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CHAPTER 1

SHARE PURCHASE OVERVIEW

1.1 The sale and purchase of shares is the most common form of corporate acquisition in Hong Kong. By acquiring part or all of the share capital of a target company, the investor can exercise control over the target company as well as its businesses and assets. Many parties tend to opt for sale of shares over sale of assets in corporate acquisitions because share acquisitions are generally simpler and more straightforward. The subject of the transaction is the shares in the target company.

1.2 The other form of corporate acquisition is through the sale and purchase of the target company's asset. To do this however, the buyer has to identify and then acquire ownership of each asset to be sold and assigned. The asset sale transaction structure and procedures are often more complex. Transfer of assets may also trigger the application of the Transfer of Business (Protection of Creditors) Ordinance (Cap 49), which requires the publication of gazette and newspaper notices of transfer and affects the timing of completion of the asset sale transaction.

LEGAL ISSUES

1.3 The following are some common legal issues that the parties should consider when structuring a share acquisition.

Ownership of shares

1.4 The buyer should ascertain that the selling shareholder has the sole legal and beneficial ownership over the sale shares and ensure that the seller can validly transfer and the buyer can effectively acquire the full rights and powers under the sale shares without third party encumbrances or consent.

Shareholder loans

1.5 If the selling shareholder has extended shareholder loans to the target company, the buyer should acquire the shareholder loans together with the sale shares to avoid situations where the target company remains indebted to its old shareholder after the new shareholder has taken over the target company. The

pricing of the acquisition should include both the sale of the shares and the sale and assignment of the shareholder loans, if any.

Restrictions on share transfers and pre-emptive rights

1.6 The articles of association of private Hong Kong companies must contain restrictions on the right to transfer shares. The restrictions may comprise pre-emptive rights or may require approval from the board of directors to effect the transfer. If the target company has more than one shareholder, the buyer should check whether there are existing shareholder agreements which may stipulate similar restrictions that are binding on the selling shareholder.

Third party consent

1.7 Sometimes the selling shareholder or the target company may have entered into agreements with third parties such as loan agreements with banks, which contain change of control provisions to disallow any transfer of shares in the target company without their prior consent. Furthermore, the relevant statutory requirements relating to change of control will need to be complied with if the target company operates in a regulated industry such as financial institutions and insurance companies. This will impact the complexity and timing of the transaction.

Source of funds and financial assistance¹

1.8 The buyer should consider from where its source of funds for the acquisition will come. Hong Kong companies are generally prohibited under the Companies Ordinance (Cap 622) (CO) from giving financial assistance for the acquisition of their own shares. As such, the target company cannot provide any financial assistance to the buyer for purchasing its shares. In addition, the meaning of financial assistance is rather broad as it includes but is not limited to assistance given by way of gift, guarantee, security, indemnity or loan.

1.9 The prohibition is somewhat relaxed in respect of Hong Kong private companies provided that certain conditions are met. The exemption will apply if:

- (a) The financial assistance will not reduce the company's net assets or if it would, it is provided out of distributable profits;
- (b) The majority of directors of the target company have made a statement explaining the form of assistance and have given their opinion that the company will remain solvent immediately after providing the assistance; and

¹ See Chapter 16.

- (c) The assistance has been approved by a special resolution passed at a general meeting of the shareholders within 30 days of the majority of directors making the above statement.

Competition law²

1.10 In the past, Hong Kong did not have a generic anti-competition law regime. The competition laws were only applicable to the telecommunications and broadcasting industries. In June 2012, the Legislative Council of Hong Kong enacted the Competition Ordinance (Cap 619) which came into effect on 14 December 2015. This created an anti-competition regime to prohibit acquisitions and mergers that would substantially lessen competition in Hong Kong. The buyer will need to review this new piece of legislation in structuring transactions.

Taxation

1.11 Transfers of Hong Kong stock including shares are subject to Hong Kong stamp duty.³ The rate of stamp duty is 0.1% of the amount of the consideration or of its value on every sold note and every bought note and HK\$5 on an instrument of transfer. It is common for the buyer and the seller to each share 50% of the total stamp duty in a share sale transaction. Subject to payment of an adjudication fee, which is currently HK\$50, anyone can request the Collector of Stamp Revenue to express his opinion on whether an executed instrument is chargeable with stamp duty and the amount payable.

1.12 Hong Kong does not have any capital gains tax regime that is chargeable on the disposal of shares or assets.

STEPS AND DOCUMENTATION

Pre-contractual agreements

1.13 At the initial stage of negotiation, the parties often record their key understandings in a heads of terms (also called a letter of intent or a term sheet), which is usually subject to contract but non-binding except for certain provisions such as confidentiality, exclusivity and non-solicitation. The heads of terms sets a platform for negotiation of the definitive transaction documents pending due diligence. To protect their respective interests in the negotiation and due diligence stage, the parties can separately enter into confidentiality, exclusivity and non-solicitation agreements. The parties can agree to the payment of a break fee⁴ should one decide not to proceed with the transaction.

² See Chapter 17.

³ See Chapter 19.

⁴ See Chapter 5.

Due diligence⁵

1.14 Through legal and financial due diligence, the buyer can obtain information about the seller, the sale shares, the target company and its business and assets for the purposes of assessing the benefits and risks associated with the acquisition, valuation and negotiation of definitive transaction documents. The results of the due diligence will be reported to the buyer by its professional advisers. The buyer should engage foreign experts if the target company carries on businesses or own assets in another jurisdiction.

1.15 For legal due diligence, the types of information to be gathered generally include the ownership of shares, the target company's business, assets and financial information, material contractual commitments, employment issues, contingent liabilities, foreign corrupt payment and regulatory and compliance matters. The seller should ensure that the information will only be provided subject to confidentiality and non-solicitation. A practical way to ensure that such requirements are met is to set up a data room.⁶

Definitive transaction documents

1.16 Share purchase agreement⁷ – a share purchase agreement is the main definitive transaction document in a share acquisition. The share purchase agreement sets out the terms and conditions of the transaction and delineates the rights and obligations of the parties.

1.17 Disclosure letter⁸ – to qualify the representations and warranties given under the share purchase agreement, it is usual for the seller to issue a disclosure letter to the buyer at completion of the transaction which makes specific qualifications against the relevant representations and warranties.

1.18 Deed of assignment – if shareholder loans are involved, the sale and assignment of the shareholder loans should be completed simultaneously with the transfer of shares under a deed of assignment.

1.19 Guarantee and indemnity⁹ – to ensure the performance of their respective obligations, the buyer and seller can ask their respective parent companies or other guarantors to execute guarantees and indemnities. The guarantors can join in and execute the share purchase agreement which will contain provisions of similar effect. It is common for the buyer to require a tax indemnity from the seller for tax liabilities incurred by the target company prior to completion of the transaction.

1.20 Shareholder agreement and deed of adherence – if the buyer will only acquire part of the share capital of the target company, the other existing shareholders will usually execute a shareholder agreement with the buyer

⁵ See Chapter 6.

⁶ See Chapter 8.

⁷ See Chapter 10.

⁸ See Chapter 9.

⁹ See Chapter 12.

stipulating how the target company should be managed after completion and the rights and obligations of each shareholder. If the existing shareholders have previously executed a shareholder agreement, the buyer should be asked to execute a deed of adherence to bind itself under the terms of the existing shareholder agreement with amendments agreed by the buyer and all other shareholders.

COMPLETION

1.21 Subject to the fulfilment of the conditions precedent to the transaction, the acquisition will close, upon which the buyer will become the legal and beneficial owner of the sale shares and the shareholder loans (if any).

1.22 Upon the buyer paying the purchase price, major items and documents which shall be delivered by the seller to the buyer to effect the transfer of shares include:

- (a) Executed instrument of transfer as well as bought and sold notes relating to the sale shares;
- (b) Share certificates relating to the sale shares;
- (c) Statutory records and financial books and records of the target company, together with its company chops and seals; and
- (d) Resolutions of the boards of directors of each of the seller (being a corporate body) and the target company approving the relevant agreements and the transactions contemplated thereby, including the transfer of shares, assignment of shareholder loans and change of directors and officers of the target company, etc.

1.23 If all conditions precedent required to be fulfilled before completion have been fulfilled or waived, completion can take place once the share purchase agreement and other applicable transaction documents are executed.

1.24 To ensure that the buyer gains sufficient control over the target company, the buyer should require the company's board of directors to approve the resignation of its old directors/officers/auditors and appoint the buyer's nominees in substitute simultaneously at completion. The buyer should require the resignation of such personnel be on a no-recourse basis against the target company.¹⁰

POST-COMPLETION

1.25 Certain practical steps should be taken by the parties after completion. The first is the payment of stamp duty. Late payment will result in penalty. Further, the Stamp Duty Ordinance (Cap 117) provides that no instrument chargeable with stamp duty shall be acted upon, filed or registered by any public officer or corporate body unless such instrument is duly stamped. Therefore the target company's board will often refuse to register the sale shares in the buyer's name unless the transfer has been duly stamped.

¹⁰ See Chapter 13.

1.26 The second important step is to ensure that the registers of the target company are duly updated to reflect the change of ownership of the sale shares as well as the cessation and appointment of the directors and company secretary. The old share certificates should be cancelled and new ones issued.

1.27 To protect itself, the buyer should undertake to complete the making of filings and returns to the Companies Registry relating to the change of registered office, directors and company secretary within the prescribed time limit.

CHAPTER 2

HEADS OF TERMS

2.1 A heads of terms, sometimes called a letter of intent or a term sheet, is a short document that sets out the basic understanding of the parties and the material terms of a proposed transaction during the initial stage of negotiation and before preparation of definitive transaction documents. The heads of terms serves as a platform for discussion to identify major areas of disagreement and to avoid misunderstanding. Often it will serve as a guide for the preparation of the definitive transaction documents.

REASONS TO USE HEADS OF TERMS

2.2 It is common for parties to negotiate and execute heads of terms first, whether binding or non-binding, in commercial transactions. There are a number of advantages in doing so:

- (a) The heads of terms provides a practical framework for the parties to consider the structure and material terms of a proposed transaction. It helps the parties to identify the areas of consensus and disagreement before incurring significant costs in preparing detailed definitive transaction documents. Guided by the heads of terms, the parties can focus on issues which matter most to them because it is inefficient and expensive to draft definitive transaction documents without a basic agreement on the material terms and structure.
- (b) Executing heads of terms, whether binding or not, is a good indication of the parties' intention to enter into the transaction. It gives a sense of assurance to the parties to proceed to the next stage, for example to commence due diligence and engage professional advisers with a view to consummate the transaction.
- (c) The heads of terms records the initial agreement between the parties on the major issues of a proposed transaction. It creates a moral commitment and can prevent the parties from deviating from what has been agreed in principle which may otherwise frustrate the transaction. As such the parties should be careful when preparing the heads of terms as it may be difficult for them to change the proposed terms of the transaction at a later stage.

9.11 As mentioned above, disclosures are made so that the purchaser will have, or be regarded to have, sufficient knowledge relating to the transaction prior to its execution. It is common for a seller to qualify its representations and warranties in the sale and purchase agreement with reference to what the purchaser knows or should have known. However, the purchaser should argue that only its actual knowledge rather than its constructive or imputed knowledge should qualify the seller's representations and warranties. This will prevent the purchaser from assuming risks and liabilities for not actually knowing certain facts when it enters into the transaction and losing its ability to claim against the seller when a breach of such facts occurs later.

CHAPTER 10

SHARE PURCHASE AGREEMENT

10.1 The sale and purchase agreement sets out the terms under which the purchaser agrees to acquire from the seller the share capital of the target company (**Sale Shares**). The scope and overall substance of the Sale and Purchase Agreement will depend largely on the transaction structure.

10.2 The first draft of the Sale and Purchase Agreement is usually prepared by the purchaser's solicitors except if the target company (**Target**) is to be sold by way of auction in which case it will usually be prepared by the Seller's solicitors.

10.3 The purchaser agrees to pay to the seller the purchase price for acquisition of the Sale Shares (**Consideration**) in return for the seller's transfers of title in the Sale Shares to the purchaser. This takes effect at completion of the transaction (**Completion**) when the necessary formalities to conclude the share acquisition are performed. The Completion occurs either at the same time the Sale and Purchase Agreement is executed (**Exchange**) or at a later date agreed upon by the parties.

10.4 Since the purchaser will acquire title to the Sale Shares at Completion, it thereby acquires all assets, liabilities, rights and other obligations attached to the Target including those that the purchaser may not want and does not know about.

10.5 The purchaser has to ensure that it will obtain full title guarantee from the seller who has to respect its covenants to transfer good title to the purchaser free from any encumbrances or third party interests. The allocation of risk for the Target's liabilities, necessarily impacting its prospects post-completion, is at the heart of many negotiations that take place over the drafting of the sale and purchase agreement. Much of the negotiation deals with the contractual statements that the seller makes regarding the state of affairs of the Target at the date of acquisition (ie, the seller's warranties). The negotiation may run in parallel with the purchaser's review of the Target's legal, business, tax and financial information, asset title documents and other information that the purchaser may need in order to gain a full picture of the Target's affairs or, depending on the timetable, may be undertaken subsequent to the due diligence exercise.

10.6 Contractual protections in the sale and purchase agreement are no substitute for a thorough due diligence exercise because all purchasers would prefer to find out about serious problems before Completion so that they can renegotiate a

reduced Consideration and/or seek specific contractual protections or, in extreme circumstances, decide not to proceed to Completion. Nevertheless, contractual protections will offer some comfort to the purchaser if, for example, time is short and a full due diligence cannot be done. Under such circumstances the purchaser should investigate key issues, ensure that warranties and indemnities are appropriately wide, and provide for particular issues to be conditions precedent to Completion.

10.7 Apart from risk allocation, it is important that the sale and purchase agreement fully and accurately document the transaction and cover all practical issues relating to a change of ownership. This is especially true if the Consideration is not full payment in cash at Completion (for example, if the parties agree that the Consideration will be adjusted by reference to completion accounts or linked to an earn-out arrangement or if there is a retention of the Consideration to cover potential warranty and indemnity claims). Further drafting will be required if there is a gap period between Exchange and Completion because there are certain conditions (for example, shareholder or third party consents to the transaction) that must be satisfied before Completion can take place.

COMMON ISSUES TO BE CONSIDERED WHEN DRAFTING THE SALE AND PURCHASE AGREEMENT

10.8 The following issues are always considered when drafting the sale and purchase agreement:

- (a) Who are the parties to the sale and purchase agreement;
- (b) The manner in which and when Consideration is to be paid;
- (c) Completion arrangements and mechanics;
- (d) Whether the share purchase is subject to any conditions precedent;
- (e) Provisions governing any time period between Exchange and Completion;
- (f) Warranties, indemnities and limitations given by the seller to the purchaser; and
- (g) Any restrictive covenants which bind the parties.

PARTIES

10.9 In a straightforward transaction there are usually only two parties involved, namely the seller and the purchaser. If a party is concerned about the other party's financial standing it is desirable for the obligations of the other party to be guaranteed, in which case guarantor(s) will be involved.

10.10 Purchaser's solicitors need to be aware that in certain circumstances issues may arise as to the seller's capacity to enter into and perform obligations under the sale and purchase agreement (eg, trustee/fiduciary sellers). In these circumstances, the purchaser needs to be satisfied with the seller's capacity to sell the Sale Shares and to give warranties and indemnities; and if a claim arises

under the sale and purchase agreement against the seller, the purchaser is able to enforce its rights.

10.11 If there is more than one seller, practical issues will need to be addressed, for example, whether the sellers give the same warranties, whether the sellers accept liability jointly, severally or jointly and severally, and the sellers' proportionate caps on liability.

CONSIDERATION

10.12 Three key questions need to be addressed regarding the Consideration: How much? When? What? The Consideration clause should be short and straightforward if the purchase price for the Sale Shares is payable by the purchaser in full in cash at Completion. However, there are different ways that the Consideration¹ can be structured.

Adjustment of the purchase price post-Completion

10.13 It may be appropriate to adjust the purchase price post-Completion because the true value of the Target cannot be accurately ascertained before Completion.

10.14 Depending on the nature of the Target's business, fluctuations in the value of the Target's assets and liabilities and its profit levels may mean that it is sensible from both parties' point of view to value the Target and thereby finalise the purchase price after Completion. Each party's accountant will analyse the Target's financial information for the period between Exchange and Completion to ascertain whether the initial valuation (on which the pre-adjustment purchase price was calculated, either by reference to net asset value, net profits or working capital) requires adjustment. These financial calculations (which are distinct from periodic company accounts and management accounts) are specifically prepared for valuation purposes and are generically known as completion accounts. Both the seller's and the purchaser's accountants may be involved in the preparation and finalisation of the completion accounts. An independent accountant may become involved if the parties are unable to agree on the completion accounts.

10.15 The sale and purchase agreement should set out the basis for the preparation of the completion accounts, how and to what extent the provisional Consideration is to be adjusted by reference to the completion accounts. The definitions of the key terms and applicable accounting methods for determining the purchase price adjustments are critically important.

10.16 To avoid having to recover money from the seller, the purchaser may wish to retain part of the purchase price pending the outcome of the completion accounts. The purchaser may also seek to link any such retention with a right to set-off the balance of the Consideration due against any warranty or indemnity liability of the seller. If the purchaser is not paying the full amount of Consideration

¹ See Chapter 11.

at Completion, the seller may seek to secure the purchaser's obligations to pay the balance of the Consideration due pursuant to the completion accounts. This can be achieved by paying the difference between the Consideration paid at Completion and the full amount of the provisional Consideration into a retention account or escrow account. If the parties agree to an escrow arrangement, the sale and purchase agreement should contain some basic details concerning the escrow arrangement. Furthermore, the parties often enter into a separate escrow agreement with a third party that will govern the management and release of escrowed funds.

Non-cash Consideration

10.17 Typically, the Consideration is payable in cash. While full payment in cash at Completion is preferable for the seller, this may not be feasible for the purchaser. If the purchaser has insufficient funds, is unable, or unwilling to obtain a bank loan facility then it may seek to pay in alternative ways. The Consideration may take the form of shares in the Target or some form of debt instrument issued by the purchaser (such as loan notes) or a combination of both and/or cash.

10.18 *Loan notes:* If loan notes are issued by the purchaser, a loan note instrument will be prepared and negotiated. Loan notes defer the purchaser's obligation to pay the Consideration and are therefore attractive if the purchaser has insufficient cash available at Completion. For the purchaser, issuing loan notes to the seller will be an attractive alternative to bank financing as loan notes may carry a lower interest rate and are not subject to the onerous provisions that would usually be found in bank facility agreements. The seller will usually want the loan notes to provide for accelerated repayment in the event of certain specified default events. The purchaser will wish to set off any future warranty or indemnity claims it may have against repayment of the loan notes.

10.19 *Consideration shares:* Consideration shares are shares in the Target which are issued directly to the seller as part of the Consideration. Consideration shares may prove to be an attractive option for the purchaser, particularly, if the seller will participate in the combined business or Target's business post-Completion. However, the purchaser will need to consider the effect of issuance of the Consideration shares on existing shareholders and the costs and formalities of such issuance.

DEFERRED PAYMENT OF CONSIDERATION

10.20 In certain circumstances the parties may agree that payment of the Consideration (whether in full or in part) will be deferred until after Completion. Deferred payment is most common where the parties agree that the Consideration is determined by reference to the Target's performance post-Completion (ie, an earn-out arrangement). An earn-out will be appropriate where:

- (a) The seller will remain involved in the Target's business post-Completion, an earn-out will incentivise the seller and retain its loyalty to the Target; or
- (b) The valuation of the Target is based more on expectations of future profit levels than on the value of its assets; or
- (c) Part of the Consideration is conditioned upon a future event or an ongoing state of affairs (for example, renewal of a key contract for the Target).

10.21 The sale and purchase agreement will include the parties' agreement on the level of earnings and profits during the earn-out period and set out how deferred Consideration payments are calculated based on the Target's performance in reaching certain specified targets. Clear provisions for definitions and calculations of earnings and profits are important. Earn-out arrangements are difficult to negotiate and, even after agreement, are often contentious when the earn-out is calculated.

10.22 The purchaser will typically require a cap on the amount payable under the earn-out arrangement (ie, the maximum amount payable) and the seller will typically require a floor (ie, a minimum amount payable).

10.23 When acting for the seller it is appropriate to secure the purchaser's obligations to pay any deferred Consideration. Unless the deferred Consideration is secured, the seller should be concerned about the good-standing, solvency and future prospects of the purchaser as it will be taking a credit risk on the purchaser. Accordingly, the seller may require certain purchaser warranties to protect itself.

COMPLETION

10.24 Completion will take place either at the same time as Exchange or at a later date agreed upon by the parties. If there is a time period between Exchange and Completion, the sale and purchase agreement will require considerable additional drafting. At Completion, the necessary formalities to conclude the transaction are performed, eg, documents required to effect the legal transfer of the Target are signed.

10.25 The sale and purchase agreement will include provisions (usually in the main body and in a schedule to the sale and purchase agreement) setting out the actions that each party must take at Completion and the documents that each party must deliver thereby forming a checklist of documents to be used by the parties' solicitors at the Completion meeting where documents are exchanged.

SIMULTANEOUS EXCHANGE AND COMPLETION

10.26 Exchange and Completion will be simultaneous in many straight-forward acquisition transactions. This is appropriate if conclusion of the transaction is entirely within the parties' control and there is no need for the parties' shareholders or third parties to give consent or approval. Simultaneous Exchange and Completion is preferable for the purchaser (and often for the seller as well) since:

- (a) It eliminates transaction risks during the intervening period (eg, the Target may lose a key contract with an important customer after Exchange but before Completion);
- (b) It provides certainty that the transaction will be completed without the transaction failing post-Exchange because some required consents cannot be obtained; and
- (c) The purchaser can immediately gain control of the Target's affairs once it has committed to the transaction by executing the sale and purchase agreement without the risk of the seller retaining control of the Target pending Completion.

CONDITIONAL COMPLETION

10.27 Simultaneous Exchange and Completion may not always be feasible due to various business, regulatory, financial, tax, legal and practical reasons. Under such circumstances, the parties will enter into the sale and purchase agreement based on an understanding that Completion is subject to the satisfaction or waiver (where appropriate) of certain outstanding conditions known as conditions precedent (**Conditions**). This is known as conditional completion. The most common Conditions include:

- (a) *Shareholder approval*: if either the seller or the purchaser is a publicly listed company then shareholders may need to approve the terms of the transaction before proceeding to Completion. If the purchaser is paying the whole or any part of the Consideration by allotment of shares to the seller then the purchaser may need to obtain its shareholder's approval.
- (b) *Restrictions on share transfer*: private Hong Kong companies are required to contain restrictions on the right to transfer their shares in their articles of association. These restrictions may be pre-emptive rights or requirement to obtain approval of the board of directors before effecting any transfer.
- (c) *Regulatory approvals*: the purchaser and/or the Target may operate in a regulated industry (eg, financial institutions and insurance companies) which makes regulatory consent to the transaction a strict requirement.
- (d) *Third party consents*: consent to a change of control of the Target may be required under certain agreements entered into by the Target, eg, major supplier and customer contracts, loan agreements, joint venture agreements, leases, and statutory licenses, etc.
- (e) *Transaction financing*: there may be a period between Exchange and Completion to enable the purchaser to raise funding for the acquisition. If so, the purchaser will not be able to proceed to Completion until its funding documentation becomes unconditional.

10.28 These Conditions will affect the complexity and timing of the transaction.

10.29 The sale and purchase agreement should set out the party or parties responsible for satisfying each particular Condition and whether parties are

obligated to use their best or reasonable endeavours to procure satisfaction of the relevant Conditions for which they are responsible.

10.30 The sale and purchase agreement should also provide a time frame by which the Conditions must be satisfied (**Long Stop Date**). If a Condition is not satisfied by the Long Stop Date or if it becomes evident at an earlier date that the Condition cannot be satisfied by that date (eg, consent or approval has been denied) then the parties should be afforded the opportunity as appropriate to extend the Long Stop Date, waive satisfaction of the Condition and proceed to Completion or terminate the Transaction as discussed below.

10.31 If the parties do not extend or waive before the Long Stop Date, it is common to provide that the sale and purchase agreement will terminate automatically. However, such termination should be without prejudice to any rights which have already accrued to any party (eg, for breach of contract such as failure on the part of one party to use its best or reasonable endeavours to satisfy the Condition for which it is responsible). Consideration should be given as to whether any of the provisions in the sale and purchase agreement should survive termination.

PRE-COMPLETION UNDERTAKINGS

10.32 If there is to be a time lapse between Exchange and Completion, the seller will retain control of the Target's business until Completion. Since the purchaser is committed to completing the transaction pending satisfaction of the Conditions, it will want to ensure that the business is not adversely affected by anything that occurs during this period. Therefore, the sale and purchase agreement will contain provisions regulating how the seller is to conduct the business of the Target during the period between Exchange and Completion. The extent of these provisions may vary depending on the length of such period.

10.33 The purchaser will seek the following common covenants from the seller:

- (a) Carry on the business as it has done before Exchange and preserve goodwill and all business relationships pending Completion;
- (b) Not engage in or undertake particular matters (usually listed in a separate schedule, for example not take certain major corporate actions such as amending the Target's articles of association or declaring a dividend, not enter into any transactions above an agreed value, not borrow money outside the ordinary course of business and not materially amend any of its contractual terms with major customers and suppliers);
- (c) Not encumber/grant security over the Sale Shares; and
- (d) Provide the purchaser with full access to the properties, books and records of the Target pending Completion and provide such information regarding the business and affairs of the Target as the purchaser may require.

10.34 If the seller breaches its pre-Completion undertakings it will trigger the purchaser's right to terminate the sale and purchase agreement and the purchaser

may choose not to proceed to Completion (see below). Sometimes the purchaser may allow the seller time to remedy any breach capable of remedy and only when such breach has not been remedied within a specified time period do such termination rights kick in.

TERMINATION PROVISIONS

10.35 Given the inherent risks for the purchaser to structure the transaction by reference to conditional Completion, the purchaser will generally insist on the right to terminate the sale and purchase agreement and not proceed to Completion if the Target's value and future prospects have been damaged during the period between Exchange and Completion because one of the following events has occurred:

- (a) The seller is in breach of its pre-Completion undertakings;
- (b) There has been a breach of the seller's warranties between Exchange and Completion or there would be a breach if the seller's warranties are repeated at Completion; or
- (c) There is an adverse change affecting the Target's business between Exchange and Completion.

10.36 The seller may wish to terminate the sale and purchase agreement rather than be faced with the purchaser proceeding to Completion and subsequently making a claim for damages.

10.37 Possible compromises may include provisions in the sale and purchase agreement allowing the purchaser to terminate the sale and purchase agreement but with no corresponding right to claim for damages and restricting the right of termination to material breaches/adverse changes only.

WARRANTIES AND INDEMNITIES²

10.38 Warranties are statements of fact made by the seller in the sale and purchase agreement concerning the condition of the Target and its underlying assets and liabilities at the date they are given or repeated. They are usually numerous and wide-ranging. Their function is to allocate risks for matters relating to the period prior to Completion. After the purchaser has obtained a warranty from the seller concerning a specific matter, the risk of liability for that matter passes to the seller, subject to the purchaser ultimately succeeding in pursuing a claim against the seller for breach of such warranty.

10.39 Warranties give the purchaser recourse against the seller for breach of contract (**Warranty Claim**). In bringing a Warranty Claim the purchaser is seeking a remedy in damages for the loss suffered from the position it would have been in had the warranty been true. The purchaser is entitled to recover the difference between the market value of the Sale Shares at the time the warranties were given and the market value of the Sale Shares at Completion taking into

² See Chapter 12

account the breached warranty. This is subject to the rules governing remoteness and mitigation of losses. The seller's liability under the warranties is commonly limited by contractual limitations. It is also qualified by the seller's disclosure letter which sets out the facts and circumstances which qualify a particular warranty or warranties.

10.40 If there is a time lapse between Exchange and Completion the issue arises as to whether warranties given at Exchange should be repeated at (or even at all times up to and including) Completion. Repeating the warranties at Completion protects the purchaser from any intervening events and liabilities which give rise to a breach of warranty and places the risk of such events and liabilities on the seller. Accordingly, the purchaser will want such repetition together with a right to terminate so that it can pull out of the acquisition if there is a breach of warranty before Completion. The seller may resist this on the basis that the purchaser has protection for this period in the form of pre-Completion undertakings. If warranties are repeated at Completion, it is reasonable for the seller to reserve its right to update the disclosure letter or prepare a supplemental disclosure letter at Completion.

10.41 Indemnities afford the purchaser greater protection than warranties. An indemnity is a covenant by the seller to reimburse the purchaser for losses arising from a specified event. In contrast to a warranty claim the purchaser does not have to prove breach (rather it simply has to show that the specified event has occurred), the principle of remoteness of damages does not apply and the purchaser is not under a duty to mitigate its losses. Unlike warranties, indemnities should not be qualified by disclosures or a disclosure letter.

10.42 Indemnities should be clearly and precisely worded because they will be construed by the courts strictly as indemnity liability will not go beyond what is expressly stipulated.

STANDARD OF DISCLOSURE AND THE PURCHASER'S KNOWLEDGE

10.43 Disclosure is the process by which the seller seeks to reduce its exposure and potential liability to the purchaser under the warranties. If a matter is deemed to be disclosed, the purchaser will in effect take the risk associated with that matter.

10.44 In accordance with the terms of the sale and purchase agreement, disclosure will take place by means of the seller's preparation of a disclosure letter. The disclosure letter is usually divided into two parts namely general disclosures followed by specific disclosures. Copies of the documentation referred to in the body of the disclosure letter will be attached to it (usually known as disclosure bundle). Negotiation of the disclosures in the disclosure letter will run alongside negotiation of the warranties in the sale and purchase agreement.

10.45 The seller's defence to a warranty claim is to argue that the seller has made the purchaser aware of the liability concerned and thereby qualified the statements

CHAPTER 19

STAMP DUTY ISSUES

19.1 The law governing the charge and collection of stamp duty in Hong Kong is contained in the Stamp Duty Ordinance (Cap 117) (SDO). The Inland Revenue Department of the Hong Kong Government (IRD) is responsible for tax assessment and enforcement. Within the IRD, the Stamp Office is the designated office responsible for stamp duty assessment and collection.

19.2 Stamp duty is chargeable on any contract note for the transfer of Hong Kong stock by way of sale and purchase. The term Hong Kong stock is broad in scope for stamp duty purposes; it is defined in SDO to mean that the transfer of stock is required to be registered in Hong Kong, including inter alia and shares of Hong Kong private companies. As with other Hong Kong taxes, stamp duty is territorial in scope. The territorial nature is reflected in the property which is the subject of the underlying transaction as opposed to the place where the instrument is executed. Therefore, even if a sale and purchase agreement in relation to shares of a Hong Kong private company is executed outside Hong Kong, the transaction will still give rise to Hong Kong stamp duty collection.

19.3 The transfer of legal title to shares in a Hong Kong company is effected by an instrument of transfer. Beneficial title to shares is transferred by way of contract notes (a bought note and a sold note).

19.4 SDO requires a person who purchases or sells Hong Kong shares either as principal or agent to:

- (a) Make and execute a contract note (each contract note is liable to stamp duty at the rate of 0.1% of the amount of the consideration paid or of the value of the shares transferred, whichever is higher);
- (b) Cause the note to be stamped;
- (c) Transmit the stamped contract note to his/her principal if the person is an agent;
- (d) Execute an instrument of transfer (which attracts a fixed duty of HK\$5); and
- (e) Cause an endorsement to be made on the instrument of transfer of the shares or cause a stamp certificate to be issued in respect of the instrument to the effect that the required stamp duty has been paid on the contract note.

19.5 Several exemptions and reliefs from stamp duty are available. The exemption from stamp duty in relation to transfer within a corporate group is most commonly used in corporate reorganisation. To qualify for this exemption, among other conditions to be fulfilled, the transferor and the transferee must be associated; in other words they must have common ownership of not less than 90% of their issued share capital. The exemption is obtained by application.

CONTRACT NOTE

19.6 Although there is no statutory format for contract notes, SDO requires that a contract note contain the following particulars:

- (a) Whether the person effecting the sale or purchase of the Hong Kong shares is acting as principal or agent, and, if acting as agent, then the name of the principal;
- (b) The date of the transaction and of the making of the contract note;
- (c) The quantity and description of such Hong Kong shares;
- (d) The price per unit of such Hong Kong shares and the amount of the consideration or, in the case of an exchange, particulars of the property for which such Hong Kong shares is exchanged; and
- (e) The date of settlement.

STAMP DUTY PAYABLE

19.7 The current stamp duty for every sold note and every bought note is 0.1% respectively of the amount of the consideration or of the value of the shares. Thus, the total rate of stamp duty on a transfer of shares of a Hong Kong company is effectively 0.2%.

19.8 For stamp duty purposes if the consideration is in a currency other than Hong Kong dollars, it will be converted into Hong Kong dollars by using the buying rate for the currency in question. This rate is determined by the Hong Kong Monetary Authority for telegraphic transfers at the commencement of business on the date of transfer or on the business day immediately preceding that date if that date is a Sunday or a general holiday.

19.9 According to current regulations, the value upon which the Hong Kong stamp duty is calculated is the higher of the consideration stated in the contract notes or the market value of the shares which is the subject of the contract notes. As a matter of practice the Collector of Stamp Revenue (**Collector**) initially charges the stamp duty based on the consideration stated by the parties in the contract notes. However, if the stated consideration is substantially lower than the market value of the shares the stamp duty will be assessed based on the market value of the shares as of the date of transfer. Given that there is no market mechanism to value the shares of Hong Kong private companies, their value will be ascertained from the latest management accounts of the company as the audited accounts may not be up to date.

PROCEDURES OF STAMPING

19.10 The IRD explained in its official stamping procedures and explanatory notes that to enable the Stamp Office to assess the proper amount of stamp duty payable, the following documents and information must be presented together with the duly executed contract notes and instruments of transfer to the Stamp Office for stamping:

- (a) The memorandum and articles of association of the Hong Kong company whose shares are being transferred;
- (b) A certified true copy of the share sale and purchase agreement, if any, or a confirmation by letter signed by either the seller or the purchaser that no such agreement exists;
- (c) A statement on whether the company has acquired any landed property, rights to acquire landed property or investments and, if so, a completed schedule of property in the proforma as required by the IRD (ie, IRSD Form 102 Schedule of Landed Properties); and
- (d) A set of documents depending on whether the company has commenced business or is just recently incorporated and hence no audited accounts have been prepared:
 - (i) If the company has commenced business then the following documents must be presented to the Stamp Office:
 - The company's latest audited accounts;
 - Certified management accounts of the company made up to a date close to the date of transfer and, if not, then within 6 months prior to the date of the transaction;
 - A certified copy of the Return of Allotments for increase of share capital (if relevant); and
 - A certified copy of the resolution of meetings of directors for dividends paid or payable (if relevant).
 - (ii) If the company is a recently incorporated company which has yet to commence business and hence no audited accounts have been prepared then a written confirmation of such is required.

19.11 The Stamp Office has the discretion to ask for additional documents when assessing the stamp duty payable.

TIME FOR STAMPING

19.12 Contract notes are required to be stamped within the following specified time periods after any sale or purchase of Hong Kong shares is effected:

- (a) Within two days after the sale or purchase if the contract notes are executed in Hong Kong; or
- (b) Within 30 days after the sale or purchase if the contract notes are executed outside Hong Kong (as a matter of practice in order to

qualify for the 30 day-time limit the location of execution should be stated on the contract notes)

PENALTY FOR LATE STAMPING

19.13 If the contract notes are not properly stamped within the specified timeframe, they can thereafter be stamped only upon payment of the stamp duty owing and a penalty. The penalty imposed will depend on the length of delay:

- (a) If the delay is no more than one month, the penalty shall be double the amount of the stamp duty payable;
- (b) If the delay is more than one month but no more than two months, the penalty shall be four times the amount of the stamp duty payable; or
- (c) In any other cases, the penalty shall be ten times the amount of the stamp duty payable.

19.14 SDO also grants the Collector discretion to remit the whole or any part of the penalty depending on individual circumstances. Any request for remission of late penalty should be made in writing with full explanation of the delay and supporting evidence.

LEGAL CONSEQUENCES OF FAILURE TO STAMP

19.15 In general, an instrument effecting a transfer of Hong Kong shares is duly stamped only if it bears an endorsement by the Collector to the effect that the duty has been paid or that the instrument is not chargeable with stamp duty.

19.16 Besides a few exceptions, SDO provides that unless an instrument is duly stamped it will be inadmissible in evidence and will not be 'available for any other purpose whatsoever'. A further consequence of failure to stamp an instrument properly is that the instrument may not be 'acted upon, filed or registered by any public officer or body corporate'.

19.17 Therefore, even if the share acquisition has been completed, the company's board of directors will refuse to register the sale shares in the name of the purchaser unless the instrument has been duly stamped. Hence, stamping has important legal implications in relation to recording title to shares with a company and it is always in the purchaser's interest to have the instrument of transfer and the contract notes duly stamped according to SDO.

ADJUDICATION

19.18 If the parties have any doubt as to the amount charged by the Collector, subject to the payment of an adjudication fee (which is currently HK\$50 per instrument), they can request the Collector to express his or her opinion on whether an executed instrument is chargeable with stamp duty and, in the case of chargeable instruments, on the amount of duty payable.

19.19 Request for adjudication should be submitted to the Stamp Office together with the original instrument and relevant supporting documents.

19.20 Only executed instruments can be submitted for adjudication. The Collector will not adjudicate on the duty payable on the basis of a draft or partly executed instrument.

19.21 After making adjudication, the Collector sends a notice of assessment by post either to the person who requested the adjudication or to the person who is liable for stamping such instrument. The adjudication becomes final and binding if no appeal is lodged against it within one month.

APPEAL AGAINST ASSESSMENT

19.22 A party who is dissatisfied with the assessment made by the Collector may appeal to the District Court against the assessment. An appeal usually must be lodged within one month from the date of assessment by notice served on the Registrar of the District Court. An appeal cannot be lodged against a stamp duty assessment unless:

- (a) The stamp duty in question has been paid in conformity with the assessment; or
- (b) The Collector has given notice in writing allowing the postponement of the stamp duty payment; or
- (c) The court has issued an order allowing the appeal to be made without payment of the stamp duty or with partial payment of the stamp duty on the basis that requiring the person to pay the stamp duty would impose hardship upon him or her.

19.23 Upon hearing the appeal the court will decide whether the instrument in question is chargeable. If it is chargeable, SDO requires the court to assess the amount of the stamp duty. Therefore, the court will not be able to remit the case back to the Collector to reconsider the issue again. If the stamp duty assessed by the court is less than the assessment of the Collector, the excess stamp duty that has been paid shall be ordered by the court to be remitted. If the court is of the opinion that the assessment of the Collector is not excessive, the court shall make an order confirming the Collector's assessment.