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ALERT MEMORANDUM

June 29, 2015 clearygottlieb.com

Court of Appeal of England and Wales considers important questions for UK M&A transactions including rights of minority shareholders to challenge insertion of drag right into constitutional documents to facilitate sale of company and target directors' duties in connection with a bid

The UK Companies Act provides that a company can amend its constitutional documents by special resolution (being a shareholders' resolution passed by 75%+ of votes cast by those shareholders voting on the resolution). In private M&A transactions where the target has multiple shareholders and a drag right does not apply, a bidder wishing to acquire the entire issued share capital of the target may, given an amendment to the constitutional documents does not require unanimity, consider conditioning its proposal on the insertion of a drag right into the target's constitutional documents. Some practitioners have historically taken the view that amendments of this sort are unlikely to be enforceable.

In *Arbuthnott v Bonnyman*[1], the Court of Appeal of England and Wales (which is England's second most senior Court) recently considered an appeal from a High Court decision relating to the right of a minority shareholder (Arbuthnott) to challenge certain amendments to the constitutional documents of a company of which he was a shareholder. The challenged amendments inserted an amended drag right into the constitutional documents in connection with a proposed sale of the company. The Court of Appeal rejected the appeal and upheld the prior decision of the High Court which had, in turn, rejected Arbuthnott's claims.

The judgements of the Court of Appeal and the High Court consider a number of important issues for UK M&A transactions including:

- the circumstances in which an amendment to the constitutional documents of a company to insert a drag right might be challenged; and
- the duties of target company directors in connection with a bid for the target company.

Background

Arbuthnott was a founder of Charterhouse, a prominent UK private equity business. In 2008, Arbuthnott retired as an executive of Charterhouse. However, following his retirement, Arbuthnott retained an approximately 9% shareholding in a member of the Charterhouse group (referred to as the "Company"). All of the shareholders of the Company were subject to a shareholders agreement. The shareholders agreement contained a drag right but the constitutional documents of the Company contained a different and more restrictive drag right (so there was an inconsistency between the two documents).

[1] [2015] ALL ER (D) 218

Over time, retired executives of Charterhouse ended up holding approximately 55% of the shares in the Company. The other 45% of the shares in the Company were held by current executives of Charterhouse.

In 2011, Charterhouse was considering raising an additional fund and became concerned that the misalignment between active executives of Charterhouse and the shareholders of the Company (which included a number of retired executives) would cause difficulties with investors when raising funds.

In order to address this misalignment, in 2011 the active executives of Charterhouse formed a newly incorporated company (the "Offeror") which made an offer to acquire all of the shares in the Company. The Offer was conditional upon a number of conditions precedent being satisfied including that the shareholders of the Company approve by special resolution certain amendments to the constitutional documents of the Company to introduce an amended drag right similar to the drag right contained in the shareholders agreement. The conditions precedent to the Offer were subsequently satisfied (including the making of the amendments to the constitutional documents). The Offer was then accepted by all of the shareholders in the Company (other than Arburthnott, who believed that the offer significantly undervalued the Company) and subsequently the Offeror sought to exercise the amended drag right to acquire Arbuthnott's shareholding.

Arbuthnott's claims

The relief sought by Arbuthnott included injunctive relief and an order that his shares be purchased at a fair and proper price determined by the Court or a valuer determined by the Court. Arbuthnott principally sought this relief on the grounds of statutory "unfair prejudice" (which is described below).

The Court of Appeal's and the High Court's findings in relation to Arbuthnott's claims can be summarized as follows:

The Statutory Unfair Prejudice Claim

The UK Companies Act allows a shareholder in a company to claim relief on the grounds that the company's affairs are being conducted in a manner which is unfairly prejudicial. A claim for unfair prejudice has three distinct elements:

1. conduct of the company's affairs;
2. prejudice to the claimant's interests as a shareholder of the company; and
3. unfairness.

Conduct of the company's affairs

In this case, it was not entirely clear to what extent Arbuthnott's claims related to the conduct of the Company's affairs. For instance, the offer had been made by the Offeror, the Company's

shareholders (rather than the Company itself) had accepted the offer and it was the Offeror who had purported to exercise the drag rights.

However, it was held that Arburthnott's claims did in fact relate to the affairs of the Company in certain respects – specifically, the manner in which the directors of the Company responded to the offer (see the discussion below as to whether the Company's directors breached their duties in connection with the offer) and the alteration of the Company's constitutional documents.

Prejudice to the claimant's interest as a shareholder of the company

It was accepted that an expropriation or acquisition of shares at an undervalue could constitute prejudice to the claimant's interests as a shareholder.

Unfairness

One of the key elements of a claim for unfair prejudice is the aspect of "unfairness". In this context, UK Courts have held that "unfairness" does not bear a broad, colloquial meaning. Instead, for this purpose "unfairness" normally requires the claimant to demonstrate:

1. a breach of established legal principles (such as directors' duties or constraints which apply to shareholders' ability to amend constitutional documents);
2. a breach of the constitutional documents of the Company and/or a related agreement (such as a shareholders agreement); or
3. a failure to satisfy a legitimate expectation of the claimant.

In this case, categories 2 and 3 of "unfairness" above were not applicable - Arbuthnott accepted that there had been no breach of the shareholders agreement and that no legitimate expectations had arisen in light of the detailed nature of the shareholders agreement.

Arbuthnott however argued that category 1 of "unfairness" above applied in that:

- the Company's directors had breached their duties in connection with the offer; and
- the shareholders of the Company had not, as was required by law, acted "bona fide in the interests of the company" in amending the constitutional documents.

Taking each of these arguments in turn:

Did the Company's directors breach their duties in connection with the offer?

Arbuthnott argued that, in connection with the offer, the directors of the Company had a duty to:

- seek to involve themselves in negotiations with the Offeror;
- generally attempt to obtain the best price and terms for the shareholders; and
- obtain and provide information and advice to shareholders.

This argument was rejected and it was held that, in fact, the duties of directors of a target company are limited in connection with a bid. It was held that the primary role of the directors is to ensure that the offer and any competing offer are put to shareholders so that they can decide for themselves whether or not to accept the best offer available. Additionally, it was held that directors do not have a positive duty to give advice to shareholders regarding an offer for their shares – however, if the board chose to give such advice, such advice should be factually accurate.

Were the amendments to the constitutional documents made by the shareholders "bona fide in the interests of the company"?

Under English law, shareholders do not normally owe fiduciary duties to each other. However, there is an established principle that the exercise of the power of shareholders to alter the constitutional documents by special resolution must be exercised bona fide for the benefit of the company as a whole. This test is subjective and the onus is on the shareholder seeking to challenge the passing of the relevant resolution to show that the amendment was not bona fide believed by the shareholders to be in the interests of the company as a whole.

In general, the UK Courts have typically only sought to strike down amendments to constitutional documents which provide for the expropriation of shares of minority shareholders. In this case, Arbuthnott argued that the offer and the amendments to the constitutional documents effectively fell within the prohibited expropriation cases (i.e they were carried out improperly in order to expropriate Arbuthnott's shares at a gross undervalue). This argument was rejected on the basis that:

- the drag right already existed in the shareholders agreement and therefore had always been part of the bargain reached between the shareholders; and
- the "independent" shareholders of the Company (being other retired executives of Charterhouse) had voted in favour of the amendments and had received the same terms under the offer as the other shareholders of the Company (including Arbuthnott).

Arbuthnott argued that even if this case did not constitute a prohibited expropriation of his shares that, in any event, the offer related and amendment related steps were not taken bona fide in the interests in the Company. This argument was again rejected on the basis that:

- there was no suggestion that the power had been exercised in any dishonest way; and
- there was evidence that the shareholders genuinely believed that the misalignment between the current executives of Charterhouse and the shareholders of the Company could threaten the ability of Charterhouse to raise new funds.

Conclusion

Having failed to established any "unfair" conduct (either in respect of the arguments around breach of directors' duties or the amendments to the constitutional documents), it was held that Arbuthnott's claims for unfair prejudice failed.

The key takeaways from this case are as follows:

Expropriations: It remains the case that amendments to constitutional documents introducing expropriation provisions aimed a specific minority shareholders (which will often provide for a sale to the majority shareholders or a vehicle owned by them) will likely be struck down as invalid except in exceptional circumstances. This case arguably had some of the features of an expropriation (including, for instance, that the Offeror was arguably not independent of many of the accepting shareholders in the Company who were also active executives of Charterhouse) but the amendments survived challenge. However, in this case, the fact that the shareholders agreement contained a similar drag right was a key factor in the judgements of the Court of Appeal and the High Court – this allowed the defendants to (successfully) argue that the overall terms applicable to Arbuthnott's shareholding in the Company did not fundamentally change as a result of the amendments.

Genuine drag rights: Although much will depend on the precise facts of each case, the judgements of the Court of Appeal and the High Court do seem to imply that the introduction of a drag right into constitutional documents in connection with the sale to a genuine third party bidder is capable of surviving challenge in circumstances where it can be demonstrated that: (i) there will be a genuine benefit to the company as a separate entity in connection with the transaction; and (ii) the terms of the offer were within the bounds of reasonableness.

Directors' duties: The judgements reaffirm the commonly accepted view that directors of an English company in receipt of a bid are generally not subject to *Revlon* type duties of the sort recognised by Delaware Courts to take active steps to maximise value for shareholders. Under English law, the primary role of the target directors is therefore not to frustrate a bona fide offer so that the offer (and any relevant competing offer) can be put to the shareholders.

If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our partners and counsel listed at our website at http://www.clearygottlieb.com.

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099