

TAKEOVERS AND MERGERS PANEL

Panel Decision

In relation to an application by Charterbase Management Limited for a review of a ruling by the Executive that shares in UDL issued to the Scheme Administrator do not carry voting rights within the meaning of the Hong Kong Code on Takeovers and Mergers ("Takeovers Code")

UDL Holdings Limited ("UDL")

1. The Panel met on Thursday, 13 September 2001, to consider an application by Charterbase Management Limited ("**Charterbase**"), a minority shareholder of UDL, under section 11 of the Introduction to the Takeovers Code, for a review of a ruling by the Executive dated 16 July 2001.

Salient Facts

Restructuring

2. UDL has been in financial difficulties for some time. In early 2000, UDL and a number of companies within the UDL group, entered into a formal restructuring with their creditors, by way of a scheme of arrangement under section 166 of the Companies Ordinance ("**Scheme**"). The purpose of the Scheme was to provide the creditors with a better chance of recovery of their debts than would otherwise be possible in a winding-up.
3. The Scheme involved a number of connected transactions under the Listing Rules and was duly approved by UDL's independent shareholders at a Special General Meeting held on 24 March 2000.
4. The Scheme was sanctioned by the Court on 18 April 2000. As part of the Scheme, in May 2000, UDL launched a rights issue to all existing shareholders ("**Rights Issue**") and a contemporaneous issue of 252,306,195 new shares of \$0.10 each ("**Scheme Shares**"). The Scheme Shares were intended to be distributed among the non-preferential creditors ("**Scheme Creditors**"). However, as their claims had yet to be proved, the Scheme provided that the Scheme Shares would be issued to

the Scheme Administrator to hold on trust for the Scheme Creditors pending proof of their claims.

5. At the time of their issue, the Scheme Shares represented 50% of UDL's issued share capital as enlarged by their issue and the Rights Issue.

Consultation with the Executive

6. Before the Scheme became effective, UDL's advisers consulted the Executive in respect of the restructuring proposals. During the consultation, the Executive was informed that Harbour Front Limited ("**Harbour Front**"), UDL's then controlling shareholder, wished to maintain a controlling interest in UDL after completion of the restructuring. One of the key issues was whether or not the Scheme Shares carried voting rights as defined in the Takeovers Code ("**Voting Rights**"). The Takeovers Code defines Voting Rights as *"all the voting rights currently exercisable at a general meeting of a company whether or not attributable to the share capital of the company"*.
7. This issue was important because :
 - (1) If the Scheme Shares did carry Voting Rights, then the restructuring would have had the effect of reducing the percentage of Harbour Front's Voting Rights from 54.53% to 31.11%. This in turn would mean that any further acquisitions of UDL shares by Harbour Front might trigger a general offer obligation under Rule 26 of the Takeovers Code, if such acquisitions increased Harbour Front's holding of Voting Rights in UDL to 35% or more.
 - (2) On the other hand, if the Scheme Shares did not carry Voting Rights, then the issue of the Scheme Shares would not have affected the percentage of Voting Rights held by Harbour Front, which would have remained at 54.53% and increased to 62.21% as a result of the Rights Issue. Consequently, further acquisitions would not have triggered a general offer obligation.
8. Based on representations from UDL's advisers, the Executive verbally indicated its agreement with UDL's advisers that the Scheme Shares did not carry Voting Rights and that therefore any further acquisitions of UDL shares or Voting Rights by Harbour Front would not trigger a general offer obligation under the Takeovers Code. This is because once a person holds more than 50% of the Voting Rights in a company, further acquisitions of Voting Rights do not trigger an offer obligation

under the Takeovers Code.

Subscription of shares by Harbour Front

9. About a year later, on 30 March 2001, UDL announced a capital reorganisation involving, amongst other things, a proposed subscription by Harbour Front for a further 100,922,478 shares in UDL at \$0.04 each ("**Subscription**"). As a result of this acquisition, Harbour Front's shareholding in UDL increased from 31.11% to 42.59% of the enlarged issued share capital. However, according to UDL's advisers, its Voting Rights increased from 62.21% to 73.01% and hence no general offer was made.
10. The Subscription was a connected transaction under the Listing Rules and was duly approved by UDL's independent shareholders at a Special General Meeting held on 17 May 2001.
11. At the time of the Subscription, UDL provided the Executive with a draft of its press announcement, which included reference to the percentage of Harbour Front's Voting Rights in UDL before and after the Subscription. In response, the Executive confirmed that the announcement did not need its clearance.

Charterbase's application

12. Between May 2001 and July 2001, Charterbase (a minority shareholder of UDL holding 20,000 shares), and its legal advisers raised a number of questions regarding the calculation of the Voting Rights held by Harbour Front and whether the Subscription should have triggered a general offer obligation by Harbour Front. The Executive responded by letter dated 16 July 2001, confirming, amongst other things, its earlier verbal decision that the Scheme Shares did not carry Voting Rights and that therefore Harbour Front's subsequent acquisition (through the Subscription) did not trigger a general offer obligation ("**Executive's Ruling**").
13. On 19 July 2001, Charterbase applied for a review of the Executive's Ruling. It essentially argued that :
 - (1) the Scheme Shares did carry Voting Rights;
 - (2) as a result of the restructuring, the percentage of Voting Rights held by Harbour Front dropped from above 50% to 31.11%; and
 - (3) this percentage then increased to 42.59% as a result of the Subscription

thereby triggering a general offer obligation under Rule 26 of the Takeovers Code.

Preliminary hearing of the Panel

14. After Charterbase lodged its application for a review, a number of allegations were made concerning the identity of the person(s) behind Charterbase and the motive for bringing this application. As a result, on Friday, 17 August 2001, the Panel met to consider whether Charterbase's application was frivolous or an abuse of process and therefore whether the application should proceed to a full substantive hearing. The Panel decided that the application was neither frivolous nor an abuse of process and that it should proceed to a full substantive hearing. The Panel's reasons are set out in a separate written decision dated 4 September 2001.

Issue

15. The central issue before the Panel at the substantive hearing was whether the Scheme Shares held on trust by the Scheme Administrator for the benefit of the Scheme Creditors carry Voting Rights. It is not disputed that the Scheme Shares carry voting rights within the ordinary meaning of the term. The key question for the Panel is whether these voting rights are "*currently exercisable*".

Decision and reasons

16. The Panel carefully considered the written and oral representations before it (including those of the Scheme Administrator) together with the evidence given by the witnesses to the proceedings, including an expert witness on the laws relating to trust and schemes of arrangement.

Currently exercisable voting rights

17. The Panel held that the Scheme Shares do carry "*currently exercisable*" voting rights for the following reasons.
 - (1) Under clause 45(b) of the Scheme, the Scheme Shares were allotted to the Scheme Administrator to hold "***on trust for the non-preferential Scheme Creditors pending their distribution***" (emphasis added).
 - (2) It is not disputed that the Scheme Shares were issued to rank *pari passu* with all existing shares of UDL, and that the existing UDL shares carry voting rights

within the ordinary meaning of that term (rather than the Takeovers Code definition).

- (3) Under the Scheme, the only stated powers given to the Scheme Administrator in relation to the Scheme Shares are to receive, hold and distribute them to the Scheme Creditors upon proof of their claims. Other than this the Scheme is silent as to the rights of the Scheme Administrator in relation to the Scheme Shares or the voting rights attached to them.
 - (4) The expert witness confirmed that :
 - (i) in view of this silence, one had to look to the general law of trusts to establish what further rights the Scheme Administrator may have in relation to the Scheme Shares;
 - (ii) under the general law of trusts, the Scheme Administrator as trustee of the Scheme Shares, is under a fiduciary duty to protect the interests of the Scheme Creditors; and
 - (iii) where appropriate, this duty would extend to voting the shares on their behalf.
 - (5) In view of the above, the Panel is satisfied that the Scheme Administrator was and is in a position to vote the Scheme Shares.
18. The Panel was urged to disregard the strict legal position of the Scheme Administrator as trustee and instead to look to the commercial reality (on the basis of section 1.3 of the Introduction to the Takeovers Code). It was argued that in this case the commercial reality was that the voting rights attached to the Scheme Shares were not "*currently exercisable*" because in reality the Scheme Administrator would not vote the Scheme Shares unless directed to do so by the Court. It followed, it was argued, that the Scheme Shares were effectively disenfranchised and therefore do not carry Voting Rights. The Panel, however, does not accept that it is entitled to so disregard the legal position. The Scheme sets out the Scheme Administrator's role and responsibilities. It is a legal document which is approved by the Court. As such, the Panel is of the view that it should be interpreted according to the law.
19. The Panel further notes that while it accepts, that as a matter of prudence, the Scheme Administrator would not vote the Scheme Shares without the sanction of the Court, it does not accept the contention that shares which may only be voted with the sanction of a third party amount to shares which do not carry Voting Rights.

General offer obligations triggered

20. In light of the Panel's ruling that the Scheme Shares carry Voting Rights, technically two general offer obligations arose under Rule 26 of the Takeovers Code: the first, when the Scheme Shares were allotted to the Scheme Administrator in May 2000 (as these shares amounted to 50% of UDL's issued share capital) and the second, as a result of the Subscription by Harbour Front (which increased both its shareholding and Voting Rights in UDL from below to above the 35% threshold).

No breach of Takeovers Code

21. So that the position is absolutely clear, the Panel would like to emphasise that these proceedings are not disciplinary in nature and there has been no finding of a breach of the Takeovers Code in respect of this matter.

Remedies - Scheme Administrator on behalf of Scheme Creditors

22. The Panel was urged by all parties to waive the general offer obligation falling on the Scheme Administrator on behalf of the Scheme Creditors either under various Notes to Rule 26 or on the basis that it would be inequitable to do otherwise. The Panel carefully considered all submissions made in this regard. It also noted that section 2.1 of the Introduction to the Takeovers Code permits the Panel to "*modify or relax the application of a Rule in exceptional circumstances*".
23. The Panel decided that there are exceptional circumstances as required by section 2.1 of the Introduction which justify the waiver of the general offer obligation incurred by the Scheme Administrator on behalf of the Scheme Creditors in its entirety. Both the Scheme Administrator and the Scheme Creditors agreed to participate in the Scheme of Arrangement on the basis that there would be no Takeovers Code implications. The Panel is of the view that it would be repugnant to common sense and logic to now require Scheme Creditors, who as the situation currently stands are likely to recover only a miserable percentage of the amounts owed them, to be exposed further to the totally unforeseen predicament of having to make a general offer to take out the minority shareholders whose right to a pay out in an insolvency situation would rank behind their own, and at a price of \$0.10 which is substantially above the current market level.

Remedies - Harbour Front

24. As for the general offer obligation falling on Harbour Front, both the Executive and Harbour Front submitted that any such obligation could be waived on the basis that the independent shareholders' approval could be regarded as substitute whitewash approvals. Charterbase however urged the Panel to consider a range of options effectively aimed at reducing Harbour Front's percentage of Voting Rights to their level immediately prior to the Subscription.
25. The Panel carefully considered all submissions made in this regard as well as each of the proposed remedies. The Panel decided however that in the exceptional circumstances of this case, the most fair and appropriate ruling is to waive the general offer obligation incurred by Harbour Front under section 2.1 of the Introduction to the Takeovers Code rather than direct any of the other remedies sought. The exceptional circumstances are :
- (1) If a general offer were to be made, it would be at an offer price of \$0.04 per share, this being the Subscription price. The Panel is mindful of the fact that the offer price of \$0.04 would be well below the current market price of the shares. In this regard, the Panel notes that the Executive, Harbour Front and Charterbase have all submitted that such an offer would be futile and of no benefit to anyone.
 - (2) Despite allegations to the contrary, the Panel is satisfied on the evidence before it, that throughout this matter, UDL and Harbour Front acted in good faith. They employed professional advisers and were openly working towards a proposal which would enable Harbour Front to maintain control. They consulted the Executive at the earliest opportunity. At the time of the Subscription, they forwarded to the Executive a draft of UDL's press announcement which included reference to the Voting Rights held by Harbour Front. Irrespective of whether or not this amounted to a formal consultation under section 8 of the Introduction to the Takeovers Code, it is indicative of their acting in good faith.
 - (3) In view of the above, and in particular the Panel's finding that Harbour Front acted in good faith throughout this matter, it would be unfair to make any direction aimed at reducing Harbour Front's percentage of Voting Rights to the level immediately before the Subscription.

Whitewash waiver

26. The Panel wishes to make special mention as to whether Harbour Front should be directed to make a formal application for a whitewash waiver under the Notes on dispensations from Rule 26 of the Takeovers Code. The Panel does not accept the submission that the independent shareholders' approvals of both the Scheme and the Subscription could be regarded as substitute whitewash approvals, as the requirements and provisions for a whitewash are quite different from those of a special general meeting held to approve a connected transaction under the Listing Rules. However, given that any general offer at \$0.04 would be futile, a whitewash application in relation to such an offer would be equally futile and of no benefit. Moreover, the process would only expend unnecessary time, efforts and costs for the company. For these reasons and given the particular circumstances of this case, the Panel would not in this case require a formal application for a whitewash waiver.

Reminder to public

27. Finally, the Panel would like to take this opportunity to remind practitioners of the importance of early consultation with the Executive, particularly where doubt exists as to the Code implications of a transaction. The Panel would also like to highlight that under section 8.1 of the Introduction to the Codes, views expressed by the Executive verbally are preliminary and **do not bind** the Executive as do written rulings. When practitioners intend to rely on a view given by the Executive during consultation, they are encouraged to apply for a formal ruling under section 15 of the Introduction. Rulings under section 15 are binding on the Executive and normally involve a consideration of all the relevant information and a more thorough analysis than that permissible under a consultation.

Dated 28 September 2001