PRACTICE NOTE

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Put and Call Option Agreements (Hong Kong)

by Virginia Tam, K&L Gates

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A Practice Note of the key considerations when drafting a put and call option agreement to make it compliant with Hong Kong law. Key considerations include the option exercise period, exercise price, restrictions on transfer, anti-dilution mechanisms, and other typical features of a put option and call option agreement regarding shares in private companies incorporated in Hong Kong.

This Practice Note provides background commentary in relation to issues of Hong Kong law that may impact Standard Document, Put and Call Option Agreement: Cross-Border: Clause 1.1. Where clauses in the Standard Document need to be amended to comply with Hong Kong law, suggested drafting is provided. For consistency with the Standard Document, the grantor of an option is generally referred to as "seller" and the grantee as "buyer" in this Note.

This Note also assumes that the assets underlying the options, as in the Standard Document, consist only of shares of common stock of private companies incorporated in Hong Kong and covers only issues of Hong Kong law that may impact the Standard Document. Additional Hong Kong law and regulations outside the scope of this Note must be considered if either:

- The underlying shares the option or the shares of the buyer or seller are publicly traded in Hong Kong.
- Exercising the option will result in a transfer, directly or indirectly, of shares that are publicly traded in Hong Kong.

Put and Call Options

A right of purchase, or a call option, is a contractual right to purchase shares from the seller. Conversely, a right of sale, or a put option, is a contractual right to sell shares to the seller. In each case, the right of the option holder to require the counterparty to consummate the share purchase (in a call option) or the share sale (in a put option) is subject to the terms and conditions agreed between the parties, such as:

- The conditions that must be fulfilled before the right becomes exercisable.
- The period during which the holder may exercise the right.
- The consideration payable (in a call option) or receivable (in a put option) by the holder in exchange for the underlying shares.

An option agreement usually prescribes a series of actions for the parties to take when the holder exercises its option, including settlement of the consideration. These actions are influenced strongly by the local law applicable to the transfer of the underlying shares.

A share is a share in a company's capital or stock (section 2, Companies Ordinance (Cap 622)). In other words, shares are units of stock representing equity ownership of the company whose terms and conditions are prescribed by the company's articles of association.

Shares in a Hong Kong company only exist in registered form. Bearer shares are not recognised (section 139, Companies Ordinance). Before a transfer of legal title to shares in a Hong Kong company can be effected under section 155 of the Companies Ordinance, the parties must:

- Enter a set of bought and sold notes (section 150, Companies Ordinance and section 19, Stamp Duty Ordinance (Cap 117)).
- Have the Hong Kong tax authority stamp the notes after paying the statutory stamp duty (section 150, Companies Ordinance and section 19, Stamp Duty Ordinance).
- Have the company secretary enter the option holder's name in the company's register of members (section 112(3), Companies Ordinance).

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Unlike shares, an option to acquire shares is only a contractual right and does not confer its holder any statutory ownership right in the company unless the agreed terms of the option are incorporated into the company's articles of association. The requirements governing the issue, transfer, and redemption of shares under the Companies Ordinance are limited to shares and do not apply to options or other equity derivatives of a company.

An option is freely transferable under Hong Kong law unless the terms of the option provide otherwise. However, the absence of transfer restrictions on the face of the option agreement does not mean that the underlying shares are freely transferable or that the parties have the right to deal with the underlying shares in the manner contemplated by the option agreement. For example, the company's constitutional documents, applicable law of other jurisdictions, or contractual undertakings previously made by a party, such as a right of first refusal contained in a shareholders' agreement, may limit the sale, purchase, or transfer of the option or underlying shares (see Transfers to Third Parties).

A buyer should conduct due diligence to confirm that any legal or other impediments have been dealt with at the time of the option purchase (and if not, is reflected in the pricing). For example, in a Hong Kong private company, a transfer of shares may be blocked by the board of directors of the company on reasonable grounds (sections 11 and 151, Companies Ordinance).

An issuance of shares, unless previously approved by shareholders, is subject to the pre-emptive right of all existing shareholders (sections 140(1), 140(2), and 141(2), Companies Ordinance). A transfer of a controlling interest in a regulated entity generally requires the prior consent of the regulator, such as:

- The Securities Futures Commission for any company or individual to become a substantial shareholder of a licenced corporation.
- The Hong Kong Monetary Authority for any person to become a controller of an authorised institution incorporated in Hong Kong.

Other regulators have similar consent and approval requirements where there is a change of control for a regulated entity.

Put and call options can be found outside option agreements. Some constitutional documents of corporate entities include put and call rights for shareholders and the company that are typically exercisable when certain events occur. Options can also be used:

- As a pre-agreed mechanism to resolve deadlock between business partners, such as "Russian roulette" or "Texas shootout" clauses in joint venture contracts.
- To regulate the sale of shares in a private company, such as a right of first offer or refusal and tag along or drag along rights in shareholders' agreements.
- As equity kickers to lower interest rates in a company's debt instruments. For example, investors in a preferred stock may accept warrants in exchange for lower dividends.

Convertible bonds of publicly traded companies work under a substantially similar concept. With all else equal, a debt derivative with an option component carries a lower interest rate than straight bonds of the same company when issued. After issuance, however, the debt derivative's market value diverges from its straight bond counterpart, as the value of the embedded option is affected by the trading price of the underlying shares.

Option Exercise Period

An exercise period, the period during which an option can be exercised, is an important commercial term of options. Most options have an exercise period and can have more than one. These periods are formulated in many ways, such as:

- Specific dates, for example:
  - any time before 31 December 2026; and
  - between the second anniversary and the fourth anniversary of the issuance date.
- Specific events, for example:
  - any time if the company cannot complete an initial public offering within three years of the issuance date; and
  - within 10 business days after the notice of a trade sale is given.

An option's expiration date is a related but distinct concept to an option's exercise period as:

- The expiration terminates the contract. An option can expire without the right becoming exercisable.
- The exercise period defines when the option can be exercised. An exercise period can end with the option remaining exercisable in future exercise periods.

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If an option does not contain an end date for its exercise period, the exercise period ends, in practice, when either:

- The option expires.
- The underlying asset ceases to exist.
- It becomes clear that the conditions precedent to the exercise can never be fulfilled.

For example, an option that is only exercisable when a company exceeds a specific income threshold in the fiscal year ending 31 December 2024 effectively expires without ever having been exercisable if the company's net income in 2024 does not meet the threshold.

However, an option with neither an expiration date nor an end date for its exercise period can possibly never lapse. For example, an option may never lapse where both:

- The underlying asset has an indefinite shelf life, such as securities and land.
- There remains a real possibility that the condition precedent to the option's exercise can be fulfilled.

Options of this nature are sometimes called perpetual or evergreen options.

Options with no expiration date and with an indefinite exercise period can be written, valued, and traded, such as perpetual preferred stock, which is dividend-paying stock with no redemption rights for the holder. Investment products of this nature usually contain a call option giving the issuer the right to redeem the stock, force a conversion into common stock, or both.

Hong Kong does not have statutory law governing options relating to shares. If there is a dispute on the validity or enforceability of an option without an expiration date or end date to the exercise period of an option, the issue is analysed in the context of the parties' bargain. Hong Kong judges have the discretion to consider case law in all Commonwealth jurisdictions. If a Hong Kong court were asked to rule on the validity and enforceability of a perpetual option, the court would likely interpret the option agreement using the common law principles applicable to contracts generally under English law, which would result in either:

- A literal interpretation (see Literal Interpretation).
- A rectification (see Rectification).
- A nullification (see Nullification).

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 1.1. However, a lack of clarity on the exercise period could bring uncertainties on the validity or enforceability of an option under Hong Kong law. The concept of the defined term "Option Period" should be retained, whether in clause 1.1 or elsewhere in the agreement, even if the parties intended that the options be exercisable immediately upon the execution of the agreement.

Literal interpretation

In a literal interpretation, a court follows the parol evidence rule. The court would hold that the buyer's option right continues indefinitely. This outcome is more likely if:

- This reading is consistent with the remainder of the agreement.
- The obligations can be performed on the terms stipulated.
- The facts do not justify the court to make an exception to the parol evidence rule.

Rectification

In a rectification, a court exercises its discretion to rectify an option agreement by adding an end date to the exercise period. Common law courts are reluctant to imply terms into a contract. This outcome is more likely if there are exceptional circumstances calling for the court's intervention. When interpreting a contract, the court considers:

- The parties' intent, commercial purpose, and prior dealings.
- Industry custom.
- A reasonable person's expectations under the circumstances then existing.

When an agreement does not contain any provisions addressing termination, it is not a narrow construction question of putting a meaning that the parties have used. Rather, it is a wider question of ascertaining the parties' common intention when they entered the agreement considering all admissible evidence and what the parties have said or omitted to say in the agreement (Hong Kong Polytechnic Uni. v Rehabaid Society [2022] HKCFI 2830).

In *Hong Kong Polytechnic*, a university granted a licence to use its premises that did not contain an express provision on how the licence could be cancelled. The court ruled in the licensor's favour, holding that a term could only be implied if, without the term, the contract would lack commercial or practical coherence. Considering the heavy financial burden the licensor shouldered in subsidising the use of the premise, the end of the

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collaboration between the parties gave rise to a right to terminate the licence unilaterally after giving reasonable notice and a perpetual licence would be unreasonable.

Implied terms are rarely added to a contract unless these terms are necessary (*L. French & Co v Leeston Shipping Co* (1922) 1 A.C. 451, 455). The court in *L. French* refused to imply a provision preventing a ship owner from selling its ship to a third party during the duration of a charter. Although the sale terminated the charter and principal-agent relationship early, the agent's lost commission for the remaining charter term did not remove the commercial coherency of the agreement.

Generally, an agreement that is silent on termination is not terminable unless the facts of the case, such as subject matter, nature, or context of its formation, support a finding that the parties intended that it should be terminable (*Directors, &C., of Llanelly Railway and Dock Co. v Directors, &C., of London and Northwestern Railway Co.* (1874-75) L.R. 7 H.L. 550). In *Llanelly Railway*, and agreement in which a railroad operator granted another railroad operator the right to run its trains over its tracks as part of a loan arrangement did not contain a termination clause. The court refused to imply a term into the arrangement, which made the grant perpetual.

Although common law courts are reluctant to imply a termination clause into an agreement without one, as a matter of contract interpretation, the courts consider trade usage and industry customs when ascertaining the parties' intended meaning of existing contract clauses (*Hutton v Warren* (1836) 1 M. & W). In *Hutton*, a farmer contended that it was customary for a landlord to pay its tenant a reasonable sum for the cost of seeds and labour bestowed on the land when a lease expired. Although the lease did not contain an express term, the court adopted the tenant's position on the grounds that customary practice was, by implication, imported into the lease.

Common law courts are more receptive to imply a term into a contract if the contract parties, acting reasonably, would have agreed to the term had it been suggested to them (*Liverpool City Council v Irwin (1977) A.C. 239, 258, 266*). In *Liverpool City Council*, a tenant-in-arrears counter-claimed his landlord for its failure to maintain common facilities. Although the lease did not impose this obligation on the landlord, the court held that the lease requires the landlord to take reasonable steps to maintain common areas in a reasonable state of repair.

Nullification

In a nullification, the court declares an option agreement void because substantial uncertainty exists in ascertaining the bargain struck between the parties (*Teekay Tankers Ltd v STX* [2017] EWHC 253 (Comm)). In *Teekay*, a shipping company and shipbuilder entered an option agreement for purchasing additional oil tankers. The court voided the agreement, as the delivery date of the oil tankers was an essential term for dealings of this nature and this term could not be determined with certainty under the circumstances.

Acceleration Events

Some options contain acceleration provisions that make the option immediately exercisable when a specific event occurs. Acceleration provisions can also be considered as the commencement of the exercise period of an option.

Call options for shares in a company can be held by the company, company founder, private equity investors, management, and employees. Acceleration provisions in these call options can vary, as the commercial objectives behind them are different. For instance, option rights held by private equity investors are usually accelerated when the company reaches a milestone, such as a trade sale. Controlling persons, including a founder and senior management, of the company may have similar rights in the same situation but with a different acceleration timetable, as their knowledge and services may be essential during the transition period.

Acceleration provisions serving the same commercial objectives can vary. Depending on the agreement between the parties, call options a passive investor holds can contain acceleration provisions triggered by:

- A trade sale, which is triggered when a company's business is sold to a third party. The rationale for this provision is that when all of the company's shareholders are selling their shares for cash, whether by choice or under a contractual obligation, an option holder should be treated the same as the other shareholders. A carefully drafted provision usually contains a mechanism requiring the company to:
  - provide advance notice to the option holder, allowing the holder to exercise the option prior to the trade sale, with the company being obligated to unwind the option exercise if the trade sale cannot be completed; or

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- remit a cash amount that reflects the price difference between the exercise price and consideration the third party paid in the trade sale without the option holder having to exercise the option.

- A change of control, which is like a trade sale except that controlling persons, not the remaining shareholders (such as professional managers and private equity funds), sell their shares to a third party for cash. One rationale for this arrangement is that the option holder's fundamental investment assumption (that people who are deeply knowledgeable of the business's core elements operate the company) is no longer true and the investor should have an exit option. To address the option holder's concern over the departure of the controlling persons, acceleration provisions of this nature are either accompanied by a tag-along right to co-sell with these persons or a right to require the company to redeem the underlying shares.
- An initial public offering, which is triggered when a company completes its initial public offering. The rationale for this provision is that, when the company achieves a significant milestone, all investors, including option holders, should be given the opportunity to exit by exercising the option and selling the underlying shares in the public market. To increase the confidence of the company's new investors, controlling persons who exercise their options usually agree not to sell their shares for a certain period after the initial public offering. Controlling persons therefore may exercise their options later than the other investors even though the exercise period of their options is identical to the one for passive investors.

Options containing acceleration provisions may work to the holder's disadvantage, especially when the acceleration event starts a short exercise period after which the option expires. For example, an unexercised option can expire when a trade sale or initial public offering concludes. If the company's valuation in the acceleration event is lower than the valuation that the exercise price of the option implies, the acceleration provision leaves the holder with the unappealing choices of either:

- Losing all investment in the option.
- Paying the option price to retain the equity interest in the company and suffering an immediate capital loss.

Options usually include mechanisms that preserve the holder's bargained rights when the company's capital structure changes. For example, if the company merges into another company and the underlying shares are exchanged into a different class of securities or property, the option remains outstanding after the event and becomes exercisable for that different class of securities.

Under market practice in Hong Kong, option holders are often required to exercise their options after the company enters a contract when an acceleration event occurs. However, the exercised notice is deemed cancelled if the triggering event is not completed. Thus the term "Third Party Offer" in the Standard Document, Put and Call Option Agreement: Cross-border: Clause 1.1 should be modified to the term "Trade Sale" and its definition should refer to "a sale to a third party" instead of "an offer by a third party."

Consideration for Grant of a Put or Call Option

Consideration is construed broadly under common law in Hong Kong. Any benefit on the part of the seller or detriment on the part of the buyer suffices, however small. Notwithstanding the foregoing, market practice in Hong Kong is for the parties to execute option agreements in the form of deeds. Deeds are enforceable irrespective of whether the grant is supported by consideration. Deeds also enjoy a longer statute of limitations (12 years from the date of breach) than contracts (six years, from the date of breach).

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 3.1 and Clause 3.2.

Determination of Exercise Price

If an option requires the exercise price be payable in cash, the parties can agree on a dollar amount or formula, together with any adjustment mechanism, so that the amount payable when the option is exercised reflects their economic expectations. The exercise price is a product of the bargaining power between the parties, allocation of the risks inherent to the underlying shares, and the purpose behind the option. An option granted to protect a private equity investor against the consequences of a future down round is often formulated differently from an option granted to protect a shareholder against the consequences of a deadlock between the parties.

The common calculation methods are an agreed:

- Dollar figure, which is usually a fixed amount subject to anti-dilution adjustments.

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- Comparable, which is usually linked to the most recent equity financing the company completed at the time of exercise.
- Cost of funds, which is usually based on the original investment amount plus the accrued interest on that amount at a fixed rate (or a prescribed benchmark rate).
- Valuation formula, which is usually based on:
  - data that can be derived from the company's audited financial statements, such as net asset value, EBITDA, or earnings; or
  - closing market prices in a fixed period, if the underlying shares are publicly traded.
- Valuation mechanism, which is usually based on valuation opinions from one or more professional firms.

There is no statutory provision that restricts the parties' freedom to set the option exercise price, payment schedule, or form of payment in Hong Kong. However, it is important to check the law applicable to the seller's jurisdiction of incorporation or principal place of business. For example, there are detailed procedures governing the disposition of assets by a state-owned enterprise in China, including pricing.

It is not essential that the exercise price be determined when the option is granted. An option agreement could, in lieu of a fixed dollar amount, prescribe the mechanisms for the parties to arrive at an exercise price at the time of exercise. The parties should also consider stipulating the dispute resolution procedures, such as a third party valuation firm or mediator, to minimise delay and litigation costs (see Independent Determination).

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 7.2. If the option can be exercised in part, there should be an adjustment mechanism in determining the amount of consideration payable by the buyer.

Exercise Price Set at Fair Market Value

For parties who cannot agree to a fixed dollar amount, formula, or benchmark for the exercise price, a solution is to fix the exercise price at the fair market value of the shares on the date the option is exercised. Fair market value is the price at which a willing seller would sell and a willing buyer would buy in an arm's-length transaction without unusual time constraints or business considerations.

Fair market value can be determined by referencing the company's performance based on selected accounting figures contained in its financial statements either for a given:

- Date, such as net assets.
- Period, such as net income.

Depending on special circumstances of the company and industry practice, the parties can agree to either:

- Adjust the accounting figures to consider various assumptions.
- Use the accounting figures as a starting point to arrive at financial measures that more accurately reflect the company's performance.

Another method is for the parties to agree on a mechanism where third parties determine fair market value instead of agreeing to a formula at the outset.

Independent Determination

The exercise price and the number of underlying shares to be delivered on exercise are among the most important commercial terms in an option agreement. It is common for the parties to pre-agree on a mechanism to arrive at these numbers. The dispute risk is higher when these terms can only be determined either:

- When the option is exercised based on a complex formula or potentially contentious methodology.
- By using a modified formula or methodology due to changes in the company's capital structure or status, such as a spin-off or business combination.

Most anticipated disagreements can be resolved by appointing an independent expert if there is little ambiguity in the pricing formulae.

Under market practice in Hong Kong, the original agreement usually sets the mechanisms for selecting and appointing third party experts, such as:

- A selection, where an expert is selected by mutual agreement based on a set of pre-agreed criteria (for example, a "big four" accounting firm).
- A failure to agree, where, if the parties cannot agree on a candidate, each party can nominate one expert that in turn jointly select a third expert. Depending on the amount at stake, either the third expert or the three-expert panel resolves the dispute.
- An appointment, where after finding a suitable expert, both parties jointly appoint the expert.
- An effect of the findings, where an expert's ruling on the financial terms is deemed final absent manifest error.

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- Costs, where costs are borne by:
  - the parties equally; or
  - the party whose position the expert rejected.

These mechanisms are not mandatory and the parties are free to agree otherwise.

Usually, the independent expert's role is limited to the numbers. If there are disputes relating to other terms, such as the conditions precedent to the exercise, the parties would need to resolve them in court or, if pre-agreed, through arbitration or mediation.

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 7.3 or Clause 12. Under market practice in Hong Kong, the party whose position is rejected by the independent expert sometimes bears the independent expert's costs.

Consideration in the Form of Shares in the Buyer

An exercise price can be settled in securities of another issuer or other assets instead of cash. The option becomes an agreement on the potential exchange of assets. The seller should seek standard warranties from the buyer regarding the properties when the buyer exercises the option, including the warranty of:

- Power and authority, in which the buyer has full power and authority and taken all requisite actions necessary to deliver the properties.
- Approvals and consents, in which the buyer obtained any necessary third-party approvals, waivers, or consents to sell the properties, all of which are in full force and effect.
- No encumbrances, in which the properties are free and clear of all encumbrances.
- No needed regulatory approval, in which the sale does not require an action or filing with any person or governmental body.
- No conflict or breach, in which the sale does not create a conflict, breach, or default under the constitutional documents, applicable law, or the buyer's material contracts.
- Title to properties, in which the seller is duly registered as owning the properties.

If the properties to be delivered by the buyer are shares or other equity securities of the buyer or another entity, the seller may want the buyer to make additional warranties related to those securities, such as:

- The capitalisation of the issuer and equity ownership in the issuer that the securities represent.
- The results of operations.
- The issuer's financial condition.
- The absence of any material adverse change since the option was granted.
- The issuer's status, such as operations that comply with the law, no litigation, and title to assets.

If the shares underlying the option are delivered in exchange for another class of securities, the exchange ratio between these two classes of securities can be complex, as the capital structure of the buyer and seller can change in the future. The parties should consider whether to incorporate anti-dilution provisions in the agreement or agree on a numeric formula with one or more illustrated examples.

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 7.1 if the exercise price will be settled in cash. If the exercise price will be settled in securities the buyer issues, the scope of the warranties should be agreed and set out in the option agreement. The buyer's giving of these warranties should be a condition precedent to the seller performing its obligations.

Statutory Restrictions on Transfer of Shares

When an option gives the buyer the right to subscribe for shares in a Hong Kong company, exercising the option triggers a statutory right that allows the company's existing shareholders to subscribe for additional shares in proportion to their respective shareholdings unless either:

- Each existing shareholder waives the right.
- The shareholders approve the share issuance as prescribed by sections 140 and 141 of the Companies Ordinance.

Shareholder approval is the preferred approach. The threshold for shareholder approval is a majority vote in a shareholders' meeting. In comparison, the company can only grant a waiver of pre-emptive rights with the consent of every shareholder.

In practice, the shareholder resolution approving the option grant typically covers the issuance of new shares when the option is exercised. Therefore, no additional waivers are needed when the option is exercised.

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When an option gives the buyer a right to acquire shares held by a shareholder of a Hong Kong company, neither granting nor exercising the option requires a waiver or approval by the other shareholders (section 150, Companies Ordinance). However, the buyer should check if the other shareholders have a right of first refusal or similar rights under the company's constitutional documents or any contracts to which the seller is a party, such as a shareholders' agreement.

Additionally, the board of directors of a Hong Kong private company must approve any transfer of the company's shares (section 11, Companies Ordinance). Therefore, the buyer should obtain evidence of board approval by the company issuing the shares to the option holder before acquiring an option to acquire existing shares.

Transfers to Third Parties

Since an option is deemed a binding promise of the seller to sell to (in a call option) or purchase from (in a put option) the buyer the underlying shares at the buyer's discretion, it is important to consider the transferability of the option from a commercial perspective (see Put and Call Options). The option agreement should contain a provision that either limits the transferability or clarifies that the option can be freely transferred.

Under market practice in Hong Kong, buyers rarely have an unrestricted right to transfer an option, whether in full or in part, to a third party. The limitations are partly due to statutory restrictions on the transfer of shares and the number of shareholders in a Hong Kong private company (sections 11, 150, and 151, Companies Ordinance). If the intent is to transfer the option, both parties should conduct the necessary due diligence to ensure that no additional consent is needed when the option is transferred or exercised by the transferee.

If the intent is to not transfer of the option, the option agreement can contain a clause such as:

> "This option is personal to the grantee and shall not be transferable or assignable. The grantee shall not sell, transfer, charge, mortgage, encumber or otherwise dispose of or create any interest in favour of or enter into any agreement with any other person over or in relation to this option or any portion thereof, unless prior written consent is given by the grantor, which consent may be withheld for any reason or no reason."

Employee Consultation

Employees of a Hong Kong company do not have a statutory right to be consulted in a change of control of the company (section 31J, Employment Ordinance (Cap 57)). In a trade sale of a Hong Kong business, there is no general requirement to consult employees in relation to the sale and employees are not automatically transferred by law. When a seller wishes to transfer its employees to the buyer:

- The relevant employee's contracts must be terminated.
- The buyer must make an employment offer to the employees.
- The employees must accept the offer.

The company can agree to similar measures through contracts, such as shareholders' agreements and employment agreements, or incorporate these measures into the company's articles. However, these scenarios are rare under market practice in Hong Kong.

Dividends

Hong Kong statutory law has no mandatory provisions that limit the parties from deciding how dividends (or other distributions) regarding shares underlying an option are apportioned. Shares are issued in registered form. A Hong Kong company distributes dividends related to shares to owners whose names are shown on its register of members.

The buyer of a call option is not the registered holder of the underlying shares before exercising the option and completing the share transfer procedures under Hong Kong law. Until the buyer completes these actions, the default position is that the buyer is not entitled to receive dividends related to the shares (see section 177, Companies Ordinance).

Absent a contrary provision in an option agreement, the seller can retain the benefit of the dividends until the option is exercised. After the option is exercised, market practice is that the buyer acquires all beneficial interest in the shares on the date of notice, subject to the buyer paying the exercise price. Therefore, the buyer is entitled to all the rights of a shareholder before becoming the legal owner of the shares.

The parties can allocate the beneficial ownership of the underlying shares in the option agreement.

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For example, the parties can agree that the seller must forward all dividends received regarding the underlying shares to the buyer after granting the option while the seller retains the voting rights attached to those shares.

A company's dividend distribution can be a dilutive event for the buyer. Market practice is to protect the buyer's economic interests by incorporating protective provisions in the option agreement. The mechanisms of these provisions can vary, including an option agreement that:

- Links the exercise price to the net asset value or a fixed percentage of the share capital of the company at the time of exercise.
- Requires the seller to deposit dividends (or other distributions) into an escrow account and release the escrowed assets to the buyer when the option is exercised.
- Includes anti-dilution adjustments that automatically adjust the exercise price if the company distributes assets to shareholders while the is option outstanding.

Under Hong Kong law, a buyer only acquires legal ownership over the underlying shares when the buyer is registered in the company's register of members. In a transfer of Hong Kong shares, this registration can only be made after paying the applicable stamp duties to the Inland Revenue Department, the Hong Kong tax authority.

The Inland Revenue Department assesses stamp duties based on the share transfer documents, a process that can take a week or more. Therefore, completion, as defined in Standard Document, Put and Call Option Agreement: Cross-Border: Clause 1.1, cannot occur concurrently with the signing of the transfer documents. Some changes are needed in Standard Document, Put and Call Option Agreement: Cross-Border: Clause 3.3. There are two options, either:

- Allow completion to continue over a period of time and provide that no actions at completion are deemed to have taken place until the registration is completed.
- Make the change of legal ownership a condition subsequent and amend the definition of completion to cover only the change of beneficial ownership.

Warranties in an Option

At a minimum, the seller on an option arrangement should be prepared to give the buyer standard warranties. In an option giving the buyer the right to acquire shares in the seller, the seller should be prepared to offer a warranty of:

- Due incorporation, that the seller is duly incorporated and is validly existing.
- Power and authority, that the seller can and has taken all requisite actions necessary for entering the arrangement, including for:
  - executing the agreement;
  - authorising, issuing, and delivering the shares when the option is exercised; and
  - performing the seller's other obligations under the agreement.
- Approvals and consents, that any shareholder approvals, waivers, or consents necessary for the corporate actions have been obtained by the seller and are in full force and effect.
- Enforceability, that the agreement is valid, binding, and is enforceable against the seller.
- Reservation of shares, that the shares issuable when the option is exercised:
  - have been reserved;
  - will be validly issued, fully paid, and non-assessable when issued; and
  - will be free and clear of all encumbrances.
- No regulatory approval, that the arrangement, including the offer, issuance, and sale of the shares, does not require an action or filing with any person or governmental body.
- No conflict or breach, that entering the agreement, issuing and selling the shares when the option is exercised, and the seller performing other obligations under the agreement do not conflict with, breach, violate, or cause a default of:
  - the seller's constitutional documents;
  - the applicable law; or
  - the seller's material contracts.

In addition to the legality of the arrangement, the seller should be prepared to give additional warranties covering the economic expectations of the option arrangement. For example, a buyer looking for assurances on the value of the underlying shares when the option is granted could ask for a warranty concerning:

- The capitalisation of the seller and the interest the underlying shares represent on a fully diluted basis.

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- The accuracy of the seller's audited financial statements and unaudited management accounts.
- The absence of material adverse change since the date of the most recent audited financial statements.
- The status of the seller's business, such as legal compliance, title to assets, and no litigation.
- The accuracy of any disclosure materials concerning the seller.

The above standard warranties require corresponding changes if the shares deliverable when the option is exercised were issued by another entity and are held by the seller in its capacity as a shareholder of the issuer. These changes address the risk that a person that is not a party to the option agreement issued the shares. The above additional warranties should cover the issuer instead of the seller. However, the seller should be expected to offer both the standard warranties and additional warranties in its own capacity.

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 7.2, but a buyer should consider asking for additional warranties.

Anti-Dilution Mechanisms

Anti-dilution mechanisms in an option agreement are intended to protect the option holder from the impact of dilutive events that may disproportionately benefit the shareholders at the option holder's expense, such as an in-kind dividend or asset distribution. A key objective of anti-dilution mechanisms is to enable the buyer to retain the benefit of its bargain in terms of economic expectations.

The anti-dilution mechanisms in option agreements can vary. Limited anti-dilution provisions are needed (as the consequences of any dilutive events are built into the option's financial terms) when both:

- The number of shares underlying the option is a percentage of the company's issued share capital.
- The exercise price is calculated based on the company's net asset value when the option is exercised.

If a controlling shareholder of the company purchased the option, the option usually does not contain extensive anti-dilution protections, as the controlling shareholder assumes any dilutive event risk and, in practice, is somehow within that shareholder's control.

Generally, if the option price is a fixed dollar figure and the number of shares underlying the option is also a fixed number, anti-dilution provisions often protect the impact from:

- Free distributions of shares.
- Consolidating, subdividing, or reclassifying of shares.
- Restructuring the company.

Anti-dilution provisions may protect the impact from:

- Distributing rights to shareholders to subscribe for new shares.
- Distributing dividends in cash or assets in kind.
- Issuing equity securities that enable a holder to subscribe for shares at below their fair market value or the option exercise price.

Because it is not possible to set out all the company actions that could have a disproportionate impact on the option holder, the seller is often expected to give a standard non-impairment undertaking in which it agrees not to take any actions that would lessen its observance of the terms of the option.

Even if the buyer cannot get full anti-dilution protections for all the dilutive events that it would like, the buyer should seek an information undertaking from the seller in which the seller must alert the buyer before a dilutive event occurs and notify the buyer of the adjusted exercise price after the event. The buyer may want to bargain for an acceleration provision in the option and a pre-emptive right in the shares so that it can decide whether to exercise its option before the dilutive event and participate in the dilutive event as a shareholder.

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 9, but a buyer should decide on whether to ask for more extensive anti-dilution protections depending on the structure, terms, and purpose of the option arrangement.

Formalities to Transfer Shares on Exercise

Once an option has been validly exercised (meaning all the conditions precedent are fulfilled), the seller must deliver the shares within the timeframe specified in the option agreement (if no specific timeframe is stated, then as reasonably as possible,

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typically within a few days). The mechanism for delivery depends on whether the underlying shares:

- Are already issued and outstanding (see Shares Already Issued).
- Remain to be issued (see Shares to Be Issued).

Shares Already Issued

The seller executes an instrument of transfer with a set of "bought and sold" notes regarding the shares. The buyer then countersigns the documents. The transfer instrument and bought and sold notes are then submitted to the Inland Revenue Department for stamping. Copies of certain ancillary documents, such as any underlying contract and the issuer's most recent financial statements and management accounts must also be submitted for assessment purposes.

The stamping process requires paying both:

- A HKD5 per instrument fixed duty for the transfer instrument.
- An *ad valorem* stamp duty for the bought and sold notes that is 0.26% (that is, 0.13% for each note) of the higher of the exercise price or the fair market value of the shares. Under market practice, the seller and buyer usually split paying this amount equally.

Following stamping, the transfer documents are forwarded to the issuer for its records. The issuer (acting through its company secretary) updates its shareholders register so the buyer is the registered holder of the newly issued shares. The old stock certificate is cancelled and a new stock certificate in the buyer's name is issued.

The issuer must update the identities of shareholders in its next annual return on Form NAR1, which is publicly filed with the Hong Kong Companies Registry (HKCR). The filing discloses the buyer's name and the number of shares held but not the option exercise price.

Shares to Be Issued

The buyer executes a subscription form for the seller's records. The seller then updates its shareholders register so the buyer is the registered holder of the newly issued shares. The seller issues a stock certificate evidencing the shares when the shareholders register is updated. The seller must make a public filing with the HKCR under Form NSC1 to report a change in the issued share capital. The filing discloses the option exercise price, number of shares issued, and buyer's name. No stamp duty is payable.

No changes are needed to Standard Document, Put and Call Option Agreement: Cross-Border: Clause 8.4, except that there should be provisions stating whether the buyer has the obligation to pay part of the stamp duty (if applicable).

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