# SCHEMES OF ARRANGEMENT: ECONOMIC ANALYSIS OF THREE ISSUES RELATING TO CLASSIFICATION OF CLAIMS

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## I INTRODUCTION

This article considers, in cost and benefit terms, the optimal ways of resolving three issues relating to the legal rules on determining classes of rights-holders' claims for the purposes of a scheme of arrangement between a company and its shareholders or creditors. A scheme of arrangement is a 'compromise or arrangement … between a company and … its creditors, or any class of them, or … its members, or any class of them'.[1] A scheme modifies the rights of the company's shareholders or creditors (claimants). This procedure facilitates a 'cramdown'.[2]

Schemes facilitate collective decision-making in that, absent this procedure, a proposed arrangement or compromise would not be binding unless there is unanimous consent, which can be costly to obtain. Schemes serve a useful economic function since they may lessen the difficulty and costs for a company to rearrange its relationship with its shareholders or creditors for the purposes of facilitating, amongst other things, changes to capital structure,[3] corporate

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1 *Companies Act 2006* (UK) c 46, s 895(1); see also *Corporations Act 2001* (Cth) s 411(1).

2 This means the ability of the majority to bind the minority: see Jennifer Payne, 'Debt Restructuring in English Law: Lessons from the United States and the Need for Reform' (2014) *Law Quarterly Review* 282, 284, 291.

3 *Re Cheung Kong (Holdings) Ltd* [2015] 2 HKLRD 512.

reorganisations such as mergers and takeovers,[4] dispute settlement, and the restructuring of a sinking firm.[5]

Schemes have been proven to be a useful corporate restructuring tool within Commonwealth jurisdictions in recent decades.[6] Rehabilitative restructuring is preferable, as compared to immediate liquidation, when a company is financially, as distinguished from economically, distressed.[7] Apart from schemes, available restructuring tools include contractual workouts and (voluntary) administration. The latter is a statutory restructuring procedure available in Australia and the UK.[8]

The advantage of schemes over workouts is obvious, as a restructuring through the latter requires unanimous consent, which can be hard and costly to obtain, while the former can be used to cramdown dissentients. Schemes also have a number of advantages over administration. One of these is that a scheme can be used regardless of the company's solvency status, so that a creditor scheme can be used to restructure the company before the company reaches insolvency or immanent insolvency. Earlier intervention may be helpful in turning an ailing company around. In contrast, administration is an insolvency procedure, which is not open unless the company is insolvent or likely to become insolvent. A further advantage of schemes, which administration does not possess, is that they can be used to obtain a compromise with claimants against not only the company but also third parties (eg, a person who has guaranteed the debt owed by the company).[9] To a certain extent, this quality of schemes explains why '[c]reditors' schemes of arrangement have risen (like a phoenix) from the ashes'[10] in Australia recently.[11]

Scheme claimants make their decisions by way of scheme meetings, which can be convened when the court issues an order for the meetings upon application. The requisite majority for passing a resolution is a majority in

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4 *Re Aston Resources Ltd* [2012] FCA 229; *Re Kumarina Resources Ltd* [2013] FCA 549; *Re SABMiller Plc* [2017] 2 WLR 837; Tony Damian and Andrew Rich, *Schemes, Takeovers and Himalayan Peaks* (Ross Parsons Centre of Commercial, Corporate and Taxation Law, University of Sydney, 3rd ed, 2013); Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation* (Cambridge University Press, 2014) chs 3–4.

5 Rebecca Langley, 'The Future Role of Creditors' Schemes of Arrangement in Australia after the Rise of Voluntary Administrations' (2009) 27 *Company and Securities Law Journal* 70, 78–9; Kim Reid, 'Difficult Issues in Creditors' Schemes – A Commentary' in Kanaga Dharmananda, Anthony Papamatheos and John Koshy (eds), *Schemes of Arrangement* (Federation Press, 2010) 101, 101; Charles Zhen Qu, 'Sanctioning Schemes of Arrangement: The Need for Granting the Court Curative Power' [2016] *Journal of Business Law* 13; *Re T & N Ltd [No 4]* [2007] 1 Bus LR 1141; *Re Opes Prime Stockbroking Ltd [No 2]* (2009) 179 FCR 20.

6 Qu, above n 5.

7 This means that the company is balance sheet insolvent but economically viable. In contrast, '[w]here the company is economically distressed, so that the net present worth of the business as a going concern is less than the total value of its assets were they to be broken up and sold separately, then liquidation may be the only sensible option': Payne, above n 2, 'Debt Restructuring in English Law', 282.

8 *Corporations Act 2001* (Cth) pt 5.3A; *Insolvency Act 1986* (UK) c 45, pt II.

9 *Re T & N Ltd [No 4]* [2007] 1 Bus LR 1141; *Re Opes Prime Stockbroking Ltd [No 2]* (2009) 179 FCR 20.

10 Reid, above n 5, 101; see also Qu, above n 5.

11 For further discussion on the utilities, advantages, and disadvantages of schemes, see Langley, above n 5; Payne, 'Debt Restructuring in English Law', above n 2.

number (ie, more than 50 per cent of the number of claimants present and voting) representing 75 per cent of the total value of claims.[12] For the majority's approval decision to become binding, the scheme needs to be sanctioned by the court.[13]

For the purposes of schemes, the majority's cramdown power can only be exercised within a class of claimants. Cross-class cramdown is not permitted, as the statutory provisions require the approval of *all classes* of claimants.[14] In other words, where the scheme requires the support of more than one class of claimants, the rejection of a single class stymies the scheme. Dissentients would therefore have an incentive to form themselves into a separate class. The nature of the majority's cramdown power has therefore been a hotbed of disputes on classification of claims. A further source of dispute of the same nature is the rule that the court does not have jurisdiction to sanction a scheme that has been approved through wrongly constituted class meetings.[15]

The principle on determining classes is as set out in the seminal decision of Bowen LJ in *Sovereign Life Assurance Co v Dodd* ('*Dodd*')[16] and refined by Chadwick LJ in *Re Hawk Insurance Co Ltd* ('*Re Hawk Insurance*').[17] That principle says that: (i) claimants are to be classed according to the similarity or dissimilarity of their rights as distinguished from interests not derived from their class rights; and (ii) a difference in rights does not mandate separate classes as long as the claimants are able to consult together with a view to their common interest.[18]

In resolving disputes over whether a scheme should be sanctioned, the court's decision on how the rules on classes operate in the given factual matrix can determine the fate of the scheme. The three issues that this article proposes to debate have been raised in recent cases and deal with the abovementioned principle for determining whether claimants should be placed in separate classes. The cases in question have purported to further refine the same principle. It is necessary to assess whether the approaches adopted in those cases are appropriate.

The first issue relates to the first limb of the above rule from the *Dodd* decision and is concerned with the question of whether the concept of

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12 *Corporations Act 2001* (Cth) s 411(4); *Companies Act 2006* (UK) c 46, s 899(1); *Companies Ordinance* (Hong Kong) cap 622, s 674(1). In Australia and Hong Kong, the court may waive the headcount test for members' schemes under the above provisions. A different threshold to the headcount test is also applied in Hong Kong for schemes involving takeovers or general offers for buy-backs: *Companies Ordinance* (Hong Kong) cap 622, s 674(2)(b)(ii).

13 If sanctioned, there is also a final procedural step for the scheme documents to be registered with the regulator before the scheme can take effect: *Corporations Act 2001* (Cth) s 411(10); *Companies Act 2006* (UK) c 46, s 899(4); *Companies Ordinance* (Hong Kong) cap 622, s 673(6).

14 *Corporations Act 2001* (Cth) s 411(4); *Companies Act 2006* (UK) c 46, s 899(1); *Companies Ordinance* (Hong Kong) cap 622, s 674(1).

15 *Re Hawk Insurance Co Ltd* [2002] BCC 300. However, see the views of Damian and Rich on this topic: Damian and Rich, above n 4, 342.

16 [1892] 2 QB 573, 583.

17 [2002] 2 BCC 300, 306–10. On the refinement of the *Dodd* principle in the *Re Hawk Insurance* case, see Payne, *Schemes of Arrangement*, above n 4, 46–7.

18 *Dodd* [1892] 2 QB 573, 583 (Bowen LJ); *Re Hawk Insurance* [2002] 2 BCC 300, 306–10 (Chadwick LJ). See also *Re Hills Motorway Ltd* (2002) 43 ACSR 101, 104 [12] (Barrett J).

commercially 'different rights' that Lord Millett NPJ raised in *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* ('*UDL Argos*')[19] is useful and appropriate in the application of the legal rules on classes. This concept deviates from the principle explained in *Dodd*, which is based squarely on an analysis of the claim-holders' *legal rights*. In a recent case, Hildyard J mentioned Lord Millett NPJ's views on the significance of the commercially different rights as a source of 'remaining confusion' about the test for identifying classes.[20] An assessment of the 'commercially different rights' test is therefore necessary.

The second issue which has also been raised in the application of the first limb of the principle in *Dodd* is whether a claimant that is also a wholly owned subsidiary of the scheme proponent should be placed in a separate class. The treatment of intra-group claimants is an issue that the courts have had to confront frequently. Related bodies corporate of a scheme proponent, naturally, tend to vote in favour of the scheme. This tendency may be stronger if the claimant is a subsidiary of the scheme proponent. Where a subsidiary, especially where it is wholly owned, is still in the hands of their directors (namely, not under external control by liquidators, receivers, and the like), it is most likely to vote in deference to the wishes of the scheme company.[21]

The general rule of dealing with votes of related parties, consistently with the traditional rules on classes, is to determine whether there is a need for separate classes on the basis of similarities or dissimilarities in legal rights. If the legal rights are sufficiently similar, then the related parties should not be placed in a separate class. It is then left to the court, at the stage of the court hearing to sanction the scheme,[22] to determine the weight to be given to the votes of the related parties. In a recent case, however, the Singapore Court of Appeal held that where the related party is a wholly owned subsidiary, placing the latter in a separate class was a 'more straightforward' way of dealing with that claimant's votes.[23] The problem raised by this ruling is which approach, as far as the votes by a wholly owned subsidiary claimant are concerned, is optimal.

The last issue to be addressed relates to an objective formula in applying the test on whether claimants are able to consult together under the second limb of the *Dodd* principle so as to obviate the need for separate classes, which Hildyard J recently referred to in obiter dictum in *Re Apcoa Parking Holdings GmbH* ('*Re Apcoa*').[24] The question is whether such an approach should be endorsed. Prior to

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19 (2001) 4 HKCFAR 358, 369.

20 *Re Apcoa Parking Holdings GmbH* [2015] BCC 142, 158–9 [54]–[55].

21 *Re Landmark Corporation Ltd* [1968] 1 NSWR 759, 765 (Street J).

22 There are three main stages in the implementation of a scheme of arrangement. Firstly, meetings of the shareholders or creditors (claimants) with whom the company proposes to enter into an arrangement or compromise need to be convened. An order from the court is required for the convening of the meetings. Where an application of the rules on classes requires the claimants to be placed in separate classes, then separate meetings of each class need to be convened. At the second stage, the scheme meeting(s) are held, where the claimants make a decision on the proposed scheme. For the majority's approval decision to become binding, the scheme needs to be sanctioned by the court. This is the third stage where there is a court hearing for determining whether the court should approve and sanction the scheme: *Re BTR plc* [2000] 1 BCLC 740, 742 (Chadwick LJ).

23 *The Royal Bank of Scotland NV v TT International Ltd* [2012] 2 SLR 213, 267–8 [165].

24 [2015] BCC 142.

*Re Apcoa*, the courts' assessments on the claimants' ability to consult, which were typically backed up by evidence as to their *actual* ability to consult, were not based on a clearly articulated formula.[25] An answer to this question will therefore have implications on the delineation of the scope of the court's sanction power.

The remainder of this article is organised into the following parts. Part II discusses the reasons why efficiency has been chosen as an analytical benchmark. Parts III–V debate the three issues raised, and Part VI concludes. As will be seen, we will answer the first and second questions in the negative and the third in the affirmative. This article will analyse cases not only from Australia and the UK, but also from Hong Kong and Singapore, given the similarity of the provisions on schemes of arrangement, and the experience on schemes accumulated, in these various jurisdictions.

## II LAW AND ECONOMICS AS AN ANALYTICAL INSTRUMENT

### A Why Law and Economics?

Schemes of arrangement are a tool to achieve an economic purpose. It therefore makes sense to make a judgment on whether and how to use that tool for achieving an intended purpose against a benchmark expressed in economics terms.[26] There are of course other values against which legal rules can be assessed, such as 'fairness' and 'law's immanent goals'.[27] Notwithstanding the difficulties from which it may suffer, the law and economics approach is prima facie preferable (at least in the context of corporate insolvency) in that it suffers less from inadequacies such as indeterminacy and internal inconsistency as compared to other normative positions.[28] Regardless of which policy objective is to be preferred, it is in the interest of each stakeholder to achieve that objective at the least cost.[29]

Law and economics is not just an analytical tool for generating scholarship. It is also used in judicial decisions, especially in the United States. To a certain extent this is also the case in the UK,[30] where the law is perceived to be formalistic rather than consequential.[31] A value external to law may be useful in resolving issues arising from 'hard cases'.[32]

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25 See below n 99 and accompanying text.

26 The relevance of other values such as fairness can be resolved under the existing machinery, namely court discretion.

27 J Armour, 'The Law and Economics of Corporate Insolvency: A Review' in R D Vriesendorp, J A McCahery and F M J Verstijlen (eds), *Comparative and International Perspectives on Bankruptcy Law Reform in the Netherlands* (Boom Juridische Uitgevers, 2001) 99, 107.

28 Ibid 110.

29 Ibid 110–11.

30 See, eg, *Item Software (UK) Ltd v Fassihi* [2004] IRLR 928; *Re Apcoa* [2015] BCC 142.

31 Michael J Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (Ashgate, 2001) 2.

32 Ronald Dworkin, *Taking Rights Seriously* (Duckworth, 1977) 81.

## B Analytical Benchmarks

The benchmarks to be used for the purposes of this article include transaction costs and the benchmarks of efficiency from a welfare economics point of view. The transaction costs that each option will incur will be measured by the size of costs generated from various sources of transaction costs, as well as from the nature of the legal rule that is applied.

A scheme is a court-controlled multi-party contract. The formation of this type of contract incurs transaction costs, which are 'dead weight' costs that lower efficiency by making it more difficult or costly for such contracts to be formed. The issue, in comparing two alternative approaches against the benchmark of efficiency, is therefore which one incurs less transaction costs.

The costs to be assessed for the present purpose include those for organising meetings (organisation costs), which include the costs for the venue of the meeting as well as those for managing the process of the meeting, the costs for controlling majority or minority oppression (rent-seeking costs), the costs for the scheme company to make classification decisions (the decision making costs), the costs of uncertainty caused by the court's exercise of its discretion (uncertainty costs),[33] as well as the costs for judicial time and resources (adjudication costs). Some of the alternative approaches to be considered in the remainder of the paper will be assessed in the light of each of these heads of costs.

One of the factors that may affect the costs for applying a legal rule is the extent to which the rule allows room for court discretion in the application of the rule. Where the rule does not require the court to make an assessment of some general 'standard', such as 'reasonableness', then the application of the rule is easier to predict or replicate. Such rules reduce the costs for planning and out-of-court dispute settlement,[34] and are more efficient in terms of adjudication costs, as they do not leave much room for court discretion. Such rules lead to finality more speedily, although they are less precise than standards in reaching the right outcome in any particular case.[35] Standards are more costly to apply, given the extra costs for a decision on the specific circumstances.

The choice that shareholders or creditors make between alternative options for a scheme proposed by a company may affect the wellbeing of not only the company but also the individual shareholders or creditors. The choice to be made

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33 The 'court's exercise of its discretion can provide a level of uncertainty, and risk, for the parties': Payne, *Schemes of Arrangement*, above n 4, 6.

34 Melvin Aron Eisenberg, *The Nature of the Common Law* (Harvard University Press, 1988) 10–11; see also text accompanying below n 62.

35 A distinction can be made between 'rules' in the narrow sense, which are contrasted with 'standards': Kathleen M Sullivan, 'Foreword: The Justices of Rules and Standards' (1992) 106 *Harvard Law Review* 22; Ward Farnsworth, *The Legal Analyst: A Toolkit for Thinking about the Law* (University of Chicago Press, 2007) 167; Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557, 559–60:

> a rule may entail an advance determination of what conduct is permissible, leaving only factual issues for the adjudicator. (A rule might prohibit 'driving in excess of 55 miles per hour on expressways'.) A standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator. (A standard might prohibit 'driving at an excessive speed on expressways.')

is therefore the identification of the option that helps maximise the benefit for all parties concerned. The question can therefore be answered by using some of the analytical tools that welfare economics offers. Welfare economics 'explores how the decisions of many individuals and firms interact to affect the well-being of individuals as a group'.[36] The welfare economics concepts that will be used in this article include Kaldo-Hicks efficiency and Pareto superiority.[37]

# III COMMERCIALLY DIFFERENT RIGHTS

## A The Concept of Commercially Different Rights

In *UDL Argos*, Lord Millett NPJ, sitting in the Hong Kong Court of Final Appeal, affirmed the basic principle that whether separate class meetings are required depends on similarity or dissimilarity of legal rights against the company and not similarity or dissimilarity of interests that are not derived from such legal rights.[38] However, his Lordship appears to have added a novel element to the test, in referring to rights which are '*commercially* dissimilar'.[39] In this article, we refer to such rights as 'commercially different rights'.

Lord Millet NPJ raised the notion of commercially different rights in *UDL Argos* to rationalise Templeman J's decision in *Re Hellenic & General Trust Ltd* ('*Re Hellenic*').[40] In the latter case, a scheme was proposed to facilitate the takeover of a company by Hambros Ltd ('Bidder'). The Bidder's wholly owned subsidiary ('M') already owned 53.01 per cent of the shares in the scheme company. The scheme was approved by a single shareholders' meeting. Templeman J declined to sanction the scheme on the basis that M should have been placed in a separate class such that there should have been a separate meeting for the shareholders other than M.

Templeman J's reason appeared to be that the *interests* of a shareholder which is also a wholly owned subsidiary of the intended purchaser of the shares under a scheme was different from those of other shareholders. So, prima facie, Templeman J's judgment on the issue of whether there should be separate classes appeared to be based on the different *interests* of the shareholders, rather than the dissimilarity of their *rights* against the scheme company. His Lordship's judgment has accordingly been criticised as being incorrect in requiring M to be placed in a separate class as it deviates from the established principle that focuses on rights rather than interests.[41]

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36 Robert B Cooter Jr and Thomas Ulen, *Law and Economics* (Pearson, 6th ed, 2012) 37–8.

37 See below n 105 and accompanying text.

38 (2001) 4 HKCFAR 358, 372 [27].

39 Ibid 370 [23] (emphasis added).

40 [1976] 1 WLR 123.

41 See Damian and Rich, above n 4, 549–50 (citations omitted):

> Templeman J arrived at the correct result in this case, but for the wrong reasons. If, as seems to be the position from the facts set out in the judgment, [M] was to be treated in exactly the same way under the scheme as every other shareholder in Target, then it was appropriate to include it in the same class as all the other shareholders. However, the Court ought to have completely disregarded the votes of [M] on the

Lord Millet NPJ in *UDL Argos*, however, agreed with Templeman J's approach of placing M in a separate class from the other shareholders. His Lordship took the view that Templeman J's approach could be justified because of the different rights conferred under the scheme on M and the other shareholders respectively. Lord Millet NPJ stated:

> What put M into a different category from the other shareholders was the different treatment it was to receive under the Scheme. The other shareholders were being bought out. In commercial terms M was transferring its shares to its own parent company and obtaining for its parent company the right to acquire the remainder of the shares from the other shareholders. The rights proposed to be conferred by the Scheme on M and the other shareholders were commercially so dissimilar as to make it impossible for M and the other shareholders to consult together with a view to their common interest, for they had none.[42]

Lord Millet NPJ did not elaborate further on what he meant by the rights being commercially dissimilar. However, it appears that his Lordship was referring to the commercial effects of legal rights. If this interpretation of Lord Millet NPJ's comments is correct, then it means that in addition to cases where the legal rights are sufficiently different to require separate classes, it is also necessary to have separate classes where the commercial effects of the legal rights for the shareholders (or creditors, in a creditors' scheme) are so different that the shareholders (or creditors) cannot sensibly consult together.

The above approach of resorting to the notion of commercially different rights has been explicitly adopted in at least one UK decision.[43] But as Hildyard J noted in *Re Apcoa*,[44] the concept of commercially different rights gives rise to 'some remaining confusion' or 'blurred boundaries' in the application of the test for identifying classes in a scheme of arrangement. Australian courts do not appear to have applied this concept from *UDL Argos*. A fundamental question to consider is whether the concept of commercially different rights ought to be adopted.

### B Application of the 'Commercially Different Rights' Test

To assess the merits of the notion of commercially different rights, it is necessary to examine how that concept has been applied to determine whether separate classes are required. We turn firstly to examine more closely Lord Millet NPJ's analysis of the decision in *Re Hellenic*.[45]

In Lord Millett NPJ's comments on commercially different rights in the passage quoted above,[46] his Lordship pointed out that M should be placed in a different class meeting from other shareholders because of their different treatment under the scheme. Lord Millett NPJ stated that while the other

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> grounds that it had an extraneous commercial interest … which rendered its view a 'self-centred view rather than a class-promoting view' (to use the words of Street J in *Re Jax Marine Pty Ltd*).

42 *UDL Argos* (2001) 4 HKCFAR 358, 369–70 [41].

43 *Re Indah Kiat International Finance Company BV* [2016] BCC 418, [64]–[68]. See also *The Royal Bank of Scotland NV v TT International Ltd* [2012] 2 SLR 213, 267–8 [165].

44 [2015] BCC 142, 158–9 [54].

45 [1976] 1 WLR 123.

46 See text accompanying above n 42.

shareholders were being bought out, in commercial terms M was transferring its shares to its own parent and obtaining for it the right to acquire the remaining shares from the other shareholders.[47]

In other words, the difference between the position of M and that of other shareholders, in terms of the commercial effect of the transaction, is that a sale of all the shares to the Bidder would alter the position of all existing shareholders of the scheme company with the exception of M. In Templeman J's words:

> So far as the [M] shares are concerned it does not matter very much to [the Bidder] whether they are acquired or not. If the shares are acquired a sum of money moves from parent to wholly owned subsidiary and shares move from the subsidiary to the parent. The overall financial position of the parent and the subsidiary remain the same. The shares and the money could remain or be moved to suit [the Bidder] before or after the arrangement. From the point of [M], provided [M] is solvent, the directors of [M] do not have to question whether the price is exactly right.[48]

M's position would not change in a real sense. From the strict legal perspective, M would be divested of its legal interests in the scheme company by the sale of its shares to the Bidder. But looking at the commercial or economic realities of M's position as a wholly owned subsidiary of the Bidder, it can be seen that following the sale M would still have commercial interests in the scheme company arising from its membership of a corporate group that now owns the shares in the scheme company.

Moreover, the size of the price M was to receive from the Bidder would not matter to M, as the Bidder owned all of the shares in M. As long as M was solvent, whether or not M received a fair price from the Bidder for the shares would not be significant since the commercial reality is that any shortfall in price would only affect the Bidder (since the Bidder is the sole owner of the shares in M). Yet the Bidder would be indifferent to such shortfall since the shortfall only means that a smaller sum of money has moved from itself to M, with the amount constituting the shortfall being retained by the Bidder itself.

Mere proof that the commercial effect of M's rights and the rights of other shareholders under the scheme are dissimilar, however, would be insufficient to justify a decision to require M to vote separately. To justify such a decision, it is necessary to consider the reason why the dissimilarity between the commercial effect of M's rights and that of other shareholders' rights renders it impossible for M to consult with other shareholders. Lord Millett NPJ's view appears to be that M and the other shareholders did not have common interests.[49] A possible explanation for why this is so, gauging from the above-quoted words of Templeman J, is that whereas the other shareholders would make their decisions on the basis of the terms on offer, M would not, being indifferent to the purchase price. Under a *Re Hellenic*-like scheme, whilst the other shareholders have an interest in a buyout offer, one way or the other, M does not.

More fundamentally, not only did M and the other shareholders have different interests, but their interests were *conflicting*. The conflict stems from

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47 *UDL Argos* (2001) 4 HKCFAR 358, 369–70 [23].

48 *Re Hellenic* [1976] 1 WLR 123, 126.

49 *UDL Argos* (2001) 4 HKCFAR 358, 369–70 [23].

the position of M as a wholly owned subsidiary of the Bidder, which was seeking to acquire the shares in the scheme company. Thus, as stated by Lord Millett NPJ, '[t]he key to the decision [in *Re Hellenic*] is that M was effectively identified with [the Bidder]'.[50] It is perhaps this understanding as to the identity of M that led Templeman J to observe that M would make its decision in the light of what was good not only for itself but also for the Bidder.[51] If Templeman J was right on this, a stronger reason why M was unable to consult with other shareholders would be the impossibility of consulting on *conflicting* interests.

In the recent case of *Re Indah Kiat International Finance Co BV*,[52] Snowden J applied Lord Millett NPJ's notion of commercially different rights in the context of a creditors' scheme where there were also conflicting interests between the creditors. Under the proposed creditors' scheme, notes issued by the scheme company would be compromised with the note-holders. The parent company of the scheme company had guaranteed the notes and was, pursuant to the guarantee, jointly and severally liable with the scheme company to the note-holders. One of the holders of the notes (Capital Unity) was suspected to be a nominee or under the control of the parent.

Snowden J, in applying Lord Millett NPJ's approach,[53] took the view that it is at least arguable that if it were to transpire that the parent or one of its associated companies was the 'true commercial owner' of the notes held by Capital Unity, it would be inappropriate for Capital Unity to vote at the same meeting with the other scheme creditors. Thus Capital Unity would need to be classed separately from the other creditors even though they all held the same legal rights under the notes. The dissimilarity between the creditors' rights in commercial terms was that one of the creditors (namely Capital Unity) was not the real holder of the notes (in commercial terms) but was merely a nominee or was under the control of a party who is liable for repayment of the debts represented by the notes. As such, that particular creditor had *conflicting* interests with the other creditors.

## C The Pros and Cons of the 'Commercially Different Rights' Test

### *1 Advantages*

#### *(a) Avoiding Distortion of Decision of Meeting: Controlling Majority Oppression*[54]

If persons with commercially different rights are placed in a separate class, then their votes would not be able to affect the outcome of the meeting of the other class of shareholders or creditors. Thus, the possible utility of a test adopting the notion of commercially different rights for determining classes is that it helps correct a distortion of the majority's decision in a single meeting caused by a strict application of the approach to classification based on strict legal rights. This is illustrated by the case of *Re Hellenic* itself. Including M in

50 Ibid 369 [22].
51 *Re Hellenic* [1976] 1 WLR 123, 126.
52 [2016] BCC 418.
53 Ibid 432–3 [64]–[68].
54 This means action by the majority that oppresses the minority.

the same class as the rest of the shareholders could have potentially distorted the decision of the meeting. This was because if M is effectively identified with the Bidder, the arrangement proposed would really be one that is only between the Bidder and shareholders other than M.[55] Allowing M to vote together with the other shareholders would have distorted the decision of those with whom the arrangement was to be made if M held a majority shareholding or otherwise M's votes were crucial in enabling a resolution to be passed to approve of the scheme.

*(b) Reducing Adjudication Costs in Certain Circumstances*

A second possible advantage of the concept of commercially different rights is that this approach may help save adjudication costs in certain circumstances. Where the circumstances compel certain shareholders or creditors to be placed in a separate class, and the other class disapproves of the scheme at their own meeting, there would be no need for the scheme to move to the sanction stage. In this situation, the final decision on the scheme is made at stage two and the absence of the need for court involvement helps save adjudication costs and public resources.

### *2 Disadvantages*

*(a) Increase in Organisation Costs and Rent-Seeking Costs*

There are, however, a number of disadvantages of the 'commercially different rights' test. The first is that, whilst it can be used to control majority oppression, a decision on classes made under that test can lead to an increase in organisation costs and can also render the scheme vulnerable to minority oppression,[56] thereby increasing rent-seeking costs for using schemes. Given the need to place in a different class those whose rights are commercially different, a prima facie effect of the 'commercially different rights' test would be an increase of the number of class meetings, hence higher organisation costs.

A mushrooming of class meetings provides opportunities for the minority to distort the decision of the majority. This is not only because of the effect of the rule that the court does not have jurisdiction to sanction a scheme where the class meetings are incorrectly constituted, but also because the requirement of a separate class meeting on the basis of commercially different rights held by a person is likely to result in an increase in the voting power of rent-seekers within the other class (because their voting power can be proportionately higher if the membership of the class is smaller). Hence the increased rent-seeking costs.

*(b) Difficulties in Applying Test: Increased Adjudication Costs*

A second downside of the 'commercially different rights' test is that, as a conceptual tool, it is likely to incur high decision-making or adjudication costs because it is difficult to apply. The ease at which a concept can be invoked depends in part on the level of clarity at which that concept is defined. A

55 See *Re BTR plc* [1999] 2 BCLC 675, 682 (Jonathan Parker J).

56 This means action by the minority that oppresses the majority.

difficulty of the 'commercially different rights' test is its lack of a judicial definition. Lord Millett NPJ did not define with any specificity the notion of commercially different rights when he referred to that concept in *UDL Argos*.[57] Indeed it is not even easy to completely understand some aspects of Lord Millett NPJ's statements on the concept. For example, his Lordship said that '[i]n commercial terms M was … obtaining for its parent company the right to acquire the remainder of the shares from other shareholders'.[58] It is, however, unclear how M was doing this. M's rights under the scheme were to be bought out at a certain price. Even if this transaction did not alter M's position in any real sense, pointed out above, it does not follow that that transaction helped the Bidder to obtain the right to acquire the remainder of the shares. The Bidder's right to acquire the remainder was not conditional upon the sale by M of all the shares it held in the scheme company.

The fuzziness of the concept of commercially different rights suggests that where the facts are not identical or similar to those in *Re Hellenic*, the 'commercially different rights' test will need to be given content in light of the factual matrix of the case before it could be applied. This may be so even if the notion of commercially different rights is understood as the commercial effects of a right. Applying the principle on determination of classes on the basis of a comparison of the commercial effects of rights of the parties will further increase the costs for resolving the issue. The principle from *Dodd*,[59] as traditionally understood, involves a comparison of legal rights, which are clearly defined in the company's constitution or other contractual documentation (where the rights of shareholders or creditors are created or provided for). On the other hand, the commercial effects of rights may not be easily ascertainable by reference to any statutory provisions, corporate documentation, or other sources of rules. The need for a higher level of expertise and the greater amount of time to ascertain whether rights are commercially different will incur additional costs.

Also, even where the commercial effects of the rights at issue are ascertainable, there is still a need to determine whether the commercial effects are so dissimilar to warrant separate classes. Indeed, it is difficult to draw a distinction between different commercial effects of a right and different interests of persons. For example, consider the Australian case of *Re Aston Resources Ltd*,[60] where a scheme was proposed for a company (Aston) and its shareholders for the purposes of effecting a merger. The scheme involved Aston becoming a wholly owned subsidiary of another company (Whitehaven). An aspect of the proposed transaction was that Whitehaven would acquire all the shares of another company (Boardwalk). The Boardwalk acquisition was not a part of the Aston scheme of arrangement, but it was conditional upon successful implementation of the scheme.

The shareholders of Aston who were also shareholders of Boardwalk may well have additional benefits flowing from approval of Aston's scheme, since

57 *UDL Argos* (2001) 4 HKCFAR 358, 369–70 [23].
58 Ibid 370 [23].
59 [1892] 2 QB 573, 583 (Bowen LJ). See also text accompanying above n 18.
60 [2012] FCA 229.

they would also have the opportunity of selling their shares in Boardwalk. Jacobson J held, though, that this did not require the common shareholders of Aston and Boardwalk to form a separate class. His Honour stated: 'Their different interest is a commercial one flowing from their interest in a separate transaction which is not a condition of the scheme'.[61]

Yet if the concept of commercially different rights was invoked, it might be said that the commercial effects of the rights conferred on Aston shareholders under the Aston scheme were different for those who were also Boardwalk shareholders. This is because the latter, in approving of the scheme, were acquiring for themselves further rights to be bought out from another company, namely Boardwalk. Jacobson J clearly considered that these different interests of the common shareholders were simply commercial motivations which cannot be taken into account for the purpose of determining classes. But if the 'commercially different rights' test is adopted, it would be necessary to consider whether those commercial effects were so dissimilar as to require separate classes. Such an assessment further complicates the process of decision-making, hence a higher level of decision-making costs. Making such a decision is a tall order even for the courts, let alone scheme users.

Following on from the above, a further disadvantage of the concept of commercially different rights is the lack of replicability of that concept, which also results in decision-making or adjudication costs. One of the principles of lawmaking, according to Eisenberg, is that courts should utilise a process of reasoning that is replicable by lawyers. Due to lawyers' roles in planning and dispute resolution, 'in the vast majority of cases where law becomes important to private actors, as a practical matter the institution that determines the law is not the courts, but the legal profession'.[62]

The principle of replicability helps facilitate planning and dispute settlement on the basis of law without the need for official intervention, which intervention is likely to be more expensive and time consuming.[63] In other words, the replicability principle makes planning and out-of-court dispute settlement less costly. A replicable reasoning process requires the courts to employ a consistent methodology across cases, 'unless there were clear principles that controlled which criteria were used in which cases'.[64] The difficulty of determining the content of commercially different rights, relative to legal rights, makes the former harder to replicate, hence more costly to employ.

Replicability is of particular significance in the context of schemes of arrangement. A slight error in determining classes can result in a court rejection of the scheme. The adoption of the 'commercially different rights' test, due to its low level of replicability, is likely to lead to an increase of errors in determining classes. The error-prone nature of the 'commercially different rights' test renders it unfit as an instrument to achieve the purpose for which the concept of

61 Ibid [32].
62 Eisenberg, above n 34, 10.
63 Ibid 10–11.
64 Ibid 12.

commercially different rights was presumably introduced, namely, to correct the perceived distortion of a meeting's decision caused by majority oppression.

### *3 Assessment: 'Commercially Different Rights' Test Too Costly*

Given the above analysis, the 'commercially different rights' test arguably should not be adopted. This can be seen through a closer look at the function and costs of the 'commercially different rights' test in comparison with the dissimilarity of legal rights approach.

Firstly, it is true that the commercially different rights approach, seen in the context of *Re Hellenic*, functions to control possible majority oppression. This function, however, comes at the cost of the weakening of the control of minority oppression by (i) increasing the number of classes and (ii) altering the power relationship within the class of independent shareholders/creditors.

It is, in fact, unnecessary to rely on the notion of commercially different rights to police majority oppression, since such oppression can be controlled under the dissimilarity of legal rights principle as well. As can be inferred from Jonathan Parker J's judgment in *Re BTR plc*,[65] the same outcome could result in *Re Hellenic* even if the question of class meetings was determined solely on the basis of differences in legal rights. Even if M was allowed to vote in the same meeting with other shareholders, the votes of the former could always be discarded by the court at the sanction hearing.[66] This was the case in *Re Aston Resources Ltd*, where the votes of the common shareholders of Aston and Boardwalk could be discounted or disregarded, though that was unnecessary in the particular circumstances as the common shareholders indicated that they would not vote at the scheme meeting.[67]

In contrast, there is no way for the court to exercise any control over the possible minority oppression under the commercially different rights approach, which may occur where an otherwise beneficial scheme is rejected by the class of the 'other shareholders/creditors', due to reinforced voting power of the rent-seekers caused by the separation into different classes.

Secondly, it is also true that the 'commercially different rights' test, by obviating court involvement in certain circumstances, may help minimise adjudication costs. This saving, however, is likely to be more than offset by the adjudication costs that are likely to be incurred for using the same test because of the uncertainty associated with its use (either by courts or scheme users), and the low level of replicability, of the test. The 'commercially different rights' test helps minimise adjudication costs under certain circumstances, such as where the scheme is rejected by the class of the 'other shareholders/creditors', and that decision is not fraught with minority oppression. But the same approach is likely to generate higher decision-making or adjudication costs in all circumstances in which it is invoked.

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65 His Lordship said that Templeman J in *Re Hellenic* effectively 'discounted' the shares that M (the wholly owned subsidiary of the scheme proponent) held in the scheme company: [1999] 2 BCLC 675, 682.

66 This was how Street J dealt with the votes of the related creditors in *Re Landmark Corporation Ltd* [1968] 1 NSWR 759, 766–7. See also *Re BTR plc* [1999] 2 BCLC 675, 682 (Jonathan Parker J).

67 [2012] FCA 229, [34] (Jacobson J); Damian and Rich, above n 4, 333.

# IV WHOLLY OWNED SUBSIDIARIES

## A Requiring Wholly Owned Subsidiaries to be Placed in a Separate Class

Our discussion on the utility of the 'commercially different rights' test above shows that there is no need for that test to be applied to require separate classes in a situation such as that in *Re Hellenic*. If the purpose of separate classes is to protect dissentients from majority oppression, that job can be done by the court at stage three pursuant to the court's sanction discretion. However, apart from applying the concept of commercially different rights, are there other grounds to justify the approach that Templeman J adopted for separate classes in *Re Hellenic*? A recent Singapore Court of Appeal case suggests that this question can be answered in the affirmative.

In *The Royal Bank of Scotland NV v TT International Ltd* ('*TT International*'),[68] the Singapore Court of Appeal dealt with a scheme of arrangement between a company and its creditors. The Court held that requiring a separate class for one of the creditors was justified on the basis that the particular creditor was a wholly owned subsidiary of the scheme company.[69]

Although the scheme in *TT International* was a creditors' scheme and not a scheme to effect an acquisition of shares in the scheme company as in *Re Hellenic*, a similar issue arises in both cases – namely, whether a wholly owned subsidiary of the proponent of the scheme should be placed in a separate class. On the approach adopted in *TT International*, it is possible to justify *Re Hellenic* solely on the basis that the shareholder in question was a wholly owned subsidiary of the bidder company seeking to purchase the shares of all the shareholders in the scheme company.

The traditional way of dealing with related parties whose rights are not prima facie dissimilar to those of the ordinary creditors, is to allow the related parties to vote at the same meeting as the other creditors but with the court having a discretion at the sanction hearing to discount or disregard entirely the votes of the related party for the purpose of determining whether the scheme was approved by the requisite majorities. The weight that the votes by the related parties carries for the purpose of determining whether the scheme should be sanctioned is determined by the court when exercising its discretion at the sanction hearing.[70] A classic example where the wholly owned subsidiaries of the scheme proponent were dealt with under such an approach is *Re Landmark Corporation Ltd*.[71] In that case, which involved a creditors' scheme, Street J discounted to zero the weight of the votes of creditors which were also wholly owned subsidiaries of the scheme company. This was done on the ground that those votes had no probative force on what is best for the class.[72]

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68 [2012] 2 SLR 213.

69 Ibid 265 [158].

70 *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145*; Re Landmark Corporation Ltd* [1968] 1 NSWR 759, 767 (Street J); *Re BTR plc* [1999] 2 BCLC 675; *TT International* [2012] 2 SLR 213.

71 [1968] 1 NSWR 759.

72 Ibid 767.

In *TT International*, the Singapore Court of Appeal agreed with Street J's decision on the need for discarding the votes of those subsidiaries.[73] The Court, however, preferred to achieve the same purpose via the approach that Templeman J adopted in *Re Hellenic* for placing the subsidiary into a separate class, stating that that approach was preferable to the approach for discounting votes at the sanction hearing as it commends itself as more straightforward.[74]

The Singapore Court of Appeal's decision in *TT International* raises a question on whether the requirement for wholly owned subsidiaries to be placed in a different class is a worthwhile exception to the general rule that classes are determined on the basis of differences in legal rights. Our answer to this question, which is arrived at by a cost and benefit analysis of the alternative approaches, differs from the view of the Singapore Court of Appeal.

## B Analysis

### *1 Organisation Costs*

The approach involving court discretion for dealing with votes of wholly owned subsidiaries will lead to a smaller number of meetings when compared with the approach mandating separate classes. Under the approach which leaves the treatment of wholly owned subsidiaries to the discretion of the court at the sanction hearing, there is no need for organising a separate meeting for the shareholders or creditors which are wholly owned subsidiaries. In other words, this approach does not incur extra organisation costs. The approach requiring separate classes, in contrast, involves the arrangement of an extra meeting for the wholly owned subsidiaries. It is therefore clear that insofar as organisation costs are concerned, the court discretion approach is more efficient.

### *2 Adjudication Costs*

The adjudication costs hinge chiefly on the nature of the relevant legal rule in terms of the level of complexity at which the rule is applied. Under the court discretion approach, the court makes a decision whether to discount the votes of the wholly owned subsidiary on the basis of whether the votes reflect private or special interests in supporting the scheme rather than being fairly representative of the interests of the class in question.[75] Under this approach, a decision whether to discount votes is to be made on the basis of the extent to which interests of different persons are similar. Similarity is not a bright-line notion. The court is required to analyse the degree of similarity between the interests of the wholly owned subsidiaries and the other shareholders or creditors who voted at the same meeting. Under the approach mandating separate classes, a decision is made with reference to a bright-line rule, namely, the wholly owned subsidiaries must form a separate class. In terms of the costs for judicial discretion, therefore, the approach requiring separate classes is prima facie more efficient.

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73 [2012] 2 SLR 213, 265–6, [159]–[162] (The Court).

74 Ibid 267 [165].

75 See, eg, *UDL Argos* (2001) 4 HKCFAR 358.

The difference between the two alternative approaches in terms of costs for judicial discretion, however, may not be all that great. In *TT International*, Rajah JA, who delivered the judgment on behalf of the Court, said that 'the authorities say with one voice that it is the norm for the votes of related party creditor to be discounted in light of their special interests to support a proposed scheme by virtue of their relationship to the company'.[76] Although this statement of the Court of Appeal is arguably too sweeping,[77] it appears that under most circumstances the votes of wholly owned subsidiaries are likely to be discounted,[78] in which case, the decision to discount those votes would not take the court too much time and resources.

The approach requiring wholly owned subsidiaries to be placed in a separate class is, however, clearly more efficient in terms of costs for court involvement. Under this approach, for example, if the independent shareholders or creditors disapprove of the scheme, the final decision on the scheme is made at stage two and there would be no longer a need to move the scheme to the sanction stage. In comparison, under the alternative approach, the scheme is more likely to progress to the sanction stage because of the support of the votes of the wholly owned subsidiaries. Even if the court discounts the votes of those subsidiaries at the sanction hearing to reach the same outcome, extra costs need to be incurred in requiring the sanction hearing.

Given that the approach requiring separate classes is likely to necessitate a lower degree of court involvement and that it is marginally more efficient in terms of costs for judicial discretion, it is fair to suggest that that approach is moderately more efficient as compared to the alternative court discretion approach in terms of adjudication costs.

### *3 Uncertainty Costs*

Uncertainty costs are those costs caused by the difficulty of predicting the future. The degree of this difficulty is positively correlated to the number of contingencies to be accounted for.[79] In the present context, the contingencies that may give rise to uncertainty costs are those on the ways in which wholly owned subsidiaries are to be treated for the purpose of determining classes. A high level of certainty on the ways in which such subsidiaries are to be dealt with informs the scheme organiser on the most efficient ways to organise scheme meetings.

The chief source of uncertainty on the treatment of wholly owned subsidiaries is the court's exercise of its discretion on this matter. The size of the court's discretion determines the level of uncertainty. Thus the approach

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76 *TT International* [2012] 2 SLR 213, 264 [155].

77 In *UDL Argos*, which was cited in *TT International*, the Hong Kong Court of Final Appeal upheld the decision of the courts below not to discount the votes of the subsidiaries of the scheme company, even though a significant number of these subsidiaries were wholly owned: see, eg, UDL Holdings, '2000 Special General Meeting' (Media Announcement, 29 February 2000) <http://www.hkexnews.hk/listedco/listconews/SEHK/2000/0301/LTN20000301062.HTM>. For more discussion, see below n 83 and accompanying text.

78 In Australia, it was considered necessary to give the court an express statutory power to take away related creditors' right to vote for the purposes of creditors' meetings: *Corporations Act 2001* (Cth) s 415A.

79 Stephen M Bainbridge, *Corporation Law and Economics* (Foundation Press, 2002) 34.

requiring separate classes would be, prima facie, superior in terms of uncertainty costs. The rule under this approach compels the scheme company to place wholly owned subsidiaries in a different class. Under the court discretion approach, the weight of the votes of the subsidiaries will be determined by the court through an exercise of its discretion. There is therefore a prima facie case that the court discretion approach would incur more uncertainty costs.[80] However, similar to the analysis of adjudication costs above, the uncertainty costs for the court discretion approach are unlikely to be high if in most cases the courts would require the votes of the wholly owned subsidiaries to be discounted to zero at the sanction hearing.

### *4 Rent-Seeking Costs*

#### *(a) Court Discretion as a Control of Both Majority and Minority Oppression*

Under the approach which allows wholly owned subsidiaries to vote in the same class as other shareholders/creditors with similar rights, as long as the scheme has moved to the sanction stage, both majority and minority oppression can be controlled by the court. The court, for example, will be able to control potential majority oppression by discounting the votes of related parties and deal with minority oppression (eg, in the form of opportunistic objection on the basis of incorrect classes) according to the established rules and principles (such as the *Dodd/Re Hawk Insurance* formula[81] and principles governing courts' sanction discretion). The costs for doing so are part of the adjudication costs. No additional costs need to be incurred.

In contrast, the approach placing wholly owned subsidiaries in a separate class is likely to be more costly in terms of the policing of minority oppression. Separately classing wholly owned subsidiaries is unlikely to create opportunities for their inter-class opportunistic behaviour, given their inclination of voting in deference to the wishes of the scheme proponent. Shifting wholly owned subsidiaries to a separate class, however, has the effect of leaving the fate of the scheme largely in the hands of the independent shareholders/creditors. If the independent shareholders/creditors were to vote for the scheme, that the wholly owned subsidiaries have also voted for the scheme would not change the decision of the former. If the class of independent shareholders/creditors have rejected the scheme, whilst the wholly owned subsidiaries have voted for the scheme, the decision of the former would also prevail, given the requirement that the scheme be approved by all classes.

Terminating the scheme at stage two, however, would deprive the court of an opportunity to determine the fate of the scheme in the light of the configuration of the minority or majority oppression in the factual matrix. The Hong Kong case of *UDL Argos*[82] is a telling example. There, the court was asked to sanction 25

80 That said, the uncertainty costs of the court discretion approach might not be as high as what it might first seem. As noted in the preceding section on adjudication costs, a decision to discount the votes of claimants which are wholly owned subsidiaries of the scheme proponent is unlikely to take too much of the court's time and resources: see text accompanying above n 78.

81 See above n 18 and accompanying text.

82 *UDL Argos* (2001) 4 HKCFAR 358.

inter-linked creditor schemes for a company and 24 of its subsidiaries. Former employees of seven of the subsidiaries, which voted against the scheme, objected to the sanction of the scheme. They argued, inter alia, that preferential and internal creditors should have been placed into separate classes.

In *UDL Argos*, Le Pichon J at first instance held against the objectors and sanctioned the schemes. This decision was upheld by both the Court of Appeal and, on further appeal, by the Court of Final Appeal. It was held in *UDL Argos* that, in the circumstances of the case, it was unnecessary to require the internal creditors to form a separate class nor to discount the votes of the internal creditors. The schemes in *UDL Argos* would not have had a chance had the decision been made under an approach mandating separate classes. It is clear from Le Pichon J's decision that the requisite majority would not have been achieved if the votes of internal creditors, a significant proportion of which were wholly owned subsidiaries of the primary scheme company,[83] had been discarded.

Le Pichon J's rejection of the objectors' argument on the need for the subsidiaries and preferential claimants to form separate class meetings was clearly based on a consideration of the factual matrix of the case. This was one where: (i) a sector of the creditors was attempting to block a beneficial rescue scheme pursuant to their extraneous interests; (ii) the internal creditors' votes could not be challenged on the basis of majority oppression; and (iii) although the requisite statutory majority would not be reached without counting the votes of the internal creditors, the scheme would command a considerable level of support even if the votes of internal creditors were to be excluded.

The extraneous interests of the objectors referred to above were the interests over and above the relevant creditors' interests *qua* preferential creditors, which interests were preserved under the scheme. The extraneous interests here were derived from a fund created by statute in favour of former employees of a bankrupted employer. The reason why the internal creditors' votes could hardly be impugned on the basis of suspected majority oppression was that under the scheme, some of the internal creditors (the scheme companies) were not to participate in the distribution of dividends. This downward adjustment of these internal creditors' rights under the scheme was beneficial to other creditors in that it would lead to an augmentation of the pool of assets available for distribution. This arrangement indicated an absence of majority oppression in the circumstances.

If the approach requiring separate classes for wholly owned subsidiaries had been adopted in *UDL Argos*, the court would not have been able to salvage the schemes. The votes of the wholly owned subsidiaries would have been effectively discarded since they would not be voting at the meeting of the general creditors. An exclusion of those votes would have resulted in a failure to meet the requisite statutory majority requirement. A disapproval of the scheme at stage

83 According to UDL Holdings' announcement on 29 February 2000, 23 out of 24 of the scheme companies were wholly owned subsidiary claimants: UDL Holdings, '2000 Special General Meeting' (Media Announcement, 29 February 2000) <http://www.hkexnews.hk/listedco/listconews/SEHK/2000/0301/LTN20000301062.HTM>.

two would prevent the scheme from moving to the sanction stage, thereby depriving the court of an opportunity to safeguard the scheme through, inter alia, policing minority oppression.

Another example from the case law which also illustrates this point is the Australian decision of *Re Kumarina Resources Ltd*.[84] Here, the scheme was one between a company and its shareholders for the acquisition of all the shares of the company by another entity ('Bidder'). The Bidder was a wholly owned subsidiary of another company ('the parent company'). The parent company also held shares in the scheme company. One of the issues in the case was whether the parent company should be placed in a separate class, and if not, whether its votes should be discounted at the sanction hearing. Although *Re Kumarina* dealt with the position of the parent company rather than with the wholly owned subsidiary, some similar issues arise due to their status as related companies to the scheme proponent.

Gilmour J held that it was not appropriate to require the parent company to vote in a separate class meeting. His Honour distinguished *Re Hellenic* by noting that the rights and commercial effect of the scheme are the same for all of the company's shareholders, including the Bidder's parent company.[85] His Honour also distinguished *Re Landmark Corporation Ltd* [86] and held that it was unnecessary to discount the votes of the parent company at the sanction hearing.[87] It appears that critical to Gilmour J's decision was his Honour's finding on the evidence that the scheme was fair and reasonable and in the best interests of the shareholders of the scheme company.[88] It seems that the objectors had not articulated their reasons for objecting to the scheme.[89] In those circumstances, Gilmour J considered that it was unnecessary to disregard the votes of the Bidder's parent company notwithstanding the fact that the parent company may have extraneous interests by being the controller of the Bidder.

Both *UDL Argos* and *Re Kumarina* indicate that an approach which leaves it to the court's discretion in determining whether there is any need to discount votes rather than requiring separate classes for wholly owned subsidiaries of the scheme proponent would be more effective in controlling minority oppression.

### *(b) Multiple Classes and Increased Rent-Seeking Power of Recalcitrant Shareholders/Creditors*

The absence of a minority oppression control mechanism and the lack of flexibility to deal with infinitely varied factual matrixes are not the only shortcomings of an approach requiring wholly owned subsidiaries to be placed in a separate class. A further downside of that approach is that, at a general level, it has the potential to strengthen the rent-seeking power of recalcitrant shareholders/creditors. A thought experiment illustrates the point. Say there are

84 [2013] FCA 549.
85 Ibid [44].
86 [1968] 1 NSWR 759.
87 [2013] FCA 549, [45].
88 Ibid [53]–[57].
89 Ibid [54]–[55].

20 creditors with equal weight of claims, and four of them are wholly owned subsidiaries of the scheme company. Assume that: (i) the four subsidiaries will vote in favour of the scheme; and (ii) the court will not discard the votes of the subsidiaries, as was the case in *UDL Argos*. If there was just one meeting where all 20 creditors attend and vote, then 11 of the independent creditors, who constitute a 'majority in number', need to vote in favour in order to obtain 75 per cent approval. In other words, it would take six dissentient independent creditors' votes to block the scheme.

Assume now that the four subsidiaries are voting in a separate class meeting and they all vote in favour. Now, in the meeting of the independent creditors, in order to obtain 75 per cent approval, there needs to be 12 independent creditors voting in favour in order for the scheme to be approved at that other meeting. Thus, in contrast to the situation for a single meeting, the scheme can be stymied by five, instead of six, dissenting creditors.

An increase of rent seekers' voting power may result in not only the stymieing of a beneficial scheme but also, where the arrangement is one of inter-linked schemes, the frustration of a number of other schemes. The social costs of the negative externalities generated through the reinforcement of rent seeker's voting power under the approach mandating separate classes can be extremely high.

The alternative approach of relying on court discretion to discount votes would be more efficient by a very wide margin in light of: (i) the fact that it hardly incurs any extra costs for controlling minority oppression; and (ii) the inadequacy of the rent-seeking monitoring mechanism under the approach requiring separate classes, which can be socially consequential.

### C Summation

The above analysis shows that: (i) the approach requiring separate classes for wholly owned subsidiaries is moderately more efficient in terms of adjudication costs and marginally more efficient in terms of uncertainty costs; but (ii) the alternative approach of relying on court discretion to discount votes of the subsidiaries at the sanction hearing is clearly more efficient in terms of organisation costs and more efficient by a very wide margin in terms of rent-seeking costs. The latter approach therefore appears to be less costly overall. This view is fortified by a consideration of the centrality of rent-seeking control as an aim of the rules on determining classes. If the main concern of the law of classification is containing oppression, whether by the majority or by the minority, then more weight should be given to rent-seeking properties in assessing classification approaches.

# V THE 'ABILITY TO CONSULT' TEST

## A The Need for the Test

The principle in *Dodd*[90] does not require shareholders or creditors to vote in different groups simply because their rights are dissimilar. It does so only where this dissimilarity makes it impossible for them to consult together.[91] The determination of classes based on minor differences as to rights alone may result in a mushrooming of class meetings, which may make the scheme more susceptible to minority oppression.[92] '[A]ny overzealous subdivision may give a small group a right of veto that would defeat the basic object of the provisions dealing with schemes of arrangement which is to enable large groups to achieve a compromise or effect an arrangement'.[93] The 'ability to consult' principle serves to minimise minority oppression.

## B Establishing the Shareholders' or Creditors' Ability to Consult

### *1 General*

Commenting on the principle in *Dodd* in a 2002 Australian case, Barrett J said:

> The test is thus not one of identical treatment. It is one of community of interest. The court must ask itself whether the rights and entitlements of the different groups, viewed in the totality of the scheme's context, are so dissimilar as to make it impossible for them to consult together with a view to their common interest. The focus is not on the fact of differentiation but on its effects. The extent and nature of the differentiation must be measured in terms of the effect on the ability to consult together in a common interest or, in other words, the ability to come together in a single meeting and to debate the question of what is good or bad for the constituency as a whole and where the common good lies. Only if the differentiation destroys that ability – the word used by Bowen LJ is 'impossible' – does class distinction come to prevail.[94]

On this interpretation, the focus of the possibility to consult test is the *ability* of different groups to consult together, or whether the differentiation, if any, has destroyed the scheme participants' ability to consult together.

### *2 Factual Matrix and Relevance of the Conduct of Claimants*

How is this ability established? If 'ability' here means the actual ability to consult on the part of the shareholders or creditors (claimants), that ability can sometimes be evidenced in the facts of the case. Examples include: (i) that the proposed scheme had unanimous support of all claimants;[95] (ii) that the currency

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90 [1892] 2 QB 573.

91 *Re Hawk Insurance* [2002] BCC 300.

92 Ibid 310 (Chadwick LJ); *TT International Ltd* [2012] 2 SLR 213, 260 [141] (The Court).

93 *Re United Medical Protection Ltd* [2007] FCA 631, [15]. See also *Nordic Bank Plc v International Harvester Australia Ltd* [1983] 2 VR 298, 301 (The Court): 'To break creditors up into classes … will give each class an opportunity to veto the scheme, a process which undermines the basic approach of decision by a large majority'.

94 *Re Hills Motorway Ltd* (2002) 43 ACSR 101, 104 [12].

95 *Re Hawk Insurance* [2002] BCC 300.

conversion formula, which has allegedly resulted in different treatment of sterling and dollar claimants in terms of sizes of dividend payments, was decided by the bondholder committee, which was constituted by representatives of both sterling and dollar claimants;[96] (iii) that the submission by the opposing creditors itself contained an implied concession to the effect that it would be possible for all the relevant creditors to consult together over the issue on dispute;[97] or (iv) where all creditors have given a pre-filing consent, by way of an inter-creditor agreement, on differential treatment of different types of creditors.[98]

### *3 Where Factual Evidence Unavailable*

A decision on the basis of factual evidence is unlikely to be controversial. What can be more vexed is whether the absence of the abovementioned evidence in the factual matrix necessarily leads to a negative conclusion on the ability of different groups to consult. In *Re Apcoa*,[99] Hildyard J answered this question in the negative. In that case, his Lordship refused to let the only two objecting creditors to vote separately. His Lordship held that on the *Re Hawk Insurance* formula, the dissentients' rights against the company did not differ from those of other creditors, adding that even if he was wrong on this analysis, a single meeting process was still justifiable. This was because, on analysis, all the creditors *should be able to* consult together on a 'reasonable and rational person' test.

In *Re Apcoa*, the proposed scheme was vehemently opposed by both dissentients at all three stages of the court process. So it would be hard, one would have thought, to establish the ability of all creditors to consult together in those circumstances. Hildyard J, however, believed that his decision on creditors' ability to consult was justifiable because: (i) there was evidence indicating a strong likelihood that a liquidation of the Group would result in far less overall recovery than if the Group was saved by the proposed restructuring; and (ii) a reasonable and rational creditor acting without extraneous interest would not prefer the prospect of doing proportionately better than other creditors at the expense of doing considerably less well in terms of that creditor's overall

96 *Re Telewest Communications plc* [2004] BCC 342.

97 *Re Nine Entertainment Group Ltd [No 1]* (2012) 211 FCR 439.

98 *Re Perfect Sense Group Ltd* [2007] HKEC 966. There are also examples in the cases where particular claimants, who might otherwise need to be placed in a separate class, agree or undertake not to vote or participate at a single meeting of claimants to ensure that the other claimants at the meeting are able to consult together. The courts have accepted that this is permissible in obviating the need for a separate class meeting: *Re SABMiller plc* [2017] 2 WLR 837; see also *Re Aston Resources Ltd* [2012] FCA 229, [34] (Jacobson J). Furthermore, in Australia, the absence of objection to the constitution of the classes by the Australian Securities and Investment Commission ('ASIC') is also an indicator on the facts that the court may take into account in concluding that the 'ability to consult' test is met in the circumstances. Under *Corporations Act 2001* (Cth) s 411(2), the court must not order scheme meetings unless it is satisfied that, inter alia, ASIC has had a reasonable opportunity to: (i) examine the terms of the scheme and the draft explanatory statement; and (ii) make submissions in relation to the proposed scheme and the draft explanatory statement. On the role of ASIC, see *Re Hills Motorway Ltd* (2002) 43 ACSR 101, 103 [5] (Barrett J); Damian and Rich, above n 4, 281–3 (heading 5.12.1), 417 (heading 8.2.7), 691–2 (heading 14.2.3).

99 [2015] BCC 142.

recoveries.[100] A reasonable and rational creditor in the dissentients' position would therefore be able to consult together with other creditors with a view to their common interest. Their common interest, in the circumstances, would be the improved overall recoveries.

## C The 'Reasonable and Rational Person' Test: An Assessment

### *1 Explicit Objective Standard*

Hildyard J's obiter dicta on this point has made an important contribution towards the law on whether the shareholders or creditors (claimants) are able to consult together. In most of the pre-*Re Apcoa* cases, it would seem that while the courts made their own objective assessments on the claimants' ability to consult through analysis of whether their rights are sufficiently similar,[101] supplemented by subjective evidence on their *actual* ability to consult,[102] the courts have not previously articulated a clear test on how an objective assessment is to be made as to whether the claimants' rights are sufficiently similar such that they are able to consult together. The contribution that Hildyard J made in *Re Apcoa* was to explicitly set out an objective standard, namely the 'reasonable and rational person' test that he put forward in that case.

On Hildyard J's approach, the claimants' ability to consult can be established by considering the ability to consult of *a reasonable and rational person* who is in the objector's position. The problem is whether this objective standard approach should be adopted where there is no evidence on the claim-holders' actual ability to consult, or where available evidence clearly shows a lack of the actual ability to consult on the part of the objector. The answer is that it should be as it makes economic sense. The objective standard approach helps prevent the majority decision from being distorted by rent-seeking behaviour and ensures fair treatment to all.

### *2 Efficiencies of Test in Controlling Strategic Behaviours*

The efficiency properties of Hildyard J's objective test are evidenced in its function to control strategic behaviours. A scheme is a multi-party statutory contract. The transaction cost for the formation of such a contract is positively correlated to the number of parties to such an agreement. 'In a situation where contracts depend on the consent of an increased number of parties, each party has an opportunity to engage in strategic hold-out behaviour, by withholding consent in order to extract the gains from trade'.[103]

In the context of a creditors' scheme to restructure a company in financial distress, there is a chance that the creditors of a given seniority may seek to

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100 Ibid 171 [115]–[116].

101 See for example, *Re Hawk Insurance* [2002] BCC 300, 314–16 [42]–[51] (Chadwick LJ); *UDL Argos* (2001) 4 HKCFAR 358, 373–4 (Lord Millett NPJ); *Re Nine Entertainment Group Ltd [No 1]* (2012) 211 FCR 439, 446–7 [58]–[61] (Jacobson J).

102 See, eg, *Re Hawk Insurance* [2002] BCC 300, 316 [51] (Chadwick LJ); *Re Telewest Communications plc* [2004] BCC 342, 354 [40] (David Richards J); *Re Nine Entertainment Group Ltd [No 1]* (2012) 211 FCR 439, 447 [62] (Jacobson J).

103 Whincop, above n 30, 19–20 (emphasis removed).

extract a share of the debtor company's assets in excess of the legal entitlements. They may, for example, credibly threaten to block a value-maximising scheme unless they are paid a premium.[104] A scheme of arrangement system equipped with mechanisms to de-motivate rent-seeking behaviour will therefore help reduce transaction costs generated by rent-seeking behaviour. The objective test that Hildyard J has adopted is such a mechanism. It functions to deny rent-seekers the opportunity to hold out by using their status as members of a class separate from other claimants.

### *3 Kaldo-Hicks Efficient*

The objective standard test is also Kaldo-Hicks efficient.[105] As Hildyard J found, on evidence, the restructuring option would result in a 'larger cake' for all creditors. In other words, in comparison with an insolvent liquidation, the restructuring option, in the circumstance, is more efficient in the Kaldo-Hicks sense, which says that 'efficiency corresponds to the "size of the pie"',[106] and a decision is efficient 'if it creates more benefits than costs overall'.[107] The objective test that Hildyard J has developed is such a test because it can lead to a positive conclusion on the claimants' ability to consult even if, on a subjective test, all rights-holders may not, as a matter of fact, be able to consult together. Such a positive conclusion should in turn lead to the sanction of a value-maximising scheme where the resolution was passed at a single scheme meeting.

### *4 Pareto Superior*

Hildyard J's objective test is Pareto superior too. 'A state of affairs is Pareto optimal if it cannot be changed without making at least one person worse off, and it is Pareto superior to another state of affairs if it makes at least one person better off and no one worse off'.[108] In the context of restructuring, the state of affairs under the scheme would be Pareto superior to that under the comparator scenario if the scheme makes at least one person better off and no one worse off (as compared to the alternative scenario). Thus, where every claimant would be in a better position under a scheme than in the comparator scenario, the scheme is Pareto superior. An application of Hildyard J's objective test would ensure that minority dissentients could not exercise a veto power through a separate class

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104 J J Quinn, 'Corporate Reorganization and Strategic Behaviour: An Economic Analysis of Canadian Insolvency Law and Recent Proposals for Reform' (1985) 23(1) *Osgoode Hall Law Journal* 1. This appeared to be what Hildyard J suspected the opponents in *Re Apcoa* were trying to do: 'There has been, in my judgment, a whiff of a "hold out creditor" in FMS's conduct: in other words, that FMS has been seeking leverage to obtain an advantage greater than the vindication of its rights': *Re Apcoa* [2015] BCC 142, 171–2 [118].

105 According to the Kaldo-Hicks notion of efficiency, a decision is efficient 'if it creates more benefits than costs overall': Farnsworth, above n 35, 22.

106 A Mitchell Polinsky, *An Introduction to Law and Economics* (Wolters Kluwer Law & Business, 4th ed, 2011) 7.

107 Farnsworth, above n 35, 22.

108 Richard A Posner, 'Norms and Values in the Economic Approach to Law' in Aristides N Hatzis and Nicholas Mercuro (eds), *Law and Economics: Philosophical Issues and Fundamental Questions* (Routledge, 2015) 1, 12.

meeting where the scheme is one that results in a state of affairs where everybody is better off.

### *5 Adjudication Costs*

Given the efficiency properties of Hildyard J's objective test, can a case against that test be made out on the ground of a countervailing cost, such as increased adjudication costs, resulting from the need for the court to undergo an assessment of what a reasonable and rational person would consider? The answer is 'unlikely'. First of all, bar situations where evidence of the claimants' actual ability to consult is readily available, the costs for a decision on the claimants' ability to consult is unavoidable.

More importantly, the cost for the court to assess what a reasonable and rational person would consider is likely to be minimal, as the necessary information, in any case, would have been made available with the help of corporate insolvency professionals and no extra cost will need to be incurred. The hallmark of the common interest of claimants, in the context of a restructuring scheme, it will be remembered, is the improved overall recoveries.[109] Information on the overall recoveries would be readily available, as this item of information must be included in the Explanatory Statement sent to claimants.[110] Where disclosure in this regard in the Explanatory Statement is inadequate, scheme objectors, if any, may issue warnings that are likely to contain the necessary information, and the court may make its decision on the basis of information so provided.[111]

In any event, when considering a sanction application, the court will need to consider, inter alia, whether the scheme is such as 'an intelligent and honest man, who is a member of that class … might approve of it',[112] and in making this judgment the court will need to consider, inter alia, the overall recoveries under the scheme.[113] In other words, the information necessary for an application of the objective test on claimants' ability to consult would need to be made available before the court in any event.

Notwithstanding the cost effectiveness of Hildyard J's objective test, the limitations of this approach should be noted. The 'reasonable and rational person' test is likely to be restricted to situations where it is possible to establish the

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109 See Part V(B)(3).

110 John Marsden and Gaven Cheong, 'Schemes of Arrangement' in Susan Kwan et al (eds), *Company Law in Hong Kong – Insolvency 2014* (Sweet & Maxwell, 2014) 342, 345. For an example, see, eg, DLA Piper Australia and Ferrier Hodgson, 'Explanatory Statement for Scheme of Arrangement under Section 411 of the Corporations Act 2001 (Cth) – Great Southern Managers Australia Limited (in liquidation) ACN 083 825 405' (Publication, 15 December 2015) <https://www.ferrierhodgson.com/au/-/media/ferrier/files/documents/corp-recovery-matters/great-southern-managers-australia-ltd-scheme-of-arrangement/scheme-booklet.pdf>.

111 *Re Ferro Constructions Pty Ltd* (1976) 2 ACLR 18. In Australia, ASIC should also be able to issue such warnings, as before the court makes its order, ASIC: (i) must be given, inter alia, a reasonable opportunity to examine the scheme terms and a draft explanatory statement (*Corporations Act 2001* (Cth) s 411(2)(b)(i)); and (ii) may make submission in relation to the proposed scheme and the draft explanatory statement (*Corporations Act 2001* (Cth) s 411(2)(b)(ii)). See also above n 98.

112 *Re Alabama, New Orleans, Texas and Pacific Junction Rly Co* [1891] 1 Ch 213, 247 (Fry LJ).

113 *Re Interform Ceramics Technologies Ltd* [2001] HKEC 469.

position of a reasonable claimant. One situation where it may be hard to establish the position of a reasonable claimant is one where an insolvent run-off scheme is proposed to, among others, contingent claimants. The position of a reasonable contingent claimant,[114] for example, would be hard to gauge. The utility of the objective test may therefore be limited for this type of scheme, unless and until the position of contingent claimants under a given type of scenario is established by, say, empirical data.

## VI CONCLUSION

The judgment of Chadwick LJ in *Re Hawk Insurance*[115] did much to clarify the legal rules from *Dodd*[116] for determining whether claimants (shareholders or creditors) should be placed in separate classes for the purpose of scheme meetings. Cases subsequent to *Re Hawk Insurance* have attempted to refine further that basic rule. Some of those attempts have given rise to further questions and complexities. In this article, we have sought to analyse those questions from a cost–benefit perspective in assessing whether various approaches suggested in the case law post-*Re Hawk Insurance* should be adopted.

To recap, the three issues from the recent cases analysed are: (i) whether the concept of 'commercially different rights' from *UDL Argos*[117] should be adopted; (ii) whether wholly owned subsidiaries of the scheme proponent should be placed in a separate class even if they hold the same legal rights as other claimants in the class; and (iii) whether the assessment of whether claimants are able to consult together should be made on the basis of a test of the 'reasonable and rational person'.

Our answers to the three issues raised are as follows. Firstly, the concept of 'commercially different rights' is a costly and unnecessary tool for distinguishing different classes. Secondly, there is no need to place, in a separate class, shareholders or creditors which wholly owned subsidiaries of the scheme proponent if the rights, as opposed to interests, of the wholly owned subsidiary are sufficiently similar with the other shareholders or creditors. It is more efficient to leave the matter to the court to determine at the sanction hearing to determine whether the votes of the wholly owned subsidiary need to be

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114 Such as that of the so-called 'incurred but not reported' ('IBNR') claimant under a run-off scheme, whose claim may or may never materialise on a future date: *Re Hawk Insurance* [2002] BCC 200, 311 [35] (Chadwick LJ). 'Run-off' refers to the process of managing accounts and settling claims for an insurance business or investment fund that has stopped accepting new risks, or has been closed to new business. A compromise reached with contingent policy creditors through a scheme allows the company to exchange early payout for cancellation of the company's future and contingent obligations (such as those arising from coverage of diseases caused by asbestos, an example being an obligation owed to employees who have been exposed to asbestos, but in whom the harm has not yet manifested harm): Langley, above n 5, 82; Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart, 2011) 631, 635.

115 [2002] 2 BCC 300.

116 [1892] 2 QB 573.

117 *UDL Argos* (2001) 4 HKCFAR 358.

disregarded or discounted. Thirdly, the reasonable and rational person test that Hildyard J put forward in the *Re Apcoa* case on the shareholders' or creditors' ability to consult is efficient and should be endorsed.

No doubt, future cases will raise further issues on the question of classification of claims for schemes. In our view, the application of a cost–benefit analysis, as illustrated in this article, will assist in determining the appropriateness of specific rules proposed to be adopted.