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Acquisition Finance

Hong Kong

Peter Lake, Mike Ringer and Ariad Porat
Slaughter and May

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Law and Practice

Contributed by:
Peter Lake, Mike Ringer and Ariad Porat
Slaughter and May see p.21

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1. MARKET

1.1 Major Lender-Side Players

Banks are the leading source of funding for primary loans, particularly for corporate borrowers. It is common for deals to be arranged and underwritten by banks, with the debt syndicated more broadly post-closing; for leveraged loan transactions, the composition of the syndicate depends on the nature and location of the acquisition, size of the facility and the identity of the borrower (especially its credit rating and industry sector). A syndicate typically comprises local and international banks, particularly for larger cross-border deals. Hong Kong has a strong syndicated loan markets, typically accounting for over 20% of the total volume of syndicated loans in the Asia-Pacific region (excluding Japan).

1.2 Corporates and LBOs

In 2020, Hong Kong M&A activity increased by 0.7% year on year to USD22 billion, while Asia-Pacific buy-out activity increased by 8.1% in value compared to 2019.

Unlike the rise in M&A activity, Hong Kong aggregate loan value fell by 15.5% from an aggregate value of USD53.79 billion in 2019 to an aggregate value of USD45.47 billion in 2020. This is mainly attributable to COVID-19.

See **1.3 COVID-19 Considerations** for further details.

1.3 COVID-19 Considerations

In the first half of 2020, a larger proportion of M&A deals were aborted prior to signing, as parties chose either to cancel or to defer the transaction indefinitely. Obstacles to the deal-making process included the economic downturn and related uncertainties caused by COVID-19 and the impact of government closures, travel restrictions and lockdowns. However, many paused deal processes were restarted in the third quarter of 2020. As noted in **1.2 Corporates and LBOs**, Hong Kong M&A activity increased by 0.7% year on year to USD22 billion in 2020.

Following the onset of COVID-19, a growing number of deals feature the adoption of price adjustment and deferred consideration mechanisms, as well as the use of share-for-share exchanges and a mixture of shares, loan notes and cash in varying proportions.

Looking ahead, opportunistic M&A is expected to rise, as businesses explore strategic options (including sale) and excess liquidity is utilised.

As noted in **1.2 Corporates and LBOs**, unlike the rise in M&A activity, Hong Kong's aggregate loan value fell by 15.5% from an aggregate value of USD53.79 billion in 2019 to an aggregate value of USD 45.47 billion in 2020. This is part of a broader trend in the Asia-Pacific region, which has experienced a general decline in loan activity attributable to the uncertainty caused by COVID-19, as many borrowers placed fundraising, as well as acquisition and capital expenditure plans, on hold. In addition, given the volatility in the market, more borrowers sought covenant amendments or waivers from lenders. Overall, in 2020 there was a decline in banking activity involving new transactions or new credits, as many banks prioritised preserving their capital to support existing clients.

The Hong Kong regulatory authorities have also introduced various relief measures in 2020 to assist struggling businesses and support borrowers.

In February 2020, the Hong Kong Monetary Authority (HKMA), the government authority responsible for maintaining monetary and banking stability in Hong Kong, published a circular on "Measures to relieve the impact of the novel coronavirus" where it welcomed initiatives taken

by Authorised Institutions (AIs), which broadly comprise banks and deposit-taking institutions, to roll out temporary relief measures for their customers. Measures considered included a principal repayment moratorium for residential and commercial mortgages, fee reductions for credit-card borrowing and restructuring of repayment schedules for corporate loans.

The HKMA also extended the pre-approved principal-payment holiday scheme for small and medium corporates, most recently on 2 September 2020, to include principal that was otherwise due to be repaid on or before 30 April 2021.

In April 2020, the Government introduced a "Special 100% Loan Guarantee" under the SME Financing Guarantee Scheme, under which a 100% loan guarantee is provided by the Government to lending AIs. With effect from 29 March 2021:

- eligible enterprises must have been in operation for at least three months in Hong Kong as at 30 June 2020, and have suffered at least a 30% decline in sales turnover in any month since February 2020 (Affected Period) compared with the monthly average of any quarter from January 2019 to June 2020 (Reference Period), provided that the Affected Period must not be earlier than the Reference Period;
- the maximum loan amount for each eligible enterprise is the total amount of employee wages and rents for 18 months or HKD6 million, whichever is the lower; and
- the maximum guarantee period is eight years.

2. DOCUMENTATION

2.1 Governing Law

Loan agreements involving Hong Kong companies as borrowers are generally governed by Hong Kong or English law. Hong Kong market-template forms of facility agreement are published by the Asia Pacific Loan Market Association (APLMA) and include Hong Kong law templates and English law templates. Both sets of templates are similar in form and content.

2.2 Use of LMAs or Other Standard Loans

The Hong Kong syndicated loan market uses the template Asian facility documentation published by the APLMA.

The APLMA's Asian facility documents include various unsecured facilities agreements and a secured facilities agreement.

The APLMA does not have a specific template leveraged facilities agreement and so the Hong Kong market uses the Loan Market Association's (LMA's) senior facilities agreement for leveraged acquisition finance transactions. This LMA template contains certain funds language which is used in the Hong Kong market (noting that the certain funds language is drafted for private acquisition finance and so requires modification to be used for public takeover cash confirmation purposes).

Corporate acquisition facility agreements are often based on the terms of the corporate's working capital facility agreements, and adapted to include the required acquisition mechanics and any additional protections sought by the lenders to address the group's increased leverage.

Private equity sponsors typically have their own preferred forms of facility agreement and intercreditor arrangements.

2.3 Language

Although there is no legal requirement relating to language, a Hong Kong or English law-governed loan agreement that is based on the

APLMA forms is commonly written in the English language.

2.4 Opinions

Legal opinions are typically provided by the legal advisers to the agent and the arrangers for the transaction, and will be a condition precedent to completion. The lenders will generally require that the opinion cover three key areas:

- the capacity and authority of the entities entering into the finance documentation;
- the validity and enforceability of the finance documentation; and
- the effectiveness of any security to be granted as part of the transaction.

Private equity sponsors may, however, prefer that the private equity sponsors' legal advisers give legal opinions to the lenders covering the capacity and authority of the private equity funds and related parties (such as general partners), in order to avoid disclosing fund formation documentation.

3. STRUCTURES

3.1 Senior Loans

Corporate acquisitions are typically financed by bank debt, using either:

- pre-existing loan facilities, which are capable of being drawn to fund the acquisition; or
- newly arranged acquisition facilities.

Leveraged acquisitions may involve more complex financing structures with additional credit protection. Acquisition financing invariably involves a senior term facility, typically secured or guaranteed. Mezzanine debt and intercreditor agreements are less common in the Hong Kong market compared to the UK and US markets.

3.2 Mezzanine/PIK Loans

Leveraged acquisitions may involve subordinated loans.

Subordination may be structural (with the mezzanine lender lending to a holding company, and the senior lender lending to the subsidiary) or contractual (where the mezzanine lender and the senior lender both lend to the same entity).

For structural subordination, the holder of the shares in the relevant borrowing entity (eg, a holding company borrower and a subsidiary borrower) typically grants security over those shares. In order to simplify the enforcement of the share security, the chargor of the subsidiary borrower shares will not be the same entity as the holding company borrower. There will therefore usually be at least four entities from the subsidiary borrower to the entity that grant security over its shares in the holding company borrower. Other security may also be taken.

For contractual subordination, the lenders (who both lend to the same borrowing entity) will enter into an intercreditor agreement. This will set the terms on which the agent/security agent will pay out to the senior lender in priority to the mezzanine lender.

Separately from the above concept of subordination between third-party lenders, existing shareholder loans will often be subordinated (in timing for payment as well as priority) to the third-party loans.

3.3 Bridge Loans

Bridge-loan facilities are common. They are used to provide financing, arranged within a few short weeks, to fund an acquisition. Bridge loan facilities are intended to be short term and are therefore structured to encourage swift refinancing.

The drafting of a bridge loan is similar to a typical longer-term financing, but with the following characteristics:

- the bridge loan is generally available for drawdown for a short period:
  (a) for a private acquisition facility, the availability period may be a few weeks from signing; and
  (b) for a public takeover acquisition facility, given the timetable (from initial announcement of the takeover, to satisfying or waiving conditions, to closing) can take a number of months, the availability period is more likely to have a long-stop date of around nine months from signing (noting that the public takeover financing conditions precedent usually will not be satisfied for a few months after signing the facility agreement, so the loan will not be able to be drawn down at the beginning of the availability period); and
- the bridge loan typically includes an interest rate margin step-up, to encourage early prepayment (usually sourced by a refinancing) before that pricing step-up takes effect.

3.4 Bonds/High-Yield Bonds

The issuance of bonds for initial acquisition financing is unusual in the Hong Kong market.

Bonds are often issued post-acquisition, on the corporate group's usual terms, to refinance the initial acquisition financing.

3.5 Private Placements/Loan Notes

See **3.4 Bonds/High-Yield Bonds**.

3.6 Asset-Based Financing

Asset-based financing typically involves assets such as aircrafts, jet engines, vessels and other movable equipment.

Hong Kong is well-positioned for asset-based financing, in particular in light of its mature industrial and trade markets.

Asset-based financing usually involves taking security over the relevant assets. Hong Kong's legal system for taking security is based on the English position and permits security to be granted over a broad range of assets, including future property. Fixed charges and floating charges may be granted, as well as assignments by way of security. Other types of security such as mortgages, title retention, collateral arrangements and flawed asset mechanics are also used.

Separate registers are maintained for mortgages over ships and aircraft registered in Hong Kong.

Further information on taking security is set out in **5. Security**.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

In Hong Kong, two common methods for establishing the relative priorities of different classes of creditor are:

- structural subordination, where the senior creditors lend at a lower level in the group structure than structurally subordinated creditors; and
- contractual subordination, where an intercreditor agreement is used by the creditors to set out an agreed ranking.

The Hong Kong market uses the recommended forms of intercreditor agreement published by the LMA.

Intercreditor agreements are less common in the Hong Kong market compared to the UK and US markets.

The parties to an intercreditor agreement generally include each class of finance-provider – for example, senior lenders, hedge counterparties, high-yield bondholders and any providers of intra-group debt or intragroup loans which downstream any equity contributions into the borrowing group.

To protect the agreed subordination, each creditor group is subject to restrictions on the extent to which they can amend or waive the terms of their debt. To preserve the seniority of the senior creditors' claim, each class of creditor (other than the senior creditors) is generally restricted in relation to:

- the principal, interest, fees and other payments they are permitted to receive; and
- the steps they can take to enforce their debt.

In addition, if a junior creditor receives a payment (or the benefit of a payment) to which it is not contractually entitled in accordance with the intercreditor agreement, a turnover trust or claw-back mechanism generally ensures that any prior-ranking creditor (or security trustee on its behalf) can recover the relevant amount from the junior creditor.

4.2 Bank/Bond Deals

As previously mentioned, the issuance of bonds for initial acquisition financing is unusual in the Hong Kong market.

4.3 Role of Hedge Counterparties

In order to minimise the impact of any interest rate and exchange rate fluctuations, a borrower in a leveraged transaction may enter into hedging arrangements. The hedge counterparty will typically be a party to the intercreditor agreement (and hence will be a secured creditor), ranking at least pari passu with the senior creditors.

5. SECURITY

5.1 Types of Security Commonly Used

Investment grade acquisition financings may be provided on an unsecured basis. Guarantees are commonly provided, in particular from the ultimate parent company in cases where the financing is provided to a subsidiary.

Financings for sub-investment grade/leveraged loans typically involve the provision of both guarantees and security.

The implementation of the security package is usually phased as follows:

- before the closing date, the lenders take security over the shares in the acquisition vehicle and its rights under the acquisition agreement;
- shortly after the closing date, the acquisition vehicle grants security over the shares of the target;
- thereafter, the remainder of the transaction security (which comprises both share security and asset security provided by the target and members of its group (eg, "material companies")) is put into place within an agreed period from the date of closing, in accordance with a set of "agreed security principles" (that is, principles outlining the security sought and the considerations to be taken into account in determining whether security should be provided).

Guarantees are provided on a similar basis and may be required from all "material companies".

If the group involves Hong Kong companies only, all-asset security may be granted. Particu-

lar assets should be considered for any legal impediments to security – the obvious one being receivables agreements which contain a prohibition against granting security.

The choice of security interest depends on the nature of the asset and its importance in the context of the security package. Secured acquisition finance may involve a combination of mortgages, charges and assignments by way of security.

Mortgages

Mortgages involve the transfer of title to the asset to the mortgagee by way of security, with a right to the transfer back of the mortgaged property when the secured obligation is satisfied. Mortgages may be legal or equitable. A legal mortgage involves the transfer of the legal estate in the property. An equitable mortgage involves the transfer of an equitable or beneficial interest and can be of two types. The first type is the transaction that fails to conform to the formal requirements of a legal mortgage but is recognised in equity as a binding undertaking to create a legal mortgage. The second type concerns property that is recognised only in equity (eg, an interest in a trust fund, an asset which is already subject to a legal mortgage, or future property) and over which, therefore, only equitable security can be created.

Lenders do not generally require the more complex steps required to transfer legal title to an asset by way of legal mortgage to be taken in respect of all security assets at the outset of the transaction. In general, only real property, significant items of tangible movable property and aircraft and ships are the subject of legal mortgages (although technically a mortgage over real property may be effected only by a charge by deed expressed to be a legal charge).

In relation to other types of asset, typically equitable security is created and the secured creditors rely on contractual further assurance clauses and a security power of attorney to enable them to transfer the legal title on the security becoming enforceable.

Charges

A charge involves an agreement by the chargor that certain of its property will be charged as security for an obligation. It is a security interest which entails no transfer of title or possession to the chargee. In practice, there is little to distinguish a charge from an equitable mortgage, as the enforcement rights of a mortgage (such as the power to take possession, to sell the secured assets, and/or to appoint a receiver) are routinely included in documents creating charges.

Hong Kong recognises fixed and floating charges.

Fixed charge

A fixed charge may be created over a particular identified property (which may include future property). A fixed charge attaches to a specific asset and a chargor is unable to deal with that asset. The chargee's consent is required for the chargor to dispose of the property free from the charge. If the chargor defaults, the chargee may enforce the charge by selling the property. Typically, the chargee will appoint a third-party receiver to enforce the charge to protect the chargee from potential liability arising from enforcement.

Floating charge

A floating charge is similar to a fixed charge but is created over a moving class of assets (such as stock), which may change on occasion. Unlike a fixed charge, the chargor may dispose of the charged assets and carry on its business as usual until an event (such as the acceleration of an event of default) occurs, which crystallises the floating charge into a fixed charge. Floating charges rank behind fixed charges granted

(before floating charge crystallisation) over the same property.

The key implications of whether a charge is fixed or floating are the registration requirements and the ranking of payments on insolvency. Fixed charges take priority over floating charges where the chargee has had no notice of negative pledge prohibitions. In this case, a floating charge will rank behind the fixed charge on insolvency, as well as the claims of preferential creditors (eg, wages to employees and statutory debts owed to the government). A holder of a fixed charge may be paid out of its security in the winding-up of a company; however, a floating charge-holder can only be paid out if a company's unsecured assets can satisfy the claims of preferential creditors. Preferential creditors are entitled to assets coming into the hands of a receiver in priority to any claims of any holder of a floating charge, even if the company is not being wound up. Further, a charge that was created as a floating charge will continue to be treated as a floating charge (rather than a fixed charge), even after it has crystallised.

When characterising a charge as fixed or floating, the courts will consider the substance of the relationship between the parties (and not simply the words contained in the charge). The descriptive security label used by the parties themselves is largely irrelevant and, if inconsistent with the rights and obligations that the parties have granted to one another, the security will be re-characterised.

Assignments by Way of Security

Assignments by way of security are generally used to secure contractual rights and receivables.

The terms of the contractual rights and receivables should be reviewed to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

The Hong Kong courts (like the English courts) make little distinction between a fixed charge and an assignment by way of security.

As assignment by way of security may be legal or equitable, depending on whether the assignment complies with the requirements for a legal assignment set out in Section 9 of the Law Amendment and Reform (Consolidation) Ordinance (Cap. 23). These include the requirement to provide written notice of the assignment to the debtor or payor to which the contractual rights and receivables relate. The primary difference between a legal and an equitable assignment is that the former entitles the assignee to sue the debtor or payor in its own name without having to join the assignor in the proceedings (although this is not a major issue in practice).

Notice of assignment should in any case be given to the debtor or payor to which the contractual rights and receivables relate to preserve priority.

Security over Certain Types of Assets

The following is a broad indication of the usual types of security which can be taken over various kinds of assets.

Shares

Shares are generally secured under a fixed or floating charge. The charging language used will depend upon whether the shares are held directly in certificated form or indirectly via a nominee or custodian. When taking security over shares, the terms governing the underlying shares must be checked to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended). In the case of a charge over shares held indirectly via a nominee or custodian, the charging language

is more similar to that used for contractual rights and receivables (described below). In the case of a charge over Hong Kong shares held directly in certificated form, the chargor will transfer the share certificate to the chargee and execute a blank form of instrument of transfer and a blank sale contract note, which the chargee may complete upon enforcement and use to transfer the shares to a third party. The chargee may also ask the chargor to arrange for the signature – by the directors of the underlying company whose shares are charged – of certain undated board resolutions and undated resignation letters of directors, with authority for the chargee to complete these documents upon enforcement.

Inventory
Inventory is generally secured under a floating charge.

Bank accounts
A bank account is generally secured under a fixed or floating charge. If the parties intend to create a fixed charge, it is important that the underlying security sufficiently restricts the chargor's ability to deal with the bank account. For example, it is common practice that withdrawals or transfers from the account require the chargee's prior consent. However, many chargor companies will need to maintain some degree of access to their bank accounts, so a fixed security may not be practical.

Contractual rights and receivables
As previously mentioned, an assignment by way of security is generally used to secure contractual rights and receivables. The terms of the contractual rights and receivables should be reviewed to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

Intellectual property rights
Security over intellectual property rights is generally in the form of a mortgage, charge or assignment by way of security.

Real property
Security over Hong Kong real estate is often given by way of a fixed legal charge (whereas security over choses in action related to the property is given by way of an assignment).

Movable assets
Movable assets are generally secured under a fixed or floating charge.

5.2 Form Requirements
A mortgage over a Hong Kong-registered ship must be in a prescribed form.

Although lenders are not required to adopt any specific mortgage form with respect to security created over Hong Kong real estate, the Hong Kong Mortgage Corporation Limited has introduced a set of standard-form model mortgage documents in respect of residential properties.

Certain Hong Kong law security documentation is required to be executed as a deed (see further **10. Jurisdiction-Specific Features**).

5.3 Registration Process
The Companies Registry
Where the grantor is a Hong Kong-incorporated company, or is a non-Hong Kong company that is registered at the Companies Registry (usually required by reason of having a place of business in Hong Kong) and is granting security over Hong Kong property, specified types of securities must be registered with the Companies Registry within one month of execution. Otherwise, the security will be void against any creditor or liquidator, and the chargor company (and certain of its officers) will be committing an offence.

Commonly, registration takes place in respect of security granted over the following asset classes:

- any property where the security granted is a floating charge;
- chattels;
- land;
- book debts (but excluding bank accounts);
- ships;
- aircraft; and
- goodwill, patents, trade marks and copyright.

The above list is not exhaustive. The full list of securities that must be registered is set out in Section 334 of the Companies Ordinance (Chapter 622 of the Laws of Hong Kong).

Although security over a bank account is not registrable as a book debt, it will be registrable if the security is a floating charge. The question of characterisation of security is a matter of both form and substance. A factor to take into account will be the nature of the dealings and interactions between the chargor and chargee.

Registration requirements also apply where an asset is acquired that is subject to security.

Hong Kong Real Estate – the Land Registry

Security over Hong Kong real estate (if registrable) must be registered with the Land Registry to protect its priority. If the document is registered within one month of execution, it takes priority from the date of execution. Late registrations will take priority from the date of registration.

IP Registers

Hong Kong has specific registries for patents, trade marks and designs, although there is no registry for copyright.

Security over patents, registered designs and trade marks are subject to the following registrations:

- security over patents and registered designs must be recorded at the Hong Kong Patents Registry by filing Form P19 or at the Designs Registry by filing Form D5; and
- security over a registered trade mark must be registered at the Trade Marks Registry by filing Form T10.

An unregistered security interest over a registered patent, design or trademark is ineffective against acquirers who did not have notice of the security interest at the time of the acquisition. There is no legal requirement to make the registrations within a specified time, although late registration may impact upon damages' claims as well as priority and perfection against third parties.

Aircraft

Although there is no statutory duty, market practice is to notify the Civil Aviation Department in Hong Kong of the security interest, and to include chargee details on the nameplate of the aircraft to give notice of the security interest to third parties.

Ships

Security over ships is usually by way of mortgage. A mortgage over a Hong Kong-registered ship must be registered with the Hong Kong Shipping Registry. Priority is accorded from the time of registration.

Other Movable Assets

To reduce the risk of tangible charged property being sold to a bona fide purchaser of the legal estate without notice of the charge, where possible, plaques should be attached to the charged property to give notice to third parties of the existence of the charge.

Share Charges

Unless the share charge extends to a charge over dividends, notice is typically not sent to the company whose shares are charged as this will not affect priorities (Section 634 of the Companies Ordinance states that no notice of trust may be entered in a Hong Kong company's register of members). This means that, under a share charge, a chargee is exposed to the risk of a chargor transferring legal title to the charged shares to a bona fide purchaser without notice. Such a bona fide purchaser without notice would likely take the shares free of the charge. Although the chargee holds the share certificate, the chargor may apply to the company for a new share certificate on the basis that the previous share certificate has been lost or destroyed. Although there is a court process under which a "stop notice" may be served by the chargee on the underlying company whose shares are charged, requiring the underlying company to give notice to the chargee if the chargor attempts to transfer the shares, this process is rarely used.

Notice should be sent to the nominee or custodian to preserve priority. For other financial instruments, notice of a charge should usually be given to preserve priority (with the notice given to the person who either owns the instrument on behalf of the chargor, or to the payor under the instrument, as applicable).

Contractual Rights and Receivables

Notice of a charge should be given to the debtor or payor to which the contractual rights and receivables relate to preserve priority.

5.4 Restrictions on Upstream Security

Directors should consider corporate benefit in relation to the granting of upstream or cross-stream guarantees or security (which are granted in favour of obligations of holding companies or sister companies). In these circumstances, the benefit to the company providing the guarantee or security is usually indirect and can be difficult to demonstrate. If directors are in breach of their fiduciary duties by reason of entering into a transaction with no corporate benefit to the company, the directors may be liable to the company and the guarantee or security granted by the company may be unenforceable.

If there is any doubt as to corporate benefit, then (in addition to the directors' resolution) a unanimous shareholders' resolution should be passed which approves the relevant granting of the guarantees or security. Regarding corporate benefit, see further **5.6 Other Restrictions**.

5.5 Financial Assistance

On 3 March 2014, a restatement of the Companies Ordinance was brought into effect. Financial assistance no longer results in underlying transactions becoming voidable, although it remains a criminal offence for the companies (and officers) giving financial assistance. The exemptions from financial assistance have also been broadened.

It is unlawful for a company or any of its subsidiaries to provide financial assistance, either directly or indirectly, where a person has acquired, is acquiring or is proposing to acquire shares in a Hong Kong-incorporated company.

The prohibition only applies in relation to the acquisition of shares in a company which is incorporated in Hong Kong. This means that a Hong Kong-incorporated subsidiary may provide financial assistance for the purpose of a person acquiring shares in a non-Hong Kong-incorporated holding company of that Hong Kong-incorporated subsidiary.

The financial assistance prohibition is subject to a number of exceptions, such as:

- dividend distributions; and
- loans to employees to acquire shares.

Where proposed financial assistance is prohibited, there are a number of procedures (such as shareholder approval or, in limited circumstances, board approval) that may be followed to permit the financial assistance to be given. The particular procedure to take will depend upon the particular fact pattern.

5.6 Other Restrictions

The main considerations in terms of validity of security are compliance with registration requirements, claw-back rules and financial assistance, as well as the presence of corporate benefit.

A company director is under a fiduciary duty to act in the interests of the company. This means that each act of the directors must provide a "benefit" (whether direct or indirect) to the company. Corporate benefit is analysed on a company-by-company basis. Best practice is for the perceived benefits to be recorded in the security-provider's board minutes. A unanimous shareholder resolution may validate a transaction that would otherwise fall outside the scope of the directors' powers. If directors are in any doubt as to whether an act would provide a corporate benefit, they should, therefore, obtain shareholders' approval.

5.7 General Principles of Enforcement

Generally speaking, lenders will draft security documents to enable the lenders to enforce security themselves (or through a security trustee acting on their behalf) without applying to court. The triggers for enforcement will mainly be a matter of contract, and well-drafted security documentation will include detailed provisions relating to the timing and manner of enforcement. Except in limited circumstances, such as real property, Hong Kong law does not prescribe the powers of lenders and/or receivers upon enforcement. Hong Kong law security documents therefore contain a broad list of enforcement powers, which will permit the lender and/or receiver to undertake a range of actions (such as a power of sale and a right to appoint a receiver).

6. GUARANTEES

6.1 Types of Guarantees

Guarantees are commonly used in Hong Kong as a form of credit enhancement. Market documentation prepared by the APLMA includes loan facility agreements with integrated guarantee provisions. The guarantee is typically a downstream guarantee by the parent company of the borrower or upstream guarantees by subsidiaries of the borrower.

A guarantee is a secondary obligation, as it is generally granted to support a borrower's primary obligation to a third party (eg, a loan). Therefore, any variation in that primary obligation will discharge the guarantor's secondary obligation. However, it is usual for this protection to be contractually excluded, such that the obligations of the guarantor are unaffected by any waiver or release of the borrower's obligations.

6.2 Restrictions

When considering whether it is appropriate to enter into a guarantee, the directors of the company must consider whether it is in the best interests of the company to give the guarantee. For downstream guarantees, the directors of a parent guarantor may well be able to conclude that, where a subsidiary borrows funds under the facility agreement (particularly if it is a condition of the agreement that the parent provides a guarantee), the borrowings will enable the subsidiary to carry on and enhance its business, which in turn will provide value to the parent guarantor.

Upstream guarantees can be more complicated. The analysis will always depend on the facts of each transaction, but relevant factors may include the benefit the subsidiary guarantor will

derive from being a member of a group which will have access to increased liquidity or, if the subsidiary guarantor is dependent on the parent borrower for liquidity support or other intra-group services, the benefit derived may be the continuation of those services as a result of the loan being made to the parent borrower. Lenders are likely to require a shareholder resolution to be passed to approve upstream guarantees.

Financial assistance restrictions should be considered if the upstream guarantee relates to a transfer or issue of shares (see further **5.4 Restrictions on Upstream Security** and **5.5 Financial Assistance**).

Claw-back rules should also be considered (see further **7.2 Claw-Back Risk**).

Maintenance of capital rules must also be complied with.

6.3 Requirement for Guarantee Fees

When considering whether it is appropriate to enter into a guarantee, the directors of the company must consider whether it is in the best interests of the company to give the guarantee. For downstream guarantees, the directors of a parent guarantor may well be able to conclude that, where a subsidiary borrows funds under the facility agreement (particularly if it is a condition of the agreement that the parent provides a guarantee), the borrowings will enable the subsidiary to carry on and enhance its business, which in turn will provide value to the parent guarantor.

Upstream guarantees can be more complicated. The analysis will always depend on the facts of each transaction, but relevant factors may include the benefit the subsidiary guarantor will derive from being a member of a group which will have access to increased liquidity or, if the subsidiary guarantor is dependent on the parent borrower for liquidity support or other intra-group services, the benefit derived may be the continuation of those services as a result of the loan being made to the parent borrower. Lenders are likely to require a shareholder resolution to be passed to approve upstream guarantees.

Financial assistance restrictions should be considered if the upstream guarantee relates to a transfer or issue of shares (see further **5.4 Restrictions on Upstream Security** and **5.5 Financial Assistance**).

Claw-back rules should also be considered (see further **7.2 Claw-Back Risk**).

Maintenance of capital rules must also be complied with.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

While Hong Kong law does not prescribe equitable subordination rules, transactions are subject to the risks set out in **7.2 Claw-Back Risk**.

7.2 Claw-Back Risk

Unfair Preferences

If the company in liquidation has previously entered into any transaction influenced by the desire to prefer a particular creditor, guarantor or surety, the liquidator may apply to the court to have the transaction set aside.

Transactions involving persons "connected with the company" (other than by reason only of being an employee) are presumed to be influenced by a desire to prefer (unless the contrary is shown).

In order for the unfair preference transaction to be set aside, the transaction must have occurred within six months prior to the commencement of the liquidation (or, if the preference is given to a person who is connected with the company

(other than by reason of being an employee), within two years prior to the commencement of the liquidation).

The company must have been unable to pay its debts at the relevant time of the unfair preference (or as a consequence thereof).

Where the unfair preference is also a transaction at an undervalue involving persons "connected with the company", the transaction is presumed to have been entered into at a time when the company was unable to pay its debts (unless the contrary is shown).

Undervalue Transactions

A transaction at an undervalue takes place where a company: (i) makes a gift to or enters into a transaction with a person on terms that provide for the company to receive no consideration; or (ii) enters into a transaction with a person for a consideration the value of which is significantly less than the value of the consideration provided by the company.

The transaction at an undervalue must have been entered into in the five-year period before the company's winding-up is commenced.

The company must have been unable to pay its debts at the relevant time of the unfair preference (or as a consequence thereof).

Transactions at an undervalue involving persons "connected with the company" (other than by reason only of being an employee) are presumed to have been entered into at a time when the company was unable to pay its debts (unless the contrary is shown).

The transaction will not be set aside if the court is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and there were reasonable grounds for believing that the transaction would benefit the company.

Invalidity of Floating Charges

Floating charges may be declared invalid by the court if the creation of the charge is within:

- two years before the company's winding-up commenced (if granted in favour of a person who is connected with the company); or
- within 12 months before the company's winding-up commenced (if granted in favour of a non-connected person),

except to the extent of the aggregate amount of: (i) the value of so much of the cash/services consideration (in effect, new consideration) for the creation of the charge; and (ii) the amount of any interest payable thereon pursuant to the charge or consideration agreement (up to 12% per annum).

8. TAX ISSUES

8.1 Stamp Taxes

Hong Kong stamp duty is chargeable on certain transactions (including the issue of certain bearer instruments) but is not chargeable on the entering into or transfer of loan facility agreements (on the basis that a transfer under a loan facility typically will not require registration in a register located in Hong Kong). Lenders may, therefore, transfer their commitments and loans by way of either assignment or novation.

Customarily, lenders will request an indemnity from the obligors for any stamp taxes, as well as a representation that no stamp taxes are payable on the entering into or transfer of the facility agreement.

8.2 Withholding Tax/Qualifying Lender Concepts

Hong Kong does not impose withholding tax on interest.

8.3 Thin-Capitalisation Rules

There are no thin-capitalisation rules in Hong Kong.

However, there are specific rules governing the deductibility of interest expense. For example, no deduction is generally allowed for interest paid to a non-financial institution if the recipient is not subject to tax in Hong Kong on the interest (except where the interest is paid to an overseas associate by a taxpayer that carries on an intra-group financing business). There are also certain anti-avoidance measures, such as a "secured-loan test" and an "interest flow-back test".

9. TAKEOVER FINANCE

9.1 Regulated Targets

The "Merger Rule" in the Competition Ordinance (Cap. 619) prohibits anti-competitive mergers and acquisitions. At present, the Merger Rule only applies to mergers involving carrier licence-holders within the meaning of the Telecommunications Ordinance (Cap. 106).

Where an acquisition involves a target listed on The Stock Exchange of Hong Kong Limited (SEHK), the Rules on Takeovers and Mergers (Takeovers Code) may affect the transaction. Where the Takeovers Code applies, the financial adviser to the offeror is required to provide a letter to the SFC confirming its satisfaction that there are sufficient resources to satisfy the offer in full, outlining the basis for that confirmation and detailing due diligence steps taken (including listing documents reviewed) in order to satisfy itself, and confirming, where relevant, that no subjective conditions are attached to the financing. In relation to any debt financing, the financial adviser therefore needs to be satisfied that the financing constitutes "certain funds". See further **9.2 Listed Targets**.

In acquisitions involving private companies, there is no legal or regulatory requirement for certainty of funding. However, it is nonetheless usual for financing documents for private acquisitions to include "certain funds" provisions, particularly for private equity-backed deals.

In addition, transactions in certain sectors may give rise to specific requirements. Regulated industries in Hong Kong include (but are not limited to) the following sectors:

- telecommunications;
- banking and money lending;
- securities business (including dealing, advisory and asset management); and
- insurance.

The effect on the transaction will vary according to the sector. For example, the consent of the regulator may be required and/or sector-specific licence requirements may need to be complied with. Regulatory compliance by the target group and the maintenance of its required authorisations may need to be addressed in the terms of the debt financing documents (for example, in the conditions precedent, representations, undertakings and events of default in the loan agreement).

9.2 Listed Targets

As explained above, where an acquisition involves a target listed on the SEHK, the Takeovers Code may affect the transaction. Relevant rules under the Takeovers Code for acquisition financing are considered below.

Methods of Acquisition

Takeovers of listed companies are structured either as contractual offers or schemes of arrangement.

A general offer is an offer to acquire all of the shares in the target (ie, those shares not already owned by the offeror or its concert parties). A general offer may either be voluntary or mandatory. In general, a mandatory general offer must be made:

- where a person acquires 30% or more of the voting rights of a company; or
- when a person already holds between 30% to 50% of the voting rights of a company, and that person then acquires additional voting rights which has the effect of increasing that person's holding of voting rights by more than 2% from the lowest percentage holding in the previous 12-month period.

A scheme of arrangement is a statutory process. A scheme of arrangement under Division 2 of Part 13 of the Companies Ordinance (Cap. 622) applies to Hong Kong incorporated companies. Similar provisions exist under both the Cayman Islands and Bermuda companies' legislation. A scheme involves a corporate restructuring sanctioned by the court, where the shares held by the target shareholders are either acquired by the offeror or cancelled – the end result in both cases is that the offeror holds 100% of the target. Under the Companies Ordinance (which applies to Hong Kong-incorporated targets), a scheme must be approved at a shareholders meeting by shareholders representing at least 75% of the voting rights present and voting, in person or by proxy, and the votes cast against the scheme must not exceed 10% of the total voting rights attached to all "disinterested shares" in the company. Similar requirements are also contained in the Takeovers Code, although the definition of "disinterested shares" under the Takeovers Code is different from that used in the Companies Ordinance (although the two definitions overlap substantially). Where both the Companies Ordinance and the Takeovers Code apply, care should be taken to check that the requirements have been met under both sets of rules.

Funding

The Takeovers Code imposes requirements on both the offeror and its financial adviser relating to financing the proposed offer. It is a general principle under the Takeovers Code that no offer can be announced unless the offeror (and its financial adviser) has every reason to believe that the offeror can and will continue to be able to implement the offer in full (including the availability of financial resources).

The requirements apply in the context of any kind of offer – mandatory general offer, voluntary general offer or scheme of arrangement, and whether or not announced on an absolute or pre-conditional basis. The requirements also apply to all types of consideration (eg, cash, securities, other assets, etc), with slightly different implications and practical requirements for each type.

The financial adviser's confirmation that financial resources are available to the offeror which are sufficient to satisfy full acceptance of the offer is required on the following occasions:

- Rule 3.5 of the Takeovers Code requires the initial announcement of the offer to include the financial adviser's confirmation to the offeree/target shareholders; and
- the Takeovers Code also requires the offer document to the offeree/target shareholders to include a further confirmation from the financial adviser in respect of the same matter.

The Takeovers Code expects that a financial adviser – who has given the cash confirmation – may be required to provide the cash consideration if the offeror is unable to pay for the offer. The financial adviser will not, however, be expected to provide the cash consideration itself if, in giving the confirmation, it acted responsibly and took all reasonable steps to assure itself that the cash was available. An erroneous cash confirmation may have serious consequences for a financial adviser's licensed regulatory status in Hong Kong.

The Takeovers Code requires the financial adviser to provide a letter to the SFC confirming its satisfaction that there are sufficient resources to satisfy the offer in full, outlining the basis for that confirmation and detailing due diligence steps taken (including listing documents reviewed) in order to satisfy itself, and confirming, where relevant, that no subjective conditions are attached to the financing. A financial adviser is not expected to provide copies of supporting documentation unless requested to do so by the SFC. The financial adviser is also required to provide the SFC with an updated supplementary confirmation before the offer document is despatched to the offeree/target shareholders.

The SFC may ask for further evidence to support the financial adviser's confirmation statement and/or the offeror's ability to satisfy its obligations (and has even gone as far as requiring the offeror to put funds into escrow).

Note 3 to Rule 3.5 of the Takeovers Code states that the financial adviser, in discharging its duties to confirm financial resources, should observe the highest standards of care to satisfy itself of the adequacy of the resources and perform due diligence. This usually requires a degree of financial due diligence from the financial adviser, sufficient to justify an unconditional confirmation.

If the cash resources are to come wholly or partially from an external financing facility, the full facility agreement (and not a non-binding term sheet) should be signed prior to announcement. The key is that the documentation needs to be in a form under which the offeror is unconditionally entitled to draw down funds on a "certain funds" basis for a sufficient period to complete the offer. Key considerations in this regard include the following.

- Typical limitations on draw-down (such as conditions relating to the continued accuracy of representations and warranties, the non-occurrence of events of default, the inclusion of a business MAC or a market MAC condition) would not be permissible, unless the limitation addressed specific core representations and defaults such as offeror insolvency or a change in the law making lending illegal (which are events that can be caused or triggered by third parties). The Practice Notes to the Takeovers Code address this distinction by stating that "no subjective conditions should be attached to any financing" in the context of the financial adviser's confirmation.
- The financial advisers must ensure that the facility continues to be available throughout the whole of the offer period (without amendment to its terms that would affect its availability without their approval), and be capable of being drawn down for the full offer period and throughout the compulsory acquisition period.
- If the loan financing contemplates security being granted at the target level or below, draw-down needs to be structured so that the facility is available initially without that security having been created (as usually it would be necessary to acquire 100% of the target first, and then go through financial assistance whitewash procedures before the security can be granted). Creation of security at this level is therefore usually structured as a con-

dition subsequent to draw-down, rather than a condition precedent.

The Takeovers Code emphasises the vital importance of secrecy before an announcement. Care must be taken to preserve absolute secrecy and all persons privy to confidential information, particularly price-sensitive information concerning an offer or contemplated offer, must treat that information as secret and must conduct themselves so as to minimise the chances of an accidental leak of information. These rules affect the manner in which debt can be arranged and syndicated, both prior to and after the commencement of an offer period.

The information in the offer document must be sufficient for shareholders to reach a properly informed decision as to the merits of the relevant offer, and it is important that information about the companies involved in the offer is made equally available to all shareholders. In this regard, various documents must be on display until the end of the offer period. In limited circumstances, documents on display include documents relating to the financing arrangements for the offer.

All offer documents must contain a description of how the offer is to be financed and the source of the finance (except for cash offers seeking to privatise the offeree company, and without any waiver of the acceptance condition). The principal lenders or arrangers of such finance must be named. Where the offeror intends that the payment of interest on, repayment of or security for any liability (contingent or otherwise) will depend to any significant extent on the business of the offeree company, a description of the arrangements contemplated will be required. Where this is not the case, a negative statement to this effect must be made.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

The Companies (Corporate Rescue) Bill

Unlike England and Wales, Hong Kong does not have a prohibition against "wrongful trading" or "insolvent trading".

The Hong Kong government proposes to update the insolvency regime and include a statutory corporate rescue procedure and insolvent trading provisions. This follows previous proposals made in 1996.

The proposed bill includes a statutory moratorium (ie, a suspension on all winding-up petitions and other civil proceedings against a company facing financial difficulties). This is a timely proposal in light of the recent distress faced by many companies due to the COVID-19 outbreak. In addition, practitioners, judges and academics have long criticised the limited opportunities for a business facing economic difficulties to be able to restructure its debts.

Under the proposed bill, a provisional supervisor (an independent professional third party) will displace the directors and management of the company and act as the company's agent – although the provisional supervisor may agree for a director or officer to continue in their existing roles (or to appoint a new director). This arrangement is different from the US Chapter 11 debtor-in-possession model, which allows the directors and management of the company to remain in control of the company.

The corporate rescue regime is also expected to include a wrongful trading/insolvent trading provision to make directors (and possibly other officers) liable for debts incurred during the period from when they knew or should have known that the company would not be able to avoid

insolvency. These proposed "creditor-friendly" changes will supplement the existing framework on fraudulent trading (which exposes directors to criminal and civil liability for carrying on business with the intention to defraud creditors or for any fraudulent purpose).

After a company goes into insolvent liquidation, the liquidator will be empowered to apply to the court to seek a declaration that a director of the company is responsible for insolvent trading of the company is liable to make a contribution to the company's assets that the court considers appropriate. The director's liability is civil in nature.

Execution of Deeds – Non-Hong Kong-incorporated Companies

Hong Kong's Companies Ordinance (Cap. 622) is silent on the formalities of execution by a foreign corporation of a Hong Kong law document. Market practice differs on the approach for giving Hong Kong law enforceability legal opinions in respect of Hong Kong law deeds executed by foreign corporations, in particular when the foreign corporation does not have a seal.

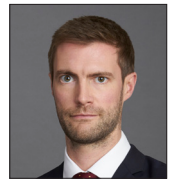
Where a foreign corporation is to sign a Hong Kong law deed, the process and method of execution should be discussed and settled between Hong Kong legal counsel before commencing the process of seeking corporate authorisations and collecting signatures.

Slaughter and May is a leading international law firm with a worldwide corporate, commercial and financing practice. Globally, the firm has over 800 legal staff in its London, Hong Kong, Beijing and Brussels offices. Slaughter and May has a long-standing presence in Asia, and has 13 partners and over 40 lawyers in the Beijing and Hong Kong offices. The firm has a premier financing practice and regularly advises on loan financing and financing of public takeovers, private acquisitions and asset purchases, debt issues and MTN programmes. The firm's expertise spans the breadth of the market, including investment grade corporate acquisition facilities, acquisition financing packages to support leveraged buyouts and entirely bespoke loan financing arrangements. Relevant clients include S.F. Holdings, Tencent Holdings, Allianz Real Estate, CK Asset Holdings, Hong Kong Exchanges and Clearing Limited, China Power International, SPIC, United Energy Group, PTT Exploration and Production Public Company Limited, China Investment Corporation, China Construction Bank, CICC, OCBC.

The authors would like to thank their colleague Adrien Yeung for her assistance in preparing this chapter.

AUTHORS

Peter Lake is a partner at Slaughter and May, based in Hong Kong. He joined the firm in 1997 and became a partner in 2008. Peter is involved in a wide range of corporate work, advising companies, financial institutions and fund management groups. Peter is a member of the APLMA Hong Kong Documentation Committee and a member of the Law Society of Hong Kong's Investment Products and Financial Services Committee. Peter has authored and co-authored several publications relating to acquisition finance. Peter is admitted as a solicitor in England and Wales and in Hong Kong.



Mike Ringer is a counsel of Slaughter and May based in Hong Kong. He joined the firm in 2010 and became a counsel in 2020. Mike has a wide-ranging practice covering the full spectrum of corporate, financing and regulatory work. His clients include regulators, market infrastructure operators, commercial and investment banks, insurers, asset managers and corporates, as well as international fintech businesses and other emerging tech businesses at various stages of development. Mike has authored and co-authored several publications relating to acquisition finance. Mike is admitted as a solicitor in England and Wales and in Hong Kong.

Ariad Porat is an associate at Slaughter and May based in Hong Kong. He joined the firm in 2018. Ariad has a wide-ranging corporate practice, including banking and finance, private equity, mergers and acquisitions and general corporate advice. Ariad is a member of the Israel Bar Association and a registered foreign lawyer in Hong Kong.

Slaughter and May

47th Floor
Jardine House
One Connaught Place
Central Hong Kong
China

Tel: +852 2521 0551
Fax: +852 2845 2125
Email: mike.ringer@slaughterandmay.com
Web: www.slaughterandmay.com

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