CHAPTER 6

"HEADCOUNT" TEST FOR APPROVING A SCHEME OF COMPROMISE OR ARRANGEMENT

6.1 A recent court case[75] has drawn public attention to the current requirement under section 166(2) of the CO, namely, in order for a compromise or arrangement between a company and its members or creditors (hereinafter referred to as "a scheme") to be approved at a meeting ordered by the court under section 166(1), a majority in number of those who cast votes in person or by proxy at the meeting must have voted in favour of the compromise or arrangement. Some commentators and market practitioners have argued that the "majority in number" requirement or "headcount" test, which is originally intended to protect the minority interests in a scheme of arrangement, deviates from the "one share one vote" principle and is prone to be circumvented by share splitting. The background to the headcount test and the policy options for reforming it are set out below. The Government would like to hear the views of various stakeholders before taking a final view.

Background

Current Position

6.2 Section 166 provides that where a scheme is proposed between a company and its members or creditors or any class of them, the court may, on the application of the company, or any member or creditor, order a meeting of the members or creditors of the company or a class of them to be summoned in such manner as the court directs. The section also provides that if the statutory majority of members, or creditors, or a class of them agree to any scheme of arrangement, the scheme shall, if sanctioned by the court, be binding on all members, or creditors, or a class of them as the case may be, and also on the company.

6.3 In recent years, section 166 has been used in the following circumstances:

(a) listed companies changing their status to that of a private company (privatisation);

[75] *Re PCCW* Ltd, HCMP 2382/2008 and CACV 85/2009.

(b) listed companies in liquidation selling their listing status; and

(c) a group of companies reorganising to create a new holding company.

6.4 Under section 166(2), the procedure to sanction a scheme involves the following:

(a) an application, usually by the company ex-parte, is made to the court for an order that a meeting be summoned pursuant to section 166(1);

(b) at least a majority in number of the members, creditors, or the relevant class, present and voting in person or by proxy in favour of the scheme (headcount test);

(c) that number must hold at least three-fourths in value of the holdings (or claims in the case of creditors) of those present and voting in person or by proxy ("share value" test); and

(d) the proposals, if approved by the requisite majority, may be sanctioned by court.

6.5 The law implies that the court has the discretion not to sanction a scheme even though it has been approved under both the share value test and the headcount test (for instance, where there is doubt that the process has been unfairly administered, such as where the approval under the headcount test was achieved by share splitting).[76] Nonetheless, the court does not have the jurisdiction to sanction a scheme where the headcount test had not been passed even in the event that share splitting has increased the headcount of members opposing the scheme.

6.6 Apart from complying with section 166 of the CO, any person who seeks to use a scheme to acquire or privatise a listed company must also comply with the Code on Takeovers and Mergers ("Takeovers Code") issued by the SFC under the SFO. Under the Takeovers Code, there are additional requirements to protect the interests of minority shareholders, including:

(a) under Rule 2 of the Takeovers Code, an independent board committee comprising all non-executive directors who have no conflict of interest in the scheme has to be established to give advice to disinterested

[76] *Re PCCW Ltd*, CACV 85/2009.

shareholders about its recommendation of voting. The independent board committee would seek advice from an independent financial adviser who will set out its recommendation and the details of its analysis of the merits of the scheme in its letter to the independent board committee reproduced in the scheme document; and

(b) Rule 2.10(b) of the Takeovers Code stipulates that the number of votes cast against the resolution shall not be more than 10% of the voting rights attached to all disinterested shares, i.e. shares not held by the controlling shareholders or their connected parties. This requirement, which renders an additional safeguard for minority shareholders, is not provided in other jurisdictions adopting similar rules on takeovers and mergers such as the UK, Australia and Singapore.

6.7 A table summarising the thresholds under section 166 of the CO and the Takeovers Code is at **Appendix 2**.

Other Jurisdictions

6.8 Other common law jurisdictions such as the UK, Australia, Singapore, Bermuda and Cayman Islands, all have legislative provisions similar to section 166 of the CO, including the headcount test. The headcount test originated from the days when the procedure applied only to insolvent company schemes with creditors, presumably to place a check on the ability of creditors with large claims to carry the day. When the provision was extended to non-insolvent schemes with members in 1900, the composition of the required majority remained unchanged.[77]

6.9 In the UK, the Company Law Review Steering Group ("CLRSG") has reviewed the "majority in number" requirement (i.e. headcount test) under section 425(2) of the UK Companies Act 1985. The CLRSG recommended that the test should be abolished as the widespread use of nominees had made it an irrelevant test, and that no other meeting of members of a company required a majority otherwise than by reference to value or voting powers.[78] However, the UK Government did not adopt the

[77] UK Company Law Review Steering Group, *Modern Company Law: Completing the Structure* (November 2000), paragraph 11.34.

[78] *Ibid*. See also UK Company Law Review Steering Group, *Final Report on Modern Company Law for a Competitive Economy* (July 2001), paragraph 13.10.

recommendation in the UKCA 2006 as it considered that the headcount approval was still an important investor safeguard.[79]

6.10 In Australia, in order to tackle the problem of share splitting by parties opposing a scheme, section 411(4) of the ACA was amended in December 2007 to give the court a discretion to approve a members' scheme if it was approved by a 75 percent majority in value even though approval by a majority in number of those members present and voting at the scheme meeting was not obtained. The reasons for the amendment, as stated in the Explanatory Statement to the Exposure Draft of the Corporations Amendment (Insolvency) Bill 2007, were that:

> *"A members' scheme could be defeated by parties opposed to the scheme engaging in 'share splitting', which involves one or more members transferring small parcels of shares to a large number of other persons who are willing to attend the meeting and vote in accordance with the wishes of the transferor. By splitting shares to increase the number of members voting against the scheme, an individual or small group opposed to the scheme may cause the scheme to be defeated. This may occur even though a special majority is achieved in terms of voting rights attaching to share capital, and if the share split had not occurred, the majority of members were in favour of the scheme."*

6.11 The Australian Corporations and Markets Advisory Committee has recently conducted a review of various matters relating to members' schemes, including whether the headcount test in a members' scheme should be removed. A consultation paper was issued in June 2008.[80] So far, no decision has been made by the Australian Government.

Concerns

6.12 Recently, there has been some public debate concerning the headcount test and the issue of share splitting. Some commentators have suggested that the headcount test should be removed.[81] Their main arguments are:

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[79] *Hannigan and Prentice – The Companies Act 2006 – A Commentary* (Butterworths, 2007), paragraph 8.76.

[80] Corporations and Markets Advisory Committee (CAMAC), *Members' Schemes of Arrangement – Discussion Paper* (June 2008) ("CAMAC Discussion Paper").

[81] See, for example, Civic Party, *Policy Proposals to the SFC in relation to the various issues arising from the PCCW Privatisation Scheme of Arrangement under s. 166 of the CO* (12 February 2009) (available at http://www.civicparty.hk/cp/pages/cpnews-e.php?p=10) and Webb-site.com, *Vote-rigging plan for PCCW meeting* (1 February 2009) (available at http://www.webb-site.com/articles/pccwrig.asp).

(a) the headcount test is inconsistent with the "one share one vote" principle in other provisions dealing with shareholder meetings in the CO[82];

(b) as a very large proportion of shares in listed companies are held by nominees and custodians, the headcount test is not indicative of the decisions of the beneficial owners of the shares (see paragraph 6.14 below);

(c) the headcount test requirement attracts attempts to manipulate the outcome of the vote (for or against a scheme) by share splitting.

6.13 At present, shares in listed companies can be held in the following ways:

(a) within the CCASS,[83] in which case the shares are registered in the name of HKSCC Nominees Limited and the investor holds only a beneficial interest in them, i.e. his name does not appear in the Register of Members ("ROM"); or

(b) outside CCASS, in which case the shares are registered in the name of the investor (or his nominee, if he chooses to hold the shares through a nominee), i.e. the name of the investor (or his chosen nominee) appears in ROM.

6.14 A vast majority of investors have chosen to hold their shares within CCASS through their brokers, banks or custodians, mainly because that facilitates electronic trading and transfer of their shareholdings within CCASS. However, this has given rise to concerns about the exercise of voting rights by beneficial owners. The concerns may be summarised as follows:

(a) Investors holding shares through CCASS are in effect disenfranchised unless they take the step in (b) or (c) below;

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[82] The other exception in the CO that makes reference to a similar headcount test is under section 114 which concerns the extension of the length of notice for calling meetings.

[83] CCASS is a computerised book-entry settlement system. Shares in CCASS are registered in the name of HKSCC Nominees Limited, which is a nominee of Hong Kong Securities and Clearing Company Limited, which in turn is a recognised clearing house under the SFO. Investors who hold their shares within CCASS may hold them directly as investor participants or indirectly through brokers/banks/custodians that are CCASS participants. As of June 2009, HKSCC Nominees Limited held approximately 72% of all issued shares of companies listed in Hong Kong (i.e. irrespective of whether they are incorporated in Hong Kong or not) and its holdings represented some 48% of market capitalisation.

(b) Beneficial owners of shares may request (directly as investor participants or indirectly through their brokers, banks or custodians that are CCASS participants) Hong Kong Securities and Clearing Limited to authorise themselves or another person to act as a corporate representative so as to attend and vote at a meeting in respect of the number and class of shares they own. However, it appears that many beneficial owners have chosen not to express their views; and

(c) As an alternative, a beneficial owner may choose to withdraw their shareholdings from CCASS and become a registered shareholder, but this would involve considerable processing time and cost. In gist, they must first apply to withdraw their shares from CCASS and the process may take a few days (depending on the availability of the required denomination of the share certificates to be withdrawn). Share certificates thus withdrawn from CCASS will be in the name of HKSCC Nominees Limited. They must then be re-registered with the share registrar in the investor's (or his nominee's) name and this normally takes 10 days (although the share registrars also offer an expedited service, where operationally feasible, at a higher charge). There is also a charge for both withdrawal from CCASS and re-registration with the share registrar[84].

6.15 The SFC, the SEHK and the Federation of Share Registrars have scheduled to conduct a consultation shortly on a proposed operational model for implementing a scripless securities market in Hong Kong. It is understood that the proposed model will provide options for investors to hold shares in their own names within CCASS without the need to hold physical certificates. This could help enhance shareholder transparency and facilitate shareholder participation (for instance, facilitating individual shareholders to vote at company's meetings and to receive corporate information). However, if the widespread use of nominees/custodians continues, the concerns about beneficial owners exercising voting rights would remain.

Policy Options for Members' Schemes of Listed Companies

6.16 In view of the above concerns, we have considered **three possible options** for dealing with the headcount test in respect of members' schemes of listed

[84] Hong Kong Securities and Clearing Limited charges $3.50 per board lot of shares withdrawn from CCASS and share registrars generally charge $2.50 for each certificate to be re-registered or issued, whichever is greater.

companies, namely, (a) no change to the status quo, (b) retain the headcount test but give the court discretion to dispense with the test, or (c) abolish the headcount test. The arguments for or against each of the options are set out in paragraphs 6.17 to 6.22 below. In considering these policy options, we believe that the following factors should be taken into account:

(a) whether the drawbacks of applying a headcount test have outweighed its intended benefits; and

(b) whether there is sufficient safeguard for small shareholders and creditors if the headcount test is removed.

Option 1: no change

6.17 An argument for retaining the headcount test is that it gives minority shareholders an opportunity to have a significant say in the future nature and structure of a company under a scheme.[85] It may reduce the possibility of schemes being oppressive to, or ignoring the interests of, minority shareholders, particularly under a provision like section 166, whereby a sanctioned scheme has the capacity to bind all members or creditors including the dissenting or apathetic ones.[86] We also note that the headcount test has been retained in most other common law jurisdictions including the UK, Australia and Singapore as well as some off-shore jurisdictions such as Bermuda and Cayman Islands.

6.18 A contrary view is that the headcount test places significant veto power in the hands of small shareholders, out of proportion to their financial involvement in the company. It can result in a group of persons, who together have contributed only a small proportion of the company's equity capital, having the capacity to block a scheme that is supported by shareholders who have contributed a much larger portion of equity. This may deter companies from proposing a scheme, given the time and cost involved in preparing the documentation and holding a shareholder meeting. By contrast, the outcome of a vote by shares may be easier to predict.[87] There are also practical concerns over the difficulties for beneficial owners to express their views in a headcount test as outlined in paragraph 6.14 above.

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[85] CAMAC Discussion Paper, paragraph 4.2.4.

[86] This view is shared by the Court of Appeal in its judgment in *Re PCCW* case, CACV 85/2009, see in particular Rogers VP and Barma J's remarks in paragraphs 40 and 177 respectively.

[87] CAMAC Discussion Paper, paragraph 4.2.4.

Option 2: retain the headcount test but give the court discretion to dispense with the test

6.19 Another option is to refine the legislation so as to enable the court to look into the true headcount position both for and against the proposal in cases where there is reason to believe that the apparent headcount either way is not fairly reflective of the class concerned.[88] A possible model for legislative amendment may be section 411(4) of the ACA mentioned in paragraph 6.10 above. The proposed amendment will give the court a discretion to make an order that the requirement for a majority of members present and voting (i.e. the headcount test) may be dispensed with.

6.20 It is expected that the court would only exercise the discretion to disregard the headcount test in circumstances where there is evidence that the result of the vote has been unfairly influenced by activities such as share splitting.[89] Nevertheless, there may be concern over the uncertainty as to when the court would exercise its discretion. Companies may still be deterred from proposing a members' scheme, given the time, cost and uncertainty involved.

Option 3: abolish the headcount test

6.21 The main arguments for abolishing the headcount test have been set out in paragraphs 6.12 to 6.15 above. One should also note the difference in the shareholding structure between Hong Kong and other jurisdictions like the UK and Australia which retain the headcount test. Both the UK and Australia have implemented a scripless market albeit to different degrees and both have a higher percentage of publicly traded shares being held by institutional investors than in Hong Kong.[90] This may explain why disenfranchisement of individual beneficial owners in the headcount test is less a concern in those jurisdictions.

6.22 If the headcount test for members' schemes of listed companies is to be abolished, there may be a concern over the adequacy of safeguards for minority shareholders under the CO or the Takeovers Code. The CO is not the appropriate tool to provide safeguards specifically for minority

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[88] CACV 85/2009, paragraph 192.

[89] Explanatory Statement to the Exposure Draft of the Australian Corporations Amendment (Insolvency) Bill 2007.

[90] Institutional investors play a more active role in corporate governance and they may be more willing to express their views through brokerage firms, banks and custodians even if they are beneficial owners.

shareholders of listed companies. As noted in paragraph 6.6(b) above, the Takeovers Code already stipulates that the number of votes cast against the resolution shall not be more than 10% of the voting rights attached to all disinterested shares. This requirement already renders an additional safeguard for minority shareholders beyond similar rules in comparable common law jurisdictions. If any additional safeguard is considered necessary, it should be tackled separately by the SFC and the Takeovers Panel through the normal consultation process on Takeovers Code amendments.

Question 1

In respect of members' schemes of listed companies, which of the following options do you prefer? Please explain the reasons.

Option 1: retain the headcount test;

Option 2: retain the headcount test but give the court a discretion to dispense with the test; or

Option 3: abolish the headcount test.

Policy Options for Members' Schemes of Non-Listed Companies

6.23 Private companies with a small shareholder base are unlikely to use a scheme for reorganisation. Members' schemes among public non-listed companies are also uncommon. If either Option 1 (retention) or Option 2 (retention but give the court a discretion to dispense with the test) for members' schemes of listed companies is adopted, we believe the same approach should apply to members' schemes of non-listed companies. It should be noted that the court's discretion applies to both listed and non-listed companies under section 411(4) of the ACA in Australia.

6.24 If Option 3 (abolition) is adopted in respect of members' schemes of listed companies, there may be conflicting arguments as to whether the same should apply to non-listed companies. On the one hand, as using nominees to hold shares is much less common in non-listed companies, the case for abolishing the headcount test in respect of members' schemes of non-listed companies may appear to be less persuasive. On the other hand, one may

still argue for abolition of the test on the grounds of inconsistency with the "one share one vote" principle and the potential problem of share splitting.

6.25 If there is public support for abolishing the headcount test in respect of members' schemes of non-listed companies, a further question is whether any additional protection for small shareholders is needed. On the one hand, since non-listed companies do not commonly use the scheme provisions in section 166 of the CO and the court already has a general discretionary power to reject a scheme that improperly prejudices the interests of small shareholders, there does not appear to be a strong case for introducing any alternative safeguard in place of the headcount test. On the other hand, some may believe that certain additional protection would be useful because small shareholders often lack resources in making representations before the court.

6.26 We have considered the possibility of codifying the requirement of Rule 2.10(b) of the Takeovers Code (i.e. the number of votes cast against the resolution shall not be more than 10% of the voting rights attached to all disinterested shares) and extending it to members' schemes of non-listed companies. However, we do not favour such an approach. There may be difficulties in defining "disinterested shares" in the absence of administration by the SFC. Moreover, as the majority of non-listed companies are private companies having a small number of shareholders, the application of Rule 2.10(b) may give too strong a veto power to a few shareholders.

Question 2

(a) If your answer to Question 1 is Option 3, do you think that the headcount test should also be abolished in respect of members' schemes of non-listed companies?

(b) If your answer to (a) is yes, do you think that some form of additional protection should be provided for small shareholders? If so, what should such protection be?

Policy Options for Creditors' Schemes

6.27 Some similar factors come into play in the headcount test of members' schemes and creditors' schemes. Like share splitting in members' schemes, there is a possibility of manipulation of the outcome of voting by assigning part of one's debts to other persons. Nevertheless, certain considerations may be different. These include:

(a) it is possible in a creditors' scheme for major creditors to buy out the debts from small creditors to ensure the smooth sailing of a proposed scheme in a creditors' meeting;

(b) it is less likely for small creditors who oppose a proposed scheme to manipulate the outcome of voting by assigning part of their debts to other persons because of the difficulty in finding assignees who are willing to take on the debts especially as the chance of recovery as small creditors is relatively slim; and

(c) those creditors who are not satisfied can always petition to the court for the winding up of the company where the court may stay the process.

The problems arising from the headcount test are thus less evident in the creditors' scheme.

6.28 If Option 1 (retention) is adopted in respect members' scheme, there seems no reason for treating creditors' schemes differently. If Option 2 is adopted in respect of members' schemes, we are not inclined to extend the court's discretion to cover creditors' schemes in view of paragraph 6.27(b) above. It is noted that the court's discretion to dispense with the headcount test in section 411(4) of ACA only applies to members' schemes and not creditors' schemes.

6.29 If Option 3 (abolition) is adopted in respect of members' schemes, we are open to and would appreciate views on whether creditors' schemes should be treated differently. There are both arguments for and against abolishing the headcount test in respect of creditors' schemes. Some may see the headcount test as a means to ensure that the voices of small creditors (including employees who are owed wages or other entitlements by the company) are heard. On the other hand, some query the need for a headcount test as small creditors already stand in a better position than

minority shareholders as they can always petition to court for winding-up in the last resort.

6.30 We have incorporated views expressed by the SCCLR to facilitate discussion on this topic.

Question 3

If your answer to Question 1 is Option 2 or Option 3, do you think that the same approach should apply to creditors' scheme?