Takeovers Panel upholds ruling on offer for L&A International

12 Oct 2016

The Takeovers and Mergers Panel (Takeovers Panel) has upheld the ruling of the Takeovers Executive (Note 1) in relation to an offer for the shares of L&A International Holdings Limited.

On 22 July 2016 Favourite Number Limited (the offeror) informed L&A's board of directors that it intended to make an offer for the shares of L&A with a combination of cash and securities as consideration. It subsequently came to light that in early July a concert party of the offeror had dealt in L&A shares prior to the approach. As a result the Takeovers Executive required the offeror to match the terms of its offer so that the consideration offered for each L&A share would have a value of at least equal to the highest purchase price paid by the concert party. The offer was publicly announced on 18 August 2016 on this basis.

Subsequently, L&A made an application requesting the Takeovers Executive to rule that the offer did not comply with the Code on Takeovers and Mergers (Takeovers Code) and should be altered so that the consideration offered to shareholders reflected the same ratio of cash to securities as contained in the offeror's earlier private letter to L&A's board. The Takeovers Executive ruled that the consideration offered already complied with the Takeovers Code as the purchases were made before the terms of the offer had been publicly announced (Note 2). L&A applied to the panel to review the ruling.

On 22 September 2016 the panel met to consider the matter and upheld the Takeovers Executive's decision and concluded that there is no basis to alter the offer in the way as requested by L&A. The panel agreed with the Takeovers Executive's ruling that the requirement to maintain the same ratio of cash to securities as requested by L&A only arises under the Takeovers Code if a concert party has purchased shares after the formal announcement of an offer.

The Takeovers Panel's decision can be found in the "Takeovers and Mergers Panel and Takeovers Appeal Committee decisions and statements" section on the SFC's website.

End

Notes:

1. The Executive Director of the SFC's Corporate Finance Division or his delegate.
2. Under Rule 24.2 of the Takeovers Code, if an offer involves a combination of cash and securities and further purchases of the offeree company's shares oblige the offeror to increase the value of the offer, the offeror must endeavour, as far as practicable, to effect such increase while maintaining the same ratio of cash to securities as is represented by the offer.

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TAKEOVERS AND MERGERS PANEL

Panel Decision
in relation to the interpretation of Rule 24.2 in the
context of the offer for the shares in, and the share options of,
L&A International Holdings Limited (the "Offeree Company")

Purpose of the hearing

1. The Takeovers and Mergers Panel (the "Panel") met on 22nd September, 2016 to consider an application by the Offeree Company under Section 9.1 of the Introduction to the Codes on Takeovers and Mergers and Share Buy-backs (the "Takeovers Code") for a review of the Takeovers Executive's ruling that Rule 24.2 did not apply to the offer by Favourite Number Limited (the "Offeror") for the shares in, and share options of, the Offeree Company announced on 18th August, 2016 and 12th September, 2016 of 57 new shares in WLS Holdings Limited ("WLS") and HK$5.60 in cash for every 400 shares in the Offeree Company and 8 new shares in WLS and HK$0.7775 in cash for every 100 outstanding share options of the Offeree Company.

Background and facts

2. On 22nd July, 2016 the Offeree Company received a letter from the Offeror informing the board of its intention to make a voluntary conditional offer to acquire all the issued share capital of the Offeree Company on the basis of one share in WLS and HK$0.28 in cash for every 20 shares in the Offeree Company. This letter stated that the offer would be conditional upon, among others, the approval of the shareholders of WLS of the offer and the Offeror having acquired not less than 50% of the voting rights of the Offeree Company during the offer period in respect of the offer. The letter also noted that its contents were strictly confidential and should not be made public without the consent of the Offeror.

3. Subsequently, on the same day, the Offeror sent a second letter to the Offeree Company confirming that the Offeror was held as to 47% by WLS and 53% by Mr. Hue Kwok Chu, Raymond.

4. According to the financial adviser of the Offeree Company, on the same day in advance of the receipt of the first letter from the Offeror, the Offeree Company held a board meeting at which it was resolved to grant options in respect of 2,000 million shares in the Offeree Company, of which options in respect of 1,800 million shares were accepted. The grant of options was only announced a month later on 22nd August, 2016.

5. On 26th July, 2016, the Offeror sent a further letter to the Offeree Company reiterating its firm intention to make the offer referred to in its first letter and reminding the Offeree Company of its obligations under the Takeovers Code to take no action to frustrate the offer [General Principle 9 and Rule 4].

6. On 28th July, 2016, the Offeree Company published a holding announcement referring to the intended offer as a "purported" possible offer and stating that, based on the advice of its financial adviser, the board of the Offeree Company did not view the offer as a bona fide offer

because the Offeror had not satisfied the Offeree Company that it had available resources to carry out the "purported" possible offer in full and such offer was subject to unspecified conditions. The Offeree Company had wanted to publish the terms of the "purported' possible offer in its holding announcement but the Takeovers Executive did not permit this disclosure in accordance with the guidance it had published in its Takeovers Bulletin, Issue Number 37, of June, 2016. The offer period, as defined by the Takeovers Code, commenced on the publication of this holding announcement.

7. Also on 28th July, 2016, the financial adviser of the Offeror informed the Takeovers Executive that on 6th July, 2016, being within three months before the commencement of the offer period, Mr. Yuen Chun Fai ("Mr. Yuen"), a director of WLS and at the time a director of the Offeror, had purchased 440,000 shares in the Offeree Company at a price of HK$0.058 and sold them on the same day at HK$0.039, incurring a loss of HK$8,360 and applied for a ruling that these purchases be considered irrelevant in the determination of the offer price.

8. On 11th August, 2016, the Takeovers Executive issued a ruling confirming that, as Mr. Yuen was regarded as a party acting in concert with the Offeror as he was one of its directors, the purchase would not be regarded as irrelevant. In this regard the relevant rule of the Takeovers Code applied by the Takeovers Executive was Rule 24.1(a)(i), read in conjunction with Note 6, and not Rule 23. Accordingly, the Takeovers Executive required the Offeror to match the terms of its offer to give effect to Note 6 of Rule 24 so that its value per share in the Offeree Company would be no less favourable than HK$0.058. As the intended offer comprised shares in WLS and cash, the Takeovers Executive noted that it *"would be concerned to see that the price per share at which the securities are valued in the calculation of the consideration is not affected by undue movements in price or volume of trading in the securities. If there has been any such undue movement in the period leading up to such an announcement, the [Takeovers] Executive may require the consideration to be adjusted or re-calculated"*

9. On 15th August, 2016, the Takeovers Executive issued at the request of the Offeree Company a "put up or shut up" ruling and directed that the Offeror must either announce its intention to make an offer under Rule 3.5 of the Takeovers Code or announce a decision not to proceed with an offer by 5:00 p.m. on 18th August, 2016.

10. On 18th August, 2016, the Offeror made its announcement of its firm intention to make an offer in accordance with Rule 3.5 of the Takeovers Code. On the same day the financial adviser of the Offeree Company informed the Takeovers Executive that in its opinion the offer did not comply with Rule 24.2.

11. On 22nd August, 2016, the Offeree Company announced the grant of the share options referred to above, of which 1,600 million options had already been exercised into shares in the Offeree Company.

12. On 31st August, 2016 the financial adviser of the Offeree Company submitted the application for the ruling made on 5th September, 2016 which was the subject of the Panel's hearing.

13. On 2nd September, 2016, the Takeovers Executive issued a second "put up or shut up" ruling setting a deadline of 14th September, 2016 for the Offeror either to proceed with the offer or to announce that it would not proceed. On the same date, at the insistence of the Takeovers Executive, the Offeror announced that it would extend its offer to include the new shares in the Offeree Company issued upon the exercise of share options and the outstanding share options.

14. On 12th September, 2016, the Offeror published a supplemental announcement under Rule 3.5 confirming its intention to proceed and extending the offer to cover the share options and newly issued shares following the exercise of share options.

The relevant provisions of the Takeovers Code and other relevant information

15. It is accepted that the commitment to proceed with an offer under the Takeovers Code commences when a Rule 3.5 announcement is made of a firm intention to make an offer. Properly, this announcement can only be made by the Offeror or with its explicit approval. The introductory paragraph of Rule 3.5 reads as follows:

    "The announcement of a firm intention to make an offer should be made only when an offeror has every reason to believe that it can and will continue to be able to implement the offer. Responsibility in this connection also rests on the financial adviser to the offeror."

16. Once a Rule 3.5 announcement had been made, an offeror is committed to make that offer, other than in the most exceptional circumstances. There is a central concept underpinning the Takeovers Code that, when an offer is announced, shareholders and the market generally can be confident that it will be implemented subject to the fulfilment of any condition. This also reinforces the importance of the financial sufficiency statement confirming an offeror's ability to finance full acceptance of its offer, which confirmation is contained in a Rule 3.5 announcement. Rule 5 sets out the requirement that, once announced, an offer cannot be withdrawn and this is stated as follows:

    "When there has been an announcement of a firm intention to make an offer, except with the consent of the Executive, the offeror must proceed with the offer unless the offer is subject to the fulfilment of a specific condition and that condition has not been met."

17. In the period before a firm intention to make an offer is announced, there may be circumstances when an announcement is required. Such an announcement does not commit a potential offeror to make an offer, however as a matter of practice, if terms are announced, this provides a floor to the price of any offer which may be made subsequently. These requirements are set out in Rule 3.7, which states the following:

    "Until a firm intention to make an offer has been notified a brief announcement by a potential offeror or the offeree company that talks are taking place or that a potential offeror is considering making an offer will normally satisfy the obligations under this Rule 3. If following the announcement of a possible offer no further announcement has been made in respect of that offer or possible offer within one month, an announcement must be made setting out the progress of the talks or the consideration of a possible offer. This obligation continues (and announcements will be required monthly) until announcement of firm intention to make an offer under Rule 3.5 or of a decision not to proceed with an offer. When talks are terminated or a potential offeror decides not to proceed with an offer an announcement must be made to that effect."

18. In response to an increasing trend for "talks" announcements to be made, the Takeovers Executive published guidance on when Rule 3.7 announcements are required and what they should contain in Issue 37 of its Takeovers Bulletin of June, 2016. The relevant paragraphs of this guidance read as follows:

    "In general, when parties are in negotiation and until a firm intention to make an offer is announced under Rule 3.5, it is vitally important that parties maintain confidentiality in compliance with Rule 1.4. If confidentiality is maintained, there should not be a need to issue a "talks" announcement as the obligation to make an announcement under the other provisions of Rule 3 should not arise. This should also apply if the board of directors of the subject offeree company has been approached about, or informed of, a possible offer (including a possible privatisation proposal) which is being contemplated or negotiated. As such, when parties and their advisers or the subject offeree company are deciding whether to issue a Rule

3.7 announcement, they should carefully consider whether such an announcement is required to be made.

In the event that the obligation to make a Rule 3.7 announcement arises, [the Takeovers Executive] would normally expect the announcement to be relatively short and to disclose no more than the fact that talks are taking place. In cases where the board of directors of the subject offeree company has been informed of the indicative offer price and/or the form of consideration, [the Takeovers Executive] would not normally find it acceptable for such information to be disclosed in the Rule 3.7 announcement. This is because the possible offer (or whitewash transaction) is still in the negotiation stage and may not materialise, and parties are under as obligation to keep such information confidential until a firm intention to make an offer is announced."

19. Rule 24 and its Notes set out the requirements of the Takeovers Code in connection with purchases resulting in an obligation to offer a minimum consideration. For the purpose of determining the present matter the most pertinent Rule is 24.1(a)(i) read together with Note 6. However, for completeness, the whole of the Rule 24.1 is set out, together with Note 6.

(a) Purchases before a Rule 3.5 announcement

Except with the consent of the Executive in cases falling under paragraph (i) or (ii) below, when an offeror or any person acting in concert with it has purchased shares in the offeree company:–

(i) within the 3 month period prior to the commencement of the offer period;

(ii) during the period, if any, between the commencement of the offer period and an announcement made by the purchaser in accordance with Rule 3.5; or

(iii) prior to the 3 month period referred to in (i), if in the view of the Executive there are circumstances which render such a course necessary in order to give effect to General Principle 1,

the offer to the shareholders of the same class shall not be on less favourable terms.

(b) Purchases after a Rule 3.5 announcement

If, after an announcement made in accordance with Rule 3.5 and during the offer period, the offeror or any person acting in concert with it purchases shares in the offeree company at above the offer price (being the then current value of the offer), then the offeror must increase the offer to not less than the highest price (excluding stamp duty and dealing costs) paid for any shares so acquired.

Purchases of shares in the offeree company may also give rise to an obligation under Rule 23. Where an obligation is incurred under Rule 23 by reason of any such purchases, compliance with Rule 23 will normally be regarded as satisfying any obligations under this Rule 24 in respect of those purchases."

20. In this matter, Rule 23 was not considered relevant in relation to Mr. Yuen's purchase. Since the matter could be dealt with satisfactorily under Rule 24.1(a)(i), there was no issue that Rule 23 had to be invoked to give effect to General Principle 1 of the Takeovers Code [Even-handed and similar treatment of shareholders].

21. The relevant part of Note 6 reads as follows:

"For the purpose of Rule 24.1(a), except where Rule 26 (mandatory offer) or Rule 23 (requirement for cash offer or securities offer) applies, it will not be necessary to make a cash offer available even if shares have been purchased for cash. However, any securities offered as consideration must, at the date of the announcement of the firm intention to make the offer, have a value at least equal to the highest relevant purchase price. The proposed consideration should be discussed with the Executive, which will be concerned to see that the price at which the securities are valued in the calculation of the consideration is not affected by undue movements in price or volume of trading in the securities. If there has been any such undue movement in the period leading to such an announcement, the Executive may require the consideration to be adjusted or re-calculated so as to exclude, so far as practicable, the effects of the undue movement."

It should be noted that Note 6 requires an offer with "a value at least equal to the relevant highest price", it does not set out the form the offer should take and, in particular, does not require a cash offer.

22. Rule 24.2 was added to the Takeovers Code following the application to the Takeovers Committee, the predecessor of the Panel, seeking guidance on the value to be ascribed to shares in a securities exchange offer and how would further purchases be treated when the consideration took the form of new shares in a listed company and cash. The decision was published on 11th August, 1990 and concerned the offer by Swilynn International Holdings Limited ("Swilynn") for Teletech International Holding Limited which took the form of shares in Swilynn and cash. Rule 24.2 states the following:

"For the purposes of this Rule 24, if the offer involves a further issue of securities of a class already listed on the Stock Exchange, the current value of the offer on a given day should normally be established by reference to the weighted average traded price of board lots (excluding special bargains and odd lots) of such securities traded during the immediately preceding trading day. If the offer involves a combination of cash and securities and further purchases of the offeree company's shares oblige the offeror to increase the value of the offer, the offeror must endeavour, as far as practicable, to effect such increase while maintaining the same ratio of cash to securities as is represented by the offer."

23. While the London City Code and the decisions of the London Panel do not necessarily establish precedents for our Takeovers Code, the Takeovers Code was originally derived from the London City Code and follows it closely. Therefore, there are times when the London City Code can give a useful insight into how the Takeovers Code should operate when the Takeovers Code is not explicit on a point. The London City Code has no equivalent of Rule 24.2, which is peculiar to Hong Kong. Note 3 to Rule 2.5 in the London City Code which is headed "Terms and pre-conditions in possible offer announcements" sets out who is responsible for making announcements and the binding nature of them. Note 3 states the following:

"Any statement made by the offeree company in relation to terms on which an offer might be made must be made clear whether or not it is being made with the agreement or approval of the potential offeror. When the statement is made with the agreement or approval of the potential offeror, the statement will be treated as one to which Rule 2.5(a) applies [a statement made and not withdrawn immediately is binding] in the same way as if it had been made by the offeror itself. Where it is not so made, the statement must also include a prominent warning to the effect that there can be no certainty that an offer will be made, nor as to the terms on which any offer will be made."

The case of the Offeree Company in summary

24. The basic contention of the Offeree Company was that Rule 24.2 applied equally to Rule 24.1(a) and (b) and that the Takeovers Executive had interpreted Rule 24.2 too narrowly by taking the meaning of "further" purchases to apply only when a Rule 3.5 announcement had been made. If the Rule applied also to the circumstances covered by Rule 24.1(a), it would follow that it covered offers which had not been announced in accordance with Rule 3.5.

25. The Swilynn precedent was irrelevant to the present matter as the circumstances of that matter clearly fell under Rule 24.1(b).

26. The offer to which Rule 24.2 related in this case was the offer conveyed to the board of the Offeree Company on 22nd July, 2016. It did not matter that the terms of that offer were not known by all shareholders, although the Offeree Company's directors in their capacity as shareholders certainly knew. While the Offeree Company was sceptical about the offer the Offeror had made, this related primarily to its ability to finance the offer. In any event, the Offeree Company in its holding announcement had tried to set out the terms of the offer and had been prevented from doing so by the intervention of the Takeovers Executive.

27. The Offeree Company was not to blame for the purchases made by Mr. Yuen and the Offeror had to bear the consequences of such purchases which had required its offer to be increased following the revelation of those purchases. The proper application of Rule 24.2 would require the same balance between cash and shares in WLS as the original offer. That it had not, meant that the shareholders of the Offeree Company were being denied an aggregate amount of between HK$78 million and HK$92 million, which is what they should receive under the proper application of Rule 24.2.

The case of the Offeror in summary

28. Rule 24.2 clearly applies to further purchases after an offer was announced. Mr. Yuen's purchases were made before any offer was announced or even before an initial approach being made. Manifestly, Rule 24.2 cannot apply.

29. The Offeror had complied with Rule 24 in that the purchases made in advance of its offer had resulted in the value of the offer being set at a minimum as calculated with reference to Note 6. That must be sufficient to comply fully with the requirements of Rule 24 of the Takeovers Code.

The case of the Takeovers Executive in summary

30. Rule 24.2 does not apply in this case. The Rule was introduced to deal with a set of circumstances which does not apply in this matter. It requires two conditions to be met, before it can operate, neither of which requirements are met.

31. Rule 24.2 only applies when the terms of the offer have been announced to shareholders and are in the public domain and hence can be relied upon by the investing public. This is consistent with the fact that the Takeovers Code does not bind a potential offeror to statements contained in a private approach letter, even if the letter states that the offeror has a firm intention to make such an offer. There is no reference in the Rule to an approach or to the situation as it applies before an offer is formally announced.

32. Secondly, Rule 24.2 only applies to "further" purchases: that is, purchases made after an offer has been announced. The word "further" should be given its natural meaning and should not be extended to cover purchases made before the commencement of an offer period or even before an offer was in contemplation.

33. In this case, the purchases were made before the offer period commenced and the announcement of a firm intention to make an offer in compliance with Rule 3.5 which would commit the Offeror to proceed with its offer.

34. The time when a potential offeror is bound to proceed with its offer is consistent with the London City Code when an offeror is bound only by announcements made by it or approved by it. The Guidance issued in June, 2016 in relation to Rule 3.7 announcements also follows this logic by requiring announcements by a potential offeree company to be brief and not to contain the terms of an offer which has yet to be announced by the offeror and may never eventuate.

35. The fact that some directors who were also shareholders, in their capacity as directors, knew about the intended offer cannot be taken as evidence that the offer was announced or that it was generally known and the details of it could be relied upon by shareholders and the investing public.

36. When asked, the Takeovers Executive agreed that the Takeovers Code attempts to create conditions of certainty with regard to an offer in the interests of not only shareholders and the investing public but also the offeror. This is why Rule 3.7 provides for a warning statement which informs the market that a company may be in play. That is all it is doing. When a Rule 3.5 announcement is made then the need for certainty starts to operate as the offeror is now bound to proceed with the offer and all of the terms and conditions of the offer are in the public domain. There are other General Principles and Rules which encourage certainty, of which the Takeovers Executive specifically cited General Principle 3 [Providing information equally to all shareholders], General Principle 6 [Prompt disclosure], Rule 5 [No withdrawal] and Rule 8 [Timing and contents of documents].

The Panel's decision and reasons for it

37. Given the way Rule 24.2 is worded and the circumstances it was designed to address, Rule 24.2, and in particular the second part of the Rule, cannot apply in normal circumstances when no offer has been formally announced as in the present case. For the second part of the Rule to operate there must be an offer which has been announced publicly in accordance with the requirements of the Takeovers Code and this would normally be when a Rule 3.5 announcement had been published. In addition, the clear meaning of "further purchases" must refer to purchases made subsequently to the formal announcement of an offer.

38. It is important also that there is a clear acknowledgement exactly when an offeror is committed to making an offer and when the full disciplines of the Takeovers Code which are designed to encourage conditions of certainty apply to it. It is apparent that the private letter to the Offeree Company's board of directors containing terms of an offer which the Offeror stated it had a firm intention to make did not constitute a binding obligation to proceed under the Takeovers Code. The Offeror could have withdrawn its proposal or proceeded with a different one. Only after it had made its Rule 3.5 announcement on 18th August, 2016 was the Offeror bound to proceed with its offer. This was several weeks after the purchases of shares in the Offeree Company made by Mr. Yuen which had placed a minimum value on the offer.

39. In these circumstances, the Panel finds that there is no basis through the application of Rule 24.2 to alter the Offeror's offer which has been made in full compliance with Rule 24.1(a)(i).

7th October, 2016

Parties:

The Takeovers Executive

L&A International Holdings Limited – advised by Yu Ming Investment Management Limited and Hastings & Co.

Favourite Number Limited – advised by VBG Capital Limited (advised by David Norman & Co.) and Leung & Lau, Solicitors