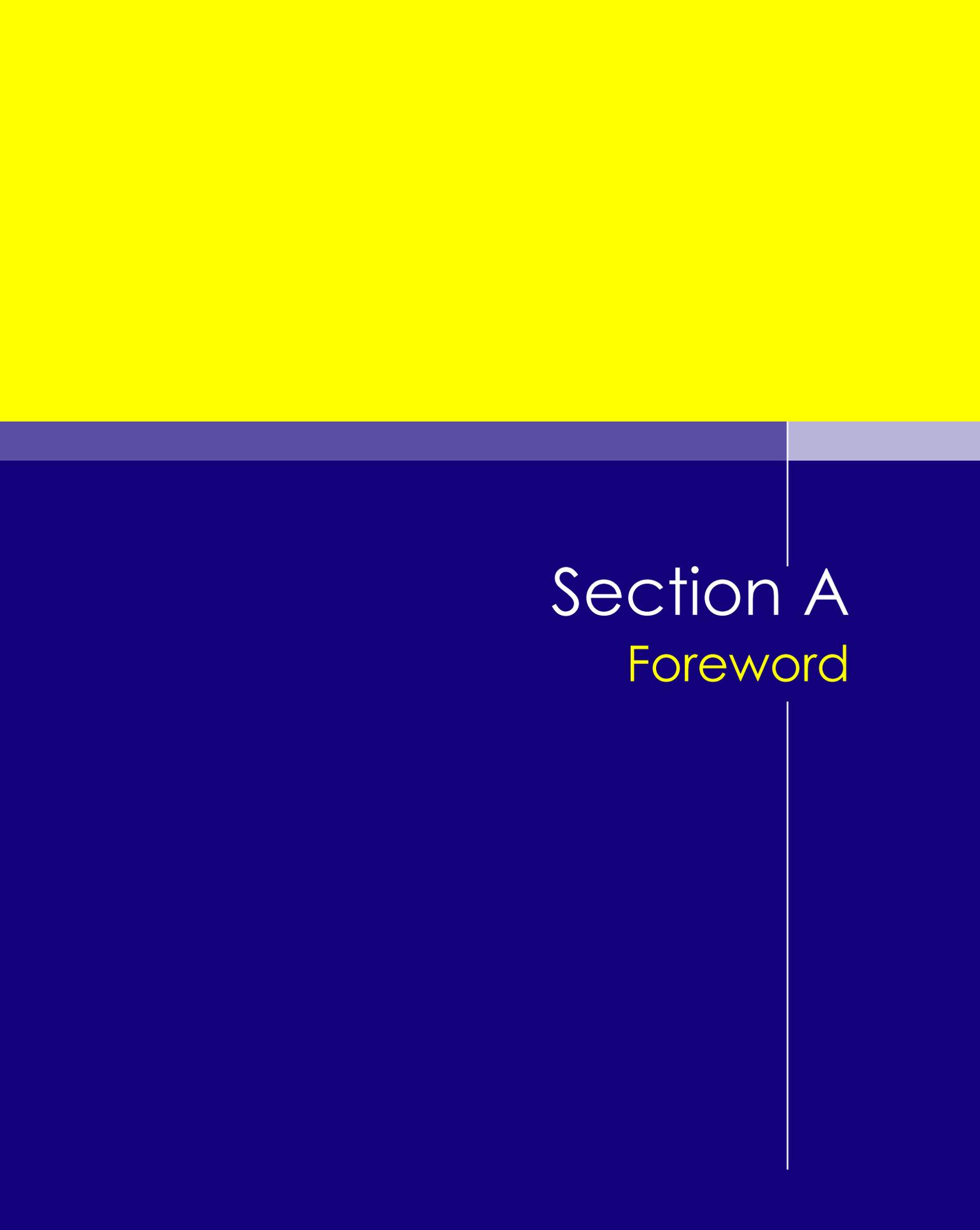
The Corporate Law Reform Committee invites comments, by **25 July 2007** on the issues set out in this consultative document.

You are invited to send comments, together with any supporting evidence on any part of this consultation. We would be grateful if you could refer to the recommendation number(s) and/or paragraph number(s) in your feedback, preferably by email, to:

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Section A  
Foreword



## SECTION A - FOREWORD

This is the second Consultation Document to be issued under the area of law pertaining to Capital Maintenance Rules and Share Capital. This Consultation Document relates to an earlier Consultation Document on 'Capital Maintenance Rules and Share Capital: Simplifying and Streamlining Provisions Applicable to Shares' where the underlying premise of the review is to ascertain whether the existing capital maintenance rules serves its creditors' protection purpose.

This Consultation Document is the result of the deliberation of the Working Group B of the CLRC which discusses the following capital maintenance rules, i.e., the share buy back, the financial assistance and the reduction of capital provisions in the Companies Act 1965. The CLRC wishes to highlight that the capital maintenance rules reviewed in this Consultation Document are recommended with the intention of preventing dissipation of company's funds that will prejudice creditors.

Whilst there is a need to protect creditors' interests against any dissipation of available assets that may be used to pay creditors, the CLRC is of the view that some restatement and reform to the existing capital maintenance rules i.e., sections 64, 67 and 67A of the Companies Act 1965 should be made as there is a need for providing businesses with the regulatory framework which would make it easier for a company to rearrange the capital structure, to operate more efficiently and reduce unnecessary costs of compliance. As such, the CLRC is proposing the introduction of a 'solvency test' regime that would be based on the 'balance sheet' solvency and 'cash flow' solvency tests. There are certain criteria which have to be fulfilled when using the solvency test. It is hoped that the introduction of this test together with other new proposals, will simplify and streamline the provisions relating to the reduction of capital, share buy back and financial assistance.

We hope to continue receiving your support and to receive views and comments on the recommendations stated in this Consultation Paper. Please reply to Nor Azimah Abdul Aziz of the Companies Commission of Malaysia (SSM) before **25 July 2007**.

Thank you

**Dato' K.C. Vohrah**

Chairman

Corporate Law Reform Committee

**Peter Lee Siew Choong**

Chairman

Working Group B

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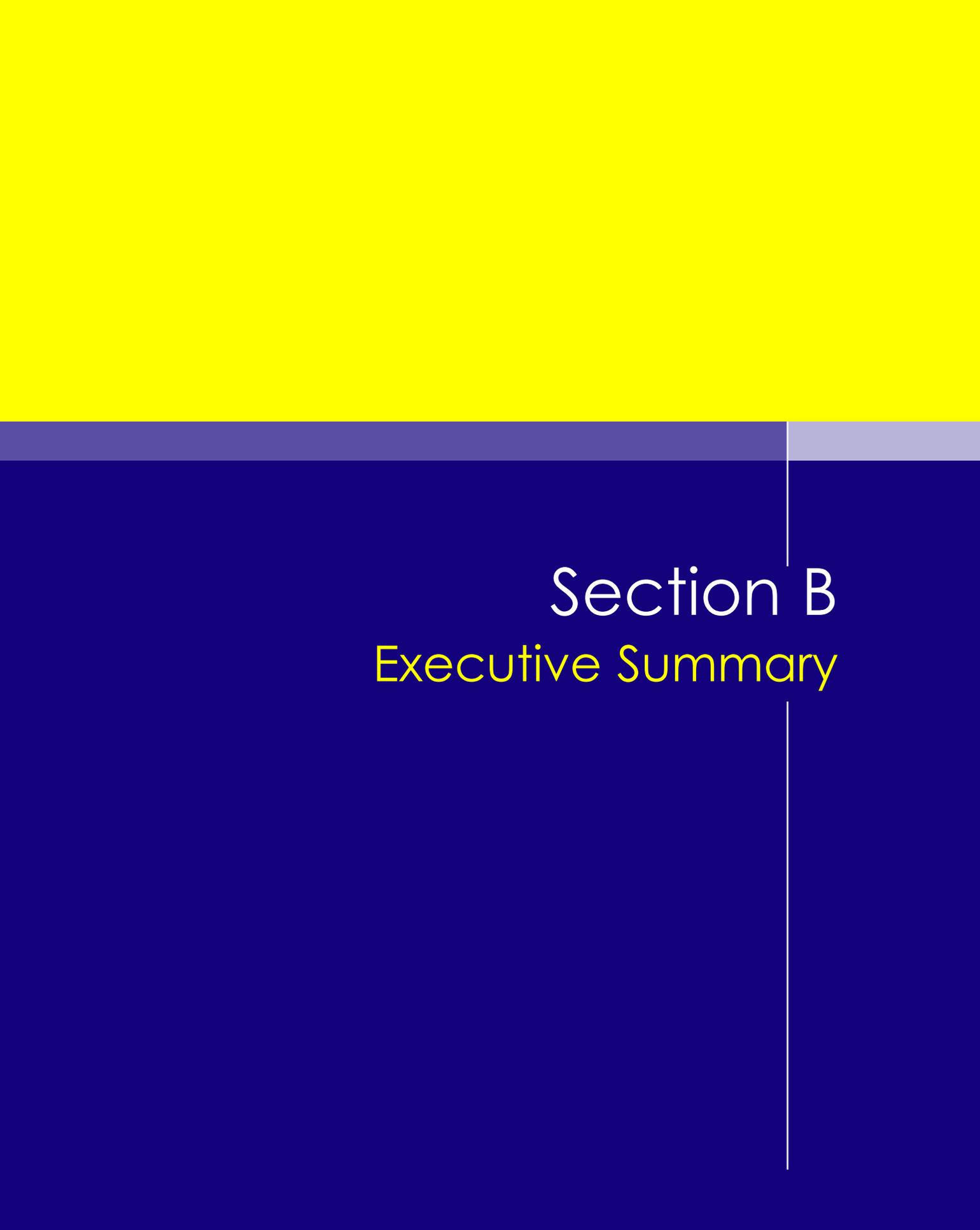
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Section B  
Executive Summary



## SECTION B - EXECUTIVE SUMMARY

### 1. Background

- 1.1 The review of section 64 of the Companies Act 1965 is conducted on the premise that regulation of this aspect of corporate exercise is deemed necessary so as to ensure the interests of creditors are protected as a reduction of the company's capital may result in the company making a distribution to its members which will reduce the available assets that may be used to pay creditors. However, the need to regulate the company's ability to reduce its capital must also be balanced against the need to provide businesses with a legal and regulatory framework that facilitates business and reduces burdensome and unnecessary costs for compliance.
- 1.2 The share buy back provision i.e. section 67A was introduced in 1997 whereby public listed companies were allowed to buy back its own shares which were listed on the Stock Exchange. The CLRC is of the view that the existing legal and regulatory framework for share buy back should be retained. However, some further improvement as stated in Part II may be made to the existing legal framework.
- 1.3 Section 67 prohibits a company from giving financial assistance for the purchase of its shares or shares of its holding company. Whilst a categorical prohibition of giving financial assistance is perceived as being able to ensure the protection of creditors' and (minority) shareholders' interest, there are some entirely legitimate and commercially sound reasons for the giving of financial assistance (for example to facilitate venture capital investment, to promote wider ownership of the company's shares or to facilitate a management buy-out) which cannot be undertaken as the giving of financial assistance is prohibited.

## 2. Proposals

2.1 Under Part I, the CLRC is recommending :

- (a) the retention of the current section 64;
- (b) the introduction of an additional alternative procedure for the reduction of capital where a company may reduce its capital provided it satisfies the solvency test;
- (c) the introduction of a statutory solvency test that is based on both the "balance sheet" and "cash flow" solvency, which is as follows:

"The company is able to satisfy the solvency test if:

- (i) the company is able to pay its debts as they become due in the normal course of business ("cash-flow" solvency); and
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities ("balance sheet" solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

- (a) must have regard to -
  - (i) the most recent financial statement of the company; and
  - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;
- (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances";
- (d) the introduction of a right to creditors to object to the reduction by the company (whether private or public) that is reducing its capital;
- (e) the introduction of grounds for objections and these are that the creditors have not been offered security for the debts or any other safeguards or that the company does not have sufficient assets;

- (f) a creditor who did not have reasonable grounds for the objection should be liable to pay costs;
- (g) criminal liability be imposed on directors in relation to the declaration of solvency; and
- (h) liability on members for the amount that they have received as a result of the reduction except where they have received the distribution in good faith.

2.2 The CLRC is recommending, under Part II, that section 67A be amended:-

- (a) by introducing a solvency test which reads as follows:
  - “The company is able to satisfy the solvency test if:
    - (i) the company is able to pay its debts as they become due in the normal course of business (“cash-flow” solvency); and
    - (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities (“balance sheet” solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

  - (a) must have regard to -
    - (i) the most recent financial statement of the company; and
    - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;
  - (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances”;

- (b) by requiring that the declaration of solvency is to be made by a majority of the directors;
- (c) by removing the words “on the market of the Stock Exchange on which the shares are quoted” in section 67A(3B)(b). This will enable the treasury shares to be sold not just on the stock exchange but also *via* direct business transaction.

2.3 Under Part III, the CLRC is recommending:

- (1) that a company be permitted to give financial assistance provided the company is able to satisfy the solvency test;
- (2) that the solvency test proposed for a reduction of capital and share buy back be adopted for the financial assistance transaction;
- (3) that the solvency statement be made by a majority of the directors and criminal liability be imposed on the directors for making a statement which is not based on reasonable grounds;
- (4) the company obtain a special resolution from the shareholders for the financial assistance.

# Section C

Capital Maintenance Rules and  
Share Capital:  
Simplifying and Streamlining  
Provisions Applicable to the  
Reduction of Capital, Share Buy  
Back and Financial Assistance



# SECTION C - CAPITAL MAINTENANCE RULES AND SHARE CAPITAL : SIMPLIFYING AND STREAMLINING PROVISIONS APPLICABLE TO THE REDUCTION OF CAPITAL, SHARE BUY BACK AND FINANCIAL ASSISTANCE

## PART I REDUCTION OF CAPITAL

### INTRODUCTION

- 1.1 Under section 64 of the Companies Act 1965, the company's Articles of Association must include a provision allowing a company to reduce its capital, the reduction of capital must be approved by a special resolution of the company and the company must seek the court's confirmation for any reduction in its share capital.
- 1.2 Under section 64 of the Companies Act 1965, a company may undertake a reduction of capital in any way but may do all or any of the following envisaged by the section :-
- (a) extinguishing or reducing the liability of shareholders to pay the amount due on their shares;<sup>1</sup> or
  - (b) cancelling any paid-up share capital which is lost or unrepresented by available assets;<sup>2</sup> or
  - (c) pay off any share capital which is in excess of the company's need.<sup>3</sup>

<sup>1</sup> See section 64(1)(a) of the Companies Act 1965.

<sup>2</sup> See section 64(1)(b) of the Companies Act 1965.

<sup>3</sup> See section 64(1)(c) of the Companies Act 1965. See also section 78A of the Singapore Companies Act (Cap 50) which is in *pari materia* with section 64(1) of the Companies Act 1965.

## **A INTRODUCING AN ADDITIONAL ALTERNATIVE PROCEDURE - REDUCTION OF CAPITAL WITH A SOLVENCY STATEMENT**

- 1.3 The CLRC noted that there are views that the requirement to obtain confirmation from the court is time consuming and causes delay to corporate exercises. There are also views that, in practice, the court's confirmation is a mere formality to endorse the company's proposal. Under section 64, the company has to prepare a list of creditors who are entitled to object to the reduction and the court must be satisfied that these creditors have consented or have been provided with security for their debts or have been paid off before confirming the reduction. Nonetheless, the court may dispense with the list. In most cases, once the company has reached an agreement with its creditors, the list is often dispensed with and thus, the confirmation by the court is readily given. Consequently, the question arises whether the requirement to obtain the court's confirmation is really necessary as a means of protecting the interests of creditors and minority shareholders and should this requirement be removed, what would be the appropriate mechanism in ensuring that the interests of creditors are protected.
- 1.4 The CLRC is of the view that the interests of creditors may be better protected by ensuring that the company has available and sufficient assets to pay its creditors. Other jurisdictions have moved away from requiring the court's confirmation for a reduction of capital. Instead, the company will have to determine whether or not the company is solvent before the reduction may be carried out. The solvency requirement is more relevant as a means to protect creditors' interest because creditors are more concerned that any distribution or return of capital to shareholders will not affect the company's ability to pay its debts.

- 1.5 Nonetheless, the CLRC is aware that the courts' confirmation provides certainty as to the legality of the transaction and thus, still has its value. It is noted that this was one of the arguments that influenced the UK Corporate Law Review (CLR) in retaining the existing reduction procedure and at the same time introduce an alternative capital reduction procedure with a solvency statement. The CLRC noted that the initial proposal of the UK CLR to delete the existing procedure for reduction which requires the approval of the court and replacing it with a reduction procedure requiring a solvency statement was not adopted in the UK CLR Final report and in the UK Companies Act 2006.<sup>4</sup> On the issue of certainty as to the legality of the reduction, it is the recommendation of the CLRC that the reduction should not be immediately carried out until after the expiration of a time frame within which any objection to the reduction may be made. However, there may be other reasons why the existing procedure under section 64 may still be attractive. For the time being, the CLRC propose the retention of the existing section 64 of the Companies Act 1965. In addition, the CLRC is also recommending the introduction of a new (additional alternative) procedure for reduction where the company will have to satisfy the solvency test in order for the company to reduce its capital. In this situation, there will not be a necessity to obtain the confirmation of the court.
- 1.6 Cross-jurisdictional studies showed that the statutory solvency test is found in the New Zealand Companies Act 1993 whereby the test must be satisfied in all types of distributions made by a company. The New Zealand Companies Act 1993 treats a 'reduction' as a distribution especially if it involves a cancellation or reduction of the shareholders' liability in relation to the shares held by the shareholders. The requirement under the New Zealand Companies Act 1993 is that the directors should

<sup>4</sup> Section 641 of the UK Companies Act 2006.



satisfy themselves that the company is a going concern with a reasonable expectation of meeting its liabilities. The New Zealand 'solvency test' requires the directors to satisfy themselves that both the tests below are met:

- (a) the company is able to pay its debts as they become due in the normal course of business ("cash-flow" solvency); and
- (b) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities ("balance sheet" solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

- (a) must have regard to -
  - (i) the most recent financial statements of the company; and
  - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;
- (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

1.7 The UK CLR and the Singapore CLRFC<sup>5</sup> have also proposed that the procedure for the reduction of capital be further liberalised by providing a reduction of capital conditional upon a solvency statement. Under the UK Companies Act 2006,<sup>6</sup> the solvency statement is a statement made by the directors which states that the directors are of the opinion that there does not exist any basis upon which the company will be unable to pay its debts, and if the company intends to commence winding up within 12 months of the date of the statement, that the company will be able to pay its debts in full within 12 months from the commencement of winding up,

<sup>5</sup> Companies (Amendment) Bill No 11/2005 which came into force from Monday 30 January 2006. see <http://appiqs.acra.gov.sg>.

<sup>6</sup> See section 643. See also the UK Company Law Reform Bill 2005, section 562.



or in any other case, the company is able to pay its debts as they fall due during the year immediately following the date of the statement ("cash-flow" solvency).

- 1.8 The Singapore Companies Act combines the approaches adopted by the UK Companies Act 2006 and the New Zealand Companies Act 1993. The Singapore Companies Act states that the solvency statement is a statement made by the directors that they are of the opinion that there does not exist any basis upon which the company will be unable to pay its debts, and if the company intends to commence winding up within 12 months of the date of the statement that the company will be able to pay its debts in full within 12 months of the commencement of winding up, or in any other case, that the company will be able to pay its debts as they fall due during the year immediately following the date of the statement ("cash-flow" solvency). The directors must also form an opinion that the value of the company's assets is not less than the value of its liabilities. This is known as "balance sheet" solvency. In determining whether the value of the company's assets is not less than the value of its liabilities, the directors<sup>7</sup>
- (a) must have regard to -
    - (i) the most recent financial statements of the company; and
    - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of its liabilities (including contingent liabilities); and
  - (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

<sup>7</sup> See section 7A of the Singapore Companies Act (Cap 50).



- 1.9 The CLRC noted that under the current accounting practices, a company's solvency is determined by both the "balance sheet" solvency and the "cash flow" solvency and therefore, the CLRC is of the view that the solvency test should be based on both the "balance sheet" solvency and the "cash flow" solvency.
- 1.10 In relation to the solvency statement, the CLRC considered whether, in addition to the solvency statement, the company has to submit audited accounts or have the accounts confirmed by an external auditor. The Singapore CLRFC recommended that where a company's accounts are not audited, the directors would be required to make a statutory declaration of solvency. Where a company's accounts are audited, the solvency statement shall be in the form of a statutory declaration, or should be confirmed by external auditors.<sup>8</sup> This proposal has been enacted in the Singapore Companies Act.<sup>9</sup> On the other hand, the UK CLR Final Report recommended that there would be no requirement for the solvency statement to be supported by an auditor's report.<sup>10</sup> However, the UK Companies Act 2006 requires the solvency statement to be supported by an auditor's report.<sup>11</sup> The CLRC is of the view that the solvency statement is sufficient and does not recommend introducing the requirement to attach an auditor's report as this may complicate the matter further. Furthermore, the CLRC recommends that the solvency statement is to be made by all the directors of a company.

<sup>8</sup> Recommendation 2.19 of the Singapore CLRFC. This was similar to the initial proposal of the UK Company Law Review in Modern Company Law: Company Formation and Capital Maintenance (1999) para 3.30.

<sup>9</sup> Section 7A of the Singapore Companies Act as amended by section 6 of the Singapore Companies (Amendment) Bill No 11/ 2005.

<sup>10</sup> Para 7.90 completing the structure, Final Report para 10.6.

<sup>11</sup> See the UK Companies Act 2006 section 714.

1.11 It has been noted by the CLRC that in Singapore, a cancellation of the paid-up share capital which is lost or unrepresented by available assets<sup>12</sup> does not have to satisfy the solvency requirement.<sup>13</sup> But it is not clear whether a company that reduces capital by the cancellation of the paid-up share capital which is lost or unrepresented by available assets has to obtain the court's confirmation.<sup>14</sup> There are views that for this type of reduction of capital there is theoretically no risk of diminution of assets to be used to pay creditors by a return to shareholders or by the cancellation of the shareholders' liability for unpaid amounts although there is a possibility of abuse of the process.<sup>15</sup> However, where there are huge losses, a company would normally not be solvent and because of this, the CLRC is of the view that the company would then have to obtain the court's confirmation under the existing section 64 of the Companies Act 1965.

<sup>12</sup> Which is equivalent to section 64(1)(b) of the Companies Act 1965.

<sup>13</sup> Section 28 of the Singapore Companies (Amendment) Bill No 11/ 2005 introducing sections 78B(3) and 78C(3) into the Singapore Companies Act (Cap 50).

<sup>14</sup> Section 78H of the Singapore Companies Act (Cap 50).

The Singapore Companies Act (Cap 50) also provides that court's confirmation may be obtained for a reduction of capital that involves:

(a) a reduction of liability in respect of unpaid share capital; or  
(b) the payment to a shareholder of any paid-up share capital,

and also applies if the Court so directs in any other case where a company makes an application under that section.

<sup>15</sup> There are concerns that there is a risk of fictitious or over-estimation of losses reported by a company where a company could subsequently sell the asset and due to the write down in the value of the company's assets, treat the proceeds as profits and return it to shareholders, thereby reducing the assets available to pay the creditors. See R. Pennington, *Company Law* (8<sup>th</sup> Edn, 2001) Butterworths, at p 215.

## **B** RIGHT TO OBJECT

1.12 The CLRC noted that the UK CLR distinguishes private companies from public companies in respect of the right of the creditor to object to the reduction. Creditors will have to be notified of the reduction. For public companies, the creditors are provided with the option of challenging the reduction. The grounds for objections are that the creditors have not been offered security for the debts or other safeguards; and that the company's assets are insufficient to make this unnecessary. A time frame of 4 weeks is given after the special resolution to enable objections to be made. The right to object is given to any individual creditor where there would be no threshold in terms of the number of objections or the amount of the debt.<sup>16</sup> However, since the UK Government White paper and the UK Companies Act 2006 have rejected the recommendations in relation to public companies, public companies will have to comply with the existing requirement to obtain confirmation from the court.<sup>17</sup>

1.13 The CLRC also noted that under section 78D of the Singapore Companies Act, the right to object to the reduction is made available to both private and public companies.<sup>18</sup> The Singapore CLRFC's recommendation is that for public companies, the alternative capital reduction process would further require the publication of a notice (in advance of the proposed capital reduction) in a national newspaper and making available for public inspection the shareholders' resolution and the solvency statement as well as be susceptible to the challenge by a creditor in court.<sup>19</sup> The CLRC is of the view that the right to object should be given to creditors of private as well as public companies. Requirements for publicity are essential to enable creditors

<sup>16</sup> Modern Company Law: Company Formation and Capital Maintenance (1999) para 3.31.

<sup>17</sup> See the UK Companies Act 2006, Chapter 10.

<sup>18</sup> Section 28 of the Singapore Companies (Amendment) Act 2005 introducing new section 78D into the Singapore Companies Act.

<sup>19</sup> Recommendation 2.19 of the Singapore CLRFC.

to be informed of the proposal for reduction and an appropriate time frame should be specified to facilitate any challenge made by the creditors on the reduction.

- 1.15 Another issue which was considered by the CLRC is whether there should be any threshold in terms of the number of objecting creditors or the amount of the debt. The UK CLR did not recommend such a restriction. The CLRC noted that there are concerns that as there is no threshold in terms of the number of objecting creditors or the amount of the debt, any individual creditor may easily prevent a reduction of capital. On this point, the CLRC noted that it was suggested by the UK CLR that where a creditor did not have reasonable grounds for objection, he should be liable to costs.<sup>20</sup> This would be a sufficient deterrent against any abuse of the process. Therefore, the CLRC recommends that for a reduction of capital with a solvency statement, the creditors of the company will be allowed to challenge the reduction in court and to object to the reduction and where a creditor did not have reasonable grounds for the objection, he should be liable to pay costs.

## **C** LIABILITY OF DIRECTORS AND MEMBERS

- 1.16 Whilst the solvency requirement will ensure that the creditors' rights are protected, there are concerns that since the decision on whether or not the company is solvent is made by the directors, there should be personal liability imposed on the directors in relation to the making of the solvency statement.
- 1.17 The New Zealand Companies Act 1993 provides that recovery from the directors for the distribution may be made if:

<sup>20</sup> Modern Company Law: Company Formation and Capital Maintenance (1999) para 3.31.



- (a) the board failed to take the procedural steps of authorising the distribution or certifying compliance with the solvency test; or
- (b) there was no reasonable ground to believe that the company would satisfy the solvency test at the time the compliance certificate was signed; or
- (c) the distribution is not deemed to have been authorised under section 52(3).

The New Zealand Companies Act 1993 also provides for recovery from shareholders except where they have received the distribution in good faith, have not changed their position and if it would be unfair to insist on recovery.<sup>21</sup> If recovery from shareholders is not possible, then the statutory provision in relation to recovery from directors will apply.

1.18 Section 78J of the Singapore Companies Act provides that a director who makes groundless or false statements in relation to the capital reduction provisions shall be guilty of an offence.<sup>22</sup> Section 78K also provides that a member of a company (past or present) is not liable in respect of the issue price of any shares to any call or contribution greater in amount than the difference (if any) between -

- (a) the issue price of the share; and
- (b) the aggregate of the amount paid up on the share (if any) and the amount reduced on the share.

1.19 It is the view of the CLRC that there is merit in imposing criminal liability on the directors in relation to the solvency statement. Further, the company should be allowed to recover from the shareholders the amount received by the shareholders pursuant to the reduction except where they have received the distribution in good faith.

<sup>21</sup> Section 56 of the New Zealand Companies Act 1993.

<sup>22</sup> The statements are those made under section 78E(1)(ii)(B), (2)(i), (3)(iii)(A) or (4)(iii)(A). Under section 7A the criminal liability is a fine not exceeding \$100,000 or imprisonment for a term not exceeding 3 years or both.



## RECOMMENDATIONS

1.20 The CLRC recommends :

- (a) the retention of the current section 64;
- (b) the introduction of an additional alternative procedure for the reduction of capital where a company may reduce its capital provided the solvency test has been satisfied;
- (c) the introduction of a statutory solvency test that is based on both "balance sheet" and "cash flow" solvency which is as follows:

"The company is able to satisfy the solvency test if:

- (i) the company is able to pay its debts as they become due in the normal course of business ("cash-flow" solvency); and
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities ("balance sheet" solvency).

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- (a) must have regard to -
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  - (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities.
- (b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances";
- (d) the introduction of a right of creditors to object to the reduction by the company (whether private or public) that is reducing its capital;
- (e) the introduction of grounds for objections and these are that the creditors have not been offered security for the debts or any other safeguards or that the company does not have sufficient assets;

- (f) a creditor who did not have reasonable grounds for the objection should be liable to pay costs;
- (g) there should be criminal liability imposed on directors in relation to a false declaration of solvency; and
- (h) there should be liability on members for the amount that they have received as a result of the reduction except where they have received the distribution in good faith.

### Questions for Consultation

#### Question 1:

**Do you agree that the current procedure of obtaining the court's confirmation which is provided for under section 64 of the Companies Act 1965 should still be retained?**

#### Question 2:

**Do you agree to the introduction of an additional alternative procedure that a company may reduce its capital provided it satisfies the solvency test?**

#### Question 3:

**Do you agree that the solvency test should be as follows:**

**“The company is able to satisfy the solvency test if:**

- (i) the company is able to pay its debts as they become due in the normal course of business (“cash-flow” solvency); and**
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities (“balance sheet” solvency).**

**In determining whether the value of the company's assets is not less than the value of its liabilities, the directors**

**(a) must have regard to -**

**(i) the most recent financial statement of the company; and**

**(ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;**

**(b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances".**

**Question 4:**

**Do you agree that the directors should be required to make a declaration of solvency? If yes, should the solvency test be made by all the directors or a majority of the directors? Should the solvency statement be supported by an auditor's report (in the case of a company that must have its accounts audited)?**

**Question 5:**

**Do you agree that the creditors of a company (whether private or public) that is reducing its capital under the alternative procedure should be given the right to object to the reduction?**

**Question 6:**

**Do you agree that the grounds for objections should be that the creditors have not been offered security for the debts or any other safeguards or that the company does not have sufficient assets?**

**Question 7:**

**Do you agree that a creditor who did not have reasonable grounds for the objection should be liable to pay costs?**

**Question 8:**

**Do you agree that there should be criminal liability for directors in relation to the declaration of solvency?**

**Question 9:**

**Do you agree that it should be possible for the company to recover from shareholders the amount that they have received in relation to the reduction except where they have received the distribution in good faith?**

## PART II REFORMING THE PROVISIONS ON SHARE BUY BACK

### INTRODUCTION

2.1 The CLRC recommends the retention of the existing legal and regulatory framework for share buy back with some modifications as stated below.

#### **A INTRODUCTION OF A SOLVENCY TEST**

2.2 The CLRC noted that currently, section 67A of the Companies Act 1965 and regulation 18A of the Companies Regulation 1966 require that there must be a declaration made by the directors stating, amongst others, that it is the opinion of the majority of the directors (where there are more than two directors) that the listed company is solvent at the date of declaration and the share buy back will not result in the company being insolvent or its capital being impaired.

2.3 Under the proposal for the reduction of capital, the CLRC had considered the different approaches in comparable jurisdictions in relation to the solvency test and had proposed to introduce a solvency test. The CLRC is of the opinion that the same solvency test as proposed for a reduction of capital be adopted for the share buy back provision. The test is as follows:

“The company is able to satisfy the solvency test if:

- (i) the company is able to pay its debts as they become due in the normal course of business (“cash-flow” solvency); and
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities (“balance sheet” solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

(a) must have regard to -

- (i) the most recent financial statement of the company; and
- (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;

(b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances".

2.4 However, under the share buy back provision, unlike a capital reduction with a solvency test where the declaration of solvency must be made by all of the directors, the CLRC is proposing that the solvency declaration be made by a *majority* of the directors. This is a more lenient approach as compared to the proposal *vis-à-vis* the reduction of capital. The lenient approach is proposed as there is no other alternative procedure in the case of share buy back. This position is unlike the proposal for a reduction of capital where the additional alternative procedure requires all the directors to declare the company is able to comply with the solvency test. In such a case, where a company is unable to obtain all the directors to make the declaration the company may follow the existing procedure for capital reduction and go to court to obtain the court's confirmation.

## **B TREATMENT OF TREASURY SHARES**

2.5 The CLRC noted that there are already statutory provisions relating to treasury shares and how the treasury shares are to be treated. Under the current section 67A, the shares which have been bought back may be cancelled or kept as treasury shares

or both. The treasury shares may be distributed as share dividends or be sold on the stock exchange in accordance with the existing rules of the stock exchange.

- 2.6 The Singapore Companies Act provides that treasury shares may be -
- (a) sold for cash;
  - (b) transferred for the purposes of or pursuant to an employees' share scheme;
  - (c) transferred as consideration for the acquisition of shares in or assets of another company or assets of a person;
  - (d) cancelled; or
  - (e) sold, transferred or otherwise used for such other purposes as the Minister may by order prescribe.<sup>23</sup>

The UK Companies Act provides that:

'Where shares are held as treasury shares, a company may at any time -

- (a) sell the shares (or any of them) for cash,
- (b) transfer the shares (or any of them) for the purposes of or pursuant to an employees' share scheme, or
- (c) cancel the shares (or any of them).<sup>24</sup>

- 2.7 The CLRC is of the view that whilst the current provision in relation to "treasury shares" should be retained, the law should be amended to remove the restriction that the shares are to be sold "on the market."<sup>25</sup> This will enable the treasury shares to be sold not just on the market of the stock exchange but also by private treaty via direct business transactions provided existing safeguards (for example in terms of a

<sup>23</sup> Section 76K of the Singapore Companies Act.

<sup>24</sup> Section 162D of the UK Companies Act 1985.

<sup>25</sup> "On the market" is not defined in the Companies Act although section 67A(3B) (and also section 67A(2)(b) ) further provide that the resale (and purchase) must be done in accordance with the relevant rules of the Exchange. However, under paragraph 12.02 of the Bursa Malaysia Securities Berhad Listing Requirements, "on the market" is defined to mean transactions made through the Automated Trading System of the Exchange and shall exclude Direct Business transactions as defined in the Rules of the Exchange.

minimum disposal price, related party transactions and disclosure obligations) as stated in the Bursa Malaysia Securities Berhad Listing Requirements are complied with.<sup>26</sup>

- 2.8 It was further noted by the CLRC that section 67A(3C) provides thatse treasury shares shall have no voting rights or the right to share in any distribution (i.e., dividends or distribution of assets upon a winding-up). This is in line with the Companies Act of other jurisdictions such as UK and Singapore. In addition, section 67A(3C) also provides that the treasury shares shall not be taken into account in calculating the number or percentage of shares or class of shares in the company for any purposes, including, without limiting the generality of this provision, the provisions of any law or requirements of the Articles of the company or listing rules of a Stock Exchange on substantial shareholding, takeovers, notices, the requisitioning of meetings, the quorum of a meeting and the result of a vote on a resolution at a meeting. There are views that the underlined wording is too wide and lacks clarity especially on whether the treasury shares are to be counted for the purposes of the listing rules of a stock exchange on substantial shareholding or takeovers. The effect of these wording is that since the treasury shares are not taken into consideration in relation to ascertaining substantial shareholding, a share buy back may inadvertently creates a substantial shareholder or changes in the shareholding of an existing substantial shareholder through no conduct of the person. The practice in such cases is for an application for a waiver to be made as this will enable better surveillance and

<sup>26</sup> For e.g., the 10 per cent limit and pricing control, amongst others.



enforcement. Nevertheless, the CLRC is of the view that in such situations, there should be an automatic waiver. Alternatively, section 67A(3C) should be redrafted to simply state that the company shall have no voting rights or the right to share in any distribution (i.e., dividends or distribution of assets upon a winding-up) and that the treasury shares are to be treated as carrying no voting rights.<sup>27</sup>

- 2.9 Furthermore, corollary amendments to section 67A will also have to be made in view of the earlier recommendation of the CLRC to introduce a 'no par value' environment.<sup>28</sup> This will entail an amendment to section 67(3E). In addition, the CLRC is also recommending clarification of section 67A(5) to state where there is a cancellation of shares bought back pursuant to section 67A, the directors will have the powers necessary to effect a cancellation of shares without having to comply with the procedure under a reduction of capital.

<sup>27</sup> This requires the deletion of the wording in section 67A(3C) that states treasury shares shall not be taken into account in calculating the number or percentage of shares or class of shares in the company for any purposes, including, without limiting the generality of this provision, the provisions of any law or requirements of listing rules of a Stock Exchange on substantial shareholding, takeovers. As a comparison the Singapore Companies Act provides that the company shall not exercise any right in respect of the treasury shares and this includes any right to attend or vote at meetings. The company shall be treated as having no right to vote and the treasury shares shall be treated as having no voting rights: section 76(2) and (3). In addition, no dividends may be paid and no other distribution in respect of the company's assets, including distribution in a winding up, may be made to the company in respect of the treasury shares: section 76(4).

Section 726 of the UK Companies Act 2006 states that "The company must not exercise any right in respect of the treasury shares, and any purported exercise of such a right is void. This applies, in particular, to any right to attend or vote at meetings." In addition "No dividend may be paid, and no other distribution (whether in cash or otherwise) of the company's assets (including any distribution of assets to members on a winding up) may be made to the company, in respect of the treasury shares."

<sup>28</sup> Corporate Law Reform Committee, "Capital Maintenance Rules and Share Capital: Simplifying and Streamlining Provisions Applicable to Shares."

## RECOMMENDATIONS

2.10 The CLRC recommends that section 67A be amended:-

(a) by introducing a solvency test as follows:

“The company is able to satisfy the solvency test if:

- (i) the company is able to pay its debts as they become due in the normal course of business (“cash-flow” solvency); and
- (ii) the value of the company's assets is greater than the value of its liabilities, including contingent liabilities (“balance sheet” solvency).

In determining whether the value of the company's assets is not less than the value of its liabilities, the directors

(a) must have regard to -

- (i) the most recent financial statement of the company; and
- (ii) all other circumstances that, the directors know or ought to know, affect or may affect the value of the company's assets and the value of the company's liabilities, including its contingent liabilities;

(b) may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances”;

(b) by requiring that the declaration of solvency is to be made by a majority of the directors;

(c) by removing the words “on the market of the Stock Exchange on which the shares are quoted” in section 67A(3B)(b). This will enable the treasury shares to be sold not just on the stock exchange but also *via* direct business transaction.

## Questions for Consultation

### Question 10:

Do you agree to the introduction of the solvency test as stated above as part of section 67A?

### Question 11:

Do you agree that the declaration of solvency for a share buy back is to be made by only a majority of the directors?

### Question 12:

Do you agree that the words “on the market of the Stock Exchange on which the shares are quoted in section 67A(3B)(b)” should be removed to enable the treasury shares to be sold not just on the stock exchange but *via* direct business transaction?

### Question 13:

Do you agree that if the company decides to re-sell the treasury shares, a time frame should be stated for the treasury shares to be resold and that the treasury shares are to be cancelled if not resold within this time frame? If yes, what would be the appropriate time frame?

### PART III REFORMING SECTION 67 OF THE COMPANIES ACT 1965

- 3.1 The CLRC noted that the following jurisdictions, i.e., the United Kingdom (UK),<sup>29</sup> Australia,<sup>30</sup> New Zealand,<sup>31</sup> Hong Kong<sup>32</sup> and Singapore<sup>33</sup> have amended the strict prohibition provision against a company giving financial assistance for the purchase of its shares and now allows a company to give financial assistance subject to certain statutory safeguards.
- 3.2 Under the UK Companies Act 1985, a public company is prohibited from giving financial assistance<sup>34</sup> but a private company may give financial assistance for the acquisition of its shares or its holding company's shares provided the holding company is also a private company and if the net assets of the company are not reduced by the financial assistance.<sup>35</sup> The UK Companies Act 2006 retains the prohibition imposed on a public company from giving financial assistance.<sup>36</sup>
- 3.3 Under the Australian legislation, financial assistance can be given if:<sup>37</sup>
- (a) it does not materially prejudice the interests of the company or its shareholders
  - or if it does not materially prejudice the company's ability to pay its debts;

<sup>29</sup> Sections 155(1) and 155(3) of the UK Companies Act 1985.

<sup>30</sup> Australian Corporations Act 2001 section 260A(1)(a), (b) and (c).

<sup>31</sup> Sections 76(1)(a), 78 and 80 of the New Zealand Companies Act 1993.

<sup>32</sup> Section 47D-'Special restriction for listed companies' of the Hong Kong Companies Ordinance (Cap 32 1950) which was introduced into the HK Companies Ordinance on 30/06/1997 whilst s 47E-'Relaxation of section 47A for unlisted company' was introduced on 13/02/2004.

<sup>33</sup> Singapore's provision in the Companies Act (Act 42 of 1967) on financial assistance i.e., section 76(1) originated from the UK, and was also modelled on section 129 of the Australian Companies Act 1961 and is similar to section 67 of the Malaysian Companies Act 1965. The section was extensively redrafted by the Singapore Companies (Amendment) Act 1987 (Act 13 of 1987). Singapore has reviewed its financial assistance provision as part of the comprehensive company law review programme undertaken by the Company Legislation and Regulatory Framework Committee ('CLRFC'). The present statutory provisions on financial assistance are the result of Report of the Company Legislation and Regulatory Framework Committee ('CLRFC') (2002).

<sup>34</sup> See UK Company Law Review, Modern Company Law: Company Formation and Capital Maintenance: Consultation Document (October 1999), para 3.41 where it states that "As noted in the Strategic Consultation Document, financial assistance is normally regarded as part of the capital maintenance regime, although transactions involving financial assistance do not in fact diminish a company's share capital. Article 23 of the Second Directive requires us to maintain a prohibition on financial assistance by public companies, subject to limited exceptions; but there is no external requirement on us to maintain a prohibition, or restrictions, on financial assistance by private companies."

<sup>35</sup> However, if the net assets will be reduced, to the extent that the net assets are reduced, the assistance can be given if it is from distributable profits. Sections 155-158 of the Companies Act 1985.

<sup>36</sup> Sections 677-680 of the UK Companies Act 2006.

<sup>37</sup> Section 260A(1)(a), (b) and (c) of the Australian Corporations Act 2001.

- (b) the financial assistance is approved by shareholders, with disclosure of information to the shareholders and the Australian Securities and Investment Commission ('ASIC') and the persons acquiring the shares or their associates are not allowed to vote; or
- (c) if the financial assistance is exempted under the statute.

3.4 The New Zealand Companies Act 1993 allows a company to give financial assistance provided the board is satisfied on reasonable grounds that the company, immediately after the giving of the financial assistance, is able to comply with the solvency test. The New Zealand Companies Act 1993 has the same solvency test for any distribution to shareholders, financial assistance and payment of dividends.<sup>38</sup> The New Zealand Companies Act 1993 allows the following types of financial assistance:

- (a) if the board resolves to give financial assistance and there is unanimous shareholders' approval;<sup>39</sup> or
- (b) where the directors resolve that the giving of financial assistance is of benefit to those shareholders not receiving the assistance and that the terms and conditions under which the assistance is given are fair and reasonable to those shareholders not receiving the assistance;<sup>40</sup> or
- (c) financial assistance given where the amount of the financial assistance, inclusive of the amounts of any other financial assistance by the company must not exceed 5 per cent of the aggregate of amounts received by the company in respect of the issue of shares and reserves as disclosed in the most recent financial statements of the company.<sup>41</sup>

3.5 However, if after a resolution is passed and before the financial assistance is given, the board ceases to be satisfied on reasonable grounds that the company will,

<sup>38</sup> See the insolvency test proposed under Part I on Reduction of Capital.

<sup>39</sup> Section 76(1)(a) of the New Zealand Companies Act 1993.

<sup>40</sup> Section 78 of the New Zealand Companies Act 1993.

<sup>41</sup> Section 80 of the New Zealand Companies Act 1993.



immediately after the financial assistance is given, satisfy the solvency test, any financial assistance given by the company is deemed not to have been authorised. The solvency statement must be made by a majority of the directors.

3.6 In Singapore, a company may give financial assistance if the company is able to comply with the solvency test and the financial assistance may be given in the following manner:

- (a) if the board so resolves and there is unanimous shareholders' approval;<sup>42</sup>
- (b) if the board so resolves and subject to a special resolution of the shareholders;<sup>43</sup>
- (c) financial assistance given where the amount of the financial assistance, inclusive of the amounts of any other financial assistance by the company must not exceed 10 per cent of the aggregate of the amounts received by the company in respect of the total paid-up capital of the company and reserves as disclosed in the most recent financial statements of the company.<sup>44</sup>

The solvency statement must be made by a majority of the directors and must also be accompanied with an auditor's report for companies which must have their accounts audited.

3.7 The CLRC recommends that the strict prohibitive regime for financial assistance be replaced with a more facilitative regime where the financial assistance transaction shall be made subject to a special resolution of the shareholders. The CLRC is of the view financial assistance by way of a unanimous shareholders' approval may not be viable for a public listed company and allowing financial assistance by itself gives too much discretion to directors and may be open to abuse. Nonetheless, *if it is suggested* that it should be possible for directors to approve the giving of financial assistance without having to obtain the approval of shareholders, this should be

<sup>42</sup> Section 76(9B) of the Singapore Companies Act (Cap 50).

<sup>43</sup> Section 76(10) of the Singapore Companies Act (Cap 50).

<sup>44</sup> Section 76(9A) of the Singapore Companies Act (Cap 50).



limited to, for example financial assistance given where the amount of the financial assistance, inclusive of the amounts of any other financial assistance by the company must not exceed 5 per cent (similar to new Zealand) or 10 per cent (similar to Singapore) of the shareholders' fund or where applicable on a consolidated basis as disclosed in the recent financial statement of the company. The shareholders' funds is chosen as the basis for the calculation as this ensures that any losses have been taken into account whilst a consolidated position would be a more accurate assessment of the company's financial position.

- 3.8 The CLRC is of the view that the company must also satisfy the solvency test before the company may give any financial assistance. As the CLRC is also proposing the introduction of a solvency test for a reduction of capital and a share buy back proposal, the CLRC recommends the same solvency test as is proposed for a reduction of capital and a share buy back to be adopted for the financial assistance provision. The CLRC also proposes that the solvency statement is to be made by a majority of the directors. However, as in the case for a reduction of capital and a share buy back, there is no requirement for the solvency statement to be accompanied by an auditor's report.

## RECOMMENDATIONS

- 3.9 The CLRC recommends:
- (1) that a company be permitted to give financial assistance provided the company is able to satisfy the solvency test;
  - (2) that the solvency test proposed for a reduction of capital and share buy back be adopted for the financial assistance transaction;
  - (3) that the solvency statement be made by a majority of the directors and impose personal liability on the directors for making a statement which is not based on reasonable grounds;

- (4) to require the company to obtain a special resolution from the shareholders for the financial assistance.

### **Questions for Consultation**

#### **Question 14:**

**Do you agree that:-**

- (a) a company should be allowed to give financial assistance in relation to the acquisition or purchase of its shares subject to the company satisfying the solvency test?**

**OR**

- (b) only a private company is allowed to give financial assistance in relation to the acquisition or purchase of its shares subject to the company satisfying the solvency test?**

#### **Question 15:**

**Do you agree that (subject to compliance with the solvency test) a company may give financial assistance only if the company obtains a special resolution from the shareholders?**

#### **Question 16:**

**Do you agree that (subject to compliance with the solvency test) a company may also give financial assistance without obtaining the shareholders' approval if the board so resolves? If yes, do you agree that the amount of the financial assistance, inclusive of the amounts of any other financial assistance by the company must not exceed 5 per cent of the aggregate of amounts received by the company in respect of amounts received by the company in respect of the total paid-up capital of the company and reserves as disclosed in the most recent financial statements of the company?**