

Amendments to the Listing Rules: Reverse Takeover and how it affects corporate rescues

Background

Following the consultation papers published by the Stock Exchange on Initial Listing, Continuing Listing Eligibility and Cancellation of Listing Procedures in 2002 and 2003, the Stock Exchange finally issued its consultation conclusions in towards the end of January 2004. The policy issues were explained in the Consultation Conclusions paper and are translated into a set of revised listing rules, with Chapter 14, covering *Notifiable Transactions*, completely rewritten. The new Listing Rules will take effect as from 31 March 2004.

Policy

Perhaps the most important policy statement affecting corporate rescues out of all these is that

“the underlying principle of the requirement is to prevent circumvention of the initial listing criteria by an otherwise unqualified listing candidate to obtain a listing status by buying into a listed shell.”

To the insolvency practitioners and even the courts to have ascribed a value to the listed shell, the Stock Exchange’s answer is that

“if an issuer has failed as a corporate entity, its shell company should not be entitled to treat the listed status as an asset of value nor to retain its listed status unless an asset that meets the initial listing criteria is injected into it.”

It is obvious that the Stock Exchange’s prerogative comes from maintaining a level playing field the listing by the issuers of assets, rather than from the protection of investors. This is despite interesting statistics that corporate failures of restructured companies are far and few in between. Unfortunately, of course, the interests of minority shareholders have largely been ignored, and perhaps, if considered at all, then the logic would be that when a corporate entity has failed, the fortune of the minority investors should be consistent with that of its creditors and deserves no sympathy.

Changes of significance

Reverse Takeover

For the first time, the term 'Reverse Takeover' is defined in the Listing Rules under Chapter 14. It is an acquisition or a series of acquisitions of assets by a listed issuer which is regarded by the Stock Exchange as an attempt to achieve a listing of the assets to be acquired and a means to circumvent the requirements for the new applicants set out in Chapter 8 of the Listing Rules. The wordings of this definition would appear, to many practitioners, that the opinions of the Stock Exchange in treating a particular transaction a Reverse Takeover could be open to legal challenges.

Listed Assets

Whereas in the existing Listing Rules, Very Substantial Transactions giving rise to a transaction being regarded a 'backdoor' listing (thus requiring the assets to meet new listing requirements set out in Chapter 8 of the Listing Rules) has an interesting exception given to *listed assets*, most commonly applied in rescue situations, the new Listing Rules have this removed any reference to *listed assets* all together.

Corporate Rescues

Traditionally corporate rescues for listed companies could take two forms, namely,

Creditors' Rescue

For Creditors' Rescue, typically creditors forming a view that the management of the corporate is basically sound, thereby either the creditors affording some form of moratorium or otherwise agreeing to accept shares or convertible loans to reduce the liabilities of the corporate. The controlling shareholders, and indeed all shareholders, will have to suffer a dilution due to the issue, or potential issue, of new shares to the creditors. The existing management, probably after certain reinforcement, will continue to manage the corporate.

The new Listing Rules do not appear to have much effect on this form of corporate rescue. Creditors obtaining shares or convertible loans can still opt to sell the listed corporate to a third party investor after the financial situation of the corporate has stabilised.

White-knight Rescue

For White-knight Cash Rescue, a new controlling shareholder will emerge either by injecting cash and/or its assets in exchange for which it acquires the controlling interest of the failed corporate and the subscription money and/or parts of the assets will go towards the creditors in discharge of the debts owed. The controlling shareholders will no longer be involved in the new management and, along with minority shareholders, will have their equity interest in the corporate substantially diluted.

White-knights injecting assets would most likely be existing listed corporates taking advantage of the *Listed Assets* exemption. The new Listing Rules have taken this exemption away and assets used for rescue taken out from the existing listed corporates will have to satisfy new listing criteria if such transaction is deemed by the Exchange as a “reverse takeover”.

Under the existing Listing Rules, white-knights coming in with cash only and wanting to inject assets within 12 months from the date of their acquiring controlling interests are subject to Chapter 14 restrictions. The new Listing Rules will extend this period to 24 months, and the criteria for assessing the acceptance or otherwise of new assets being acquired by the listed corporates have also been changed.

Transaction Type and Percentage Ratios

Chapter 14 has been rewritten and has carefully covered many different situations to prevent circumvention. In the main, the existing Listing Rules provide 4 ratio tests to determine the type of transaction which in turn determines the degree of disclosure and shareholder approval. The new Listing Rules have added Revenue ratio to the existing ratio tests of Assets, Profits, Consideration and Equity Capital. Total assets as oppose to net assets are now adopted, and the thresholds for Share, Discloseable and Major transactions have been lowered. A new transaction type, namely, Very Substantial Disposal, has been added.

More disclosure and shareholders’ involvement would be expected, and the lead time for completing the relevant transactions would be longer.

New Listing Criteria

There are changes to Chapter 8 of the Listing Rules covering new listing criteria. The main changes include the introduction of a new waiver of three financial year trading record requirement subject to the market capitalization/revenue test, an increase in the minimum number of initial shareholders from 100 to 300, an increase in the initial market capitalization from HK\$100 million to HK\$200 million, and an increase of the number of independent non-executive directors from 2 to 3. These do not appear to have much effect on IPOs, or, for that matter, investors seeking a 'reverse takeover'.

Conclusions

The net results of these changes, coupled with the 24 months period from the major shareholder gaining control within which the Stock Exchange can aggregate a series of transactions, are that investors wanting to acquire a listed corporate with a view to simultaneous or subsequent injection of assets would become more difficult. Listed corporates no longer enjoy the special exemption to inject their assets into financially troubled companies unless the threshold for VSA is not reached or these assets can satisfy the new listing criteria. However, investors wanting to acquire a listed corporate and continue with its existing businesses should not be affected.

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