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Schemes of Arrangement: Share-splitting unsuccessful in blocking a takeover scheme

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In a corporate world where the capital structures of companies are becoming increasingly complex, schemes of arrangements under the Companies Act 2006 have established themselves as the restructuring procedure of choice for many distressed companies. This popularity is evidenced by the fact that schemes of arrangement have been increasingly used by overseas companies wishing to restructure their debts under the flexibility offered by English law.

Perhaps the most attractive feature of a scheme of arrangement is that an agreement made between a company and its members/creditors will be binding on the whole class; even dissenting voters, providing the voting thresholds are met. To approve a scheme of arrangement, for voting purposes the creditors and members are divided into classes which are approved by the court. A scheme must be approved by both a majority in number of the voting shareholders/creditors (the 'headcount test') as well as at least 75% in value of each voting class. Before this case, it was unclear whether shareholders/creditors could legitimately split their shareholding in order to artificially meet or defeat the headcount test. However, the pragmatic judgement of Re Dee Valley – which was a shareholder rather than a creditor scheme – has shed some much needed light on this debate and in doing so, preserved the significant role that schemes of arrangement play in relation to the restructuring of struggling companies.

The case

Dee Valley Group PLC was the object of a proposed take-over bid from Severn Trent Water Limited through a scheme of arrangement. Shortly before shareholders were scheduled to vote on the scheme, a shareholder transferred one share each to 434 individuals who were also opposed to the proposed takeover. The new shareholders attempted to defeat the scheme by the headcount test, through increasing the number of shareholders voting against the scheme.

The company applied to the court for a direction that the chairman of the class meeting be given the discretion to reject the votes of these new shareholders. The direction was given and the chairman consequently rejected the votes of the new shareholders, enabling the scheme to be approved.

The decision

Before this case, many commentators felt that the strict wording of the legislation would give the court little choice but to respect the outcome of the headcount test in every scenario, regardless of the existence of manipulative share-splitting practices.

However, the judge held that the Chairman was correct in choosing to reject the votes of the new shareholders. This is because the shares were transferred to the new shareholders for the sole purpose of defeating the scheme of arrangement. The Chancellor concluded that the ‘Chairman was entitled to protect the integrity of the court meeting against manipulative practises’ and explained that all members/creditors have a duty to exercise their voting rights in order to benefit the class as a whole.

Although this case concerned share-splitting by shareholders, the judgement is likely to be equally relevant to situations of debt splitting by creditors, due to the fact that s899 (1) CA 2006 also applies to creditor schemes of arrangements.

Ramifications for the insolvency profession

This decision is significant as it has provided some clarity over how the court will react to organised share/debt splitting intended to defeat the headcount test. Furthermore, it is likely that debt splitting prior to a creditor meeting will be unsuccessful in blocking a scheme of arrangement that would otherwise have been approved.

However, there are three issues left unanswered by this case:

1. Firstly, the court may find it more challenging to apply this decision in restructuring cases. This is because unlike share-splitting, debt splitting occurs frequently for a number of valid reasons, such as the diversification of risk.

2. Secondly, it is unclear whether a chairman would be entitled to reject the votes of new shareholders/debt owners if they obtained their ownership in anticipation of, but before the announcement of the meeting.

3. Thirdly, although the judgement has granted chairmen the discretion to reject votes resulting from a deliberate share split, had the headcount test not been satisfied, the court would not have had the opportunity to sanction the scheme even though it was aware of the manipulative agenda of the new shareholders.

Conclusion

Although the decision has been helpful in clarifying an area of law rife with debate, it leaves a number of questions unanswered.

The judge in deciding this case has placed a great deal of responsibility on chairmen. Chairmen must be mindful of irregular movements of debts between creditors ahead of creditor meetings in order protect a scheme from potentially harmful debt splitting practices.

In the wake of this judgement, it will be interesting to see if the court’s wide discretion to sanction schemes, combined with chairmen’s discretion to reject votes will be adequate enough to protect the interests of companies and their creditors. In the event that schemes are in fact sabotaged by debt splitting despite this ruling, it may be necessary for Parliament to re-evaluate the necessity of the headcount test in line with the recent legislative reform in Hong Kong and Australia respectively.

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