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Better late than never…Hong Kong Government's proposal to abolish the headcount test

In Hong Kong, takeovers by way of schemes of arrangement are subject to a number of voting thresholds. Under the Hong Kong Takeovers Code, they need to be approved at a shareholders' meeting by at least 75% of the votes attaching to the shares owned by the independent shareholders that are cast either in person or by proxy at such meeting, with no more than 10% of all independent shares (i.e. not just of those voting) voting against the scheme (the "**10% Rule**"). On top of that, Hong Kong company law requires that the scheme must be approved by a majority in number of the shareholders, which in turn represent 75% in value of the shareholders present and voting at the meeting. The "majority in number" threshold (also known as the "headcount test") came under spotlight when the Hong Kong Court of Appeal refused to sanction PCCW's privatisation scheme in May 2009, on the grounds that it found vote manipulation and share splitting practices were used to satisfy the "headcount test". We published a client briefing in March 2009 (**click here**) recommending the removal of the "headcount test". Our reasoning for this was: (1) the test runs contrary to the "one share, one vote" principle and hence may produce an inequitable and unrepresentative outcome in scheme votes; and (2) the safeguards offered under the Hong Kong Takeovers Code (in particular the 10% Rule) should suffice to protect minority shareholders' interests. In addition, as we noted in our previous client briefing, there is no equivalent of a "headcount test" for takeovers of companies in the PRC.

In 2009/2010, the Hong Kong Government consulted the public on the issue of how the "headcount test" should be reformed in light of the PCCW privatisation court case. Despite strong views to the contrary, the Government concluded that the "headcount test" should be retained, although the law would be amended to give the court a discretion to dispense with the test so as to tackle the problem of share splitting by parties interested in the outcome of the scheme. A draft Companies Bill containing the reform proposal was submitted to the Legislative Council in January 2011.

Finally, earlier this week, the Government submitted a revised reform proposal to the Bills Committee of the Legislative Council formed for the Companies Bill. The revised proposal, which applies to members' schemes in the context of takeover offers and general offers for share buy-backs, comprises the following key features:

- an abolition of the "headcount test"
- maintaining the current 75% in value approval threshold
- turning the 10% Rule currently in the Hong Kong Takeovers Code into law
- maintaining the requirement for the court's sanction of the scheme

For the reasons set out in our earlier client briefing (**click here**), we welcome the above proposal.

However, the story will not end if the proposal passes into law in Hong Kong. The requirements under the company laws of Bermuda and the Cayman Islands (where the majority of companies listed in Hong Kong are incorporated) are substantially the same as Hong Kong law *in its current form* i.e. "headcount tests" do exist in the respective jurisdictions. Unless we see a corresponding change in the company laws of Bermuda and the Cayman Islands, the majority of Hong Kong listed companies will continue to be subject to a "headcount test" in a takeover scenario, with the resulting additional level of uncertainty that this brings for the bidder.

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