



Hong Kong

May 2016

## HONG KONG'S TAKEOVERS PANEL RULES THAT ALIBABA BREACHED TAKEOVERS CODE DUE TO "SPECIAL DEAL"

The Securities and Futures Commission's (SFC) Takeovers and Mergers Panel (**Panel**) has published its decision on whether Alibaba Group Holding Limited (**Alibaba**) breached the Code on Takeovers and Mergers and Share Buy-backs (the **Takeovers Code**) when it acquired healthcare company, CITIC 21CN Company Limited (**21CN**). During the acquisition, Alibaba also acquired Hubei Huiyan Medical Technology Co. Ltd. (**OpCo**) by entering into a series of agreements (**OpCo Agreements**) with its sole shareholder (**Mr. Chen**), who was also a shareholder of 21CN.

The Panel has ruled that the OpCo Agreements constituted a special deal with favourable conditions under Rule 25 of the Takeovers Code that was not extended to all shareholders of 21CN. As a result, the whitewash waiver (**Whitewash Waiver**) that was granted to Alibaba was invalidated and a Rule 26 mandatory general offer obligation was triggered. However, the Panel waived that obligation because it could not arrive at a fair and reasonable price for the mandatory general offer.

### Alibaba's acquisition of 21CN and the OpCo Agreements

21CN is a Hong Kong listed company whose main businesses include the development of a Product Identification, Authentication and Tracking System (**PIATS**) for the healthcare industry and other industries. One of its shareholders was Mr. Chen, the sole shareholder of OpCo, which was developing a business-to-consumer drug transaction platform. Mr. Chen is the brother of **Ms. Chen**, an executive director, vice chairperson and substantial shareholder of 21CN.

In 2013, Alibaba entered into negotiations to acquire the 21CN group, which was represented mainly by 21CN's Chief Technology Officer and two consultants. Ms. Chen was generally present in these negotiations, but Mr. Chen did not take an active part in them. During the negotiations, Alibaba learned that OpCo was applying for a permit to operate an online transaction platform between online pharmacies and consumers for over-the-counter drugs and related products (**Permit**). Alibaba assumed that OpCo was a subsidiary of 21CN, when in fact it was wholly owned by Mr. Chen. When Alibaba failed to obtain its own Permit and learned that OpCo had obtained one, it asked Ms. Chen to convey to Mr. Chen Alibaba's proposal to acquire OpCo.

On the 23 January 2014, Alibaba entered into an agreement to subscribe for 21CN shares at HK\$0.30 per share, subject to the Takeovers Executive granting a whitewash waiver (which would then require approval by the independent shareholders) so that a mandatory general offer obligation can be avoided. On the same date, Alibaba and Mr. Chen entered into several agreements, under which:

- Alibaba acquired OpCo for RMB 3 million in cash;
- Alibaba agreed to use its commercially reasonable endeavours to transfer its over-the-counter drugs business to OpCo's internet platform; and
- the parties agreed to reorganise OpCo into an offshore shareholding platform in which Mr. Chen would receive a 10% interest.

Subsequently, the Whitewash Waiver was approved by the shareholders of 21CN. Ms. Chen and Mr. Chen did not vote at that shareholders' meeting. Several months later, Alibaba reorganised its online pharmacy business and its economic interest in OpCo into a new company (the **Target Company**), of which Mr. Chen held a 9.56% shareholding.

## Special Deal under Rule 25 of the Takeovers Code

Rule 25 of the Takeovers Code prohibits offerors from transacting with a shareholder of the offeree company without the consent of the Takeovers Executive (**Special Deals**). Alibaba's acquisition of 21CN was subject to the grant of a whitewash waiver (so that a mandatory general offer obligation would not be triggered), which in turn was subject to compliance with the Takeovers Code, including Rule 25. If the OpCo Agreements constituted a Special Deal, the Whitewash Waiver granted to Alibaba would be invalidated and a mandatory general offer would have to be made to the other shareholders of 21CN.

The Panel therefore had to decide the following:

- whether the OpCo Agreements constituted a Special Deal under Rule 25 of the Takeovers Code; and if so
- whether the Whitewash Waiver granted to Alibaba in respect of its acquisition of 21CN was invalidated; and if so
- whether Alibaba is under a mandatory general offer obligation in respect of shares of 21CN that are not owned by Alibaba; and if so
- what the price for the mandatory general offer should be.

Alibaba argued that the OpCo Agreements did not constitute a Special Deal because Rule 25's purpose is to disallow arrangements under which an offeree shareholder, in the capacity of shareholder, is offered a favourable arrangement as an incentive to accept an offer (or approve a whitewash waiver, in this case). This was not the purpose of the OpCo Agreements. Alibaba did not know at the time that Mr. Chen was a shareholder of 21CN, the consideration for the acquisition reflected the market value of a company with a Permit (which Alibaba argued did not constitute a "favourable condition") and neither Mr. Chen nor Ms. Chen voted during the independent shareholders' approval of the Whitewash Waiver.

The Takeovers Executive argued that the OpCo Agreements constituted a Special Deal, since they provided favourable conditions for Mr. Chen. It was irrelevant whether or not: (a) the favourable conditions were an incentive for the counterparty to approve the Whitewash Waiver; (b) the offeror knew that the counterparty was a shareholder of the offeree; (c) the arrangement was evidenced by a contract; or (d) the arrangement was fair and reasonable (or priced at fair value). The purpose of Rule 25 is to give effect to General Principle 1 of the Takeovers Code: "All shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly." As long as Alibaba entered into an arrangement with a shareholder of 21CN (during its acquisition of 21CN, while the acquisition was in contemplation or 6 months after the acquisition) that conferred a favourable condition to that shareholder that wasn't extended to the other shareholders of 21CN, that arrangement was a Special Deal under Rule 25.

## The Takeovers and Mergers Panel's Decision and Waiver of the Mandatory General Offer Obligation

The Panel ruled that the OpCo Agreements were a Special Deal under Rule 25 of the Takeovers Code. It agreed that it is irrelevant whether the OpCo Agreements were meant to induce support for the Whitewash Waiver or whether Alibaba knew that Mr. Chen was a 21CN shareholder. The Panel did not accept Alibaba's argument that the OpCo Agreements were unrelated to the acquisition of 21CN, since they were negotiated by largely the same people and executed on the same date, for the same ultimate purpose (i.e. developing Alibaba's over-the-counter drug online platform). Lastly, the Panel considered "favourable condition" under Rule 25 to mean any positive value or benefit enjoyed by the shareholder of the offeree, and not necessarily something in excess of the fair value of the asset or service contributed by the shareholder.

Since the Panel ruled that Alibaba was in breach of Rule 25 of the Takeovers Code, it also considered whether to exercise its discretion to modify or relax the application of that rule, as permitted under Section 2.1 of the Introduction to the Takeovers Code. The Panel did not accept that the invalidation of the Whitewash Waiver would cause Rule 25 to operate in an unnecessarily restrictive or unduly burdensome or otherwise inappropriate manner. Furthermore, the Takeovers Executive did not indicate that it would have consented to the OpCo Agreements if it had known of them at the time the Whitewash Waiver application was made. The Panel therefore ruled that the Whitewash Waiver was invalidated, and a mandatory general offer obligation arose for Alibaba.

The final matter for the Panel to decide was the price of the mandatory general offer. While the Panel acknowledged that the starting point should be HK\$0.30 (i.e. the price at which Alibaba subscribed for shares in 21CN), it was unable to arrive at a precise value for the favourable terms enjoyed by Mr. Chen since, at the time that the OpCo Agreements were executed, there was no certainty that he would receive any shares in the Target Company. The Panel also considered that, while the share price of 21CN had risen significantly since it was acquired by Alibaba, much of that price increase was likely to have been due to the acquisition itself and the market's expectation of the value Alibaba would add. The Panel thus considered that to require a mandatory offer at the market price would be neither fair nor reasonable. Lastly, the Panel noted that, given the prevailing market price of 21CN shares or the prices at which they traded since its acquisition by Alibaba was announced, any additional value that might be determined to be added to the base price of HK\$0.30 would be unlikely to be material. The Panel therefore decided to waive Alibaba's mandatory general offer obligation.

# CHARLTONS

**Best Boutique Firm 2015**

Asian Legal Business Awards

---

**This newsletter is for information purposes only.**

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at [unsubscribe@charltonslaw.com](mailto:unsubscribe@charltonslaw.com)

---

**Hong Kong Office**

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

**Tel:** + (852) 2905 7888

**Fax:** + (852) 2854 9596

[www.charltonslaw.com](http://www.charltonslaw.com)