Private M&A

Contributing editors
Will Pearce and John Bick

2019

GETTING THE DEAL THROUGH

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Second edition

Getting the Deal Through is delighted to publish the second edition of *Private M&A*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Brazil, Costa Rica, Ecuador, Egypt, Indonesia, Malaysia, Myanmar, Philippines, Singapore and Taiwan.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Will Pearce and John Bick of Davis Polk & Wardwell, for their continued assistance with this volume.

GETTING THE DEAL THROUGH

London
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Hong Kong

Paul Chow and Yang Chu
Davis Polk & Wardwell

Structure and process, legal regulation and consents

1 How are acquisitions and disposals of privately owned companies, businesses or assets structured in your jurisdiction? What might a typical transaction process involve and how long does it usually take?

Typically, a contract, referred to as a sale and purchase agreement, is executed between the relevant parties to acquire or dispose of privately owned companies, businesses or assets. Privately owned companies can also be acquired by 'contractual offer' followed by a minority squeeze-out, provided that the offer is made in accordance with Part 13 of the Companies Ordinance (Cap 622) (CO), or by 'scheme of arrangement' proposed by the company to be acquired in accordance with Part 4 of the CO.

The process of acquiring a company, business or assets will often turn on the complexity of the issues and the number of parties involved, as well as whether the transaction involves a bilateral negotiation or a controlled auction process with multiple potential buyers.

An auction process in which interest from several buyers is solicited will typically involve:

- drafting an information memorandum as the basis of marketing the company, business or assets, completion of vendor due diligence, and drafting of a sale and purchase agreement and other transaction documentation (approximately six to eight weeks);
- 'round one' expressions of interest from potential buyers who will then be permitted to undertake due diligence (approximately four weeks);
- 'round two' offers by potential buyers with mark ups of the transaction documentation (approximately four weeks); and
- negotiation of transaction documentation with one or more buyers until definitive terms are agreed with one party (up to two weeks).

The larger and more international the target company, business or assets, the longer each phase of a process can take. Up to three months will often elapse between distribution of an information memorandum and execution of definitive transaction documents. A bilateral transaction can take longer to complete owing to the lack of competitive tension in the process.

2 Which laws regulate private acquisitions and disposals in your jurisdiction? Must the acquisition of shares in a company, a business or assets be governed by local law?

The CO sets out the regulatory framework for Hong Kong-incorporated companies. There is a range of statutes and regulations dealing with the transfer of employees, title to property, third-party rights, data protection, pensions and competition that are relevant to private acquisitions and disposals in Hong Kong.

Although most sales of Hong Kong incorporated companies will be governed by the laws of Hong Kong, there is no requirement to be so, and accordingly it is possible for acquisitions to be governed by the law of an overseas jurisdiction. Further, legal formalities applicable to the transfer of shares and assets and liabilities that are subject to local law will also have to be complied with. In Hong Kong, there have been cases for transactions to be governed by the laws of China. These transactions usually involve assets that are based in the China, albeit they are owned by a Hong Kong natural person or Hong Kong incorporated entity or transaction parties that are both in China.

3 What legal title to shares in a company, a business or assets does a buyer acquire? Is this legal title prescribed by law or can the level of assurance be negotiated by a buyer? Does legal title to shares in a company, a business or assets transfer automatically by operation of law? Is there a difference between legal and beneficial title?

The content and implications of title to shares and related assurances are not expressly prescribed by Hong Kong law and can generally be negotiated by the parties.

Legal title to shares in a company incorporated under the CO transfers upon the company's register of members being updated to reflect the buyer as the registered holder of the shares following receipt by the company of an instrument of transfer duly executed by the parties. The transfer of title to assets subject to Hong Kong law may require notifications to be given, consents from third parties to be obtained and registrations to be made.

Legal and beneficial titles are distinct interests in property. A person registered as holding the legal title to a share in a company incorporated under the CO may be a nominee with a different party having the right to receive the economic benefits of the share. Accordingly, the beneficial interest can be transferred without having to update the register of members of the company. Interests in other assets, such as real estate, can be held in the same way.

4 Specifically in relation to the acquisition or disposal of shares in a company, where there are multiple sellers, must everyone agree to sell for the buyer to acquire all shares? If not, how can minority sellers that refuse to sell be squeezed out or dragged along by a buyer?

Typically a buyer will prefer all sellers to sign the transaction documentation and agree to be bound by the same.

Minority shareholders may, however, be required to sell their shares pursuant to 'drag-along' provisions contained in a company's articles of association or in a shareholders' agreement requiring the transfer of title to their shares if specified conditions are satisfied.

Under the CO, if a purchaser makes an offer to acquire all the shares not held by it in a Hong Kong incorporated company and has, by virtue of acceptances of the offer (through signing of transaction documentation or otherwise), acquired at least 90 per cent in number of the shares of any class to which the offer relates, the purchaser may invoke the procedures set out in the CO in order to compulsorily acquire the remaining shares.

If the target company is a 'public company' under the Hong Kong Code on Takeovers and Mergers (Takeovers Code), the Takeovers Code would also apply to the process of compulsory acquisition, regardless of whether the target company is incorporated in Hong Kong or elsewhere. The primary factor in determining whether a company is considered as a public company is the number of shareholders in Hong Kong. Accordingly, an unlisted company with a significant number of Hong Kong shareholders is likely to be a public company to which the Takeovers Code applies. Pursuant to the Takeovers Code, in addition to complying with the relevant laws of the jurisdiction of incorporation of the target company, the offeror (purchaser) must have acquired 90

per cent of the disinterested shares (ie, shares other than those owned by the purchaser or persons acting in concert with it) during the four-month period after posting the initial offer document before it can exercise its right to compulsorily acquire the remaining shares not already acquired by it. This is a more stringent threshold than the one set out in the CO.

If structured as a scheme of arrangement to acquire all shares of a Hong Kong incorporated company, the CO requires the holding of a High Court of Hong Kong-sanctioned shareholders' meeting in which:

- the approval by shareholders of the target representing at least 75 per cent of voting rights of the shareholders present and voting in person or by proxy at the meeting; and
- the votes cast against the arrangement at the meeting do not exceed 10 per cent of the total voting rights attached to all 'disinterested shares' in the target company (where the target company is also a public company to which the Takeovers Code applies, the number of votes cast against the resolution to approve the scheme at such meeting must not be more than 10 per cent of the votes attaching to all disinterested shares. While the definitions of 'disinterested shares' under the CO and the Takeovers Code are largely similar, they are however not identical. Accordingly, care needs to be taken to determine if the 10 per cent threshold is satisfied under both the CO and the Takeovers Code).

In addition to the shareholders' approval, the scheme must also be sanctioned by the High Court of Hong Kong.

5 Specifically in relation to the acquisition or disposal of a business, are there any assets or liabilities that cannot be excluded from the transaction by agreement between the parties? Are there any consents commonly required to be obtained or notifications to be made in order to effect the transfer of assets or liabilities in a business transfer?

As a matter of Hong Kong contract law, a buyer can generally choose which assets or liabilities it wishes to acquire in a transaction that is structured as a business or asset sale.

The transfer of assets or liabilities may require customary third-party consents: for example, a landlord's consent to the assignment of a lease, or a counterparty's consent to the assignment or novation of a contract (see question 7).

6 Are there any legal, regulatory or governmental restrictions on the transfer of shares in a company, a business or assets in your jurisdiction? Do transactions in particular industries require consent from specific regulators or a governmental body? Are transactions commonly subject to any public or national interest considerations?

There are no legal, regulatory or governmental restrictions on transfers of shares in a Hong Kong incorporated company unless the target business belongs to the banking, insurance, securities and futures, or telecommunications or broadcasting sectors. Details of relevant requirements are set out below.

Banking Ordinance (Cap 155)

Persons who intend on becoming a 'shareholder controller' in banks, restricted licence banks or deposit-taking companies (collectively, authorised institutions) must serve a notice to the Hong Kong Monetary Authority of such intention and obtain its prior approval. A shareholder controller is any person (together with his or her associates) who is entitled, directly or indirectly, to control 10 per cent or more of the voting shares at a general meeting of an authorised institution. Only upon receiving a notice of consent from the Hong Kong Monetary Authority or the passing of three months after having given notice (without receiving a notice of objection) may that person become a shareholder controller.

The Hong Kong Monetary Authority will take into account a wide range of factors to determine the 'fitness and properness' of a potential shareholder controller.

Insurance Companies Ordinance (Cap 41)

Becoming a 'shareholder controller' of an insurance company requires completing an application process to ensure that the Hong Kong Insurance Authority has no objection for someone to become the proposed shareholder controller of such insurance company. Shareholder controller refers to any person who alone or with an associate is entitled to exercise 15 per cent or more of the voting power at any general meeting of the insurance company. If the Hong Kong Insurance Authority then notifies the proposed controller that there is no objection, or three months pass without any such notice, the proposed controller may become a controller. The Hong Kong Insurance Authority has the power to object to an application to become a shareholder controller if the person is not fit and proper to hold that position.

Securities and Futures Ordinance (Cap 571)

To become a substantial shareholder of a licensed corporation, the proposed shareholder must gain prior approval from the Securities and Futures Commission (SFC). The relevant regulated activities are listed in Schedule 5 of the Ordinance and include, among others, dealing in or advising on securities, advising on corporate finance and asset management.

A 'substantial shareholder' includes a person who controls either 10 per cent of voting power (at the relevant company's general meetings) of a licensed corporation, or 35 per cent of voting power of a company that in turn controls 10 per cent of voting power of the licensed corporation.

A substantial shareholder needs to pass the 'fit and proper' assessment before the SFC can grant approval.

Telecommunications Ordinance (Cap 106)

No 'disqualified person' shall 'exercise control' of a corporation that is a licensee under the Telecommunications Ordinance (Cap 106). Disqualified persons include advertising agents, suppliers of material for broadcasting, a licensee, a person who transmits sound or television material or an associate of a licensee. Any person who is a beneficial owner of more than 15 per cent or holds an office in that company can 'exercise control'.

Additionally, to own (directly or indirectly) more than 49 per cent of voting shares in a licensee, a person must satisfy the requisite residency requirements. For individuals, they must ordinarily be resident in Hong Kong and have been resident for a continuous period of not less than seven years. If it is a company that acquires the shares, it must ordinarily be resident in Hong Kong with an absolute majority of persons taking an active part in the management of the corporation meeting the residency requirements and the management of the company must be bona fide exercised in Hong Kong.

Broadcasting Ordinance (Cap 562)

Similar to provisions of the Telecommunications Ordinance (Cap 106), a person is not permitted to exercise control (being the beneficial owner of more than 15 per cent) of a domestic free television programme service licence if it is a 'disqualified person', which includes, among others, a sound broadcasting licensee or a proprietor of a newspaper printed or produced in Hong Kong.

A television programme service licensee and any person exercising control of it must be 'fit and proper', which can be determined using several factors including the person's business record, and criminal record in respect of offences involving bribery, false accounting, corruption or dishonesty (section 21(4) of Broadcasting Ordinance (Cap 562)).

7 Are any other third-party consents commonly required?

For purchases of shares from an existing shareholder, the consent of the other shareholders may be required to waive pre-emptive rights, tag-along rights or other restrictions on transfer that are usually specified either under the articles of association of the target company or the relevant shareholders' agreements.

Similarly, for any acquisition or disposal of assets, the transaction parties must scrutinise the provisions under the articles of association and shareholders' agreement, if any, to see if there are any restrictions on the transfer or prior shareholders' approval for the transfer, or both. The parties will also need to follow the proper procedures for transferring certain rights, permits, licences and consents that may be necessary for the smooth transition and the continuous operation of the business in Hong Kong or, if needed, for obtaining new permits or licences, or both, when there is an acquisition of a business or assets.

Consents from third parties may also be required under previous agreements of the target company with its landlords, creditors, debenture holders, mortgagees or other contracting parties that may

be affected as a result of a transfer of assets or upon a change in control of the target company.

If a transaction involves a transfer of personal data, which is defined under the Personal Data (Privacy) Ordinance (Cap 486) 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, the transaction parties must be minded to observe the restrictions as stipulated under the Ordinance. Under the Ordinance, no transfer of personal data is allowed to a place outside Hong Kong unless such place has a similar level of personal data protection as that afforded in Hong Kong.

8 Must regulatory filings be made or registration fees paid to acquire shares in a company, a business or assets in your jurisdiction?

For transfer of shares in relation to a Hong Kong incorporated company, it is not required to deliver any specified form to the Hong Kong Companies Registry for reporting the transfer when it takes place. However, if such transfer takes place before the lodgement of the company's annual return with the Hong Kong Companies Registry, the transfer should be reported in the annual return after the transfer has taken place. Any change subsequent to the filing of the annual return should be reported in the next annual return. For a private company, the annual return should be filed within 42 days after the anniversary of the date of incorporation in every year. Each annual return should be accompanied with an annual registration fee.

For transactions involving a subscription of new shares of a Hong Kong incorporated company, a form relating to return of allotment must be filed with the Hong Kong Companies Registry within one month after the allotment. Details, such as the total number of allotted shares, a description of the shares allotted and a statement of capital that shows the company's latest share capital structure, must be included. There is no filing fee involved in the submission of such return.

A deed or other written instruments such as an assignment or a mortgage are required to be executed upon the sale of an immovable property in Hong Kong. Such document will be registered at the Hong Kong Land Registry. There is no time restriction within which the registration must be made under law; however, late registration may possibly result in a loss of registration priority. If an instrument has been registered within one month after the date of its execution, it may retain its priority back to the execution date, otherwise the priority will be counted only from the date of registration. A registration fee, which varies in accordance with the nature of the instrument or the amount of consideration paid or the value of the property, will be charged.

For a discussion on stamp duties, see question 31.

Other fees are also payable when seeking regulatory approval to become a controlling or substantial shareholder of companies in certain industry sectors (see question 6).

Advisers, negotiation and documentation

9 In addition to external lawyers, which advisers might a buyer or a seller customarily appoint to assist with a transaction? Are there any typical terms of appointment of such advisers?

Parties will typically appoint a financial adviser and accountants to assist with a transaction. The financial adviser will provide strategic and valuation advice, while the accountants will assist with accounting matters, financial and tax due diligence and tax-related issues. Strategy and business consultants may also be engaged to conduct commercial due diligence. If the transaction involves an entity that is listed on a stock exchange, public relations advisers are usually appointed, and they will be responsible for liaising with the relevant parties to ensure that timely information is disseminated to the public by way of announcements.

Most professional advisers have standard terms of engagement that they will agree with the buyer or seller, as the case may be. The level of fees will typically depend on the monetary value of the deal, the complexity of the issues, the timetable for the transaction and the nature of any required work product. In aggregate, a buyer's financial, accounting and legal advisory fees may amount to several percentage points of the monetary value of the deal.

10 Is there a duty to negotiate in good faith? Are the parties subject to any other duties when negotiating a transaction?

Hong Kong contract law does not impose a general duty to negotiate in good faith, and so parties to a transaction are permitted to pursue their own self-interest. It is, however, possible for parties to impose an obligation to act in good faith, for example pursuant to binding heads of terms.

While there is no general duty to act in good faith, directors of a Hong Kong incorporated company are subject to fiduciary and statutory duties that include the duty to act in a way a director considers, in good faith, promotes the success of the company for the benefit of its members as a whole. Financial advisers are subject to certain standards of professional conduct monitored by the SFC.

11 What documentation do buyers and sellers customarily enter into when acquiring shares or a business or assets? Are there differences between the documents used for acquiring shares as opposed to a business or assets?

When acquiring shares, a business or assets, parties to a transaction will customarily enter into:

- a confidentiality agreement governing the exchange of confidential information relating to the transaction;
- a sale and purchase agreement setting out the terms of the transaction, which will be substantially similar whether shares, a business or assets are being acquired except that in respect of a business or asset acquisition there will be detailed provisions defining the scope of the assets and liabilities that are to be transferred to the buyer and mechanisms (a 'wrong pockets' clause) to address the misallocation of assets and liabilities between the seller and buyer;
- a disclosure letter in which general and specific disclosures are made by the seller qualifying the warranties included in the sale and purchase agreement;
- a transitional services agreement specifying the basis upon which the seller will ensure the continued provision of certain services to the target company or business by the seller or its affiliates following completion of the transaction; and
- documents to transfer or register title to assets that in respect of the acquisition of shares in a Hong Kong incorporated company will consist of an instrument of transfer, and in respect of the acquisition of a business or assets will consist of notifications to update registers of, for example, real property at the Land Registry of Hong Kong and trademarks at the Trade Marks Registry of Hong Kong.

In addition:

- a buyer will often deliver one or more offer letters to a seller expressing its interest in the transaction and the terms, including the price upon which it would be willing to proceed;
- in a bilateral transaction, the parties may negotiate heads of terms in an attempt to ensure that resources are not wasted evaluating a transaction before key terms are agreed; and
- key members of management in the target business may enter into new employment agreements to secure their continued employment following completion of the transaction.

12 Are there formalities for executing documents? Are digital signatures enforceable?

The laws of Hong Kong draw a distinction between the execution of simple contracts and the execution of deeds. Certain documents must be executed as deeds, including transfers of interests in land, mortgages and charges, powers of attorney and contracts that are not supported by consideration. Simple contracts require the signature of a suitably authorised person to be effective. Additional formalities must be observed for the execution of deeds. The failure to observe any applicable formalities for execution could cause a document to be invalid and unenforceable.

A Hong Kong law-governed deed executed by a natural person must also be sealed and delivered. In this regard, the Conveyancing and Property Ordinance (Cap 219) presumes that a document is sealed if it describes itself as a deed, states that it has been sealed, and bears any mark, impression or addition intended to be or to represent a seal or the position of a seal. There is no requirement that a deed be witnessed, although it is recommended practice by the Hong Kong Law

Society. In some circumstances, delivery of a deed is presumed when a deed is executed.

In respect of a Hong Kong law-governed deed executed by a company incorporated under the CO, it must be similarly stated in the contract that the contract is executed and delivered as a deed. The document must be executed by either:

- affixing the company's common seal, which must be metallic and have the company's name engraved thereon in legible characters, in accordance with the requirements contained in its articles of association; or
- signing the document by the sole director (in the case of a company with only one director), or any two directors or any director and a company secretary (in the case of a company with more than one director).

Hong Kong law does not specify the precise formalities for deed execution by companies incorporated outside Hong Kong. As a matter of best practice, it is recommended the execution of such Hong Kong law governed deeds should meet the requirements of the place of incorporation of the foreign company, Hong Kong law (as described above) and the place of execution of the document.

While electronic signatures are enforceable, pursuant to the Electronic Transactions Ordinance (Cap 553), note that the following types of documents are excluded:

- testamentary documents;
- trusts (other than resulting, implied or constructive trusts);
- powers of attorney;
- documents concerning land and property transactions;
- negotiable instruments;
- court orders and judgments;
- warrants issued by a court or a magistrate;
- oaths and affidavits; and
- statutory declarations.

Due diligence and disclosure

13 What is the typical scope of due diligence in your jurisdiction? Do sellers usually provide due diligence reports to prospective buyers? Can buyers usually rely on due diligence reports produced for the seller?

Due diligence provides potential buyers with the opportunity to evaluate the legal, financial, tax and commercial position of a company, business or asset. Legal due diligence will typically confirm title to the company or business, the legal structure, terms of financial obligations, ownership and use of information technology, intellectual and real property, physical assets, employee arrangements, litigation and compliance with law.

Vendor due diligence reports are a common feature of controlled sales processes in Hong Kong, enabling a seller to accelerate the sale process, minimise disruption to the target business, and have access to management and explain any complexities associated with the transaction. It is customary for a successful buyer, and its lenders, to be able to rely on such vendor due diligence reports, although buyers will often also complete confirmatory due diligence to complete their evaluation of a transaction.

14 Can a seller be liable for pre-contractual or misleading statements? Can any such liability be excluded by agreement between the parties?

A seller can be liable for pre-contractual misrepresentation. Except with respect to fraudulent misrepresentations, the parties generally have freedom to negotiate the extent of the seller's liability for pre-contractual and misleading statements in the sale and purchase agreement. Practice differs widely according to the nature of the transaction and the parties, but it is customary for the buyer to confirm that it has not relied on any representation outside the contract. Alternatively, parties may agree to a contractual term that limits the scope of liability for (non-fraudulent) pre-contractual misrepresentation or restricts any remedy available by reason of such misrepresentation. In such a case, the term is not effective unless it is fair and reasonable in the circumstances, as set out under the Control of Exemption Clauses Ordinance (Cap 71).

15 What information is publicly available on private companies and their assets? What searches of such information might a buyer customarily carry out before entering into an agreement?

Hong Kong incorporated private companies are required to make certain filings with the Hong Kong Companies Registry. Information that is made publicly available includes:

- the company's articles of association;
- incorporation form (Form NNC1) and the subsequent annual returns (Form NAR1) containing information about the directors, the identities of shareholders and their respective shareholdings;
- notice of alteration of shares capital (Form NSC11) setting out details of changes to a company's share capital;
- statement of particulars of charge (Form NM1) containing information relating to mortgages over the company's assets; and
- certain specified types of shareholders' resolutions, including special resolutions.

As part of the legal due diligence, a buyer of a company will typically carry out searches of publicly available information at the relevant governmental authorities. Nominal fees are generally payable to carry out such searches. The searches serve as an independent check against the information provided by the seller. In Hong Kong, these governmental authorities typically include:

- Companies Registry: to ascertain that the target has been duly incorporated and that it remains registered at the relevant time of the transaction;
- Land Registry: to verify the ownership of real property, mortgages and charges, and other attributes of real property land pertinent to the transaction;
- Trade Marks Registry: to confirm the ownership of the trademarks that form a crucial part of the transaction;
- Patent Office: to ascertain the ownership of a patent that may be the subject matter of the transaction;
- Official Receiver's Office: to check for any petition for compulsory winding up; and
- Registry of the High Court or District Court of Hong Kong: a search of the cause book for any proceedings that have been taken against the target for a certain period of time relevant to the transaction.

16 What impact might a buyer's actual or deemed knowledge have on claims it may seek to bring against a seller relating to a transaction?

A buyer's actual or deemed knowledge at the time of entering into an acquisition may preclude claims being brought against the seller in respect of relevant representations, warranties and covenants. Parties generally are free to modify this principle and set out the way in which actual or deemed knowledge of the buyer may or may not affect any claims afterwards.

Apart from such contractual negotiations, if there are any restrictions or provisions under the articles of association or by way of resolution of a Hong Kong company that is a party to the transaction or whose shares form the subject matter of the sale and purchase, section 120 of the CO provides that a person is not to be taken to have notice of such restrictions or provisions merely because they are disclosed in the articles of association or a return of such resolution kept by the Hong Kong Companies Registry.

Pricing, consideration and financing

17 How is pricing customarily determined? Is the use of closing accounts or a locked-box structure more common?

Pricing mechanisms with post-completion cash, net debt or working capital adjustments with reference to the completion accounts are more common in M&A transactions in Hong Kong than locked-box structures. Nonetheless, locked-box mechanisms are also often used in the secondary buyout market. Auctions of companies, particularly conducted by private equity funds, typically use locked-box pricing as they force a buyer to diligence the accounts before agreeing to the deal and provide greater certainty for the seller on an exit.

18 What form does consideration normally take? Is there any overriding obligation to pay multiple sellers the same consideration?

Cash is the most common form of consideration in private M&A transactions. Other forms of consideration are principally driven by the tax position of the seller, who may defer a capital charge by receiving securities.

There is no obligation to pay multiple sellers the same consideration in respect of an acquisition by way of a sale and purchase agreement. However, if the transaction is structured as a contractual offer, the same consideration must be paid to all shareholders in order for the buyer to avail itself of the statutory squeeze-out mechanism. If shareholders are offered different consideration in connection with a transaction structured as a scheme of arrangement, they will comprise different classes, with each class participating in the scheme of arrangement having the opportunity to approve the proposal made to them.

19 Are earn-outs, deposits and escrows used?

The earn-out structure is not commonly adopted in Hong Kong for private M&A transactions as such structure creates uncertainties for both buyers and sellers.

Deposits and escrow arrangements are more commonly used in Hong Kong. The amount of money involved usually accounts for about 5 to 10 per cent of the total consideration of the transaction. Deposits and escrow arrangements essentially serve a similar purpose of demonstrating the buyer's good faith. If certain conditions precedent (within the control of the purchaser) to the completion of the transaction cannot be satisfied before the long-stop date, the deposits or the funds being arranged in escrow will be forfeited to the seller.

Deposits are predominantly used if buyers are based in a jurisdiction where there is a degree of uncertainty about their ability to proceed to completion. Escrow arrangements are instead usually used as security for warranty claims. There are a wide range of corporate services providers that are eligible to act as escrow agents.

20 How are acquisitions financed? How is assurance provided that financing will be available?

Bank-led acquisition financing is a common feature of private M&A transactions. However, buyers increasingly borrow from alternative finance providers such as direct lending funds and institutional investors. Where an acquisition is highly leveraged, payment-in-kind instruments may be included in the financing structure, and for acquisitions of a sufficient size, high-yield bond financing may be a financing component employed by a buyer.

In relatively limited situations where there is intense competition between buyers, the sellers may require the buyers to prepare the consideration on a 'certain funds' basis, broadly mirroring the approach taken on public takeovers under the Takeovers Code. However, unlike in the context of public takeovers, there is no regulatory regime to comply with or oversight by a financial adviser with respect to certainty of funding, and so documentation conditionality and flexibility can vary significantly from deal to deal.

Where a newly incorporated entity is to be the buyer and requires capital, for example from a private equity fund, the seller will typically be provided with a directly enforceable equity commitment letter that will be conditional upon satisfaction of the conditions set out in the sale and purchase agreement and any debt financing arrangements. An equity commitment letter will typically require the buyer to draw on any debt financing that has been negotiated, but the provider of equity capital to the buyer will not usually be required to increase its equity contribution in the event that a lender defaults on its commitment to advance finance.

21 Are there any limitations that impact the financing structure? Is a seller restricted from giving financial assistance to a buyer in connection with a transaction?

While there is no general prohibition against the seller providing financial assistance to the buyer, section 275 of the CO states that, unless otherwise provided, if a person is acquiring or proposing to acquire shares in a Hong Kong incorporated company, such Hong Kong incorporated company or any of its subsidiaries must not give financial assistance directly or indirectly for the purpose of the acquisition before or at the same time that the acquisition takes place.

Hong Kong incorporated companies are prohibited from giving 'financial assistance' in connection with, among other things, the acquisition of shares of public limited companies. Financial assistance includes:

- the giving of a gift, a guarantee, a security or an indemnity;
- waiving or releasing obligations;
- advancing a loan; and
- a novation or an assignment of rights arising under a loan agreement or any other agreements with a similar nature.

It also includes any other financial assistance given by a company if the net assets of the company are reduced to a material extent by the giving of the assistance or the company has no net assets. Breach of this statutory prohibition may result in the company, and every responsible person of the company, committing an offence, and each is liable to a fine of HK$150,000 and to imprisonment for 12 months.

This prohibition does not apply if it is given for the acquisition of a shares in its holding company that is incorporated outside Hong Kong.

Conditions, pre-closing covenants and termination rights

22 Are transactions normally subject to closing conditions? Describe those closing conditions that are customarily acceptable to a seller and any other conditions a buyer may seek to include in the agreement.

Signing and completion of transactions can occur simultaneously in the absence of legal or regulatory obligations to satisfy before completing the transfer of title to shares or assets. A seller will accept conditions relating to such legal or regulatory obligations.

A buyer may seek conditions regarding the accuracy of fundamental (relating to a seller's title, capacity and authority) and business warranties at completion and the absence of any material adverse change since entering into the transaction, although a seller will often only accept extending conditionality to include the accuracy of fundamental warranties.

While it is unusual for Hong Kong-law governed transactions to be subject to financing conditions, in light of foreign exchange control regulations of China, some sellers in Hong Kong may be willing to accept a financing condition from a PRC-based buyer that allows the buyer not to close an acquisition if it is unable to obtain the required funds to settle the transaction in full. However, this will normally entail the payment of a deposit or escrow account arranged by the buyer.

23 What typical obligations are placed on a buyer or a seller to satisfy closing conditions? Does the strength of these obligations customarily vary depending on the subject matter of the condition?

All parties will be expected to exert at least their reasonable efforts to ensure the satisfaction of any closing conditions. A best efforts standard may be agreed, which is more onerous and can require the expenditure of money, but it is not an absolute obligation to achieve the specified outcome.

24 Are pre-closing covenants normally agreed by parties? If so, what is the usual scope of those covenants and the remedy for any breach?

A seller will typically agree to operate the target business in the ordinary course of business consistent with past practice and will commonly agree to specify pre-closing covenants, including:

- not to alter the share capital or make distributions to shareholders;
- not to acquire or dispose of assets, incur liabilities, enter into material agreements or commit to capital expenditure in excess of a specified value;
- not to create encumbrances;
- to maintain, without alteration, insurance policies;
- not to alter terms of employment or benefit entitlements or hire new employees on salaries in excess of a specified amount;
- not to commence litigation or waive any claims;
- to conduct the business in accordance with applicable laws; and
- to grant access to the target company's books, records and premises.

The seller may also agree not to solicit competing proposals, to notify the buyer of any unsolicited approaches in respect of the target company or business and in respect of an auction process, with effect from closing, and to assign the benefit of any confidentiality agreements entered into with other potential buyers.

In addition, the parties also typically undertake not to solicit senior employees, to maintain the confidentiality of the transaction and to make public announcements relating to the transaction only with the other party's consent.

A breach of covenant will result in a claim for damages which, unlike a claim for breach of warranty, is typically uncapped. A Hong Kong court may make an order for specific performance to the extent that damages are not an adequate remedy.

25 Can the parties typically terminate the transaction after signing? If so, in what circumstances?

Consistent with the concept that risk with respect to the company, business or assets passes to the buyer from the date of entering into the sale and purchase agreement, typically parties cannot terminate a transaction in advance of a negotiated long-stop date except to the extent that any condition is, or becomes, incapable of satisfaction. It is rare that a breach of warranty or covenant permits a buyer to terminate a transaction, although this can be expressly provided for in the sale and purchase agreement.

26 Are break-up fees and reverse break-up fees common in your jurisdiction? If so, what are the typical terms? Are there any applicable restrictions on paying break-up fees?

Break-up fees are not common in the acquisition of private companies, businesses and assets. It is possible for a Hong Kong incorporated company to include in its articles of association to restrict or prohibit certain transactions, including the giving of break-up fees. If not so prohibited, directors must be satisfied that agreeing to a break-up fee is consistent with their fiduciary and statutory duties, including to promote the success of the company for the benefit of its members as a whole. A break-up fee may constitute unlawful financial assistance (see question 21) to the extent that it results in a material reduction of the net assets of a Hong Kong incorporated company or that the company has no net assets.

For public companies to which the Takeovers Code applies in a takeovers transaction, an inducement fee or break-up fee must be de minimis (normally no more than 1 per cent of the offer value). The board of directors of the target and its financial adviser must also confirm to the SFC that each of them believe that the fee is in the best interests of the shareholders.

Reverse break-up fee arrangements have also been gradually gaining recognition. Reverse break-up fee arrangements are normally entered into between a preferred bidder and the vendor or the target company. Under such arrangements, the preferred bidder agrees to pay a break-up fee if it decides not to proceed with the transaction, usually upon the expiry of or during a period of exclusivity or because of failure to satisfy certain conditions precedent.

Representations, warranties, indemnities and post-closing covenants

27 Does a seller typically give representations, warranties and indemnities to a buyer? If so, what is the usual scope of those representations, warranties and indemnities? Are there legal distinctions between representations, warranties and indemnities?

A seller will typically give representations and warranties and, subject to the negotiating position of the parties and specific issues arising from due diligence, indemnities. The parties are generally free to negotiate the representations, warranties and indemnities, and their scope vary widely from transaction to transaction. In Hong Kong transactions, warranties typically cover:

- the capacity and authority of the seller to enter into the sale and purchase agreement;
- in respect of the acquisition of a company, the share capital of the target company and its direct and indirect shareholdings;
- the basis of preparation of the target's financial statements;

Update and trends

Driven both by private and public M&A transactions, the Hong Kong M&A market has been going through an increase in activities, deal volume and deal value with the most active sectors being real estate, financial services, and energy and infrastructure. With the implementation of the new Hong Kong Listing Rules allowing the listing of pre-revenue biotech issuers and the weighted voting rights structures, it is expected that there will be a corresponding increase in pre-initial public offering (IPO) investments for HK IPO candidates in these sectors.

- where listed securities are involved, the business and other information relating to the underlying company;
- the absence of changes to the condition of the business since the date of the warranted financial statements;
- operational aspects of the business relating to employees, pensions and benefits, real property, financial commitments, tax, commercial contracts, litigation and investigations, compliance with law, intellectual property and information technology; and
- in respect of a business acquisition, the condition and adequacy of the assets to be acquired.

An inaccurate warranty or representation will give rise to a damages claim for breach of contract whereby a buyer will have to prove that he has suffered a diminution in value of the asset purchased that is causally related to the inaccuracy of the statement and is not regarded by law as being so remote that it would be unreasonable for the seller to incur damages, subject to a buyer's duty to mitigate the seller's damages.

Subject to the negotiating position of the parties, specific risks identified through due diligence or disclosure are typically subject to indemnities (as a buyer is typically precluded from bringing a warranty or misrepresentation claim in relation to a matter he or she is aware of signing). For example, specific indemnities may be given in respect of the outcome of ongoing litigation, the cost of remediating environmental damage prior to the buyer's acquisition or product liabilities in excess of an agreed level relating to the period prior to completion of the acquisition.

Subject to the particular drafting, an indemnity is an undertaking to pay in specified circumstances and so is not subject to the causation, remoteness and mitigation rules of a claim for damages. In Hong Kong, indemnities are customarily given in respect of tax matters.

Covenants can also be given where circumstances require, for example, post-completion covenants as to specific outstanding issues to be resolved by the seller or further procurement obligations to be discharged by it (see question 30).

Claims for misrepresentation can result in damages under the Misrepresentation Ordinance (Cap 284), and so a seller will typically avoid making representations in a sale and purchase agreement.

28 What are the customary limitations on a seller's liability under a sale and purchase agreement?

A seller's aggregate liability under a sale and purchase agreement will customarily be capped at an amount equal to or less than the purchase price.

Business warranty claims may be subject to a separate regime whereby:

- each individual claim must exceed a materiality threshold (or de minimis threshold), often up to 0.1 per cent of the purchase price;
- the aggregate value of claims must exceed a threshold, often between 1 and 2 per cent of the purchase price, with the entire value of claims then being recoverable;
- the seller's aggregate liability is capped, often at less than 25 per cent of the purchase price; and
- the ability to bring warranty claims expires 12 to 24 months after completion.

Fundamental warranties (see question 22) and tax warranties are often carved out of the limitation regime.

In addition, more general limitations on a seller's liability will customarily include:

- knowledge qualifications in warranties and materiality qualifications in warranties and covenants;
- qualifying warranties with disclosure contained in the disclosure letter and all information contained in a data room;
- provisions granting the seller the conduct of claims brought by third parties; and
- barring double recovery and requiring the buyer to exhaust other available remedies.

29 Is transaction insurance in respect of representation, warranty and indemnity claims common in your jurisdiction? If so, does a buyer or a seller customarily put the insurance in place and what are the customary terms?

Representation, warranty and indemnity insurance is not common for private M&A transactions in Hong Kong.

Nonetheless, there has been an increase in the consideration and use of warranty and indemnity insurance in M&A transactions both globally and across Asia.

Warranty and indemnity insurance is intended to cover losses suffered by the policyholder where a successful claim can be made for breach of certain warranties or under a tax covenant. Typically, a policy will not provide the policyholder with protection in respect of specific indemnities that may arise as a result of due diligence by the buyer or disclosure by the seller. However, it is possible to negotiate insurance for known and specific contingent risks such as tax and environmental liabilities.

Insurance may be arranged by either a seller or buyer. A seller policy may be suitable where the seller is selling a company or business and intends to invest or distribute to its shareholders the proceeds of sale. A buyer's policy secures greater financial recourse than is offered by a seller, which is of particular assistance in an auction where low caps on liability may be offered or the only financial recourse available in respect of business warranties comes from target management.

A Hong Kong law-governed policy will typically exclude:

- issues that are known to the policyholder;
- financial obligations payable as a consequence of the selected pricing mechanism;
- fines and penalties that are uninsurable by law;
- financial obligations resulting from pension underfunding;
- liabilities arising from transfer pricing;
- issues relating to anticorruption and anti-bribery;
- product liability;
- issues relating to variable interest entity structures; and
- social security payments in China.

In addition, a seller's policy would exclude recovery in respect of fraud by the seller.

In Hong Kong, premiums charged for warranty and indemnity insurance usually range between 1 and 2 per cent of the policy value.

30 Do parties typically agree to post-closing covenants? If so, what is the usual scope of such covenants?

Parties will often agree not to solicit each other's senior employees (or extend beyond completion any such undertaking effective from signing), and a seller will often covenant not to compete with the company or business that has been sold. To be enforceable, any non-competition covenant must apply to a reasonable geographic area for a reasonable time period, typically considered to be up to two years.

Tax

31 Are transfer taxes payable on the transfers of shares in a company, a business or assets? If so, what is the rate of such transfer tax and which party customarily bears the cost?

The two main categories of documents for which stamp duty is chargeable in Hong Kong are contract notes for sales of stock, and agreements for the sale or lease of immovable property.

The seller and purchaser of shares of a Hong Kong incorporated company must each pay 0.1 per cent (total effective rate of 0.2 per cent) of the consideration paid or the fair market value, whichever is higher, as stamp duty. There is no stamp duty for the subscription of new shares.

The amount of stamp duty charged for a sale or lease of immovable property varies and depends on the purchase or rental price and duration (for leases). The legal obligation rests on both the buyer and the seller, although the stamp duty is usually paid by the purchaser. The highest rate of stamp duty to be paid for the sale and purchase of non-residential immovable property in Hong Kong is 8.5 per cent for properties having a value of HK$21,739,120 or more. The purchase of residential properties is subject to a flat rate of 15 per cent, although a lower stamp duty exemption is applicable to first-time home buyers who are Hong Kong permanent residents.

32 Are corporate taxes or other taxes payable on transactions involving the transfers of shares in a company, a business or assets? If so, what is the rate of such transfer tax and which party customarily bears the cost?

There are no capital gains or value added taxes in Hong Kong.

Employees, pensions and benefits

33 Are the employees of a target company automatically transferred when a buyer acquires the shares in the target company? Is the same true when a buyer acquires a business or assets from the target company?

The acquisition of a Hong Kong incorporated company by way of share transfer does not alter the employment relationship such company has with its existing employees.

In a business or asset transfer, however, employees of the target company will not be automatically transferred to the purchaser. To execute a transfer, all existing contracts of employment have to be terminated and, if the purchaser desires to retain employees in the

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business, new contracts of employment would need to be offered to those employees who are being transferred.

If employees are not retained, redundancy issues may arise on termination, and the original employer may be liable to make severance payments and provide other statutory benefits unless the employee unreasonably refuses a new term of employment that is no less favourable than the existing one and that is offered to such employee not less than seven days before the end of the previous contract.

34 Are there obligations to notify or consult with employees or employee representatives in connection with an acquisition of shares in a company, a business or assets?

There are no specific requirements in this regard under the laws of Hong Kong.

35 Do pensions and other benefits automatically transfer with the employees of a target company? Must filings be made or consent obtained relating to employee benefits where there is the acquisition of a company or business?

Pensions and other employee benefit obligations remain the responsibility of a target company following its acquisition.

Pensions in the form of the Mandatory Provident Fund scheme need individual employees' consent before the accrued benefits can be transferred to the contribution account under a registered scheme sponsored by the new employer in accordance with section 14 of the Mandatory Provident Fund Schemes Ordinance (Cap 485), although consent is usually obtained as a packaged deal when employment is offered by the new employer.

Transfer of benefits under other retirement schemes that are regulated by the Occupational Retirement Schemes Ordinance (Cap 426) will be governed by the trust deeds of the relevant schemes.

Getting the Deal Through

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Private Client
Private Equity
Private M&A
Product Liability
Product Recall
Project Finance
Public M&A
Public-Private Partnerships
Public Procurement
Real Estate
Real Estate M&A
Renewable Energy
Restructuring & Insolvency
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