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Back on track – Court of Appeal allows privatization rejected by lower court

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The Hong Kong Court of Appeal has allowed the proposed privatization of a Hong Kong listed company through a scheme of arrangement, overturning the decision of the Court of First Instance (CFI).

In *Re Allied Properties (HK) Ltd* [2020] HKCFI 2624, the CFI had taken the rare step of refusing to sanction a scheme of arrangement and proposed privatization of a Hong Kong listed company, saying that the company had not provided sufficient explanation for the scheme and questioning whether the results of member votes had been properly accounted for.

In the appeal, [2020] HKCA 973, the Honorable Madam Justices Kwan and Yuen, and the Honorable Mr. Justice Barma, said that whilst the company could be faulted for the information it provided about the proposed scheme, the statutory requirements for sanction of the scheme had ultimately been met and adequate explanation had been given to the scheme shareholders in the composite document.

Proposal

The company, a property investment company listed since 1981 on the main board of the Hong Kong Stock Exchange, asked the court's sanction for a scheme of arrangement proposed to be made between Sunhill Investments Limited (the offeror), the company, and certain scheme shareholders under section 673 of the Companies Ordinance (Cap. 622) and for a capital reduction under section 229 of the Ordinance.

In April 2020, the offeror put forward a proposal to the scheme shareholders (i.e., the holders of shares in the company other than those held by the offeror and the 'offeror concert parties') which involved the privatization of the company and a dividend payment.

The applicants claimed that the shares had been trading at a substantial discount and that the listing status had become ineffective and costly to maintain. It had also prevented the company from pursuing various potentially beneficial investments.

Poor preparation

At first instance, the court faulted the company for providing inadequate information as to the effect of the scheme in the composite document presented to shareholders.

One concern was the HK$1.92 per share proposed to be paid to the scheme shareholders described as "cash consideration required to effect the Proposal," of which HK$1.50 was stated to be paid by the company in the form of a dividend. The other concern was that no comparison between the closing share prices over a six-month period with the scheme consideration of HK$0.42 was disclosed to shareholders.

The court also took the company to task for commencing a separate set of proceedings for the sanction of the scheme, which was wrong in procedure and contrary to settled practice.

The judge at first instance noted there was no explanation as to why the dividend should be treated as part of the cash consideration and that if the company considered it appropriate to use its own funds to assist the offeror to acquire the shares, it should explain why the arrangement would not fall foul of the principle that a company cannot provide financial assistance for the acquisition of its own shares and it would be fair and reasonable to expect the company to use the same amount to declare and pay a dividend to all the shareholders if the scheme fell through.

The Court of Appeal concurred with the view at first instance that it was not the role of the court at the originating summons stage to scrutinize the preparation of the draft composite document to ensure full compliance with the relevant statutory requirements before ordering a court meeting be convened to vote on a scheme of arrangement.

In allowing the meeting to proceed, the judge had not approved the explanatory statement provided. The adequacy of the explanatory statement would only be considered at the next stage of the proceedings when the company petitioned for the scheme to be sanctioned.

Appropriate test

The Court of Appeal set out the appropriate test for a takeover offer within section 674(5).

Where a scheme involves a takeover offer, the headcount test is replaced by the requirement that the votes cast against the scheme of arrangement do not exceed 10 percent of the total voting rights attached to all disinterested shares in the company and a 75 percent majority in value of the voting rights of the members present and voting. The headcount test was not applicable in this situation and the judge had erred in considering the court may not have jurisdiction to sanction the scheme if the headcount test was not met.

On the evidence, the dual requirements of the negative ten percent test and the 75 percent test were met.

Business decision

The Court of Appeal also queried the judge's view that it would be fair and reasonable to expect the company to use the same amount it proposed to use by way of dividend, to pay a dividend to all the shareholders if the scheme were not implemented.

The Court of Appeal judges agreed with counsel for the company that this amounted to substituting the judge's own view on dividend policy for that of the company. It was not for the court to 'second guess' the directors' reasoning in the exercise of their discretion regarding the declaration of dividends.

As for the failure to make a comparison with the scheme consideration of HK$0.42 per scheme share, it was decided that the more important consideration for the scheme shareholders was the total price they would receive under the scheme for the cancellation of their shares, and all information was made available in the composite document to enable the scheme shareholders to make such a comparison if they wished to do so.

In sanctioning the scheme, the Court of Appeal noted that the privatization had the overwhelming support of the scheme shareholders and that the scheme was one that an intelligent and honest person, a member of the class concerned and acting in respect of his interest, might reasonably approve.

The court, it said, "should be slow to differ from the majority views, as it normally acts on the principle that businessmen are much better judges of what is to their commercial advantage than the court could be." The Court of Appeal therefore exercised its discretion to sanction the scheme.

Commentary

It is rare for schemes of arrangement not to be sanctioned by the court, and the Court of Appeal judgment is helpful in restating the applicable principles.

The judgment serves as a cautionary tale to listed companies that they should abide by the proper procedures and ensure clear and adequate disclosure is made to enable scheme shareholders to make an informed decision if they wish to effect a privatisation.

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