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Clerk to the Bills Committee on Companies Bill
Legislative Council Secretariat
Room 1010, Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

16 March 2012

Dear Sirs

Re: Submission on the Retention of the Headcount Test for Members' Scheme (clause 664)

Thank you for the invitation and apologise for missing the deadline for submission.

It is the considered view of the joint authors of this submission that in order to afford maximum protection to the interests of all scheme shareholders in members' schemes of listed companies, the headcount test should be **abolished**.

Our view is based on the arguments made in an article written by one of the authors. The article has been attached as Enclosure 1 for the information of Members of the Bills Committee.

The arguments are summarised as follows.

1. The headcount test gives too great a veto power to small shareholders disproportionate to their individual financial contribution to the company. This contravenes the 'one-share-one-vote' principle, which has been enshrined in Section 114A(1)(e) of the Companies Ordinance (CO).

2. According to the recently revised Rule 13.39(4) of the Rules Governing Listing of Securities on the Stock Exchange, voting by shareholders on any resolution in general meetings must be taken on a poll (i.e., one share, one vote). The headcount test, however, is predicated on a 'show-of-hands' vote (i.e., on person, one vote) and effectively establishes a veto on the outcome of a poll vote, hence in breach of Rule 13.39(4).

3. The introduction of a scripless registration system in Hong Kong cannot adequately address the criticisms that the headcount test fails to reflect the decisions of the beneficial owners of a company's equity. This is because most investors, for convenience, will still prefer to hold their stocks at CCASS even after Hong Kong stock market becomes scripless. The current problem of CCASS being instructed by beneficial owners to vote both a 'Yes' and a 'No' on a resolution and hence cancel their preferences out, will thus remain. Those parties who intend to manipulate the vote, safe in the knowledge that the CCASS vote, no matter how overwhelming the proportion of shareholders it represents in favour of or against the scheme, has no actual impact on the outcome of the vote.

4. We disagree with the Securities and Futures Commission's claim that since there have been only two cases of manipulation in the last 20 years, vote splitting is an uncommon phenomenon in Hong Kong, hence there is no need to abolish the headcount test. The fact is that if the stakes are high enough, manipulators have the incentive, as the case of *Re PCCW Ltd* [2009] 3 HKC 292 clearly demonstrates, to engage in extensive share splitting to boost the head count in favour of a privatisation artificially.

5. The abolition of the headcount test will not undermine investors' protection because the interests of the scheme shareholders are more than adequately protected by the so-called 10 per cent rule, i.e., a scheme will fail under Rule 2.10(b) of the Takeovers Code if the number of votes against the scheme is more than 10 per cent of the votes attaching to all disinterested shares voting on the proposition.

   In respect of the Government's contention that the Takeovers Code is to supplement, not a substitute for the statutory protections provided in the CO, our view is that the main concern of scheme shareholders in a members' scheme is whether or not their interests have been adequately protected, not whether Rule 2.10(b) of the Takeovers Code supplements or substitutes for the relevant section of the CO. It is important to note that of the 1,502 companies currently listed on the Stock Exchange, nearly all of them attract the protection of the Takeovers Code[1] (only nine are secondary listees[2] that are not subject to the Takeover Code). To ensure maximum protection of scheme shareholders' interests, it is submitted that the Government, in its current effort to give statutory backing to selective Listing Rules, should also consider giving similar backing to Rule 2.10(b).

6. Finally, we do not share the Government's view on the suggested merit of arming the court with a new discretion to dispense with the headcount test if there is evidence of, say, vote manipulation. It is noteworthy that the new statutory discretion is closely modeled on Section 411(4)(a)(ii)(A) of the Australian Corporations Act 2001 (ACA), which was introduced by way of amendment in December 2007. There has been little Australian case law to date on how this statutory discretion should be exercised and thus no guidance is provided for the Hong Kong courts to refer to if such cases were to arise in Hong Kong.

   More important, the Australian government has been recommended to abolish the headcount test and repeal the relevant subsection in the ACA. If this recommendation is accepted, Hong Kong will be left with a model of statutory discretion that no longer exists in the jurisdiction that created it. Since the Australian authorities are likely to abandon the headcount test which Hong Kong proposes to continue to embrace, the better view is that the Government should accept that the headcount test no longer has any substantial support in a leading common law jurisdiction and should likewise follow the Australian example and abolish it.

To conclude, Hong Kong can ill afford a repeat of the PCCW fiasco which will, in our view, substantially weaken the SAR's reputation as an international financial centre. However, retention of the headcount test is not the best way to ensure minority protection in such circumstances and provides an incentive to those in favour of such schemes to attempt to manipulate the vote and, in any event, can be unjust in providing too great a veto power to a

[1] See the Takeovers Code, paragraph 4.1 of the Introduction.
[2] CapitalMalls Asia Ltd; Coach, Inc; Glencore International plc; Kazakhmys plc; Manulife Financial Corporation; Midas Holdings Ltd; SBI Holdings, Inc; SouthGobi Resources Ltd and Vale S.A.

tiny number of shareholders. For the above reasons, the Government is urged to abandon the headcount test.

However, Government should also address the root cause of inadequate protection of minority shareholders' interests in Hong Kong which is the nature and operations of some family owned conglomerates. Such corporations often adopt policies that are inimical to the interests of minority shareholders. The government should amend the Bill and propose more effective and tailored remedies to address these very important concerns.

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Enclosure 1

Whither Headcount Test in Scheme Privatisations of Hong Kong-listed Companies?

*Daniel T.L. Lam**

This article examines the Hong Kong government's decision to maintain the headcount test for privatisations of listed companies by schemes of arrangement despite the verdict in Re PCCW Ltd [2009] 3 H.K.C. 292 that the test is susceptible to vote manipulation, and the consensus of the financial services industry in Hong Kong as well as the recommendation by Australia's Corporations and Markets Advisory Committee to abolish the test.

Introduction

On 4 November 2008, Pacific Century CyberWorks Ltd (PCCW), the leading telecommunications provider in the Hong Kong Special Administrative Region (Hong Kong or HKSAR), announced that Pacific Century Regional Developments Ltd and China Network Communications Group Corp (Joint Offerors), which owned a total of 47.72 per cent of PCCW's issued shares between them, had jointly offered to buy out the remaining 52.28 per cent at HK$4.20 (US$0.540) a share in a bid to privatise PCCW by a scheme of arrangement[1] (Scheme) under section 166 of the Companies Ordinance (CO) (Cap. 32).

After the Scheme passed the so-called 'headcount test', that is, a simple majority in number of affected shareholders voted in favour of the Scheme at a class meeting, PCCW petitioned the Court of First Instance (CFI) to sanction the Scheme. The

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[1] A scheme of arrangement involves a compromise or an arrangement to alter rights of creditors or members who are parties to the scheme: *Re Moulin Global Eyewear Holdings Ltd* [2007] 4 H.K.L.R.D. 315 (CFI) at [37] per Barma J. A compromise presupposes some dispute about the rights compromised: *Re Wah Nam Group Ltd (No 2)* [2003] 1 H.K.L.R.D. 282 (CFI) at [33] per Kwan J. An arrangement, on the other hand, implies some form of accommodation or 'give and take' between the parties to the scheme: *Re National Farmers Union Development Trust* [1972] 1 W.L.R. 1548 (Ch) at 1555C-D per Brightman J.

Securities and Futures Commission (SFC), which is the HKSAR's securities regulator and a party represented at the hearing before the CFI, opposed PCCW's petition because Pacific Century Regional Developments Ltd (PCRD) and its concert parties, it was alleged, had engaged in share splitting[2] to artificially boost the number of approving voters to ensure that the Scheme could pass the headcount test. The regulator regarded share splitting as a form of vote rigging, and in breach of section 166.

The CFI, however, rejected the SFC's allegations, and sanctioned the Scheme. On appeal, the Hong Kong Court of Appeal (HKCA) held[3] that extensive share splitting had distorted the shareholders' vote at the meeting, and resulted in a breach of section 166. The HKCA thus allowed the SFC's appeal, and refused to sanction the Scheme.

The controversy caused by share splitting in this case prompted the HKSAR government, as part of its effort to rewrite[4] the CO,[5] to consult market practitioners on whether or not the headcount test should be abolished.[6] At the end of the consultation, the government decided to maintain the test, but allow the court to dispense with it under certain circumstances.[7]

Likewise, the UK government has retained the headcount test in the new Companies Act 2006[8] (CA) as it considers the test an important investor safeguard.[9] An assertion[10] by the Company Law Review Steering Group[11] that the test was prone to

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[2] Share splitting involves one or more shareholders transferring small parcels of shares to a large number of other persons willing to attend the meeting and vote according to the wishes of the transferor. See Treasury, *Explanatory Statement to the Exposure Draft of Corporations Amendment (Insolvency) Bill 2007* (Canberra, 10 November 2006) para. 4.170.

[3] CACV 85/2009, 11 May 2009; reported as *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA).

[4] The HKSAR government has been rewriting the CO since mid-2006 to make it more user-friendly and conducive to the conduct of business for enhancing Hong Kong's competitiveness and attractiveness as an international business and financial centre.

[5] The new Companies Bill was gazetted on 14 January 2011.

[6] See Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) Chapter 6.

[7] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) para. 43(a).

[8] Chapter 46 of 2006.

[9] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) para.15, n. 4.

[10] Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure* (November 2000) para. 11.9.

share splitting was dismissed by Lord Goldsmith, the former Attorney General, in a House of Lords debate on the issue in 2006, as a 'theoretical possibility' and was 'not a good enough reason to do away with the protection … [the headcount test] provides'.[12]

Despite the force in the arguments of both the Hong Kong and UK governments, this article will contend that the headcount test should be abolished in respect of members' schemes of listed companies. The structure of the article is as follows. Part two will set out, in brief, the context and judgments of the *PCCW* case. Part three will first describe the HKSAR government's market consultation on the headcount test and then set out my arguments for rejecting the test. It will be suggested that other means exist to protect minority shareholders' interests which are just as effective as the test but less susceptible to manipulation. Hence, the abolition of the headcount test will not result in weaker protection of minority shareholders' interests, but reduce the risk of vote manipulation and unnecessary litigation to determine whether or not such manipulation has occurred.

Background to the Scheme[13]

PCCW's predecessor was Cable & Wireless HKT Ltd (HKT), which held a de facto monopoly of all domestic telephone traffic in Hong Kong for over 80 years.[14] However, in August 2000, HKT was taken over by PCCW, which was controlled by businessman Richard Li through a number of subsidiaries and associated companies including PCRD, in a deal worth HK$296,000 million (US$38.046 billion).

Although the takeover immediately catapulted PCCW into being the fourth-largest listed company in Hong Kong by market capitalisation, the company's operating environment deteriorated due to the bursting of the Internet bubble, and the emergence of a fiercely competitive market place filled with mobile telephone

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[11] An independent body appointed by the UK government in 1988 to conduct a root-and-branch review of the UK's company law. Its recommendations led to the eventual enactment of the CA.
[12] See HL Deb 16 May 2006, vol. 682, col. 217 (Lord Goldsmith).
[13] Based on Yeung, 'A Corporate Career Cast in Controversy' *South China Morning Post* (Hong Kong, 12 May 2009) B1.
[14] HKT's forerunner was Hong Kong Telephone Co Ltd which was granted the sole right to supply and operate telephone services in Hong Kong in 1925.

operators challenging PCCW's core fixed-line business. The company was also crippled with a mountain of debt it had incurred to finance the takeover.

Between 2001 and 2007, PCCW entered into a number of controversial transactions which were heavily criticised by its shareholders and the market alike. In early 2008, PCCW's share price dropped to a historically low level, and Richard Li decided to delist the company from the Stock Exchange of Hong Kong Ltd (SEHK) to avoid further scrutiny[15] of PCCW's corporate activities by the investing public.

Under Rule 6.15 of the Listing Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd (Listing Rules), a listed issuer may withdraw from listing after an incumbent majority shareholder has acquired all the shares that he does not already own in the company[16] (scheme shares or disinterested shares) by a scheme of arrangement[17] (scheme) under section 166 or a general offer under section 168.

The scheme procedures[18]

Where a scheme is used to take over the target company, the majority shareholder offers to cancel the scheme shares by paying their holders (scheme shareholders) a cancellation price as consideration. The resulting credit arising in the target company's books of account will be applied to pay up in full and issue to the majority shareholder the same number of new shares as will be cancelled under the scheme. In this way, the majority shareholder becomes 100 per cent owner of the target company.

The need for sanction

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[15] See Ferran, *Principles of Corporate Finance Law*, (OUP 2008) 415-16 for other reasons of privatisation.

[16] Lovells, *Privatisation of Companies Listed in Hong Kong* (November 2008) pp. 1-4; DLA Piper, *Takeovers of Listed Companies in Hong Kong* (23 June 2011) p. 3.

[17] Originally designed to facilitate compromises and arrangements between creditors to help companies avoid liquidations, schemes of arrangement are now frequently used for privatising companies: *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [77] per Rogers V-P; *Re Savoy Hotel Ltd* [1981] Ch. 351 (Ch) at 354B per Nourse J.

[18] See, e.g. *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [3] per Rogers V-P.

Section 166(1) of the CO prescribes that the scheme shareholders approve the scheme at a class meeting convened as a result of a court order (court meeting). Subsection 2 requires that the scheme be approved:

(i) by a simple majority in number of the members present, either in person or by proxy, at the court meeting, which, as previously mentioned, is usually referred to as the 'headcount test'; and
(ii) that number must hold at least 75 per cent in value of the shareholdings in respect of which votes have been cast – the so-called 'share value test'.

If the target is a listed company, these approval thresholds are overlaid by rules 2.9 and 2.10 of the Codes on Takeovers and Mergers and Share Repurchase (Takeovers Code), which stipulate that the scheme:

(a) be approved by the scheme shareholders holding at least 75 per cent in value of the disinterested shares voted, in person or by proxy, on a poll; and
(b) not be rejected by the scheme shareholders by way of a poll holding more than 10 per cent in value of *all* the disinterested shares (the 10 per cent rule).

Introduced in its current form in 2002 by the SFC, rule 2.10(b) is peculiar to Hong Kong and cannot be found in other common law jurisdictions which have retained the headcount test such as the UK, Australia and Singapore.[19] According to the SFC, the 10 per cent threshold test was introduced to 'accommodate more fairly the relative positions of the controlling or major shareholders and the minorities',[20] to 'reflect more fairly the dominant influence of the shareholding of the controlling shareholder in either a privatisation or other scheme'.[21] In other words, the regulator intended to use rule 2.10(b) to counteract the dominant influence of controlling shareholders in scheme privatisations. Given that many listed companies in Hong Kong are controlled by single family interests, which tend to use privatisations to achieve their

[19] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.6(b).
[20] Securities and Futures Commission, *Consultation Paper on a Review of the Codes on Takeovers and Mergers and Share Repurchase* (10 April 2001) para. 6, p. 10.
[21] Securities and Futures Commission, *Consultation Paper on a Review of the Codes on Takeovers and Mergers and Share Repurchase* (10 April 2001) Commentary, p. 14.

own ends,[22] it is not surprising that the regulator wanted to provide an additional safeguard to minority shareholders by introducing the 10 per cent rule.

If the scheme meets the tests set out in section 166(2) and rule 2.10, the target company is then able to petition the CFI to sanction it.[23] Once sanctioned, the scheme binds the target company and its shareholders[24] including dissentients.[25] The court order sanctioning the scheme takes effect after a copy of it has been delivered to the Companies Registry for registration.[26]

The procedures for general offer

By contrast, if the takeover of the target company is effected by a general offer, the bidder makes an offer directly to the disinterested shareholders to buy their shares. After acquiring at least 90 per cent of the disinterested shares within four months from the date of the offer, the bidder is entitled to acquire compulsorily the remaining shares by notifying those concerned of its intention to purchase[27] their shares at the original offer price.[28]

This rule, however, is subject to the right of the affected shareholders to apply for a court order to stop the acquisition or vary the offer terms.[29] Generally, the court takes the 90 per cent approval as evidence that the offer is fair[30] unless the applicants can prove otherwise,[31] for example, the 90 per cent acceptors are not independent of the bidder.[32]

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[22] Many family-controlled listed companies in Hong Kong are apt to privatise their subsidiaries in a bear market and re-list them when market sentiments improve. But the attempts often fail as the cancellation prices are rejected on the ground that they represent deep discounts to the underlying value of the minority shareholdings. See, e.g., the unsuccessful attempts by the Lee Shau Kee family, the majority owner of Henderson Land Development Co Ltd, to buy out the minorities (26.52%) of its subsidiary, Henderson Investment Ltd. All of the materials are available at http://www.webb-site.com.

[23] *Re Hawk Insurance Ltd* [2001] 2 B.C.L.C. 480 (CA) at [11] per Chadwick L.J.

[24] *Srimati Premila Devi v Peoples Bank of Northern India Ltd.* [1938] 4 All E.R. 337 (PC (India)) at 343C-D per Lord Romer.

[25] *Re Cape plc* [2006] 3 All E.R. 1222 (Ch) at [62] per David Richards J.

[26] CO, s. 166(3); CA, s. 899(4).

[27] CO, Schedule 9, s. 1; Codes on Takeovers and Mergers and Share Repurchases, rule 2.11. See also CA, s. 979.

[28] *Re Hoare & Co.* (1933) 150 L.T. 374 (Ch) at 375 per Maugham J.

[29] CO, Schedule 9, s. 4; CA, s. 986(1).

[30] *Re Hoare & Co.* (1933) 150 L.T. 374 (Ch) at 375 per Maugham J.

[31] *Re Chez Nico (Restaurants) Ltd* [1992] B.C.L.C. 192 (Ch) at 207c-d per Brown-Wilkinson V-C.

[32] *Re Bugle Press Ltd* [1961] Ch. 270 (CA) at 287 per Lord Evershed M.R.

In effecting a change of control in the target company, the scheme route enjoys two distinct advantages over the general offer route, namely that:

- the incumbent majority shareholder does not pay any stamp duty on the scheme shares cancelled[33] because there is no transfer[34] of shares as in the general offer; and
- the purchase of only 75 per cent of the scheme shares enables the incumbent majority shareholder to obtain 100 per cent control of the target company,[35] whereas the general offer requires a higher threshold of 90 per cent before compulsory acquisition of the remaining disinterested shares can take place.

For these reasons, the Joint Offerors chose the scheme route to privatise PCCW.

The *PCCW* case in brief

As noted earlier, the proposed cancellation price was HK$4.20 (US$0.540) a share, but shortly after the court meeting was held on 30 December 2008, the amount was increased to HK$4.50 (US$0.577) each, apparently an 11th-hour bid to win over strong opponents of the Scheme, who would have caused it to fail.

Despite an approximately seven per cent increase in the cancellation price, many Scheme shareholders were still dissatisfied with the Scheme for two reasons. First, the revised cancellation price was substantially lower than the long-term historical share price and that of recent privatisations of other telecommunications companies.[36] Second, after the Scheme became effective, a special cash dividend of at least HK$18,134 million (US$2.331 billion) would be paid to the Joint Offerors and their

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[33] Payne, "Schemes of Arrangement, Takeovers and Minority Shareholder Protection" (2011) 11 J.C.L.S. 67, 70.

[34] Stamp duty is payable on any transfer of shares of companies in Hong Kong at the rate of 0.2% of the consideration paid or the value of the shares (whichever is higher). See DLA Piper, *Takeovers of Listed Companies in Hong Kong* (23 June 2011) p. 7.

[35] Cotton and Klineberg, "Corporate Schemes – Versatile and Effective" (2007) 4 J.I.B.F.L. 226, 226.

[36] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [80]-[82], [89] per Rogers V-P. See also *PCCW Supplemental Scheme Document* (12 January 2009) p. 12.

concert parties,[37] but not to the Scheme shareholders. With the cost of the Scheme estimated to be approximately HK$15,934 million[38] (US$2.048 billion), the amount of the special dividend would not only cover the total cancellation price, but also leave the Joint Offerors and their cohorts with a bonus payment of at least HK$2,200 million[39] (US$0.283 billion).

To ensure that the Scheme would pass the headcount test at the re-convened court meeting, PCRD's concert parties engaged in share splitting to artificially boost the number of voters in favour of the Scheme. According to the SFC, which commenced an investigation into the matter after being tipped off by a member of the public,[40] during the five-week adjournment of the court meeting in which the terms of the Scheme were revised consequent upon the change in the cancellation price, the Joint Offerors caused 500,000 PCCW shares to be split into single board lots (1,000 shares) and distributed them to 494 persons who would in turn vote for the Scheme. The regulator argued that the court should discount the votes cast by these voters.

Court meeting on 4 February 2009[41]

Despite persistent rumours of vote rigging,[42] the adjourned court meeting was re-convened, as scheduled, on 4 February 2009. A total of 2,262 Scheme shareholders attended and voted at the court meeting. These shareholders held 1,628,013,122 Scheme shares, which represented approximately 46.87 per cent of the Scheme shares in total.

The result was as follows:

- 1,404 Scheme shareholders voted for the Scheme and they held in total 1,348,536,322 Scheme shares, which represented approximately 82.83 per cent of the total number of shares voting at the court meeting.

[37] See *PCCW Supplemental Scheme Document* (12 January 2009) p. 14.
[38] See *PCCW Supplemental Scheme Document* (12 January 2009) p. 13.
[39] See *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [14] in which Rogers V-P cited with approval the views of Glass, Lewis & Co, the international proxy adviser, that payment of the special dividend to the Joint Offerors unfairly benefited them at the expense of the Scheme shareholders.
[40] *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [30] per Kwan J.
[41] See *Re PCCW Ltd*, Unreported, HCMP2382/2008, 6 April 2009, [23]-[27] per Kwan J.
[42] See, e.g., Editorial, 'PCCW Saga Leaves Much to be Desired' *South China Morning Post* (Hong Kong, 5 February 2009) A10.

- 859 Scheme shareholders holding a total of 279,476,800 Scheme shares voted against the Scheme, which represented approximately eight per cent of the total number of Scheme shares.

The Scheme was approved by a majority of 545 in number and 82.83 per cent in share value terms. It also passed rule 2.10(b) of the Takeovers Code as only eight per cent of the total number of Scheme shares were against the Scheme.

Sanction of the Scheme

At first instance, Kwan J. found evidence of share splitting to artificially boost the number of approving voters.[43] However, since there was no rule in Hong Kong prohibiting such activity,[44] she proceeded to sanction the Scheme. The SFC immediately applied for and was granted leave to appeal her decision.

The HKCA set aside the CFI's verdict after a four-day hearing. In the court's view, although share splitting was not a criminal offence, it was able to deliberately distort (i) the balance of the fairness between the holders of shares in different proportions required by section 166(2),[45] and (ii) the goal of obtaining a resolution fairly representing the will of a *bona fide* majority.[46] With the extent of share splitting at the court meeting (59.33 per cent[47]), the court was unsure if the vote was fair or not.[48]

In addition, where share splitting took place for the purpose of increasing the number of voters in favour of the Scheme, the court should disregard[49] the extra votes cast by those members because they voted for the Scheme, not in the best interest of the class of Scheme, but for a variety of collateral purposes that was not shared by the class of Scheme shareholders as a whole.[50]

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[43] *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [109], [116] and [118] per Kwan J.
[44] See *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [142] per Kwan J.
[45] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [71] per Rogers V-P.
[46] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [139] per Lam J.
[47] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [170]-[173] per Barma J.
[48] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [66] per Rogers V-P.
[49] *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* (2001) 4 H.K.C.F.A.R. 358 (CFA) at [27(6)] per Lord Millett N.P.J.
[50] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [170]-[173] per Barma J.

To conclude, share splitting was nothing less than a form of dishonesty and the court could not sanction dishonesty.[51] It was also a form of coercion as the shareholders holding the majority in number of shares forced the minority into accepting a contrary view, and the court should not allow this to happen.[52] If the court were to condone[53] share splitting and other forms of vote manipulation, it would lead to a free-for-all in which shareholders wishing to achieve a vote in a particular way simply arranged for their shares to be registered in the names of other people willing to cooperate. Any shareholders' vote in this environment would be meaningless.

Market consultation on the headcount test

In view of the public concern over vote manipulation revealed in the *PCCW* case, the HKSAR government conducted a market consultation on the headcount test in December 2009, which was modelled on a similar consultation[54] undertaken by Australia's Companies and Markets Advisory Committee (CAMAC) in June 2008. The consultation paper set out the following three options in respect of members' schemes of listed and non-listed companies and of creditors' schemes:[55]

- retain the headcount test without any change;
- retain the test but give the court a discretion to dispense with it in certain circumstances; or
- remove it.

The government received[56] a total of 241 submissions, approximately 197 of which wanted to abolish the headcount test for all three types of schemes. Insofar as

[51] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [71] per Rogers V-P.
[52] *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co.* [1891] 1 Ch. 213 (CA) at 239 per Lindley L.J.
[53] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [75] per Rogers V-P.
[54] See Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Discussion Paper* (26 June 2008) pp. 52-63.
[55] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) paras. 6.16-6.30.
[56] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) paras. 7-12.

members' scheme of listed companies was concerned, 124 respondents[57] were in favour of abolishing the test whereas 20 respondents[58] wished to retain it.

Despite overwhelming support (82 per cent) for abolishing the headcount test, the HKSAR government has decided[59] to retain the test but give the court a statutory discretion to dispense with it if the result of the vote has been unfairly influenced by share splitting and other forms of vote rigging. The revised headcount test is contained in clause 664(2)(c)(ii) of the Companies Bill which provides that the scheme will be approved if the headcount test is met *unless the court orders otherwise.* (Emphasis added)

It is submitted that the HKSAR government's decision to maintain the headcount test in respect of members' schemes of listed companies despite market consensus to abolish it is unsustainable. In the following sections, two arguments against retaining the headcount test and the rationale for abolishing the test will be explained.

1. Insufficient basis for maintaining the headcount test

In making a case for retaining the headcount test, the supporters of the test rely on two principal arguments. First, there is little evidence that the test attracts attempts at vote manipulation despite the HKCA's decision to the contrary in the *PCCW* case. Second, even if the test attracts manipulation, it should still be maintained as it protects minority shareholders' interests.

Little evidence of manipulation

The supporters of the headcount test such as Lord Goldsmith in the UK and the SFC in Hong Kong contend[60] that despite the long history of the existence of the headcount

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[57] Respondents included the Bar Association, the Law Society, Linklaters, Clifford Chance.
[58] They comprised, e.g., the SFC, the Association of Charted Certified Accountants, the Chinese General Chamber of Commerce, the Hong Kong Securities Association.
[59] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) paras. 16, 43(a).
[60] Securities and Futures Commission, *SFC's Response to Chapter 6 of the Consultation Paper – Draft Companies Bill – First Phrase Consultation*, 28 January 2010, para. 15.

test,[61] there have been very few instances of vote rigging in scheme privatisations to date. The SFC, for example, has intervened in privatisations on the ground of share splitting only twice in the past 20 years. It is therefore untenable to assert that attempts to manipulate the vote at court meetings are common.

That vote manipulation has occurred in at least two schemes in the past 20 years, if anything, gives credence to the claim that the headcount test does attract manipulation, and reinforces the view[62] that the headcount test incentivises shareholders to split their shareholdings and transfer them to 'nominees' to ensure a majority in number of members to secure the scheme's approval or rejection.

Further, whilst the SFC has intervened in only two recorded cases of vote manipulation in respect of members' schemes, it does not follow that these were the only cases where such misconduct occurred. There may well have been cases in which the minority has used share splitting to increase the head count of members opposing the scheme, and so block it as a result. Where a scheme fails to obtain the necessary voting majority at the court meeting, it can never proceed to the stage of court sanctioning. Upon being presented with the *fait accompli* of a blocked scheme, the usually apathetic[63] Hong Kong shareholders are reluctant to take legal actions to enforce their rights or complain to the regulator unless their interests have been very seriously prejudiced by the terms of the scheme.

That PCRD and its concert parties had gone to great lengths to ensure that the scheme passed the headcount test in the *PCCW* case shows that if the stakes are high enough, both proponents and opponents of the scheme will engage in extensive share splitting to boost the head count in favour of a privatisation artificially. Although the HKCA outlawed share splitting in that case, those parties intending to manipulate the vote may still be tempted to try more subtle ways to split shares including pre-emptive splitting before privatisations are proposed, for example, by handing out shares to

[61] Section 166 was based on s. 121(2) of the Companies Ordinance 1911, which, in turn, was modelled on s. 120 of the Companies (Consolidation) Act 1908 (UK).
[62] Mayo and Ong, 'PCCW: A Majority in Number' *Simmons and Simmons – In Brief*, 20 March 2009, available from http://www/simmons-simmons.com.
[63] Low, "A Roadmap for Corporate Governance in East Asia" (2004) 25 Northwest. J. Int'l L. & Bus. 165, 185; Allen and Jones, *AGGA Asian Proxy Voting Survey 2006* (September 2006) p. 11.

employees, as long as the headcount test is maintained.[64] The only way to prevent shareholders from engaging in share splitting in these circumstances is to abolish the headcount test altogether.

Protection of minority shareholders' interests

Supporters of the headcount test has argued that even if the test is prone to manipulation, it is still worth retaining because it serves as an essential check on the share value test,[65] and protects minority shareholders' interests by ensuring that a proposal which does not enjoy broad based support among shareholders cannot be forced through by a small number of shareholders who between them control a large stake of the company's equity capital.[66]

No doubt the headcount test protects minority shareholders' interests. But the main objection to this argument is that it seems to suggest that protection of minority shareholders' interests in a members' scheme depends solely on the headcount test, and that it has to be retained despite being tainted by misconduct. However, the test is but one of the safeguards of minority shareholders interests in a scheme approval process. If the headcount test is abolished, minority shareholders' interests will still be adequately protected by the following means.

Scheme's overall suitability

First, directors of the target company are required to act in the interests of the scheme shareholders generally in proposing the scheme to them.[67] Second, under rule 2.1 of the Takeovers Code, an independent board committee of the target company must be established to examine the scheme's merits with the assistance of an independent

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[64] Anand, 'Another Richard Li Deal Sinks', *FinanceAsia*, May 2009, p. 23, quoting David Webb.
[65] Financial Services and the Treasury Bureau, *Bill Committee on Companies Bill – Part 13 and Part 14 of the Companies Bill*, CB(1)2389/10-11(01) (2 June 2011) Appendix to Annex A, para. 4
[66] See *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [177] per Barma J.
[67] See Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Report* (December 2009) p. 92. See generally *Peskin v Anderson* [2001] 1 B.C.L.C. 372 (CA) at [33]-[34] per Mummery L.J.

financial adviser before making investment recommendations for scheme shareholders.

Vote at the court meeting

Most of the 124 respondents in support of abolishing the headcount test agreed that, in practice, rule 2.10 of the Takeovers Code, not the headcount test, provided protection to minority shareholders in a members' scheme.[68] Specifically, a scheme will fail under rule 2.10(b) if it is rejected by more than 10 per cent in value of all the disinterested scheme shares, not of the shares cast at the court meeting.

Accordingly, even if the majority engages in share splitting to boost the head count, the scheme may still fail because the number of votes of the dissenting minority at the court meeting exceeds the 10 per cent rule, which is not difficult to achieve given that the denominator has become larger as it is based on the total number of scheme shares. However, some critics are concerned that[69] in the *PCCW* case, rule 2.10(b) was unable to block the Scheme at the court meeting, and that the HKCA would have sanctioned the Scheme but for the vote manipulation. This is, it is submitted, not a serious concern because just as the 10 per cent rule failed to block the Scheme in the *PCCW* case, so too were a number of controversial schemes[70] defeated at court meetings in Hong Kong in the past few years by exceeding the 10 per cent threshold.

The SFC, for its part, has contended[71] that if the headcount test is abolished, rule 2.10(b) cannot protect minority shareholders adequately – for the Takeovers Code does not:

- apply to all types of schemes and rule 2.10(b) is premised on voting by disinterested shareholders only; and

[68] See, e.g., Linklaters, *Response to the Consultation Paper on Drat Companies Bill – First Phrase Consultation*, 16 March 2010, para. 1.
[69] See, e.g., Goo, "Should the Headcount Test for a Scheme of Arrangement be Abolished?" (2011) 32 Co. Law. 185, 187.
[70] As examples, the privatisations of Sunday Communications Ltd (2005), Henderson Investment Ltd (2006), Natural Beauty Ltd (2009). See Denny, 'Is it Time to Reform the Law on Hong Kong Takeovers by Way of Scheme?' *Clifford Chance – Client Briefing*, 23 March 2009, available from http://www.cliffordchance.com.
[71] Securities and Futures Commission, *SFC's Response to Chapter 6 of the Consultation Paper – Draft Companies Bill – First Phrase Consultation*, 28 January 2010, para. 18.

- have the force of law,[72] the protection under rule 2.10(b) is in addition to, and not in substitution for, the statutory protection provided by section 166.

It is important to note that while the Takeovers Code does not apply to all types of schemes, it does apply to members' schemes of listed companies in respect of which vote manipulation generally occurs.[73] Members' schemes, on the other hand, are rare in public non-listed companies[74] while the concern for vote manipulation does not exist in relation to creditors' schemes.[75] Further, voting under section 166(2) at court meetings is also premised on disinterested shares because only holders of scheme shares can vote at such meetings[76] as controlling shareholders and their concert parties are considered to have a divergent interest from scheme shareholders, and therefore cannot vote with them on the schemes.[77]

Although rule 2.10(b) lacks statutory force, any breach of it by vote manipulation may result in such sanctions[78] as public censure and cold shoulder[79] against manipulators who initiated the transgression, whereas a breach of section 166(2) on the same ground will only result in the scheme being rejected by the court. The discrepancy in the level of penalties imposed can be attributed to the summary nature of the section 166 proceedings which focuses on whether or not the petitioner can satisfy the court that the scheme should be sanctioned, not on making adverse findings against a particular person.[80] The instigators of the manipulation thus escape unscathed apart from the financial loss caused by the lapsing of the scheme. In preventing and

[72] The Takeovers Code represents a consensus of opinion of market participants on acceptable conduct for mergers and takeovers in Hong Kong. See Takeovers Code, para. 1.3 of the Introduction.
[73] See Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) paras. 7-12.
[74] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.24.
[75] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) para. 17.
[76] See, e.g., *PCCW Supplemental Scheme Document* (12 January 2009) p. 13.
[77] See Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Report* (December 2009) pp. 46-47.
[78] See generally Takeovers Code, para. 12.2 of the Introduction for the sanctions that can be imposed.
[79] It means all the SFC-licensed intermediaries cannot, for a stated period of time, act or continue to act for any person who has breached the Takeovers Code. See Takeovers Code, para. 12.2(c) of the Introduction.
[80] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [116]-[122] per Lam J.

deterring vote manipulation, the non-statutory rule 2.10(b) may be considered to be more effective than section 166(2).

To minority shareholders in a members' scheme, a vote free of manipulation at the court meeting is the best means to ensure that their interests are not prejudiced by majority shareholders. Since voting for the purpose of rule 2.10 is undertaken on a share value basis, and is therefore less susceptible to share splitting as is the case with the headcount test, only rule 2.10(b), not the headcount test, results in a vote that is unlikely to have been manipulated, hence better protects minority shareholders' interests. This, it is submitted, is what minority shareholders in members' schemes of listed companies are principally concerned about, not whether rule 2.10(b) is statutory or supplementary to section 166.

Another SFC's argument[81] against abolishing the headcount test is that it will put Hong Kong out of step with other common law jurisdictions which have retained the test. For example, both Bermuda and the Cayman Islands, the two off-shore jurisdictions in which approximately 72 per cent of companies listed on the SEHK were incorporated, have a provision similar to section 166 in their respective company laws.[82] If the headcount test is abolished in Hong Kong, asserts the regulator, it will create an asymmetry[83] in which members' schemes for listed companies incorporated in Bermuda and the Cayman Islands will continue to be subject to the headcount test, whereas members' schemes for Hong Kong-registered companies will not. Accordingly, abolishing the headcount test leaves minority shareholders in Hong Kong-registered listed companies less protected than their counterparts in listed companies registered in Bermuda and the Cayman Islands.

This so-called asymmetry is, it is submitted, of limited impact because the Takeovers Code applies to takeovers and mergers affecting public companies[84] in Hong Kong or

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[81] Securities and Futures Commission, *SFC's Response to Chapter 6 of the Consultation Paper – Draft Companies Bill – First Phrase Consultation*, 28 January 2010, para. 10.
[82] See Bermuda Companies Act 1981 (Cap. 59), s. 99(2); Cayman Islands Companies Law (2009 Revision), s. 86(2).
[83] Linklaters, *Response to the Consultation Paper on Drat Companies Bill – First Phrase Consultation*, 16 March 2010, para. 9.
[84] Factors considered include the number of Hong Kong shareholders on its register, extent of trading activity on the SEHK, location of business and central management. See Takeovers Code, para. 4.2 of the Introduction.

companies with a primary listing of their shares on the SEHK,[85] regardless of their places of incorporation.[86] As a result, members' schemes in respect of listed companies incorporated in Hong Kong, Bermuda and the Cayman Islands, are all subject to rule 2.10, which, as suggested above, protects the interests of minority shareholders more effectively than the headcount test.

Court sanctioning stage

While the courts are reluctant[87] to state definitively how they will exercise their discretion in sanctioning a scheme, they have over the years articulated a number of considerations which they have taken into account as informing their discretion, such as whether or not:[88]

- The court meeting was duly convened in accordance with the CFI's direction;[89]
- Members who vote as a single class have sufficiently similar legal rights that they can consult together with a view to their common interests at a single meeting;[90]
- Scheme shareholders have been given sufficient information about a scheme to enable them to make an informed decision;[91]
- Scheme shareholders have voted in good faith and not for an improper purpose;[92]
- The proposal is fair and reasonable so that an intelligent and honest member of the class of scheme shareholders may approve it;[93]
- The petitioner has brought to the court's attention all matters relevant to the exercise of its discretion;[94]

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[85] As at December 2011, there were 9 secondary listings on the SEHK, namely, CapitaMalls Asia Ltd; Coach, Inc; Glencore International plc; Kazakhmys plc; Manualife Financial Corporation; Midas Holdings Ltd; SBI Holdings, Inc; SouthGobi Resources Ltd and Vale S.A.
[86] Takeovers Code, para. 4.1 of the Introduction.
[87] *Re Permanent Trustee Co Ltd* (2002) 43 A.C.S.R. 601 (NSW SC) at [8] per Barrett J; *Re Mincom Ltd (No 3)* (2007) 25 A.C.L.C. 1 (Qld SC) at [16] per Fryberg J.
[88] See Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Report* (December 2009) pp. 46-52 for a summary of those considerations.
[89] *Re China Light & Power Co Ltd* [1998] 1 H.K.L.R.D. 158 (CFI) at 168D(ii) per Le Pichon J.
[90] *UDL Engineering & Heavy Industries Co Ltd v Li Oi Lin* (2001) 4 HKCFAR 358 (CFA) at [27(2)] per Lord Millett N.P.J.
[91] *Re China Light & Power Co Ltd* [1998] 1 H.K.L.R.D. 158 (CFI) at 168E(iii) per Le Pichon J.
[92] *Re Michelago Ltd (No 3)* (2006) 61 A.C.S.R. 286 (Fed Ct, Aust) at [9] per Emmett J.
[93] *Fowler v Lindholm* (2009) 74 A.C.S.R. 124 (Full Fed Ct, Aust) at [79] per Emmett, Gordon and Jagot JJ.
[94] *Re Permanent Trustee Co Ltd* (2002) A.C.S.R. 601 (NSW SC) at [7] per Barrett J; *Re Cranswick Premium Wines Ltd* (2002) 44 A.C.S.R. 113 (Fed Ct, Aust) at [8] per Conti J.

- The interests of other groups who are not parties to, but are affected by the scheme are considered;[95] and
- The scheme offends public policy.[96]

Statutory remedies

More important, the courts have held that a scheme will be rejected if its terms are unfairly prejudicial to the interests of minority shareholders even in the absence of a headcount test.[97] This means that it will be open to minority shareholders to petition the court under section 168A(1)[98] of the CO if they are concerned that their interests are unfairly prejudiced by the scheme.[99]

If the court consents to hear such a petition, it may,[100] for example:
- make an order restraining such conduct;
- appoint a receiver to manage the company's property or business; or
- award damages to the petitioners.

In addition, where it appears to the SFC that the target company has conducted its business or affairs in a manner unfairly prejudicial to its shareholders, the regulator can petition the court under section 214(1) of the Securities and Futures Ordinance (SFO) (Cap. 571) for an order to restrain the unfairly prejudicial act or obtain other remedies. The SFC may also apply under section 385(1) of the SFO to intervene in legal proceedings which concern a mater relating to its functions.

2. Abandonment of the proposed statutory discretion

[95] *Re Stork ICM Australia Pty Ltd* [2006] F.C.A. 1849 (Fed Ct, Aust) at [111]-[123] per Lindgren J.
[96] *Re CSR Ltd* (2010) 77 A.C.S.R. 592 (Full Fed Ct, Aust) at [51]-[56] per Keane C.J. and Jacobson J.
[97] *Re Central Pacific Minerals NL* [2002] F.C.A. 239 (Fed Ct, Aust) at [13] per Emmett J; *Re Seven Network Ltd (No 3)* (2010) 77 A.C.S.R. 701 (Fed Ct, Aust) at [39] per Jacobson J. See also Hollington, *Shareholders Rights* (6th edn, Sweet & Maxwell 2010) para. 7-104.
[98] CA, s. 994(1).
[99] See generally Young and others, "In the Interest of Minority Shareholders in Hong Kong: Case Study on the Privatisation of PCCW via a Scheme of Arrangement (Part 2)" (2011) 32 Co. Law. 49, 51-55.
[100] CO, s. 168A(2); CA, s. 996(2).

Clause 664(2)(c)(ii) of the new Companies Bill, the statutory discretion with which the HKSAR government proposes to arm the court, is closely modelled on section 411(4)(a)(ii)(A) of Australia's Corporations Act 2001,[101] which was introduced by way of amendment in December 2007 to relieve the Australian courts from considering the majority in number requirement under certain circumstances.[102]

The HKSAR government claims[103] that with the new statutory discretion, the court is capable of sanctioning a scheme where the headcount test has not been passed as a result of share splitting, which is an improvement on the court's common law discretion of only sanctioning the scheme after it has passed both the headcount and share value tests at the court meeting.

However, a scheme which fails to pass the headcount test at the court meeting will never proceed to the court sanctioning stage under section 166 unless aggrieved scheme shareholders take private legal action or complain to the SFC, which, as noted earlier, is unlikely to happen unless the scheme very substantially harms their interests.

Even if some scheme shareholders do complain to the SFC and the regulator intervenes on their behalf, the court may still be slow in sanctioning the scheme because there has been little Australian case law[104] directly on or having elaborate discussion of how the statutory discretion should be exercised,[105] hence no guidance is provided for the Hong Kong courts to refer to if such cases were to arise in Hong Kong.

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[101] Act No. 50 of 2001.

[102] Lindgren, *Private Equity and Section 411 of the Corporations Act 2001 (Cth)* (7 April 2008) para. 22.

[103] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.5.

[104] Financial Services and the Treasury Bureau, *Information on the Implementation of the Headcount Test for Approving a Scheme of Arrangement or Compromise in Australia*, CB(1)1004/09-10(02) (11 January 2010) para. 4.

[105] The only case to date in which an Australian court commented on the statutory discretion is *Re pSivida Ltd* [2008] F.C.A. 627 (Fed Ct, Aust) in which Jacobson J. observed, in *obiter*, at [11]-[12] that where a single shareholder held 53% of the total issued capital of a listed company on behalf of beneficial owners and that shareholder could have been outvoted under the headcount test, the petitioner might ask the court to exercise the statutory discretion to dispense with the test.

The latest development in Australia is that CAMAC has already recommended[106] to the Australian government that the headcount test be abolished. If this recommendation is accepted, section 411(4)(a)(ii)(A) will be repealed, in which case Hong Kong will be left with a model of statutory discretion that no longer exists in the jurisdiction that created it. Given that the Australian authorities are abandoning the headcount test which Hong Kong proposes to continue to embrace, the better view is for the Hong Kong authorities to accept that the test no longer has any substantial support in a leading common law jurisdiction and should likewise follow the Australian example and abandon it.

In sum, the decision to give the court a statutory discretion of uncertain scope in addition to its general discretion will only confuse the issue further and may encourage wasteful litigation on the nature of the statutory discretion, so causing uncertainty for and potential delay to the petitioner in executing the scheme.[107]

3. The rationale for abolishing the headcount test

The headcount test should be abolished because it is incompatible with the 'one-share one-vote principle', and is conducive to vote manipulation, particularly in the Hong Kong context.

Conflict with the 'one share one vote' principle

The 'one-share-one-vote' (OSOV) principle posits[108] that shareholders' voting rights should be exactly proportionate to the capital they have put at risk in the company. On this basis, shareholders who have contributed the largest proportion of the company's equity capital should have the greatest say on the company's future. While there are some disagreements over its validity,[109] the OSOV principle has

[106] Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Report* (December 2009) p. 92.
[107] Clifford Chance, *Submission on the Consultation Paper on Drat Companies Bill – First Phrase Consultation*, 16 March 2010, p. 5.
[108] Easterbrook and Fischel, "Voting in Corporate Law" (1983) 26 J. L. & Econ. 395, 408-09.
[109] Fairfax, "Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power" (2008) 3 Va. L. & Bus. Rev. 1, 16.

become the dominant approach[110] to corporate voting since the New York Stock Exchange introduced it as a self-regulatory rule in 1926.[111]

The Legislative Council in Hong Kong has enshrined the OSOV principle in section 114A(1)(e) [112] of the CO. The SEHK has also given effect to the principle by mandating that from 1 January 2009 onwards, shareholders of listed companies, under the revised rule 13.39(4) of the Listing Rules, must vote all resolutions by poll at general meetings, which means that every shareholder present, either in person or by proxy, at general meetings is entitled to cast one vote for every share that he holds.

As enshrined in a statutory requirement and a regulatory rule, the OSOV principle represents an important theoretical underpinning for Hong Kong's corporate governance regime. However, the headcount test is clearly in conflict with this principle because the test can result[113] in certain shareholders, who have contributed a small proportion of the company's equity capital, being capable of blocking a scheme that is approved by other shareholders who have contributed a much larger proportion of the equity. The headcount test thus gives too great a veto power to small shareholders, which is out of proportion to their financial contribution to the company. This, together with the time and costs involved, may deter companies from proposing schemes.

Still, the supporters of the headcount test argue[114] that the difference in subject matter between a scheme, which, if sanctioned, can be used to compulsorily acquire shares of dissenting scheme shareholders, and other shareholder votes at general meetings is such that the same OSOV principle should not apply to both schemes and other shareholder votes that have less profound consequences for shareholders. In other words, the headcount test should be made an exception to the OSOV principle.

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[110] Martin and Partnoy, "Encumbered Shares" (2005) 2005 U. Ill. L. Rev. 775, 777.
[111] Hayden and Bodie, "One Share, One Vote and the False Promise of Shareholder Homogeneity" (2008) 30 Cardozo. L. Rev. 445, 447, n. 5.
[112] Subject to the company's articles of association. For the UK equivalent, see CA, s. 284.
[113] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.18.
[114] Linklaters, *Response to the Consultation Paper on Drat Companies Bill – First Phrase Consultation*, 16 March 2010, para. 6.

Moreover, since a scheme is an all-or-nothing contest, shareholders, however small their shareholding is, should be entitled to defend their ownership under the headcount test. If the test is abolished for conflicting with the OSOV principle, this will have the effect of allowing majority shareholders to force out a minority while holding only 75 per cent rather than 90 per cent of the disinterested shares. This, as the argument goes,[115] oppresses minority shareholders.

While it is conceded that a scheme, once sanctioned by the court, can bind dissentients and force them to effectively sell their shares to the incumbent majority shareholder against their wishes, the same, however, can also be said about a takeover by way of a general offer where a bidder, having received acceptances from 90 per cent of the disinterested shareholders, can compulsorily acquire the remaining shares under section 168. Since there has been no demand to exempt from the OSOV principle takeovers by way of general offers, the supporters of the headcount test have little basis to single out the test and render it an exception to the OSOV principle.

It is also conceded that minority shareholders should be given every opportunity to defend their ownership rights which are subject to a scheme. However, it does not follow that their interests will inevitably be prejudiced if the headcount test is abolished. There are other sufficient safeguards to protect minority shareholders like rule 2.10(b) with which majority shareholders have to contend at court meetings. Even if a scheme survives the court meeting, it has to be sanctioned by the court, which, as previously mentioned, has a wide discretion to reject the scheme.

The court sanctioning procedure is what sets a compulsory purchase under section 166 apart from a squeeze-out under section 168. That a squeeze-out may never come to court is the reason[116] why the legislature has decided on a greater majority in favour of a takeover under section 168 (90 per cent) than that under section 166 (75 per cent) where minority interests are be expropriated.

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[115] Goo, "Should the Headcount Test for a Scheme of Arrangement be Abolished?" (2011) 32 Co. Law. 185, 187.
[116] *Re National Bank Ltd* [1966] 1 W.L.R. 819 (Ch) at 829H-830A per Plowman J.

Since the two alternative routes of privatisation have their own considerations and approaches,[117] a company can choose the route that better suits its circumstances.[118] If the company chooses a scheme instead of a general offer to effect privatisation, and in view of the scheme's lower threshold for invoking compulsory purchase than the general offer, the petitioner, in addition to obtaining the necessary majority approval at the court meeting, has to satisfy the court that there is a good reason for cancelling the scheme shares.[119]

Accordingly, even if the headcount test is abolished for being inconsistent with the OSOV principle, the petitioner still has to cross several hurdles to obtain the court's sanction of the scheme, minority shareholders' interests can be well protected in that process, without the need to maintain the headcount test.

Another problem with the headcount test is that it seeks to undermine the OSOV principle as a corporate voting mechanism. This is because the test is predicated on the antiquated[120] 'show-of-hands' voting method (SOHV) where every shareholder present, either in person or by proxy, at a court meeting is entitled to cast one vote, regardless of how many shares he holds. Since SOHV does not accord shareholders with rights based on their respective shareholdings,[121] it is therefore possible for a group of scheme shareholders holding in aggregate a small proportion of a company's equity capital to veto[122] a scheme supported by shareholders with a much larger shareholding as long as this group of small shareholders together outnumbers the large shareholders at the court meeting. If the headcount test were allowed to continue, it would result in a SOHV veto on a poll vote,[123] and thus contravene the objectives of section 114A(1)(e) of the CO, rules 2.9 and 2.10 of the Takeovers Code, and rule 13.39(4) of the Listing Rules.

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[117] *Re TDG plc* [2009] 1 B.C.L.C. 445 (Ch) at [33] per Morgan J.
[118] See, e.g., *Re BTR plc* [1999] 2 B.C.L.C. 675 (Ch) at 684e per Jonathan Parker J.
[119] *Re Hellenic Trust and General Ltd* [1976] 1 W.L.R. 123 (Ch) at 129D per Templeman J; *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [155], [161] per Lam J.
[120] Allen and Jones, *AGGA Asian Proxy Voting Survey 2006* (September 2006) p. 9.
[121] Singapore Exchange Ltd, *Consultation Paper – Proposed Amendment to the Listing Rules* (2 June 2011) para. 2.1
[122] See Allen and Jones, *AGGA Asian Proxy Voting Survey 2006* (September 2006) p. 59 for other problems with SOHV.
[123] See David Webb, *Vote-rigging Plan for PCCW Meeting*, 1 February 2009, available from http://www.webb-site.com.

Vote manipulation in the Hong Kong context

The headcount test is particularly conducive to vote manipulation in the Hong Kong context because of the unique way shares of listed companies are held locally after the SEHK introduced the immobilised securities settlement system called Central Clearing and Settlement System[124] (CCASS) in 1992. Instead of the previous practice of holding shares in paper form only, investors under the CCASS system can now hold their shares in electronic form for ease of holding and trading.[125]

Shares within CCASS are held in pooled accounts that brokers maintain with Hong Kong Securities Clearing Ltd (HKSCC), which is responsible for operating CCASS. Transactions are effected electronically through debit and credit entries to the brokers' accounts with HKSCC.[126] Investors hold only the beneficial interest[127] in those shares with the legal title being held by HKSCC Nominees Ltd (HKSCCN), the CCASS nominee. Hence, HKSCCN is the registered owner of all scrip in CCASS on listed companies' registers of members.[128] In the *PCCW* case, for example, of the 1,628,013,122 shares voted at the court meeting, approximately 98 per cent were held in CCASS with the remaining two per cent held by other registered owners.[129]

Listed companies are not obliged[130] to send corporate communications to beneficial owners because their names do not appear on members' registers. Neither does HKSCCN forward[131] the information directly to beneficial owners since its relationship is with the brokers, not the investors. If a beneficial owner wants to vote at a general meeting, he needs to ask his broker to instruct CCASS to appoint him as a

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[124] Under this system securities are issued in paper form and deposited with a central depository which is electronically linked with a settlement system. See Securities and Futures Commission and others, *Joint Consultation Paper on a Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong* (30 December 2009) para. 3, n. 1.
[125] Holdings in CCASS are electronic and hence more convenient as investors do not need to arrange for safe-keeping of the share certificates, and because the securities are held by the depositary at all times, investors do not need to be moved or re-registered to effect transfers within the system. See Securities and Futures Commission and others, *Joint Consultation Paper on a Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong* (30 December 2009) para. 20(2).
[126] Williams and others, *Secured Finance Law in China and Hong Kong* (CUP 2010) 129.
[127] *Re CA Pacific Finance Ltd* [1999] 2 H.K.L.R.D. 1 (CFI) at 15H per Yuen J.
[128] *Re CA Pacific Finance Ltd* [1999] 2 H.K.L.R.D. 1 (CFI) at 11C per Yuen J.
[129] *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [23] per Kwan J.
[130] Hetherington, *Mission Impossible: Casting a Proxy Vote in Hong Kong* (September 2003) p. 7.
[131] Hetherington, *Mission Impossible: Casting a Proxy Vote in Hong Kong* (September 2003) p. 7.

corporate representative of HKSCCN.[132] However, few beneficial owners have chosen to express their views in this way.[133] These exemplify the main problems with the CCASS system – it promotes passivity in company members, and provides an administrative hurdle to their active participation in general meetings.

In any event, the beneficial owner can withdraw his shares from CCASS and re-register them in his name, but this is cumbersome and not without cost.[134] Hence, the usual practice is that the beneficial owner gives instructions to HKSCCN (via his broker) on how to vote his shares. If the company is a blue chip one and has got many shareholders of different persuasions, they invariably instruct HKSCCN to vote both for and against the same resolutions at general meetings.

On the date of a court meeting, for example, HKSCCN's representative will enter on the voting paper the exact number of votes he has been instructed to cast for and against the scheme.[135] The beneficial owners' preference in share value terms is therefore expressed and counted, and it is incorrect to suggest[136] that the views of the beneficial owners are not reflected. However, in headcount terms, HKSCCN is counted as one vote for and one vote against the scheme. This explains why in the *PCCW* case there were 2,262 'heads' present, either in person or by proxy, at the court meeting, but the total number of ticks for and against the Scheme on the voting papers that scrutineers counted came to 2,263 because HKSCCN's representative voted both ways.

Of the 1,348,536,322 shares in favour of the Scheme in the *PCCW* case, approximately 99 per cent of them were held in CCASS,[137] which was reduced to only one approving vote in headcount terms, and this vote was countered by a dissenting vote representing 279,476,800 shares of which 93.7 per cent were held in

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[132] Hong Kong Exchanges and Clearing Ltd, *Combined Consultation Paper on Proposed Changes to the Listing Rules* (January 2008) para. 12.43.

[133] Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.14(b).

[134] See Financial Services and the Treasury Bureau, *Draft Companies Bill – First Phase Consultation* (17 December 2009) para. 6.14(c).

[135] Hong Kong Exchanges and Clearing Ltd, *Combined Consultation Paper on Proposed Changes to the Listing Rules* (January 2008) para. 12.43.

[136] Financial Services and the Treasury Bureau, *First Phase Consultation on the Draft Companies Bill – Consultation Conclusions* (30 August 2010) para. 8(a).

[137] *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [24] per Kwan J.

CCASS.[138] This anomaly is a boon to those parties who intend to manipulate the vote because despite the preponderant amount of scheme shares that HKSCCN holds, it has got only one vote in headcount terms, and that vote will usually be cancelled out by an opposing vote. Safe in the knowledge that HKSCCN has no actual impact on the outcome of the vote, the manipulators can proceed to engage in share splitting to outnumber the opposition in the head count and get the scheme passed or blocked as they wish, regardless of how many more shares/votes that the opposition holds.

For HKSCCN to have any impact on the voting result at the court meeting, it must be allowed to vote for the number of beneficial owners it represents in headcount terms.[139] If, for example,[140] HKSCCN has received voting instructions from 100 beneficial owners of which 60 are for the scheme and 40 against it, HKSCCN should be allowed to cast 100 votes, with 60 votes for and 40 votes against, for the purpose of the headcount test.

As appealing as this suggestion is, the court is likely to reject it because one of the fundamental principles[141] of English and Hong Kong company law is that a company is not required to take note of the interests of the 100 beneficial owners in the example just cited because their names do not appear on the company's register of members as legal owners of the shares. Even if the court were to relax this rule, other problems might follow[142] including how to identify beneficial ownership, and how to differentiate between trust arrangements entered into for genuine commercial reasons and for share splitting.

The settlement systems in the UK and Australia, namely, CREST and CHESS, on the other hand, work very differently from their Hong Kong counterpart. In short, shareholders in both systems are entitled to register as legal owners of their shares.[143]

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[138] *Re PCCW Ltd*, Unreported, HCMP 2382/2008, 6 April 2009, [25] per Kwan J.
[139] *Re PCCW Ltd* [2009] 3 H.K.C. 292 (HKCA) at [68] per Rogers V-P; [195] per Barma J.
[140] See Hong Kong Bar Association, *Comments on the First Phase Consultation on Draft Companies Bill*, 26 April 2010, para. 10.
[141] *Re Perkins; Ex parte Mexican Santa Barbara Mining Co* (1890) LR 24 QBD 613 (CA) at 616 per Lord Coleridge C.J., at 617-18 per Lord Esher M.R.
[142] See Corporations and Markets Advisory Committee, *Members' Schemes of Arrangement – Report* (December 2009) p. 84.
[143] Securities and Futures Commission and others, *Joint Consultation Paper on a Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong* (30 December 2009)

As registered owners, shareholders receive corporate information from the listed companies and can attend and vote their shares at general meetings. This leads to a greater exercise by more shareholders of their voting rights.

The HKSAR government has moved slowly[144] in the direction of the UK and Australia systems to allow shareholders holding shares in CCASS to register as legal owners of those shares. This reform, if ever implemented, remains stop-gap because Hong Kong shareholders are generally apathetic and may still choose not to attend and vote at general meetings.[145] The long-term solution to eradicate vote manipulation is to abolish the headcount test altogether and give full effect to the value of the shares cast in favor of or against the scheme. If not, there is no way to prevent, for example,[146] a hedge fund from shorting[147] a stock which is the subject of a scheme privatisation after it arranges for hundreds of holders, with one board lot (or even one share) each, to vote against the scheme, so that when the scheme is rejected at the court meeting, the hedge fund can buy back the stock from the market at a lower price and make a handsome profit.[148]

Conclusion

The *PCCW* case has clearly shown that the headcount test attracts attempts to manipulate the outcome of the vote at court meetings. As the test has been tainted by irregularities, its continued use must be conclusively justified on grounds other than protection of minority shareholders' interests as rule 2.10 of the Takeovers Code is able to provide the same level of protection to minority shareholders but is less susceptible to manipulation. The supporters of the headcount test, however, have been unable to provide credible reasons to retain the test other than minority

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Annex 1. See also Walsh, "Schemes and Scheming in Privatisations: A Tale from Hong Kong" (2009) 2 C.R.&I. 218, 220.

[144] The debate on whether or not to give shareholders the option to register shares in their names has been raging for over 10 years. The government issued a consultation paper on 30 December 2009 with the consultation conclusions released on 21 September 2010. The government has yet to make a decision on whether or not to adopt the recommendations.

[145] Low, "A Roadmap for Corporate Governance in East Asia" (2004) 25 Northwest. J. Int'l L. & Bus. 165, 185; Bainbridge, "The Case for Limited Shareholder Voting Rights" (2006) 53 UCLA L. rev. 601, 624; Allen and Jones, *AGGA Asian Proxy Voting Survey 2006* (September 2006) p. 11.

[146] See David Webb, *Vote-rigging Plan for PCCW Meeting*, 1 February 2009, available from http://www.webb-site.com.

[147] Short selling is an activity usually associated with hedge funds. See Allen and Overy, *The Future Direction of Global Financial Regulation* (12 November 2008) p. 3.

[148] See David Webb, *Henderson Investment, Post Mortem*, 25 January 2006, available from http://www.webb-site.com.

shareholders' protection. Moreover, the test's supporters cannot rely on the proposed statutory discretion to bolster their position because it has an unknown scope and will potentially create substantial uncertainty.[149]

Hong Kong can ill afford a repeat of the PCCW fiasco which will substantially weaken the SAR's reputation as an international financial centre. However, retention of the headcount test is not the best way to ensure minority protection in such circumstances because it conflicts with the OSOV principle,[150] and breaches section 114A(1)(e) and rule 2.10(b). Moreover, it provides an incentive to those in favour of such schemes to attempt to manipulate the vote[151] and, in any event, can be unjust in providing too great a veto power to a tiny number of shareholders. For the above reasons, the SAR is urged to abandon the headcount test, and apply the OSOV principle in scheme voting – the value of the votes cast at the court meeting should be the only determinant of whether or not the scheme can proceed to be considered by the CFI for sanctioning.

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[149] See text to above nn. 101-107.
[150] See text to above nn. 108-123.
[151] See text to above nn. 60-64; text to above nn. 124-148