

The PCCW Privatization: A Guide to the Applicable Law for Schemes of Arrangement

Allegations of share splitting in the proposed privatization of PCCW have raised an important question as to how the statutory majority to approve a scheme of arrangement should be determined. This question is significant both in the short-term for investors trading PCCW and in the long-term in the context of future schemes of arrangement. In this article, we examine the applicable laws and regulations with a view to providing hedge funds and other investors with guidance.

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The proposed privatization of PCCW Ltd. (“PCCW”) by Starvest Ltd. and China Netcom Corporation (BVI) Ltd. (together “**Joint Offerors**”) announced on November 4, 2008 has been the subject of much discussion since allegations were made that a number of persons had received one lot of shares of PCCW in return for signing a proxy form enabling the shares received by them to be voted in favour of the scheme of arrangement to effect the proposal.

On February 24, 2009, the court granted leave for the Securities and Futures Commission (“**SFC**”), which is investigating the allegations, to intervene in the proceedings. The court is scheduled to

hear the petition to sanction the scheme on April 1 and 2, 2009.

The allegations and the decision of the court to grant leave for the SFC to intervene have generated much discussion, with market participants no longer sure whether the privatization will conclude successfully.

Background

PCCW is a Hong Kong company listed on the Stock Exchange of Hong Kong. As a result, a privatization of PCCW by scheme of arrangement is governed both by the Companies Ordinance (“**CO**”) and the Code on Takeovers and Mergers (“**Takeovers Code**”).

Companies Ordinance

Under the CO, a company may propose a scheme of arrangement by applying to court for an order to convene a meeting of members (*i.e.* shareholders) or any class of them in such manner as the court directs. If a majority in number representing three-fourths in value of members or a class of members, as the case may be, present and voting either in person or by proxy at the meeting agree to the arrangement, the arrangement shall, if sanctioned by the court, be binding on all the members.

Takeovers Code

Under the Takeovers Code, a scheme of arrangement to privatize a company may, except with the consent of the Takeovers Executive, only be implemented if, in addition to satisfying any voting requirements imposed by law:

- the scheme is approved by at least 75 per cent. of the votes attaching to the disinterested shares that are cast either in person or by proxy at a duly convened meeting of the holders of the disinterested shares; and
- the number of votes cast against the resolution to approve the scheme or the capital reorganization at such meeting is not more than 10 per cent. of the votes attaching to all disinterested shares.

For these purposes, “disinterested shares” means shares in the company other than those which are owned by the offeror or persons acting in concert with it.

Possible Scenarios

The allegations raise at least 2 possible scenarios of concern. In one scenario, the Joint Offerors or persons acting in concert with them have split their shareholdings to support the scheme and in the second scenario, disinterested members of PCCW have done so.

In the former scenario, the splitting of shareholdings increases the probability that a “majority in number” of the members will support the scheme. At the same time, to the extent that the shares split out appear to be disinterested shares but may not in fact be so, the splitting of shareholdings decreases the risk that the scheme will be blocked by members holding disinterested shares.

In the latter scenario, the splitting of shareholdings again increases the probability that a “majority in number” of members will support the scheme but has no impact on compliance with the Takeovers Code.

Court Sanction of Scheme

Once the shareholder meeting has approved the scheme, the sanction of the court must be sought. The sanction of the court is not a formality. The court has an unfettered discretion as to whether or not to sanction the scheme, but it is likely to do so, as long as the following conditions are satisfied:

- the provisions of the CO have been complied with,
- the statutory majority were acting *bona fide* and were not coercing the minority in

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order to promote interests adverse to those of the class; and

- the scheme is such as an intelligent and honest person, being a member of the class concerned, and acting in respect of his interest, might reasonably approve.

As to whether the provisions of the CO have been complied with, the task of the court is to determine whether the class of members was properly constituted, the meeting was convened in compliance with the court's directions, a proper explanation of the effects of the scheme has been given to the members and a simple majority in number representing three-fourths in value of the members present and voting at the meeting have agreed to the scheme.

However, the court is unlikely to sanction a scheme if it appears that the majority of members of a class had regard to their own special interests when casting their votes, rather than the interests of the class as a whole to which they belong. The requirement for a majority in number thus ensures that members who hold a large percentage of the issued share capital do not oppress members holding a small percentage of the issued share capital. This is important given that the sanction of the court operates, in this context, to expropriate property (*i.e.* shares of dissenting members).

Effect of CCASS

The majority of shares are held by investors through intermediaries who, in turn, hold through the Central Clearing and Settlement System ("CCASS"). Shares held through CCASS are registered in

the name of HKSCC Nominees Ltd. ("HKSCC"). As a result, such shares are, for the purposes of the CO, held by a single member even though they may represent the beneficial interests of many investors.

In the case of meetings in Hong Kong, CCASS Operational Procedures permit CCASS participants (*e.g.* brokers and custodians) to appoint their own corporate representatives to attend and vote at a meeting in respect of shares held for their account so long as the listed company's constitutive documents and applicable law so permit. In the case of PCCW, both its articles of association and the CO permit CCASS to appoint multiple corporate representatives.

However, CCASS Operational Procedures do not appear to permit CCASS participants to appoint multiple corporate representatives in respect of persons on whose behalf they hold shares. Thus, in practice, investors holding shares through CCASS are unable to count towards the number of members voting for or against a scheme.

In any event, on a strict reading of the CO, it is doubtful whether a CCASS participant who appoints a corporate representative to attend a meeting of members may be counted as a member for the purpose of determining whether a majority in number have voted for a scheme. Ultimately, no matter how many corporate representatives are appointed, the shares being voted are being voted on behalf of a single member, namely HKSCC.

Whilst it may be suggested that such a conclusion runs counter to a policy objective of seeking the consensus of investors:

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- it would be abusive to permit a single investor to obtain a majority in number to support a scheme simply by appointing multiple corporate representatives; and
- it is likely to be too difficult to ascertain how many investors underlying CCASS in fact voted for or against a scheme, there being too great of a risk of manipulation if each investor could itself declare how many underlying persons on whose behalf it was holding shares for the purpose of determining how many investors voted in favour of the scheme.

Effect of Share Splitting

Generally, transfers of shares by a person holding a large block of shares are unlikely to cause a court concern. This is so even though the transfers increase the number of members who may attend the meeting (and may thus affect whether a majority in number vote in favour of the scheme) and even if the share recipients are known to be inclined to vote the shares in favour of the scheme.

However, where a person transfers shares for no financial consideration but on the basis that the recipient of such shares must hold the shares until the record date and sign a proxy form in favour of a person nominated by the transferor, two possible concerns arise. First, as set above, a role of the court is to see whether the majority were acting *bona fide* and were not coercing the minority in order to promote interests adverse

to those of the class. Where persons receive shares on the basis that they sign a proxy form, there is a real concern that shares voted through these proxies are not *bona fide* and do not fairly represent the interests of the members as a whole.

Secondly, the court may fairly take into account the requirements of the Takeovers Code in exercising its discretion. Indeed, the court has in the past referred to such requirements in determining petitions to sanction schemes. To the extent that interested shares are transferred to persons who appear to be disinterested, on the basis that such persons sign proxy forms in favour of the person holding the interested shares, the shares may nevertheless remain interested shares rather than disinterested shares.

Whilst the factual context is unclear and in particular, the allegations of share splitting as yet inconclusive, in light of the foregoing, it is suggested that if the SFC presents evidence not only of share splitting but of a *quid pro quo* (i.e. a requirement for shares to be held to record date and proxy forms to be signed as part of the share splitting), the court may refuse to sanction the scheme.

Whether the court will refuse to sanction the scheme will likely depend in part on whether the number of shares voted in favour of the scheme as a result of the *quid pro quo* is material, the strength of the evidence presented by the SFC and the evidence presented by PCCW or others to rebut the allegations of share splitting or suggestions as to a *quid pro quo*.

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SFC Investigation Process

In general, the SFC investigation process is slow, taking months if not years to complete. However, in this case, the court gave the SFC only 21 days to bring its investigation to a point where it could present evidence.

The SFC's powers in a formal investigation are broad. Its investigators may require any person believed to have relevant information (i) to produce, within the time and at the place reasonably required by the investigator, any record or document specified by the investigator, (ii) to attend before an investigator at a time and place reasonably required by the investigator to answer any question, and (iii) to give an investigator all

assistance in connection with the investigation which the person is reasonably able to give.

It is likely to be difficult for the SFC to collect evidence to establish a forceful and comprehensive case within the limited time given to it by the court. Legal concerns may limit the speed at which the SFC may interview persons who may have received shares as part of a share splitting to determine how they came to receive the shares and in particular, whether there was any *quid pro quo* or other evidence that such persons would not have fairly had the interests of disinterested members as a whole in mind when voting. For example, a person who receives a request for an SFC interview may seek to re-schedule on the basis of the need to seek and consult with legal counsel.

In light of the above, it is likely that the SFC will be able to do no more than to present a sampling of cases, requiring some extrapolation or estimation to determine the true extent, if any, of share splitting with *quid pro quo*. ■

TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to financial institutions including hedge funds, private equity funds, traditional funds and private wealth managers. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200. It is ranked by the International Financial Law Review 1000 as a leading practice in Hong Kong banking law and by the Asia Pacific Legal 500 as a leading practice in Hong Kong financial services.

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