HERBERT SMITH FREEHILLS

M&A STANDPOINT: SHARE SPLITTING FAILS TO DERAIL SCHEME

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Legal Briefings

Landmark court judgment sanctions Severn Trent's takeover of Dee Valley despite 'share splitting' attempts to frustrate the statutory purpose of schemes of arrangement. In our view, the decision is to be welcomed to help avoid such attempted forms of manipulation in the future.

The High Court today handed down a judgment sanctioning a scheme of arrangement between Dee Valley Group plc and its members to implement the takeover of the company by Severn Trent Water Limited. The Court did so despite an attempt by a shareholder to defeat the Scheme by gifting one share each to over 400 individuals opposed to the transaction. It was the first time that such share splitting had come before the Court and the judgment has no doubt caused those using or contemplating schemes to breathe a sigh of relief.

In the context of a takeover, a Scheme is an arrangement between a company and its shareholders under companies legislation which must be approved by the Court. Under a Scheme which the shares in the target company are transferred to the bidder in return for the relevant consideration. The Court may approve or sanction a Scheme if at a meeting specifically convened at the direction of the Court to consider it, the Scheme is approved by the relevant majorities. Importantly those majorities are (a) 75% or more of the shares voted and (b) a majority in number of the members present and voting either in person or by proxy. It is this second 'majority in number' test that was in issue in the Dee Valley case.

Schemes of arrangement have many different applications but are the most common device used to implement takeovers in the UK and in many other jurisdictions. In 2016, of the 51 announced takeovers, 31 were implemented by way of a Scheme as opposed to 20 by way of a contractual offer. A key advantage of Schemes in the context of takeovers is that if the requisite shareholder majorities are achieved, all shareholders in the target are bound to transfer their shares to the bidder whereas under a contractual offer acceptances over 90% of the shares must be achieved to squeeze-out the non-accepting minority. There are other advantages of Schemes over contractual takeover offers (for example in terms of flexibility of timetable and in relation to US securities laws) which may be relevant to particular takeover situations.

The Dee Valley case was the first in which the Court had to consider how to deal with a deliberate attempt by a shareholder to defeat a Scheme by transferring shares to others so as to create a majority of members opposed to the Scheme where (absent such 'splitting') a majority in number of members would have voted in favour of the Scheme. The significance of the case in terms of the potential impact on the use of Schemes generally was recognised by the judge in his decision.

THE FACTS

On 23 November 2016, Severn Trent announced a recommended offer to acquire the issued share capital of Dee Valley by way of a Scheme. The Court directed that the Meeting to consider the Scheme was to be held on 12 January 2017 with the last date to be on the register of members and eligible to vote being two days' before the Meeting. The Severn Trent offer was an increase on a previously recommended offer and in response to previous competing offers from a rival bidder which had acquired or received irrevocable undertakings/acceptances in respect of approximately 41% of the shares prior to the announcement of Severn Trent's Scheme.

In early January 2017, it came to the attention of Dee Valley that one employee had acquired 461 shares in the company and gifted one share to each of 443 individuals. This had the effect of more than doubling the number of members on Dee Valley's shareholder register over a two day period. Whilst there was no suggestion that the motives of the new shareholders who received one share each were dishonest, this plan appeared to be an organised attempt to defeat Severn Trent's Scheme by preventing the 'majority in number' test being satisfied.

Faced with this novel 'share-splitting' scenario, in advance of the Scheme Meeting, Dee Valley applied to the Registrar of the Companies Court for a directions order that, in light of the evidence of potential manipulation of the register of members, the Chairman of the Meeting should be given discretion to exclude the 'split votes' ie the votes of the new shareholders. The purpose was to 'hold the ring'. Failure to exclude the votes of the new shareholders at this stage would have meant that the required statutory majority would not be obtained and the Court would have no jurisdiction to sanction the Scheme. Excluding the votes was the only way to preserve the rights of all of the interested parties because it would ensure that they had an opportunity to present their arguments at the Sanction Hearing before a Judge. As announced by Dee Valley at the time, this was the basis on which the permission of the Court was sought, and the Court gave the Chairman the discretion to exclude the votes of the new shareholders and report back to the Court what the outcome would have been had those votes been included. The Chairman duly exercised that discretion at the Meeting and (on that basis) the vote to approve the Scheme passed the statutory tests.

The Court then considered whether, in the light of all this, to sanction the Scheme.

THE COURT DECISION

The Court heard a number of arguments that will no doubt be rehearsed and debated at length elsewhere. Ultimately the Court decided that the Scheme should be sanctioned. In our view, the following key points in the judgment should be highlighted:

- Share-splitting undermines the spirit of the Scheme legislation and is objectionable
- At the time of the Meeting and faced with evidence that the share-splitting was an attempt to manipulate the outcome of the Meeting, the Chairman had discretion to exclude the votes of the new shareholders even without the permission of the Court (if he acts in good faith and not perversely) as the Chairman was entitled to protect the integrity of the Meeting against manipulative practices such as share splitting that would frustrate its statutory purpose
- The Chairman rightly excluded the votes in the interests of the class as a whole. When voting at a meeting of a class of members, the interests of the class "may be very complex and are not always going to be purely financial" but members of that class must vote in the interests of the class as a whole and in these circumstances the new shareholders could have given no consideration to the interests of the class of members which they had joined when they accepted the gift of a single share

The decision is to be welcomed.

The Court has jurisdiction to sanction a Scheme where (amongst other things) the statutory requirements (including the requisite majorities) are met and the class of members was fairly represented by those attending and voting at the Meeting to approve it. The new shareholders represented 0.01% of the shares in total and 0.03% of the shares voted at the Meeting. Over 98% of the shares voted at the Meeting (excluding those held by the competing bidder) were in favour of the Scheme and 92% of those members attending and voting (in person or by proxy) were in favour (excluding the new shareholders). Absent the share splitting, the Scheme would clearly and comfortably have met the statutory majority thresholds. The Chairman was faced with evidence that the shares had been gifted to new shareholders with the specific purpose of manipulating the result of the Meeting and undermining the will of the fairly represented majorities.

Commentators have theorised about the effect of these share splitting operations in the UK but, unlike Hong Kong and Australia, our Courts have never been faced with an actual attempt to implement it. In those jurisdictions the legislation was changed to remove or mitigate the potential impact of any attempt to manipulate the voting in this way. The UK Parliament considered but rejected an attempt to amend the legislation in a similar way in 2006, no doubt swayed by the absence of concrete evidence that a problem existed in practice.

CONCLUSION

If the Court had not sanctioned the Scheme it could have effectively allowed in future the holders of a small minority of shares to organise themselves to become or threaten to become a majority in number of those voting or likely to vote at the court convened Meeting and so determine whether the statutory majority could be met. As a result the choice of a Scheme as the preferred means of effecting a takeover may have been undermined particularly where the size and nature of the shareholder base made such manipulation more likely.

It would also have potentially opened the door to greenmailing or similar interventions if the bidder's ability to use a contractual takeover offer was constrained such that a Scheme was the only viable option.

FUTURE PROOFING TAKEOVERS BY SCHEME OF ARRANGEMENTS

Those using or considering the use of a Scheme in the context of takeover transactions will need to consider the full implications of the judgment on their particular deals and the approach to be taken should a similar share splitting operation be conducted again but they will no doubt welcome the Court's decision to prevent the abuse of the statutory process in this way and the flexibility which it retains.

The High Court granted the new shareholders leave to appeal on the basis that the case was one of importance such that there was a compelling reason to refer. The judge however confirmed that the appeal had no realistic prospect of success. Faced with this and the requirement to fund such appeal the new shareholders chose not to appeal.

Herbert Smith Freehills is acting for Severn Trent on the Dee Valley Scheme.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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