

An overview on private mergers and acquisitions in Hong Kong

Rossana Chu / Jacky Chan
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Mergers and acquisitions ("M&A") transactions of public companies often receive a lot of publicity. Nevertheless, there is no shortage of activities in private M&A. In Hong Kong, there are two main types of acquisitions in the private M&A space: (1) purchase of shares of a private company and (2) asset purchase. The sale and purchase of shares is a common form of corporate acquisition in Hong Kong.

By acquiring all or the majority part of a target company's share capital, the buyer can exercise control over the target company as well as all its businesses and assets. Yet, some parties choose to acquire assets because it allows cherry-picking the suitable assets in the target company. This article provides some of the key legal issues involved in a private M&A and considers the differences between a share purchase and asset purchase.

Share purchase versus asset purchases

Whether to proceed by way of a share purchase or asset purchase will depend on the objectives of the buyer and circumstances of the target entity and its business. Some of the key considerations are set out below:

Entirety

In a share acquisition, all the assets, liabilities and obligations of the target company will in

effect pass to the buyer. By contrast, in an asset acquisition, the buyer acquires only specific identified assets and liabilities.

In other cases, a transaction may involve the sale and purchase of a division of a wider business. Unless the relevant division is neatly contained within one target entity owned by the seller, it would probably make sense for the transaction to be structured as an asset sale whereby the buyer can cherry-pick the assets it requires and house them in an appropriate entity in its own group.

Another potential avenue in this case is for the seller to implement an intra-group reorganization so that the assets of the relevant division are transferred into one dedicated entity, followed by the acquisition by the buyer of all the shares in such entity. In short, an internal asset transfer followed by a share purchase.

Tax

There may be certain tax advantages or

disadvantages, depending mainly on the nature of the target's assets, which may drive the structuring decision in favor of one option over the other.

Advantages of share purchases

Simplicity

A share purchase has the effect of transferring the target's entire business, although sometimes prior consents of third parties are required. This is in contrast to an asset purchase, which requires each piece of target asset and liability to be individually identified and transferred.

Effect on existing contracts

Existing contracts (i.e., supply agreements, customer contracts etc.) of the target company are generally unaffected by a share purchase (subject to any change of control provisions and commercial risk that counterparties may cease their contractual relationship with the target). However, under an asset purchase, such contracts must be specifically novated or assigned to the buyer under the consents of the contract parties.

Effect on licenses and permits

The target's existing licenses and permits remain in place, subject to any change of control requirements.

Tax

In general, Hong Kong stamp duty on transfer of shares of a property holding company is likely to be lower than the stamp duty on a direct transfer of its underlying land properties, assuming that company does not own any other assets.

Advantages of asset purchases

Cherry-picking

The buyer can pick and choose the target's specific assets and liabilities that it wishes to acquire, leaving behind any undesired assets and liabilities with the seller. An added advantage of cherry-picking assets is that the buyer has a reasonable degree of comfort that it needs not deal with any unwanted liabilities of the target following the completion of the transaction. Under a share purchase, the buyer acquires all the target's assets and liabilities unless these are specifically carved out from the transaction.

Pre-emption rights

Asset purchases avoid any problems in relation to the pre-emption rights of the other shareholders which may arise when purchasing shares in a private company. For example, there may be problems in locating missing minority shareholders of the target.

Share purchases

The most common Hong Kong corporate form is a private company limited by shares. Under the Companies Ordinance Cap. 622, Laws of Hong Kong ("Company Ordinance"), a private company is a company that restricts the right to transfer shares, limits the number of members to 50 people and prohibits any invitation to the public to subscribe for shares in the company.

Shares in private companies are subject to transfer restrictions set out in the company's articles of association or shareholders' agreement. For purchases of shares from an existing shareholder, the consent of the other shareholders may be required to waive pre-emptive rights, tag-along rights or other restrictions on transfer that are usually specified either under the articles of association of the target company or the

relevant shareholders' agreements. In general, there are no legal, regulatory or governmental restrictions on transfers of shares in a Hong Kong incorporated company unless the target business belongs to the banking¹, insurance², securities and futures³, provident fund⁴, telecommunications⁵ or broadcasting⁶ sectors. Moreover, businesses in the telecommunications sector are also subject to the 'Merger Rule' under the Competition Ordinance⁷.

Asset purchases

For acquisition or disposal of assets, parties should inspect the provisions under the articles of association and shareholders' agreement to see if there are any restrictions on the transfer and/or prior shareholders' approval for the transfer. The parties should follow the procedures for transferring rights, permits, licenses and consents for the transition and continuous operation of the business in Hong Kong and/or for obtaining new permits and/or licenses when acquiring a business or assets. Consents from third parties may be required under previous agreements of the target company with its landlords, creditors, debenture holders, mortgagees or other contracting parties that may be affected because of a transfer of assets or upon a change in control of the target company.

Processes

The most common process is that the seller and the buyer, after bilateral negotiations, agree on the terms and conditions of a sale and purchase agreement on the transfer of the target privately-owned company or target businesses and assets.

However, where the seller wishes to solicit interest from several potential buyers, the disposal process may take the form of a controlled auction which typically involves:

1. Drafting an information memorandum as the basis of marketing the target company, business or assets;
2. Providing vendor due diligence report;
3. Drafting of a sale and purchase agreement and other transaction documentation;
4. Round one expressions of interest from potential buyers;
5. Seller's selection of potential buyers in round one who will then be permitted to undertake their own due diligence;
6. Round two offers by potential buyers with definite bidding price and mark ups of the transaction documentation; and
7. Negotiation of transaction documentation with one or more buyers until definitive terms are agreed with one party.

In certain special situations, private companies can also be acquired by 'contractual offer' followed by a minority squeeze-out, provided that the offer is made in accordance with Part 13 of the Companies Ordinance⁸, or by 'scheme of arrangement' proposed by the company to be acquired in accordance with Part 4 of the Companies Ordinance⁹.

Due Diligence

Due diligence provides potential buyers and their financiers with the opportunity to evaluate the legal, financial, tax, commercial position and business prospects of a target company, business or asset. Legal due diligence conducted by legal advisers to the buyer typically covers the title to and encumbrances over the company or business, the legal structure, terms of financial obligations, licences and permits, material contracts, ownership and use of information technology, intellectual and real property, physical assets, employee arrangements, litigation and compliance with law.

Vendor due diligence reports are a common feature of controlled sale processes in Hong Kong, whereby the seller provides information on the target company or business in order to accelerate the sale process, minimize disruption to the target, and explain any complexities associated with the transaction. It is customary for a successful buyer, and its financier, to be able to rely on such vendor due diligence reports, although buyers may often also complete confirmatory due diligence to complete their evaluation of a transaction.

Documentations

The typical documents involved in a private M&A include:

- a confidentiality agreement governing the exchange of confidential information relating to the transaction;
- a memorandum of understanding or heads of terms setting out key terms and sometimes earnest monies and negotiation exclusivity;
- a sale and purchase agreement setting out the terms and conditions of the transaction; and an agreement on transfer of a business or assets usually includes detailed provisions on the scope of the business, assets and liabilities that are to be transferred;
- a disclosure letter in which general and specific disclosures are made by the seller qualifying the warranties included in the sale and purchase agreement;
- documents to transfer the title (e.g., an instrument of transfer and a bought and sold note in the case of a share transfer, and an assignment in the case of real property and intellectual property rights); and
- key members of management in the target business may enter into new employment agreements to secure their

continued employment following completion of the transaction.

Consideration

Consideration may be fixed or subject to post-closing adjustments. Payment of cash consideration may be in the form of a lump sum or several instalments. Non-cash consideration may be in the form of shares in the buyer (where the buyer is a listed company) or other securities, such as loan notes convertible into the buyer's shares. Non-cash transactions generally involve a more complicated payment structure.

Timetable and delays

To avoid deviating from the timetable, parties should first ensure they are prepared, both internally and externally (in terms of engaging advisers), to undertake an M&A transaction. In complex or cross-border transactions, or where the target has a complex financial or tax position, parties should understand that:

1. structuring discussions might dominate the early part of a timetable and result in a delay to processes which depend on the outcome of these discussions;
2. the scope of the due diligence exercise conducted can extend a transaction timetable prior to signing;
3. the preparation and negotiation of documentation is an integral part of any M&A process and the duration depends on the relative bargaining powers of the parties and the complexity of the transaction;
4. any delay might interrupt the buyer's funding plan or increase its funding cost; and
5. obtaining shareholders' approval, regulatory approvals and/or third parties' consents may impact completion of an M&A transaction.

Summary

Mergers and acquisitions (“M&A”) transactions of public companies often receive a lot of publicity. Nevertheless, there

is no shortage of activities in private M&A. This article provides some of the key legal issues involved in a private M&A and considers the differences between a share purchase and asset purchase.

Article references:

¹ Banking Ordinance (Cap 155)

² Insurance Companies Ordinance (Cap 41)

³ Securities and Futures Ordinance (Cap 571)

⁴ Mandatory Provident Fund Schemes (General) Regulation (Cap 485A)

⁵ Telecommunications Ordinance (Cap 106)

⁶ Broadcasting Ordinance (Cap 562)

⁷ Competition Ordinance (Cap 619)

⁸ Part 13 (Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back) of the Companies Ordinance contains provisions relating to schemes of arrangement or compromise with creditors or members, reconstructions or amalgamations of companies, and compulsory acquisitions of shares following a takeover offer or following a general offer for a share buy-back. Please see https://www.cr.gov.hk/en/companies_ordinance/docs/briefingnotes_part13-e.pdf for more details

⁹ Part 4 (Share Capital) of the Companies Ordinance contains provisions relating to the core concept of “share capital” and its creation, transfer and alteration. Please see https://www.cr.gov.hk/en/companies_ordinance/docs/briefingnotes_part04-e.pdf for more details.

KEY CONTACTS



Rossana Chu
Managing partner
Rossana.Chu@eylaw.com.hk
+852 2629 1768



Jacky Chan
Associate
Jacky-ch.Chan@eylaw.com.hk
+852 2675 2167

Contact us

LC Lawyers LLP

Suite 3106,
31/F One Taikoo Place,
979 King's Road,
Quarry Bay, Hong Kong
Tel: (852) 2629 3200
Fax: (852) 2956 1980

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