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UPDATE

Guernsey Court of Appeal rejects 'oppressive' scheme of arrangement

Update prepared by Abel Lyall (Partner, Guernsey)

The Court of Appeal has dismissed an appeal against a Royal Court decision refusing to sanction a scheme of arrangement. The Court held it had no jurisdiction to sanction the proposed scheme given the failure by the company to comply with statutory requirements for share buy-backs, and in any event it was one that the Court 'unhesitatingly' would have refused to sanction on discretionary grounds.

The Court of Appeal in Guernsey has dismissed an appeal by Puma Brandenburg (**Puma**) against the refusal by the Royal Court of Guernsey to sanction its scheme of arrangement (the **Scheme**). In a landmark judgment, the Court of Appeal was highly critical of the Scheme, describing the manner in which Puma pressured minority shareholders to accept a significantly discounted offer price on their shares, as 'oppressive'. Mourant Ozannes acted for the minority shareholder that successfully opposed the Scheme.

The decision is the first time a Court of Appeal in Guernsey has considered a scheme of arrangement proposed under the Companies (Guernsey) Law, 2008 (the **Companies Law**), and is a very rare example of a scheme of arrangement being refused sanction at an appellate level on both jurisdictional and discretionary grounds.

Background

The Scheme was proposed by Puma, an unlisted Guernsey company incorporated in 2006 for the purposes of raising capital to invest in German real estate. Puma had previously been involved in two restructurings, firstly in 2009 when it was amalgamated with Shore Capital Group Limited (**Shore Capital**) and then in 2012 on its demerger from Shore Capital.

Puma's year-on-year financial performance had been excellent and its board considered it had a 'strong future', specifically advising shareholders in the Scheme document that it 'intended to pursue long term growth by holding and improving investment assets whilst at the same time seeking to take advantage of cheap long term finance'. They had however apparently identified a 'divergence' of interests between the majority shareholders, Mr Howard Shore (who is also an executive director of Puma and an indirect owner of Puma's investment advisor) and his wife (the **Majority Shareholders**), who wanted to continue and expand the investments of Puma, and most of the various minority shareholders, who, as it was contended, said they had not intended to invest in a real estate company, having acquired their shares via the demerger in 2012. As an unlisted investment company (as with most unlisted entities), there was no liquid market for Puma shares, and the board said it was looking at means to provide a 'liquidity event' to those shareholders who were not aligned with the long-term interests of the company.

The scheme of arrangement

The Scheme proposed by the board was a simple one. Puma was to undertake a selective buy-back of all shares other than those held by the Majority Shareholders. Unlike in traditional third party 'takeover schemes' that are regularly utilised and sanctioned in Guernsey, it was Puma itself that was to pay for the shares rather than the person or entity who would benefit from the takeover, in this case the Majority Shareholders.

Puma's shares were split between A ordinary shares (holding voting rights and rights to return of capital) and B ordinary shares (holding rights to payment of dividends), with separate meetings held for each class. The consideration which Puma would pay to shareholders for the buy-back shares was €4.50 for each A share and €1.50 for each B share – a valuation which represented a 43.6 per cent discount to Puma's net asset value (**NAV**). If sanctioned, the result of the Scheme would have been a transfer to the Majority Shareholders from the (collective) minority of approximately €37 million in value, leaving the Majority Shareholder as sole owners of Puma and all of its assets. At an *ex parte* hearing on 10 November 2016, the Royal Court ordered that class meetings of the minority shareholders be convened to vote on the proposed Scheme. The Scheme was approved by the required majorities of both class meetings on 1 December 2016. In all, 95.88 per cent by value (comprising 25.89 per cent by number) voted in favour of the Scheme.

Opposition to the Scheme

Notwithstanding a number of shareholders abstained from voting (or simply failed to return a proxy form), two minority shareholders voted against the Scheme, one of which instructed Mourant Ozannes to oppose the Scheme at the subsequent sanction hearing before the Royal Court.

This shareholder asserted that the Royal Court had no jurisdiction to grant the Scheme as Puma had not (and indeed could not) comply with section 313(3) of the Companies Law which provides that before effecting a buy-back of shares the company 'must obtain the consent of the shareholders whose shares are to be acquired to that acquisition'. The shareholder also opposed the Scheme on discretionary grounds, including that (a) the Scheme was not fair and not reasonable, (b) the Scheme was disproportionate to the stated aims of Puma's board; and (c) the Scheme document contained material non-disclosures.

In a judgment delivered by the Bailiff on 24 February 2017, the Royal Court refused to sanction the Scheme, finding that it was contrary to the share buy-back provisions in the Companies Law, which specifically require a shareholder to 'consent' to the acquisition of its shares. The Royal Court went one step further in finding that when voting in favour of the Scheme, the members who approved the transaction (which included the significant shareholding of the brother of Mr Shore, one of the Majority Shareholders) were not acting in the *bona fide* best interests of the class as a whole. Puma appealed.

Decision on appeal

In a two-day hearing before the Guernsey Court of Appeal, Justices Mr Nigel Pleming QC, Mr George Bompas QC and Sir Michael Birt confirmed the decision of the Royal Court.

The Court of Appeal undertook a detailed consideration of the scheme of arrangement provisions found in Part VIII of the Companies Law. It found that these provisions, which were introduced in 2008, bear a 'close resemblance' to what is found in Part 26 of the UK Companies Act 2006. The Court of Appeal noted that the Royal Court was right to draw guidance on the interpretation and operation of the relevant sections from decisions of the English courts.

The Court of Appeal further confirmed that the term 'arrangement' under Part VIII should be interpreted broadly and that the Royal Court clearly had jurisdiction to sanction a scheme involving a takeover. The issue on appeal however, was whether Puma could effect own-share purchases under a scheme of arrangement in light of the statutory requirement for it to obtain the consent of shareholders to the acquisition of their shares.

Jurisdiction

The Court of Appeal held that the Bailiff was correct in his interpretation of the consent requirement under section 313 of the Companies Law.

The Court of Appeal noted that in general terms, there was no reason why own-share purchases should be precluded from being effected by a scheme of arrangement. However, given the statutory requirement in section 313(3), they held that before the court can sanction a scheme of arrangement to effect a purchase of its own shares from shareholders, those shareholders must be shown to have individually and specifically consented to that acquisition. The required consent element of section 313(3) could not be supplied by the court through the action of sanctioning the scheme of arrangement.

The Court of Appeal noted that this interpretation was clear from the language of the section, and supported by the absence in the Companies Law of anything expressly to disapply section 313(3) to schemes of arrangement.

Discretion

While this was sufficient to dispose of the appeal, the Court of Appeal went on to consider the question of whether the Scheme should be sanctioned on the exercise of the court's discretion.

While noting they were merely 'guidelines', the Court of Appeal agreed the Bailiff was correct to apply the traditional English tests for the exercise of the discretion, principles expounded long ago by the English Court of Appeal in *Re Alabama, New Orleans, Texas and Pacific Junction Railway Company* [1891] 1 Ch 213 and then by Lindley LJ in *Re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385. Those tests have been restated and applied many times, including by the Royal Court in *Re Montenegro Investments Limited (In Administration)* and *Re Assura Group Limited*.

Accordingly, when exercising the discretion the Court will examine whether:

- the class of members was fairly represented by those who attended the court meetings and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent;
- the scheme is such that an honest and intelligent man, a member of the class concerned and acting in respect of his interests, might reasonably approve; and
- there is a 'blot' on the scheme.

The Court of Appeal also considered the question of what is meant by a 'blot on the scheme', a principle which they held recognises that the court must be satisfied that the Scheme is appropriate to be sanctioned: in other words, the court must be satisfied that there is nothing about the Scheme which makes it oppressive of, or unfairly prejudicial to, persons who may be bound or affected by it.

Having considered the appropriate tests, the Court of Appeal held the Bailiff had not erred in exercising the discretion against sanctioning the Scheme, holding that 'unhesitatingly' they would have, in any event, refused to sanction the Scheme:

- The Scheme relied on the votes of shareholders who had committed to vote in favour of the Scheme, but who were 'insiders' closely associated with the majority shareholder, and that the offer price was the product of discussions between those insiders and the majority shareholder. As a result the Court of Appeal was not satisfied that the majority at the meetings voted bona fide in the interests of the class of members as a whole.
- They were not satisfied that the arrangement was one 'which an intelligent and honest man acting in respect of his interests might reasonably approve'. Critical to this finding was the substantial transfer of value from the minority shareholders to the Majority Shareholders as a result of the share buy-back, along with the lack of evidence or explanation in the Scheme documentation for the heavily discounted offer price which appeared to be without explanation based on the financial performance of the company.
- Finally, the Court of Appeal concluded that there was a 'blot' on the Scheme and it should not be sanctioned. They found the company put 'undue pressure' on shareholders to sell their shares at a price that had no real reference to the value of their shares by threatening that no dividends or distributions would be paid in the foreseeable future. The Court of Appeal agreed such conduct was 'oppressive'.

Disclosure in the Scheme Circular

In his decision at first instance, the Bailiff was satisfied that the disclosure made to members in the Explanatory Statement was sufficient and this decision was challenged by the minority shareholder on appeal. The Court of Appeal expressed 'misgivings' about the Bailiff's conclusions, noting that the disclosure requirement for the Explanatory Statement in Scheme Circulars went beyond the statutory requirement in section 108 of the Companies Law. Citing the commentary in *Buckley on the Companies Act*, they held that the company was required to give 'such a statement of the main facts as will enable the recipients to exercise their judgment on the proposed scheme'. In particular they noted:

- Given the price was a 'very poor return' on Puma's NAV, there was nothing to help explain to shareholders why the Scheme could be fairly approved and imposed.
- There was no information about the consultations between the company and the various committed shareholders (the 'insiders') that led to the setting of the price.
- There was no information on the relationships between those committed shareholders and the Majority Shareholders in circumstances where the Scheme held out the prospect that those committed shareholders would have their shares purchased even if the Scheme failed. The Court found there was no explanation of this prospective favoritism.
- While the Scheme Circular referred to the accounts from March 2016 there was no reasonably current statement of the company's net current assets and available reserves.
- There was no explanation as to how the interests of the company in securing shareholders aligned with the company's long term investment objectives mandated ownership by the Majority Shareholders. The Court of Appeal found it was probable that the 'real and unstated objectives' were those of the Majority Shareholders to take over the company, something the Court held ought to have been disclosed.

The substantive failures in the presentation of the Scheme led the Court of Appeal to issue a warning at the end of the judgment, reminding companies proposing schemes of arrangement that 'care should be taken' in their preparation 'to ensure a fair presentation both those to be bound and to the Court'.

Comment

Since their introduction in 2008, schemes of arrangement have become a regular and popular means of effecting corporate restructurings in Guernsey. As the Court of Appeal makes plain, the term 'arrangement' is broadly defined, and will encompass takeover schemes. Such arrangements are currently and will continue to be sanctioned by the Royal Court.

By contrast, the scheme proposed by Puma was highly unusual and not one seen either here in Guernsey or in the UK before – it was in effect a 'takeover' by the Majority Shareholders paid for by Puma itself – truly a novel concept. The problem for Puma was two-fold. First, the Scheme failed to comply with the clear and express statutory requirement for an individual shareholder's consent as per section 313(3) of the Companies Law, meaning the Court had no jurisdiction to sanction the Scheme. More fundamentally, there was simply no evidence to show that the Scheme was a fair one such that it was appropriate to be sanctioned.

The sanction of a scheme has never been a rubber stamp, and the Court in Guernsey will guard carefully its role both in ensuring the statutory requirements applicable to the scheme have been met, and that the scheme is fair and not oppressive to those proposed to be bound. It is also highly unusual for a scheme of arrangement to be refused sanction on discretionary grounds, as schemes of arrangement are normally carefully constructed to avoid these problems.

The decision should give comfort to those undertaking schemes of arrangements in Guernsey that the Courts will take a consistent and predictable approach to the sanction of schemes, while members (and indeed creditors) should be confident that the Court will be meticulous in ensuring that their rights as a minority are protected.

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