

## Hong Kong Public M&A: Time for a New Approach?

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For any potential bidder considering the acquisition of a listed company, issues such as ease of transaction execution, the ability to respond to a competing offer, timetable and cost will be of great importance. The chosen form of legal process to implement such deals can have a considerable impact on their successful, cost-effective and timely completion.

The Hong Kong public market is characterized by a significant number of companies listed on the Hong Kong Stock Exchange (HKSE) that, often for reasons of historical family ownership, have one or a small number of controlling shareholders. It is not unusual for these shareholders to seek (or agree to support a third party's attempt to acquire) 100 percent control of the business and delist the company. These transactions are commonly referred to in Hong Kong as "privatizations."

Another notable feature of the Hong Kong market is the large number of companies listed on the HKSE that are incorporated overseas, in particular the Cayman Islands, although the underlying business operations often are conducted from the People's Republic of China (PRC). Of the 1,368 companies listed on the HKSE's Main Board at the end of 2012, 535 were incorporated in the Cayman Islands.

Takeover offers (offers) and schemes of arrangement (schemes) have been the traditional preferred structures for executing successful privatizations in Hong Kong. However, in other markets, acquirers increasingly are taking advantage of statutory merger processes, including in the United States for take-private transactions. These procedures are available under local law in jurisdictions such as the Cayman Islands and can be utilized when a listed company is incorporated there. Given the advantages a statutory merger process provides to a bidder, it may be time for Hong Kong market participants to use this vehicle.

### The Appeal of Cayman Statutory Mergers<sup>1</sup>

The statutory merger process that has been available under Cayman law since 2009 provides a relatively straightforward mechanism whereby two or more companies can merge, with all rights and property of each of the merging companies vesting in a surviving company that also assumes all of their obligations. The procedure is available where the merging companies are both incorporated in the Cayman Islands or where a Cayman company wishes to merge with an overseas company from a jurisdiction that permits such a deal.

**Requirements.** In addition to obtaining board approval, the merger must be approved by the shareholders by a special resolution. Amendments to the relevant Cayman legislation in 2011 had the beneficial effect of reducing the voting threshold for such a resolution from a three-quarters to a two-thirds majority of the present and voting shareholders (subject to any higher threshold required in the target's articles of association). Dissenting shareholders usually have the right to have the fair value of their shares appraised by a court, although the exercise of these appraisal rights would not

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affect or delay the merger's implementation (subject to the conditions in the merger agreement). Moreover, it is doubtful whether a court would choose to intervene in a transaction involving cash consideration at a level above the target's pre-announcement trading price that had been approved by the target's independent directors (where an independent financial advisor had opined on the fairness of the consideration) and the requisite majority of shareholders.

**Advantages Compared to Schemes and Offers.** From the perspective of a bidder wishing to take 100 percent control of a target company incorporated in the Cayman Islands, the statutory merger process has a number of advantages compared to the typical schemes and offers used in Hong Kong privatizations, including:

- **Lower approval threshold.** The two-thirds approval threshold for a merger compares favorably with the 90 percent threshold for acceptances that is required to enable the offeror to acquire compulsorily, or "squeeze out," any remaining minority shareholders. It also compares favorably with the voting thresholds required to approve a scheme, which are a majority in number of shareholders who vote (*i.e.*, a majority on a "headcount" basis) that collectively represents at least 75 percent in value of the shares voted.
- **Ability to vote.** In the case of a merger, all shareholders are entitled to vote on the proposed transaction, including a controlling shareholder who is proposing to acquire overall control of the target. As described below, this technique has been used in the case of many recent take-privates of U.S.-listed, China-based companies. Under Cayman law, such a person typically would not participate in a vote to approve a scheme, and his or her shares typically would not count toward the acceptances required to exercise squeeze-out rights following an offer.
- **No formal court process.** Unlike a scheme, a Cayman Islands statutory merger does not require court approval, so the significant timing and cost implications associated with the court process can be avoided. Although timing can vary according to a number of factors, a merger can be completed within a two- to three-month timeframe, which is quicker than the normal timetables for a scheme or offer (including the implementation of the squeeze-out process). Additionally, the absence of a formal court process may provide a bidder with greater flexibility to respond in a timely manner to a competing unsolicited offer than would be the case with a scheme. It also means that dissenting minority shareholders and other third parties such as creditors are not provided with the forum of a court hearing, which they might use to hinder, delay or prevent the implementation of the transaction (although, in a merger, shareholders have the aforementioned appraisal rights).
- **Streamlined voting requirements and process.** The use of a merger avoids practical difficulties that can arise with the "headcount" part of the shareholder voting requirement for schemes under Cayman law, particularly where the target company has a small number of registered shareholders (*e.g.*, where a registered shareholder holds on behalf of a large number of beneficial holders, such as CEDE & Co. for U.S.-listed companies and HKSCC Nominees Limited for Hong Kong-listed companies). Where the target company has a significant number of U.S. shareholders, the use of a merger will avoid the application of the U.S. tender offer rules, which may be viewed by some non-U.S. acquirers as being somewhat complex.
- **Lower costs.** A merger may provide savings in stamp duty relative to an offer.
- **Preferable to finance providers.** From the perspective of debt finance providers, the statutory merger process provides a relatively simple path to 100 percent control of the target company and the ability to take security over its assets (although if the target's assets are largely held in the PRC, taking security can be difficult).

## U.S. Take-Privates Versus Hong Kong Privatizations<sup>2</sup>

In recent years there has been a sharp increase in the number of take-private transactions involving businesses based in mainland China with a listing on a U.S. stock exchange. These transactions typically involve a major shareholder, often the founder of the business, taking the company private along with one or more private equity investors. In many cases, the listed holding company is incorporated in the Cayman Islands or a similar jurisdiction; thus, these transactions have many features in common with a typical Hong Kong privatization.

However, unlike Hong Kong privatizations, in recent years U.S. take-privates increasingly have been implemented by a statutory merger process rather than by way of offer or scheme. A survey of a group of 21 agreed take-private deals announced between 2010 and January 2013 involving Chinese businesses with a U.S.-listed Cayman Islands or British Virgin Islands holding company indicates that 20 of these transactions were proposed to be implemented by a statutory merger, and one was proposed to be implemented by way of a scheme.

By contrast, a review of a group of 31 Hong Kong privatizations completed since 2008 indicates that 19 were implemented by a scheme and the remaining 12 were implemented by an offer. Although in 13 of these transactions the target was incorporated in the Cayman Islands, none of these deals were implemented by a statutory merger. Anecdotal evidence supports the view that there have been no privatizations of Hong Kong-listed companies incorporated in a Commonwealth jurisdiction by way of merger.

This apparent reluctance to use mergers in Hong Kong privatizations is made more curious by the fact that there are precedents for the successful privatization of PRC companies with “H Shares” listed on the HKSE by a merger by absorption under PRC law. For example, Sinopec’s privatizations of Beijing Yanhua in 2005 and of Zhenhai Refining & Chemical Company in 2006 were both implemented this way.

### The Hong Kong Takeovers Code (Code)

Although there are advantages to privatizing a HKSE-listed company by statutory merger, the Code, which is implemented by the Hong Kong Securities and Futures Commission (SFC), can present challenges.

The Code’s primary purpose is to afford fair treatment for shareholders who are affected by change-of-control transactions, including by requiring enhanced levels of shareholder support, incremental to the requirements of applicable corporate law, for a bidder to exercise squeeze-out rights following an offer and for a scheme to be approved. In the former case, squeeze-out rights may only be exercised if, in addition to satisfying any requirements of applicable law, the offeror has acquired (*i.e.*, by way of acceptances of the offer and/or market purchases) at least 90 percent of the “disinterested” shares in the target within four months after posting the initial offer document. In the case of a scheme, Rule 2.10 of the Code requires that the scheme must:

- be approved by at least 75 percent in value of the votes cast by disinterested shareholders; and
- not be opposed by more than 10 percent of the votes of all disinterested shareholders.

For these purposes, disinterested shareholders are those in the target other than the offeror and persons “acting in concert” with it.

It seems likely that the SFC would apply these voting requirements to a merger involving a company listed on the HKSE, which would have the effect of depriving a bidder of a couple of the principal

<sup>2</sup> The data in this section was culled from the HKSE, Mergermarket and SEC websites.

advantages of utilizing a merger process, namely the lower voting threshold applicable to a merger and the ability of a controlling shareholder seeking to privatize the target (or who is acting in concert with the bidder) to participate in the merger vote.

Indeed, this approach was adopted in the privatizations of the PRC “H Share” companies that were implemented by a merger by absorption referred to above. Under PRC law, these mergers only required the approval of two-thirds of the shareholders voting. However, given that the Code applied to these transactions, it also was necessary for the enhanced voting requirements of Rule 2.10 to be satisfied for these mergers to be approved.

An additional consideration is that under the HKSE’s Listing Rules, if a listed company is privatized by way of a scheme or capital reorganization and the shareholder approval requirements of the Code are complied with, the target’s listing on the HKSE may be withdrawn without the separate shareholder vote that otherwise would be needed. There appears to be a good basis for arguing that a merger approved in accordance with Rule 2.10 should be regarded as akin to a scheme or a capital reorganization for these purposes, so that no separate shareholder vote should be required to approve the delisting.

### **Conclusion**

A lack of familiarity with the Cayman Islands merger process among Hong Kong practitioners and market participants could explain the absence of this vehicle’s use in Hong Kong privatizations. Despite the drawbacks related to Rule 2.10 compliance, many of the advantages of Cayman Islands statutory mergers, including speed, reduced cost and flexibility, still would be available for such transactions. With this in mind, it may be time for the Hong Kong market to consider taking advantage of this relatively attractive and streamlined process for privatizations.