WHITE & CASE

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# The Flawed Headcount Requirement on Schemes of Arrangement

A failed takeover of a Hong Kong-listed company has highlighted a weakness in English company law.

On 16 June, a proposed take private by way of scheme of arrangement lapsed when the resolution to approve the scheme of arrangement was not approved by the requisite majority in number of the company's independent shareholders. The resolution failed as a result of the "headcount requirement" of the scheme approval process which requires both a majority in number of independent shareholders and 75% in value of independent shareholders voting at the court meeting to vote in favour of the scheme. This case demonstrates the difficulty with the "majority in number" requirement. Here, it was shareholders with a 0.037%[1] stake that were able to block the proposed privatisation as a majority in number of independent shareholders voting on the scheme.

This outcome brings into focus a serious issue when company law does not keep up with market reality. The headcount requirement stems from nineteenth-century corporate governance when shareholders generally held their shares in their own name. Today fund managers, for example, may hold significant blocks of shares but count as only one "head". So long as the majority in number test remains, schemes of arrangement are vulnerable to being voted down by a large number of shareholders with a very small aggregate holding.


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## The flaw in the headcount requirement demonstrated

New World Development (NWD), 72% shareholder when aggregating concert parties, proposed to privatise New World China Land Limited (NWCL) and this was to be effected by way of scheme of arrangement. NWCL is listed on the Hong Kong Stock Exchange and incorporated under Cayman company law. Cayman law applied, but on this point English law is the same. The take private was to be implemented via a wholly-owned subsidiary of NWD, the bidder. Neither the bidder nor its concert parties, including NWD, could vote on the scheme. Only the independent shareholders of NWCL were entitled to vote. If approved, NWD through the bidder would hold 100% of the NWCL shares by cancelling the scheme shares.

Some issues with the headcount requirement were addressed early. Following direction from the Cayman Grand Court, HKSCC Nominees Limited, for the purpose of counting the majority in number, was treated as a multi-headed NWCL shareholder. As such, it could

1 This calculation is based on the information in the announcement that followed the court meeting. On the latest practicable date for ascertaining information in the scheme document, the bidder and concert parties held 6,254,164,482 shares and the total number of independent shares entitled to be voted at the court meeting was 2,428,366,309, equalling 8,982,530,791 shares. Shareholders with 3,230,904 shares (or 0.037% stake) were able to block the scheme as a majority in number of independent shareholders voting on the scheme.

vote for and against the scheme based on instructions from both investor participants and other persons admitted to participate in the central clearing system. However, for the purpose of calculating the majority in number, each such participant or person was counted as a single shareholder.

Independent shareholders voted overwhelmingly in favour of the scheme in terms of the value of their shares (99.84%). However, independent shareholders constituting a majority in number (65.95%) voted against the scheme. Under Cayman law, as in the UK, a dual voting structure must be satisfied to approve a scheme of arrangement by both a majority in number and 75% in value of shares voted. As a result of the majority in number requirement, often referred to as the headcount requirement, this scheme lapsed.

## Cayman schemes of arrangement

Like English law, under Cayman law, a scheme must be approved by the members of the company at a special meeting convened at the direction of the court.[2] At the court meeting a majority in number representing 75% in value of the members (or class) voting must approve the scheme, whether in person or by proxy.[3] Approval is therefore subject to a dual voting structure. It is necessary to take account not only of the number of members who approve the scheme but also the value of their holdings.

## English schemes of arrangement

Under English law, approval of a scheme of arrangement[4] at the court meeting requires at least a majority in number constituting 75% in value of members (or each class) to vote in favour of the scheme for it to proceed to sanction. This means that a simple majority in number must also own at least three quarters in value of the shares voted. Members who do not vote, even if present at the meeting, do not count. There is no statutory quorum but a court must be satisfied that members (or the class) were fairly represented by those who attended. Courts will sanction schemes even if there is a low turn-out by shareholders.[5] The vote on the resolution to approve the scheme is taken on a poll to take into account not only the numbers of members but also the value of their holdings.

## The dual voting structure

The purpose of the requirement of three-quarters in value has been described as to prevent a numerical majority with a small stake outvoting a minority with a large stake. For example, to prevent 51 members with one share each outvoting 49 members with ten shares each.[6] So while 51 members with one share each could not push through a scheme due to the value requirement, those 51 members could block the scheme, as was the case with NWCL. Likewise, 49 members with ten shares each could not push through a scheme due to the majority in number requirement, although they could block it.

This balance between size of investment and the number of heads has been explained as achieving the result that mere numbers on a count of heads will not carry the day at the expense of the amount invested and on the other hand that the weight of invested money may not prevail against the desires of a sizeable number of investors.[7] The effect of the dual voting structure is that a majority in number can block a proposed scheme of arrangement without having a meaningful economic stake in the company.

The dual voting structure seems out of step with current market realities. In today's market there are a number of types of shareholders, such as fund managers, that often hold significant blocks of shares. However, because of the shareholding and investment structure of their clients, they only count as one shareholder for the purposes of the headcount requirement, distorting the true number voting for or against a scheme. This market reality undercuts the rationale for the headcount rule as currently formulated.

## Hong Kong schemes of arrangement

In March 2014, a new Companies Ordinance changed the rules relating to schemes of arrangement under Hong Kong law. Before this change, the rules under the old Companies Ordinance were broadly the same as in the UK and the Cayman Islands.[8] Now the requirements for approving a scheme of arrangement differ depending on the type of scheme. Those relating to members' schemes are set out below.

### Takeover and privatisation schemes

A members' scheme involving a takeover offer or a general offer (i.e. a share buy-back offer) requires:

- the approval of shareholders representing at least 75% of the voting rights of shareholders present and voting at the meeting; and
- the votes cast against the scheme to not exceed 10% of the total voting rights attached to all disinterested shares.

The introduction of the 10% objection test was a major change to the regime governing privatisation schemes and replaced the headcount requirement.

2 Section 86 of the Companies Law, Cap 22 (Law 3 of 1961)

3 Section 86(2)

4 A scheme of arrangement is a statutory procedure under Part 26 of the Companies Act 2006 under which a company may enter into a compromise or arrangement with its members or creditors (or any class of them).

5 *Re TDG plc* [2008] EWHC 2334

6 *Re NFU Development Trust Ltd* [1973] 1 All ER 135

7 *ANZ Executors and Trustees Ltd and another v Humes Ltd and another* [1990] VR 615 at 622

8 Rule 2.10 of the Hong Kong Takeover Code also required that on a Takeover and Privatisation by way of scheme of arrangement or capital reorganisation the number of votes cast against the resolution to approve the scheme or the capital reorganisation at the duly convened meeting is not more than 10% of the votes attaching to all disinterested shares.

### Other members' schemes

A members' scheme not involving a takeover offer or a general offer requires:

- the approval of shareholders representing at least 75% of the voting rights present and voting at the shareholders' meeting; and
- unless the court orders otherwise, approval by a majority in number of the shareholders present and voting.

The headcount requirement was retained for members' schemes (other than privatisation schemes) but, in a change to the previous position, the court now has the discretion to dispense with the headcount requirement.

## Rationale for the changes

A number of arguments were put forward during the debate about whether to abolish the headcount requirement. The main rationale for replacing the headcount requirement with the 10% objection test was that it follows the 10% objection rule in Rule 2.10 of The Codes on Takeovers and Mergers and Share Buy-backs of Hong Kong ("**HK Takeover Code**") which essentially mirrors the new Companies Ordinance provisions. It was also argued, amongst other things, that the change (i) upholds the "one share, one vote" principle and stops minority shareholders gaining disproportionate control; (ii) maintains a safeguard to protect minority shareholders' interests whilst at the same time upholding the "one share, one vote" principle; and (iii) takes away a loophole for vote manipulation (such as share splitting).

The authors of this note consider that English company law should be amended on similar lines to that of Hong Kong in respect of the headcount requirement on schemes of arrangement.

## Voluntary assumption of risk?

Had NWCL's privatisation been implemented as a takeover offer under the HK Takeover Code followed by a statutory squeeze out procedure, it would have proceeded based on the number of shares voted in favour of the scheme. Schemes of arrangement are often preferred as a method of implementing a takeover of a company because of the ability to acquire 100% of the company with a vote by 50% of shareholders representing 75% in value of the shares voted, speed of execution and, in the UK, stamp duty saving if structured properly. However, a bidder and company must realistically weigh the risks and benefits of each approach. The intrinsic weakness of the scheme with the dual voting structure is that a very small number of activist or objecting shareholders with a negligible economic stake in a company can determine the fate of a proposed transaction.

## Share splitting

Prior to the change in the voting requirements on a scheme in Hong Kong, in *Re PCCW* the Court of Appeal in Hong Kong held that share splitting, i.e. distributing blocks of shares to a number of individuals who would vote in favour of a scheme, to bolster support for the headcount requirement, was a ground for the court to withhold sanction of a scheme.[9] In that case, a controlling shareholder sought to acquire the remainder of the company but there was general opposition to the scheme on the basis that the price was perceived to undervalue the company significantly. An associate of the bidder manipulated the share register by distributing blocks of shares to increase the headcount voting in order to get the scheme approved. Ultimately, the Court of Appeal in Hong Kong was not satisfied that the votes cast were a true reflection of the shareholders' will.

The court sanction process allows a manipulation of the headcount requirement via share splitting to be defeated by the court's refusal to sanction a scheme that had technically been approved by a majority in number representing 75% of shares voted. There is, however, no equivalent mechanism to ensure that a scheme is not defeated by an equally unrepresentative "majority in number" vote by a large number of shareholders seeking to skew results and defeat the proposed scheme.

9 CACV 85/2009