

## **TAKEOVERS AND MERGERS PANEL**

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### **Panel Decision**

**In relation to the review by the Takeovers and Mergers Panel (the “Panel”)**

matter before the Panel, they are quoted in full here:

- (C) *the Zhongyu Shares remaining listed and traded on the Stock Exchange up to the Closing Date (or, if earlier, the Unconditional Date) save for any temporary suspension(s) of trading of the Zhongyu Shares as a result of the Offers and no indication being received on or before the Closing Date (or, if earlier, the Unconditional Date) from the SFC and/or the Stock Exchange to the effect that the listing of the Zhongyu Shares on the Stock Exchange is or is likely to be withdrawn...*
- (G) *since the date of the last audited consolidated financial statements of Zhongyu, there having been no change, effect, fact, event or circumstance which has had or would reasonably be expected to have a material adverse effect on, or to cause a material adverse change in, the general affairs, management, financial position, business, prospects, conditions (whether financial, operational, legal or otherwise), earnings, solvency, current or future consolidated financial position, shareholders' equity or results of operations of Zhongyu or any member of the Zhongyu Group, whether or not arising in the ordinary course of business; and*
- (H) *no material breach of any covenants, representations and warranties given by Hezhong and each of the Management Owners in favour of the Offeror under the Irrevocable Undertaking.*

*The Offeror reserves the right to waive all or any of the Conditions to the Offers set out above... in whole or in part.*

refused by Mr. Wang. At some time after the publication of announcement of the Offers the objection of certain members of management to the Offers manifested itself in a withdrawal of any assistance to the auditors of Zhongyu Gas or the Hong Kong office of Zhongyu Gas in the completion of its annual audit for the financial year ended 31<sup>st</sup> December, 2009. Audit queries were unanswered and the auditors were awaiting information relating to adjustments of gas meter readings. The directors of Zhongyu Gas were unable to overcome the impasse and the work on the audit was suspended and remained suspended at the time of the Panel hearing.

8. While Mr. Wang was not particularly forthcoming about the state of operations or the Zhongyu Gas Group's recent financial performance, there was no evidence before the Panel that the operations or prospects of the Zhongyu Gas group had suffered as a result of the suspension of the audit. Although repeated mention was made by both Mr. Wang and Mr. Liu of possible safety risks, given the industry in which it operates and the number of customers it serves, no evidence was adduced by either of them that safety procedures had been compromised by the actions taken to delay the completion of the audit. Indeed, it appears that, provided the Offers are withdrawn, work on the audit could recommence.
9. On 22<sup>nd</sup> March, 2010, trading in the shares in Zhongyu Gas which are listed on the Growth Enterprise Market ("GEM") was suspended. On 31<sup>st</sup> March, 2010 in an announcement of that date the directors gave the reason for the suspension when they explained that "although the audit field work had been completed, the senior management of some of the major PRC subsidiaries of the Company ("PRC Subsidiaries") have not provided the external auditors with responses to the auditors' follow-up questions for the purpose of finalising the audit. Such outstanding information included the adjustments of gas meter readings as at 31<sup>st</sup> December, 2009 which affects the sales revenue of the Group, discounted cashflow data for the purpose of ascertaining the value of the goodwill impairment in the accounts as well as payment status in relation to certain acquisition consideration payable by the Group". It further confirmed that "the business operations of the Group have been carried out in the normal course" and until the date of the audit could be ascertained "the shares of the Company will continue to be suspended".
10. On 16<sup>th</sup> April, 2010 an application to the Executive was made on behalf of the Offeror and China Gas for the Executive's consent not to proceed with the Offers. The Executive indicated that their application would not be granted and confirmed this in a formal ruling given on 28<sup>th</sup> April, 2010. As a result, the Panel was requested to review the ruling.

#### **The relevant provisions of the Code**

11. The provisions of the Code which relate to the invoking of the conditions to which an offer is subject are contained in the Notes to Rule 30.1, which Rule is headed "Subjective conditions". In this matter, the relevant Notes to Rule 30.1 state the following:

3. *Listing conditions*

*Except with the consent of the Executive, where securities are offered as consideration and it is intended that they should be listed on the Stock Exchange, the relevant listing condition should be in terms which ensure that it is capable of being satisfied only when the decision of the Stock Exchange to admit the securities to listing has been approved by the Stock Exchange.”*

The third Note to Rule 30.1 is included, not because the condition (Condition B of the Offers), a condition which the Offeror could not waive, requiring grant by the Stock Exchange for a listing of the shares in China Gas to be issued as part of the consideration payable under the Offers was an issue in the hearing, but because it is apparent that this Note can only apply to an objective condition which does not rely in any way on judgements by the Offeror, notwithstanding the heading to Rule 30.1.

12. The Code envisages that an offer can only be withdrawn in a limited set of circumstances. This is set out in Rule 5 which reads follows:

*“When there has been an announcement of a firm intention to make an offer, except with the consent of the Executive, the offeror must proceed with the offer unless the offer is subject to the fulfilment of a specific condition and that condition has not been met.”*

In relation to material adverse changes, these changes must not be general but “of an exceptional and specific nature”. This would indicate not only that the change would be specific to the company concerned or the industry or commercial sector in which it operates but also a change which through its exceptional nature would normally be expected to have an enduring, rather than temporary, impact. This is set out in Note 1 to Rule 5 which reads as follows:

*“A change in general economic, industrial or political circumstances will not justify failure to proceed with an announced offer: to support an application to the Executive not to proceed, circumstances of an exceptional and specific nature are required.”*

13. The consideration of the matter before the Panel was also made with regard to the certainty that the Code tries to create in the context of making a takeover offer. While it is not the intention here to quote all the Rules and Notes to Rules which are directed to achieving conditions of the greatest certainty practicable in the context of an offer, the following General Principles of the Code, being General Principles 4, 5 and 6, are directed in large measure towards reducing the uncertainties of an offer as far as the shareholders and holders of other securities of the offeree company are concerned. They state the following:

*“4. An offeror should announce an offer only after careful and responsible consideration. The same applies to making acquisitions which may lead to an obligation to make a general offer. In either case the offeror and its financial advisers should be satisfied that it can and will continue to be able to implement the offer in full.*

*5. Shareholders should be given sufficient information, advice and time to reach an informed decision on an offer. No relevant information should be withheld. All documents must, as in the case with a prospectus, be*

*prepared with the highest possible degree of care, responsibility and accuracy.*

6. *All persons concerned with offers should make full and prompt disclosure of all relevant information and take every precaution to avoid the creation or continuance of a false market. Parties involved in offers must take care that statements are not made which may mislead shareholders or the market.”*
14. References to other Notes to Rules in this decision, which are not quoted in full, are given in square brackets.

**The representations of China Gas and Mr. Wang in summary**

15. While articulated in slightly different terms, the Panel accepted the arguments advanced by the Executive, so it is unnecessary to summarise them here. Further, although Zhongyu Gas was represented at the hearing, it did not add significantly to the information available to the Panel.
16. In relation to Condition C, China Gas saw the condition operating effectively as two conditions independently of each other, an interpretation the Panel accepts.

The final of the Panel's conclusions is that the Panel's decision is based on the information available to it at the time of its decision.

19. Further, China Gas submitted that the continued suspension was also indicative of the failure of Hezhong, Mr. Wang and Mr. Hao in discharging their undertakings in breach of Condition H.
20. Mr. Wang supported the application on behalf of China Gas and the Offeror to withdraw the Offers. He believed that it would be in the interest of the shareholders of Zhongyu Gas were this to happen. While the withdrawal of the Offers may have an adverse impact in the short term, he remained confident of Zhongyu Gas's long term prospects. However, he did not explain what the potentially value-destroying actions of certain of its senior managers might have on its value in the future. He was adamant that he, Mr. Hao and Hezhong had used their best endeavours to discharge their obligations under their irrevocable undertakings and were not in breach of Condition H.

### **The Panel's decision and its reasons for it**

21. While it is not an explicit General Principle of the Code there is an underlying principle underpinning the Code that attempts to create conditions of the greatest certainty practicable in the context of a takeover offer. This is evident in a number of the Code's General Principles and in specific Rules or Notes to them, as well as in the Introduction, which states that the Code provides "an orderly framework" in which takeovers are to be conducted. This can be seen in General Principle 4, the requirement to announce an offer only after careful and responsible consideration and only in circumstances where the offeror and its financial advisers are satisfied that the Offeror can and will continue to be able to implement the offer in full; General Principle 5, the requirement to provide sufficient information, advice and time so an informed decision on the offer can be made; and General Principle 6, to make full and prompt disclosure and to take every precaution to avoid the creation or continuance of a false market.
22. The creation of conditions of the greatest certainty practicable also flows through to many of the Code's Rules or Notes to them. These include, but are not limited to, the right of the offeree company's board to be satisfied that the offeror is, or will be, in a position to implement the offer in full [Rule 1.3]; the publication of a preliminary announcement which contains all the terms and conditions to which an offer is subject and the confirmation that the offeror has sufficient financial resources to implement the offer in full [Rule 3.5]; the prohibition on frustrating actions [Rule 4]; the fact that changes in general economic, industrial or political circumstances are insufficient reasons to withdraw an offer [Note 1 to Rule 5]; the offer timetable [Rules 8 and 15]; the accuracy of information [Rule 9]; the disciplines placed on making statements during the currency of an offer [Rule 18]; restrictions on, and disclosure of, dealings during an offer [Rules 21 and 22]; and the provisions which prevent an offeror from making another offer for a period of twelve months if its present offer

24. With regard to the interpretation of Note 2 to Rule 30.1, notwithstanding the heading to the Rule which refers to subjective conditions only, its natural meaning must include, as it states, all conditions, whether subjective or objective, except the acceptance condition. It simply does not make sense to read the words “all conditions” to mean “all subjective conditions”, when the excluded condition is manifestly an objective one. We would also add that the Note applies to all conditions, other than the acceptance condition which is not permitted to be waived [Rule 30.2], whether or not they are waivable by the offeror.
25. To invoke any condition the offeror must demonstrate that “the circumstances... are of material significance to the offeror in the context of an offer”. In the case of regulatory or governmental consents and approvals this is clear-cut as, without such consents or approvals, an offer cannot be completed. This is illustrated in the following Note [Note 3 to Rule 30.1], which refers to the fulfilment of a listing condition when securities to be issued under an offer are intended to be listed on the Stock Exchange. In this event, the listing condition can only be satisfied “when the decision of the Stock Exchange to admit securities for listing has been approved by the Stock Exchange”.
26. For the invoking of general business and performance conditions of the kind of Conditions C, G and H to the Offers, it will require the offeror to demonstrate to the satisfaction of the Executive that the circumstances are of material significance to the offeror in the context of the offer. Clearly this will depend on the facts of each particular case. Consequently to the extent this decision sets out any guidance on this, it can do so only in very general terms. The circumstances which would justify the invoking of a condition would appear to require that they would go to the heart of the commercial rationale for the transaction; they are specific to the offeree company or the particular industrial or commercial sector in which it operates and not the market as a whole; they are matters which could not be adequately addressed or mitigated substantially before a firm intention to make the offer was announced; they are normally of a permanent or enduring nature; and, if they had yet to occur, they were likely to occur.
27. The operation of Rule 5 which permits the withdrawal of an offer when a condition has not been fulfilled on the application of Note 2 of Rule 30.1, as it has been described above, would only occur if general business or performance conditions, whether subjective or not, were invoked in compliance with the Note. It is apparent that the invoking of conditions as a result of circumstances which are not accepted as being of material significance to the offeror in the context of the offer are to be excluded from Rule 5.
28. In relation to Condition C, while it is undeniable that Zhongyu Gas is in breach of the GEM Listing Rules because it has not published its audited annual financial statements in the time prescribed and the suspension is likely to continue until it does publish these and subsequent financial statements in compliance with the GEM Listing Rules, this is a matter which is capable of being rectified. There is no indication that presently the listing of Zhongyu Gas is under threat and no action, apart from the suspension, has been taken against it in this regard. Further China Gas could identify no analogous example of a company which had failed to publish its audited financial statements within the time prescribed and, in the absence of other factors, which had had its listing withdrawn within a comparatively short period: that is, within a matter of months. At the very least the process of delisting generally takes eighteen months from the first indication

of its prospect by the Stock Exchange. In this case, China Gas failed to demonstrate that the listing of the shares in Zhongyu Gas is likely to be withdrawn or that the suspension in itself is, in the circumstances, of material significance in the context of the Offers.

29. In relation to condition G, it was accepted that the failure by Zhongyu Gas to publish its audited annual financial statements had triggered the early redemption of its convertible bonds. Since the change of control of Zhongyu Gas and the declaration that the Offers had become or had been declared unconditional would also trigger the early redemption of the convertible bonds, the right of early redemption had simply been brought forward by the failure of Zhongyu Gas to publish its audited annual financial statements. This accelerated right to redemption was not an event of default so the early redemption was not expected to have any significant impact on the banking and other credit facilities of the Zhongyu Group. It did not, therefore, appear that the early redemption which was in prospect when the Offers were announced could have an adverse impact on the Zhongyu Gas Group of an enduring nature. No evidence was adduced that the suspension had affected adversely its general business or prospects or compromised the safety of its operations. Even if such evidence had been adduced, it would have been necessary that it was of material significance and of more than temporary duration for it to have been the basis to consider whether this condition could be invoked under the provisions of Note 2 to Rule 30.1.

30. Lastly, in relation to Condition H, China Gas offered no evidence that Hezhong, Mr. Wang or Mr. Hao had failed to discharge their respective obligations under their irrevocable undertakings given in favour of the Offeror. The best China Gas could offer was that it could assume they had. From the evidence before the Panel, it appeared that Mr. Wang had gone to considerable lengths to placate disgruntled managers to keep the transaction on track. It was, therefore, unclear whether this Condition had been breached at -22e-6(,)6(in it)had ,

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