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Implications of Share Award Schemes in the Context of a Listed Company's Takeover

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According to the consultation paper entitled "Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers" published by The Stock Exchange of Hong Kong Limited (the "Stock Exchange") in 2021, about 14% of listed issuers had share award schemes. Share award schemes generally serve to reward and incentivize eligible participants, who are usually directors and/or employees of listed issuers, for contributing to the issuer and to align their interests with those of the issuers and their shareholders. Under the Rules Governing the Listing of Securities on the Stock Exchange (the "Listing Rules"), share awards can be funded by new shares or existing shares of issuers purchased on-market.

In view of the popularity of share award schemes amongst issuers in the Hong Kong market, this article discusses the key issues and considerations in respect of arrangements relating to share award schemes in the context of a takeover. Takeover(s) refers to a change of control as defined in the Takeovers Code, which includes general or partial offer, buy-back offer, privatization by scheme of arrangement or merger by absorption.

Provisions of the rules of share award schemes

The following are three (3) commonly seen mechanisms in rules of share award schemes in the event of a takeover:

Scenario A (automatic vesting of awards) - if a general offer, share repurchase offer or scheme of arrangement or otherwise in like manner is made to all the shareholders (other than the offeror and any persons acting in concert with him/her/it) prior to the vesting of the awarded shares, the selected participant shall be entitled to be vested with all of his/her/its awarded shares, unless the board of

directors determines otherwise. (As the amended Chapter 17 of the Listing Rules provides that there must be at least a 12-month vesting period in general, we observe that some issuers in the market provided in their scheme rules that all the awarded shares shall vest on the expiry of a period of 12 months after the change of control event becomes or is declared unconditional).

Scenario B (discretion of the board of directors to accelerate vesting of awards) - if there is an event of change in control, the board of directors shall at their sole and absolute discretion determine whether the vesting dates of any awards will be accelerated and/or whether the vesting conditions of any awards will be amended or waived.

Scenario C (lapse of awards) - in the event of change in control, all the awarded shares of an eligible participant shall lapse, unless otherwise determined by the board of directors in its absolute discretion.

Scenario C would present least issue as it would involve no acquisition of shares in an issuer nor any discretion exercised by the board of directors. However, it would also be the option which is the least in favour of the participants of a share award scheme.

Scenario A would involve acquisition of shares of an issuer and scenario B would involve both acquisition of shares of an issuer and discretion exercised by the board of directors of an issuer. Issuers should carefully consider the implications under the Code on Takeovers and Mergers and share buy-backs (the "Takeovers Code") in a takeover if their rules of share award schemes contain provisions falling under Scenario A or Scenario B. Scenario A would be seen as the most lenient option to the participants of a share award scheme, while Scenario B would offer the greatest flexibility (for the board of directors to determine the solution taking into account all relevant factors at the time) amongst the options above.

Key issues and considerations

Frustrating actions

Rule 4 of the Takeovers Code provides that “once a bona fide offer has been communicated to the board of an offeree company or the board of an offeree company has reason to believe that a bona fide offer may be imminent, no action which could effectively result in an offer being frustrated, or in the shareholders of the offeree company being denied an opportunity to decide on the merits of an offer, shall be taken by the board of the offeree company in relation to the affairs of the company without the approval of the shareholders of the offeree company in general meeting.”

Issue of shares and provide financial assistance for the purchase of any shares in the offeree company are specifically listed as examples of frustrating actions in Rule 4 of the Takeovers Code. Issuers should therefore pay attention to any grant or vesting of share awards which involve the issue of new shares or purchase of shares on-market. The Executive Director of the Corporate Finance Division of the Securities and Future Commission (the “Executive”) should be consulted at the earliest opportunity.

The Executive may grant a waiver from the general requirement to obtain shareholders’ approval where there are special circumstances, including without limitation:

- where the offeror agrees to the action to be taken by the offeree company
- where the offeree company is under a prior contractual obligation to take any such action
- where the timing and level of the action are in accordance with the offeree company’s normal practice under an established scheme

Based on the factors listed above, Scenario A may represent a low risk of being deemed a frustrating action given that the automatic acceleration of vesting is prescribed in the rules of the share award scheme, as opposed to Scenario B which involves an action to be taken by the board of directors of the issuer.

Grants of share awards as a part of a regular and routine exercise at a time and in a scale consistent with historical practices and track record would also be less likely to be treated as frustrating actions.

Implications on the offer

The Takeovers Code imposes various obligations on the offeror, party(ies) acting in concert with the offeror and associate(s) of the offeror before and during an offer period, include but not limited to those set out as follows:

Disclosure of dealings during offer period

Dealings in relevant securities by an offeror or the offeree company, and by any associates of either of them, for their own account during an offer period must be publicly disclosed. (Rule 22.1 of the Takeovers Code)

Cash offer

A cash offer is required where the shares purchased for cash by an offeror, and any person acting in concert with the offeror, during the offer period and (if carry 10% or more of the voting rights currently exercisable) within 6 months before its commencement in which case the offer for that class shall be in cash or accompanied by a cash alternative at not less than the highest price paid by the offeror or any person acting in concert with it for shares during such period and (if carry 10% or more of the voting rights currently exercisable) within 6 months before its commencement. (Rule 23.1 of the Takeovers Code)

Purchases resulting in an obligation to offer a minimum level of consideration

Under Rule 24.1 of the Takeovers Code:

- When an offeror or any person acting in concert with it has purchased shares in the offeree company:– (i) within 3 months before the offer period; (ii) during the period, if any, between the commencement of the offer period and an announcement made by the purchaser in accordance with Rule 3.5; or (iii) before the 3 month period referred to in (i), the offer to the shareholders of the same class shall generally not be on less favorable terms.
- If, after an announcement made in accordance with Rule 3.5 and during the offer period, the offeror or any person acting in concert with it purchases shares in the offeree company at above the offer price (being the then current value of the offer), then the offeror must increase the offer to not less than the highest price (excluding stamp duty and dealing costs) paid for any shares so acquired.

In view of the above, offeree companies and offerors should carefully consider and assess the implications on

the offer before making any grant and/or vesting of share awards under share award schemes. In particular, it is important to identify the parties who are acting in concert with or associates of the offeror and/or the offeree company within the meaning of the Takeovers Code when considering whether a grant and/or vesting of share awards would trigger any dealing disclosure or offer price related obligations etc..

For example, directors of the offeror or of its parent are parties acting in concert under class (2) of the definition of acting in concert in the Takeovers Code. Hence, due care should be exercised when share awards are granted to or vested in a participant who is also a director of the offeror or its parent.

In addition, a company and its employee share schemes are presumed to be parties acting in concert under class (3) of the definition of acting in concert in the Takeovers Code. The Takeovers Code provides that class (3) does not apply to an employee benefit trust and the Executive will apply the following factors to determine whether the directors and/or a controlling shareholder (or group) of a company are acting in concert with the trustees of an employee benefit trust of the same company:

- the identities of the trustees
- the composition of any remuneration committee of an issuer
- the nature of the funding arrangements
- the percentage of the issued share capital held by the employee benefit trust
- the number of shares held to satisfy awards made to directors
- the number of shares held in excess of those required to satisfy existing awards
- the prices at which, method by which and persons from whom existing shares have been or are to be acquired
- the established policy or practice of the trustees as regards decisions to acquire shares or to exercise votes in respect of shares held by the employee benefit trust
- whether or not the directors themselves are presumed to be acting in concert

- the nature of any relationship existing between a controlling shareholder (or group of shareholders acting, or presumed to be acting, in concert) and both the directors and the trustees

The following are some general tips which may lower the risk of a company, its directors and/or its controlling shareholder (or group) being deemed to be acting in concert with the trustees of an employee benefit trust:

- it may be helpful to engage a professional and independent trustee has a trust or company service providers licence under the Anti - Money Laundering and Counter - Terrorist Financing Ordinance (Cap. 615) and acts in accordance with the Trustee Ordinance (Cap. 29)
- to have a remuneration committee comprising no directors of the offeror or its parent
- not to have a scheme limit disproportionate to the issuer's needs for award shares
- to maintain independence in the selection of grantees and determination of the number of awards as well as conditions of grant, preferably by the remuneration committee
- to stipulate in the rules of the share award schemes that the trustees shall not exercise any voting rights attached to the shares held in trust in compliance with Chapter 17 of the Listing Rules
- to maintain a transparent and impartial process of giving instructions to the trustee as to purchase of award shares on-market without the interference of the offeror, preferably by the remuneration committee

Special deal

Rule 25 of the Takeovers Code provides that “except with the consent of the Executive, neither the offeror nor any person acting in concert with it may make any arrangements with shareholders or enter into arrangements to purchase or sell securities of the offeree company, or which involve acceptance of an offer, either during an offer or when an offer is reasonably in contemplation or for 6 months after the close of such offer if such arrangements have favourable conditions which are not to be extended to all shareholders.”

Parties should be mindful to check whether any of the grantees are also shareholders of an issuer, especially for

issuers who have a regular practice of granting share awards. In the grantees are also shareholders, the grant or vesting of share awards would prima facie be a special deal under Rule 25 of the Takeovers Code as there would be purchase or sale of shares of the offeree company which favours the grantees but are by definition not capable of being extended to all shareholders.

The consent of the Executive should therefore be sought before vesting any share awards in the grantees. The established exemptions as set out in Practice Note 17 – Issues relating to special deals and Rule 25 of the Takeovers Code apply only to arrangements with shareholders involving the parties' ordinary business activities. It is likely that dealing with share awards is not in an issuer's ordinary business activities, and hence the Executive's consent would be given on a case-by-case basis. In that connection, it would appear that a special deal waiver is more likely to be granted for Scenario A than Scenario B as acceleration is a default position in Scenario A involving no exercise of discretion nor change to the pre-determined arrangement.

Another way forward?

The operations of share award schemes in the case of a takeover do not appear to fit well with the existing regime under the Takeovers Code. None of Scenario A, Scenario B or Scenario C is a perfect solution and each of them has its own practical and/or compliance concerns, which create uncertainties to takeover projects.

The current regime (Rule 13 of the Takeovers Code) provides that where an offer is made, the offeror must also make an appropriate offer or proposal to the holders of outstanding convertible securities, warrants, options or subscription rights at the "see-through" price to ensure that their interests are safeguarded.

While it is well established that offerors are required to extend offers to holders of shares options granted under share options schemes adopted by issuers, there is no conclusive view as to whether Rule 13 of the Takeovers Code applies equally to share awards. It seems that a share award offer is rarely seen in the market. An example would be the proposal for the privatization of Chong Hing Bank Limited (stock code: 1111) by way of scheme of arrangement by Yue Xiu Enterprises (Holdings) Limited in 2021, under which a share award offer was made to each outstanding share award holder to cancel all his/her outstanding share award(s) in exchange for the payment of the share award offer price (as defined below) in cash.

It would be helpful if the Executive could give guidance as to the criteria for determining whether an offer is required to be extended to a holder of share award(s) or encourage a market practice whereby offerors would voluntarily make a share award offer. This would offer regulatory certainty while at the same time safeguard the interest of holders of the share awards.

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