

CHAPTER 1

Introduction to Private Equity

WHAT IS PRIVATE EQUITY?

1.0 The term 'private equity' (**PE**) usually refers to an equity investment in private companies which is quoted on the stock exchange. However, recent years have witnessed an increasing interest of PE investors participating in public companies' privatisation and private investment in public equity (**PIPE**). Private equity is an alternative to other means of financing such as bank loans and business angel financings. After the injection of equity funds in the investee companies, the PE investors will become co-owners of the investee companies together with the existing founders/shareholders.

1.1 There are a number of investment strategies including but not limited to venture capital, management and leveraged buyouts, management buy-ins, rescues, and expansion capital. Venture capital is the most common strategy adopted in Hong Kong.

PRIVATE EQUITY IN HONG KONG

1.2 Many PE funds with a presence in Hong Kong are established in offshore tax havens such as the Cayman Islands, but managed in Hong Kong. As the second largest PE centre in Asia, Hong Kong is a popular platform for PE investments in the world. As of the end of 2012, the capital pool of Hong Kong-based funds totalled approximately USD 80 billion of capital under management, which represents a two-digit growth when compared to the previous year's figure. Hong Kong's active stock market, proximity to and close connections with mainland China are good reasons for investors to choose to exit their investments through an initial public offering (**IPO**) or a sale in Hong Kong. It is expected that PE investments will grow in the Greater China region and Hong Kong will continue to be one of the major PE centres in Asia.

HOW TO USE THIS BOOK

1.3 This book is designed to provide concise guidelines and principles of certain legal aspects of PE, and will guide readers through every

stage in the life cycle of a PE investment. Chapter 2 will explain to readers the basic features of a PE fund and how a PE fund is usually structured. Preliminary matters including the necessary documentation, the preparation of a due diligence questionnaire, and the significance of binding and non-binding terms will be discussed in Chapter 3. Chapter 4 will give a tour through PE's investment structure, which essentially would consist of a component of equity, debt or a combination of both, depending on the choice of investment strategies. Chapter 5 will focus on buyouts, followed by a discussion on exit strategies and relevant tax issues at the time of sale in Chapter 6.

PRIVATE EQUITY-OVERVIEW

- 1.4 PE funds are usually structured as limited partnerships, composed of a number of limited partners (investors of the fund), a general partner and a manager. Typical limited partners may include pension funds, university and foundation endowments, sovereign wealth funds, bank holding companies, insurance companies or high net worth individuals. The general partner and the manager, although separate, are always affiliated entities. The general partner controls the private equity fund and makes financial decisions concerning the purchase and sale of the fund's portfolio companies. The general partner is usually the entity through which the sponsor of the fund shares in the private equity fund's so-called 'carried interest'. The general partner is usually the entity through which the sponsor makes a portion of its own investment in the fund so as to align its interest with those of the limited partners. The manager administers the private equity fund, sorts out investment opportunities, designs investment structure and recommends strategies for realising and exiting investments.
- 1.5 Tax considerations play an important role in deciding the jurisdictions where the PE funds will be established. Most of the PE funds are established in offshore tax havens, most popularly in the Cayman Islands, and can be managed in Hong Kong, which offers certain tax advantages as it does not charge any capital gain tax on the transfer of shares in private companies or withhold tax on repatriation of profits.

Private equity investments

- 1.6 PE investments usually involve the acquisition of an investee company's shares, by purchase of shares from the existing shareholders or through the subscription of new shares. Potential investors can utilise the following methods in their investments:
- Venture capital;
 - Management buy-outs or management buy-ins;
 - Rescues; or
 - Expansion capital.

Venture capital

- 1.7 Venture capital (VC) refers to investments in start-up companies or businesses that have a short operation history. The risks of VC investments are considerably higher because start-up companies are usually engaged in novel industries or have innovative business models, and they lack a track record of successful operation. To leverage the risks against the potential of a high-yield return, it is common for VC investors to invest in dozens of companies with perceived long-term growth potential, as a fall back that a few of them will generate massive returns in the future to compensate for the losses made in other investments.
- 1.8 For new businesses, VC investment is an attractive financing option because VC investors usually bring its business expertise into the company along with the investment fund. As professional investors, VC investors usually request participation in the management of the start-up businesses. More often than not, VC investors appoint individuals who have expertise in management, both in the technical and financial aspects of the business, as the directors of the board of the investee company. The business founders will also have the opportunity to benefit from the VC investors' extensive network of domestic and international business partners who will be valuable to the on-going development of the business.

Management buy-outs and buy-ins

- 1.9 A management buy-out (MBO) is where the management team of a company acquires the ownership of the company from its existing shareholders for the purpose of providing equity finance. A few MBOs of private companies take place by way of auction sales. MBOs of Hong Kong's listed companies will be subject to and governed by the Companies Ordinance (Cap 32) (CO), the Code on Takeovers and Mergers, and the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.
- 1.10 MBOs commonly arise in the following situations:
- disposal of a subsidiary by its parent company;
 - disposal of a company to its management instead of a trade sale;
 - management buy-back from receivership; or
 - succession issue resolution in a family-owned business.
- 1.11 A management buy-in (MBI) refers to cases where the managers or the management team of a company acquires the shares of another company and become its new shareholders. A MBI can be an outright takeover or a buy-in/management buy-out when the buy-in managers team up with the management team of the target company in the acquisition. Compared to MBOs, the investment returns of MBIs can be lower if the buy-in managers do not possess the same level of knowledge over the affairs of the target company as its own management team.

Rescue capital

- 1.12 PE plays a role in corporate rescues. Rescue capital are funds provided to re-capitalise the investee company and provide it with much needed new working capital. A rescue investment can be very risky as there is no guarantee of any improved performance of the dying company. As such, PE investments in rescue situations are uncommon. PE investors take a lot of caution and have to be satisfied that the management team of the company is still reliable to run the business before they will agree to inject any capital in a corporate rescue.

Expansion capital

- 1.13 Expansion capital, also called development capital or growth capital, is typically the injection of additional funds to an existing business venture which requires capital to finance its growth, fund acquisitions or refinance the debts of the investee company, despite instances where the company may have already obtained start-up funds from previous PE investments.

Exit strategies

- 1.14 After a certain period of investment, PE investors will look for suitable means to realise the gain of their investment by exiting the company, to pay earned returns to the limited partners of the PE fund and/or to apply the cash to new investment opportunities. In unfortunate situations where a PE investment results in a loss, the PE investors may, although not preferable and as a last resort, elect to voluntarily wind-up the portfolio company. For profitable investments, the common forms of exit strategies include the below:

Initial Public Offering (IPO)

- 1.15 If the investee company does well, it may consider listing its shares on the stock markets to enhance liquidity, raise new capital and increase its publicity. Its PE investors may either exit the whole or part of their investment prior to the company's listing depending on whether the continuation of investment will meet the investors' commercial objectives.
- 1.16 As a gateway between China and the rest of the world, the Hong Kong Stock Exchange is one of the world's most favoured stock markets. Companies listed on the Hong Kong Stock Exchange include those with Chinese and international backgrounds.
- 1.17 If an IPO in Hong Kong is an exit option for the PE investors, the investors must take into account the Hong Kong Stock Exchange's guidance letters on pre-IPO investments which provide elaborate restrictions on preferential rights which are typically requested by pre-IPO investors,

such as share subscription price adjustments, veto rights on board's or shareholders' decisions, anti-dilution rights, profit guarantee, pre-emptive rights and tag-along rights, etc. Most of the special rights are not allowed to survive after the listing of the investee company to ensure the fair treatment of the public investors and the pre-IPO investors in an orderly market.

Trade sale

- 1.18 Trade sale means the sale of the PE investors' interest in the investee company to someone who usually operates in the same industry as the investee company. Unlike IPOs, trade sales are less dependent on capital market conditions and can provide a more predictable sale price for the PE investors. A major incentive for the buyers to purchase shares of the investee company is to create synergies between its own and the investee company's business. Buyers in trade sales therefore are more willing to pay a premium to acquire a complementary business.

Management buy-back

- 1.19 In the PE investment agreements to which founders are usually a party, it is common for PE investors to require the founders or the investee company to repurchase its shares upon the occurrence or non-occurrence of certain events. For example, the founders will have an obligation to buy back the PE investors' shares if the investee company fails to launch a qualified IPO within the specified time frame.

Sale to another private equity fund

- 1.20 A PE fund may sell its investment in the portfolio company to another PE fund. A sale to another PE fund usually occurs in a secondary buy-out transaction where the selling PE fund disposes of its investment to the company's incumbent management team or another PE fund. The difference between a trade sale and a sale to a new PE fund lies in who the buyer is. For trade sale, the buyer is usually an entity that operates in the same or similar industry as the target company, while for the latter, the buyer is another PE fund.

CHAPTER 4

Financing the Transaction

THE AUCTION PROCESS IN PRIVATE EQUITY TRANSACTIONS

- 4.1 As it is not common for PE investors to invest in existing shares of an investee company, the following discussion will focus on sale of new equity by an investee company. Sale of new equity of an investee company by auction in a PE transaction allows the investee company to look for the most preferred purchaser or investor among a number of competing bidders. In some large transactions, the investee company may initiate an auction sale so that PE investors will have to compete with other potential investors and trade purchasers for the investment opportunity.
- 4.2 An auction sale offers many more advantages to an investee company than a traditional negotiated sale of new equity. It enables the investee company to reach out to a number of potential investors at the same time and make use of the competitive sentiment among them to obtain the most favourable terms. In order to win the bid, the bidders will often offer a higher purchase price for the investee company with less stringent investment terms. The investee company can maintain more control over the issuance and sale process than in a negotiated sale transaction.

Typical process of an auction sale

- 4.3 The process for an auction sale in the context of PE investments is similar to an auction sale of companies. It is typically divided into three stages:
- 4.4 *First stage:*
- Finding bidders. With the assistance of its auction sales team which includes legal, financial and business advisers, the investee company will source interested bidders in the market. The sales team will prepare an information memorandum¹ which contains basic information about the investee company and its business.
 - Evaluation and submission of indicative offers. Based on the information memorandum, interested bidders will preliminarily

¹ See chapter 8.

evaluate the proposed transaction and submit their initial indicative offers.

4.5 *Second stage:*

- Selection based on indicative offers. The investee company will review the bidders' indicative offers and decide which of them can participate in the auction sale. At this stage, the investee company will also provide a draft subscription agreement or a sale and purchase agreement to the selected bidders. The agreement will contain a framework of its expected structure and terms for the transaction.
- Initial due diligence. The selected bidders will commence initial due diligence review to obtain more information for the proposed transaction.
- Submission of second round offers. After evaluating additional information, the bidders can further consider the desirability of the proposed transaction and will submit their second round offers if interested.

4.6 *Third stage:*

- Selection of purchaser/investor. Based on the second round offers, the investee company will select the most preferred bidder to be the purchaser/investor. They will commence formal negotiation of the final terms of the transaction and execute definitive transaction documents and close the transaction.

Important issues in each stage

4.7 *First stage:*

A. Confidentiality

4.8 As there will be a number of bidders having access to the investee company's information, the auction process will generate a higher risk of unauthorised use and dissemination of such information. Therefore, preservation of confidentiality will be a major concern for the investee company.

4.9 It is preferable for the investee company to prevent the bidders from knowing the identity of each other. Otherwise there may be a risk that some bidders will collaborate in secret and conspire to make offers on more or less the same terms that are not favourable to the investee company. This will frustrate the investee company's purpose to drive for the best transaction terms. In extreme cases, it may even lead to the abortion of the proposed transaction. As such, the investee company should require the bidders to keep their participation in the auction sale confidential.

4.10 If the investee company is a listed company in Hong Kong, it shall also impose on bidders the obligation to observe the insider dealing prohibitions under the Securities and Futures Ordinance (Cap 571) (SFO)

and the bidders should not deal in any securities of the investee company when they have obtained inside information. The investee company should comply with the relevant Listing Rules and the Takeovers Code including all the disclosure and approval requirements in each step of the auction process.

4.11 These confidentiality matters are usually dealt with in a binding confidentiality agreement signed at the outset of an auction sale. Typical parties will be the investee company as the disclosing party and the bidder as the recipient. If any unsuccessful bidder breaches the confidentiality agreement, the investee company can enforce its rights against such person.

B. Information memorandum and process letter

4.12 An information memorandum is the principal selling document prepared by the investee company in an auction sale. It contains basic information about the investee company and its business which will be provided to potential bidders for evaluating their proposed investments. It assists potential bidders to decide whether to proceed with their initial indicative offers and on what terms. An information memorandum generally contains the following information of the investee company:

- its incorporation history;
- its business and operation;
- its financial information and projections;
- its major assets, major business relationships and material contracts;
- information on its board members, management team and senior employees; and
- an overview of market conditions and how the investee company competes in the market.

4.13 A process letter is usually distributed by the investee company together with the information memorandum. The process letter includes information such as a timetable of the auction sale, the required format of the indicative bids and other general instructions of the auction process. It is common for the investee company to state in the process letter that it has the right to amend or discontinue the auction. It will also reserve the investee company's right to select the most suitable bid at its sole discretion which means the highest-price offer may not necessarily mean a successful bid. This will give the investee company flexibility in controlling the auction process and choosing the most suitable purchaser/investor.

C. Initial indicative offers

4.14 A PE investor interested in making an indicative offer should prepare such an offer according to the format described in the process letter. Its contents should include a brief description of the major terms of the proposed investment such as the offer price, basis and form of consideration, and manner of payment. The PE investor can add conditions which must

be fulfilled before making its offer such as satisfactory due diligence results, obtaining its investment committee's approval and consents and regulatory clearance, if required. Since an initial indicative offer is preliminary, the terms therein are non-binding and subject to contract.

4.15 *Second stage:*

A. Due diligence and data rooms

- 4.16 Unlike a negotiated acquisition where the purchaser/investor often prepare a due diligence questionnaire for the investee company to answer, the investee company in an auction sale usually takes the initiatives to prepare the data room to facilitate the potential bidders' due diligence review. The advantages of preparing a data room are that the information which the investee company will disclose to the bidders will be standardised, thus ensuring a fair auction process in respect of information disclosure. It also spares the investee company from having to duplicate its efforts to answer various sets of similar but different due diligence questionnaires of the bidders. The investee company can better monitor the dissemination, use and security of information through the use of data rooms. To enhance efficiency and security, virtual data rooms are becoming popular nowadays. They allow multiple bidders to review the documents at the same time in a secured manner which also prevents the bidders from learning each other's identity in the due diligence process. At this stage, the investee company will send the bidders a draft subscription agreement or a sale and purchase agreement (the **Subscription Agreement**) which illustrates its position.

4.17 *Third stage:*

A. Selection of the most preferred investor

- 4.18 Based on the results of a due diligence review and after reviewing the investee company's draft Subscription Agreement, the potential bidders will prepare and submit their second round offers. Similar to the initial indicative offers, the second round offers are not binding and subject to further negotiations and execution of definitive transaction documents.
- 4.19 Apart from the offer price when deciding which investor should be formally selected, the investee company should also consider whether the proposed transaction structure and the major proposed terms as stated in the second round offers are acceptable. If a preferred investor is a PE investor and the investee company will retain its existing shareholders, the investee company should take into account, the PE investor's management record of other portfolio companies, its management style and whether it can blend in with the existing management, and restrictions which are likely to be imposed by the PE investor on the company and its future operation.

B. Exclusivity

- 4.20 It is common for the selected investor to ask for an exclusivity period considering it would have already spent much time and costs on the auction process and due diligence. An exclusivity period ensures the investee company will not continue to solicit other bidders. Sometimes the investee company will, on its own initiative, grant the selected investor an exclusivity period to demonstrate sincerity and enhance the confidence of the selected investor in the on-going course of dealings. It will provide a period of time for the selected bidder to conduct a final round of due diligence and for the parties to negotiate the final transaction terms and prepare and execute the definitive transaction documents.

PRIVATE EQUITY FINANCING – EQUITY

- 4.21 The structure of a PE investment, as well as its terms and conditions will vary in nature and complexity depending on the type and size of the investment. Key goals for a PE investor will usually include:
- gaining full access to management decisions/discussions, business records and other information so as to monitor the investment;
 - allowing management to run the business but gaining the ability to take control of the management of the business or block certain types of action if necessary; and
 - exiting the investment for a profit (a return on investment measured either by an internal rate of return or an investment multiple) usually after three to five years.
- 4.22 In short, a PE investor wants to monitor, prevent actions that might harm its investment and find a profitable exit.
- 4.23 These key goals can be broadly achieved by a combination of careful structuring of the investment and clarity in the equity documentation as to the rights and obligations of all parties. At the outset, it is important that all parties seek tax advice on the structure of the proposed investment as even slightest variation can have a marked impact on the tax efficiency and harmony of interests.

Structure

Developmental capital

- 4.24 A developmental capital investment will generally consist of a PE investor subscribing for preferred ordinary shares and/or redeemable preferred options or notes in an existing company. The shares issued to the PE investor will usually be preferred ordinary shares, generally known as A shares, B shares or preferred shares, depending on whether other rounds of investment have preceded or are anticipated. Existing shareholders prior to the first investment will hold standard (or vanilla) ordinary shares.

CHAPTER 7

Due Diligence Questionnaire – Private Equity Investment

INTRODUCTION AND BACKGROUND

- 7.1 This is a legal due diligence questionnaire for use in connection with an investor's Proposed Investment in a Company (**Proposed Investment**).
- 7.2 The main purpose of due diligence is to obtain sufficient information about the company and its business to enable the investor to evaluate the benefits and risks of the Proposed Investment. The results of due diligence review are significant because they can impact the pricing and the structure of the transaction. If the investor considers that there are lots of risks associated with the Proposed Investment, it may negotiate a lower purchase price or seek additional warranties, indemnities or other contractual protections. In extreme cases, the Proposed Investment may be abandoned by the investor if it is of the view that the risks outweigh the benefits.
- 7.3 Legal due diligence is essentially an investigation of the legal affairs of the company and its business. The process will, typically, consist of the Investor's solicitors preparing an initial due diligence questionnaire which is designed to elicit certain required information about the founder(s) of the company, the company and its business. The areas typically covered include the status and capacity of the company, property, intellectual property rights, information technology, regulatory, environmental issues, financial matters, material contracts, director and employee arrangements, litigation and insurance. Supplementary questions may be raised subsequently to clarify responses received or as a result of the Investor finding out more about the company and its business.
- 7.4 Due diligence takes a number of forms (eg business due diligence, financial due diligence or legal due diligence) and is often carried out by the investor with the assistance of its professional advisers (eg financial advisers, accountants and solicitors). In order to derive maximum benefit and avoid unnecessary duplication and costs, it is essential that both the Investor and its advisers understand precisely what is required of the due diligence exercise. In particular, consideration needs to be given to both:

- the scope of the due diligence (ie aspects of the affairs of the company to which the due diligence relate) – this will generally be governed by practical realities, such as the nature and business of the company, available time, budget and the parties' desire to complete the transaction; and
- the extent of the due diligence (ie materiality thresholds to be adopted for the due diligence exercise) – there will generally be a limit on the information received, for example, a question in the questionnaire asking all contracts to which the company is a party to be disclosed might elicit a large number of small contracts entered into in the ordinary course of business which should not impact the price or risks of the Proposed Investment.

7.5 There is no standard form of due diligence questionnaire – each is prepared to suit the relevant investment. This questionnaire is for general reference only. Appropriate revisions to this questionnaire will be needed depending on the scope and extent of the due diligence, and in particular the nature and business of the company (eg a comprehensive list of questions on environmental issues will be needed if the company is in the manufacturing industry, whereas the due diligence questions will be more focused on regulatory and compliance issues if the company is a financial institution). All questions should be specific for ease of comprehension and encourage the provision of meaningful answers.

PRECEDENT DUE DILIGENCE QUESTIONNAIRE

To: *[insert name of the investee company]*

Date: *[insert date]*

Dear Sirs,

We have been instructed by our client, *[insert name of the private equity investor]* (the **Investor**), to carry out a legal due diligence review on *[insert name of investee company]* (the **Company**) and its subsidiaries in relation to the proposed investment in the Company by the Investor (the **Proposed Investment**).

This questionnaire is designed to enable the Investor, the Investor's solicitors and other professional advisers involved in the Proposed Investment to obtain the information which the Investor requires to assist in its valuation of the Company. We request that you provide to us the following information and copies of the following documents at the earliest opportunity.

If appropriate, a separate file of answers and related documents should be produced for the Company and each of its subsidiaries (together the **Group** or **Group Companies** and individually a **Group Company**). It would be most helpful if the answers and related documents are given

to us and identified using the same numbering system set out below. Please keep key information on the copies, including but not limited to dates, seals, signatures and numbers legible. If some of the answers and/or documents cannot be given or provided immediately, it will expedite matters if the relevant question number is marked 'to be provided' by you and the remainder of the questions and documents are answered and provided in any event. If the answer to a question is 'no' or that no document of the description requested can be provided, please mark 'no' beside the relevant question and provide a written explanation (as applicable).

We reserve our rights to raise further enquiries and requests for any additional information for the purpose of our due diligence review on the Group Companies.

1 Corporate Matters¹

- 1.1 Please provide copies of documents in relation to the background of the Company, including but not limited to:
- (a) certificate of incorporation and any certificate of incorporation on change of name or re-registration;
 - (b) business registration certificate(s);
 - (c) current memorandum and articles of association (together with copies of all resolutions amending

- 1 At most times, the Investor will invest in the Company by way of subscribing to its shares. It is crucial for the Investor to ascertain that the Company has been duly incorporated, is validly existing and has the necessary power to hold the assets and conduct its business. The incorporation documents, constitutional documents and all statutory returns and filings relating to the Company should be obtained. If the Company has subsidiaries, the due diligence questionnaire should cover these subsidiaries. If the Company is a Hong Kong company, in addition to the corporate documents provided by the Company or the founder(s), the Investor should also carry out independent public searches at the Hong Kong Companies Registry to obtain information about the Company and its subsidiaries (to the extent that they are incorporated in Hong Kong or registered as non-Hong Kong companies), including copies of incorporation documents and statutory returns made to-date. The Investor should carry out searches at the Official Receiver's Office to find out whether any Group Company has been or is in the process of being compulsorily wound up. To ensure that the Investor can acquire the legal and beneficial title in the shares of the Company absolutely, the Investor must check the Company's constitutional documents to ensure that the Company has or can be duly authorised to allot and issue new shares to the Investor. In particular, in reviewing the Company's articles of association, the Investor and its professional advisers shall pay attention to any pre-emption rights granted to the existing shareholders of the Company. Before execution of the formal investment agreement such as subscription agreement and shareholders agreement, the Investor should ensure that the existing shareholders have consented to waive their pre-emption rights (getting the documentation evidencing the existing shareholders' waiver usually constitutes a condition precedent to the transaction).

- the same to the extent that those amendments have not been incorporated in the documents provided);
- (d) latest annual return and details of the changes which would be required if an annual return is required to be completed at the date of your reply to this questionnaire;
 - (e) joint venture agreement, investment agreement, shareholders agreement, voting agreement or similar agreements made between shareholders, if any;
 - (f) registers of members, directors and secretaries;
 - (g) share certificates issued to shareholders;
 - (h) all minutes of board meetings and directors' resolutions;
 - (i) all minutes of meetings of shareholders and shareholders' resolutions; and
 - (j) powers of attorney (if any) granted by the Company for any reason whatsoever.
- 1.2 Please provide:
- (a) a list of all investments (if any) held by the Company in other corporations and/or joint ventures wherever situated; and
 - (b) copies of documents in relation to the background of any subsidiaries of the Company, including but not limited to all the documents set out in paragraph 1.1 above (as applicable).
- 1.3 Please provide copies of documents in relation to the background of the parent company and/or existing direct and indirect shareholders of the Company, including but not limited to all the documents set out in paragraph 1.1 above (as applicable).
- 1.4 Please provide a chart showing the corporate structure of the Group and shareholding information of the Group Companies.
- 1.5 Please provide details of the corporate structure of the Group Companies, including but not limited to:
- (a) current authorised share capital;
 - (b) names and addresses of current shareholders of the Company and their respective shareholding;
 - (c) any changes in authorised share capital, any changes in shareholdings among the shareholders of the Company and any changes in shareholders since the incorporation of the Company;

- (d) details of any rights, options granted (eg employees share options scheme) and other incentive schemes (if applicable) established by the Company;
 - (e) any pre-emptive rights granted by the Company or any current shareholders to any person in respect of future increases in the authorised share capital of the Company or their relevant equity interest, as the case may be; and
 - (f) any charges, mortgages, pledges or other encumbrances on or affecting any shares in the Company.
- 1.6 Please provide details of the management of the Company, including but not limited to:
- (a) in relation to the board of directors, its composition, term of office of the directors, quorum for board meeting and matters requiring unanimous consent of the board; and
 - (b) in relation to the senior management, the term of office of the management staff and the ambit of their power.
- 1.7 Please provide details of the registered office and other trading addresses, branches, representative offices, sales offices, agencies or permanent establishments of the Group Companies, including but not limited to copies of business registration certificates or business licences of all branches and representative offices.
- 1.8 Please provide a list of all business names other than the respective corporate names of the Group Companies under which these Group Companies have carried on business.
- 2 Real Property²**
- 2.1 Please provide a list of the real property owned and/or leased by the Group in Hong Kong or elsewhere, detailing the address of the property, and, in the case of rented property, as applicable, the current occupier, the term of lease, the name of landlord and the rent payable.
- 2.2 Please provide details and copies of documents in relation to all real property owned by the Group, including but not limited to:
- (a) all title deeds or title information documents;

² This paragraph enables the Investor to identify the real property owned and/or leased by the Group Companies and ascertain any encumbrances affecting the interest of the Group Companies in such real property.

CHAPTER 13

Investment Agreement – Single Investor

INTRODUCTION AND BACKGROUND

- 13.1 The following is a precedent of an investment agreement for a management buy-out. It sets out the terms and conditions of the transaction between the private equity investor and management relating to their joint establishment of a new company (a triple newco structure is assumed in this precedent) for the purpose of acquisition and post-buyout operation. Modifications to this precedent will be needed to reflect the actual result of negotiation between the private equity investor and the management.

PRECEDENT INVESTMENT AGREEMENT

THIS AGREEMENT is made on *[insert day and month]* 20*[insert year]*

AMONG:¹

- (1) *[insert name of company whose shares are held]* incorporated in Hong Kong, Special Administrative Region of the People's Republic of China (**Hong Kong**), under number *[insert company number]* whose registered office is at *[insert address]* (the **Company**);
- (2) *[insert name of company whose shares are held]* incorporated in Hong Kong under number *[insert company number]* whose registered office is at *[insert address]* (**Newco 2**);

¹ The registered company name, office and number of the Company, Newco 2, Newco 3 and the Investor should be inserted accordingly. If a company is trading under a name other than the registered company name, the words 'trading as *[insert trading name]*' may be inserted just after the relevant Party's address.

If a company is registered in a place other than Hong Kong, the words 'Hong Kong' should be replaced with the relevant country of registration (eg 'China'). If a Party is a foreign entity consider inserting a provision setting out the procedure for service in Hong Kong.

Each of the managers should be detailed in Schedule 1, including their full names, addresses, fax numbers and email addresses.

- (3) [insert name of company whose shares are held] incorporated in Hong Kong under number [insert company number] whose registered office is at [insert address] (**Newco 3**);
- (4) The several persons whose names and addresses are set out in Schedule 1 (together the **Managers**); and
- (5) [insert name of fund] incorporated in Hong Kong under number [insert company number] whose registered office is at [insert address] (the **Investor**)

[(each of the Company, the Managers and the Investor being a **Party** and together the Company, the Managers and the Investor are the **Parties**)].

RECITAL:²

The Investor has agreed to invest in the Company subject to and in accordance with the terms and conditions of this Agreement.

THE PARTIES AGREE:

1 Definitions and Interpretation³

- 1.1 In this Agreement, unless the context otherwise requires the following expressions shall have the following meanings:

2 Recitals are intended to explain the background of, and purpose to, the Agreement. They do not constitute substantive provisions, and are not binding unless they are specifically stated to be incorporated in the main body of the Agreement. They often state what is obvious from the title or from the first few clauses of an agreement, in which case the Parties may agree to omit them.

This Agreement has been prepared on the basis that the drafter is acting on behalf of the Investor and it has been assumed that:

- there is a single investor;
- there are a number of individual managers who will also be shareholders in the Company;
- there are conditions to the investment and, as such, it has been drafted with split exchange and completion with rights in favour of the Investor to terminate the Agreement between exchange and completion;
- there is a triple newco structure appropriate for most leveraged buy-outs in order to achieve structural subordination of debt for banking purposes and to separate investor debt from equity for tax purposes;
- there are restrictions on the managers operating the business between the date of the Agreement and completion; and
- the Agreement is subject to the laws of Hong Kong.

Provisions for syndication of the investment by the Investor (see Investment agreement – syndication provision) can be used with this Agreement, which depending on the nature of the transaction:

3 The definitions and interpretation provisions in this clause apply throughout the whole of this Agreement. The drafter should consider whether it is simpler to put certain definitions at the beginning of the relevant clause, Schedule or paragraph if used only in that context.

A Ordinary Shares	means the A ordinary shares of HK\$ [insert amount] each in the capital of the Company;
Accountants' Report	means the accountants' report prepared by [insert name], a true copy of which comprises Annexure 1;
Annual Budget	means the annual operating budget adopted under clause 6.3.1;
Articles	means the proposed new articles of association of the Company in the approved terms to be adopted at Completion (as amended from time to time);
B Ordinary Shares	means the B ordinary shares of HK\$[insert amount] each in the capital of the Company; ⁴
Board	means the board of directors of the Company from time to time;
Business Day	means a day, other than a Saturday, Sunday or public holiday, on which clearing banks are open for non-automated commercial business in Hong Kong;
Business Plan	means the business plan, a true copy of which comprises Annexure 2;
CO	means the Companies Ordinance (Cap 32);
Completion	means completion of the matters described in this Agreement by the performance of the Parties of their respective obligations in accordance with clause 3;
Completion Date	means [insert date] 20[insert year] or such other date as the Parties agree in writing; ⁵

4 *B Ordinary Shares*: These shares are subscribed for by Management. If there is to be a ratchet, the price at which they are subscribed should be at a premium calculated to take into account the value of the ratchet, otherwise an income tax and national insurance charge may be incurred.

5 *Completion Date*: If exchange and Completion occur on the same date, the definition should be amended to 'the date of this Agreement'. The date shown will be the same date as that on which completion is to occur under the Share Purchase Agreement.

Conditions	means the Conditions set out in clause 2.1; and Condition means any one of them; ⁶
Confidential Information	means all data or information (whether technical, commercial, financial or of any other type) in any form acquired under, pursuant to or in connection with, this Agreement and any information used in or relating to the Business (including information relating to [the Company's][any Group Company's] products (bought, manufactured, produced, distributed or sold), services (bought or supplied), operations, processes, formulae, methods, plans, strategy, product information, know-how, design rights, trade secrets, market opportunities, customer lists, commercial relationships, marketing, sales materials and general business affairs), and which are for the time being confidential to the Company; ⁷
[Consequential Loss]	means consequential, special, indirect, incidental or punitive damages or loss or any loss of profits or other form of economic loss however arising; ⁸

6 *Conditions*: The Agreement includes a number of Conditions set out in clause 2.1 which must be satisfied before Completion. The drafter should consider whether there should be deemed repetition of the Warranties at Completion.

7 *Confidential Information*: This definition should include all information relevant to the Company and its business.

8 *Consequential Loss*: 'Consequential loss' means any loss that is not a direct loss and refers to damage which falls within the second limb in *Hadley v Baxendale* (see below). To be recoverable, indirect or consequential loss must not be beyond the reasonable contemplation of the parties to the contract at the time when the contract was made and it is sufficient that the kind of damage which may be caused by a breach was within the reasonable contemplation of the parties. Direct losses fall within the first limb and this may include loss of profit, depending on the circumstances. Due to this uncertainty, the Managers will want to exclude liability for loss of profit. The Investor, on the other hand, will want to be able to recover loss of profit if it flows naturally from the breach. A clause which excludes 'any direct or consequential loss (including loss of profit)' will not be sufficient to exclude all profits, only those which are consequential, whereas a clause which excludes 'any loss of profit or any indirect or consequential loss' would exclude all profit. The inclusion of a definition of 'Consequential Loss' will flow through the Agreement via its inclusion in the definition of 'Losses' (see below).

Hadley v Baxendale [1843-60] All ER Rep 461.

Deed of Adherence	means the deed of adherence to this Agreement in the form of Schedule 5;
Disclosure Letter	means the letter dated the same date as this Agreement from the Warrantors to the Investor disclosing matters against the Warranties, together with its schedules and the documents attached to it; ⁹
Environmental Report	means the environmental report, a true copy of which comprises Annexure 4;
Exit	means a Sale or Quotation;
Financing Documents	means the facilities agreement to be entered into on the same date as this Agreement between [Newco 3] and [insert name of bank] together with the [list other financing documents, such as security and intercreditor documentation] in the agreed form, as amended, supplemented, novated or replaced from time to time;
Fund	means any bank, company, unit trust, investment trust, investment company, limited, general or other partnership, industrial provident or friendly society, any collective investment scheme, any investment professional, any high net worth company, unincorporated association or partnership or any high value trust (all as defined under the SFO), any pension fund or insurance

The rule in *Hadley v Baxendale* says that where two parties have made a contract, which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either (1) arising naturally (ie according to the usual course of things form such breach of contract itself) or (2) such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it.

9 *Disclosure Letter*: Normally the Warrantors will provide a disclosure letter to qualify the Warranties. The Agreement assumes that the Warrantors will address the letter to the Investor. The Disclosure Letter should not normally be addressed from the Managers' Solicitors to the Investor's Solicitors on its clients' behalf, as the Warranties are given by the Warrantors (who include the Managers) to the Investor in the Agreement. The Warranties themselves may require that certain documents are 'disclosed' and it is usual for such documentary evidence to be appended to (and form part of) the Disclosure Letter.