

steps which serve no commercial or business purpose. Any lawyer advising a client on the structure of a share acquisition and the possible stamp duty implications should bear in mind the implications of the *Arrowtown* decision.

(c) Structuring share subscriptions post-*Arrowtown* -

It will be erroneous to believe that ever since *Arrowtown*, all share acquisitions have proceeded by way of share transfer instead of subscription. An investor may prefer to acquire shares by subscription for other legitimate, non-stamp duty related reasons. For example, an investor who proposes to acquire only part of the share capital of a company may prefer to have new shares issued to it by the company, instead of taking over part of the existing shares held by the shareholders (and thus avoid any possible liabilities or third party interests which may attach to the existing shares). This is quite common when a new investor is admitted into a joint venture company, but is less common when an existing shareholder desires to exit and wishes to dispose of its entire investment in the company. So long as there exists sound commercial justifications for the share subscription, and the savings in stamp duty is merely incidental to the larger commercial purpose, the transaction should be able to withstand challenge on the ground of *Arrowtown*.

(d) Increase in share capital -

If the amount of the company's authorised capital is insufficient to meet the proposed allotment of shares, the company must first increase its authorised capital.⁸⁷ The company is theoretically required to pay capital duty on the amount of the increase. However, this is no longer an issue, now that capital duty is effectively "abolished".⁸⁸

(e) Financial assistance -

The prohibition contained in section 47A of the Companies Ordinance against the giving of financial assistance applies to any "acquisition" of shares.⁸⁹ The prohibition therefore applies equally to an acquisition of shares by subscription as it applies to a share purchase.

⁸⁷ This will no longer be necessary when the 2012 Ordinance (which abolishes nominal value of shares) comes into operation.

⁸⁸ The applicable rate has been reduced to zero for all notifications in respect of increase in authorised capital which are filed after 1 June 2012. It is unlikely that capital duty will be revived, with the 2012 Ordinance dispensing with the concept of "authorised capital" completely.

⁸⁹ For a discussion of the application of this prohibition, see para.2.2.3(b) of Chapter 2 below.

2

SHARE PURCHASE - THE INITIAL EXCHANGES

2.1 Introduction

2.1.1 Stages in a typical share purchase transaction

A typical transaction for the sale and purchase of shares will go through the following stages:

1. The initial exchanges: Taking client's instructions, giving preliminary advice, and structuring the deal.
2. Due diligence.
3. Drafting and negotiating the transaction documentation.
4. Signing and exchange of contracts.
5. Completion.
6. Post-completion.

2.1.2 Initial contact between client and lawyer

(a) The "transactional" approach -

It should be noted that the client's expectations of a lawyer in a corporate-commercial transaction are quite different from those of a client involved in or contemplating litigation. So long as the risks involved are explained to them and are considered acceptable, clients in a corporate-commercial transaction want to proceed to signing and completing the transaction. To the extent possible, clients want to sign and complete the transaction promptly and economically. The approach is more appropriately described as "collaborative" than "adversarial". Very rarely would clients want to walk away from a deal (it is more often used as a negotiation tactic) unless the parties have truly failed in their attempts to resolve a "deal breaker" (usually a matter of fundamental importance or commercial significance). Therefore a client would appreciate its lawyer's advice on how the transaction can progress smoothly rather than what arguments can be formulated against

the other party. Similarly, a client would be more interested in its lawyer's proposed solutions to a problem than a detailed analysis of case law to explain why a problem exists in the transaction.

Besides, a client would expect its lawyer in a corporate-commercial transaction to anticipate for the client what problems may arise if the transaction proceeds in the way the parties initially envisaged. Unlike a litigation lawyer who deals with a "done deal" from which a problem has arisen (hence, the dispute), transactional lawyers are expected to "look to the future", anticipate possible problems and find ways to avoid them (or at least minimise their adverse impact) right from the start. This may be achieved in a variety of ways – for example, by adopting an alternative structure for the transaction, including provisions in the agreement to provide for the parties' rights and obligations if the problem should arise, or permitting rescission or termination of the agreement in certain specified circumstances.

(b) Taking client's instructions -

As with most corporate-commercial transactions in Hong Kong, the parties will have begun their discussions of the transaction and come to some consensus by the time lawyers are instructed. More likely than not, the parties will have reached an understanding as regards the subject matter of the transaction and its major commercial terms. When lawyers are instructed, it often means that the parties are serious about proceeding further with the transaction and want to formalise their understanding into a legally binding contract.

When the parties instruct their lawyers to act for them in a share sale and purchase transaction, they would expect their lawyers to:

- (i) devise an appropriate structure for the sale and purchase;
- (ii) prepare, review and negotiate the necessary documentation for the sale and purchase;
- (iii) take all incidental actions which are necessary or appropriate to bring about the successful conclusion of the sale and purchase; and
- (iv) in the course of carrying out the tasks described in (i) to (iii) above, advise the client generally on all matters relevant to the sale and purchase.

To enable them to competently carry out these tasks, the lawyers must first take full and clear instructions from their respective clients as to the subject

matter of the sale and purchase, the terms on which the parties have reached an understanding, the client's goals and objectives in entering into this sale and purchase, and any specific concerns which the client may have.

(c) The role of the purchaser's lawyer -

The role of the purchaser's lawyer in a share sale and purchase can be summarised as follows:

- (i) Advise the purchaser as to the appropriate structure for the transaction.
- (ii) Conduct legal due diligence against the target company and prepare the due diligence report.
- (iii) Discuss with and advise the purchaser on issues which emerge from the due diligence investigation, with a view to resolving the issues and allocating the risks among the relevant parties.
- (iv) Draft, negotiate, and finalise the share purchase agreement and the other transaction documents.
- (v) Prepare or review the condition precedent documents (if completion is conditional upon the fulfillment of conditions precedent).
- (vi) Prepare for completion (for example, engrossing the deed of tax indemnity, deed of loan assignment, updating all relevant searches, etc).
- (vii) Facilitate completion of the transaction.
- (viii) Advise the purchaser on all relevant issues throughout the transaction.

Generally speaking, in a share sale and purchase, the purchaser's lawyer will take upon a heavier workload than the vendor's lawyer, with much of the time and energy focused on conducting legal due diligence and preparing the share purchase documentation. The usual practice is for the purchaser's lawyer to prepare the first draft of the share purchase agreement, since the purchaser's lawyer would know what his or her client wants in terms of conditions precedent, completion items and warranties.

(d) The role of the vendor's lawyer -

The role of the vendor's lawyer in a share sale and purchase can be summarised as follows:

- (i) Advise the vendor as to the appropriate structure for the transaction.
- (ii) Prepare any confidentiality undertaking to be given by the purchaser.
- (iii) Provide information in response to the due diligence questionnaire, set up data room (where appropriate) and answer the purchaser's due diligence queries.
- (iv) Review and suggest amendments to the draft share purchase agreement, and negotiate its terms with the purchaser's lawyer.
- (v) Prepare the disclosure letter and the disclosure bundle.
- (vi) Facilitate the fulfillment of those conditions precedent for which the vendor is responsible (for example, obtaining any requisite consent to the change in shareholding).
- (vii) Prepare for completion (for example, preparing the completion board minutes, resignation letters, etc).
- (viii) Advise the vendor on all relevant issues throughout the transaction.

Generally speaking, the role of the vendor's lawyer in a share sale and purchase is more "reactive". The vendor's lawyer will focus more on responding to due diligence queries and reviewing the share purchase agreement and other related documents prepared by the purchaser's lawyer. The principal drafting task of the vendor's lawyer is the preparation of the disclosure letter.

2.2 Preliminary considerations**2.2.1 The subject matter of the sale and purchase****(a) All or part of the issued share capital? -**

If the entire issued share capital of a company is to be acquired, the purchaser

is effectively taking over the target company together with all the subsidiaries which the target company may have. If the purchaser is a company, it will become the holding company of a group of companies comprising the target company and its subsidiaries, all of which will become the purchaser's subsidiaries. In such a case, due diligence should be extended to each of the subsidiaries which will be indirectly taken over.

If the purchaser is only acquiring part of the issued share capital of the target company, then the purchaser is effectively entering into a joint venture with the other shareholders of the company. In such a case, there are issues which the purchaser and the purchaser's lawyer should consider at an early stage of the transaction:

(i) Board's discretion to refuse to register a transfer:

Where the target company is a Hong Kong private company, its articles of association must restrict the right to transfer shares in it.¹ The restriction may take the form of giving pre-emption rights to the other shareholders (see (ii) below) or giving the board of directors an absolute discretion to refuse to register a transfer of shares. For a company which adopts Part II of Table A as its articles of association, the board of directors is given the absolute discretion to refuse to register a transfer of shares (irrespective of whether the shares are fully paid), without having to give reasons for its refusal.²

Although the transferee may apply to the court for an order that the transfer be registered³, in the absence of evidence showing that the board has acted with an improper motive, the court has been reluctant to interfere.⁴

The board's discretion to refuse registration should not be a problem if the purchaser is acquiring the entire issued share capital of the target company.

¹ This is an essential characteristic of a Hong Kong private company. (S.29(1) of the Companies Ordinance, retained in s.11 of the 2012 Ordinance.)

² This will be changed when the 2012 Ordinance comes into effect. Under s.151(3) of the 2012 Ordinance, if a company refuses to register a transfer of shares, the transferor or the transferee may require the company to provide a statement of reasons for the refusal. The company is obliged to either provide such a statement or register the transfer within 28 days of receiving the request.

³ S.69(1B) of the Companies Ordinance, retained in s.152 of the 2012 Ordinance.

⁴ *Choy Bing Wing v Max Share Ltd* [1993] (unreported) MP No.1096 of 1993.

The data room is set up when the vendor places all documents and information which it considers relevant to the purchaser's due diligence questionnaire into a specially designated room for the purchaser and its professional advisers to come and review. It may be located on the vendor's or the target company's premises but, more often, it is set up in the office of the law firm representing the vendor. Having the data room "off site" will have the added advantages of keeping the identity of the vendor confidential (for auction sales) and minimising disruption to the target company's day-to-day operation. It may be accessed by the purchaser or its employees and professional advisers by prior arrangements with the vendor or its lawyer. Almost inevitably, access will be subject to detailed "data room rules" prepared by the vendor's lawyer. These rules may cover matters ranging from persons who may access the room to the number of copies which may be made. Persons allowed access into the data room may also be required to give confidentiality undertakings in terms similar to the ones set out in para. 2.3.2(b) of Chapter 2 above.

Upon receiving supplementary due diligence requests from the purchaser's lawyer, the vendor's lawyer will provide further clarification and confirmation, or approach the vendor for any outstanding information. When responding to the due diligence questionnaire or any supplementary due diligence requests, it is of vital importance that all information provided must be accurate, lest they amount to pre-contractual mis-statements which may give rise to claims for misrepresentation in the future.³³

³³ Discussed in para.6.3 of Chapter 6 below.

4

SHARE PURCHASE – DOCUMENTATION

4.1 The share purchase agreement

Although there is neither law nor precedent which mandates this, the first draft of the share purchase agreement is often prepared by the purchaser's lawyer, and then sent to the vendor's lawyer for review and comments.¹

The drafting and negotiation of the share purchase agreement are often carried out alongside the due diligence investigation, although the agreement is rarely finalised until after the due diligence investigation is at least substantially completed and the purchaser is satisfied with at least the material aspects of the investigation. The terms of the agreement are constantly revised in the light of findings in the due diligence investigation and the resultant negotiations between the parties. The final draft of the agreement will reflect the agreed allocation of risks between the parties.

There is no prescribed format for the share purchase agreement. That said, most share purchase agreements drafted in Hong Kong tend to adopt a similar format and it has become common practice for certain standard provisions to be included. A sample share purchase agreement is included as Appendix D of this book to show what these standard provisions normally cover. It should be noted, however, that the sample share purchase agreement appearing in Appendix D is drafted (i) from the purchaser's perspective, so the terms are extremely "purchaser-friendly", and (ii) as a first draft of the agreement, so the terms are still subject to negotiation between the parties.

4.1.1 Parties to the agreement

The obvious parties to the share purchase agreement are the vendor and the purchaser. The target company is not a party to the share purchase agreement, and there is no reason why it would have to be, as it is merely the subject of the acquisition.

¹ An "exception" is where the sale is by auction. In auction sales, the share purchase agreement is often prepared by the vendor's lawyer and presented to prospective purchasers for acceptance.

The vendor will be the existing shareholder who is selling its shares in the target company. Where all or any of the shares are registered in the name of nominees, it is the beneficial owner of the shares who should be named as the vendor. It is not necessary for the nominee to be made a party to the agreement. It is sufficient to impose upon the vendor the obligation to procure the nominee to execute the necessary transfer documents and have them delivered to the purchaser at completion.²

Where there is more than one vendor, provisions should be included in the share purchase agreement as to the relationship between the purchaser and the vendors, including in particular, the basis on which obligations and liabilities are assumed by the vendors, as well as the relationship between the vendors *inter se* – for example, whether the vendors are giving the warranties to the purchaser on a joint and several basis (that is, they will be jointly and severally liable for any breach), whether the consideration is to be paid to the vendors pro rata their respective shareholdings in the target company, etc.

Instead of taking over shares in the target company itself, the purchaser may wish to have the shares held by its wholly-owned subsidiary, or may even set up or acquire a new shelf company to be used as the actual purchaser of the shares. In that situation, that company should be named as the purchaser in the share purchase agreement. When acting for the purchaser, a lawyer should seek the client's clear instructions in this regard.

In some cases, one of the parties may require that the other party's obligations under the share purchase agreement be guaranteed by say, its parent company or controlling shareholder. This is especially so where that other party is a newly-incorporated shelf company or a special purpose vehicle company with no substantial business and hardly any assets of its own. For example, if the vendor is a special purpose company formed for the sole purpose of holding shares in the target company, then after the sale of all its shares in the target company, the vendor's only asset left will be the purchase price

² See para.5.5(a) of Chapter 5 below. A nominee shareholding arrangement is essentially a bare trust or a custodian agreement, terminable at will by the beneficial shareholder. For a nominee arrangement which is properly set up, the beneficial shareholder will have obtained from the nominee those documents which are necessary for the beneficial shareholder to transfer both the legal and beneficial title in the shares to a third party (including a declaration of trust by the nominee shareholder in favour of the beneficial owner of the shares, an instrument of transfer endorsed in blank by the nominee shareholder, and the share certificate issued in the name of the nominee shareholder).

received from the purchaser (after deducting any legal fees and stamp duty payable by the vendor), which it may later utilise to pay to its shareholders (by way of dividend, repayment of shareholder's loan, or other distributions). The vendor will then be left with hardly any asset to meet any future claim by the purchaser for breach of warranties or indemnities. In such a case, the purchaser should be advised to require a guarantee from the vendor's parent company or controlling shareholder to cover such claim.³ If such a guarantee is required, it is quite common for the guarantee to be set out in the share purchase agreement, and the guarantor made a party to the agreement.

Alternatively, where the vendor is a special purpose company and the controlling shareholder is actively engaged in the management of the target company (for example, as a director of the target company), the controlling shareholder may be asked to become a party to the share purchase agreement as a warrantor and give the warranties in the agreement in relation to the target company. If any of the warranties turns out to be untrue, the purchaser can claim against the warrantor who will be personally liable for the untrue warranty.

4.1.2 The agreement to sell and to purchase

This is the most important (though probably the least controversial) clause in the entire share purchase agreement, and sets out the vendor's agreement to sell and the purchaser's agreement to purchase. This provision will also identify the subject matter of the sale and purchase. In particular, it will provide clearly whether the sale and purchase is of the entire issued share capital of the target company, or only part of it. If the purchaser is also taking over the shareholder's loan advanced by the vendor to the target company, the agreement to sell and to purchase the shareholder's loan should also be set out here.

Where the subject matter of the sale and purchase consists of both shares and shareholder's loan, it is of vital importance from the purchaser's perspective that a provision be included to ensure simultaneous completion of the two purchases – basically, the purchaser will be under no obligation to complete the purchase of the shares or that of the loan unless both purchases are

³ An alternative "solution" would be to retain part of the consideration for a certain period after completion. See para.4.1.3(c)(iii) below.

completed at the same time. A purchaser will be most reluctant to take over the shareholder's loan if it is not also taking over the shares in the target company. Similarly, if it is to become the new shareholder in the target company in place of the vendor, it will not normally wish to leave the corresponding shareholder's loan in the hands of an outsider (namely, the vendor).

In the sale and purchase of shares in a private company, the equitable title to the shares passes to the purchaser when the parties enter into an unconditional share purchase agreement, since the contract is one for which specific performance will be granted.⁴ Thus, if the parties intend certain conditions must be fulfilled before the share purchase is to complete, it is important to provide clearly in the share purchase agreement that the parties' agreement to sell and to purchase the shares (and the shareholder's loan, if appropriate) is not absolute but is subject to the conditions stated in the agreement. The conditions will usually be set out separately in a "conditions precedent" clause.⁵

Where there is more than one selling shareholder, it is quite common for the share purchase agreement to provide that each shareholder is only agreeing to sell those shares it owns in the company. From the perspective of each selling shareholder, it would prefer the basis of the agreement to be several, such that it is only obliged to sell and transfer its own shares to the purchaser, without assuming any obligation or liability in respect of the other selling shareholders. However, the purchaser may not be prepared to purchase the shares of any one shareholder, unless it can take over the shares of all the selling shareholders at the same time. In such a case, the purchaser would want the share purchase agreement to provide for the simultaneous completion of all the selling shareholders' shares. Lawyers acting in such a transaction should seek clear instructions from their clients as to their preferred options and any consensus reached among the parties.

⁴ The position is different if the subject matter of the sale and purchase is listed shares, since they are not unique but are readily available in the market, so specific performance is unlikely to be granted. This distinction was drawn by Lord Parker of Waddington in *Howard v Miller* [1915] AC 318, at 326. See also *Okachi (Hong Kong) Ltd v Nominee (Holding) Ltd* [2007] 1 HKLRD 55.

⁵ See para.4.1.4 below.

4.1.3 Consideration

The consideration clause is one of the most important clauses in the share purchase agreement, and is often the subject of heavy negotiation. It is also one of the areas where lawyers' poor drafting may have quite serious consequences. The consideration is one of the essential terms of a contract, and if the mechanism for its determination is not adequately put in place, the contract may be void for uncertainty⁶. Instead of relying on the courts to work out a "reasonable price" later, lawyers acting for the parties in the share sale and purchase should focus the parties' attention to the consideration and include clear and detailed provisions as to the mechanism for its determination as well as the time and manner of its payment.

The consideration clause should cover at least three main areas:

What is the amount of the consideration?

- How is the consideration payable?
- When is the consideration payable?

(a) What is the amount of consideration?

(i) Determination of consideration:

Quite likely, a purchaser will not want to pay more for the target company than what it believes the company is "worth". How much is a company "worth", and how is it determined?

A logical starting point would be the company's net asset value. A company's net asset value is the value by which the aggregate of its assets exceeds the aggregate of its liabilities. This means that if the purchaser proceeds to sell off all the target company's assets upon taking over the company, then after paying off all the company's liabilities and deducting all the related costs and expenses, it will realise an amount roughly equal to the net asset value of the company. For most companies, the net asset value represents their "basic" value. Therefore, unless the vendor is under some pressure to dispose of the company quickly or there exist special circumstances, it is uncommon for a vendor to agree to sell at less than the target company's net asset value.

⁶ *May and Butcher Ltd v R* [1934] 2 KB 17 and *Scammel v Ouston* [1941] AC 251.

Ancillary documents like the notice of transfer to be published under the TBPCO, consent by third parties, notice to customers, etc will also have to be prepared.

8.8.2 Signing

The vendor and the purchaser will sign the business purchase agreement. If any disclosure is to be made, the vendor will also issue the disclosure letter to the purchaser at the time the business purchase agreement is signed.

8.8.3 Completion

It is very probable that completion will not be simultaneous with the signing of the business purchase agreement, but will be subject to the prior fulfillment of conditions precedent. Ideally, the purchaser will want completion to take place only after the notice of transfer under the TBPCO has become complete and all the requisite third party consents have been obtained.

9

BUSINESS PURCHASE – DUE DILIGENCE

9.1 Introduction

In a business acquisition, the law may imply certain warranties into the sale and purchase of some of the assets which form part of the business being transferred. For example, insofar as these assets are “goods” for the purpose of the Sale of Goods Ordinance¹, there will be implied into the business purchase agreement a condition that the vendor has the right to sell those assets and a warranty that they are free from any charge or encumbrance.² Where the business assets to be transferred include land in Hong Kong, the Conveyancing and Property Ordinance will imply certain covenants by the vendor into the assignment.³ The parties may also voluntarily incorporate into the business purchase agreement by reference the covenants set out in Part A of the Second Schedule of the Conveyancing and Property Ordinance in respect of the land to be transferred. However, the scope of such implied warranties is limited, and the law does not imply any warranties in relation to intangible assets and other aspects of the business. Therefore almost all professionally-drafted business purchase agreements will include substantial warranties by the vendor on the assets being transferred.

However, as explained in the context of share acquisitions⁴, warranties are no substitute for a thorough due diligence investigation by the purchaser before committing itself to the business purchase. Besides, if the vendor of the business is in receivership or liquidation, then the purchaser should be

¹ S.2 of the Sale of Goods Ordinance.

² S.14(1) of the Sale of Goods Ordinance. The implied warranties as to merchantable quality (s.16(1)) and fitness for purpose (s.16(2)) only apply where the seller is selling the goods in the course of a business, so they do not normally apply to the sale of a business.

³ S.35 of the Conveyancing and Property Ordinance. Part I of the First Schedule of the Conveyancing and Property Ordinance is implied into every assignment of the whole of the interest in land held under a Government Lease. Part II is implied into every assignment for valuable consideration where the vendor assigns “as beneficial owner”.

⁴ See para.3.1.2 above.

advised to place less reliance on the availability of warranties and indemnities in the business purchase agreement and more reliance on satisfying itself by carrying out a full and thorough due diligence. In practice, it is extremely difficult to extract any warranties from receivers and liquidators except in very limited terms.⁵ In any event, it would often not be cost-effective for a purchaser to enforce any warranty or indemnity against an impecunious vendor.

The due diligence exercise is often limited to those assets and other matters to be taken over, and in this respect can be less extensive (and less costly) than a full due diligence investigation into a target company whose entire issued share capital is to be acquired. For example, issues relating to the share capital of the owner of the business and encumbrances over assets which are unrelated to the business to be taken over or are otherwise not intended to be taken over will be of no concern to the business purchaser. Conversely, a purchaser can (and often will) make use of the due diligence exercise to determine which assets and contracts it would want to be transferred, and leave out those assets and contracts which appear to be problematic or undesirable.

The process largely resembles due diligence for a share purchase, as discussed in detail in Chapter 3 above, and will involve the purchaser's lawyers as well as financial advisers.

It is important from the purchaser's perspective to ensure that title to all the assets to be transferred is vested in the vendor and can be transferred to the purchaser at completion. It is not uncommon in Hong Kong for a company to make use of assets and intellectual property rights belonging to its majority shareholder, a company controlled by the shareholder, or another company within the same group of companies in carrying out its business, in the absence of any formal documents or arrangements between the parties. For example, three companies (including the vendor company) all share the same office premises located inside an office block owned by Topco, their holding company. They also share the information technology personnel to maintain and develop software for their computers. These personnel are all employed by Topco. No formal agreement has ever been signed between

⁵ A receiver or liquidator may be persuaded to give limited warranties on his or her appointment, but it is unlikely that he or she will agree to give warranties on the assets which form the subject matter of the sale and purchase.

Topco and any of these three wholly-owned subsidiaries in relation to the office premises, the information technology support and the software. If the purchaser is now taking over the vendor company's business, the issues relating to the office premises, the ownership and the right to use (and to continue to use) the software, and the provision of information technology support must be clarified and resolved early on in the transaction, with a view to putting in place appropriate arrangements on terms acceptable to the purchaser. If that is not practicable, then the purchaser will have to consider alternative arrangements. In the example given above, it is unlikely Topco will agree to share its office premises and information technology department with the purchaser, nor will the purchaser necessarily desire such a sharing arrangement. So it is quite probable the purchaser will seek an alternative business location and engage its own information technology staff (or outsource the work to an outside provider). If Topco is not prepared to let the purchaser use the software developed by Topco's staff, or the purchaser is unhappy with the terms offered by Topco for the use of the software, the purchaser may decide to shift to a different software for the business, and this decision may impact upon whether the purchaser will take over the existing computer system used in the business and also the method by which data or other records will be transferred or provided to the purchaser at completion. This may ultimately affect the exact scope of the sale and purchase, as well as the consideration payable for it.

9.2 Some matters which require special attention in due diligence

9.2.1 Accounts

The accounts of a business may not be the same as the accounts of the vendor company which owns and operates the business. For example, the vendor may carry on a range of different businesses. Where possible, the purchaser will wish to review a separate set of accounts which relate specifically and exclusively to the business which is to be transferred, which will enable the purchaser to assess more accurately the value of the business it is acquiring.

9.2.2 Land

If the business comprises land in Hong Kong which will be transferred to the purchaser, review of the title deeds of the land must be carried out to ensure the vendor has good marketable title to the land. Provisions relating to the use of the premises in the land grant and any applicable deed of mutual

covenant must also be checked, so as to ensure the carrying on of the business is not in contravention of such provisions.

If the land is mortgaged to secure bank loans advanced to the vendor, the purchaser should discuss with the vendor early on in the transaction in respect of the discharge of the mortgage by the time the business purchase is completed. If all or part of the consideration payable by the purchaser is to be applied in discharge of the mortgage, this must be noted and duly reflected in the provision in the business purchase agreement concerning the mechanism for the payment of the consideration. For the purchaser's maximum protection, that part of the consideration should be paid directly to the mortgagee bank or the law firm representing the mortgagee bank, in order to ensure the mortgage over the land will be discharged.

Stamp duty is payable on an agreement for the sale of Hong Kong landed properties and an assignment of Hong Kong landed properties. In the case of residential properties, a "special stamp duty" may be payable if a residential property is sold within a few years of its purchase⁶, and also a "buyer's stamp duty" if the purchaser of the property is a person other than a Hong Kong permanent resident⁷. In view of these stamp duty charges, the purchaser's lawyer should review the title deeds of the land carefully to check (i) whether the land is "residential property" for the purpose of the Stamp Duty Ordinance⁸, and (ii) if the land is "residential property", the date it was acquired by the vendor (which will affect whether "special stamp duty" will be payable and, if payable, the rate at which it will be charged). Besides, the parties should address their minds to who should bear the stamp duty which may be quite a sizeable amount especially if stamp duty, special stamp duty, and buyer stamp duty are all payable.

The purchaser should also be advised to consider commissioning a valuation of the land, so that a portion of the consideration can be specifically attributed to the land (and by reference to which stamp duty may be charged).

Instead of operating on premises owned by the vendor, the business may have been conducted on rented premises. If the business is to continue on

⁶ See para. 1.6.1(g) above.

⁷ *Ibid.*

⁸ As explained in para. 1.6.1(g)(i) above, whether a property is a "residential property" for the purposes of s. 29A of the Stamp Duty Ordinance is determined with reference to its permitted use rather than its actual use.

the same premises after completion of the business purchase, the purchaser will have to become the new tenant in place of the vendor. Most business tenancies in Hong Kong are non-assignable, which means the vendor cannot simply assign the tenancies to the purchaser. During due diligence, the terms of the tenancies must be carefully reviewed to ascertain: (i) whether the tenancies are assignable, (ii) whether the tenancy agreements contain any unusual or onerous terms (to which the purchaser will become subject if the landlords consent to the purchaser assuming the tenancies); and (iii) whether the manner in which the purchaser intends to carry on business on these premises will result in a breach of any of the terms of the tenancy agreements.

Some landlords may charge a sizeable fee for granting consent, so the vendor and the purchaser will have to agree between themselves as to who should pay the consent fee.

9.2.5 Contracts

A business has no separate existence in law, so the vendor, as the person who carries on the business, would have entered into contracts with the various suppliers, customers, employees and contractors in the course of running the business. Whilst the benefits under a contract can be assigned by the vendor to the purchaser without the other party's consent (unless the contract is expressed to be non-assignable), obligations under the contract cannot be transferred except with the consent of the other party. Again, as part of the legal due diligence exercise, the purchaser's lawyer should review the terms of the contracts carefully to ascertain: (i) whether the contracts are assignable, and (ii) whether they contain any unusual or onerous terms (and hence, the purchaser may not wish to continue with them). If the purchaser is desirous of continuing with all or any of these contracts, steps should be taken to obtain the consent of the other parties to these contracts, with a view to either having the vendor's contracts novated to the purchaser⁹, or the purchaser entering into new contracts with the other parties on substantially the same terms.

⁹ By way of novation, a new contract arises between the purchaser and the counter-party, as a result of which the vendor is released from its obligations under the original contract with the counter-party, and the purchaser assumes those obligations in substitution for the vendor. The novation agreement will be executed by the vendor, the purchaser and the other party to the original contract.