The Abolition of the 'Headcount Test' for Cayman Islands Members' Schemes of Arrangement: Ensuring Practice Reflects Commercial Reality

Neil Lupton, Partner, Fiona MacAdam, Partner, and Siobhan Sheridan, Associate, Walkers, Cayman Islands

Synopsis

The Cayman Islands continues to be at the forefront of developments in restructuring and insolvency law in the offshore world and one of the premier jurisdictions of choice to facilitate complex and high-value cross-border restructurings.

The Companies (Amendment) Act 2021 (the 'Companies Amendment Act') of the Cayman Islands (which came into force on 31 August 2022) not only introduced the new restructuring officer regime to Cayman Islands legislation[1] but also made certain other amendments to the Cayman Islands Companies Act (as amended) (the 'Companies Act') including, amongst others, the abolition of the statutory 'headcount test' which a Cayman Islands members' scheme of arrangement was previously required to satisfy under section 86(2) of the Companies Act.

This important legislative amendment (the 'Cayman Scheme Amendment') eliminates the technical challenges that the 'headcount test' historically had brought to members' schemes of arrangement in the Cayman Islands (particularly in circumstances where shares of public companies are held by a nominee entity) which are often utilised to effect the privatisation of Cayman Islands incorporated companies that are listed on The Hong Kong Stock Exchange (the 'HKEX').

The Cayman Scheme Amendment has brought Cayman Islands law in line with certain other jurisdictions that have imported schemes of arrangement from English law and now reflects modern commercial reality. This article explains the previous concerns surrounding the historical application of the statutory 'headcount test' which has led to this welcome reform in the Cayman Islands.

Schemes of Arrangement

A Cayman Islands scheme of arrangement is a statutory procedure under the Companies Act which allows a company to enter into a compromise or arrangement with its members or creditors (or any class of them) provided the requisite majority of stakeholders have approved the proposed scheme of arrangement and it has been sanctioned by the Grand Court of the Cayman Islands (the 'Grand Court').

Up until the Companies Amendment Act coming into force, the position was previously that a scheme of arrangement between a company and its creditors and/or shareholders (or any class of them) would bind all affected stakeholders (including any dissenting creditors and/or shareholders) provided that: (i) a majority in number; *and* (ii) 75% in value of each class of stakeholder present and voting (either in person or by proxy) at the court ordered meeting(s), voted to approve the Cayman Islands scheme – often known as the 'headcount test' (or 'majority in number test') and the 'majority in value test', respectively. The removal of the 'headcount test' for members' schemes of arrangement only will provide certainty as to the approval required which will be 75% in nominal value of the members, or class of members, who are present and voting either in person or by proxy at the relevant members' meeting(s) (that is, only the 'majority in value test' applies to members' schemes of arrangement). The 'headcount test' has been retained and will continue to be applicable to Cayman Islands creditors' schemes of arrangement.

Cayman Islands schemes of arrangement are frequently used to implement cross-border and multilevel debt restructurings by varying or cramming down the rights of the relevant creditors and/or shareholders of a company and is an invaluable tool given its flexibility and predictability. A Cayman Islands scheme enables a company to enter into a binding compromise

Notes

1 The new restructuring officer regime is a standalone rehabilitation process which does not require a winding up petition to be first presented in order to obtain the protection of a moratorium. Walkers acted as Cayman Islands legal counsel to Oriente Group Limited and Rockley Photonics Holdings Limited in respect of the very first two successful petitions for the appointment of restructuring officers (appointed by the Grand Court) in November 2022 and in February 2023, respectively.

or arrangement with its creditors and/or shareholders without the need to enter into an individual and separate contract with each and every affected stakeholder and provides companies with a tried and tested mechanism to implement an arrangement where it is not possible or practical to obtain a higher level of consent from stakeholders or a fully consensual deal. As such, they can also be utilised to effect corporate reorganisations, privatisations and acquisitions. A Cayman Islands scheme of arrangement will only become effective in accordance with its terms and binding on the company and all members of the relevant classes (including any dissenting stakeholder and regardless of whether or not they voted) once the Grand Court has sanctioned the scheme and the court sanction order has been filed with the Cayman Islands Registrar of Companies.

The 'headcount test' in its historical context

The Cayman Islands legislation for schemes of arrangement is derived from 19th century English legislation and was first introduced into the Cayman Islands by the Companies Law in 1961 (replicating Section 206 of the English Companies Act 1948).[2]

When schemes of arrangement were introduced in England and Wales (over 100 years ago), members (and creditors) typically held their interests both beneficially and legally, so there was little difference between the persons whose name was entered onto the company's register of members and the person beneficially entitled to such interests. In this historical context, the 'headcount test' prevented a minority shareholder with a large stake prevailing over a majority with a smaller stake (and the 'majority in value test' prevented a numerical majority with a small stake prevailing over the minority with a large stake): in other words, the dual statutory majority tests operated as an appropriate 'check and balance'. As summarised by Brooking J, the dual majority test ensures that '… mere numbers on a count of heads will not carry the day at the expense of the amount invested and on the other hand that the weight of invested money may not prevail against the desires of a sizeable number of investors.'[3]

However, this is no longer the case due to stakeholders' interests often being held beneficially through third parties such as nominees, custodians (such as The Depositary Trust Company in the United States or HKSCC Nominees Limited in Kong Kong), clearing houses or other third parties. As such, any 'headcount test' is unlikely to accurately reflect the wishes of the underlying stakeholders who ultimately hold the real economic interest in the relevant company's shares / equity (if only registered shareholders are considered for such purpose).

For the avoidance of doubt, whilst Cayman Islands law does provide that the Grand Court may 'look through the register' for the purposes of determining whether the relevant statutory majorities have been met and in respect of members' schemes of arrangement, 'the majority in number will be calculated on the basis of the number of clients or members giving instructions to the custodian or clearing house',[4] given the complex arrangements in which shares may be held today, 'looking through' a single layer of ownership – to a custodian or nominee, for example – may be insufficient to determine the views of the economically enfranchised shareholders.

Criticisms of the 'headcount test' in respect of modern members' schemes of arrangement

The 'headcount test' – in the context of modern Cayman Islands members' schemes of arrangement – has been criticised on the following bases:

i) **the headcount test effectively gives minority shareholders the power to 'veto' a Cayman Islands members' scheme of arrangement, notwithstanding its merits**: Practically, the application of the 'headcount test' provides minority members with significant control (effectively a veto) to vote against and prevent the implementation of an otherwise commercially reasonably scheme of arrangement, which has been approved by shareholders with a more significant stake in the equity of the scheme company;

ii) **the extant scheme of arrangement process provides an effective mechanic for the protection of minority shareholders:** The Cayman Islands statutory procedure provides minority shareholders with sufficient protections. In particular, the Grand Court retains the discretion to refuse to sanction any Cayman Islands scheme of arrangement where there is (or may be) an abuse of the minority and further, any person (including any member) who voted at a scheme meeting(s) or gave voting instructions is entitled to appear and be heard at the sanction hearing (that is, the party with a beneficial interest in the shares has the opportunity to bring any matter in respect of the

Notes

2 Section 83 of the Cayman Islands Companies Law 1961.

3 *ANZ Executors and Trustees Ltd. v Humes Ltd* [1990] VR 615 at paragraph 622.

4 Cayman Islands Grand Court Rules 1995 (Revised Edition) (the 'Grand Court Rules'), Order 102, rule 20(6) and see also Practice Direction No. 2 of 2010, paragraph 4.

Cayman Islands scheme of arrangement to the attention of the Grand Court);

iii) **the 'headcount test' is not in line with modern Cayman Islands company law/policy approach to voting:** Modern Cayman Islands company law, as encapsulated in a Cayman Islands company's articles of association, typically provided for shareholder approvals to be calculated on a 'one share one vote' basis (including, but not limited, to ordinary resolutions and special resolutions, and also, the approvals required for statutory mergers and the winding up of companies as set out under the Companies Act). It is not clear, from a policy perspective, why Cayman Islands schemes of arrangement adopt a different approach;

iv) **the 'headcount test' does not reflect how shares are held in the modern Cayman Islands company context:** Notwithstanding the application of the 'look through' in the Cayman Islands, in modern complex ownership structures, such approach does not (necessarily) operate to ensure that votes (at scheme meeting(s)) accurately reflect the views of underlying beneficiaries. Furthermore, the approach is inconsistent with the Cayman Islands law approach in determining the ownership of shares: that is, persons entered onto the register of members of a Cayman Islands company being *prima facie* evidence of ownership; and

v) **the 'headcount test' is at risk of manipulation:** Members may attempt to 'split' their relevant shareholdings across multiple entities or persons in order to manipulate the 'headcount test' in order to acquire a disproportionate level of influence on the outcome of any vote at a scheme meeting the proposed scheme of arrangement.

The Cayman Scheme Amendment and Hong Kong

The Cayman Scheme Amendment has now aligned the position for Cayman Islands incorporated companies with that of Hong Kong incorporated companies in that the statutory 'headcount test' was abolished for schemes of arrangement in Hong Kong in March 2014 when the new Hong Kong Companies Ordinance (Cap. 622) came into force.

The majority of companies listed on the HKEX are incorporated in the Cayman Islands.[5] As such, the removal of the 'headcount' test is a welcome legislative amendment and has brought an end to the technical challenges that would sometimes arise in members' schemes of arrangement that are often utilised to facilitate the privatisation of Cayman Islands incorporated companies listed on the HKEX. The position now is that a members' scheme of arrangement for a Cayman Islands or Hong Kong-incorporated company listed on the HKEX would need to be approved by a majority of 75% in value and must not be opposed by more than 10% in value of independent and/or disinterested shareholders (noting that the relevant requirements under the Hong Kong Takeovers Code would also need to be satisfied).

The implications of the previous application of the 'headcount test' in Cayman Islands members' schemes of arrangement has resulted in a number of privatisation schemes of Hong Kong-listed Cayman Islands-incorporated companies having failed:

1) *In the matter of New World China Land Limited* (Cause No. FSD 33 of 2014 (AJJ)): in March 2014, a Cayman Islands member scheme of arrangement was proposed to effect the privatisation of New World China Land Limited ('NWCL'). 99.84% by value of the shares voted to approve the proposed scheme, however, the scheme failed because the statutory 'headcount test '(that is, the 'majority in number test') was not met: only 34.05% by number of the shareholders were present and voted in favour of the scheme at the scheme meeting. The result being that 0.16% by value of the shares were able to 'block' the implementation of the privatisation of NWCL;[6]

2) *Glorious Property Holdings Limited* (SEHK:845) (Cause No. FSD 149 of 2013 (CQJ)): in January 2014, 58 shareholders holding 96.62% of the shares present and voting at the scheme meeting voted in favour of, and 62 shareholders holding 3.08% of the shares present and voting at the scheme meeting voted against, the proposed scheme resulting in such privatisation scheme failing;[7] and

3) *Dorsett Hospitality International Limited* (SEHK:2266) (Cause No. FSD 125 of 2015 (IMJ)): in September 2015, 42 shareholders holding 97.78% of the shares present and voting at the scheme meeting voted in favour of, and 39 shareholders holding 2.22% of the shares present and voting at the scheme meeting voted against, the privatisation scheme resulting in such privatisation scheme thereby only being marginally approved.[8]

Notes

5 See for example HKEX Fact Book 2021: of the 2,219 companies listed on the HKEX as at the end of 2021, 1,234 were incorporated in the Cayman Islands.
6 See New World China Land Limited announcement dated 16 June 2014.
7 See Glorious Property Holdings Limited announcement dated 17 January 2014.
8 See Dorsett Hospitality International Limited announcements dated 29 September 2015 and 16 October 2015.

In some other privatisation cases, controversies have arisen where share splitting and vote manipulation had or was alleged to have taken place in order to satisfy the statutory 'headcount test' so that a proposed scheme would be approved at the relevant scheme meeting(s).

Approaches in other jurisdictions

A 'modified' approach to the headcount test for members' schemes of arrangement (or the removal of the headcount test entirely) has been adopted in a number of jurisdictions that have imported the English law scheme of arrangement. For example, in Australia, the 'headcount test' for members' schemes of arrangement has been retained but the court has the discretion to dispense with it; and in New Zealand, the applicable legislation does not set out a specific test for approving a members' scheme of arrangement, but provides that shareholders must approve the proposed arrangement, amalgamation or compromise in such manner and on such terms as the court may specify.[9]

Conclusion

The long awaited abolition of the 'headcount test' for members' schemes of arrangement in the Cayman Islands has eliminated the challenges that previously arose in counting members' 'heads' for the purposes of ascertaining whether the relevant voting and scheme approval threshold had been met. The Cayman Scheme Amendment has been welcomed by practitioners not only in the Cayman Islands but also around the world and ensures that the practice for Cayman Islands members' schemes of arrangement now reflects commercial reality.

Notes

9 The headcount test was re-introduced in the context of certain listed entities by the 2014 amendment to the Companies Act, but such statutory requirement only applies to 'code companies': see Section 236A of the Companies Act 1993.