Take-Private Transactions: The Emergence of a New Approach?

The past 5 years has seen changes in the approach to transactions in which companies listed on the Main Board of the Stock Exchange of Hong Kong have been taken private and delisted. Where the share purchase once dominated, the scheme of arrangement has gained favour. In this article, we argue that the change has been driven by developments on the regulatory front and set out the case that we may be at the beginning of a new shift from schemes of arrangement to asset purchases.

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TIMOTHY LOH
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Timothy Loh,
Principal
tloh@timothyloh.com
Hong Kong: +852 2899.0179

Gavin Cumming,
Registered Foreign Lawyer
gcumming@timothyloh.com
Hong Kong: +852 2899.0149

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The year 2006 saw 8 transactions in which a company listed on Main Board of the Stock Exchange of Hong Kong ("**SEHK**") was taken private (whether by a major shareholder or otherwise) and consequently de-listed. Of these 8 transactions, 5 took the form of a scheme of arrangement, 2 took the form of a share purchase and 1 took the form of an asset purchase.

Overview

The 2006 numbers reflect a preference apparent from 2002 onwards in take private transactions towards schemes of arrangement over share purchases. They also suggest the possible beginnings of a new preference towards asset purchases over schemes of arrangement.

To understand the shift in practice in take private transactions from share purchases to schemes of arrangement and the basis for our suggestion that prevailing practice is likely to shift from schemes of arrangement to asset purchases, we review these 3 forms of transaction.

Share Purchase

In a share purchase, a bidder offers to purchase the outstanding shares of the target company not owned by the bidder. Share purchases of companies listed on the Main Board of the SEHK are governed by the Code on Takeovers and Mergers ("**Takeovers Code**") and by the company law of the jurisdiction of incorporation of the target company.

Compulsory Acquisition

In general, in a share purchase, the bidder seeks to acquire such percentage of shares in the target company as would enable him to exercise a statutory right, known as a right of compulsory acquisition, to compel remaining shareholders to sell their shares to him.

The precise nature of the right of compulsory acquisition varies depending on the company law of the jurisdiction of incorporation of the target company. In Hong Kong, the bidder (i) must offer to acquire all the shares of the target company not already held by it on the same terms, and (ii) must in fact acquire 90 per cent. or more of the shares for which the offer is made during the 4 month period beginning on the date of the offer. In this respect:

- under Hong Kong company law, the 90 per cent. threshold applies not to the total shares in the target company but to the shares for which the offer is made; and
- under the Takeovers Code, only shares ("**disinterested shares**") held by shareholders ("**disinterested shareholders**") other than the bidder and his concert parties count towards the 90 per cent. threshold.

Thus, if the bidder already owns 25 per cent. of the shares of the target company, he must offer to acquire and in fact acquire 90 per cent. of the remaining 75 per cent. of the shares of the target company before he can exercise a right of compulsory acquisition.

Mandatory Offers

A possible problem for a bidder in a take private transaction is that the bidder may not wish to commit to buying shares of the target company unless he will be able to exercise a right of compulsory acquisition (*i.e.* unless he is certain that he will acquire at least 90 per cent. of the disinterested shares which are subject to the offer).

However, many companies listed on the Main Board of the SEHK are held by a single majority shareholder. If the bidder enters into an agreement with the major shareholder to purchase shares of the target company which would, upon completion, give the bidder 30 per cent. or more of the shares of the target company (when aggregated with any other shares held by the bidder prior to entering into that agreement), the Takeovers Code prohibits him from making that offer conditional upon 90 per cent. or more of those disinterested shareholders accepting that offer. This is because under the Takeovers Code, when the bidder acquires 30 per cent. or more of the voting control of the target company, the bidder triggers a mandatory general offer.

A mandatory general offer carries a number of restrictions including a restriction that, except with the consent of the Takeovers Executive, it may only be subject to a condition that the bidder hold 50 per cent. of the shares of the target company (including shares acquired both before and during the offer).

Voluntary Offers

In light of inability under the Takeovers Code to establish a 90 per cent. acceptance condition in a mandatory general offer, it is preferable for the bidder to proceed by what is known as a "**voluntary offer**". In a voluntary offer, the bidder may set a 90 per cent. ac-

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ceptance condition and may, at his election, waive that condition.

Significantly, where a major shareholder irrevocably undertakes to the bidder to accept a voluntary offer made by the bidder, the Takeovers Code does not regard the giving of the undertaking as triggering a mandatory general offer. Thus, despite the agreement of the major shareholder to the offer, the offer may proceed as a voluntary offer with a 90 per cent. acceptance condition.

Possibly as a consequence, in both transactions in 2006 which proceeded by share purchase, the major shareholder gave irrevocable undertakings to the bidder to accept the bidder's voluntary offer.

[A] scheme of arrangement must be approved by 75 per cent. of the disinterested shareholders of the target company and no more than 10 per cent. of the disinterested shareholders voting on the scheme may vote against the scheme.

Scheme of Arrangement

In the common form of a scheme of arrangement for a take private transaction, the target company puts forward a proposal for shares of the target company, other than those held by the bidder, to be cancelled in exchange for cash or shares. If the proposal is approved, the bidder will gain 100 per cent. control of the target company.

Like share purchases, such schemes of arrangement are governed by the Takeovers Code and the company law of the jurisdiction of incorporation of the target company.

The precise requirements to effect a scheme of arrangement will depend upon the company law of the jurisdiction of incorporation of the target company but normally, there will be both a shareholder approval requirement and a court approval requirement.

Shareholder Approval

In the case of a Hong Kong company, to obtain shareholder approval for a scheme of arrangement, the following requirements must be satisfied:

- the scheme of arrangement must be approved by 75 per cent. of the disinterested shareholders of the target company; and
- no more than 10 per cent. of the disinterested shareholders voting on the scheme may vote against the scheme.

As with share purchases, for the purposes of voting, the bidder and his concert parties are not regarded as disinterested shareholders.

Court Approval

If the meeting of disinterested shareholders is properly constituted, disinterested shareholders receive a sufficient explanation as to the scheme and its effects and disinterested shareholders approve the scheme, past experience suggests that a court would approve the scheme.

Asset Purchase

In an asset purchase, the bidder purchases the underlying assets of the target company. The cash or other consideration received by the target company from the bidder on the sale of its assets may then be distributed to the shareholders as part of the de-listing of the target company.

Unlike share purchases and schemes of arrangement, asset purchases are governed not by the Takeovers Code but by the Rules Governing the Listing of Securities on the SEHK ("**SEHK Listing Rules**") and by the law of the jurisdiction in which the assets are located or exist. Depending on the law of the jurisdiction of incorporation of the target company, the distribution to shareholders may require a reduction in share capital.

Very Substantial Disposal

Under the SEHK Listing Rules, the disposal by a target company listed on the Main Board of the SEHK of 75 per cent. or more of the value of its assets constitutes a "**very substantial disposal**". A very substantial disposal must be approved by 50 per cent. or more of the shareholders ("**independent shareholders**") excluding shareholders who either have a material interest in the disposal and associates of shareholders who have a material interest in the disposal.

For the purposes of shareholder approval, the major shareholder of the target company may be regarded as an independent shareholder if his interest in the disposal is the same as other shareholders. If however, there are special arrangements between the bidder and the major shareholder, the major shareholder may not be regarded as an independent shareholder.

Connected Transaction

If the bidder is a substantial shareholder of the target company or is otherwise connected to the target company, the disposal may be regarded as a "**connected transaction**" in addition to being a very substantial disposal. As a connected transaction, the bidder and his associates are not regarded as independent shareholders and must abstain from voting to approve the disposal.

Distribution and De-listing

Following the completion of an asset purchase, the target company will normally wish to distribute the sale proceeds to its shareholders. However, once the sale proceeds have been distributed, the target company will have no material assets and, as a consequence, will not normally be eligible for continued listing. It should therefore seek de-listing.

Under the SEHK Listing Rules, de-listing is subject to:

- approval of 75 per cent. or more of the holders ("**minority shareholders**") of shares held other than by (i) controlling shareholders and their associates or, (ii) if there are no controlling shareholders, the chief executive, directors (excluding independent non-executive directors) and their associates;
- no more than 10 per cent. of the minority shareholders voting against the de-listing; and
- minority shareholders being offered a reasonable alternative to the listing.

Significantly, there is no express requirement in the SEHK Listing Rules that an asset purchase be made conditional upon minority shareholders approving de-listing. Indeed in the single asset purchase transaction in 2006, the asset purchase was not conditional on de-listing. Rather, the distribution of the sale proceeds, which constitutes a reasonable alternative to the listing, was made conditional on de-listing so that if minority shareholders did not approve of the de-listing, they would not be entitled to any distribution.

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Reduction of Share Capital

It may be necessary for the target company to reduce its capital to distribute the proceeds of an asset purchase. In the case of a Hong Kong company, a capital reduction is subject to approval of the court and 75 per cent. or more of the shareholders of the target company. For this purpose, the majority shareholder may vote. If the shareholders approve the reduction and appropriate arrangements are made with creditors, court approval is generally a formality.

Share Purchases to Schemes

Based on historical data, it would appear that the scheme of arrangement has gained favour over a share purchase in a take private transactions.

Transactions from 2002 to 2006

From 2002 to 2006, there were 30 take private transactions resulting in de-listing of the target company from the Main Board of the SEHK. Of these, 22 (representing approximately 73 per cent. of transactions) took the form of a scheme of arrangement (including mergers).

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Transactions from 1999 to 2001

In contrast, from 1999 to 2001, there were 16 take private transactions resulting in de-listing of the target company from the Main Board of the SEHK. Of these, 9 (representing approximately 56 per cent. of transactions) took the form of share purchases (including share repurchases).

Hypothesis

We argue that the origins of the shift in dominant practice from share purchases to schemes of arrangement in take private transactions may be traced to regulatory changes in 2001. In effect, we argue that these regulatory changes made schemes of arrangement easier from a regulatory perspective than share purchases. Consequently, bidders have since then preferred more often to pursue schemes of arrangement rather than share purchases.

Amendments to Requirements for Schemes

In 2001, the Takeovers Code was amended so that the shareholder approval requirement in a scheme of arrangement was lowered from 90 per cent. of disinterested shareholders to only 75 per cent. of disinterested shareholders and so that a scheme of arrangement could only be blocked by 10 per cent. of the disinterested shareholders instead of 2.5 per cent. of all shareholders. These amendments made schemes of arrangement easier.

These amendments complemented the natural advantage enjoyed by schemes of arrangement over share purchases as a result of shareholder apathy. In a scheme of arrangement, shareholder approval is based on the number of shares voted in person or by proxy at the shareholder meeting for or against a scheme. Accordingly, where disinterested shareholders are apathetic, there is unlikely to be a strong vote to block the scheme.

In contrast, in a share purchase, where disinterested shareholders are apathetic, there are unlikely to be sufficient acceptances of the share offer for the bidder to exercise a right of compulsory acquisition.

Amendments to Requirements for De-listing

At the same time, in 2001, the SEHK Listing Rules and the Takeovers Code were both amended so that a de-listing could be blocked by 10 per cent. of minority or disinterested shareholders voting against.

These amendments supplemented the requirement that a de-listing of a company listed on the Main Board of the SEHK require 75 per cent. of minority and disinterested shareholders to vote in favour of the de-listing. Prior to the amendments, there was a greater probability that a bidder could successfully threaten to de-list the target company if minority and disinterested shareholders did not accept the share offer. This threat provided a strong economic incentive for minority and disinterested shareholders to accept the share offer as otherwise they would remain shareholders in an unlisted company.

These amendments to the de-listing requirements made share purchases more difficult.

From Schemes to Asset Purchases

The year 2006 saw the first take private transaction in recent history successfully structured as an asset purchase.

The Sunday Privatization

In this case, the bidder, PCCW, acquired a control position in the target company, SUNDAY, as a result of an unconditional share offer at $0.65 per share but did not secure 90 per cent. acceptances of the share offer. As a result, the bidder was unable to exercise a right of compulsory acquisition.

The bidder then attempted a scheme of arrangement at $0.65 per share but dissenting disinterested shareholders of the target company blocked the scheme.

The bidder finally succeeded by structuring the transaction as an asset purchase. Under this structure, the bidder purchased the assets of the target company and offered a distribution of $0.65 per share. The asset purchase was approved by shareholders.

Advantages of Asset Purchases

Assuming the prospects of the target company did not change markedly during the course of these 3 transactions and in light of the market price of the shares as compared to the offer prices, these numbers provide empirical evidence that an asset purchase may be easier than a scheme of arrangement from a regulatory perspective. Based on the regulatory framework, this is expected:

- Asset purchases have lower shareholder approval thresholds than schemes of arrangement.
- Unlike a scheme of arrangement, in asset purchases, a fixed level of independent or disinterested shareholders cannot block the transaction.
- Asset purchases may be easier to leverage in that financiers can take security directly over assets upon completion.

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Projection

If, as we argue, the shift from share purchases to schemes of arrangement in the period from 2002 to 2006 in take private transactions can be explained by lower regulatory hurdles for schemes of arrangement as compared to share purchases, it is probable that bidders may shift from schemes of arrangement to asset purchases in the future as the regulatory hurdles for asset purchases are, in many ways, even lower than those for schemes of arrangement.

In the ideal asset purchase, the target company has no liabilities and a single class of assets, namely the shares of private operating subsidiaries which in turn hold all the assets of the business of the target company.

Practical Challenges in Asset Purchases

This is not to say that asset purchases are necessarily suitable for all take private transactions. Indeed, there is no single appropriate form which is right for all take private transactions. Each transaction brings with it unique individual circumstances.

Most significantly, both schemes of arrangements and asset purchases may only be effected in a friendly bid (*i.e.* with the cooperation of the target company). In the former case, the target company, rather than the bidder, places the scheme of arrangement before the shareholders and the court. In the latter case, the target company must agree to sell its assets.

The Ideal

In the ideal asset purchase, the target company has no liabilities and a single class of assets, namely the shares of private operating subsidiaries which in turn hold all the assets of the business of the target company. In such an ideal asset purchase, the bidder simply purchases the shares of the operating subsidiaries owned by the target company.

Asset Transfer Problems

Asset purchases may become far more complicated where the target company holds a number of operating assets in its own name which must be transferred or where the target company has liabilities of its own.

- Certain key assets (*e.g.* government licenses to carry on a business) may not be transferable to the bidder. Other key assets (*e.g.* shares of public companies) may be transferable only in compliance with burdensome regulatory requirements.
- Certain liabilities attached to key assets (*e.g.* obligations to clients under client contracts) may not be transferable without the consent of third parties and such third parties may be numerous or unwilling to consent.

Tax

The purchase of assets may result in various tax liabilities. For example, the transfer of certain assets may be subject to tax (*e.g.* stamp duty). Equally, for example, the transfer of other assets may result in capital gains or profits taxes for the target company.

Timing and Transparency

The SEHK Listing Rules require the target company to provide information on assets to be transferred depending on the type of assets. These requirements may affect the timing of an asset purchase.

- On the disposal of a business or company, the target company must provide an accountant's report on the target company group which must relate to a financial period no more than 6 months before the circular describing the transaction.
- On the disposal of assets other than a business or a company which are revenue-generating with an identifiable income stream or valuation, the target company must prepare a profit and loss statement and valuation on those assets for the 3 preceding financial years. This statement and valuation must be reviewed by reporting accountants.
- If the assets constitute real property, a valuation must be prepared by appropriate valuers no more than 3 months before the circular describing the transaction.

Newly Listed Target Companies

Target companies who have only recently been listed on the Main Board of the SEHK may be subject to restrictions on the disposal of their assets under SEHK Listing Rules in addition to the requirements set out in this article.

TIMOTHY LOH, SOLICITORS serves as Hong Kong and International Legal Counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.

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