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CORPORATE
SHARE SPLITTING

The grand scheme of things

The High Court's decision to disregard the votes of a majority of shareholders opposing the sale of their company will likely force those companies using schemes of arrangement to monitor their share register for any unexpected movements

1 MINUTE READ

A recent UK High Court judgment has outlined some basic rules on the parameters for share splitting - what amounts to unacceptable manipulation and what does not.

But whilst the decision is helpful to show that there is protection against manipulative practices, there remain several unanswered questions including what is the necessary evidence required to demonstrate shareholder behaviour that could be objectionable. There was also confirmation in the judgment that, at a court meeting (rather than a general meeting), those voting must vote for the purpose of benefitting the class as a whole.

A recent contested takeover gave the UK High Court its first opportunity to rule on the validity of share splitting in the context of a takeover by way of scheme of arrangement. In short, it ruled that actions clearly seeking to manipulate the outcome of a scheme are objectionable and can lead to the rejection of the votes of those participating in such behaviour. The outcome of the judgment has, broadly, been met with relief by practitioners, given that any other outcome could have resulted in schemes of arrangement becoming less attractive for takeovers in the UK. As is discussed below, however, the wider implications of the decision are far from clear.

The judgment in Re Dee Valley Group plc (2017), given on the basis of some very singular facts, may have been greeted with a warmer welcome had it provided settled rules on the parameters for share splitting (ie as to what amounts to unacceptable manipulation and what does not). Some further guidance may have been forthcoming had the matter gone to appeal.

By way of background, Dee Valley Group, a water company operating in North East Wales and the North West of England, was the subject of two competing takeover bids, by Severn Trent Water and by Ancala Fornia. There was much local opposition from employees and other stakeholders towards the Severn Trent proposal. The share splitting in question related to the proposed scheme with Severn Trent, being the higher recommended bid. Switching to a contractual bid was unattractive to Severn Trent given the terms of certain irrevocable undertakings given by significant shareholders to Ancala in connection with the underbid.

One of the statutory requirements for a scheme in the UK is the approval by a majority in number, representing 75% in value, of shareholders voting at a court-convened meeting of the target's shareholders. The two limbs to this test can allow a dissenting majority in number, which holds less than a majority in value, to veto a scheme. In such a case, the scheme cannot progress and the court has no jurisdiction to sanction the scheme. If, however, the shareholders approve the scheme, it proceeds to a court sanction hearing.

An employee of Dee Valley who was opposed to Severn Trent's bid acquired approximately 460 shares in the company a few days before

the record date for the court meeting, and gifted most of those shares to around 440 other people, all of whom subsequently sought to vote against the scheme. The votes of those opposing shareholders, if accepted and valid, would have defeated the scheme on the majority of number limb (but not the 75% in value limb).

Upon becoming aware of these significant movements on its share register, Dee Valley applied for a direction from the Court permitting the chairman of the court meeting to reject the votes of the opposing shareholders so that the scheme could progress to a sanction hearing, at which the validity of those votes could be considered. This was thought an appropriate way to preserve the rights of all parties pending the sanction hearing – to accept the opposing shareholders' votes would be to permit the scheme to be voted down, and therefore stop progression to the sanction hearing at which parties could make representations. The judgment ultimately sanctioned the scheme and the takeover completed.

The judgment, in relation to the central issues at hand, concluded that in this case the conduct of the opposing shareholders was such that the only explanation for their actions was to further a share manipulation strategy to defeat the scheme by use of the majority in number test. Further, the chairman was entitled to protect the integrity of the court meeting against such manipulative practices that would frustrate the meeting's statutory purpose.

There was also confirmation in the judgment that, at a court meeting (rather than a general meeting), those voting must vote for the purpose of benefitting the class as a whole. The judgment acknowledged, however, that the interests of a class may be very complex and will not always be purely financial, and that, unless it can be shown that those voting are motivated by interests in a capacity different to that of membership of the class, it will be difficult to reject the votes. The judge made clear that a strategy could be manipulative and therefore objectionable even if the motivations of the participants were sincere.

So, whilst the judgment is helpful to show there is protection against manipulative practices, there remain several unanswered questions. There was also the practical issue that in circumstances where there looks to have been some behaviour that could be objectionable, the requisite evidence may be difficult to present to the Court given it will more than likely require analysis and investigation of the complex and intertwined voting motivations which the judgment acknowledges can exist within the voting class.

So where does this leave a company and its chairman in the event of signs of share splitting? Irrespective of discerning shareholders' voting intentions and motivations, a chairman may be faced with movements or positions on the share register which point towards an inference of grounds to reject votes to maintain the integrity of the court meeting. It is unlikely, though, that the circumstances around the movements will be as stark as in the Dee Valley case (ie the shareholder register increasing by 50% in a matter of days prior to the record date following the identified gift of one share each to persons who were not shareholders prior to the court meeting being convened).

This will make the chairman's decision difficult. The judgment makes clear that the chairman has an inherent power to reject votes to ensure that the purpose of the meeting is secured and that the Court will be slow to interfere with his decision. But in the absence of such extreme circumstances as in the Dee Valley case, a chairman may, rather than reject votes on his own authority, prefer to seek directions from the Court (as was the case in Dee Valley), or to adjourn the court meeting pending further enquiries.

Even where such protective measures are adopted, there are a host of possible circumstances which are likely to lead to an uncertain outcome. For example, an activist shareholder acquires multiple small blocks of shares through different nominees with the intent to use the threat of voting the scheme down as leverage to secure a higher offer – should that be permitted? The activist shareholder would seem to be voting, in financial terms at the very least, with regard to the class. Should a rival underbidder be able to vote having acquired a shareholding (possibly even a 25% holding by value) with a view to voting down the scheme, to increase the chances of its own (lower) bid being approved? In that situation, arguably the acquisition is not manipulative, but the shareholder may struggle to show that it is voting for the benefit of the class as a whole. Does the timing of the acquisition or splitting affect the analysis – are shares acquired and/or split prior to a bid being announced (which clearly could, in any event, offend other regulations) immune from any inference as to manipulation?

The answers to these questions remain uncertain. Whilst it will only ever be a realistic tactic to disrupt a scheme in relation to a small number of companies with a sufficiently small share register, particularly in combination with a situation where there are practical restrictions on switching to a contractual offer, this uncertainty could lead to steps being taken at relatively low cost, and little effort to at least to create a situation where the uncertainty gives rise to leverage and/or a robust argument at a sanction hearing. For example, shares could be distributed amongst employees at a time when no bid is in contemplation in such small numbers per employee that such employees are likely to vote with regard to interests of the class wider than purely financial; or an activist shareholder could facilitate the acquisition of shares for value by stakeholders likely to be against a particular bid (again, employees may be the obvious example) in a more subtle manner which could lead to the need for enquiry of each participant's motivations. This is something unlikely to be attractive to a bidder and therefore something of leverage.

Certainty can arguably only be obtained on this point by way of change to the law – removing the majority in number limb of the test which is currently required to be satisfied to give the Court jurisdiction to sanction the scheme (or making its application part of the Court's discretion at the sanction hearing). This would provide clarity not just for takeovers but as, if not more, importantly for debt restructurings which often use the same scheme mechanism. This is something which has been considered previously in the UK and rejected. Some other jurisdictions with similar mechanisms to the UK scheme of arrangement have removed the majority in number limb of the test while others have permitted the Court to disregard the outcome of the vote at the sanction hearing. This is in effect what happened in Dee Valley, through the exercise of the chairman's power to reject the votes specifically on the basis that the parties would then be able to argue the point at the subsequent sanction hearing. Unless and until the dual test is repealed, further case law will refine the rules on share splitting.

Travers Smith provided legal advice to Dee Valley Group.

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