Hong Kong

Negotiated M&A Guide

Corporate and M&A Law Committee

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1. INTRODUCTION

The terms “merger” and “acquisition” have no legislative interpretation or meaning in Hong Kong. While defined by statute in a number of jurisdictions, “merger” is not a legal term of art in Hong Kong and, used generically, is often indistinguishable from acquisitions and amalgamations. “Acquisition” has a more generally accepted meaning and can encompass a number of methods by which a party acquires whole or partial ownership of a business enterprise or shares in a target company. “Amalgamation” is a legal process by which the undertaking, property and liabilities of two or more companies merge and are brought under one of the original companies or a newly formed company and their shareholders become the shareholders of the new or amalgamated company.

Mergers and acquisitions in Hong Kong are typically structured through the transfer of the target company’s shares, or the target company’s assets, to the purchaser.

The detailed discussion in this guide is mostly focused on share transfers. In addition, it should be noted that much M&A activity in Hong Kong involves public (and, in which case, almost invariably listed) companies, in which case the relevant listing and takeover rules will be applicable. An examination of such rules is, however, beyond the scope of this guide.

2. STRUCTURE OF THE TRANSACTION

Generally, share transfers tend to be more common than asset transfers in Hong Kong. Various factors would be relevant in determining which structure is to be preferred in a particular case. For example:

- a share transfer may not be appropriate if the purchaser only wants to purchase a small or specific part of the target company's business
- in an asset transfer, the purchaser can choose to avoid the assumption of undisclosed or contingent liabilities
- a share transfer may be more appropriate if the target company's assets are not transferable, e.g. non-transferable government licences or non-assignable agreements with third parties – subject, of course, to any change of control provisions

3. COMMON LEGAL ISSUES

(a) Employees

Normally there will be no transfer of employees in a share transfer, as the employees will remain in the employment of the target company. There should not be significant employment law issues, subject to any change of control provisions in the relevant employment contracts (which would be quite unusual).

In an asset transfer, however, employees of the target company will not be automatically transferred to the purchaser. Under Hong Kong law, all existing contracts of employment have to be terminated and, if it is desired to retain employees in the business, new contracts of employment offered to those employees who are being transferred. If employees are not retained, redundancy issues may arise on termination and the old employer may be liable to make severance payments and provide other statutory benefits. The Employment Ordinance provides a specific exemption regarding redundant liability of the old employer where the new owner of the business makes an offer to re-employ the employees on no less favourable terms and conditions, at least seven days before the previous employment terminates. No liability to make severance payments will arise if that offer is refused by the relevant employee, although there may still be residual liabilities to make long service payments. If the employees accept the offer, they achieve continuity of employment for the purposes of the Employment Ordinance. As a result, the eventual liability for redundant benefits is rolled over to the new employer by reference to the total period of employment.

(b) Transfer of Liabilities

The Transfer of Businesses (Protection of Creditors) Ordinance provides that whenever a business is transferred, the purchaser shall, notwithstanding any agreement to the contrary, become liable for all the debts and obligations arising out of the carrying on of business by the seller, unless the procedures set down in that ordinance are followed. These procedures require the parties to publish a notice of transfer (setting out prescribed particulars of the transfer) not more than four months and not less than one month before the date the transfer takes place.

The purchaser ceases to be liable for all obligations of the seller with effect from the date on which the notice of transfer becomes complete, which occurs upon the expiration of one month after the date of the last publication of the notice, unless within that period a creditor commences proceedings against the seller in respect of any liability of the seller arising out of its carrying on of the business.

Under the Transfer of Businesses (Protection of Creditors) Ordinance, the purchaser is entitled to be indemnified by the seller for all amounts for which the purchaser is made liable under that ordinance and for which it would not otherwise be liable. In most cases an express indemnity provision in favour of the purchaser would be included in the contractual documents between the parties.

(c) Landlords

Hong Kong real estate leases are almost invariably not assignable without the consent of the landlord. It is also very often the case that consent of the landlord will be required for any change in control of the tenant. Failure to obtain consent will usually give rise to a right of termination of the lease. Thus in most merger and acquisition transactions where there is Hong Kong property under lease and the lease is to be transferred to the purchaser (in a sale of business) or acquired with the target company (in a sale of shares), landlord's consent may be a relevant issue.

Obtaining consent is not necessarily a formality and will not necessarily be done quickly. The landlord will invariably look to the financial strength of the acquiring group and may seek to renegotiate the rent if the contractual rent is below market rent. To avoid problems in a transaction where the target business or company has real estate leases, the question of approaching landlords should be addressed as early as possible. In practical terms, whether landlords' consent is likely to be a difficult issue may depend on the state of the market at the relevant time and the strength of covenant of the acquirer.

(d) Competition and Other Investment Restrictions

Competition regulation

The Competition Ordinance was enacted in June 2012 and came into full operation on 14 December 2015 as the first cross-sector competition law regime in Hong Kong. It contains prohibitions against three types of anti-competitive conduct:

- The First Conduct Rule - prohibits agreements or arrangements between market participants that have the aim or effect of preventing, restricting or distorting competition in Hong Kong
- The Second Conduct Rule - prohibits businesses with substantial degree of market power in a market from abusing that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong
- The Merger Rule - prohibits an undertaking from directly or indirectly carrying out a merger that has, or is likely to have, the effect of substantially lessening competition in Hong Kong

The First Conduct Rule and the Second Conduct Rule apply to all sectors of the Hong Kong economy, whereas the Merger Rule currently applies only to mergers involving carrier licence holders within the meaning of the Telecommunications Ordinance.

Sectorial regulation

In Hong Kong, the consent of the relevant regulatory body is required for a change of ownership of companies operating in certain sectors of the economy, including radio and television broadcasting, banking, insurance, and financial services.

Foreign exchange and investment restrictions

Hong Kong currently does not impose controls on the inflow and outflow of foreign exchange, or any restrictions on investment or repatriation of capital or remittance of profits or dividends to or from a Hong Kong company. Unless one of the few regulated industries such as radio and television broadcasting is involved, there are generally no approval requirements or restrictions on foreign ownership of Hong Kong companies.

(e) Tax Issues

The tax regime

Local tax considerations play a subsidiary role in the structuring of mergers and acquisitions in Hong Kong, due to the simplicity and transparency of the tax regime. Some of the principal features of the Hong Kong tax regime are:

- Hong Kong does not recognise the concept of taxing capital gains on the disposal of assets (including property and shares)
- there is no withholding tax payable in respect of distributions to shareholders by way of dividend
- dividends are not taxable income
- there is no concept of group taxation

Stamp duty

Stamp duty is charged on the sale of Hong Kong stock. Currently the rate is calculated at 0.2% on the higher of the amount of the consideration paid and the value of the shares being transferred. It is normally paid in equal proportions by the seller and the purchaser, although there is no hard and fast rule in this regard. Relief is available (subject to certain conditions) in respect of intra-group share transfers between associated companies (90% ownership is the applicable threshold). For acquisitions where the stamp duty payable is substantial, techniques such as "swamping" allotment of shares or the reclassification of existing shares may sometimes be adopted to minimise the duty. There may also be other methods that can be used to minimise (and sometimes even eliminate) the stamp duty charge, but there may be uncertainty as to the effectiveness of some of these methods, in particular those involving non-commercial steps which may be disregarded as a result of application of anti-avoidance provisions. . Capital duty, which was previously levied for increases in the authorised share capital of the Hong Kong companies, has been abolished with effect from 1 June 2012.

(f) Consent by Third Parties

In many merger and acquisition transactions, consents, approvals or waivers from third parties are required under the articles of association of the target company or shareholders' agreements. For example, in an acquisition of some, but not all, of the shares of a company, the consent of the other shareholders may be required to waive pre-emptive rights or other restrictions on transfer under the articles of association of the target company.

In an acquisition of assets, the target company's constituent corporate documents should be reviewed to ascertain whether the disposal of assets requires consent from all or some of its shareholders. The same considerations apply to shareholders' agreements entered into by the shareholders of the target company, which may contain provisions restricting asset disposal.

Consents from third parties may also be required under previous agreements of the target company with creditors, landlords, debenture-holders, mortgagees and other contracting parties, which may impact on a transfer of assets or a change in control.

The parties will need to consider the procedures for transferring the licences, consents and permits which may be required for the conduct of a business in Hong Kong or for obtaining new licences, consents and permits when there is an acquisition of assets.

Parties should bear in mind that if the transaction involves the transfer of personal data (defined as any data relating directly or indirectly to a living individual, from which it is practicable for the identity of the individual to be directly or indirectly ascertained and in a form in which access to or processing of the data is practicable) to a place outside Hong Kong, certain provisions of the Personal Data (Privacy) Ordinance (including consent required from the data subject (defined to mean the individual who is the subject of the personal data)) may also be relevant.

(g) Hong Kong Company Law

Company law in Hong Kong has developed through the interaction and interdependence of case and statute law.

The Companies Ordinance sets out the general rules and regulations governing Hong Kong companies (with certain provisions applying to overseas companies having a place of business in Hong Kong) and contains a number of specific provisions relating to matters which may impact upon mergers and acquisitions and how they can be structured, including the following:

- the giving of financial assistance by a company for the purchase of its own shares is subject to certain procedural requirements, including the satisfaction of a solvency test and board and shareholder approval (albeit that there is also a *de minimis* threshold in lieu of obtaining shareholder approval)

- restrictions on the methods whereby a company can reduce its share capital or vary the rights attaching to a particular class of shares. The Companies Ordinance provides for a court-free procedure for capital reduction. The requirements under this procedure include the satisfaction of a solvency test and the passing of a special resolution by disinterested shareholders. This court-fee procedure will likely be faster and cheaper than the alternative court-sanctioned procedure

- restrictions on the amounts which can be distributed by way of dividend

Intra-group amalgamations

The Companies Ordinance provides for a court-free procedure for two categories of intra-group amalgamations: vertical amalgamations (meaning amalgamations between a holding company with one or more of its wholly-owned subsidiaries) and horizontal amalgamations (meaning amalgamations between two or more wholly-owned subsidiaries of the same company).

Certain requirements will have to be complied with under this court-free procedure. These include requiring the directors of each amalgamating company to make a solvency statement, issue a certificate on the solvency statement, give written notice of the proposed amalgamation to every secured creditor and publish the proposal in newspaper. The members of each amalgamating company must approve the amalgamation by a special resolution, which must also be registered with the Companies Registry. The effect of an amalgamation is that the amalgamating companies form one company. On the effective date of such amalgamation, each amalgamating company ceases to exist as an entity separate from the amalgamated company, and the amalgamated company succeeds to all the property, rights and privileges, and all the liabilities and obligations, of each amalgamating company.

Private and public companies

An important distinction is drawn in Hong Kong between private and public companies. The Companies Ordinance prescribes that a company is a "private company" if its articles of association restrict the right to transfer shares; limit the number of its members to no more than 50; and prohibit any invitation to the public to subscribe for shares in or debentures of the company. The term "public companies" is defined in the Companies Ordinance as companies other than private companies and companies limited by guarantee.

Bill to enhance transparency in the beneficial ownership of Hong Kong companies

The Companies Ordinance requires a Hong Kong company to disclose information of the legal ownership of its shares by keeping a register of members at its registered office and filing the information with the Companies Registry via an annual return for public inspection. The current law does not, however, require a company to ascertain, keep or file information about its ultimate beneficial owner. A bill to amend the Companies Ordinance was published in June 2017 to enhance transparency in the beneficial ownership of Hong Kong companies by requiring each Hong Kong company (other than a company listed on The Stock Exchange of Hong Kong Limited) to, among others things, maintain a register of its significant controllers (e.g. a person holding, directly or indirectly, more than 25% of the issued shares in the company or the right to appoint or remove a majority of the board of directors of the company, or a person having the right to exercise, or actually exercises, significant influence or control over that company) for inspection by law enforcement officers, upon demand, for the purpose of the officers' performance of functions relating to the prevention, detection or investigation of money laundering or terrorist financing. The bill, if passed, is expected to come into effect in March 2018.

(h) Listing Rules and Takeovers Code

Companies listed in Hong Kong are also subject to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited or the Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (as the case may be), as well as The Codes on Takeovers and Mergers and Share Buy-backs (which apply to public companies).

(i) Use of offshore companies

One factor which is quickly apparent to those conducting business in Hong Kong is the common use of offshore companies, incorporated in jurisdictions such as the British Virgin Islands. These companies are used for a number of reasons, including the relative simplicity of maintenance under the company laws applicable to those offshore jurisdictions as compared to Hong Kong company law and the avoidance of Hong Kong stamp duty on share transfers (save as regards shares traded on The Stock Exchange of Hong Kong Limited, which are required to be registered on a Hong Kong branch register).

4. PROCESS AND DOCUMENTATION

(a) Typical Documentation

Core documentation involved in a sale and purchase of a company or a business in Hong Kong is similar to that used in many international jurisdictions and typically includes the following:

- a confidentiality letter in which the parties undertake to keep confidential the actual transaction and any information they may obtain during the due diligence process. In some cases, it may include a provision for exclusive negotiations for a particular period so that the purchaser knows that there will be no dual negotiations or auction type process
- a due diligence questionnaire and report in relation to the business or company
- a sale and purchase agreement that specifies the obligations and liabilities of each party in relation to the sale. This normally includes detailed representations and warranties regarding the business or company. In a share transfer, all the company's obligations and liabilities remain in the company whereas in a business sale, subject to the Transfer of Businesses (Protection of Creditors) Ordinance, the purchaser will normally be able to pick and choose which assets it wishes to purchase and which liabilities it wishes to acquire
- a disclosure letter in which the seller makes disclosures against the representations and warranties in the sale and purchase agreement
- share transfer forms where the sale and purchase involves the sale of shares, and bought and sold notes if these are shares in a Hong Kong company
- a notice under the Transfer of Businesses (Protection of Creditors) Ordinance in the case of the sale of a business
- with respect to public companies, any documentation specifically required by relevant listing or takeover rules

(b) Letter of Intent / Memorandum of Understanding

The process for a merger and acquisition transaction in Hong Kong is similar to typical international practices. The parties will initiate discussions to reach a preliminary agreement on the key commercial terms. Having reached an agreement in principle and before the due diligence and documentation drafting process, which can be time consuming and costly, the parties may want to record the principal terms of the transaction in writing, which may be referred to as a letter of intent, a memorandum of understanding, a term sheet or heads of terms.

A letter of intent / memorandum of understanding may or may not be legally binding and the parties should specify this clearly in the relevant documentation. Normally a letter of intent / memorandum of understanding would not be expressed to be legally binding except for certain specific provisions, such as those relating to confidentiality, exclusivity, and liability for costs in the event of an unsuccessful transaction. In relation to those parts of the document which are to be legally binding, the legal requirement for the creation of a valid contract must be satisfied.

(c) Confidentiality Agreement

Where the seller is prepared to provide commercially sensitive or confidential information before a legally binding sale and purchase agreement is entered into, the seller would typically require the purchaser to enter into a confidentiality agreement which may contain the following:

- a definition of the confidential information
- an obligation on the purchaser not to disclose or use such information except for the purpose of evaluating the acquisition
- restrictions on the purchaser from soliciting customers, suppliers and/or employees of the target company
- an undertaking by the purchaser to return or destroy such information (including copies and documents prepared on the basis of information provided)
- an agreement that the parties will not, without the written consent of the other party, make any announcement or disclosure of the fact that negotiations are taking place

The undertakings of the purchaser may be contained in a separate agreement between the parties (which may be in the form of a letter to the seller) or in the letter of intent / memorandum of understanding.

(d) Exclusivity Agreement

While an agreement which purports to commit the parties to enter into a definitive sale and purchase agreement would be unenforceable under Hong Kong law on the basis that it is an agreement to agree, the seller may commit that it will not enter into negotiations for a sale with other parties. Such a commitment would be enforceable provided that it is sufficiently certain. Consideration should be provided for the commitment to be enforceable, which is often drafted as the incurring of fees by the potential purchaser in the due diligence investigation of the target company. Again the commitment may be contained in a separate agreement between the parties or in the letter of intent / memorandum of understanding or the confidentiality agreement.

(e) Due Diligence

Matters investigated

In any merger and acquisition transaction, in addition to financial and business due diligence, legal due diligence in some form is normally undertaken by the purchaser. Reports on title are sometimes prepared in relation to properties owned by the target company. Other items commonly investigated in a legal due diligence include, the statutory books, major contracts, plant and machinery leases, service agreements, loan details, licences/permits and particulars of litigation.

Extent of legal due diligence

The due diligence process usually involves the following steps: a questionnaire is submitted to the target company, teams of lawyers review documents and a legal due diligence report is prepared. The report may be a comprehensive one or simply reporting on disclosures made against warranties given in the contractual documentation. In answering due diligence enquiries, the seller must be careful to avoid any misrepresentation which may subsequently be relied upon by the purchaser to rescind the agreement and claim damages.

As part of the legal due diligence, searches of publicly available information may be made at the relevant government authorities (e.g. the Hong Kong Companies Registry, the Hong Kong Land Registry, the Trade Marks Registry, the Official Receiver's Office and the Hong Kong Courts in respect of litigation and winding-up proceedings) to serve as an independent check against the information provided by the seller.

When the target company has operations or assets in mainland China, a greater degree of proactivity in due diligence is usual and prudent.

Exemption to privacy law for due diligence exercise

The Personal Data (Privacy) Ordinance (the primary piece of legislation in Hong Kong aimed at protecting the privacy of individuals in relation to personal data) includes an exemption which allows personal data to be transferred or disclosed by a data user (defined to mean a person who controls the collection, holding, processing or use of the personal data) for the purpose of a due diligence exercise to be conducted in (i) a transfer of the business or property of, or any shares in, the data user; (ii) a change in the shareholdings of the data user; or (iii) an amalgamation of the data user with another body, even though such purpose was not provided for at the time of collection of the personal data.

Certain conditions will have to be fulfilled for this exemption to apply. These include:

- the personal data transferred or disclosed are not more than necessary for the purpose of the due diligence exercise

- goods, facilities or services which are the same as or similar to those provided by the data user to the data subject (defined to mean the individual who is the subject of the personal data) are to be provided to the data subject, on completion of the proposed business transaction, by a party to the transaction or a new body formed as a result of the transaction

- it is not practicable to obtain the prescribed consent of the data subject for the transfer or disclosure

This exemption does not apply if the primary purpose of the proposed business transaction is the transfer, disclosure or provision for gain of the personal data. Further, if a data user transfers or discloses personal data to a person for such due diligence exercise, that person (which arguably may include a professional adviser such as a lawyer or an accountant) must (i) only use the personal data for that purpose; and (ii) as soon as practicable after completing the due diligence exercise, return the personal data to the data user, and destroy any record of the personal data kept by him.

5. SALE AND PURCHASE AGREEMENT

The terms and conditions contained in a sale and purchase agreement will depend on the commercial terms and the circumstances of each particular case. For example, completion of purchaser's due diligence investigation may precede the negotiation and signing of the sale and purchase agreement or may continue after the signing of such agreement, with the satisfactory completion of due diligence being a condition precedent to completion of the transaction. The terms and conditions are a matter of negotiation between the seller and the purchaser. However, there are common provisions typically found in sale and purchase agreements and these are further discussed below.

It is common practice for the agreement relating to the acquisition of shares or assets in the target company to be drafted by the lawyers for the purchaser.

(a) Parties

The parties to a sale and purchase agreement will normally be the shareholder(s) of the target company (in a share transfer) or the target company (in an asset transfer) as seller(s) and the purchaser. Depending on the circumstances, a guarantor may also be made a party to the agreement to guarantee the obligations of the seller (for example, under the warranties) or the purchaser (for example, to pay part of the consideration in instalments after completion).

(b) Sale and Purchase

This clause will specify the subject matter of the sale and purchase. It will normally provide that the seller sells as beneficial owner free from all liens, charges, encumbrances, equities and adverse interests. In a share transfer, the agreement will sometimes provide that the purchaser will not be obliged to buy any of the shares unless the purchase of all the shares is completed simultaneously.

(c) Conditions Precedent

Where it is necessary to obtain regulatory and/or other consents or approvals before completion or for the purchaser to complete further due diligence (e.g. an audit) after signing of the agreement, the sale and purchase agreement will be made conditional upon the fulfillment or (if feasible) waiver of such conditions precedent. In this case, the signing of the agreement and completion of the transaction will not be simultaneous. There will be a period of time between signing and completion during which the conditions precedent are to be satisfied. This would normally give rise to questions such as who will be responsible for the fulfillment of which conditions, the conduct of the affairs of the target company during the period between signing and completion, and the allocation of risk regarding any adverse changes in the business of the target company during such period. These questions should be addressed in the sale and purchase agreement to avoid any doubts.

The date by which all conditions must be met or waived by the benefiting party should also be stated and typically the agreement will terminate if such conditions are not met or waived by that date. Normally the seller will not be in favour of the inclusion of any condition precedent which may effectively give the purchaser an option to proceed or withdraw from the agreement.

(d) Pre-emption Rights

The articles of association of a private company, particularly if it has more than one shareholder, usually contain restrictions on transfer of shares (e.g. pre-emption rights in which the selling shareholder will be required to offer the shares pro rata to the remaining existing shareholders before the shares can be sold). The sale and purchase agreement often contains the waiver of the selling shareholders of their pre-emption rights, whether conferred by the articles of association or incorporated in a shareholders' agreement. When a purchaser is not acquiring all the shares in issue or, if for some reason, one of the sellers is not a party to the sale and purchase agreement, then the purchaser's lawyers should enquire whether there is a shareholders' agreement, between the existing shareholders of the target company, containing pre-emption rights for those shareholders who are not parties to the sale and purchase agreement.

If the approval of a significant shareholder is required to effect the transaction, consideration should be given as to whether an irrevocable undertaking to vote in favour of the resolution to approve the transaction should be sought from such shareholder in advance.

(e) Restricting the Operation of the Target Company's Business between Signing and Completion

Where there is a period between signing of the sale and purchase agreement and completion, the purchaser should seek to ensure that the target company's business is carried on in the normal course and that no significant decisions affecting the target company are made without its consent. The typical approach taken to address these concerns is to provide that:

- the seller remains in management control of the target company during the period between signing and completion

- the business of the target company shall be carried on in the normal and ordinary course consistent with past practice, subject to a list of matters which shall require the prior approval of the purchaser (see a list of typical matters below)

- warranties given on the date of the sale and purchase agreement are repeated on completion

- the purchaser is given a right to rescind for a material breach of warranty and the seller is obliged to disclose events occurring which might give rise to a breach of warranty

- the seller shall provide the purchaser with reasonable access to the target company and its books and records during such period

The seller will typically agree to procure that the target company does not do any of a list of matters between signing and completion without the purchaser's prior written consent, including the following:

- amend its constitutional documents

- issue any shares or other securities

- appoint any additional directors

- lend or borrow money except in the ordinary course of its business (such as extension of credit to customers) or grant any mortgage, charge or debenture over its assets

- dispose of all or part of its business or assets except in the ordinary course of its business

- initiate any legal action (other than e.g. debt recovery action in the ordinary course of business) or settle any claim or dispute

- agree to acquire any property, commit to make any capital expenditure exceeding a certain sum or enter into any hire-purchase or leasing arrangements

- carry on any business other than its existing business

- enter into any partnership or joint venture

- vary the terms of employment of any employee or director

The seller and the purchaser may agree to set certain monetary thresholds in relation to some of these activities below which the target company may continue to operate without consent between signing and completion, to minimise any interruption to the target company's normal course of business.

(f) Consideration

The sale and purchase agreement will usually stipulate the amount of the consideration, the form it will take and the timing of the payment. The consideration will usually take the form of cash, shares or loan notes, or a combination of them.

Cash

Cash is the most common and straightforward form of consideration. The parties should be aware of the rules surrounding the giving of financial assistance by a company in connection with the purchase of its own shares and ensure that the relevant shareholders' approvals and solvency test are satisfied..

Loan notes

The purchaser may issue loan notes to the seller for the purchase price or part of it, usually on terms that the seller can demand repayment of all or part of it at specified intervals, after a certain period from completion.

Shares

If the purchaser is a company, rather than funding the acquisition by selling its assets or from other internal resources or by external borrowings, shares in the purchaser may be issued to the seller as consideration for the acquisition. The transfer of shares in private companies, however, is often restricted and hence the issuance of such shares may be less attractive to a seller as a form of consideration. Where shares are issued as consideration, the sale and purchase agreement should specify whether they are shares in the same class or how the shares issued will rank with the other shares of the purchaser and the rights the seller will have to any dividend declared in relation to a period in which completion falls.

For shares of listed companies as consideration, the purchaser may require a lock-up provision restricting the seller from, for example, disposing of some or all of the shares in the purchaser for a specific period after completion so as to avoid an adverse effect on the market for the shares.

(g) Time for Payment of Consideration

The consideration will in many cases be paid in full on completion. The parties may, however, agree to have part of the consideration paid at completion, with the balance to be paid, for example, after the accounts, as at the date of completion, have been prepared. The consideration may be adjusted upward or downward on the basis of such completion accounts.

In such cases, it is essential for the parties to agree with sufficient clarity and precision the bases on which the completion accounts will be prepared, the identity of the relevant auditor / accountant, the party responsible for the costs of preparing such completion accounts, and how the consideration should be adjusted.

A typical clause in this regard will provide for the following:

- completion accounts will be prepared within e.g. one month after completion
- the seller's accountant (who is likely to have been the target company's auditor until completion) or an independent accountant jointly appointed by the seller and the purchaser will be instructed to prepare the completion accounts on a basis which is consistent with the latest audited accounts of the target company
- if the seller’s accountant, instead of an independent accountant, is instructed to prepare the completion accounts, the purchaser and its accountant will have the right to dispute the accounts within a specific period
- if the parties cannot agree to the completion accounts, the dispute would be referred to an independent firm of accountants acting as an expert

(h) Deferred Consideration

The parties may agree to defer payment of part of the purchase price. The most common form of “deferred consideration” is where the consideration is determined on the basis of the future performance of the business of the target company, for example by reference to the results of the target company for a period of two financial years after completion. Such an “earn-out” provision is perhaps more commonly adopted if the seller will continue to stay in the management of the target company after completion.

As the deferred consideration is dependent on future performance and will not be determinable at completion, the sale and purchase agreement should provide clearly for its calculation, as well as how and when such consideration will be payable. Earn-outs are normally calculated by reference to certain financial performance targets to be met over a specific period and the actual profits achieved as reflected in the relevant accounts to be drawn up. These accounts are often referred to as “earn-out accounts”, and similar considerations to the preparation of completion accounts would apply.

The parties should agree in advance the formula for determining the financial performance targets. The seller will clearly prefer the target company's existing accounting policies and practices to continue to apply in the preparation of the earn-out accounts and that neither the target company nor the purchaser will take any action which might adversely affect or divert the target company’s profits.

(i) Instalments as a Means of Financing the Acquisition

Sometimes the seller will agree to receive payment by instalments if interest is payable on the outstanding amount and satisfactory security, such as a mortgage or charge over the purchaser’s other assets or a guarantee from a third party with substantial financial resources, is given. If a charge is to be taken over the assets of the target company, as mentioned above this may constitute financial assistance by the target company for the acquisition of its shares, which is only permitted if certain procedural requirements are complied with.

(j) Representations and Warranties

The common law rule of *caveat emptor* (or "purchaser beware") still applies to the acquisition of shares or assets in private companies in Hong Kong. In respect of a share transfer, there is no statutory protection by way of implied terms in favour of the purchaser. A purchaser will normally require comprehensive warranties to be provided by the seller in the sale and purchase agreement. However, enforcing a claim for a breach of warranty by litigation or arbitration can be both expensive and time consuming. Recovery of damages will also depend on the creditworthiness of the sellers and/or the warrantors at the time the judgment is enforced. Some liabilities may not be revealed until after the warranties have expired. In addition, it will be necessary to establish loss i.e. a diminution in the value of what has been acquired attributable to the breach, which can be a notoriously difficult exercise, particularly if it involves an assessment of the impact on the value of private company shares. Further, normally the purchaser will have a common law duty to mitigate its loss in the event of a breach. Purchasers will therefore try to negotiate assessment of loss on an indemnity basis.

In a share transfer, the warranties will generally cover the seller’s capacity and its title to the shares in the target company (and ownership of any shareholder’s loan to be assigned), the target company's financial statements and related matters, business / trading, contracts, taxation, corporate matters, title to assets, land and properties, plant and equipment, insurance, intellectual property rights, goodwill, employment matters, environmental matters, banking and finance, regulatory and tax compliance, disputes and litigation, and the accuracy and completeness of information provided by the seller.

It is likely that representations made by the seller in pre-contract discussions and negotiations, which induce the purchaser to enter into the sale and purchase agreement, will be included as warranties in the agreement. It is relatively rare, therefore, for an action for misrepresentation to be founded on a matter which is not included in the agreement. It is in fact common for the sale and purchase agreement to include an acknowledgment by the purchaser that it has not relied on any representations which are not expressly contained in the agreement and that the agreement sets out the entire agreement and understanding between the parties and supersedes any previous discussions or agreements. A contract clause which excludes liability for misrepresentation is subject to the reasonableness requirement under section 4 of the Misrepresentation Ordinance.

(k) Warranties from the Purchaser

The seller will normally obtain some basic warranties from the purchaser on matters such as its capacity. In certain circumstances other warranties may also be sought, for example where the purchaser issues its own shares to the seller as consideration for the acquisition. Under such circumstances, the seller will want to seek representations from the purchaser on its financial and other matters similar to what the purchaser would require from the seller in respect of the target company.

(l) Date of Warranties

Warranties are usually given on the date of signing of the sale and purchase agreement. However, where there is a gap between signing and completion, the agreement usually provides for repetition on completion. The purchaser will want to have a right to terminate the agreement if the seller is in breach of its warranties before completion, such that the seller will bear the risk of adverse changes occurring between signing and completion.

The competing interests of the parties are sometimes addressed by the purchaser allowing certain warranties to be qualified by materiality to cover off immaterial changes between signing and completion.

(m) Individual Warranties

The following summary is most relevant to a sale of shares rather than business or assets.

Organisation of the target company and ownership

Particulars of the target company such as its share capital and directors are usually included in a schedule to the sale and purchase agreement. The seller will be required to warrant that it is entitled to transfer the full legal (where applicable) and beneficial ownership in the shares (and any shareholder's loan to be assigned) to the purchaser and that the shares are not subject to any charge, option, lien, or other encumbrance. The purchaser will also require confirmation of, among other things, the following:

- that the articles of association provided to the purchaser are true, accurate and complete
- that the statutory books and records of the target company have been properly maintained and are true, accurate, complete and up to date
- that all documents required to be filed with the Companies Registry have been duly filed

Authority

The seller will normally be required to warrant that it has all requisite authority to execute and deliver the sale and purchase agreement and to perform the transactions contemplated under the agreement; that all necessary approvals to authorise the execution and delivery of the sale and purchase agreement have been obtained; and that the agreement constitutes a valid and binding obligation of the seller, enforceable against the seller in accordance with its terms.

Financial statements

Typically, the purchaser will seek to include, among other things, the following warranties in relation to the latest audited financial statements of the target company:

- that the bases and policies of accounting adopted for the purpose of preparing these are the same as those adopted in preparing the target company's audited financial statements in respect of the three last preceding accounting periods

- that these are complete and accurate and give a true and fair view of the assets, liabilities (including contingent, unquantified or disputed liabilities) and state of affairs of the target company at the date of the balance sheet and of its profits for the financial period ended on that date

- that these comply with the requirements of the Companies Ordinance and any other relevant laws

- that these have been prepared in accordance with generally accepted accounting principles in Hong Kong and comply with all applicable accounting practices and standards and are not affected by any extraordinary, exceptional or non-recurring item

In general, the seller will wish to see that the wording of such warranties does not extend further than the existing legal or regulatory requirements.

Financial matters

The purchaser may seek assurances from the seller that the target company has not undertaken certain actions, such as the following, since the last accounts date:

- declared or paid any dividend or made any other distribution

- incurred any material liabilities not reflected in the accounts

- incurred or agreed to incur any capital expenditure or disposed of any capital assets

Business / trading

The purchaser may seek warranties in relation to, among other things, the following trade-related matters:

- that the target company has obtained all approvals, licences and permits required to carry on its business and is not in breach of the relevant terms

- that the target company has conducted its business in accordance with all applicable laws and regulations

- that the business of the target company has been carried on in the ordinary and normal course and that its financial and trading position has not deteriorated since the date of the last audited financial statements

- that the target company is not a party to any litigation or arbitration proceedings and no such proceedings are pending, threatened or, as far as the seller is aware, likely to arise

- that the seller has no knowledge, information or belief that any supplier will cease to supply the target company after completion, or that any customer will cease to deal with the target company after completion

- that the target company is not a party to any contract or arrangement which is not on normal commercial terms or entered into on an arm's length basis, or is unduly burdensome in nature

- that (if applicable) the target company has not manufactured or sold products which are materially defective

Taxation

Tax matters are usually covered in a deed of tax indemnity and/or by means of tax covenants. It is common for the purchaser to require the seller to provide compensation for any relevant breaches of tax related matters on an indemnity basis.

Assets other than land

The purchaser may require warranties in relation to the underlying assets of the target company other than land, such as the following:

- that except for those that have subsequently been sold or realised, the target company owns and has good title to and possession of all the assets included in the latest audited financial statements and all assets acquired since the date of such financial statements

- that the plant, machinery, vehicles and other equipment owned and used by the target company are in its possession and control, are its absolute property, in a good and safe state of repair and condition and have been regularly and properly maintained

- that the stock-in-trade of the target company is in good condition and is capable of being sold by the target company in the ordinary course of its business, in accordance with its current price list, without rebate or allowance to a purchaser

Warranties should be tailored to take into account particular concerns of the purchaser over any specific assets.

Insurance

The purchaser will usually require warranties that the target company's insurance provides for sufficient cover against risks which prudent companies carrying on a similar business would normally cover by insurance and is in full force and effect. The purchaser will also seek a warranty that no insurance claims are outstanding or pending and that the seller is not aware of any circumstances likely to give rise to an insurance claim.

Intellectual property

The sale and purchase agreement will normally contain details of intellectual property rights, such as patents, trade marks, service marks, design rights and copyrights, owned or used by the target company. Warranties are typically included to confirm that there are no outstanding claims against the target company for breach of the intellectual property rights of any other person and that the target company is not in breach of any such rights. The purchaser may also require the seller to warrant that it is not aware of any infringement of the intellectual property rights of the target company by any third party.

Effect of the sale and purchase agreement

The seller is usually expected to warrant that the execution and delivery of the sale and purchase agreement and the performance of the transactions contemplated under the agreement do not and will not:

- conflict with, or result in a breach of, or constitute a default under, any of the terms, conditions or provisions of any agreement or instrument to which the seller or the target company is a party, or any provision of the constitutional documents of the seller or the target company or any encumbrance, lease, contract, order, judgment, award, injunction, regulation or other restriction or obligation of any kind or character by which or to which any asset of the seller or the target company is bound or subject

- require the target company or the seller to obtain the consent or approval of any person, body or authority

- relieve any person from any obligation to the target company, or trigger any termination right

Information disclosed

The purchaser will typically require a warranty that all information about the target company provided to the purchaser or its advisers prior to the parties' entering into the agreement is true and accurate in all material respects.

(n) Remedies for Breach of Warranties

The rights and liabilities for a breach of warranty are twofold, namely rescission and damages.

Representation incorporated as part of the contract

If a representation is incorporated in the sale and purchase agreement as a warranty, the purchaser will be able to claim damages for breach of contract. The question is whether the purchaser will also have a right to rescind the contract. According to section 2 of the Misrepresentation Ordinance, where a misrepresentation has become a term of the contract, this will not affect the innocent party's right to rescind. This should be contrasted with the remedy of breach of a warranty which does not entitle the innocent party to treat the contract as discharged. It is therefore common for the purchaser to want a right of rescission in the agreement. A misrepresentation is a false statement of fact made by one party to the contract to the other which induces the other party to enter into the contract. Accordingly, where a purchaser has relied on a representation of past or existing fact about the target company which turns out to be untrue, it will, prima facie, have a claim for misrepresentation.

Damages

Under the Misrepresentation Ordinance, damages may also be available for negligent misrepresentation. The representor will bear the burden to show that it had reasonable grounds to believe, and did believe up to the time the contract was made, that the facts represented were true. At common law, an innocent misrepresentation does not give rise to a right to damages. Under certain circumstances, however, the court might exercise its discretion to award damages in lieu of rescission under section 3 of the Misrepresentation Ordinance.

The parties may agree in advance to quantify the loss for the breach of certain specific warranties. This is enforceable so long as the figure chosen is a genuine pre-estimate of the actual loss which would be suffered by the purchaser, and not a penalty.

Statements by the seller

Liability could potentially extend to the seller of shares or a business in relation to pre-contractual statements or representations made to the purchaser about the target company, given that the seller has special knowledge of the target company and the parties are in a "special relationship".

If a purchaser is making a claim under common law based on a negligent misstatement, it is likely that it will also bring a claim for misrepresentation under section 3 of the Misrepresentation Ordinance. Misrepresentation may be easier to prove than a negligent misstatement because section 3 of the

Misrepresentation Ordinance places the onus on the maker of the statement to prove that it had reasonable grounds to believe and did believe in the truth of the statement. However, whereas an action for negligent misstatement can be founded on statements of fact, advice and opinion, a misrepresentation claim can only be based upon statements of fact. In practice, the purchaser is likely to make both claims, as well as to sue for breach of contract.

(o) Limitations on Warranty Liability

Where representations and warranties are given, the seller will have liability as a result of a breach. However, it is common for the seller to seek to restrict its liability in a number of ways, including:

- limiting the liability of a number of sellers on a “several” basis instead of on a “joint and several” basis
- imposing a “de minimis” threshold before claims can be made and setting the maximum liability of the seller
- providing for a period during which claims for a breach of warranty may be made, but after which the warranties would expire
- qualifying the representations and warranties by reference to the seller's knowledge of the relevant matters
- preventing double recovery
- by way of disclosure of matters already known to be inconsistent with the representations and warranties

(p) Joint and Several Liability

If there is more than one seller, the purchaser will usually request that all of the sellers give the warranties and indemnities and be responsible for any breach of the sale and purchase agreement, on a joint and several basis. In this case, the purchaser may claim against any one (or more) of the sellers for the total liability under the agreement.

If the purchaser chooses to sue only one of the sellers, the seller being sued may then try to obtain a contribution from the others pursuant to section 3 of the Civil Liability (Contribution) Ordinance.

In assessing the amount of contribution for an action under section 3 of the Civil Liability (Contribution) Ordinance, the court will make a decision on the basis of what is just and equitable having regard to the extent of that person's responsibility for the damage in question. The sellers who are giving the warranties and indemnities may agree in advance as to how liability should be borne among themselves when a breach occurs. This can be set out in a separate agreement or incorporated as part of the sale and purchase agreement.

To maximise its protection, a purchaser will try to resist the inclusion of the provision whereby each seller is, as between itself and the purchaser, responsible only for that percentage of the loss equal to the percentage of shares sold (or price received) by it.

(q) Maximum Liability

The seller will usually place a limitation on the maximum liability for breach of the warranties and indemnities (and even other covenants and undertakings under the sale and purchase agreement and any ancillary agreements) by equating it to the sale proceeds, or where there are several sellers, to the proportion of the sale proceeds received by it.

(r) De minimis

The seller may seek to set a ”de minimis” limit or minimum threshold amount for any individual warranty claim to avoid being pursued for trivial matters and incurring unnecessary legal costs defending such claims. The seller may also seek to set an aggregate “de minimis” sum, which is the sum that all individual claims must reach before a claim under the warranties will arise, or further seek to restrict the seller’s liability to only the excess of this aggregate de minimis amount. It is common for the aggregate claims limitation is to be set at between 1% and 5% of the purchase price.

(s) Time Limitation

The seller will usually try to restrict the period in which the purchaser can make claims under the sale and purchase agreement to one which is shorter than the statutory limit of six years (or 12 years if the agreement is made by deed) for bringing a claim for a breach of contract. It is common for the length of the period to be linked to the target company's audit or accounting period on a share transfer, e.g. a time period sufficient for at least one full audit to be carried out, or longer, depending on the underlying assets transferred.

For tax related matters, the period agreed is generally just over six years. This is because the time limit for making a tax assessment by the Inland Revenue in Hong Kong is six years from the end of the relevant tax year. However, it should be noted that in certain circumstances such as fraud, the Inland Revenue may assess tax beyond this period. It is a common practice to distinguish between the time limit for claims under the commercial warranties and the time limit for claims under the tax warranties. The purchaser usually gets protection against taxation liabilities by a separate deed of tax indemnity, in addition to detailed tax representations and warranties under the sale and purchase agreement.

(t) Double Recovery

If the circumstances giving rise to the breach of a warranty also give rise to the purchaser’s right to recover against a third party, the seller may require the purchaser to account to the seller for any amounts subsequently recovered by the purchaser from third parties (after deducting the purchaser’s costs of recovery), so that the purchaser will not recover twice in relation to the same breach (once from the seller, and once from the third party).

(u) Restricting Liability to Matters within the Seller’s Knowledge

The purchaser will prefer all representations and warranties to be given without any qualification. In some cases, however, particularly where a warranty is speculative in nature (e.g. regarding prospects or future profitability or future economic or market conditions) or relates to circumstances which may give rise to a future event (e.g. potential litigation), some qualifications such as “so far as the seller is aware after having made all reasonable enquiries” or “to the best of the knowledge, information and belief of the seller” may be permitted.

(v) Disclosure

The sale and purchase agreement will provide that the warranties are given subject to matters disclosed in the disclosure letter, with copies of the documentation being disclosed attached to it. The disclosure letter will list all information and documents already disclosed to the purchaser and will operate to exclude liability on the part of the seller regarding the specific matters disclosed, as the purchaser has or is deemed to have knowledge of such matters. It is usually divided into two parts: general disclosures followed by specific disclosures.

The purchaser will normally require the seller to warrant that the disclosures are true and limit disclosure to matters which are clearly identifiable and quantifiable.

General matters which would be disclosed will often include:

- information in the public domain, such as documents available from searches of the public records kept by the Companies Registry, the Land Registry, the Official Receiver's Office, the High Court Registry, the Patent Office and the Trade Mark Registry

- the contents of the statutory books and records inspected by the purchaser

- the contents of the minutes of meetings of the board of directors and shareholders inspected by the purchaser

- all information previously disclosed to the purchaser, such as the contents of the documents previously provided to the purchaser and correspondence between the parties. A list of such documents and correspondence will normally be set out or the parties may agree on a disclosure bundle containing all such documents

- in the case of a property, all information which might be revealed by a physical inspection

- all information contained in the accounts of the target company disclosed to the purchaser

The purchaser will try to restrict the scope of disclosure, especially matters which are not specific or general in nature, and will normally want to restrict disclosure to information which has been “fully, fairly and specifically” disclosed by the seller.

(w) Indemnities

In addition to the warranties, the purchaser may seek to include indemnity clauses in the sale and purchase agreement or in a separate deed for further protection. Indemnities are promises by the seller to reimburse the purchaser on a dollar for dollar basis in respect of a designated type of liability which may arise in the future. It is common to enter into a separate deed of tax indemnities, usually given by the seller in favour of both the target company and the purchaser, in addition to tax warranties in the sale and purchase agreement. There may also be specific issues e.g. identified in the due diligence process that the purchaser will want to deal with by way of specific indemnity.

(x) Seller’s Liability under Guarantees

On a share transfer, the liabilities of the target company remain with it. The seller may, however, continue to have exposure in respect of the target company’s liabilities after completion where it has guaranteed obligations of the target company.

The sellers, being shareholders of the target company, may have provided personal guarantees or other securities to third parties in respect of the target company’s borrowings, tenancies or other commercial contracts. The sellers will have continuing liability after completion of those obligations, unless and until they are released. In order to extinguish such remaining liabilities, the seller will usually (i) seek to obtain a release from those guarantees which remain effective after completion of the acquisition; and (ii) require the purchaser to procure such release by providing similar securities as soon as possible after completion, and to indemnify the seller for any claims in respect of the target company’s liabilities incurred after completion.

(y) Restrictive Covenants

The purchaser will usually seek to include in the sale and purchase agreement provisions which restrict the competitive freedom of the seller, such as non-compete covenants, non-solicitation clauses in relation to the target company's customers, suppliers or employees, confidentiality provisions prohibiting the seller from disclosing or using any confidential information about the target company and its customers, and provisions restricting the seller from using the same name or similar name of the target company. These restrictive covenants are for the protection of the purchaser's investment from the seller's activities after completion which may harm the goodwill and/or competitiveness of the target company.

At common law, restrictive covenants are prima facie unenforceable as they restrain trade and are therefore contrary to public policy. However, the courts are willing to uphold restrictive covenants which they consider to be reasonable in order to protect the legitimate interest of a purchaser. In order to be enforceable, however, the restraints must not go beyond what is necessary to achieve that purpose. It may be easier to argue for the enforceability of the covenants contained in a sale and purchase agreement if they at least appear to be reasonable to protect the legitimate interests of the purchaser, i.e. contain sensible limitations in broadly three typical aspects, being the geographical area restricted, the duration of the restraint and the business activities prohibited.

(z) Completion

The completion provisions will typically cover, among other things, the following matters.

Transfer of title of shares of Hong Kong incorporated companies takes place by the delivery of a properly executed instrument of transfer and related contract or "bought and sold" notes (required for stamp duty purposes) and the original share certificate, followed by the stamping and registration of the transfer in the statutory records and books of the target company. The approval of the board of directors of the target company is normally required to register the transfer. The instrument of transfer and contract notes must be duly stamped with the appropriate amount of stamp duty. Stamping must take place before a transfer can be reflected in the register of members, which registration is determinative of legal title. Since stamping invariably follows completion, there will be a period when the purchaser has beneficial but not legal title.

It is therefore common for the sale and purchase agreement to contain provisions to ensure that the purchaser obtains practical control of the target company at completion. This will invariably involve resignations of the existing directors and other company officers, each confirming that he or she has no claims for loss of office or otherwise against the target company. It should be noted that the Companies Ordinance prohibits payments to a director or his connected entities for the director's loss of office without the approval of the company's members.

The purchaser should also ensure that the outgoing shareholders hold a shareholders' meeting, or the board of directors of the target company, including the outgoing board nominee(s) of the outgoing shareholders, hold a board meeting to appoint persons nominated by the purchaser to the board of directors of the target company.

At the completion board meeting the purchaser will usually require the outgoing directors to approve the following matters:

- (subject to due stamping, if required) the registration of the purchaser or its nominees as members of the target company in its statutory records and the issuance of new share certificate to the purchaser or its nominees

- the appointment of the purchaser's nominees as directors and officers

- the acceptance of the resignations of the existing directors and other officers

- the alterations to the authorised signatories of the target company's bank accounts

The sale and purchase agreement will provide for these resignations to be delivered to the purchaser at completion, together with a duly executed instrument of transfer, the contract notes, the relevant share certificates and the seller's share of the stamp duty. In addition, provision will be made for the books and records and other documents of the target company, such as documents of title to be handed to the purchaser, on behalf of the target company, since the target company will retain ownership throughout.

(aa) Post-completion

After completion of a share transfer, it would normally be the purchaser who would attend to the stamping of the instruments of transfer and the bought and sold notes so as to ensure that it can be duly recorded in the register of members of the target company after the transfer documents have been stamped. The purchaser will also ensure that the register of directors of the target company is updated to reflect all changes pursuant to the sale and purchase agreement, and that all appropriate forms, e.g. those relevant to change of directors and company secretary, are submitted to the Companies Registry for filing.

(bb) Dispute Resolution

Litigation and arbitration are the two typical alternatives for dispute resolution.

If litigation is selected, it is common for the parties to irrevocably submit to the non-exclusive jurisdiction of the courts of Hong Kong in respect of all matters arising out of or in connection with the sale and purchase agreement. Typically, process agents will be appointed to receive service locally for parties not ordinarily resident in Hong Kong.

If the parties agree to adopt arbitration, the arbitration clause must be carefully drafted to ensure that it is effective and enforceable. The arbitration clause must require arbitration to be adopted for dispute resolution and must set out correctly the name of the arbitration institution and rules chosen. The Arbitration Rules of the United Nations Convention on International Trade Law are commonly adopted with specific amendments made to provisions such as the number of arbitrators, and the place and language in which the arbitration will be conducted.

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