Hong Kong Bar Association's comments on

Rewrite of the Companies Ordinance -

Consultation Paper on Draft Companies Bill (First Phase Consultation)

Question 1

1. The Hong Kong Bar Association ("the Bar") considers that option 3 is the preferred option. The artificiality and inherent unfairness of the headcount test lies in the fact that after the introduction of CCASS in 1992, the vast majority of the shares held by the shareholders in a listed company are registered in the name of HKSCC Nominees and a small number of CCASS participants. Although HKSCC Nominees holds a large number of shares on behalf of many beneficial shareholders, for the purpose of the headcount test, HKSCC Nominees is only counted as **one** shareholder. Moreover, as HKSCC Nominees is obliged to vote in accordance with the instructions of the beneficial shareholders, it has to vote both for and against a scheme. In other words, the votes of HKSCC Nominees will be cancelled out and has **no** impact under the headcount test.

2. The position in Australia is very different. Under the Clearing House Electronic Subregister System ("**CHESS**") operated by the Australian Securities Exchange, a shareholder can choose to register the legal title to his shares on either the (a) CHESS subregister, maintained by ASTC, or (b) Issuer Sponsored subregister, maintained by the company who issued the shares. Most companies engage a share registry to administer their subregister on their behalf. Registration in both subregisters is by electronic means. No paper certificates are issued for either subregister.

3. Under this system, there is no problem of any shareholders being disenfranchised from voting as discussed in §6.14 of the Consultation Papers. Moreover, any "share splitting" can readily be ascertained by looking at the 2 subregisters maintained by ASTC which will show the date of the transfers, the number of shares transferred and the identity of the transferor and transferee. For example, if one takes the date of the announcement of the privatization as the cut-off date for the purpose of deciding whether or not a shareholder has engaged in "share splitting", the regulator and the Court can simply look at the 2 subregisters and determine whether any shareholders have engaged in "share splitting".

4. The same cannot be achieved under CCASS in Hong Kong. This is because all the shares are registered in the name of HKSCC Nominees or CCASS participants. Any beneficial shareholder who wants his vote to be counted under the headcount test has to undergo the

process of withdrawing the shares from CCASS and transferring them to his name (or the name of his nominee). This will be time consuming process and perhaps only known to a small portion of experienced and sophisticated investors. Moreover, any withdrawal, transfer and registration of the shares after announcement of an offer may potentially be regarded as "share splitting" in the sense described by the Court of Appeal in Re PCCW Limited, CACV 85 of 2009.

5. The inherent unfairness of the headcount test was explained by Kwan J in §§13-15, 139-152 of the Judgment in Re PCCW Limited, HCCW 2382/2008, 6 April 2009.

6. In Hong Kong, the headcount test must be seen in the context of the following:-

    6.1. Our CCASS under which the vast majority of shareholders by number and by value in nearly all publicly traded companies in Hong Kong all hold their shares through CCASS.

    6.2. There is already protection given to minority shareholders in rule 2.10(b) of the *Takeovers Code.*

    6.3. The *Takeovers Code* originally contained a requirement of majority in number. That requirement was abolished after consultation.

7. Prior to 2001, the *Takeovers Code* used to contain a majority in number requirement, which was removed after consultation:-

    7.1. Takeovers Code rule 2.10 used to require that, for a scheme of arrangement to privatize a company, "in addition to satisfying any voting requirements imposed by law, [the scheme] must be approved by a majority in number, representing 90% in value of those shares that are voted either in person or by proxy" or "if not so approved by the requisite majority, not disapproved by shareholders voting in person or by proxy at such general meeting holding more than 2.5% of the total number of shares in issue."

    7.2. In April 2001, the SFC proposed major changes to this rule. In its consultation paper, p. 14, SFC explained "the two tier voting test is amended so that, instead of requiring 90% of disinterested shareholders to vote in favour or not more than 2.5% to vote against, the Rule will now require that 75% of disinterested shareholders

vote in favour and no more than 10% of disinterested shareholders vote against. The second change reflects more fairly the dominant influence of the shareholding of the controlling shareholder in either a privatization or other scheme and replaces the need for the 90% test with a 75% test to provide a level playing field for all companies." (*SFC's Consultation Paper*, April 2001, p.14).

7.3. In its subsequent conclusions paper, at p.6, it was noted that the majority of respondents supported the proposed amendments, and at p.7, the SFC adopted the changes, stating: "The Panel and the SFC note the strong support for the principles behind these amendments."

7.4. The result is the rule as it presently stands, requiring that a Scheme be approved by at least 75% of the votes attaching to the disinterested shares, and that the number of votes cast against the scheme be not more than 10% of the votes attaching to all disinterested shares.

8. The abolition of the requirement for majority in number was done after due consideration of the issue and public consultation, and clearly reflects what the SFC considered to be proper in the interests of the investing public.

9. If the headcount test is abandoned, there will be a level playing field amongst all shareholders who support or against a scheme. If it is considered that the present levels of approval and objection by independent shareholders prescribed under rule 2.10 of the Takeover Code, which are more stringent than the 75% in value prescribed under s.166, the proper avenue should be to revise the level of approval required for sanctioning a scheme.

10. As a further alternative to the 3 options proposed, it may be desirable to retain the headcount test under s.166 but add certain provisions which have the effect of recognising the votes cast by HKSCC Nominees on behalf of the beneficial shareholders for the purpose of the headcount test. For example, if HKSCC Nominees received 100 proxies from the beneficial shareholders of which 40 are for the scheme and 60 are against the scheme, HKSCC Nominees will be allowed to cast 100 votes for the purpose of the headcount test, with 40 votes for and 60 votes against. In this way, the scheme will be defeated under the headcount test. The introduction of such provisions will remove the unfairness of the voting system brought about by CCASS.

Question 2

11. The consideration for non-listed companies is very different from listed companies. This is because the problems associated with CCASS and "share splitting" do not exist as the shares are registered in the names of the shareholders and any "share splitting" can be stopped by the Board refusing to approve the transfer of the shares. There is therefore no reason or justification to abandon the headcount test.

Question 3

12. The Bar considers that there should be no change for creditors' scheme, for the reasons set out in §6.27 of the Consultation Papers.

Question 4

13. The Bar supports the maintenance of the current regime to require disclosure of directors' residential addresses in public registers which are available for inspection. The Bar agrees with the Administration's observations and further observes that:-

13.1. It is a fairly common feature of Hong Kong private companies that they use the address of service companies as their registered addresses. In these instances it may not often be possible to contact the directors through the company's registered address. If directors are allowed to provide a service address as opposed to their usual residential address, the problem may be compounded. This problem is particularly pronounced in situations where the director is personally subject to the Companies Ordinance and is seeking to avoid being located or served for such purposes. The use of service addresses is likely to create obstacles for the proper implementation of enforcement, regulatory or other actions against directors and is not desirable.

13.2. As the Administration observes, there is no or no compelling case of abuse of the current system. In these circumstances the Bar believes that the benefit to be derived from the use of service addresses (namely to further protection of personal data) is insufficient to outweigh the practical benefits which the current system has.

13.3. Further, adoption of the Australian or British approach would require the Companies Registrar to form a judgment on whether, in any given case, the usual residential address of a director should be disclosed or the old records of such address expunged. The Bar believes this will impose an onerous duty on the Registrar, and there will also be further repercussions in e.g. whether there should

be an avenue of appeal or should the aggrieved applicant be left to pursue judicial review proceedings, the allocation of resources, as well as the efficient administration of the Companies Registry, for which proper consideration should be given before any change is to be attempted.

Question 5

14. The Bar does not believe the disclosure of personal identification numbers on public registers has created a major problem which would justify the introduction of a system to fully or partially withhold personal identification numbers of directors and company secretaries. The Bar echoes the observation that it is not an uncommon feature to have individuals with similar or identical names (in the case of Chinese individuals, there can be identity either in the Chinese names or the English transliteration). In these circumstances the availability of personal identification numbers provides the most effective means of identification. The practical benefits from having such a means of identification outweigh the (perceived) need for greater personal data protection (when there is no evidence of abuse of such information being a recurring problem). Accordingly, the Bar takes the view that the current system should be maintained.

Question 6

15. The Bar favours Option 1 i.e. retaining the definition of "relevant private companies" in section 157H(10) so that private companies within a group of companies of which a listed company is a member will continue to be subject to more stringent regulations than other private companies.

16. The rationale for the current regime of more stringent control is protection of minority shareholders in listed companies. The Bar notes that the proposal is to extend the "disinterested shareholders' approval" exception to public companies as well. The Bar believes that even on this assumption, there is much to be said for retaining the current system in relation to "relevant private companies" in order to protect the interests of the minority shareholders in the listed company.

17. Assuming the subject company (X) is a subsidiary of a parent company (A) which is the majority shareholder of a listed company i.e. the scenario contemplated in Option 3.

18. It is not unheard of, and indeed it is commonly known, that majority shareholders of listed companies often use nominees who purport to be independent members to hold shares for them, though this is a matter which is notoriously difficult to prove. In practice, with the

help of these ostensibly "independent shareholders", the majority shareholder may well be able to procure the necessary "independent shareholders' approval" required under the Listing Rules for connected transactions. Since the "disinterested shareholders' approval" proposed is a similar concept, the same comments would apply to it, and the reality of the protection conferred on the minority shareholders by this new exception may be suspect.

19. Further, if the prohibition on "relevant private companies" is removed partially or completely, a further avenue of abuse may arise in that the listed company may first procure the conferral of a benefit on company X (by obtaining "independent shareholders' approval" for such connected transaction as suggested above), followed by a transfer of such benefit from company X to its director e.g. by way of loan. The only safeguard in the second transaction is the "disinterested shareholders' approval", but such approval may not be difficult to obtain as the shareholders of Company X are often nominees appointed by those in control of Company A, and as long as they are not family members, trustees or partners of the director in question, they would not be excluded from voting.

20. In such a case, assets of the listed company will be siphoned off into the hands of directors of its associated company, but it will not be as obvious as a case of outright transfer in favour of the listed company's directors, which is more likely to attract the attention of the minority shareholders. The minority shareholders of the listed company may not even be aware of the transfer, at company X's level, in favour of its directors.

21. While the aggrieved minority shareholder in the listed company may in theory be able to bring a derivative action on the "fraud on the minority" exception, it is well known that bringing derivative actions (in particular on behalf of a listed company) is fraught with practical difficulties and the costs involved are often prohibitive. It is therefore undesirable to suggest that the minority shareholders should look to derivative action for their protection.

22. For the above reasons, the Bar believes that there is a case for retaining the current prohibition in relation to the "relevant private companies". The problem above cannot be sufficiently addressed by adopting Option 3 or Option 4.

Question 7

23. The Bar has considerable reservations on the proposed abolition of the common law derivative action for the following reasons.

24. First, the Bar fully appreciates the Court of Final Appeal's concern that the co-existence of the common law and statutory regimes should not be a source of confusion for the court users, for that would be contrary to one of the purposes of the codification, namely to make the derivative action more user-friendly and accessible to minority shareholders which it seeks to protect. That said, it does not appear from the case law following the introduction of the statutory derivative action that this dual system has created confusion – rather, the litigants and those advising them appear to be fully able to grasp the differences between the two regimes, and would select the one considered to be most suitable or appropriate in the circumstances of their case.

25. Second, given the ultimate rationale for derivative action is to afford a procedure to allow the minority shareholder to ventilate, for the company's benefit, the company's complaint which would otherwise not be ventilated (because of wrongdoer control), the Bar believes that the existence of an alternative avenue i.e. common law derivative action is not objectionable, and would further the purpose of making derivative action more accessible to the public.

26. In particular, unlike statutory derivative action, there is no leave requirement for the common law derivative action. Whilst the minority shareholder must still be able to show a *prima facie* case in the event that his standing to sue is challenged, the common law derivative action provides a cheaper and speedier option to the minority shareholder, for the frontloading of costs in the statutory derivative action (the need to obtain leave from court at an early stage of the proceedings) is likely to be a huge disincentive for a minority shareholder to take on the battle against Goliath. In the common law derivative action, unless the shareholder's standing is challenged by way of a striking out application, the action will proceed as normal, and the costs which a minority shareholder will have to bear upfront is likely to be comparatively low. Similar observations can also be made in respect of the time factor.

27. Third, the Bar is also concerned that the abolition of the common law regime, which has existed for over a century and a half and has bred a very substantial body of case law, at a time when the statutory derivative action is still at its infancy and many of its features have yet to be worked out by the court, may be counter-productive. The statutory regime introduces a new system which targets a defined type of misconduct ("misfeasance" as defined, which includes conduct outside the scope of common law derivative action e.g. negligence) and sets its own procedures and thresholds (leave requirement based on whether there is a serious issue to be tried and other defined criteria). It remains to be seen how far the case law on the common law derivative action is applicable or of relevance to the

statutory regime. Given also that the scope of the two systems differ, there are questions to be answered as to whether certain of the principles or concepts in the common law regime can or should be applied in the statutory regime. An example is that the common law derivative action recognizes equitable fraud or misuse of power by the majority shareholder as sufficient to ground a derivative action: see Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2. Does "fraud" (which is not defined in section 168BB(2)) include equitable fraud so that such misconduct can be addressed by the statutory derivative action? If not, the abrogation of the common law regime may unwittingly abolish certain protections which have hitherto been conferred. As such, the Bar believes there is much to be said for retaining both regimes for the time being. When the statutory regime has developed to a fuller extent, the matter can be reviewed and reconsidered.

28. The Bar also agrees with the arguments set out in §9.7 of the Consultation Papers and believe that they are valid grounds for retaining common law derivative action.

Other matter

29. Although the Bar is not asked to comment on the draft Companies Bill, it notes that there may be a case for amending the definition of "holding company" in cl.1.12(3), which refers to control of majority of voting rights on the board as opposed to numbers of directors (otherwise that would make no sense – see the definition of "parent undertaking" which uses the benchmark of voting rights on the board (cl.1.16). The Bar has doubts as to whether it is right to leave it to the FS to make regulations on the circumstances in which the court should not make an order for inspection of registers because of abuse (under the current s.158(9), cf. cll.12.110(6)-(7), 12.117(6)-(7), 12.125(4)(e)), for it is undesirable to define the scope of abuse and it is best left to the court to work out on a case-by-case basis).

Hong Kong Bar Association

26th April 2010