20/1/12

IN THE GRAND COURT OF THE CAYMAN ISLANDS
FINANCIAL SERVICES DIVISION

The Hon Mr Justice Andrew J. Jones QC
In Chambers, 29 and 30 November 2011
And in Open Court, 20 January 2012

CAUSE NO.FSD 182 OF 2011 (AJJ)

IN THE MATTER of sections 15 and 86 of the Companies Law (2010 Revision) (as amended)

AND IN THE MATTER of the Grand Court Rules 1995 Order 102

AND IN THE MATTER of Little Sheep Group Limited

Appearances : Mr Nigel Meesn QC and Mr Stephen Leontsinis of Conyers Dill & Pearman for Little Sheep Group Limited

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REASONS

INTRODUCTION

1. This application raises a question about how to decide whether the "double majority" mandated by section 86 of the Companies Law has been achieved for the purposes of a scheme of arrangement between a company and its shareholders, when all or substantially all of the shares in question are held through a single custodian or clearing house. The Grand Court Rules Committee answered this question many years ago by enacting Order 102, r.21(6), but it has been submitted by counsel in this case that the rule is *ultra vires* or would be *ultra vires* if it is interpreted and applied in the manner set out in Practice Direction No.2/2002.

2. Little Sheep Group Limited ("the Company") applied by a summons dated 9th November 2011 for an order to convene a "court meeting" in respect of a scheme of arrangement proposed to be made between the Company and its shareholders for the purpose of privatizing the Company ("the Scheme"). The Company's issued share capital comprises 1,037,220,620 ordinary shares of HK$0.10 each ("the Issued

Shares") which are presently listed on the main board of the Hong Kong Stock Exchange. The current shareholder profile has been described to the Court as follows. Approximately 29.7% of the Issued Shares are beneficially owned by Possible Way Ltd, a company owned by the Company's principal founders, Mr Zhang Gong and Mr Chen Hongkai, members of their families, and various other individuals involved with the establishment and management of the Company. Messrs Zhang Gong and Chen Hongkai own a further 3.24% of the Issued Shares in their own right. Approximately 27% of the Issued Shares are beneficially owned by Wandle Investments Limited "Wandle"), an indirect wholly owned subsidiary of Yum! Brands Inc, a company whose shares are listed on the New York Stock Exchange. The balance of approximately 40% of the Issued Shares are beneficially owned by an unknown number of independent investors.

3. The Company owns a large chain of restaurants in the Peoples Republic of China. On 2nd May 2011 it entered into an agreement with Wandle that it would promote the Scheme, the purpose and effect of which is that the Company will become a subsidiary of the Yum! Brands Group, the world's largest operator of franchised restaurants including *Kentucky Fried Chicken, Pizza Hut* and *Taco Bell*. This agreement was publically announced on 13th May 2011. The intention is that Wandle will acquire 97.23% of the Company's equity and the balance will continue to be owned by Possible Way Ltd. The mechanism by which this privatization is to be achieved is that the relevant shares, including all those owned by the independent investors (referred to as "the Scheme Shares") will be cancelled and the resulting credit will be applied to pay up and issue to Wandle the same number of new shares. Wandle will pay to the holders of the Scheme Shares HK$6.50 in cash for each share. Economically, this mechanism has the same result as a tender offer made by Wandle. Legally, there is an important distinction. If Wandle had made an offer to buy the outstanding shares which it does not already own, it would have to acquire 90% of them by agreement before it could compulsory acquire the balance pursuant to section 88 of the Companies Law. The effect of structuring the transaction as a scheme of arrangement is that section 86 provides for a lower threshold of acceptance. The Scheme will become binding only if (a) it is approved by a majority in number representing seventy-five per cent in value of the Company's members (referred to as the "double majority" or "the statutory majority") and (b) it is sanctioned by the Court. The effect of the Court's sanction is that the Scheme becomes binding upon those members who abstained or voted against the proposal.

THE APPLICATION FOR DIRECTIONS

4. The Company's summons for directions in respect of the matters which necessarily arise in connection with convening the court meeting initially came on for hearing on 29th November 2011. The applicable procedural rules and practice are contained in the Grand Court Rules 1995 (Revised Edition), Order 102, rule 21 and Practice Direction No.2/2002, which set out in detail all the matters which must be addressed

by the Court. First, the Court will consider whether or not it is appropriate to convene class meetings and, if so, the composition of the classes. Second, the Court will consider whether the proposed time and place of the court meeting and the method of giving notice is appropriate in all the circumstances. The test is whether the proposed arrangements are likely to afford the persons having the economic interest in the Scheme Shares a reasonable period within which to make an informed decision and deliver their proxy forms or voting instructions in time for their votes to be counted. Third, the Court must be satisfied that the scheme documentation will provide the shareholders with all the information reasonably necessary to enable them to make an informed decision about the merits of the Scheme. The Rules and Practice Direction specifically recognize and take account of the fact that, in the ordinary case, the shares in question are likely to be listed on a stock exchange and that the registered holders of the shares are unlikely to be the persons having the economic interest. For the purposes of giving directions the Court takes account of the interests of the underlying investors. Fourth, the Court will require evidence in order to satisfy itself that the directions for the court meeting and the content of the scheme documentation comply with any the applicable stock exchange rules and any other applicable regulations. The Company's affidavit evidence addressed all these matters and I was satisfied that the directions sought were appropriate, save in one important respect.

5. GCR Order 102, r.21(6) states as follows –

> "The Court shall give such directions as may be necessary for the purpose of enabling it to determine whether or not the statutory majorities will have been achieved. If all or substantially all of the shares or debt instruments to which the proposed scheme relates are registered in the name of one or more custodians or clearing houses, the Court may direct that -
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> (a) such custodian or clearing house may cast votes both for and against the propose in accordance with the instructions of its clients;
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> (b) such custodian or clearing house shall specify the number of votes cast in favour of the scheme and the number of clients or members on whose instructions they are cast and the number of votes cast against the proposed scheme and the number of clients or members on whose instructions they are cast."

6. The shareholder profile which I have described in paragraph 3 above relates to the beneficial ownership of the Issued Shares. The Company's evidence is that, as at 21st November 2011, 87.73% of the Issued Shares were registered in the name of HKSCC Nominees Limited which acts as a common nominee in respect of securities held in the Central Clearing and Settlement System of the Hong Kong Securities Clearing Company Limited, which I shall refer to as "CCASS". It is accepted by counsel for the Company that CCASS is a "custodian or clearing house" within the meaning of Rule 21(6). The Company's affidavit does not actually specify what proportion of the Scheme Shares (as opposed to the Issued Shares) are registered through CCASS, but counsel accepted that it must be "all or substantially all" of them. It follows that I am bound to consider whether or not I should direct that CCASS (a) may cast votes for and against the Scheme in accordance with the instructions received from its Participants (as defined in its General Rules) and (b) should specify the number of votes cast in favour of the Scheme and the number of Participants on whose

instructions they are cast and the number of votes cast against the Scheme and the number of Participants on whose instructions they are cast.

7. Notwithstanding Rule 21(6), the Company's summons seeks a direction that "CCASS be counted as one person for the purpose of ascertaining whether or not the requirement that a majority in number of the Scheme Shareholders approve the Scheme". I refused to make a direction in these terms because I considered it to be wrong in principle and contrary to Rule 21(6). CCASS can only cast votes in accordance with instructions received from its Participants. The Court is bound to assume that some Participants will instruct CCASS to vote in favour of the Scheme and some will give instructions to vote against it. CCASS is bound to vote, if at all, strictly in accordance with its instructions, which necessarily means that it must be able to vote both for and against the Scheme. Arguably, this means that the Court is treating CCASS as if it were two members/voters for the purposes of calculating the majority in value. As I understand it, Mr Meeson accepts that CCASS can vote for and against the Scheme (otherwise it will not be able to vote at all) but argues that I should direct that it be treated as one member/voter for the purpose of calculating the majority in number. As I understand paragraph 33 of his written submission, the theory is that the Court should look at the number of shares voted by CCASS and set off the positive and negative votes against each other. CCASS should then be treated as one voter, either for or against the Scheme depending upon the net position. In my judgment this method of calculation would not be consistent with the purpose of section 86. It would also contravene Rule 21(6)(b).

8. Having regard to the fact that CCASS holds 87.7% of the Issued Shares and possibly holds an even higher proportion of the Scheme Shares, the effect of allowing it to vote for and against the Scheme is that the outcome as regards the "majority in value" will be determined, almost inevitably, by the instructions received from its Participants. This is the common sense approach. It produces a commercially acceptable result which will be readily understood by investors. It is also the approach mandated by Rule 21(6)(a). However, the effect of treating CCASS as one member (with one vote) for the purpose of ascertaining the "majority in number" without regard to the number of Participants from whom instructions are received is not only inconsistent with the purpose of section 86, but would be highly artificial and could conceivably produce a result which is commercially unacceptable. This approach makes it easier for an opponent of the Scheme to defeat it by the simple mechanism of having a nominal number of its shares registered in the names of the requisite number of individuals who agree to vote against it. In this way it would be possible for someone having a minimal economic interest in the Company to hold it to ransom and demand a higher price for his shares. Conversely, it would make it easier for the Company's management to guarantee that the majority in number will be achieved by making the same kind of arrangements. The approach mandated by Rule 21(6)(b) is intended to mitigate against manipulation of this sort.

9. I should make it clear that there is no suggestion that any share manipulation has taken place or is likely to occur in this case. I dismissed this part of the Company's summons simply because I considered that, in the circumstances of this case, the Court was being asked to make an order which was both contrary to the Rules and wrong in principle. Instead, I intended to make an order in accordance with Rule 21(6) as follows –

> "CCASS shall be permitted to vote for and against the Scheme in accordance with instructions received from Investor Participants (as defined in the Scheme Document). Each Investor Participant who gives voting instructions to CCASS shall be counted as one person for the purposes of ascertaining whether or not the requirement that a majority in number of the Scheme Shareholders approve the Scheme".

I also directed that certain consequential amendments would need to be made to that part of the Scheme Document which dealt with the procedure for voting.

THE MEANING AND EFFECT OF SECTION 86

10. The following day, before my order had been drawn up and signed, I was persuaded to re-open the hearing for the purpose of allowing counsel for the Company to make the argument that there is no jurisdiction to make an order in these terms. The complaint is that my intended order appears to have the effect of treating the Participants of CCASS as if they are members of the Company and that the Court is prevented by section 38 of the Companies Law from treating anyone other than CCASS itself as the member. Section 38 states that –

> "The subscribers of the memorandum of association of any company shall be deemed to have agreed to become members of the company whose memorandum they have subscribed, and upon the registration of the company shall be entered as members on the register of members hereinafter mentioned, and every other person who has agreed to become a member of the company and whose name is entered on the register of members, shall be deemed to be a member of the company.

11. In order to become a member of the Company it is necessary to have one's name placed on the register of members. Accordingly, it is said that each registered member is a single member and for the purposes of what Mr Meeson calls "the head-count test", it is only the registered members who may be counted. It follows, according to counsel, that CCASS must be counted as one voter for the purposes of the "majority in number" although by his reasoning it is effectively being counted as two voters for the purposes of the "majority in value". Counsel referred me to three authorities in support of this proposition.

12. *Re pSivida Limited* [2008] FCA 627 is relied upon in support of the proposition that "it is the law in Australia that the registered shareholder [of a company] is one member even if it is a depository". This is a decision of the Federal Court of Australia in which Jacobson J. made an order convening a scheme meeting pursuant to section 411(1) of the Australian Corporations Act 2001. The report is a very brief statement

of the reasons for an *ex parte* order to convene a meeting in connection with a scheme of arrangement. It does not recite the relevant provisions of the Act or the applicable rules, but it is apparent that the application was the equivalent of the Company's application before this Court. It is also apparent that it was an *ex parte* application. In paragraph 11 of his reasons Jacobson J. said that 53% of the company's shares are held through ANZ Nominees Ltd. He commented that "This may have consequences in relation to the headcount test imposed by s.411(4)(a)(ii) of the Act". However, he did not explain the head-count test or indicate what the consequences might be. This is perhaps not surprising since he also said in the next paragraph that "This is not a matter which affects my discretion to convene a meeting of the shareholders of pSivida. However, it may become a relevant factor at the second court hearing. In that event the plaintiff may seek to rely on recent amendments to s.411 ...." None of this is explained in the judge's reasons. Nor is it reflected in the order itself, which makes no reference to ANZ Nominees Ltd. I do not find this report at all helpful in connection with the construction and application of section 86 of the Cayman Islands Companies Law or Order 102, rule 21 of the Grand Court Rules.

13. I was also referred to the decision of the Hong Kong Court of Appeal in *Re PCCW Ltd* [2009] 3 HKC 292. This case concerned the privatization of Pacific Century CyberWorks Ltd and involved an application to the court to sanction a scheme of arrangement pursuant to section 166 of the Hong Kong Companies Ordnance, Cap.32 which is the equivalent of section 86 of the Cayman Islands Companies Law. The mechanism used to privatize PCCW Ltd was the same as that proposed to be used in this case. Approximately 93.75% of PCCW Ltd's shares were registered in the name of CCASS. There was evidence that shareholdings owned by two supporters of scheme of arrangement had been "split" by transferring and registering single shares in the names of hundreds of individuals prior to the court meeting for the sole purpose of ensuring that the majority in number would be achieved and/or boosting the margin by which it is achieved. The court held that the majority in number would not have been achieved but for this share manipulation exercise. The Court of Appeal reversed the trial judge's decision to sanction the scheme, but it did not do so on the basis that the manipulative practices had invalidated the vote. It was held that when the court comes to the conclusion that a material number of votes have been influenced by manipulative practices, it cannot accord the majority its usual weight for the purposes of deciding whether or not to sanction the scheme. I agree with this proposition, but the Hong Kong Court of Appeal did not address the opposite scenario in which the majority in number *would* have been achieved but for manipulative share splitting carried out by opponents of a scheme of arrangement. If the scheme of arrangement is considered to have been rejected as a result of manipulative share splitting, the question of whether or not to sanction it would never come before the court.

14. Mr Meeson relied upon the observations of the Honourable Anthony Rogers VP at paragraphs 66-75 and in particular the statement in paragraph 66 in which he said

"All those who voted, whether for or against the Scheme, were registered shareholders. Company law takes no notice of any trust or beneficial interest attaching to shares. Hence, as far as the formalities are concerned, there is no question of challenge. Although it can be said that the threshold has been achieved because those who voted in favour of the Scheme were shareholders, the fact remains that there was a clear manipulation of the vote and because of the extent to which that happened the court cannot be sure the vote was fair. That is relevant on the second part of the court's function."

Cayman Islands law is the same in the sense that section 38 of the Companies Law requires a company to treat registered shareholders, and only registered shareholders, as its members. The judge went on to say in paragraph 68 that –

"One of the aspects of the aspects highlighted by the facts of this case is that shares which remain registered in CCASS can be counted, on the basis of proxy votes, as regards the number of shares but cannot be counted on a head-count. In those circumstances, this court simply does not know how individual shareholders whose shares remain in CCASS would have voted."

In this regard Hong Kong law is apparently different from Cayman Islands law. Whilst it is right to say that the Cayman Islands Companies Law takes no notice of any trust or beneficial interest attaching to shares, this does not lead to the conclusion that custodians and clearing houses such as CCASS "cannot be counted on a head-count" for the purposes of section 86. The effect of section 38 is that the Company and the Court is bound to treat CCASS as a member. However, this does not mean that the Court is bound to adopt the fiction that CCASS is an investor. The Court is perfectly entitled to take notice of the fact that custodians or clearing houses such as CCASS are not the beneficial owners of the shares registered in their names. It is specifically spelt out in Rule 21(6) that the Court will recognize that an institution such as CCASS, which is doing nothing more nor less than providing the market with a custodian service, can only vote the shares registered in its name in accordance with the instructions received from its members or clients. This Court gives directions designed to enable it to carry out a head-count based upon the number of Participants who give instructions to CCASS. As a result of the direction made in this case in accordance with Rule 21(6)(b), the Court will know both the number of Participants who instructed CCASS to vote in favour of the Scheme and the number who gave instructions to vote against it. In my judgment the combined effect of section 38 and 86 of the Companies Law is that all those, and only those, whose names are on the register must be counted for the purposes of both limbs of the double majority. The method by which they will be counted is not spelled out in section 86 and it is open to the Court to give appropriate directions consistent with the statutory purpose.

15. Finally, I was referred to the decision of the Court of Appeal in *Schultz v. Reynolds* [1992-93] CILR 59. The Court of Appeal held that a person having a beneficial interest in the shares of a company has no *locus standi* to commence a derivative action on its behalf or in its name. This can only be done by or in the name of the registered shareholder. Zacca P. said at page 69 –

"*The Companies Law (Revised) recognizes only members who are registered. The appellant has no*

voting rights and as a beneficial owner of the shares has no rights under the Law. The instant case can therefore be distinguished from [Great Western Railway Co v. Rushout (1852) 64 E.R.1121]. *In my view is it only CMS, the registered shareholder of Newport Ltd, who can institute an action against Newport Ltd."*

This case did not involve a scheme of arrangement. The Court of Appeal was not considering the meaning and effect of section 86. Its analysis simply leads to the conclusion that CCASS should be regarded as a member of the Company and that its Participants are not members of the Company. This conclusion is not in issue. The question which I am being asked to decide is whether the mechanisms for determining the statutory majorities mandated by Rules 21(6)(a) and (b) are *ultra vires* because they are tantamount to treating the Participants as members.

16. I remind myself that the basic rule of statutory interpretation is that it is taken to be the Legislature's intention that a statute will be construed in accordance with the general guides to legislative intention laid down by law. I must consider section 86(2) in its proper context and seek to avoid an interpretation which produces an unworkable or impractical result, which is inherently unlikely to have been intended by the Legislature. (See Francis Bennion's *Statutory Interpretation* (Fourth Edition), Section 313, pages 832-9). The purpose of section 86 is to provide a mechanism whereby rights vested in large numbers of shareholders (or creditors) can be varied in circumstances where it would be impractical to negotiate and reach agreement with each one separately. The mechanism is that the rights of shareholders or classes of shareholders (or creditors) may be varied with majority consent. Because vested contractual rights are being compulsorily varied, an essential part of this mechanism is that the procedure for obtaining majority consent is fixed by the Court and the scheme of arrangement (which is a contract) becomes binding upon the parties only if it is sanctioned by the Court. The company has no power to summon an extraordinary general meeting for the purposes of considering and, if though fit, approving a scheme of arrangement. A meeting for this purpose can be convened only by order of the Court "in such manner as the Court directs". These words give the Court a wide discretion to give directions about the procedure by which the meeting will be convened and also the mechanisms by which the statutory majorities will be calculated.

17. Mr Meeson submits, rightly in my view, that the concept of a "majority in number" implies some form of head-count. However, section 86 does not stipulate any mechanism by which the head-count should be conducted. It is a matter for the Court to fix the mechanism in accordance with the Rules, having regard to the circumstances of the case. When shares are registered in the names of two or more natural persons as joint owners, it is open to the Court to treat them as a single head for the purpose of the count. Similarly, when shares are registered in the name of a custodian or clearing house such as CCASS, the Court is bound to treat it as a member of the company but it is also entitled to treat it as multi-headed member for the purpose of the count. Rule 21(6)(b) sets out the mechanism for determining the

number of heads which will be attributed to CCASS. This mechanism is simple, practical and well understood by institutions such as CCASS which have been acting upon it for many years without any difficulty.

CONCLUSION

18. On its true construction, section 86 does not mean that each member must necessarily be treated as one head for the purposes of the calculating majority in number. Nor does it mean that each member must necessarily cast only one vote for the purpose of calculating the majority in value. For these reasons I made an order that CCASS be permitted to vote for and against the Scheme in accordance with the instructions from its Participants and that it shall specify the number of votes cast in favour of the Scheme and the number of Participants on whose instructions they are cast and the number of votes cast against the Scheme and the number of Participants on whose instructions they are cast. CCASS will be treated as a multi-headed member for the purposes of the head-count. The number of Participants from whom it received instructions (both for and against) will determine the number of votes attributable to CCASS for the purpose of determining whether the majority in number has been achieved.

DATED this 20th day of January 2012

The Hon Mr Justice Andrew J. Jones QC
JUDGE OF THE GRAND COURT