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# Lectures on Hong Kong Listing Rules 香港上市规则讲座系列

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## **How to Avoid an Option to Exit a Joint Venture (with Uncertain Exercise Price) from being Deemed as a Major Transaction Requiring Shareholders' Approval**

Formation of joint ventures has been a popular form of arrangement between entities which aim to obtain expertise, resources, technology and network that one party lacks. In a joint venture, each of the participants is responsible for profits, losses, and costs associated with it, such that it may increase the opportunity of the accomplishment of a project. Joint venture arrangements often entail exit mechanisms to facilitate a smooth separation in case the joint venture does not work out. Such exit mechanisms are put in place as a standard precaution only, and often not because the parties contemplate a real likelihood of failure of the joint venture at the beginning.

### Normal Exit Mechanism (For Instance, Grant of Right to Acquire a Listed Issuer's Interest in a Joint Venture) May Become a Major Transaction

A joint venture arrangement may often involve the granting of a right to acquire one of the parties' interest in the joint venture as an exit mechanism in case of certain events, including but not limited to a change in control of a party, occurrence of a deadlock matters, insolvency, or material breach of the joint venture agreement by the party. Granting of such call option or put option may be beneficial to the reasonable solution of the potential conflicts between the joint venture parties in relation to the termination of the joint venture arrangement and is beneficial to the signing and performance of the joint venture agreement.

Under Rule 14.74(1) of the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules), if the exercise of an option is not at the listed issuer's sole discretion, the grant of the option would be classified as if it had been exercised at the outset. Where no actual

monetary value of the exercise price can be determined, the grant of the option would be classified as at least a major transaction pursuant to Rule 14.76(1) of the Listing Rules.

The following issues need to be determined: (i) whether a right to acquire another party's interest in the joint venture as pre-determined exit mechanism would fall under the definition of an "option" under Chapter 14 of the Listing Rules; and (ii) if so, whether granting of such rights, should be classified as a major transaction pursuant to Rule 14.76(1) of the Listing Rules.

In practice, even if the formation of a joint venture may not be a discloseable transaction in view of its size tests, the exit option mechanism may be regarded as a major transaction.

### Listing Decision LD2-2011

The Stock Exchange of Hong Kong Limited (the Exchange) sought to clarify the situation in a listing decision LD2-2011 (the Listing Decision). The case involved a listed issuer (the Listed Issuer) entering into an agreement with an independent third party (JV Partner) to form a joint venture (the Joint Venture) and the JV Partner would have the right to acquire the listed issuer's interest in the joint venture in case of certain exit events (Right). The listed issuer sought the Exchange's view on the application of the notifiable transaction requirements to the Right. It submitted that the Right was a common commercial arrangement between joint venture partners to protect their rights and investments. It was not an "option" under Rule 14.72(1) of the Listing Rules because it was exercisable by the JV Partner only upon occurrence of events which might or might not happen.

### Applicable Listing Rules

The Listing Decision sets out, among others, the applicable Listing Rules considered by the Exchange as follows:

Rule 14.04(1)(b) states that any reference to a “transaction” by a listed issuer: “includes any transaction involving a listed issuer writing, accepting, transferring, exercising or terminating (in the manner described in Rule 14.73) an option (as defined in Rule 14.72) to acquire or dispose of assets or to subscribe for securities.”

Rule 14.72(1) defines “option” to mean: “the right, but not the obligation, to buy or sell something;...”

Rule 14.73 states that: “the grant, acquisition, transfer or exercise of an option by a listed issuer will be treated as a transaction and classified by reference to the percentage ratios.”

Rule 14.74(1) states that the following would apply to an option involving an issuer, the exercise of which is not at the issuer’s discretion: “on the grant of the option, the transaction will be classified as if the option had been exercised. For the purpose of the percentage ratios, the consideration includes the premium and the exercise price of the option;”

Rule 14.76(1) states that: “For the purpose of Rules 14.74(1) ..., where, on the grant of the option, the actual monetary value of each of the premium, the exercise price, the value of the underlying assets and the profits and revenue attributable to such assets has not been determined, the listed issuer must demonstrate to the satisfaction of the Exchange the highest possible monetary value, which value will then be used for the purpose of classification of notifiable transaction. Failure to do so will result in the transaction being classified as at least a major transaction...”

### The Exchange’s Analysis and Conclusion

#### *Whether the Right was an “option” under Chapter 14*

The Exchange considered that the Right was an “option” which is defined widely in Rule 14.72 to mean the right “to buy and sell something”. It disagreed with the Listed Issuer’s view on the application of this rule.

#### *Classification of the Right*

As the exercise of the Right was not at the Listed Issuer’s sole discretion, the grant of the Right would be classified as if it had been exercised.

In determining the classification of the Right, the Exchange considered the size test calculations for the Right prepared by the Listed Issuer and the following:

- The formation of the Joint Venture was not a material transaction to the Listed Issuer.
- The Right was an exit arrangement that was common in joint ventures. It would be exercised only upon occurrence of certain triggering events which were extraordinary or beyond the parties’ control. This could be distinguished from other circumstances where put options were granted.
- The exercise price would be based on the Joint Venture’s fair market value determined by an independent valuer agreeable to both parties, which would protect the Listed Issuer’s interests in the Joint Venture in the event of a buyout, deadlock or insolvency. In the event of a default, the Listed Issuer considered it reasonable to use a different basis for determining the exercise price when it was in breach of a material term of the joint venture agreement.
- The Joint Venture was not yet established and the exercise price of the Right had not been determined at the time of the JV agreement. Even if the grant of the Right was classified as a major transaction and the Listed Issuer’s shareholders were given an opportunity to vote on it, they would have little information to make an informed decision.

In light of the above, the Exchange decided that the grant of the Right would not be treated as a major transaction. Despite this, the Exchange considered that the Listed Issuer should disclose the formation of the Joint Venture and the terms of the Right because they would bind the Listed Issuer to a possible disposal in the future which might be material to the Listed Issuer at that time.

In conclusion, the Right was an “option” under Chapter 14. It would not be classified as a major transaction but its terms should be disclosed by an announcement.

### Cases Following the Listing Decision

Following the Listing Decision, there have been many cases involving call option and/or put option granted to the one of the joint venture partners that were classified as major transactions pursuant to Rule 14.76(1) of the Listing Rules. It seems that there remains significant grey area as to when such option would become a major transaction.

For instance, Great Wall Motor Company Limited (a company listed on the Stock Exchange with stock code 2333) (Great Wall Motor) has entered into a joint venture contract with (BMW Holding) that involves the bilateral grant of call option and put option to Great Wall Motor and BMW Holding. Since the call option and put option were granted to BMW Holding in relation to the fault based termination of the joint venture contract and the relevant

exercise prices for the call option and put option granted to BMW Holding (and their exercise will be at the discretion of BMW Holding, which was therefore not at the listed issuer's discretion) were yet to be confirmed at the time of entering into the joint venture contract (as the exercise price would be referred to the fair value of the joint venture company), such grant constitute a major transaction of Great Wall Motor pursuant to Rule 14.76(1) of the Listing Rules.

In another case of 3SBio Inc. (a company listed on the Stock Exchange with stock code 1530) in 2017, the exercise price of the relevant put option granted to the listed issuer's joint venture partner will be determined with reference to private equity firms' investments in recent successful Hong Kong initial public offerings in the healthcare sector, there is no actual monetary value of the exercise price has been determined, the grant of the put option was classified as at least a major transaction for the Company pursuant to Rule 14.76(1) of the Listing Rules.

#### Practical Considerations

From the Listing Decision, it seems that in determining whether the grant of the relevant option would be treated as a major transaction pursuant to Rule 14.76, the Exchange would in fact consider whether the listed issuer's interests in the joint venture in the event of a buyout, deadlock or insolvency would be protected even though the actual monetary value of the exercise price has not been determined and the highest possible monetary could not be given. Also, whether it is viable for the listed issuers' shareholders to vote in view of the little information for them to make an informed decision may also be an important factor under the Exchange's consideration.

In view of the relatively recent cases above, the market seems to have taken a more prudent approach where the listed issuers would voluntarily classify the grant of such rights as a major transaction under Rule 14.76(1). Yet, practically speaking, whether such right would be classified as major transaction may not be a big issue for some listed issuers that can obtain a written shareholders' approval in lieu of holding a general meeting according to Rule 14.44 of the Listing Rules. An example of such would be the Great Wall Motor's case.

Since such issues often require stating a case before the Exchange for determination in advance (and may take time), some listed issuers may choose to treat the joint venture establishment (with exit mechanism) as a major transaction due to time constraint or other commercial reasons.

Issuers which do not wish to make pre-transaction enquiry with the Exchange may often set out contractual procedures in the joint venture agreement to avoid the triggering of a major transaction at the outset. A typical approach is to require the listed issuer to use reasonable endeavors to issue a circular (and seek shareholders' approval) if the size tests results point to a major transaction upon an exit situation. Arguably, with the right wording and in appropriate cases, a major transaction would not be triggered at the time the joint venture agreement is entered into. Listed issuers should consult experienced advisers if this approach is adopted.

In any event, as stated in the Listed Decision, the Stock Exchange would still recommend disclosure of the relevant terms of such rights to acquire interest in a joint venture. Listed issuers are therefore advised to ascertain whether or not the grant of such rights would constitute a major transaction, and details of its terms are also expected to be presented to the investors and shareholders of the listed issuer in any event.

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