

Hong Kong Takeovers Panel Invalidates Whitewash Waiver Granted to Alibaba

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The recent decision of the Hong Kong Takeovers and Mergers Panel (the Panel) in relation to Alibaba Health Information Technology Limited (formerly CITIC 21CN Company Limited (21CN)) has reemphasized the fundamental importance of the principle of equality of treatment of shareholders under the Takeovers Code. The ruling also highlights the close scrutiny any arrangement between an offeror and a target shareholder that might constitute a “special deal” in the context of a takeover or merger transaction will receive from the Hong Kong regulators, and sheds light on the Panel’s approach to some important issues relating to the conduct of mandatory general offers and whitewash waiver transactions under Rule 26 of the Takeovers Code.

Facts

In January 2014, a transaction was announced pursuant to which a subsidiary of Alibaba Group Holding Limited (Alibaba) proposed to subscribe for new shares in 21CN, a company listed on The Stock Exchange of Hong Kong Limited, at a price of HK\$0.30 per share (the Alibaba Subscription). Such a transaction, which would result in Alibaba acquiring a majority interest in 21CN, would normally trigger an obligation to make a mandatory general offer under Rule 26 of the Hong Kong Takeovers Code, absent a waiver from the Executive of the Securities and Futures Commission (the Takeovers Executive) and the approval of independent shareholders (commonly referred to as a “whitewash”). Accordingly, the Alibaba Subscription was subject to the grant of a whitewash waiver by the Takeovers Executive and the approval of 21CN’s independent shareholders.

At the time the Alibaba transaction was announced, one of the largest shareholders in 21CN was Chen Xiao Ying (Ms. Chen), an executive director and the vice chairman of 21CN. Ms. Chen’s brother, Chen Wen Xin (Mr. Chen) was not involved in the management of 21CN but did have a relatively small shareholding in 21CN, resulting from the consideration he received from the sale of a company he owned to 21CN in 2002. Importantly, in its submissions to the Panel, Alibaba claimed that it did not know that Mr. Chen was a shareholder in 21CN at the time it entered into the Alibaba Subscription.

One of 21CN’s principal operations is the development of a Product Identification, Authentication and Tracking System (PIATS) for the health care and other industries. This is the only such system available to the health care industry in the PRC. Mr. Chen was the sole shareholder in a company called Hebei Huiyan Medical Technology Co., Ltd. (OpCo), which was developing a business-to-consumer drug transaction platform on which online pharmacies could sell over-the-counter drugs and related products. OpCo had applied to the China Food and Drug Administration (CFDA) for a permit to allow it to operate an online transaction platform between online pharmacies and consumers for over-the-counter drugs and related products. OpCo’s application was supported by 21CN, as regulatory bodies in the PRC had indicated that PIATS would be an essential requirement to an effective online sales platform.

In late 2013 OpCo was awarded one of three one-year business-to-consumer permits by the CFDA. Alibaba, which had also applied for such a permit, was unsuccessful in its application. From that point, negotiations that had been ongoing for some time exploring possible avenues of cooperation between Alibaba and 21CN were expanded to include the possible acquisition of OpCo by Alibaba.

On the same day as the Alibaba Subscription was announced, Mr. Chen entered into agreements with Alibaba (the OpCo Agreements) providing for the sale of OpCo by Mr. Chen to Alibaba, the transfer to the internet platform operated by OpCo of Alibaba’s over-the-counter-drugs sales business, and the reorganization of OpCo into an offshore

Hong Kong Takeovers Panel Invalidates Whitewash Waiver Granted to Alibaba

shareholding platform in which Mr. Chen would hold a minority interest and which would be the sole vehicle for Alibaba to sell over-the-counter drugs online in the PRC.

The Takeovers Executive granted a whitewash waiver for the Alibaba Subscription, which was also approved by a large majority of 21CN's independent shareholders. The Takeovers Executive was not consulted about the OpCo Agreements at the time it processed and granted the whitewash waiver, and neither the shareholder circular nor the preceding announcement referred to OpCo or the OpCo Agreements. The Alibaba Subscription was completed and resulted in a significant increase in 21CN's share price: Immediately before the trading in 21CN's shares was suspended pending the announcement of the Alibaba Subscription, 21CN's shares had closed at HK\$0.83 per share. When trading resumed following that announcement, they closed at HK\$3.92. Since then, the shares have traded between HK\$2.19 and HK\$14.32, and for the most part well in excess of HK\$4.00.

Relevant Provisions of the Takeovers Code

Equality of treatment of shareholders in the context of a takeover or merger transaction is a fundamental principle of the Takeovers Code, and this principle applies to whitewash waiver transactions such as the Alibaba Subscription.

This fundamental principle is set out in General Principle 1 of the Takeovers Code and is given flesh in a number of the more detailed Rules of the Takeovers Code, including Rule 25, which prohibits "special deals" between an offeror or its concert parties and target shareholders that have favourable conditions that are not to be extended to all shareholders.

Under the Takeovers Code, the grant of a whitewash waiver by the Takeovers Executive is subject to compliance by the person seeking the waiver with a number of the Takeovers Code's Rules, including Rule 25.

The Panel's Decision

The fact of Mr. Chen's shareholding in 21CN came to light approximately one year after completion of the Alibaba Subscription. The Takeovers Executive referred the matter to the Panel to determine (i) whether the OpCo Agreements constituted a special deal under Rule 25; (ii) if they did, whether the whitewash waiver granted to Alibaba in respect of the Alibaba Subscription was invalidated; and (iii) whether a mandatory general offer obligation had been triggered for the shares in 21CN not owned by Alibaba and its concert parties and, if so, at what price the mandatory general offer should be made.

In its submissions to the Panel, Alibaba had argued that the real mischief at which Rule 25 is directed is arrangements under

which a shareholder, in his capacity as such, is offered a favourable arrangement in order to induce him to accept an offer or, as in this case, to support a whitewash transaction. This motivation had been absent in this case, since neither Mr. Chen nor Ms. Chen had voted their shares in support of the Alibaba Subscription; Mr. Chen's shareholding was insignificant; and the OpCo Agreements had nothing to do with and were entirely separate from the Alibaba Subscription. Further, Alibaba argued that at the time it entered into the Alibaba Subscription it did not know that Mr. Chen was a shareholder in 21CN. In the absence of such knowledge, it was difficult to see how the mischief that Rule 25 was designed to address could occur.

In its decision, the Panel declined to follow this line of argument and emphasized the fundamental importance of the principle of equality of treatment. The transactions that Rule 25 seeks to address are much wider than ones in which a shareholder is induced to accept or promote an offer or whitewash transaction, and it is not necessary to show that inducement is the underlying purpose of the arrangement.

The Panel also rejected the contention that the OpCo Agreements were not related to the Alibaba Subscription, given the valuable nature of the permit held by OpCo, which was seen as essential to the development of Alibaba's over-the-counter-drugs online platform. The Panel noted that the Alibaba Subscription and the OpCo Agreements were negotiated by the same people on a contemporaneous basis.

The Panel was also unimpressed by the argument that neither Alibaba nor its legal advisors knew that Mr. Chen was a shareholder of 21CN, finding that, given the proximity of the relationship between Mr. Chen and his sister, the advisors should have been concerned that the OpCo Agreements fell within the ambit of General Principle 1 and Rule 25 even if Mr. Chen was not a shareholder and should have consulted with the Takeovers Executive. In the Panel's view, it did not matter whether Alibaba or its advisors knew that Mr. Chen was a shareholder: They had been provided with information that should have put them on notice that he had become a shareholder in 2002 and could have asked whether he was still a shareholder, which they had failed to do.

Alibaba had also argued that the OpCo Agreements constituted an arms'-length transaction that did not contain any conditions favourable to Mr. Chen and in which he merely received the market value of the permit OpCo held. Again, the Panel disagreed with this contention. It was not necessary for a favourable condition benefitting a shareholder to exceed the market price for an asset or service; a favourable condition is one in which a positive value or benefit is received by the shareholder under an arrangement with the offeror and not something in excess of this. In this case, it was clear that the sale of OpCo in

Hong Kong Takeovers Panel Invalidates Whitewash Waiver Granted to Alibaba

exchange for cash and a minority interest in Alibaba's over-the-counter-drugs online platform resulted in Mr. Chen receiving a positive consideration, which was sufficient to be an arrangement to which Rule 25 applies.

The Panel thus concluded that the OpCo Agreements constituted a special deal in breach of Rule 25, as the Takeovers Executive had not consented to it. It therefore followed that the whitewash waiver granted by the Takeovers Executive to the Alibaba Subscription (which had been granted subject, *inter alia*, to compliance with Rule 25) would be invalidated unless the Panel exercised its discretion to allow it to remain valid. This, the Panel declined to do: In normal circumstances, it should follow that the breach of a Rule to which a whitewash waiver is subject should result in the waiver being invalidated, placing a discipline on applicants for such waivers to adhere strictly to the conditions under which the waiver is granted.

The logical conclusion of the whitewash waiver being invalidated was that a mandatory offer obligation had arisen for Alibaba, unless that obligation is waived by the Takeovers Executive or the Panel. The question then arose of the price at which the offer should be made. In its submissions to the Panel, the Takeovers Executive had rejected the notion that the offer price should be at HK\$0.30, as this price did not reflect the favourable conditions received by Mr. Chen, which should be extended to other shareholders. The Takeovers Executive had argued that the appropriate offer price should be the market price at the time when the offer obligation was triggered, *i.e.*, when the Panel invalidated the whitewash waiver. The offer price determined on this basis would have been HK\$5.11 per 21CN share.

The Panel did not accept this approach, instead concluding that the starting point for any offer must be HK\$0.30 per share, being the price at which Alibaba subscribed for shares in 21CN, which resulted in it becoming its majority shareholder. However, it was difficult to make an adjustment to this base offer price to reflect the favourable terms received by Mr. Chen. The Panel was also mindful that the price at which 21CN's shares were trading was at a substantial premium to its tangible asset value, and this increase in share price was in large part attributable to the market's expectation of the value that Alibaba could bring to 21CN. It would not be fair or reasonable to require Alibaba to make an offer at the market price that would result in it paying a substantial amount for the value that was largely attributed to its anticipated contribution to 21CN. Further, any additional value that the Panel may have determined should be added to the base offer price of HK\$0.30 was unlikely to be material in the context of the prevailing market price or the prices at which 21CN's shares had traded since the Alibaba Subscription. Hence, the Panel decided to waive the mandatory general offer obligation that otherwise would have arisen for Alibaba on the invalidation of its whitewash waiver.

Conclusion

The Panel's ultimate decision to waive the mandatory general obligation on Alibaba appears to have been a pragmatic one that was justified by the particular circumstances of this case. However, the approach of both the Takeovers Executive and the Panel to the issues raised underlines the central importance of the equality of treatment principle in any transaction that is subject to the Takeovers Code. In particular, it emphasizes the need for great caution in any situation where, in the context of a takeover or merger transaction, there is any suggestion of an arrangement between the offeror and one shareholder or a small group of shareholders that is not being extended to shareholders generally. As this decision makes clear, there is no need for any such arrangement to be intended to operate as an inducement for a shareholder to support a transaction or to provide the shareholder with a value above the fair value of any asset or service provided in exchange, or indeed for an offeror to know that the counterparty to the arrangement is in fact a shareholder in the target company, in order for it to be within the ambit of Rule 25.

The suggestion by the Takeovers Executive in its submission to the Panel that the OpCo Agreements could possibly have been subject to Rule 25 even if Mr. Chen had not been a shareholder in 21CN, given the close relationship between him and his sister, indicate the potentially broad application of the Rule. The Takeover Executive's contention that the price of the mandatory general offer should be at the current market price of HK\$5.11 rather than the Alibaba Subscription price of HK\$0.30 highlights the extremely serious consequences that can potentially flow from breaches of the Takeovers Code.

The comments made by the Panel to the effect that Alibaba's legal advisors should have been conscious of a possible breach of Rule 25 given the sibling relationship between Mr. Chen and Ms. Chen, even though they did not know that Mr. Chen was a shareholder in 21CN and hence should have consulted with the Takeovers Executive, are also noteworthy, in particular for advisors. The importance of thorough due diligence and consultation in advance with the Takeovers Executive on any areas of doubt under the Takeovers Code cannot be overstated.

Finally, in the specific context of whitewash waiver transactions, which are fairly common in Hong Kong, the Panel's decision underscores the importance of strict compliance with any conditions subject to which whitewash waivers are granted. As this case demonstrates, failure to do so may lead to the invalidation of the waiver with potentially very damaging consequences, even after a substantial period of time has elapsed following the grant of the waiver.