Preface to the Second Edition

This book is written specifically for students undertaking the Postgraduate Certificate in Laws programme (PCLL) in Hong Kong and PCLL graduates who have recently ventured into legal practice. The single, most forceful motivation for me to write this book was the plea which I received year after year from students for help and guidance on how to apply the law they have learnt to real-life legal practice. Dear students, I have heard you, and this is my response to your plea.

I have assumed that the reader of this book already has a good understanding of the principles of contract law, company law and commercial law, which is essential to corporate-commercial practice in Hong Kong. This book is not intended to be used as an academic textbook on Hong Kong company law or commercial law, nor is it my objective to engage the reader in a jurisprudential discourse or critique of legal principles and theories. Instead, the focus of this book is on the practice of law – more particularly, on the lawyer's role in carrying out transactions which involve the acquisition of shares or businesses in Hong Kong. Certain principles of contract law, company law and commercial law will be discussed in this book, but largely in the context of, and only insofar as they relate to, the transactions and the documents covered by this book. For a full, in-depth analysis of the law, I would invite the reader to refer to the leading academic textbooks on the relevant subjects instead.

This book aims to provide the reader with the essential knowledge about the law and practice in Hong Kong relating to the acquisition of shares and businesses. I keep emphasising "in Hong Kong" because the practice of law is essentially jurisdictional, although it is increasingly important for lawyers nowadays to be more "global" in their outlook. A competent, responsible legal practitioner must first have an accurate understanding of the law which applies to the transaction on which he or she is working, and be able to give advice to his or her client which is legally accurate and commercially practicable, in a clear and succinct manner. Researching into the philosophical underpinning of the law and comparing their developments in different jurisdictions is a highly interesting and intellectually rewarding endeavour. (As an academic lawyer, I am strongly in favour of genuine legal research which sharpens the mind and promotes serious learning.) However, we must all remember that a lengthy legal essay, no matter how well- researched, is of no real value to the client unless it is relevant and helps the client solve his or her problem. What the client values is the lawyer's advice and assistance in conducting the transaction smoothly and expeditiously, and ensuring it is valid, binding and enforceable under Hong Kong law. This is what I hope our PCLL graduates should be able to do, and this book is an attempt to guide them in the right direction.

Since the publication of the first edition, the Companies Ordinance, Cap.622 has come into force, and so have certain important amendments to the Stamp Duty Ordinance, Cap.117. The second edition of this book has been written so the readers can appreciate how these recent changes to the law will impact on the acquisition of shares and businesses in Hong Kong. Where appropriate, references are made to the predecessor ordinance (the old Cap.32) and legislation in other jurisdictions for comparison purposes.

The second edition of this book states the law as at 31 July 2014.

Last but not least, I wish to express my gratitude to all the students who have encouraged me with their very positive feedback on the first edition of this book. I hope all of you have learnt something useful from this book, which will motivate you and help you become better lawyers.

Jessica Young

TABLE OF CONTENTS

5 SHARE PURCHASE – NEGOTIATION, SIGNING AND COMPLETION

5.1 NEGOTIATION AND REVISION OF THE DOCUMENTS

5.001 As mentioned in Chapter 4 above, except in the case of auction sales, it is customary for the purchaser's lawyer to prepare the first draft of the share purchase agreement. Upon receipt by the vendor's lawyer of the draft agreement, he or she will review the terms of the agreement carefully. In particular, the vendor's lawyer will focus on:

(a) whether the agreement accurately reflects the terms hitherto agreed between the parties;

(b) whether the agreement contains any terms which may be detrimental to the interests of the vendor, or which impose impossible or onerous obligations on the vendor;

(c) whether the vendor is in a position to give the warranties in the terms set out in the agreement.

5.002 Often, a meeting will be held where the vendor's lawyer will explain to the vendor the meaning and implications of the terms of the draft share purchase agreement, and seek his or her client's instructions as to whether amendment to the agreement is required and, if so, the extent to which amendment should be made. The vendor's lawyer will then communicate with the purchaser's lawyer as to the amendments required. This will often be done by way of the vendor's lawyer "marking up" the draft share purchase agreement with the vendor's comments and proposed amendments. The two sets of lawyers will then negotiate to fine-tune the exact wording of the amendments. If there is any issue which involves a business decision on the part of the client or any matter which goes beyond the scope of the lawyer's authority or instructions, then the lawyer will seek the client's instructions. A negotiation meeting between the vendor and the purchaser (together with their respective lawyers) may have to be set up to resolve the business issues. There are often several rounds of negotiation and revision before a share purchase agreement is finalised and ready for signing.

As mentioned above, instead of amending the actual warranties in the share purchase agreement to include the qualifications and limitations agreed upon by the parties, the vendor's lawyer will often prepare a disclosure letter and send a draft to the purchaser's lawyer for consideration. The terms of the share purchase agreement will be negotiated *in tandem* with the disclosure letter, and any inconsistency or contradiction between the two should be avoided. 5.003

The final documents are usually the products of much negotiation between the parties and their lawyers, and will reflect the agreed risks allocation between the parties concerned. There is no hard and fast rule as to who should bear what risks, and there is no such thing as a "standard" document. It all depends on the respective bargaining powers of the parties and, to a certain extent, how good their lawyers are! For example, where the vendor agrees to give a warranty in respect of the absence of any litigation involving the target company, the vendor is effectively assuming the risk in respect of litigation, such that if it turns out that the target company is in fact involved in any litigation, the vendor will be liable for a breach of warranty and hence, any loss which the purchaser may suffer as a result. However, if the vendor is qualifying the warranty it gives with reference to its own knowledge, such that it only warrants that "to the best of its knowledge" the company is not involved in any litigation, then the "risk" which the vendor is agreeing to assume is much reduced in scope – the vendor is only assuming the risk of litigation of which it has knowledge, but not otherwise. As far as litigation of which the vendor has no knowledge is concerned, the risk is shifted to the purchaser. Therefore, if it turns out that the target company is in fact involved in litigation, then whether any loss suffered by the purchaser is recoverable from the vendor will depend on whether the vendor has knowledge of such litigation at the time the warranty is made or repeated. 5.004

5.2 SIGNING OF THE SHARE PURCHASE AGREEMENT

When the terms of the share purchase agreement are finally agreed, the parties can proceed to signing (that is, entering into a legally binding contract for the sale and purchase). In preparation for signing, the purchaser's lawyer will engross (that is, prepare formal execution copies of) the share purchase agreement. Most law firms have their own firm's 5.005

style in engrossing documents. Unless otherwise agreed, it is customary for engrossments to be prepared by the law firm which produced the first draft of the agreement, so engrossments of the share purchase agreement are likely to be prepared by the law firm acting for the purchaser.

5.006 In Hong Kong, it is customary for the share purchase agreement to be executed in duplicate, such that each of the vendor and the purchaser will retain a duplicate agreement which contains all the parties' signatures.

5.007 Signing can take place at a face-to-face meeting, usually at the offices of one of the parties or their lawyers. At the signing meeting, the vendor will issue the disclosure letter to the purchaser. The content of the disclosure letter should already have been agreed upon by the parties by the time the share purchase agreement is finalised for execution. The disclosure letter is also usually prepared in duplicate, such that the vendor can retain a duplicate of the disclosure letter which contains the purchaser's signed acknowledgement of receipt. The disclosure letter must be dated the same date as the share purchase agreement.

5.008 It is not a legal requirement, but some firms have adopted the practice of asking the signatories to initial each page of the agreement, so as to show that they have read the whole agreement and agreed with all its terms.

5.009 Where any party to the share purchase agreement is a body corporate, the lawyer acting for the other party to the agreement should ensure that the body corporate's representatives are asked to produce relevant board resolutions authorising the signing of the documents and appointing authorised signatories to sign the documents on behalf of the body corporate. The identity of the authorised signatories should also be duly verified before signing.

5.010 It is uncommon in Hong Kong to have the share purchase agreement executed as a deed.[1] In cases where the share purchase agreement is to be executed as a deed and one or more of the parties is a body corporate, care should be taken to ensure the formalities required for the execution of a deed are duly complied with.[2]

[1] If the share purchase agreement is executed as a deed, the limitation period for bringing a claim under it is 12 years, whereas the limitation period applicable to a contract under hand is 6 years.

[2] See para.5.025 below on the execution of deeds by Hong Kong companies.

Signing may also be done in counterparts, followed by the exchange of the counterparts. This arrangement is quite common, especially when the parties are in different locations and a face-to-face meeting is considered unnecessary or impracticable. Before signing, a counterpart of the agreement will have been sent to the each of the parties. The vendor will sign on its counterpart, whilst the purchaser will do likewise on its counterpart. The parties will then return the counterparts signed by them respectively to their own lawyers. The two sets of lawyers will then "exchange" the counterparts -- the vendor's lawyer will receive from the purchaser's lawyer the counterpart signed by the purchaser, in return for which the vendor's lawyer will hand over to the purchaser's lawyer the counterpart signed by the vendor. The date will be inserted into the counterparts. Upon exchange, the contract becomes legally binding on the parties (unless the contract otherwise provides). Therefore, the term "exchange" is often used to refer to the stage in a transaction where the parties enter into a legally binding contract, and is often used synonymously with "signing". 5.011

After exchange, the lawyers will send the respective counterparts to their respective clients for safe keeping, usually after having kept a photocopy for their own reference in preparation of completion. 5.012

If signing in counterparts is envisaged, the agreement should contain a provision dealing with the time the agreement comes into effect and the legal status of the counterparts. It is customary for such provisions to provide that the agreement is to come into force upon the exchange of the counterparts, and that all the counterparts will together constitute the agreement. 5.013

5.3 ANNOUNCEMENT

If the vendor or the purchaser is a subsidiary of a company listed on the Stock Exchange, the signing of the share purchase agreement may trigger certain disclosure obligations by the listed company. Depending on the size of the transaction relative to the listed group, further requirements may have to be complied with under the Listing Rules.[3] 5.014

[3] For details, see Chapter 14 of the Listing Rules.

5.7.5 Corporate restructuring

5.049 The purchaser may wish to carry out a group restructuring exercise after completion in order to streamline operation and better integrate the target company into the purchaser's existing group structure. For example, the purchaser may decide to transfer an asset or part of the business from the target company to another subsidiary of the purchaser's.

5.050 In this context, it is useful to bear in mind the availability of intra-group relief under section 45 of the Stamp Duty Ordinance for stampable transfers between intra-group companies.[37]

5.7.6 Preparation of "bible" of transaction documents

5.051 For the record and for ease of reference in the future, it is common for lawyers involved in the transaction to prepare a transaction "bible". The "bible" usually takes the form of a bound volume of all the documents executed by the parties in relation to the acquisition.

[37] For a discussion of the intra-group relief under s.45 of the Stamp Duty Ordinance, see para.1.062-1.067 of Chapter 1 above.

6 SHARE PURCHASE – REMEDIES

Not all purchasers end up satisfied with their purchases. Notwithstanding a thorough due diligence investigation into the target company (and sometimes, owing to the lack of it), the purchaser may still discover unpleasant surprises after it has completed the purchase or committed itself to it. If the cause of dissatisfaction is purely due to the purchaser's own fault, then the purchaser has only itself to blame – *caveat emptor*. For example, the problem was duly disclosed by the vendor, so the purchaser was aware of the problem, but had decided to proceed with the purchase because it had under-estimated the severity of the problem or its consequences. In such a case, the purchaser would have to bear the consequences of its own erroneous judgment. Similarly, if the problem could have been identified in due diligence but was overlooked due to time or costs constraints, the purchaser cannot now turn round to seek redress from the vendor. However, if the purchaser is in any way "misled" by the vendor into the purchase, the purchaser will want the vendor to compensate it for the loss which the purchaser has suffered (that is, claim damages). At times, a purchaser may decide "enough is enough" and wants to "pull out of the deal" altogether (that is, terminate or rescind the agreement). The availability of remedies to disgruntled purchasers, and the extent to which they are available, depend on what has gone wrong, whose responsibility that is, and when it occurred. 6.001

Although this chapter focuses on the remedies available to a dissatisfied purchaser in a share sale and purchase, the same principles and remedies will apply equally, *mutatis mutandis*, to the sale and purchase of a business. 6.002

6.1 BREACH OF WARRANTY

6.1.1 Introduction

In share purchases, it is common for the vendor to be required to give extensive warranties on the target company. A warranty is a contractual term. If what goes wrong falls within the scope of matters warranted by the vendor 6.003

and renders a warranty in the share purchase agreement untrue, then the purchaser may have a breach of contract claim against the vendor based on the breach of the warranty.[1]

6.004 Whether the vendor is in breach of a warranty will depend on the following:

(a) The disclosure letter – matters duly disclosed in the disclosure letter have the effect of qualifying and limiting the warranties set out in the share purchase agreement. If the event or circumstance which renders a warranty untrue has been adequately disclosed, then the warranty must be seen in the light of such disclosed event and circumstance. If what is warranted is not untrue, then there is no breach. What constitutes adequate disclosure for this purpose will depend on the drafting of the share purchase agreement.[2]

(b) The exact language of the warranty - whether express qualifications and exceptions are introduced into the language of the warranty in the share purchase agreement. For example, the warranty may have been qualified by reference to the vendor's knowledge and belief.[3]

6.005 Some share purchase agreements include a provision which preserves the purchaser's right to claim against the vendor for a breach of warranty notwithstanding the purchaser's knowledge of the matter complained of. Judicial dicta[4] on this kind of provision are inconclusive, so it is uncertain whether such a provision will necessarily be upheld to the fullest extent and even if upheld, whether the purchaser will be able to recover substantial damages for the breach.[5]

6.1.2 Rescission and termination

6.006 At common law, a breach of a contractual term does not allow the innocent party to rescind a contract. Similarly, a breach of warranty (as opposed to a breach of condition) does not entitle the innocent party to be discharged from the further performance of the contract and terminate it. Therefore an express provision is needed if the purchaser wishes to have the right to

[1] For a detailed discussion of the law on breach of contract, please refer to the leading contract law textbooks.

[2] See para.4.141-4.142 of Chapter 4 above.

[3] See para.4.098 of Chapter 4 above.

[4] *Eurocopy plc v Teesdale, supra* n.42 of Chapter 4 above.

[5] See para.4.148 of Chapter 4 above.

terminate the share purchase agreement or otherwise refuse to complete the purchase, if a breach of warranty is discovered before completion. This is usually achieved by making it a condition precedent to completion that all warranties remain true up to completion.[6]

To maximise the purchaser's protection, the vendor is usually required by the terms of the share purchase agreement to notify the purchaser promptly of any event or circumstance which may give rise to a breach of warranty. For a purchaser who is an outsider, such a provision will be useful because an insider like the vendor is likely to become aware of events or circumstances which may adversely affect the target company much earlier than an outsider. This is particularly so where such event or circumstance occurs before completion. If the purchaser is alerted early about the possible breach of a warranty, it will have more time to assess the likely consequences and consider the various options available to it. 6.007

6.1.3 Damages for breach

If the purchaser only discovers the breach of warranty after completion, or the breach was discovered before completion but the share purchase agreement does not empower the purchaser to refuse to complete the purchase, then the purchaser's only recourse for a breach of warranty will be a claim for damages. In such a case, the usual rules as to causation and remoteness apply in determining the amount of damages to be awarded to the purchaser for the vendor's breach of warranty. 6.008

The objective of damages in a breach of contract case is to put the innocent party in the position it would have been in if the contract had been duly performed (that is, to cover its *expectation loss*). In the case of a share purchase, the amount of damages awarded for a breach of warranty will be the difference between (i) the value of the shares purchased if the warranty had been true and (ii) the value of those shares on the basis that the warranty is untrue. The innocent purchaser in a breach of warranty case can recover damages to cover any loss of bargain which it has suffered. For example, the vendor warrants in the share purchase agreement that the target company has the exclusive right to sell a popular electronic gadget in Hong Kong. If the warranty were true, the company's shares 6.009

[6] See para.4.050-4.051 of Chapter 4 above.

8 BUSINESS PURCHASE – AN OVERVIEW OF THE TRANSACTION

8.1 INTRODUCTION

Whether a transaction should be structured as a share acquisition or a business purchase will depend on a number of factors, which are discussed in Chapter 1. 8.001

It is common for the transaction to proceed on the basis of a business purchase in the following circumstances: 8.002

(a) *The business is owned by an individual (as a sole proprietor) who is now desirous of selling the business.*
In such a case, the option of acquiring the business indirectly through acquiring the entire issued share capital of the corporate owner of the business is not available.

(b) *The business is owned by two or more individuals (as a partnership) who are now desirous of selling the business.*
As in (a) above, the alternative of acquiring the business indirectly through acquiring the entire issued share capital of the corporate owner is not available.

(c) *The business is owned by one or more individuals who are now desirous of incorporating a company to own the business.*
This is quite common in Hong Kong. A person started a small business and has been operating the business as a sole proprietor. The business flourished and expanded. The owner becomes more sophisticated and is advised of the benefits of incorporation, including perpetual succession and limited liability. He decides to incorporate a company and transfer his business to the new company.

(d) *The business to be acquired is only part of different lines of business owned by the owner (who may be a body corporate or an individual or individuals).*

For example, a company owns a hotel business which includes three food and beverage outlets, a florist and two souvenir shops within the hotel. The purchaser is only interested in acquiring the food and beverage outlets of the hotel, but not the hotel, the florist or the souvenir shops.

(e) *The purchaser is prepared to take over only the business but not the corporate owner of the business.*
There may be a variety of reasons for this. For example, the purchaser is skeptical about the way the company has been run by its management, or the purchaser has doubts as to the financial health of the company.

8.003 Although it is possible for a person to simply acquire the assets used in a business (for example, the plant and machinery used in a manufacturing business), it is more likely for a business acquisition to be structured in such a way that the entire business undertaking is transferred as a "going concern" (that is, without any disruption in the business operations). It will involve the "transfer" by the existing owner of the business (the transferor) to the purchaser (the transferee) of the assets used in the business, the contracts relating to the business (for example, contracts with suppliers and customers, lease of the premises where the business is carried out, equipment leases, employment contracts with staff, etc.), the intellectual property rights necessary for the carrying out of the business (for example, copyright and trade mark), usually together with the goodwill of the business. The intention is for the transferee to pick up exactly where the transferor has left off.

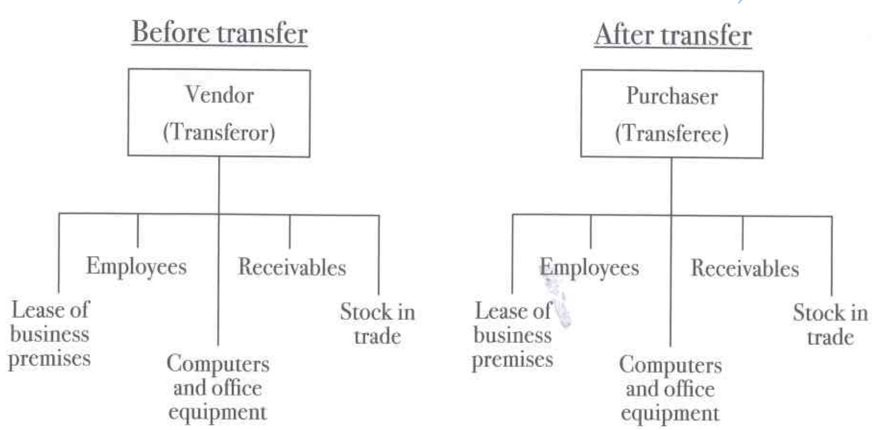

Figure 8.003: A business transfer

When considering whether an acquisition should be structured as a business acquisition, the parties (and especially the purchaser) should take into account the matters discussed below in this Chapter. 8.004

8.2 TRANSFER OF BUSINESSES(PROTECTION OF CREDITORS) ORDINANCE

8.2.1 Background

Unlike a company, a business is not a legal person. It has no legal identity which is separate from the person who operates it. Debts and liabilities which arise out of the carrying on of a business are the debts and liabilities of the person who carries on the business – that is, the sole proprietor, the partners in a partnership, or the company who carries on the business. Sometimes, the business is carried out under a "trading name". For example, Mr Dai Fu, a registered Chinese medicine practitioner, may carry on the business of selling Chinese medicinal herbs as a sole proprietor at a retail outlet under the trading name "Yeung Sheng Tong". The medicinal herb suppliers and the customers are in fact contracting with Mr Dai Fu, though most of them would think they are dealing with "Yeung Sheng Tong". 8.005

Since the transfer of a business is essentially a private matter between the transferor and the transferee,[1] it is quite possible for a business to be transferred without the creditors of the transferor being alerted, in circumstances where the transferee refuses to assume any of the debts and obligations incurred by the transferor in the operation of the business prior to the transfer. These debts and obligations will remain the personal liability of the transferor, and under the doctrine of privity of contract, creditors cannot hold the transferee responsible for the debts. If the transferor then disappears or dissipates the proceeds of sale of the business, creditors may find themselves without any recourse. In the example described above, if Mr Dai Fu sells the "Yeung Sheng Tong" business and then leaves Hong Kong for good, his suppliers may not 8.006

[1] The law imposes no duty on the part of the parties to announce their transaction or make it known to the public. However, there may be notification requirements under the Listing Rules if any listed company (or its group company) is involved and the transaction amounts to a "notifiable transaction". See para.8.038 below.

Commissioner has advised that if the personal data contained in the vendor's customer database were originally collected for providing certain goods and services to the customers, and upon the transfer of the business, the data are to be transferred to the purchaser to enable the customers to continue to enjoy such goods and services, the transfer of the data will be for the same purpose for which the data were collected and thus consistent with data protection principle 3. However, to avoid any misunderstanding by the customers, the Commissioner advised the parties to give advance notice to the customers about the transfer of business and the continual provision of the relevant goods and services by the purchaser in place of the vendor.[21]

9.049 The same reasoning can apply to the transfer of information relating to the suppliers as part of a business transfer. In any event, suppliers' details rarely involve "personal data" especially now that many businesses are incorporated. Besides, consent can be obtained from the suppliers when they are approached in respect of the possible novation of their supply contracts from the vendor to the purchaser.

9.050 As regards employees who will be re-employed by the purchaser at completion, the transfer of their employment records will be reasonable since under the Employment Ordinance, the "continuity" of their employment is deemed to be preserved notwithstanding the transfer of the business[22], and hence, their employment by the vendor may eventually become relevant when severance or other payments become payable to them by the purchaser under the Employment Ordinance. The transfer from the vendor to the purchaser of the employment records of those employees whom the purchaser will "take over" should therefore be for the same purpose or a purpose directly related to that for which the data was originally collected. In any event, the employees can be asked to give their consent in the new employment contracts or novation agreements which they will sign with the purchaser, so this should rarely be problematic.

9.051 If the data subjects are to be notified in relation to the transfer of their personal data, the notice is usually issued either jointly by the vendor and the purchaser, or by the purchaser after consultation with the vendor. Usually, the parties will not take any step to notify the data subjects until after the signing of a legally binding business purchase agreement.

[21] See the Notes on Enquiry Case no. 2001115, available from the website of the Office of the Privacy Commissioner: www.pcpd.gov.hk.

[22] S.3 and Sch1, s.5 of the Employment Ordinance.

10 BUSINESS PURCHASE – DOCUMENTATION

10.1 THE BUSINESS PURCHASE AGREEMENT

As with a share purchase, it is customary for the purchaser's lawyer to prepare the first draft of the business purchase agreement. 10.001

The terms of a business purchase agreement will be largely similar to those of a share purchase agreement. Only those terms which are unique to business acquisitions or which are significantly different from those found in share purchase agreements will be discussed below. 10.002

10.1.1 Parties to the agreement

The vendor should be the owner of the business. It is often easy to overlook the very basic principle of a company's separate legal entity from its shareholders in this context, especially in the case of the many private companies in Hong Kong which are run as if they were the *alter ego* of their controlling shareholders. Even though all the negotiations may be done by the controlling shareholder, it must be remembered that the vendor of the business is the person or company which owns and operates the business. 10.003

Where the vendor is a company and there is any doubt as to its financial strength, a guarantee may be sought from the vendor's parent company or controlling shareholder. It is quite common for the guarantee to be set out in the business purchase agreement itself, in which case the guarantor should be made a party to the business purchase agreement. Alternatively, the controlling shareholder may be asked to become a warrantor in the business purchase agreement for the purpose of giving warranties on the business jointly and severally with the vendor-company. As the person in charge of the company's business, the controlling shareholder is effectively the "brain" of the company, and is thus fully acquainted with all aspects of the company's business. Having the controlling shareholder as the warrantor will give the purchaser recourse against the shareholder as 10.004

well as the vendor-company.

10.1.2 Subject matter of the sale and purchase

10.005 Unlike a share purchase where the subject matter of the sale and purchase is relatively simple and straight-forward, the subject matter of a business purchase can be rather complex and requires clear and accurate identification.

10.006 The subject matter of the sale and purchase will be the business which should normally comprise all the assets forming the business which is to be transferred, unless otherwise agreed between the parties. It is often expressly provided in the business purchase agreement that the business is being transferred "as a going concern". If certain assets which form part of that business are to be excluded, it would be advisable for the business purchase agreements to expressly identify those assets as "excluded assets" and set out the parties' intention that they be excluded from the sale and purchase. Similarly, where the vendor operates various businesses but only one of them is to be transferred, the business which forms the subject matter of the sale and purchase must be clearly identified and distinguished from the other businesses which will be retained by the vendor.

10.007 What assets are to be included in the business purchase agreement will depend on the type of business being transferred, the parties' intention, and the results of the purchaser's due diligence investigations. They will often include both tangible assets and intangible assets. Often, in a typical business transfer, the following will be included:

(a) Premises where the business is carried out

10.008 Where the vendor is the owner of the premises, and the premises is to be purchased together with the other assets comprising the business, this must be clearly spelt out in the business purchase agreement, with the particulars of the premises clearly set out. If the premises are located in Hong Kong, the business purchase agreement will amount to an agreement for the sale and purchase of land, and as an "instrument affecting land", will require registration with the Land Registry[1].

10.009 In cases where land in Hong Kong is to be transferred as part of the business, the business purchase agreement and the assignment of the land to be executed at completion will attract stamp duty.[2] It is essential that the business purchase agreement clearly stipulates who is to bear the stamp duty, which may be quite a sizeable sum. Since stamp duty is calculated with reference to the amount of consideration payable for the land, it is common practice for the consideration payable for the business to be split into two portions: one portion attributable to the land (on which stamp duty will be paid) and another portion attributable to the other assets.

[1] S.5 of the Land Registration Ordinance.

Where the business is carried on in rented premises, whether the purchaser will take over the tenancy will often depend on the parties' success in obtaining the landlord's consent to the novation of the tenancy to the purchaser and the terms required by the landlord. If consent from the landlord is not forthcoming or the terms are not acceptable to the purchaser, the purchaser may decide not to take over the existing tenancy, but will carry out the business at an alternative location instead. The latter will often entail an early termination of the existing tenancy, so the parties to the business purchase will have to agree between themselves who is to bear the costs of early termination. 10.010

(b) Chattels

This may include office equipment and computers, machinery and fittings, motor vehicles, customer records, and diverse other items, depending on the type of business being transferred. The quantity and particulars of chattels to be transferred should be clearly and meticulously listed out in the business purchase agreement (often in a separate schedule). 10.011

(c) Stock and work in progress

All the stock and work in progress of the business will also be transferred, and should be provided for in the business purchase agreement. This is particularly important where the business to be transferred involves manufacturing or trading. However, owing to its very nature, it is impossible to determine the exact amount and value of the stock to be transferred until the date of completion. Hence, a post-completion audit is quite common in business purchases to enable adjustment of the consideration to be made. 10.012

[2] See para. 9.008 of Chapter 9 above.

3 SHARE PURCHASE – DUE DILIGENCE

3.1 INTRODUCTION

3.1.1 What is due diligence?

3.001 "Due diligence" is the process by which a purchaser exercises due diligence and carries out a thorough investigation into the subject matter of the purchase which, in the case of a share purchase, will involve investigation into the target company the issued share capital of which is being purchased, as well as its business and affairs. In this process, the purchaser is usually assisted by its legal and other professional advisers. In this chapter, the discussion will focus on the carrying out of due diligence against Hong Kong private companies.

3.1.2 Why is due diligence necessary?

3.002 The common law rule governing risks in a sale and purchase transaction is summed up in the Latin maxim *caveat emptor* – let the buyer beware. This means that, in the absence of any statutory provision to the contrary,[1] the law does not impose upon the vendor any duty to voluntarily disclose to the purchaser information about the subject matter of the sale, even if such information may influence the purchaser's decision whether or not to enter into the contract. In the absence of a duty to disclose, non-disclosure by the vendor of relevant information does not amount to a misrepresentation. In short, the vendor is not in any way obliged to alert the purchaser as to any defect in the subject matter of the sale or any risks associated with the purchase of it, even if the vendor is aware that the purchaser is labouring under some mistaken belief.[2] Applying this maxim to the context of a share purchase, unless the contract provides otherwise, the vendor will have fully discharged its obligations under the sale and purchase by transferring to the purchaser the agreed number of shares in the target company. It matters

[1] The Sale of Goods Ordinance does not apply to a sale and purchase of shares, because shares (being a "thing in action") do not fall within the definition of "goods" in s.2 of the ordinance.

[2] *Smith v Hughes* (1870-71) LR 6 QB 597.

not whether the company turns out to be on the verge of insolvency, or that the company has been running certain illegal operations. The purchaser cannot refuse to take delivery of the shares (or to pay for them), or otherwise terminate or rescind the sale and purchase and ask for the return of all monies paid.

A purchaser of shares is thus exposed to three main risks: 3.003

(a) The risk of not getting what the purchaser thought it is getting –

Example : A purchaser is interested in acquiring the target company because it believes that the target company owns a chain of retail outlets which the purchaser can integrate readily and profitably into its own retail network. To its dismay, the purchaser discovers only after having taken over the company that the company has already disposed of most of its retail outlets. The purchaser thus fails to get the benefit which it has wanted to obtain from the purchase.

(b) The risk of getting less than what the purchaser thought it is getting –

Example : Having paid HK$30,000,000 to acquire the target company in the belief that it has net assets of not less than HK$28,800,000, the purchaser is shocked to discover that the target company has an undisclosed liability of some HK$6,000,000. The purchaser has thus got significantly less than what it has bargained for.

(c) The risk of getting what the purchaser did not intend to get –

Example : After a purchaser takes over a pharmaceutical company, it discovers that the company is subject to a negligence claim for the manufacture of a very popular prescription drug. The purchaser has thus unwittingly bought itself into a law suit.

The examples above illustrate why it is prudent for a purchaser to carry out a thorough investigation into the target company and its business before it commits itself to taking over the company at a certain price. Hence, the need for a due diligence investigation. From the purchaser's perspective, the more thorough the due diligence is, the better protected the purchaser will be. A thorough due diligence investigation will equip the purchaser with relevant information about the target company and thus help the purchaser evaluate its true worth and identify the risks associated with the 3.004

purchase. Similarly, the earlier due diligence is carried out, the better it is to the purchaser. Most purchasers will prefer to have the due diligence investigation completed, or at least substantially completed, to its reasonable satisfaction before signing a legally binding contract for the share purchase. It is not uncommon for a purchaser in a strong bargaining position to request a thorough due diligence to be carried out against the target company before committing itself to purchase its shares and, more particularly, to the terms of the purchase. Whilst due diligence is being carried out, the purchaser can rely on the "*lock-out*" clause and the costs undertaking in the heads of agreement, so as to ensure that costs incurred by it in carrying the due diligence investigation will not be wasted if the vendor should change its mind and sell the shares to a third party instead.[3]

3.005 Usually, the due diligence investigation will start only after the parties are more or less committed to the sale and purchase, for example, after the signing of a heads of agreement. Due diligence will involve the purchaser engaging the services of professional advisers (for example, accountants, lawyers, surveyors and other specialist advisers), and can be a rather expensive exercise. The purchaser is therefore unlikely to proceed to instructing professional advisers unless and until some consensus has been reached with the vendor.

3.006 From the vendor's perspective, a lot of sensitive information will be disclosed to the purchaser and its professional advisers during the due diligence exercise. Also, the vendor and its staff will have to spend time dealing with the purchaser's due diligence requests and answering enquiries, which may be disruptive of its normal business operations. Understandably, a vendor will be reluctant to allow full due diligence unless and until it is assured of the purchaser's genuine interest in taking over the target company and can take comfort in the protection of a confidentiality undertaking.

3.007 One may query whether it is necessary to carry out a thorough due diligence exercise when the share purchase agreement will often contain warranties[4] from the vendor on the target company and its business, and should thus entitle the purchaser to claim against the vendor if it subsequently discovers that the target company is less desirable than warranted. The answer is

[3] See para.2.071-2.074 of Chapter 2 above.

[4] For the role of warranties in a share purchase agreement, see para.4.084-4.086 of Chapter 4 below.

a resounding "yes". Notwithstanding that warranties may be included in the share purchase agreement, a purchaser should be advised to gather as much information about the target company before committing itself to the purchase, subject to time and costs constraints. It should be remembered that litigation is often costly and time-consuming, and the outcome far from certain. Due diligence enables a purchaser to obtain relevant information on the target company at an early stage and identify issues which may affect its decision whether to take over the company. It therefore gives the purchaser the opportunity to walk away from an undesirable deal at an early stage, instead of incurring unnecessary costs and management time. This is much to be preferred than being stuck with an undesirable company after completion, and having to incur further costs and management time in order to litigate a warranty claim whilst rectifying the defect or minimising the damage it causes (if that is possible at all).

Moreover, it is precisely the information obtained from due diligence which will enable the purchaser's lawyers to draft appropriate warranties and indemnities for inclusion in the share purchase agreement. The due diligence exercise will enable the purchaser and its lawyers to identify and assess those risks to which the purchaser may be subject in taking over the target company, the extent of such risks, and thus the assurance and protection which the purchaser should seek from the vendor by the inclusion of suitable warranties and indemnities in the share purchase agreement. 3.008

Besides, it can never be assumed that the vendor will agree to give the warranties and indemnities on the matters and in the terms required by the purchaser. A vendor in a strong bargaining position may refuse to give any warranties[5] or may agree to give only very limited warranties. Instead, the purchaser and its professional advisers are allowed access to the company's documents and records (often in a data room), so they can investigate and satisfy themselves as to the target company's condition, on the understanding that no assurance will be given by the vendor by way of warranties. 3.009

[5] This is the position adopted by many governments in privatisation sales.

companies, as minority shareholders' interest is usually not an issue in such cases. Under this procedure, the board of each existing company must make a statement (i) to confirm either that the company's assets are not subject to a floating charge or the chargee has consented to the merger, and (ii) to verify the solvency of both the company and the new amalgamated company. The proposal must be approved by both companies by special resolution. Before the merger becomes effective, any shareholder or creditor unfairly prejudiced by the merger proposal may challenge it by an application to court.

1.5 DIFFERENT METHODS OF ACQUIRING SHARES IN A HONG KONG COMPANY

1.014 A person may acquire shares in a Hong Kong company, whether private or public, by way of (i) a share purchase; or (ii) a share subscription. The essential differences between a purchase of shares and a subscription for shares in a Hong Kong company are set out below:

Share purchase	Share subscription
A person purchases shares which *have already been issued*.	A person subscribes for *new* shares to be issued by the company.
The person purchases the shares from an *existing shareholder*.	The person applies to the *company* to subscribe for shares.
The *purchase price* is payable to the existing shareholder who is the vendor of the shares.	The *subscription monies* are payable to the company who is the issuer of the shares.
The existing shareholder *transfers* all or part of its shareholdings in the company to the purchaser.	The company *allots* and issues the shares to the applicant for shares.
Stamp duty is payable on the sale and purchase of shares.	No stamp duty is payable on an allotment of shares.
A transfer of shares is subject to approval by the company's board of directors.	An allotment of shares is to be approved by the company's board of directors, but if the allotment is on a non pro rata basis, then it must first be approved by the shareholders.

Figure 1.014: Comparison between share purchase and share subscription

Whilst shares in listed companies may be sold and purchased "off the market" by private agreement, they are more often traded on the relevant stock exchange where deals are struck by brokers as agents for their principals, with the identities of the vendor and the purchaser remaining anonymous. A purchase of shares in a private company is usually carried out by private agreement between the vendor and the purchaser. 1.015

A private company is prohibited by its articles of association from inviting the public to subscribe for its shares.[10] If a private company wishes to offer its shares to interested investors who are not already members of the company, it can do so by way of a private placement of shares by the company with those persons. When shares are to be issued to these non-members, prior approval of the existing shareholders will be required.[11] 1.016

If a private company wishes to offer its shares to the public, then the company must first convert itself into a "public company" by removing the relevant restrictions from its articles of association. Besides, the company must issue a prospectus which complies with the requirements set out in the Third Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance ("CWUMPO") when it offers its shares to the public. Often, such an offer will coincide with the company's application to have its shares listed on the Stock Exchange, so as to enhance liquidity and trading in its shares. The requirements and procedures relating to the listing of shares on the Stock Exchange are beyond the scope of this book. 1.017

1.6 THE WIDESPREAD USE OF OFFSHORE COMPANIES

Instead of holding assets or shares through a Hong Kong company, it is very common in Hong Kong for holding companies to hold their assets or their shareholdings in operating subsidiaries through offshore intermediate holding companies. These offshore companies are often incorporated in jurisdictions like the British Virgin Islands or Cayman Islands where the tax regime is generally perceived to be "more favourable" and the reporting requirements are minimal. So long as these 1.018

---

10 S.11 of the Companies Ordinance

11 The issue will be a non pro rata issue of shares and thus shareholders' approval under ss.140-141 of the Companies Ordinance will be required.

companies do not have a place of business in Hong Kong, they are not required to be registered as a "non-Hong Kong" company under the Companies Ordinance.[12] There is also no requirement for such companies to maintain a share register in Hong Kong unless their shares are listed on the Stock Exchange. Hence, a transfer of shares in these offshore companies will not attract any stamp duty under the Stamp Duty Ordinance.[13]

1.019 Where the proposed acquisition is of shares in an offshore company, the law of the place of incorporation of the target company must be checked, so as to ensure the legal validity and enforceability of the transaction and the due compliance with all necessary requirements for the share allotment (in the case of a share subscription) or share transfer (in the case of a share purchase). It is not sufficient for the documentation and the transaction to be valid and enforceable under Hong Kong law, if the purchaser cannot have the shares registered in its name or will be restricted in the way it exercises its shareholder's rights, or the share acquisition will not be recognised or given effect to under the law of the place of the offshore company's incorporation, due to restrictions over foreign investments or other reasons[14]. Therefore in transactions involving the acquisition of shares in an offshore company (whether it is registered as a "non-Hong Kong company" or otherwise), it is important to retain lawyers who are qualified to practise and advise on the law of that jurisdiction. It is advisable that they be retained from an early stage of the transaction onwards to advise on the structure of the transaction, the formalities to be observed, as well as all other matters concerning the law of the offshore jurisdiction which may be relevant to the client in relation to the transaction. Appropriate instructions should be sought from the client as early as possible for this purpose.

1.7 STRUCTURING AN ACQUISITION

1.7.1 Acquisition of business or acquisition of shares?

[12] S.776 of the Companies Ordinance. For what amounts to a "place of business" in Hong Kong, see para.3.039 of Chapter 3 below.

[13] See para.1.051 below.

[14] For example, if the law of the place where the target company is incorporated limits a foreigner's shareholding to 10%, a proposed acquisition by a Hong Kong purchaser of a 15% shareholding in the target company will not be recognised and given effect to by the law of that jurisdiction, though the transaction will be valid under Hong Kong law since Hong Kong law does not impose any such restrictions.

Consider this scenario: Ten years ago, Mr Cha incorporated a company 1.020
called "Tea Break Limited" which he used as a vehicle to own and operate a café. He has worked hard and his efforts have paid off. The café has become very popular and the company has been making a handsome profit. Now Mr Cha wants to retire and is desirous of realising his investment in the café. At the same time, Mr Sun, one of the café's long-standing customers, would quite like to have his own café and is considering the possibility of "taking over" Mr Cha's café. Mr Sun's proposed acquisition may proceed in any one of the following ways:

(a) Mr Sun can purchase all of Mr Cha's shares in Tea Break Limited, the company which owns and operates the café – this will take the form of an acquisition of shares by way of Mr Sun purchasing from Mr Cha his shares in Tea Break Limited.

(b) Mr Sun can ask Mr Cha to procure Tea Break Limited which owns and operates the café to allot new shares to Mr Sun – this will take the form of an acquisition of shares by way of subscription by Mr Sun for shares in Tea Break Limited.

(c) Mr Sun can purchase the whole of the business of the café from Tea Break Limited – this will take the form of an acquisition of the café business by way of a transfer of business from Tea Break Limited to Mr Sun.

(d) Mr Sun can purchase some of the assets of the café from Tea Break Limited, set up a new café at a different location under a different name, and engage his own staff to run the new café – this will take the form of an acquisition of some of the assets used in the operation of the café from Tea Break Limited but without amounting to a transfer of the café business. (Unless Tea Break Limited has other types of business than just the café and Mr Sun is interested in taking over only the café, this method is unlikely to be used for this scenario.)

Transactions of the types outlined above happen all the time in Hong 1.021
Kong. Acquisitions and disposals form the bulk of commercial transactions in Hong Kong. The target of the acquisition may range from a roadside café, a photographic supplies shop or a boutique, to a multi-national bank, a power plant or an aircraft manufacturer. Although every business is unique in its own ways and thus merits special consideration