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REGULATORY FRAMEWORK

Overview

General

[32] 'Mergers' and 'acquisitions' do not have statutory meanings under Hong Kong law. The term 'mergers and acquisitions' refers generally to corporate transactions that result in a change of control in the target business from the seller to the acquirer. Because there is no simple, court-free amalgamation procedure for the combination of companies under Hong Kong law, the acquisition of a target business is generally implemented through the transfer of a business from the target company to the acquirer, or by transferring the business of both the target company and the acquirer to a new entity controlled by the acquirer. These transactions are normally structured in Hong Kong as a stock transfer, an asset sale or a court-sanctioned scheme of arrangement.

[33] Hong Kong is a major financial hub for cross-border business transactions and a jurisdiction with an established rule of law. Mergers and acquisitions in Hong Kong thus often involve laws of other jurisdictions: Hong Kong businesses can be owned by offshore companies; Hong Kong companies can have substantial offshore operations; shares listed on Hong Kong Stock Exchange can be issued by offshore companies with offshore assets; and business transactions that do not otherwise have any connections to Hong Kong can be governed by Hong Kong law.

[34] Mergers and acquisitions present a wide range of fact patterns. The fact that each transaction has its unique facts and surrounding circumstances means that there are numerous permutations of applicable laws, with each applicable law carrying its own qualifications, exceptions and limitations. The purpose of this article is to give readers an introduction to the general principles behind the legal framework rather than a technical analysis of the underlying statutory provisions.

[35] Generally, the Hong Kong regulatory regime is relevant if a transaction involves one or more of the following elements:

- The transaction involves a company incorporated under the laws of Hong Kong (referred to in this article as a '**Hong Kong company**').
- The target business operates in Hong Kong (referred to in this article as a '**Hong Kong business**').
- The transaction involves a company with securities listed on the Hong Kong Stock Market (referred to in this article as a '**Hong Kong listed company**' or '**listed company**').
- The transaction documents are governed by Hong Kong law.

[36] To give readers an anchor to compare and contrast the various subsets of mergers and acquisitions law in Hong Kong, this Item discusses the regulatory framework from the perspective of a foreign acquirer seeking to acquire a Hong Kong target. The term '**Hong Kong target**' referred to in this article includes a

Hong Kong business, a Hong Kong company, a Hong Kong listed company and/or assets held by a Hong Kong listed company.

Hong Kong Corporate and Securities Laws

[37] The mergers and acquisitions law in Hong Kong consists mainly of the following:

- **Companies Ordinance.** The Companies Ordinance (Cap. 32) governs the registration of companies incorporated in Hong Kong and non-Hong Kong companies with a place of business in Hong Kong. The Companies Ordinance also regulates the affairs of Hong Kong companies, including their internal management, continuing reporting obligations, profit distribution, restructuring and dissolution.

  The Companies Ordinance also covers the offer of securities in Hong Kong. Under the ordinance, an offer or invitation to the public to subscribe for shares must be accompanied by a 'prospectus' approved by the Securities and Futures Commission and filed with the Companies Registry, a government department. The ordinance provides that certain offers are exempt from this requirement. Examples of exempt offers include offers to 'professional investors' (as defined in the Securities and Futures Ordinance and any rules made under that ordinance), offers to not more than fifty people and offers made under a takeover or merger made in compliance with the Takeovers Code (as defined below).

  The Companies Ordinance (Cap. 32) is administered and enforced by the Companies Registry. The ordinance is reviewed from time to time by the Standing Committee on Company Law Reform (SCCLR), an independent non-statutory body, to ensure that regular amendments are made to meet the needs of the business community and regulators. A new Companies Ordinance was adopted in July 2012, although it is not expected to take effect until 2014. When the new Companies Ordinance (Cap. 622) comes into operation, the Companies Ordinance (Cap. 32) will be retitled as 'Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap. 32)' with the core provisions affecting the operation of companies in Hong Kong repealed except those provisions relating to winding-up and insolvency of companies and prospectuses. Under the new Companies Ordinance, there will be substantive changes to the general requirements applicable to all Hong Kong companies to modernize the existing framework.

  The new Companies Ordinance has four main objectives, namely:

  (a) to modernize the law by streamlining the types of companies that can be formed, abolition of the memorandum of association for all companies, retiring the concept of par value for shares for all companies, removing the power to issue share warrants to bearers, and widening protection of personal data of directors;

  (b) to ensure better regulations in maintaining accuracy of information on the public register of the Companies Registry, improving the regime for registration of charges, refining the scheme for deregistration of companies and empowering the Companies Registrar to compound specified

offences to encourage due compliance and optimize the use of judicial resources;

(c) to facilitate business by introducing a new alternative court-free procedure for capital reduction based upon a solvency test, allowing all types of companies (other than just private companies) to purchase their own shares out of capital subject to a solvency test, and empowering all types of companies (whether listed or unlisted) to provide financial assistance to another party to acquire shares in the company or its holding company, subject to a solvency test, and simplifying financial and directors' reporting; and

(d) to enhance corporate governance through the strengthening of the accountability of directors with new restriction on the appointment of corporate directors and codifying directors' duties; the empowerment of shareholders in the corporate decision-making process; the increase in transparency to shareholders by requiring analytical and forward-looking business review and disclosure on environmental and employee matters in directors' reports of public companies and the larger private companies and guarantee companies; and the strengthening of auditors' rights by requiring a wider range of persons to provide information or explanation reasonably required for the performance of the auditors' duties.

Please also refer to '**Operation of Hong Kong Private Companies – *Organizational Structure***' of this Item for specific changes in the corporate law of Hong Kong under the new Companies Ordinance.

- **Common Law.** Hong Kong common law principles apply to the fiduciary obligations and other standards of conduct expected of directors and officers of companies incorporated in Hong Kong. The common law of contract and principles of equity apply to the rights, obligations and remedies under sale and purchase agreements that are governed by Hong Kong law. In the context of mergers and acquisitions, common law often runs parallel with statutory law and other regulations. For instance, directors of Hong Kong listed companies are subject to the Corporate Governance Code under the Listing Rules (as defined below), and the Takeovers Code (as defined below) imposes significant obligations on the directors of Hong Kong public companies that are targets of acquisitions.
- **Securities and Futures Ordinance.** The Securities and Futures Ordinance governs the conduct of financial intermediaries, issuers of securities and market operators. In the context of mergers and acquisitions, the following parts of the ordinance are the most relevant:
  (a) Part XV, which requires directors, chief executives and substantial shareholders of Hong Kong listed companies to disclose their interests (in some cases subject to a threshold percentage) in such companies.
  (b) Part XVA, which imposes affirmative obligations on Hong Kong listed companies in their handling of material non-public information (referred to locally as 'inside information') in their possession.
  (c) Parts XIII and XIV, which impose civil and criminal sanctions, respectively, on insider dealing and other types of market misconduct.

The Securities and Futures Ordinance is administered and enforced by the Securities and Futures Commission, an independent statutory body responsible for the regulation of securities and futures markets in Hong Kong and the protection of investor interests. The Securities and Futures Commission has the power to license and supervise market participants, such as corporate finance advisors, brokers, automated trading services, investment advisers and fund managers; supervise other market operators, including exchanges and clearing houses; and authorize certain types of investment products, their offering documents and product advertisements for public distribution.

The Market Misconduct Tribunal is an independent quasi-judicial body established under the Securities and Futures Ordinance (Cap. 571). This tribunal is set up to help promote market confidence by protecting the interests of the investing public and reducing market malpractice. It is chaired by a judge or former judge of the High Court of Hong Kong who sits with two members. The tribunal has civil jurisdiction over market misconduct cases, such as insider dealing, false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false or misleading information inducing transactions in securities and futures contracts.

Listing Rules. The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited or the Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited (collectively, the '**Listing Rules**') govern the disclosure, shareholder approval and other regulatory requirements if the business being acquired is an asset of or otherwise forms part of the business of a Hong Kong listed company.

The Listing Rules are promulgated and administered by the Stock Exchange, and the Securities and Futures Commission has the power to oversee the Stock Exchange's performance of such duties. The Stock Exchange is a wholly-owned subsidiary of the Hong Kong Exchanges and Clearing Limited (the '**HKEx**'), a for-profit corporation whose shares are listed on the Hong Kong Stock Market. The Hong Kong government is the largest shareholder of the HKEx, with the right to appoint six of a maximum of thirteen directors.[28]

The Listing Rules do not have the force of law. They are enforced by the Stock Exchange through the imposition of a wide range of sanctions based on its listing agreements with the companies. The Stock Exchange may impose sanctions upon listed companies and their directors, senior management, substantial shareholders and professional advisers. These sanctions range in severity and include private reprimand, public censure, referral to the Securities and Futures Commission or other relevant regulatory body, exclusion from the market for a fixed period and, ultimately, suspension or cancellation of a company's listing.

[28] Director's Handbook, June 2013, HKEx.

To maintain the standard of companies listed and to be listed in Hong Kong, the Listing Rules are amended from time to time with the more recent amendments being changes to complement the new regulation promulgated by the Securities and Futures Commission on sponsors of initial public offerings (which became effective on 1 October 2013 with a six-month transitional arrangement), amendments to the Corporate Governance Code and Corporate Governance Report relating to board diversity (which became effective on 1 September 2013), amendments reflecting the statutory backing of the obligation to disclose price sensitive information (which became effective on 1 January 2013).

- **Takeovers Code.** The main purpose of the Codes of Takeovers and Mergers and Share Repurchases (the '**Takeovers Code**') is to afford fair treatment to shareholders of public companies affected by acquisitions, mergers and share buy-backs. It applies to all public companies in Hong Kong and those with a primary listing of equity securities in Hong Kong. Whether a company is a 'public company' for purposes of the Takeovers Code is decided on a case-by-case basis.

  The Takeovers Code is administered by the Executive Director of the Corporate Finance Division of the Securities and Futures Commission or any of the delegates of such Director (the '**Executive**'). The Executive has the power to grant waivers in respect of the Takeovers Code requirements. The work of the Executive is overseen by the Takeovers and Mergers Panel (the '**Panel**'), which hears disciplinary matters in the first instance, reviews rulings by the Executive at the request of any party dissatisfied with such a ruling, and considers novel, important or difficult cases referred to it by the Executive. Also involved in the administration of the Takeovers Code is the Appeal Committee, which reviews disciplinary rulings of the Panel for the sole purpose of determining whether any sanction imposed by the Panel is unfair or excessive.

  Like the Listing Rules, the Code does not have the force of law. It is nonetheless expected to be observed by participants in Hong Kong's financial markets. The Takeovers Code is enforced through sanctions such as public criticism or censure, requiring advisors and other relevant individuals not to act in a given capacity or banning them from appearing before the Executive or the Panel, or the withholding of the facilities of securities markets of Hong Kong.
- **Industry-specific Laws and Regulations.** Specific ordinances and subsidiary legislation may apply to the ownership, operation and sale of a Hong Kong business, depending on the industry involved. Examples include the Telecommunications Ordinance and Broadcasting Ordinance, statutes governing the supply and distribution of various types of regulated goods, and rules and regulations applicable to provision of financial services.

Business Operations in Hong Kong

General

[38] This section discusses the basic regulatory framework governing the establishment or acquisition of a Hong Kong business. For an acquirer, the essential steps would involve the selection of a suitable operating vehicle and the procurement of the necessary approvals to commence operation.

Form of Operation

[39] A Hong Kong business can be operated individually, in partnership, or through entities with a separate legal identity. Most Hong Kong businesses are operated in one of the following forms:

- ***Sole Proprietorship.*** Businesses owned and operated by a single individual do not have their own legal identities. Sole proprietors are responsible for all debts or liabilities of their business.
- ***General or Limited Partnership.*** Partnerships established under Hong Kong law are regulated under the Partnership Ordinance (Cap. 38) and consist of two types: limited partnership or general partnership. Neither type has a separate legal identity. Partners typically agree certain terms and conditions of their relations with each other in a partnership agreement. Partnership agreements are not required to be filed with any public registry.

  Every partner in a general partnership under Hong Kong law is liable jointly with the other partners for all debts and obligations of the firm incurred while he or she is a partner, and the firm is liable for loss or injury caused to third parties by wrongful acts or omissions of any partner acting in the ordinary course of the business of the firm or with the authority of his or her fellow partners. Unless otherwise agreed between the partners, general partnerships are dissolved upon the death or bankruptcy of any partner or, in the case of partnerships formed for undefined terms, upon notice by any partner. General partnerships are governed by the Partnership Ordinance (Cap. 38).

  Unlike a general partnership under Hong Kong law, a limited partnership under Hong Kong law may have one or more limited partners in addition to its general partners. General partners have the responsibility for managing the business and have unlimited liability. Limited partners must not play a part in managing the business, and their liability for the debts and obligations of the partnership is limited to the amount of capital they are required to contribute upon joining the partnership. All limited partnerships operating in Hong Kong are required to be registered with the Companies Registry (if not, the partnership will be treated as a general partnership governed by the Partnership Ordinance by default). Limited partnerships are governed by the Limited Partnership Ordinance (Cap. 37).
- ***Hong Kong Company.*** Companies incorporated under Hong Kong law are currently governed by the Companies Ordinance (Cap. 32) and have separate

Operation of Hong Kong Public Companies

General

[52] The Companies Ordinance draws an important distinction between private companies and public companies. 'Private companies' must satisfy the following statutory requirements:[84]

- restrict the right to transfer shares;
- limit the number of shareholders to no more than fifty subject to certain exceptions;
- prohibit any invitation to the public to subscribe for shares in or debentures of the company; and
- have no power to issue share warrants to bearer.

[53] A Hong Kong company that does not meet the above criteria could be deemed to be a public company (referred to in this article as a '**Hong Kong public company**').

Main Differences from a Hong Kong Private Company

[54] Compared with a Hong Kong private company, a Hong Kong public company is subject to more stringent statutory requirements. For instance:

- ***Organizational Considerations.*** The company must have at least two directors instead of one, and corporate directors are not permitted.
- ***Financial Statements.*** The company must file its financial statements and its auditors' and directors' reports, as a matter of public record, with the Companies Registry.
- ***Share Repurchase.*** Unlike a Hong Kong private company, the company is unable to purchase its own shares out of capital under current law. But the new Companies Ordinance will allow any Hong Kong company (not just private companies as under the current rules) to repurchase its own shares out of capital, subject to a solvency statement, shareholder approval and other requirements under the Companies Ordinance. These new rules, however, will not exempt the on-market repurchase of shares by listed companies (a subset of the Hong Kong public companies).
- ***Restrictions under the Takeovers Code.*** The company may or may not be subject to the Takeovers Code. This is because the definition of a 'public company' under the Companies Ordinance differs from the definition under the Takeovers Code.

  For purposes of the Takeovers Code, the Executive (see '**Overview – *Hong Kong Corporate and Securities Law***' in this Item) will consider all the circumstances and will apply an economic or commercial test in determining whether the company is a 'public company' and therefore one to which the Takeovers Code applies. In making such a determination, the Executive will

[84] Section 29 Companies Ordinance.

take into account primarily the number of Hong Kong shareholders and the extent of share trading in Hong Kong. Other factors to be considered are the location of its head office and place of central management; the location of its business and assets, including such factors as registration under companies legislation and tax status; and the existence or absence of protection available to Hong Kong shareholders given by any statute or code outside Hong Kong.

Implications on Mergers and Acquisitions

[55] Due to the more onerous financial disclosure requirements and other restrictions, unlisted Hong Kong public companies are relatively rare. They are usually companies that have a large number of shareholders due to its fundraising history or non-profit organizations that prefer increased transparency for policy reasons. An acquirer planning to set up a private company should evaluate the capital structure carefully, including any subsequent financings that would result in material changes in the number and classes of securities holders.

Operation of Hong Kong Listed Companies

General

[56] Currently all companies with securities publicly traded in Hong Kong are listed on either the Main Board or the GEM Board operated by the Hong Kong Stock Exchange, a 'recognized exchange company' under the Securities and Futures Ordinance. The two trading markets target different types of companies and have similar but different listing requirements. For convenience our reference to a Hong Kong listed company is to a company with equity securities listed on the Main Board operated by the Stock Exchange.

[57] This section applies when an acquirer is considering acquiring control in a Hong Kong listed company or investing in a company that is about to be listed on the Hong Kong Stock Market.

Becoming a Hong Kong Listed Company

[58] A company can apply for a listing on the Stock Exchange in two ways:

- ***Initial Public Offering.*** Initial public offering ('**IPO**') is the most common route. The offering usually includes a public tranche, which involves an offer and sale of securities to the public at large in Hong Kong through a prospectus registered with the Companies Registry, and a private placement tranche, which involves an offer and sale of securities to specific groups of investors through a circular substantially identical to the prospectus.
- ***Listing by Introduction.*** This route is for a company whose securities are already widely held by a large number of existing shareholders and does not want to

raise capital through a listing process. A listing by introduction is effected through the posting of a listing document substantially similar to the contents of a prospectus, except that it does not involve an offer and sale of securities.

The Stock Exchange must be satisfied that appropriate arrangements will be made to minimize price volatility in the initial trading of the shares on the Stock Exchange. The sufficiency of the arrangements will be assessed on a case-by-case basis by reference to the applicant's shareholding structure and availability of arbitrage opportunities between Hong Kong and another market where the issuer is listed.

[59] The Listing Rules are grounded on a fairly prescriptive regime and may surprise acquirers who are more familiar with a disclosure-driven regime. For example, the Stock Exchange maintain fairly stringent standards as to whether certain contractual arrangements between a pre-IPO investor and the company may continue after the listing of the company. These standards are guided by the Listing Rules requirements that the issue and marketing of securities be conducted in a fair and orderly manner and that all holders of listed securities be treated fairly and equally. The key concepts are as follows:

- **Timing.** Pre-IPO investments must be completed either (a) at least twenty-eight clear days before the date of the first submission of the first listing application or (b) 180 clear days before the first date of trading of the applicant's securities. Pre-IPO investments are considered completed when the funds (for subscription or acquisition) are irrevocably settled and received by the applicant.
- **Special Rights.** As a general principle, pre-IPO investors may be offered special rights. As the range of such special rights vary for each pre-IPO investment, those rights which do not extend to all other shareholders of the company upon listing are not permitted to survive in compliance with the general principle of equal treatment of shareholders. Set out below is a list of special rights commonly granted to pre-IPO investors and guidance on whether such rights are allowed to survive upon listing:
  (1) Pre-IPO investment agreements usually include a term that states that if the company does not achieve qualified IPO within a specified period of time, the pre-IPO investors are entitled to a certain amount of compensation. This is allowed if the amount to be compensated is set out or can be derived from the compensation provision in the investment agreement.
  (2) Price adjustments that effectively create two different prices for the same securities for pre-IPO investors and other shareholders at the time of listing is disruptive and not allowed.
  (3) All put or exit options granted to pre-IPO investors to put back investments to the company or its controlling shareholders are prohibited and such option will only be allowed to survive listing if and when the terms of the pre-IPO investment clearly states that the put or exit option could only be exercised when listing does not take place and should not be exercisable in any other event.

  (4) Any prior contractual right to a pre-IPO investor to nominate a director is not allowed to survive listing as other shareholders generally do not have such right. The nomination or appointment of a director to the board by the pre-IPO investor should be made before the listing application is submitted. Further, such director should be subject to retirement and re-appointment requirements under the articles of association of the company.
  (5) All veto rights granted to pre-IPO investors such as the making of any petition or passing of any resolution to winding-up, the carrying on any new business, amalgamation or merger of the company or any of its subsidiaries must be terminated upon listing.
  (6) No preferential treatment should be given to pre-IPO investors for allocation of listing securities but purchases by pre-IPO investors of additional securities of the company to maintain its shareholding percentages is allowed.
  (7) Anti-dilution rights should be extinguished upon listing.
  (8) Compensation for profit guarantee is allowed if it is a private arrangement between a shareholder and a pre-IPO investor and such compensation is not linked to the market price or capitalization of shares.
  (9) Generally, only negative pledges that are widely accepted provisions in loan agreement, not egregious and do not contravene the fairness principle under the Listing Rules are allowed. Examples of 'widely accepted negative pledges' include an undertaking by the company not to create or effect any security interest on the assets and revenues of the company and an undertaking by the controlling shareholder not to dispose of any interest in the economic rights or entitlements of the shares held by such controlling shareholder. All other negative pledges will be reviewed on a case-by-case basis.
  (10) Information rights are allowed if the information is made available to the general public at the same time.
  (11) Representation/attendance rights of pre-IPO investor representative in senior management roles are allowed but subject to the decision of the board.
  (12) Right of first refusal and tag-along rights at the same price and on the same terms and conditions as given to a third party purchaser will be allowed to survive after listing.
- **Disclosure in Prospectus.** In addition to assessing whether special rights to pre-IPO investors are allowed or disallowed, specific disclosure requirements of pre-IPO investments have to be made in the prospectus. They include:
  (1) details of the pre-IPO investments, including the name of each pre-IPO investor, date of investment, amount of consideration paid, payment date of the consideration, cost per share paid by each pre-IPO investor and the respective discount to the IPO price, use of proceeds from the pre-IPO investment and whether they have been fully utilized, strategic benefits they will bring to the company, and shareholding in the applicant held by each pre-IPO investor upon listing;

(2) the beneficial owner and background of each of the pre-IPO investors and their relationship with the company and/ or any connected persons of the company (for an explanation of the term 'connected persons', please refer to '**Acquisition of Assets of Listed Companies – *Preliminary Considerations***' in this Item);
(3) basis of determining the consideration paid by each pre-IPO investor;
(4) whether the shares held by each pre-IPO investor will be subject to any lock-up after listing (as part of the terms of the pre-IPO investment) and, with basis, whether the shares held by the pre-IPO investors are considered as part of the public float;
(5) if the pre-IPO investment is in the form of share-based payments, setting out the accounting treatment of the pre-IPO investments; the basis of the reporting accountants' view on the accounting treatment; and a risk factor, if applicable, on the future impact on the profit and loss of the company; and
(6) the sponsor's confirmation, with basis, that the pre-IPO investments are in compliance with guidance of the Stock Exchange.

[60] If a pre-IPO investment is not in accordance with guidance of the Stock Exchange, the applicant company is expected to amend the terms of the pre-IPO investment, defer the listing date; or unwind the pre-IPO investment.

Organizational Structure

[61] The corporate governance standards applicable to a Hong Kong listed company are classified into three types: (a) standards set forth in the main chapters of the Listing Rules, which are mandatory; (b) certain provisions labelled as 'code provisions' in the Corporate Governance Code, which are optional but the non-compliance of which must be disclosed and explained for the relevant accounting period in interim reports and annual reports; and (c) the remaining provisions labelled as 'recommended best practices' in the Corporate Governance Code, which are encouraged but not required and the non-compliance of which need not be disclosed. For corporate governance practices for which only recommended best practices apply, issuers may devise their own protcols on terms they consider appropriate.

[62] In addition to the Corporate Governance Code, a Hong Kong listed company must include a Corporate Governance Report prepared by the board of directors in annual reports and must contain all required information set out in Appendix 14 of the Listing Rules. Any failure to make such disclosure is a breach of the Listing Rules.

[63] The following sets forth the main corporate governance framework of a Hong Kong listed company:

– ***Jurisdiction of Incorporation.*** The company does not have to be a company incorporated in Hong Kong, but the Stock Exchange has the right to refuse to list a company incorporated in another jurisdiction if it is not satisfied that the foreign jurisdiction has standards of shareholder protection at least

equivalent to those in Hong Kong.[85] A substantial majority of companies listed on the Hong Kong Stock Market are Hong Kong, Bermuda or Cayman Islands companies or PRC joint stock limited companies. As at 27 September 2013, the Stock Exchange has formally ruled twenty-one jurisdictions to be acceptable as an issuer's place of incorporation including, the State of California and Delaware of the US, the Province of Alberta, British Columbia, and Ontario of Canada, the Republic of Korea, and recently Labuan, Malaysia.

– ***Board of Directors.*** The company must have at least three independent non-executive directors, and the independent non-executive directors must represent at least one third of the board with at least one independent non-executive director having the appropriate professional qualifications or accounting or relating financial management expertise. The Corporate Governance Code requires board meetings to be held at least four times a year, and the chairman to hold meetings with the non-executive directors at least once a year without the executive directors present. The Code also requires directors to participate in continuous professional development to develop and refresh their knowledge and skills and the company to arrange and fund suitable training for its directors, with an appropriate emphasis on the roles, functions and duties of a listed company director. Although the Stock Exchange does not specify the amount of training a director should complete per year, the directors are required to provide a record of training they have received to the company. Further, to enable the board as a whole and each director to discharge their duties, the management of a listed company is to provide all of its directors with monthly updates on company performance, position and prospects in sufficient detail.
– ***Chairman of the Board.*** The Corporate Governance Code recommends (but does not require) a clear division between the responsibilities of the board and the day-to-day management of the company's business. Thus the roles of chairman and chief executive officer should be separate and should not be performed by the same individual.
– ***Audit, Remuneration and Nomination Committees.*** The company must establish an audit committee chaired by an independent non-executive director and consisting of a majority of the independent non-executive directors with the terms of reference approved by the board. The minimum number of committee members is three, and at least one member must be an independent non-executive director with the appropriate professional qualifications or according or related financial management experience. A company must disclose immediately any non-compliance of the above requirements by announcement and meet the requirements within three months after failing to meet them.

The company must also establish a remuneration committee chaired by an independent non-executive director and consisting of a majority of the independent non-executive directors with the terms of reference approved by the

[85] Listing Rules 19.05.

may be open before it becomes or is declared unconditional as to acceptances is sixty days. The maximum period for which all conditions of the offer must be fulfilled or waived is the eightieth day after the posting of the initial offer document, failing which the offer will lapse automatically.

If the terms of the offer are revised, then the offer must be kept open for not less than fourteen days from the date on which the revised offer document is posted. To ensure that shareholders are given enough time to consider the merits of an offer before it finally closes, the last day by which the acquirer can increase its offer is the forty-sixth day after the posting of the initial offer document.

The last day by which the target company can announce material new information is the thirty-ninth day after the posting of the initial offer document. If any announcement is made after this date, the Executive will normally extend the maximum period for which an offer may be open.

(2) *Scheme of arrangement.* The timing of a scheme of arrangement is driven primarily by the corporation law of the target company's home jurisdiction. Generally, the target company will convene a shareholders meeting after the offer document and shareholders circular are published. Once the scheme is approved, the target company will apply to the court to sanction the scheme. After the scheme is sanctioned by the court, the target company will register the court order with the regulatory authority

(3) *Reverse takeover.* The timing of a reverse takeover is driven primarily by the Listing Rules. The Stock Exchange will treat the listed company proposing the acquisition as if it were a new applicant and the Stock Exchange will require a similar disclosure standard as in the prospectus in an IPO.

– ***Delisting Resolution.*** If the acquirer seeks to have the target company withdraw its listing from the Stock Exchange after a general offer, the delisting must be approved by shareholders as a resolution as follows:[129]

(1) The delisting resolution must be approved by a majority, in number, of the target shareholders (other than (x) the directors, chief executive and controlling shareholders of the target company and their respective associates and (y) the acquirer and its concert parties) representing 75% in value of the shares voted; and

(3) The number of votes cast against the resolution is not more than 10% of the votes attaching to all shares (other than shares held by the acquirer and its concert parties).

[129] Rule 2, Takeovers Code.

Acquisition of Assets from Hong Kong Listed Companies

General

[93] This section discusses the acquisition of assets from Hong Kong listed companies, including purchases of stocks and/or other assets held by such companies. The main regulations applicable to acquisitions of this nature are the Listing Rules and the Securities and Futures Ordinance.

Preliminary Considerations

[94] Set forth below are preliminary considerations for an acquisition of this nature:

– **How is the Acquisition Classified.** The Listing Rules contain comprehensive rules governing the acquisition or disposal of assets by a listed company. These requirements are set forth in Chapter 14 of the Listing Rules, in which transactions are classified by the percentage ratios resulting from the following 'size tests':

Assets ratio:	$\frac{\text{Total assets which are the subject of the transaction}}{\text{Total assets of the company}}$
Profits ratio:	$\frac{\text{Profits attributable to the assets which are the subject of the transaction}}{\text{Total profits of the company}}$
Revenue ratio:	$\frac{\text{Revenue attributable to the assets which are the subject of the transaction}}{\text{Revenue of the company}}$
Consideration ratio:	$\frac{\text{Consideration}}{\text{Total market capitalisation of the company,}}$
Equity capital ratio:	$\frac{\text{Nominal value of the company's equity capital issued as consideration}}{\text{Nominal value of the company's issued equity capital Immediately before the transaction}}$

[95] Where any calculations of the percentage ratios produces an anomalous result or is inappropriate to the activities of the company, the Stock Exchange may disregard the above and consider alternative meaningful calculation methods or test submitted by the company on a case-by-case basis.

– ***What are the Disclosure Requirements.*** Depending on the percentage ratios resulting from the five 'size tests', different announcement, disclosure and shareholder approval requirements apply. A transaction in which any of these requirements is triggered is a 'notifiable transaction'. 'Notifiable transactions' are primarily governed by Chapter 14 of the Listing Rules.

The following table summarizes the classification of transactions based on their percentage ratios under the 'size tests':

Share transaction (acquisition of assets excluding cash):	Where all percentage ratios are less than 5%
Discloseable transaction:	Where any of the percentage ratios is 5% or more but less than 25%
Major transaction (disposal):	Where any of the percentage ratios is 25% or more but less than 75%
Major transaction (acquisition):	Where any of the percentage ratios is 25% or more but less than 100%
Very substantial disposal of assets:	Where any of the percentage ratios is 75% or more
Very substantial acquisition of assets:	Where any of the percentage ratios is 100% or more

The following table summarizes the notification, publication and shareholder approval requirements for each type of transaction:

	Notification to Exchange	*Publication of Announcement*	*Circular to Shareholders*	*Shareholder Approval*	*Accountants Report*
Share transaction	Yes	Yes	No	No	No
Discloseable transaction	Yes	Yes	No	No	No

	Notification to Exchange	*Publication of Announcement*	*Circular to Shareholders*	*Shareholder Approval*	*Accountants Report*
Major transaction	Yes	Yes	Yes	Yes	Yes
Very substantial disposal	Yes	Yes	Yes	Yes	Yes
Very substantial acquisition	Yes	Yes	Yes	Yes	Yes
Reverse takeover	Yes	Yes	Yes	Yes	Yes

The Listing Rules impose different disclosure requirements based on the significance of the transaction. Generally, the more significant the transaction, the more details are required:

– ***Whether the Acquisition involves a 'Connected Person'.*** In addition to assessing the classification of the acquisition under the 'notifiable transaction' requirements as described above, the parties should also determine whether a transaction is a connected transaction under the Listing Rules. If any contractual party in the acquisition is a 'connected person' of the listed company, the transaction is likely a 'connected transaction'. 'Connected transactions' are primarily governed by Chapter 14A of the Listing Rules.

The term 'connected persons' is broadly defined under the Listing Rules to provide safeguards against directors, chief executives and substantial shareholders (or their 'associates') taking advantage of their positions when the listed company enters into transactions with them. Generally, 'connected persons' include:[130]

(1) Directors, chief executive, 'substantial shareholders' (i.e., holders of 10% or more of the voting power at any general meeting) of the listed company and any person who was a director of the listed company in the past twelve months (referred to in this article collectively as '**core affiliates**'); and

(2) 'Associates' of the foregoing persons.

In the context of connected transactions, 'associates' are widely defined and include:

[130] Listing Rules 14A.11.

(1) In the case of a core affiliate who is a natural person, (i) his immediate family members (i.e., spouse and children), the trustees of any trusts in which the core affiliate and his immediate family members are beneficiaries; and entities in which the core affiliate, the trustees of his family trusts, and his immediate family members have 30% or more of the voting power or the ability to control a majority of the board of directors, and the subsidiaries of such entities;[131] (ii) his expanded family members (i.e., person cohabiting as a spouse, parents and siblings) and entities in which his expanded family members have 50% or more of the voting power or the ability to control a majority of the board of directors;[132] and (iii) to the extent deemed appropriate by the Stock Exchange, his further expanded family members (i.e., in-laws, grandparents, grandchildren, nephews and nieces) and entities in which his further expanded family members have 50% or more of the voting power or the ability to control a majority of the board of directors.[133]
(2) In the case of a core affiliate that is a corporate entity, (i) any entity that is its holding company or a subsidiary or a fellow subsidiary of its holding company (each, a '**group member**'); (ii) the trustee of any trust in which the core affiliate is a beneficiary (a '**corporate interest trustee**'); (iii) any entity in which the core affiliate, together with its group members and corporate interest trustees, have 30% or more of the voting power or the ability to control a majority of the board of directors;
(3) Any person or entity with whom a core affiliate has entered, or proposes to enter into any arrangement with respect to the acquisition that is in the opinion of the Stock Exchange, should be considered a connected person; and
(4) Non wholly-owned subsidiaries of the listed company where connected persons of the listed issuer (other than at the level of its subsidiaries) have 10% or more of the voting power ('**affiliated entities**') and subsidiaries of such affiliated entities.

Only a narrow category of connected transactions are exempt from the disclosure, reporting and shareholder approval requirements. The main exemptions include:

(1) Intra-group transactions; or
(2) A connected transaction on normal commercial terms where each of the percentage ratios (other than the profits ratio) is (x) less than 0.1%; or (y) less than 1% and the transaction is connected only because it involves a person who is a connected person of the Hong Kong listed company by virtue of its/his relationship with the company's subsidiary(ies); or (z) less than 5% and the total consideration is less than HKD1,000,000.

[131] Listing Rules 1.01.
[132] Listing Rules 14A.11.
[133] *Ibid.*

A connected transaction on normal commercial terms where each or all of the percentage ratios (other than the profits ratio) is/are less than 5% or less than 25% and the total consideration is less than HKD10,000,000 are exempt from independent shareholders' approval. The shareholder approval requirement will increase uncertainty in the successful completion of the acquisition, because any shareholder with a material interest in the acquisition and its associates must abstain from voting.

– ***Whether the Target Assets involve a Mineral Company.*** A transaction involving the acquisition of mineral or petroleum assets and a Hong Kong listed company will be subject to additional requirements under Chapter 18 of the Listing Rules. Among others, the requirement of a competent person's report may impact the timing of the acquisition. For additional details regarding specific disclosure requirements of a mineral company, please refer to '**Operation of Hong Kong Listed Companies – *Special Requirements for Mineral Companies***' in this Item.

Mechanics of an Acquisition Transaction

[96] The mechanics of asset acquisitions vary significantly, depending on the significance of the transaction, the parties involved and the assets being transferred. For illustration purposes, an unaffiliated acquirer entering into a 'major' or more significant acquisition with a listed company will involve the following stages:

– ***Negotiation.*** Because an asset acquisition may affect the price and market activity of the shares, information concerning a potential acquisition constitutes both 'price-sensitive information' under the Listing Rules and 'inside information' under the Securities and Futures Ordinance. The listed company must do the following:
  (1) take special precautions to maintain the confidentiality of the discussions and negotiations, such as limiting employees' access to such information on a 'need-to-know' basis;
  (2) ensure that parties in possession of price-sensitive information will not trade the shares with counterparties not in possession of such information; and
  (3) act promptly when it believes that news concerning a potential acquisition is leaked to outside parties.
– ***Pre-Deal Trading Suspension.*** If the necessary degree of confidentiality cannot be maintained or that confidentiality may have been breached before a definitive agreement can be signed, the listed company should:
  (1) make a prompt assessment of the likely impact of these events on its share price or market activity;
  (2) decide consciously whether any price-sensitive information can be released at this time; and

which case the terms of such agreement will prevail, provided that not less than seven days' notice is given.

- **Termination Payment.** The items and amount of payments payable to an employee on the termination of employment or expiry of the contract depend on a number of factors, such as the length of service, the terms of the employment contract and the reasons for the termination. Notably, two types of payments required by the Employment Ordinance may be applicable:
  (1) *Severance Payment.* An employee who has been employed under a continuous contract for twenty-four months or more and is dismissed by reason of redundancy or lay-off is entitled to a severance payment. The amount of severance payment is two thirds of the employee's last full month's wages or two thirds of HKD22,500, whichever is less, for each year of service.[147] The current maximum severance payment payable is HKD390,000.[148] The amount of any gratuity or retirement scheme payment to the employee, based on length of service, is deductible from the amount of severance payment entitlement. In the case of a retirement scheme payment, only the employer's contributions (and interest thereon) may be deducted.[149]
  (2) *Long Service Payment.* An employee is entitled to a long service payment on termination of employment by the employer if he/she (x) has been employed under a continuous contract for five years or more and (y) is dismissed for any reason other than redundancy or misconduct.[150] An employee who has been paid a severance payment will not be entitled to a long service payment. The calculation of long service payment is the same as severance payment and is also subject to the same maximum amounts as stated above.
- **Unreasonable and Wrongful Dismissal.** An employer will have litigation risks if it terminates an employee other than for a valid reason as specified in the Employment Ordinance or if the dismissal is in contravention of the law. In addition, if the terms of the employment contract are varied without the employee's consent and the employment contract does not contain an express term which allows for such a variation, this will constitute constructive dismissal.[151]

Employment Matters in Mergers and Acquisitions

[117] Employment issues are generally not problematic in a stock acquisition. An acquirer would largely depend on the due diligence conducted prior to the transaction to identify issues with respect to labour contracts in place. Any liability under

147 Section 31G Employment Ordinance.
148 Section 31G and Schedule 7 Employment Ordinance.
149 Section 31I Employment Ordinance.
150 Section 31R, Section 31S Employment Ordinance.
151 Section 32A Employment Ordinance.

labour contracts usually can be limited by contractual provisions in the share purchase agreement.

[118] If the acquisition is in the form of a transfer of business (i.e., where asset and goodwill of an enterprise are sold or transferred on an going concern basis), Hong Kong law provides that the contracts of the employees, including written or implied oral agreements, do not automatically transfer to the acquirer. Accordingly, when the acquirer acquires the business, all existing employment contracts with employees will be deemed to have been terminated and termination payment may become due and payable.

The acquirer, however, can minimize its liability of termination payments by following the following procedures:

- notice is given to the employee offering employment not less than seven days before the date of the employees' transfer;
- the offer of employment to the employees is on terms that are either identical to those under the employees' existing employment contract or constitute a written offer of suitable employment on terms no less favourable to the employees than those under which they were previously employed;
- employment is renewed on or before the date of termination of the employment contract with the former owner; and
- the acquirer agrees to recognize the employees' previous service for the purpose of calculating severance payment or other benefits in the future.

Provided that the above requirements are fulfilled, the acquirer will not be required to make any statutory severance payments when an employee unreasonably refuses an offer on these terms. However, if the employee has been under continuous employment for five years or more as of the termination date, he/she will still be entitled to the long service payment.

ACCOUNTING TREATMENT

General

[119] Hong Kong companies are required to prepare their accounts under the HKFRS. The HKFRS sets out recognition, measurement, presentation and disclosure requirements for the reporting of transactions and events that are important in general purpose financial statements. The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that give a 'true and fair view' of the financial position, financial performance and cash flows of a company.

[120] As of 30 September 2013, the HKFRS consists of twenty-nine distinct accounting standards, thirteen financial reporting standards and several interpretations. Each standard relates to a specific topic such as presentation of financial statements, inventories, statement of cash flows, and income taxes. One of the main principles of Hong Kong accounting standards is that an entity prepares its

financial statements, except for cash flow information, using the accrual basis of accounting.

Accounting Treatment for Business Combinations

[121] The financial reporting by an entity when it undertakes a business combination is governed by HKFRS 3. In particular, HKFRS 3 specifies that all business combinations should be accounted for by applying the purchase method, unless it is a combination involving entities or businesses under common control. Formations of a joint venture or the acquisition of an asset or a group of assets that does not constitute a business are not 'business combinations' under HKFRS 3.

[122] Under the purchase method, the acquirer recognizes the target company's identifiable assets, liabilities and contingent liabilities, minority (or 'non-controlling') interests in the target company, and goodwill as at the acquisition date. These items are measured, with some exceptions, at their fair values. Some assets and liabilities are required to be recognized or measured in accordance with other HKFRSs rather than at fair value. These include assets and liabilities falling within the scope of HKAS 12 (Income Taxes), HKAS 19 (Employee Benefits), HKFRS 2 (Share-based Payment) and HKFRS 5 (Non-current Assets Held for Sale and Discontinued Operations):

- **Fair Value.** Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. HKFRS 13 defines fair value, provides guidance on how to measure fair value under HKFRS, and requires information about those fair value measurements to be disclosed.
- **Acquisition Date.** Acquisition date is defined as the date on which the acquirer effectively obtains control of the target company. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee, therefore it is not necessary for a transaction to be closed or finalized at law before the acquirer obtains control. All pertinent facts and circumstances surrounding a business combination are considered in assessing when the acquirer has obtained control.

Treatment of Key Items

[123] The following summarizes the treatment to be accorded to the key items in a business combination:

- **Consideration.** The acquirer measures the cost of a business combination as the aggregate of the fair values of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the target company. The fair values of these items are measure as at the date of exchange.

- **Transaction Costs.** These are costs such as professional fees paid to accountants, legal advisers, valuers and other consultants to effect the business combination. They do not include general administrative costs, such as the costs of maintaining an acquisitions department. Such costs shall be accounted for as expenses in the periods in which the costs are incurred and the services are received. The costs to issue debt or equity securities are recognized in accordance with HKAS 32 and HKAS 39.
- **Identifiable Assets and Liabilities of Target Company.** The identifiable assets and liabilities that are recognized in accordance with the requirements set forth in HKFRS 3 include all of the target company's assets and liabilities that the acquirer purchases or assumes, including all of its financial assets and financial liabilities:
  (1) *Restructuring costs.* Examples of new liabilities that can be recognized include payments that the target company is contractually required to make to its employees in the event that it is acquired in a business combination. Such payments constitute a present obligation of the target company that is regarded as a contingent liability until it becomes probable that a business combination will take place. The contractual obligation is then recognized as a liability by the target company in accordance with HKAS 37 when a business combination becomes probable and the liability can be measured reliably. Therefore, when the business combination is effected, that liability of the target company is recognized by the acquirer as part of allocating the cost of the combination.

  In contrast, the target company's restructuring plan whose execution is conditional upon it being acquired in a business combination is not, immediately before the business combination, a present obligation of the target company. Nor is it a contingent liability of the acquirer immediately before the combination because it is not a possible obligation arising from a past event whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the target company. Therefore, an acquirer cannot recognize a liability for such restructuring plans as part of allocating the cost of the combination.
  (2) *Tax losses.* Examples of assets that can be recognized include assets not previously recognized in the target company's financial statements. For instance, a tax benefit arising from the target company's tax losses that was not recognized by the target company before the business combination qualifies for recognition as an identifiable asset if it is probable that the acquirer will have future taxable profits against which the unrecognized tax benefit can be applied.
  (3) *Non-controlling interests.* The acquirer should measure the components of non-controlling interests in the target company at either fair value or the proportionate share in the recognized amounts of the target company's identifiable net assets and such value should be assessed by reference to the acquisition date.

- **Goodwill and Intangible Assets of the Target Company.** Goodwill and intangible assets are acquired in a business combination at cost less any accumulated impairment losses:
  (1) *Goodwill.* Goodwill is defined under HKFRS as future economic benefits arising from assets that are not capable of being individually identified and separately recognized. Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognized. It is measured as the excess of (x) the aggregate of the consideration transferred and the amount of any non-controlling interest in the target company over (y) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed. If the acquirer has made a gain from a bargain purchase, that gain is recognized in profit or loss.
  (2) *Intangible Assets.* Intangible asset is defined under HKFRS as an identifiable non-monetary asset without physical substance. HKAS 38 provides guidance on determining whether the fair value of an intangible asset acquired in a business combination can be measured reliably. In accordance with HKAS 38, an asset meets the identifiability criterion in the definition of an intangible asset only if it (a) is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability); or (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Reporting of the Target Assets

[124] HKAS 36 sets forth the procedures that an entity applies to ensure that its assets (including goodwill and intangible assets) are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon. Recoverable amount is the higher of (x) fair value less costs to sell and (y) value in use.

[125] If the carrying amount of an asset exceeds its recoverable amount, the asset is described as impaired, and HKAS 36 requires the entity to recognize an impairment loss. An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

[126] At each reporting date, an assessment must be made to determine whether there is any indication that an asset may be impaired. If any such indication exists, the recoverable amount of the asset must be determined. Further, goodwill and

intangible assets with an indefinite useful life must be tested for impairment annually irrespective of whether there is any indication that such assets may be impaired, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with HKAS 36.

MANAGING DIRECTORS' CONFLICTS IN ACQUISITIONS

Overview

[127] This item discusses the management of directors' conflicts found in acquisitions by explaining the duties of directors in managing conflicts, identifying the more common scenarios in which directors' conflicts arise, describing ways to prevent, identify and manage directors' conflicts and mitigate the damages caused, and considering the limits of insurance and indemnification.

[128] Directors frequently encounter actual and potential conflicts in managing acquisitions. Improper handling of conflicts in major acquisitions is one of the most common corporate governance breaches, exposing the company and directors to potential civil and criminal liabilities. A failure to timely identify and resolve directors' conflicts is a classic scenario for shareholders litigation and regulatory investigations. Such proceedings are lengthy, costly and distracting and can often cause significant economic and reputational loss to the company. The risk of such actions has increased in recent years as shareholders and regulators become more and more proactive in subjecting directors to greater scrutiny and accountability. It is in the company's interest to take precautionary measures because most problems arising from directors' conflicts could be mitigated or cured if intervened at an early stage.

Duties of Directors

[129] Directors' duties can be classified into internal and external standards. The internal standards are set forth in the constitutional documents and corporate governance guidelines of the company and directors' service contracts with the company. The external standards are the legal requirements in which the company is incorporated, the shares of the company are listed and the transaction. To handle a conflict of interest properly, a director needs to satisfy both the internal and external standards.

[130] This section discusses the Hong Kong legal requirements for directors in handling conflicts of interest in acquisitions, with special emphasis on the standards applicable to Hong Kong listed companies. Note, however, that in most cases, the Hong Kong standards are not the only applicable external requirements

- Change of control in the company – conflicts may arise because a director is a significant shareholder of the company or a director, officer or significant shareholder of another company capable of exerting significant influence, through voting control or otherwise, over the management of the company.
- Acquisition financing – conflicts may arise because a director is associated with one or more of the company's bankers or professional advisers.
- Confidential information relating to the acquisition – conflicts may arise because a director is required to make trading decisions from time to time, such as acting as an officer in an investment bank, private equity fund, or hedge fund that takes material positions in securities.
- Industry in which the target company operates – conflicts may arise because a director is associated with the target company or one or more of the target company's competitors or where the director is otherwise in a position to profit from the acquisition through his directorship in the company.

Handling Conflicts in Acquisitions

[155] Having identified a conflict situation, management must ensure that a director whose independent judgment is tainted by his personal interest in the subject matter will not have the power to decide on the company's behalf. To mitigate issues arising from directors' conflicts, the company could:

- Delegate the subject matter to an independent committee consisting of disinterested directors – examples include a go private proposal made by a significant shareholder of the company.
- Defer the subject matter to disinterested shareholders – examples include the company's purchase of a new business from its controlling shareholder. Where such approval can be obtained, this may well be the best solution so long as full disclosure is made to shareholders.
- Present an improper exercise of power to shareholders for ratification – examples include a joint venture project in which one or more directors had an indirect interest that was not disclosed initially. Hong Kong courts generally do not interfere with ratification of breaches by shareholders, although ratification cannot cure a regulatory violation caused by the conflict.

Investigating Alleged Conflicts

[156] Many allegations of directors' conflicts are made by employees. Others are made in queries from the Stock Exchange or the Securities and Futures Commission (which in turn are often prompted by informants linked to the company) or in derivative actions (in common law or under the Companies Ordinance) against the company and the relevant directors. In the more serious cases, the allegations may have already caused a suspension or imminent suspension of trading.

[157] Disinterested directors should remain vigilant in handling such an allegation. If they do not act appropriately, they may also put themselves in breach of their duties, giving rise to another conflict situation caused by their inaction to deal with the earlier conflicts involving their fellow directors.

[158] The company may initiate internal investigations as a response. An investigation into directors' conflicts in an acquisition is typically conducted by an independent committee whose work is supported by outside professional advisors. Management should:

- Act honestly to restore market confidence in the company.
- Promptly disclose material information uncovered in the investigation as part of the company's duty to public shareholders.
- Adequately address the concerns and inquiries of the market regulators.
- Deal with any actual or potential claims against the company.
- Strengthen the company's corporate governance so that similar mistakes will not happen again.

[159] Independent investigations are often costly and time-consuming. Management should plan carefully to minimize the disruption to the company's normal operations without compromising the above principles.

[160] Understandably, the company has a strong desire to preserve the confidentiality of the analysis of its corporate counsel. Unfortunately the law of legal privilege in the context of a corporate investigation remains unsettled. A frequent issue arising in this context is whether the company is deemed to have waived its legal privilege when it voluntarily shares its internal legal memorandum and other analysis with third parties, such as forensic accountants. Although Hong Kong courts still appear to follow the English approach by adopting a strict interpretation of legal privilege, a recent decision of the Court of Final Appeal leaves it open whether courts may adopt a more liberal interpretation by following the Australian approach in the future. Under the Australian approach, the participation of lawyers in the engagement and management of the forensic accounting experts required to conduct investigations is no guarantee that the documents disclosed will be privileged.

Indemnification and Insurance

[161] The company has an interest to attract talented individuals to serve as directors and motivate them to exercise diligence in performing their roles and act solely in the company's best interests. From the perspective of the company, indemnification and insurance only serve to transfer the consequences of a director's conflict after the conflict has occurred and caused damage; they even increase the risk of conflicts occurring by minimizing the personal liability of the directors. Hence, performance motivation and liability protection are two competing interests if talented individuals are attracted solely through indemnification and insurance.

[162] From the perspective of directors, indemnification and insurance may not offer full protection. Directors of a Hong Kong company are only allowed to limit

their liability as against third parties: section 165 of the Companies Ordinance prohibits a company from indemnifying its directors for any liability owed to the company itself (or a related company). In a recent decision of the Hong Kong Court of Appeal, a director was prevented from relying on the indemnity provisions contained in the company's bylaws on the basis that she was not privy to the constitutional documents of the company. The director was also prevented from relying on the indemnity provisions contained in a separate deed of release and indemnity that she had signed with the company on the basis that the deed covered only third party claims.

[163] In contrast, if individuals are attracted to the company through a good corporate governance framework, performance motivation and liability protection need not be competing interests. The company could provide in its policy that a director's compliance with the written protocols in the framework will be presumed to have exercised his duties adequately in terms of conflicts handling. This could offer certainty and comfort without distorting their behaviour.

RECENT DEVELOPMENTS

[164] Some of the Hong Kong listed companies have a variable interest entity (generally known as **'VIE'**) structure. The structure is commonly found in companies operating in the media and telecommunications sectors in China where foreign ownership is prohibited. Under a VIE structure, the Hong Kong listed company enters into long term and extendable contractual arrangements pursuant to which the Hong Kong listed company, through PRC enterprises wholly owned by the Hong Kong listed company, effectively controls and consolidates the financial position and operating results of the PRC operating entities owned by PRC nationals. The Hong Kong listed company recognizes and receives substantially all economic benefits of the business and operation of the PRC operating entities, and their operating results are reflected in the consolidated financial statements of the Hong Kong listed company under applicable accounting principles.

[165] In an arbitration award rendered in 2011, a PRC arbitration tribunal considered a contractual dispute arising from a VIE structure. The tribunal was of the view that the VIE arrangement had violated PRC regulations prohibiting foreign investments in restricted sectors and hence invalid. However, as an arbitral award is the result of a private dispute resolution and has no judicial standing, it only serves as mere guidance as to how a court might approach similar matters. Legal risks and uncertainties related to VIE structures remain.

[166] In a court ruling rendered in October 2012, the PRC Supreme Court considered the use of an entrustment structure in a restricted industry. Although the court did not directly challenge the legality of the VIE structure, it nevertheless ruled that where agreements were entered into with the clear intent of circumventing China's restrictions on foreign investments in certain restricted industries and the contractual parties intentionally breaches PRC laws and regulations, such agreements are invalid and unenforceable.

[167] As recent as August 2013, an acquisition transaction involving a VIE structure was completed by a Hong Kong listed company. In this transaction, the Hong Kong listed company acquired an offshore target company. The offshore target company, through PRC wholly owned foreign enterprises, entered into structural agreements with PRC operating entities engaged in the remote sensing and GIS business in the geographic information industry, a sector in which foreign ownership of the business is restricted. At the time of the transaction, the PRC lawyers were of the opinion that each of the structural agreements in this case is legally binding and enforceable under applicable laws of the PRC, but no assurance could be given that such VIE arrangement would not be affected by future changes in PRC policies. The transaction suggests that VIE structures remain acceptable on a case-by-case basis with variable degrees of legal risks and uncertainties.