

**2001 OVERSEAS LAWYERS
QUALIFICATION EXAMINATION**

**HEAD III: COMMERCIAL
AND COMPANY LAW**

Thursday, 1 November 2001



HEAD III : COMMERCIAL AND COMPANY LAW

TEST PAPER

1 November 2001

Instructions to Candidates :

- 1. The duration of the examination is 3 hours and 30 minutes.**
- 2. This is an open-book examination.**
- 3. There are FIVE questions in this paper. ANSWER ANY FOUR QUESTIONS ONLY.**
- 4. IF YOU ATTEMPT MORE QUESTIONS THAN YOU HAVE BEEN INSTRUCTED TO ANSWER :**
 - (a) THE EXAMINERS WILL MARK ALL QUESTIONS THAT HAVE BEEN ATTEMPTED AND NOT DELETED; AND**
 - (b) IN COMPUTING YOUR FINAL MARK, THE EXAMINERS WILL COUNT THE MARKS FOR THE NUMBER OF QUESTIONS THAT YOU WERE INSTRUCTED TO ANSWER TAKING INTO ACCOUNT THE ANSWERS WITH THE LOWEST SCORES.**
- 5. Each question has the value noted on the question paper. You are urged to apportion your time in accordance with the relative value of each question. No marks can be awarded to a question for which there is no attempted answer.**
- 6. Do not take either this question paper or any answer books with you when you leave the examination room.**

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Head III : Commercial and Company Law

Question 1 (25 marks)

A legal commentator once said: "*The Hong Kong market is characterised by a dominance of family-controlled listed companies and very often because the board/management of such a listed company is appointed by the family shareholders, protection for the public shareholders is inadequate*".

Question:

In the light of the above statement, please prepare a memorandum identifying those areas of the Main Board Listing Rules of The Stock Exchange of Hong Kong Ltd that attempt to remedy any such inadequate protection. (25 marks)

Question 2 (25 marks)

Family Ltd (the "**Company**") was incorporated in Hong Kong more than thirty years ago by **Mr Fai** and **Ms Wan**, and several members of their respective families. Mr Fai and Ms Wan both continue to play an active role in the Company as directors, and Mr Fai is now also the Company's Chairman. Over the years various family members have become officers of the Company, and presently all other executive directors, including the Managing Director, are relatives of Mr Fai and Ms Wan.

The two families, Fai and Wan, through their various members and relatives, together hold 80% of the Company's issued share capital.

The Company recently held its annual general meeting ("**AGM**"). The meeting proved to be a rather unpleasant experience for the directors and especially for Mr Fai because among those who attended the meeting there was a minority shareholder of the Company, **Mr Wong**, who asked a great number of questions. Many of these questions related to an agenda item under the heading "*special business*" in respect of which the Company sought to pass a special resolution to approve an alteration to the Company's articles of association. The proposed alteration would enable an increase in directors' fees, within the range of 1 to 20 per cent per annum, to be determined by the Company's board of directors.

Mr Wong was highly knowledgeable as to the Company's structure and finances and seemed either to have support, or to gain support, from the members who were sitting near him at the AGM. When a vote was taken on the resolution to amend the articles, and declared by Mr Fai as being passed, there was a lot of '*booing*' and general noise of discontent from the persons in the vicinity of Mr Wong.

Since the AGM, Mr Fai received a letter from Mr Wong claiming that the AGM was invalid because the notice calling the meeting, which formed part of its Annual Report, was received less than 3 weeks before the meeting and did not include sufficient particulars of the special resolution relating to the alteration of the Company's articles. The letter also states that "*given conduct on the part of the board, which is blatantly unfair to the Company's minority shareholders, I intend to pursue all possible means to overturn the resolution concerning directors' fees which was passed at the AGM*".

Ms Wan's response to these events is to suggest more "*paper meetings*". She has put her views to the company secretary of the Company. Given that the Company's usual practice for board decisions is to circulate the relevant papers, and that the system, in the secretary's view, works well, the idea of "*paper*" general meetings is worthy of consideration.

Questions:

- (a) Please advise Mr Fai on the claims that insufficient notice of the AGM was given to shareholders and that the resolution passed at the AGM in respect of altering the Company's articles to allow the board to increase directors' fees is invalid because insufficient particulars were provided to shareholders.

(10 marks)

(See over the page for questions 2(b) and (c))

- (b) Please advise Mr Wong whether members of the board have acted in breach of their duties by participating in the vote to alter the Company's articles, and as to the steps he may take which could result in the overturning of the decisions of the AGM. (10 marks)
- (c) Please advise Family Ltd's company secretary concerning the practice of "*paper meetings*". (5 marks)

Question 3 (25 marks)

Comfort Zone Company Limited (the “**Company**”) is a medium-sized furniture company incorporated in Hong Kong a few years ago. The Company is owned by **Peter Jones** and his wife **Mary Wong** who are directors and shareholders. As a director, Peter Jones had complete control of the Company’s bank accounts and book debts.

Since March 1998, **SAR Bank** had lent funds to the Company on an unsecured basis by means of overdraft facilities. By mid-2001, SAR Bank began to be seriously worried about the prospect of repayment of such overdraft facilities by the Company. During the first six months of the year 2001 the Company experienced cashflow problems and a nearly 80% reduction in net profit. As at 30 June 2001, the Company was indebted to SAR Bank for \$22,000,000 under the overdraft facilities.

In July 2001, SAR Bank agreed to loan the Company an additional HK\$13,000,000 in exchange for the Company granting SAR Bank a floating charge to cover HK\$22,000,000 in pre-existing debt to SAR Bank under the overdraft facilities, the additional HK\$13,000,000 new loan, plus interest. The new loan of \$13,000,000 was to address the Company's cashflow problems. The debenture is an “*all-moneys*” debenture containing a floating charge over the entire business undertaking of the Company in favour of SAR Bank (the “**Debenture**”). It was executed on 3 July 2001. Although the Debenture does not contain any automatic crystallisation clause, it contains an undertaking from the Company not to use its assets as security for any subsequent borrowing that would rank ahead of, or equally with, the floating charge contained in the Debenture.

SAR Bank is now conducting a review on the financial position of the Company. The Company’s only valuable assets are its book debts in the sum of HK\$20,000,000. Although the Company owns some raw materials with a current value of HK\$9,000,000, they were supplied by ABC Fabric Limited on credit subject to a retention of title clause. SAR Bank is very worried that some of the other unsecured creditors of the Company may file a winding-up petition against the Company.

Questions:

- (a) Please prepare a memorandum of advice which will assist SAR Bank in deciding what options are available, and the best way to proceed to collect its total loan of HK\$35,000,000. (10 marks)
- (b) On 1 August 2001, Peter Jones made a loan of HK\$1,000,000 to the Company. The director’s loan was secured by, *inter alia*, a charge “*by way of fixed charge over all book or other debts ... due or owing to the Company*” executed by the Company and filed with the Hong Kong Companies Registry on the same date. The Company is now in liquidation and the liquidator applies for directions as to whether and to what extent such charge created a valid and enforceable fixed charge over the book debts of the Company. Please discuss. (9 marks)

(See over the page for Question 3(c))

- (c) **On 1 March 1998, Mary Wong signed a "*continuing guarantee*" in favour of SAR Bank guaranteeing the repayment of the Company's indebtedness to SAR Bank under the overdraft facilities that were granted by SAR Bank to the Company at the same time. Please advise Mary Wong as to any possible liabilities and defences she may have. (6 marks)**

Question 4 (25 marks)

You act for **Mr A**, a high net worth individual. His friend, **Mr B** owns **XYZ Limited**, a trading company incorporated in Hong Kong. Mr B has asked Mr A to lend XYZ Limited DEM880,000 and FRF680,000 (collectively the "**Loans**").

Questions:

- (a) Mr A informed you that in connection with the Loans, Mr B would give Mr A a comfort letter that Mr B is the sole beneficial owner of all the issued shares of XYZ Limited and that there is no winding up petition filed against XYZ Limited. Please explain whether a comfort letter is different from a guarantee, and whether a comfort letter provides sufficient protection to Mr A. Should Mr A ask Mr B to guarantee the repayment of the Loans? (5 marks)
- (b) Mr A heard that because guarantees were secondary liabilities rather than first liabilities, most well drafted guarantee documents would contain three main obligations and not just one, the three obligations being (i) a straight guarantee, (ii) a principal debtor obligation and (iii) an indemnity. Please explain what these obligations mean, why they are so and how they may complement each other and give protection to Mr A as a lender? (6 marks)
- (c) Mr A also heard that there should be consideration for the giving of the guarantee. Please explain what this means and how this can be achieved in the present case? Does it matter if Mr B signs the guarantee a week after Mr A has entered into the loan agreement with XYZ Limited for the Loans? (4 marks)
- (d) Mr A was also concerned that he might not be able to recover from Mr B the costs of enforcing the payment of the Loans and any interest accrued thereon against XYZ Limited as well as the costs of enforcing payment under the guarantee. What can you add in the guarantee document to deal with this specific concern of Mr A? (3 marks)
- (e) Mr A heard that once a guarantor paid out under a guarantee, "*subrogation*" would occur. Please explain what "*subrogation*" means? Is this good or bad for Mr A? (3 marks)
- (f) Mr A heard that sometimes it was expressly provided in the guarantee document that the guarantee would remain effective for another 7 months after XYZ Limited had repaid the Loans. He asks you why this is so? (2 marks)
- (g) Mr B would like you to represent him as solicitor too. What would be your response? If you decline, but Mr B says that he trusts you and will sign any guarantee drafted by you, what will you put in the guarantee to safeguard your position? (2 marks)

For the purpose of answering this question, you need not be concerned with the application of the Money Lenders Ordinance.

Question 5 (25 marks)

Tobias, Scannon and Juliet have been running a very successful computer hardware and software design business in Hong Kong through a limited company incorporated in Hong Kong called **Topnotch Computer Limited** (the "**Company**"). They each own 10,000 ordinary shares of HK\$1.00 each in the capital of the Company and are equal partners in the business. To ensure that there is always sufficient cash flow for research and development, the Company has retained about HK\$3,000,000 of its past profit in the Company without distributing the money to the shareholders who have all agreed to such retention. Tobias, Scannon and Juliet are directors of the Company, with Tobias doing most of the software design, Scannon most of the hardware purchase and Juliet the marketing and sales for the Company. They have 10 staff who are all non-shareholders. The Company does not have many fixed assets.

They have just secured a large hardware and software design contract which requires them to invest HK\$7,000,000 over the next three years.

Questions:

- (a) **Please advise the Company and their shareholders on two potential methods of possible fund-raising for the extra HK\$4,000,000 and the differences between such two methods. As background information for you, they mentioned to you that they have all along enjoyed a very cordial relationship with their bankers since their commencement of business more than 10 years ago, and there are also several venture capitalists who are interested in investing in the Company's business. (9 marks)**
- (b) **Tobias and Juliet have planned to eventually list the Company on the Hong Kong Stock Exchange GEM Board, but Scannon has always wanted to keep the Company small and private. In view of their divergent views, both Tobias and Juliet have indicated that they wish to buy Scannon's shares in the Company, but Scannon prefers to sell his shares to his buddy, Boatswain. They cannot reach an amicable agreement. Please advise Tobias and Juliet what they can do if Scannon insists on selling to Boatswain and if they can block his proposed sale. You may assume Table A of the Companies Ordinance applies. (3 marks)**
- (c) **Scannon has asked you if he can demand that his share of the HK\$3,000,000 retained profit be distributed to him as dividend as soon as possible so that he may set up his own business with such cash. Please advise Scannon on his rights. (3 marks)**

(See over the page for question 5(d))

- (d) Assuming that neither Tobias nor Juliet objects to the proposed sale by Scannon to Boatswain of Scannon's shares in the Company and you have been instructed by Boatswain to draft a sale and purchase agreement between Boatswain and Scannon for sale of Scannon's shares in the Company, please advise Boatswain what representations, warranties and undertakings you will include in the sale and purchase agreement in order to protect Boatswain's position as buyer of those shares? Please discuss FIVE of such clauses and briefly explain your rationale for recommending such clauses. (10 marks)

END OF TEST PAPER