SULLIVAN & CROMWELL LLP

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The Curious Case of the Allied Properties Privatization

A Practitioner's View

SUMMARY

On October 9, 2020, the Hong Kong Court of First Instance ("**HKCFI**") handed down a judgment declining to sanction the proposed privatization of Allied Properties (H.K.) Limited ("**APL**") by way of a scheme of arrangement. The HKCFI challenged various aspects of the scheme, including the conditional special dividend distribution paid by the offeree to disinterested shareholders to sweeten the scheme consideration, even though it is not an uncommon feature in Hong Kong listed company takeovers. The HKCFI also questioned the reliability of the shareholders' voting results in connection with the "headcount test", even though the headcount test has been abolished for "takeover offers" of a Hong Kong incorporated company since 2014. Nevertheless, the authors believe that this ruling is a reminder that the court sanction process is not merely procedural and provides valuable practical insights to offerors, offerees and advisers on the proper implementation of schemes of arrangements.

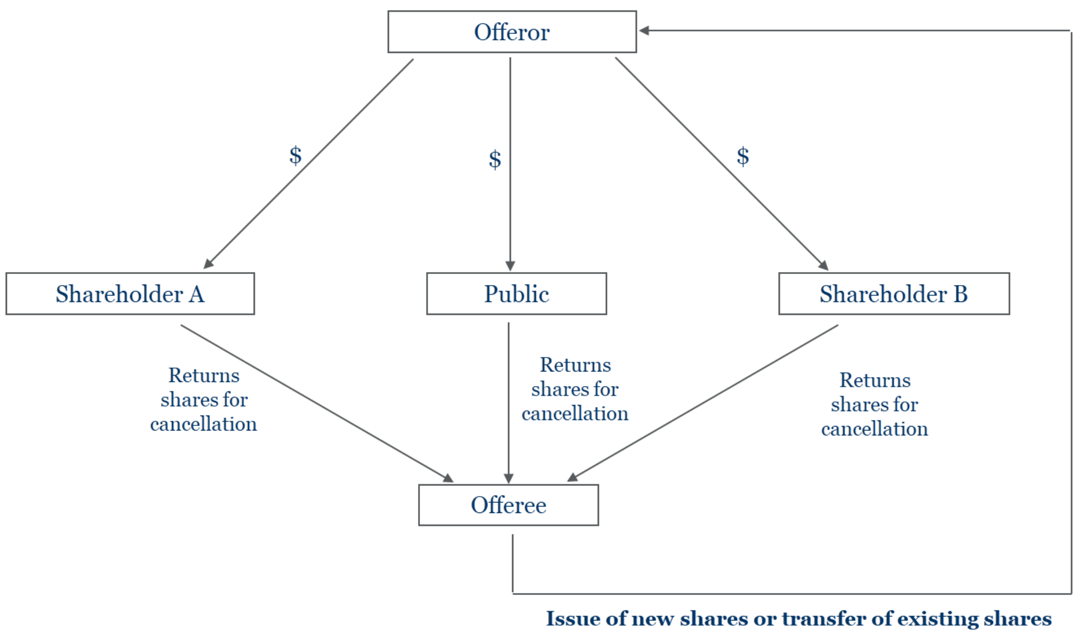
BACKGROUND

APL is a company incorporated in Hong Kong, the shares of which are listed on the Main Board of The Stock Exchange of Hong Kong Limited (the "**Stock Exchange**").[1] It is a non-wholly owned subsidiary of Allied Group Limited ("**AGL**"). On April 9, 2020, a wholly owned subsidiary of AGL (together with AGL, the "**Offeror**") put forward a proposal to certain APL shareholders (the "**Scheme Shareholders**") to privatize APL by way of a scheme of arrangement (the "**Scheme**"). A circular containing details of the Scheme (the "**Scheme Document**") was dispatched to all shareholders of APL on June 18, 2020, following which APL announced that disinterested Scheme Shareholders voted overwhelmingly in favor of passing the resolution to approve the Scheme at the court meeting (the "**Court Meeting**") and general meeting subsequently held.

Nevertheless, in a ruling that came as a surprise to many, the HKCFI declined to sanction the Scheme.[2] APL has since applied to the Hong Kong Court of Appeal (the "**CA**") to set aside the HKCFI's judgement and order and the CA will hear the appeal on November 23, 2020. The following seeks to deconstruct the case and identify best practices that offerors, offerees and their advisors could learn from.

OVERVIEW OF SCHEMES OF ARRANGEMENT

A privatization by a scheme of arrangement is a process implemented by a target company (an "**offeree**"), whereby the offeree makes a proposal to its shareholders to allow the shares in the offeree to be cancelled in exchange for a payment from the bidder (an "**offeror**"). The offeree will then issue the same number of shares that had been cancelled to the offeror with the result that the offeror will own 100% of the offeree.



A scheme is an "all-or-nothing" approach in that, if the scheme is successful, the offeror will acquire all the offeree's shares, even though some shareholders may have voted against the scheme. Schemes are subject to sanctioning by the court of the place of incorporation of the offeree company so as to uphold shareholder protection. In Hong Kong, to sanction a scheme, the Hong Kong courts (the "**Court**") will need to be satisfied that all relevant statutory provisions have been complied with, and that the scheme is fair.

Of the 62 privatization proposals that have been put forward in Hong Kong over the past five years,[3] 74% were in the form of schemes of arrangement involving Bermuda, Hong Kong and Cayman incorporated offerees. Save for the subject case of *Allied Properties*, none of such schemes were approved by shareholders but failed to be sanctioned by the relevant courts. It is extremely rare for a Court to disapprove a shareholder-approved scheme, with the last notable occurrence taking place in 2009 in the proposed privatization of PCCW Limited,[4] due to share splitting by certain offeror-related individuals, which tainted the integrity of the voting process and in particular the headcount test.

There are a variety of ways in which take private or merger deals may be structured. It is not unprecedented for an offeror to propose as part of the terms of a takeover offer that, subject to it becoming effective or unconditional, a "special" dividend distribution by the **offeree** to sweeten the deal will be made to participating offeree shareholders, with an aim to securing the requisite shareholders' approval (a "**Conditional Special Dividend Structure**"). For instance, in the conditional voluntary cash general offer to acquire the issued shares of Luen Thai Holdings Limited,[5] the payment of special dividends by the offeree board comprising HK$0.749 in cash for each share held was made subject to the general offer having been declared unconditional and approved by independent shareholders.

It is also not unusual for an offeror to seek to utilize an offeree's reserves for refinancing debt incurred for the take private. Offeror companies commonly achieve this by using the delisted target's cash to meet external debt liabilities incurred for financing the payment of the scheme consideration *after* the scheme is completed, when the target company has become a wholly owned subsidiary of the offeror and therefore the cash in the offeree can be distributed to the offeror. For example, in the 2019 privatization scheme of China Power Clean Energy Development Company Limited,[6] the offeror disclosed that it will use the profits generated from the offeree group and distributed to the offeror after the scheme takes effect to repay the amount owed under the loan liability it had taken out for funding the scheme.

Therefore, the HKCFI's contention against the Special Dividend Arrangement (defined below) in the *Allied Properties* Scheme may not have stemmed from the mere adoption of a Conditional Special Dividend Structure or extraction of cash from APL to support the Scheme, but more from the way in which the arrangement was presented to shareholders in the Scheme Document, and the disclosure of its specific particulars. Please see *Special Dividend Arrangement* and *Statutory Compliance - Disclosure Issue* below for further analysis.

OVERVIEW OF THE *ALLIED PROPERTIES* SCHEME

On April 20, 2020, the Offeror announced that it intends to privatize APL by way of a scheme of arrangement at a "consideration" of HK$1.92 per Scheme Share. This "consideration" comprises:

- HK$0.42 per Scheme Share payable by the Offeror; and
- A special interim dividend of HK$1.50 per Scheme Share to be declared by APL (the "**Special Dividend**"), the distribution of which is conditional upon the Scheme taking effect (the "**Special Dividend Arrangement**").

Effectively, the Scheme proposal is that, of the total amount receivable by the Scheme Shareholders for the Scheme Shares, 78.1% would be derived from the Special Dividend to be paid by APL using its accumulated profits.

As noted above, the Scheme was then approved by the requisite majority of shareholders at the Court Meeting and general meeting, yet on October 9, 2020, the HKCFI handed down a judgment (the "**Judgment**") ruling against the sanctioning of the Scheme.

The HKCFI's rejection of the Scheme is mainly premised upon APL's failure to demonstrate to its satisfaction compliance of the statutory requirements to (i) give sufficient explanation of the Scheme and its effects and other relevant information to the Scheme Shareholders to enable them to make a reasonable judgment as to how to vote, and (ii) make evident that the requisite majorities have voted in favor of the Scheme.

It should be noted that whilst the HKCFI did discuss the headcount test (test as to approval by a majority in number of Scheme Shareholders present and voting), it did not draw any conclusion as to whether APL failed to satisfy the headcount test. It did, however, comment that by reason of the inconsistencies and problems in the documentary evidence adduced by APL in relation to voting numbers at the Court Meeting, it felt considerable unease as to whether the voting results were properly and accurately accounted for. Nevertheless, it remains curious that the HKCFI found it necessary to delve into the headcount test. Please see *Statutory Compliance - Voting Issue* below for further analysis.

SPECIAL DIVIDEND ARRANGEMENT

As mentioned above, it is not uncommon for offerors to take advantage of a Conditional Special Dividend Structure to sweeten their privatization offers. However, the Special Dividend in this case makes up 78.1% of the total amount receivable by the Scheme Shareholders for their Scheme Shares. Such significant reliance on APL's own funds to make cash payment in exchange for cancellation of the Scheme Shares appeared to have been a factor contributing to the HKCFI's scrutiny over the Special Dividend Arrangement and, consequently, the overall Scheme structure and approval process.

Interestingly, the HKCFI also stated that given APL proposed to use a portion of its accumulated profits (the "**Relevant Reserve**") to pay the Special Dividend upon the Scheme taking effect, it would be fair and reasonable for APL to inform the Scheme Shareholders that if the Scheme failed and they remained as APL shareholders, they could expect APL to use the same amount to declare and pay a dividend to all shareholders *unless there were valid reasons not to do so*. This is because if the board had already considered APL's financial position and decided that it was appropriate to use the Relevant Reserve to pay the Special Dividend under the Scheme, it would be unreasonable, if not perverse, for the board to refuse to use the same amount of reserve to declare dividends if the Scheme fell through.

In light of the above, an offeror wishing to sweeten its offer using a Conditional Special Dividend Structure is advised to explain clearly to scheme shareholders (by way of full and frank disclosure in the circular) the implications of such structure, i.e. that (i) their right to the special dividend distribution is conditional upon the scheme being successfully implemented, and (ii) if the scheme fails, the monies that would have been applied towards declaring the special dividends will be reserved for the offeree's further usage, and no longer be available for distribution upon the lapse of the proposal. Crucially, valid justifications supporting the integrity of the Conditional Special Dividend Structure should be provided. For certain offerees, the basis may be that while a successful privatization would allow it to enjoy financial backing from the offeror, a failed privatization may mean that it will need to rely on its own financial resources for its further growth (and hence the need to withhold from declaring dividends).

Upon equipping the scheme shareholders with the above knowledge and information, notwithstanding that the declaration of an interim dividend does not normally require shareholders' approval, the offeree may consider putting forward the Conditional Special Dividend Structure to scheme shareholders for a vote to pre-empt any potential challenge by the relevant court. If a resolution is duly passed, a court will find it more difficult to challenge the arrangement at sanction stage, as a requisite majority of shareholders (who were in a position to make an informed decision) would have voted in favor of the arrangement.

STATUTORY COMPLIANCE

In considering whether to sanction a scheme, the Court will take into account whether the following statutory requirements have been complied with:[7]

(1) the classes of scheme shareholders must be properly constituted;
(2) the meetings should be duly convened in accordance with the directions given by the Court hearing the originating summons;
(3) the scheme shareholders should be given sufficient explanation of the scheme and its effects and sufficient information to enable them to make a reasonable judgement as to how to vote at the Court Meeting and general meeting; and
(4) the requisite majorities must have voted in favor of the scheme.

Requirements (1) and (2) were met to the satisfaction of the HKCFI. As to requirement (3), the HKCFI was unconvinced that sufficient disclosure had been made in the Scheme Document (the "**Disclosure Issue**"). With regards to requirement (4), APL's production of inconsistent and unsound documentary evidence in an attempt to verify the voting statistics submitted before the Court cast considerable doubt as to whether voting results were properly accounted for (the "**Voting Issue**").

A. DISCLOSURE ISSUE

Shareholders must be given sufficient information and explanation about a scheme of arrangement so as to enable them to make an informed decision as to whether to vote in favor of the scheme.[8] In this respect, the Judgment provided extensive analysis as to why the HKCFI was not satisfied that sufficient disclosure has been made.

First, the HKCFI critiqued APL's initial categorization of the HK$1.50 per share dividend as falling within "cash consideration required to effect the Proposal", noting the lack of explanation as to why such a dividend, which was essentially APL's own funds, should be treated as part of the cash consideration. In a similar vein, the HKCFI contended that it was misleading for APL to define it as “Scheme Dividend”, as this gave the impression that the HK$1.50 formed part of the consideration payable **by the Offeror**. Despite APL’s subsequent re-categorization of such a dividend as “Special Dividend” and clarification that the Special Dividends would be paid out of APL’s reserves, the HKCFI remained unsatisfied with the level of disclosure due to further outstanding concerns.

In particular, it opined that the commercial implications of the Scheme were not communicated with sufficient transparency. The HKCFI found that APL should not have merely informed the Scheme Shareholders the total price they would receive in exchange for their shares, but also, explained the source from which the total price would be paid to them and the ramifications thereof. In the present case, as a substantial part of the total price was to be paid out of the profits of APL, this arrangement should have been highlighted and a relevant comparison of value for the Scheme Shareholders’ consideration should have been provided. The HKCFI commented that it was incumbent upon APL to inform Scheme Shareholders the alternative scenarios on what they could expect (i) if they remained as shareholders without the Scheme being passed and (ii) under the Scheme - one that an intelligent and honest Scheme Shareholder would give consideration to. With respect to scenario (i), as discussed above, Scheme Shareholders should have been informed that they could expect APL to use the same amount as the Relevant Reserve to declare and pay a dividend to them if the Scheme was unsuccessful. Further, a comparison of value between the Scheme consideration payable by the offeror (i.e. HK$0.42) and the closing price / NAV per share should have been provided alongside the comparison of the total price (HK$1.92) against the same. Finally, since APL intended on using its own funds to assist the Offeror to acquire the Scheme Shares, it should have explained why the arrangement would not contravene the principle against a company providing financial assistance for an acquisition of its own shares.[9]

Notably, the HKCFI had afforded APL with multiple opportunities to rectify the inadequacy of disclosure. At the first directions hearing, the HKCFI highlighted its disclosure-related concerns to APL and its counsel, and directed them to take care in ensuring that the contents of the Scheme Document met all regulatory and statutory requirements, in particular the requirement that the explanatory statement explains the effect of the Scheme fairly and accurately. Upon their failure to do so, the HKCFI issued written directions requesting further disclosures, which remained inadequately addressed in supplemental submissions and at the second and third directions hearings. As such, the HKCFI’s ultimate decision that APL had not provided sufficient explanation of the Scheme and its commercial implications was not without warning.

B. VOTING ISSUE

Sections 673 and 674 of the Companies Ordinance (Cap. 622) (the “**CO**”) set out the statutory requirements on shareholders’ approval of schemes (the “**Relevant Provisions**”). In particular, section 674(2)(a) CO provides that schemes of arrangement involving a takeover offer require (i) the approval at the Court Meeting of shareholders representing at least 75% of the voting rights of the shareholders present and voting (the "**75% Test**"), and (ii) that the votes cast against the scheme at the Court Meeting do not exceed 10% of the voting rights attached to all disinterested shares (the "**Negative 10% Test**" and together with the 75% Test, the "**75%/10% Test**"). On a plain interpretation of the Relevant Provisions, the requirements under section 674(2)(a) CO seem to replace the headcount test requiring agreement by a majority in number of present and voting members in the context of schemes involving takeover offers. This interpretation was also adopted by the HKCFI in the case of *Re Cheung Kong (Holdings) Limited (2015)* and unequivocally confirmed by various Companies Registry publications.

Therefore, many are curious as to why the HKCFI delved into the headcount test in its Judgment and went at length to analyze the evidence produced by APL relating to headcount test satisfaction. In any event, the headcount test remains relevant for offerors seeking to privatize Bermuda or Cayman incorporated offerees, and, in view of this Judgment, the lessons learned could potentially be applied in schemes involving other Hong Kong listed target companies going forward. Hence, it may be conducive to examine (and take care to avoid) the events leading to the ruling that APL had failed to demonstrate that voting results were properly and accurately accounted for at the Court Meeting for the purposes of the headcount test.

In short, such ruling is by virtue of unexplained discrepancies in voting statistics submitted before the Court at respective direction hearings and errors in vote counting as revealed by documentary evidence. Whilst it was presented at the first hearing that 43 voting papers had been cast by Scheme Shareholders at the Court Meeting, APL could not explain why 71 shareholders were present and voted at the second hearing, a number significantly higher than the number of voting papers. In APL's unsuccessful attempt to justify its calculations at the third hearing, underlying documentation from Computershare was adduced as evidence, which revealed inconsistencies and problems, particularly with the numerous duplicated votes that were cast by the same Scheme Shareholders. It is only when the Court questioned the reliability of APL's evidence that counsel accepted that for the purpose of the headcount test, it is wrong to count the votes cast by the same shareholders more than once. As a result of the extent of the duplicated proxy forms and the votes and the manner in which they were revealed, the HKCFI felt considerable unease as to whether the results of the votes could be trusted.

In view of this, legal advisors should work with offerees and share registrars to closely monitor the process and documentation of vote counting for the purposes of the headcount test. Protocols should be agreed and adopted to ensure that the relevant legal requirements are complied with and the identities of registered shareholders are thoroughly verified to avoid any duplicated casting of votes.

The HKCFI also considered whether because a substantial number of votes cast in favor of the Scheme were cast by APL's chairman using proxy forms without voting instructions, this would affect whether the class was fairly represented by those who attended the meeting. The HKCFI decided that it should not have such effect given the proxy form had made clear that failure to give voting instructions will entitle the proxy to cast the votes at his or her discretion or abstain from the relevant resolutions. However, it was mentioned that it would be advisable for the offeree to require the scheme shareholders to state whether they vote "for" or "against" the scheme in proxy forms so that there can be no doubt as to their view on the scheme, particularly in the context of a shareholders scheme where the Court will consider whether the class was fairly represented by those who attended the meeting and whether the statutory majority are acting *bona fide*.

It may also be worthwhile to note that an offeree's ability to demonstrate due satisfaction of the headcount test could potentially assist in showing that there was fair representation of all shareholders during the approval process of a scheme. Therefore, there may be value in an offeree putting in effort to produce valid documentation to the Court showing that in addition to meeting the 75%/10% Test, (i) a majority in number voted in favor of the scheme and (ii) such voting results were properly accounted for, regardless of whether the headcount test is legally applicable. This is to provide additional comfort to the Court that shareholders were fairly represented and that shareholders' approval was not tainted by procedural deficiencies. As a point of reference, in *Re Cheung Kong (Holdings) Limited (2015)*, the offeree's ability to provide valid and consistent evidence demonstrating the satisfaction of both the headcount test and the 75%/10% Test for the HKCFI's consideration helped to assure the HKCFI that shareholders' approval was duly obtained, and appeared to be one of the reasons facilitating a smooth court sanction process. In particular, it was noted in *Re Cheung Kong (Holdings) Limited (2015)* that even if the court errs in its finding that the scheme involves a "takeover offer", given the actual voting results at the court meeting, the court was satisfied that the dual requirements of the headcount test and the 75% Test had been satisfied.

KEY TAKEAWAYS

Whilst the HKCFI's rejection of the *Allied Properties* Scheme initially came as a surprise to many, the Judgment does provide several key takeaway points that can serve as valuable practical guidance for companies looking to implement schemes involving takeovers in Hong Kong, which are covered below.

Special Dividend Arrangements

The Judgment raised a valid point as to the reasonableness of a Conditional Special Dividend Structure where dividend declaration to scheme shareholders is tied to the scheme's success. Offerees intending to adopt such a structure should be minded that it may be subject to challenge by the Court, unless the scheme shareholders are provided with sufficient information on the implications of the conditionality arrangement, and valid reasons as to why they should not be entitled to expect the offeree to use the same amount of reserves to declare dividends if the scheme falls through.

Further, where a significant proportion of the total consideration payable to scheme shareholders is intended to be attributable to dividends declared out of the offeree's reserves, the HKCFI is likely to expect the particulars and commercial effect of such an arrangement to be fully and frankly disclosed in the scheme circular. It should also be stated in the explanatory statement why such arrangement would not be in violation of statutory rules against a company providing financial assistance for the acquisition of its shares.

An offeror wishing to utilize an offeree's cash reserves for funding a scheme may consider the alternative of first obtaining a bridge loan to pay for the scheme shares, and, after the scheme is completed (when the offeree has become its wholly owned subsidiary), distribute cash from the offeree to itself for paying off the loan. However, it should be noted that whilst this approach is less likely to attract judicial scrutiny, it incurs costs (e.g. interest expenses), which a special dividend declaration does not.

Disclosure

Companies and legal advisors are also reminded to comply with the statutory requirement to disclose sufficient information and explanation of the scheme in the circular, so as to enable scheme shareholders to make a reasonable judgment as to how to vote on the proposal. Without limitation, this requires provision of detailed information on the source from which the total price will be paid to the scheme shareholders, a relevant comparison of value between what can be expected if they remain as shareholders and under the scheme, the commercial implications of the scheme and any special features thereof.

Headcount Test

APL's failure to discount duplicated votes was a factor leading to the HKCFI's decision that it was unconvinced that the results of the votes were properly and accurately accounted for, for the purposes of the headcount test. Although it may be debatable whether the headcount test should have been applied in this case, the ruling indicates that courts may take particular care in considering evidence adduced on the headcount test in attempt to detect and circumvent any vote manipulation through share splitting or other means. Offeree companies, especially those incorporated in Bermuda and the Cayman Islands where the headcount test undoubtedly applies, are advised to adopt proper meeting and record-keeping protocols to ensure that there is valid documentary proof to corroborate the voting results. Furthermore, as a matter of good practice, offeree companies should adopt appropriate protocols to safeguard the vote counting process, in particular to ensure compliance with applicable legal requirements and due verification of registered shareholders' identities so as to avoid any duplicated casting of votes.

Court Sanction

The case of *Allied Properties* serves as a reminder that the Court sanctioning process of schemes of arrangement is not merely procedural. As apparent from the Judgment, the Court would closely examine all aspects of a proposed scheme, including (among other things) its commercial effect, consideration structure and the adequacy of disclosure in the relevant circular, to determine whether it is fair and is one that should be sanctioned. To that end, it is important for offerors, offerees and their legal advisors to assist the Court by identifying special features of the scheme and any possible areas of concerns, and address such concerns. Care should also be taken to ensure that the scheme document complies with all applicable regulatory and statutory requirements, in particular that the explanatory statement explains the effect of the scheme fairly and accurately. Where the Court raises concerns about the scheme proposal at any stage throughout its course of review, considerable effort should be made to effectively address and alleviate such concerns, as a failure to do so may contribute to the Court declining to sanction the scheme.

Watch This Space

APL has lodged an appeal to set aside the Judgement and the CA will hear the appeal on November 23, 2020. In light of the rare Court interference with shareholder-approved schemes of arrangement, it will certainly be helpful for companies intending to implement schemes in Hong Kong to observe the latest developments to this case.

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ENDNOTES

1 Stock Code: 56.

2 *Re Allied Properties (H.K.) Limited (2020)*. Please see here for the full judgment.

3 January 2016 to October 2020.

4 PCCW Limited is a company incorporated in Hong Kong with limited liability and listed on the Stock Exchange with stock code 8.

5 Luen Thai Holdings Limited is a company incorporated in the Cayman Islands with limited liability and listed on the Stock Exchange with stock code 311.

6 China Power Clean Energy Development Company Limited is a company incorporated in Hong Kong with limited liability. It was listed on the Stock Exchange with stock code 735.

7 *Re China Light & Power Company Ltd. (1998)*.

8 Section 671(3) CO; *Re China Light & Power Company Ltd. (1998)*.

9 Section 275(1) CO prohibits a company from providing financial assistance for the acquisition of its shares, subject to certain exceptions. One such general exception is the distribution of a company's assets by way of dividends lawfully made (Section 277(a)(i) CO).

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