Share splitting and takeover schemes: The Dee Valley case

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In Re Dee Valley Group plc, the court was asked to consider the validity of splitting shareholdings for the purpose of defeating the "majority in number" test in a scheme of arrangement used to effect a takeover. In the first case to consider the question, the High Court has allowed the scheme to proceed, ruling that the votes of shareholders who had acquired their shares from a person splitting his holding with the sole purpose of defeating the scheme were invalid as they could not be voting in the interests of the class.

Schemes of arrangement under Part 26 (sections 895-899) of the Companies Act 2006 are a popular mechanism to implement recommended takeovers in the UK. *A significant advantage of using a scheme is that, if approved, a scheme will bind all shareholders irrespective of whether and how they voted giving bidders the security of knowing that they can achieve 100% control of the target once the scheme becomes effective. Schemes also allow more flexibility in terms of timetable as the strict timetable imposed by the Takeover Code on contractual offers is largely disapplied. The regime requires that a majority in number representing 75% of the value of shareholders present and voting either in person or by proxy at the meeting summoned by the court (the "Court Meeting") must agree to the arrangement.*

Background

In the second half of 2016, Dee Valley Group plc, a water company, became subject to competing takeover proposals from Ancala Fornia and Severn Trent Water. Severn Trent finally secured the recommendation of the board and it was proposed that the takeover be implemented by way of scheme of arrangement.

Just before the Court Meeting to approve the scheme, the Dee Valley board was made aware of a series of transfers of small holdings in ordinary voting shares. It transpired that an employee who objected to the takeover had bought shares and subsequently "split" the shareholding by transferring one share each to 445 individuals by way of gift, in an attempt to defeat the "majority in number" test. The Dee Valley board obtained a direction from the Court to allow the Chairman of the Court Meeting to ignore the transferred shares in circumstances where (as in fact transpired) the split votes would have caused the scheme to fail; this allowed the scheme to proceed to the sanction hearing where the Court could hear representations from interested parties and decide whether the transferred shares should have been counted.

Although more than 75% *in value* of the shareholders voted in favour of the scheme, if the transferred shares had not been ignored, the scheme would have lapsed under the majority in number test as 466 out of 828 shareholders present voted against the scheme.

The Court's judgment

While there has been a case on "share splitting" where the shares were given to shareholders so that they could vote in favour of the scheme (see the Hong Kong case of Re PCCW Ltd [2009] 3 HKC 292 CA), this is

the first case to consider the validity of share splitting where the shares were transferred to holders to vote against the scheme. The Court gave its judgment on 8 February 2017, ruling that the votes can be discounted and then proceeded to sanction the scheme:

- As schemes are a creature of statute, a Court Meeting convened to approve the scheme is a *sui generis* meeting under the control of the court, unlike a normal general meeting of company shareholders. Members at such a meeting must exercise their power to vote for the purpose of benefiting the class as a whole, and not in their own specific interests if they are adverse to the interests of the class (the "interests of the class test"). The scope of this principle in relation to shareholders voting against a scheme is uncertain and would require clear evidence of a motivation derived from a capacity other than that of a shareholder of the class concerned.

- The Chairman of the Court Meeting has inherent power to reject votes on proper grounds as part of his responsibility to ensure that the Court Meeting was held fairly in order to achieve its objective (of ascertaining whether the relevant statutory majority was reached).

- In this instance, the Chairman had sufficient evidence to conclude that the relevant votes were not being cast for the purpose of benefiting the class as a whole since the only explanation for the share splitting exercise was to manipulate the vote at the Court Meeting so as to defeat the scheme, and was therefore right to reject the votes.

Leave to appeal the case has been granted on the basis that this is a novel case where a firm decision will be commercially useful. If an appeal is made, the appeal will be heard on 21 and 22 February 2017. In the meantime, the scheme remains in abeyance pending the outcome of any appeal.

Implications

If the ruling stands, a blatant attempt by dissenting shareholders to manipulate the result of the Court Meeting through the use of share splitting is unlikely to succeed. This should mean that the *status quo* prevails, and that schemes of arrangement would remain the preferred mechanism to effect recommended takeovers (absent special circumstances such as class issues or a heightened risk of "bumpitrage"). Nonetheless, there remains some uncertainty as to whether any particular course of conduct by dissenting shareholders amounts to manipulation (for example, would the result have been different if the shares had been purchased and split before the Court Meeting had been convened?). A transaction that faces significant opposition from employees will therefore remain vulnerable unless there is a change to the statutory requirements (which some have suggested).

It should be noted that schemes had always run some risk of being defeated by the majority in number test even where that majority in number represents a very small percentage of shares. This is so particularly given that most large shareholders hold their shares through nominee accounts within CREST. A nominee entity (irrespective of the number of accounts it holds) only counts as one shareholder for purposes of the scheme. Further, in circumstances where a nominee votes part of its holding in favour and part against in accordance with the instructions it receives from different underlying beneficial holders, it will be treated as a person voting in favour and the same person voting against, and cancel itself out for the purpose of the majority in number requirement.

Significantly, the ruling gives the Chairman a wide power to decide whether or not to reject votes at the Court Meeting and suggests that the Court would be slow to interfere with any decision of the Chairman, absent bad faith on his or her part. In practice, it remains to be seen the extent to which a Chairman would feel comfortable to exercise this power given the risk of challenge, except in a clear-cut case of vote manipulation. Even then, the prudent course may be for the Chairman to try to obtain directions from the Court before rejecting the votes (and if necessary adjourn the meeting in order to do so).

One suggestion is that, given the ability under the Takeover Code (with Panel consent) for the bidder to switch from a scheme to a contractual offer, the parties consider switching to a contractual offer should the presence of dissenting shareholders threaten to defeat the scheme. However, as the Panel will normally only allow a switch if it makes the offer more "deliverable" (for example, by having the acceptance condition in the contractual offer set at 75% or less), this option would probably remain a "last resort" for the bidder, as it raises the risk of the bidder being unable to squeeze out minority shareholders.

As a practical matter, the onus is on the company and its registrars to be vigilant in its monitoring of the share register in order to spot any unusual movements and to always be aware of the identity of its shareholders (perhaps through more willingness to use the section 793 notice procedure) during the takeover offer period.

If the appeal proceeds, we will produce a further note following receipt of the judgment.

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