

**2002 OVERSEAS LAWYERS
QUALIFICATION EXAMINATION**

**HEAD III: COMMERCIAL
AND COMPANY LAW**

Thursday, 31 October 2002



HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

31 October 2002

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.

2002 Overseas Lawyers Qualification Examination

Head III: Commercial and Company Law

Question 1 (25 marks)

R & D Holdings Limited (“RDH”), which is incorporated in Hong Kong, is the holding company of **R & D Operations Limited** (“RDO”), also a Hong Kong company. The shares of RDH are held as to 30% by **Mr Wang**, 60% by **Mr Zhou** and 10% by **Ms Woo**. RDH is, in reality, just an investment holding company, with its only material asset being its 100% shareholding in RDO.

T Co Limited (“T Co”), which is a customer of RDO, has confidence in the business and wishes to take a 30% stake in RDH. Neither Mr Zhou nor Ms Woo wishes to sell their shares, but Mr Wang, who is in immediate financial difficulty, is willing to sell his 30% interest to T Co for HK\$40 million. Both Mr Zhou and Ms Woo have no objection to the proposed sale. In fact, they have, for personal reasons, grown increasingly displeased with Mr Wang and also believe it would be extremely beneficial to RDH if one of RDO’s substantial customers acquires an equity stake in RDH.

Mr Wang approaches you for advice. Apart from explaining the above to you, he also mentions that, on 2 January 1999, he and Mr Zhou advanced HK\$10 million and HK\$20 million respectively by way of loan to RDH. Neither loan attracts interest and each loan is payable on giving 30 days notice to RDH. The loans are still outstanding and no repayment demands have been issued.

During negotiations between T Co and Mr Wang (at which Mr Zhou and Ms Woo were also present), Mr Wang requires that his loan be repaid in full at the time of selling his shares. Since T Co does not wish to take over Mr Wang’s loan and RDH does not have immediately available funds to repay Mr Wang’s loan, Mr Zhou and Ms Woo (together with the blessing of T Co Limited) will agree to procuring that RDO (which has substantial assets) guarantees the repayment of Mr Wang’s loan if Mr Wang agrees not to demand repayment of the loan before the expiry of 6 months following the completion of the sale of his shares to T Co. By that time, Mr Zhou and Ms Woo believe that RDH should have sufficient funds available to repay Mr Wang’s loan.

Mr Wang tells you he is happy with this arrangement and wishes, therefore, to proceed with the sale at the price offered by T Co.

(See over the page for questions 1 (a) and (b))

Questions:

Answer both questions 1(a) and (b)

- (a) Mr Wang asks you to advise him on the merits of, and any potential problems associated with, the arrangement concerning the repayment of his (Mr Wang's) loan. You should also explain to Mr Wang whether, and if so how, any of the problems you identify might be overcome. (You need not consider issues relating to corporate insolvency.)

(17 marks)

- (b) Mr Wang shows you a copy of the form of guarantee to be given by RDO, which provides as follows:-

"To: Mr Wang,

Date: _____

We the undersigned, R & D Operations Limited, a company duly incorporated in Hong Kong, hereby irrevocably and unconditionally undertake to guarantee payment to you of all sums of money that shall be due, owing or incurred by R & D Holdings Limited to you under the loan agreement entered into between you and R & D Holdings Limited on 2 January 1999.

SIGNED by

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_____)
for and on behalf of)
R & D OPERATIONS LIMITED)
in the presence of:)"

What amendments would you recommend to Mr Wang should be made to the draft guarantee to avoid the guarantee being held to be unenforceable, and to afford additional protection to Mr Wang should he need to enforce the guarantee against RDO. You do not need to draft any clauses. You should simply provide your advice to Mr Wang, giving your reasons.

(8 marks)

Question 2 (25 marks)

The New Dawn Company Ltd (“Company”) was formed in Hong Kong more than thirty years ago and specialises in the manufacture and wholesale of stationary products. Mr Choy, who is the chairman and CEO, holds a majority of the Company’s shares (he presently holds 58%) and his three sons, all of whom are now directors of the Company, hold the remaining 42%.

Over the years, the Company has purchased paper manufacturing plants in various locations in Asia, including the Philippines and Indonesia. Presently it also holds 30% of the issued share capital of a fountain pen manufacturing company, Quill-write Ltd. This company is registered in Hong Kong, but all its factories are based in the PRC.

The Company has proved to be very successful and is now in the process of seeking a public listing on the Main Board of the Hong Kong Stock Exchange. You have been given the task of verifying the draft prospectus. Mr Choy is however proving to be a ‘difficult customer’ – he is unhappy about the time the IPO is taking and the cost of all the preparations. He also does not understand the importance of verifying the Company’s prospectus.

Questions:

Answer both questions 2(a) and (b)

(a) Before you commence the process of verifying the prospectus, your supervisor asks you to draft a letter to Mr Choy explaining to him:-

(i) all the possible consequences for the Company if a statement contained in the prospectus is found to be false; and

(5 marks)

(ii) all the possible consequences for the directors of the Company if a statement contained in the prospectus is found to be false.

(10 marks)

(b) Assuming that the IPO is successful, Mr Choy’s shareholding will be reduced to 45%, his three sons will hold a total of 30%, and 25% will be in the hands of the public. Mr Choy and his sons will be directors of the Company. The prospectus states that the funds raised by the float are intended to be used in upgrading the Company’s machinery at its existing manufacturing plants and in purchasing further paper manufacturing plants. Mr Choy is not convinced that this is the best use of funds, but agreed after being pressured by his three sons. He is hoping that some time after the IPO additional funds can be raised by a rights issue.

Mr Choy asks (i) whether the Company will be required to issue a new prospectus in order to undertake a rights issue and (ii) what is involved in the process of a rights issue?

Draft a letter in response to Mr Choy’s enquiries.

(10 marks)

Question 3 (25 marks)

Over the past 7 years, the SAR Bank has lent money to a technology company S.D.F. Limited (“Company”) on an unsecured basis by means of overdraft facilities. The Company has only two directors: Brian Wong and his wife, Priscilla Chan. In January 2002, the Company experienced serious bad debt problems as it failed to collect approximately HK\$2,000,000 from two major debtors from Buenos Aires, Argentina. This combination of bad debts and the acquisition of an internet business during early 2001 (which proved to be a poor investment), against the background of a price competitive industry, produced enormous difficulties for the Company, which ultimately proved insuperable. After prolonged negotiations, SAR Bank decided to lend an additional HK\$1,500,000 to the Company. The money was advanced to the Company after the execution of an “all-money” floating charge dated 1 February 2002 securing both the new loan of HK\$1,500,000 and the previous outstanding debt of HK\$7,000,000. Unfortunately, by October 2002, the Company was unable to repay any part of the loans despite repeated written demands. According to the report prepared by the credit department of SAR Bank, the Company’s main assets are its book debts, which were estimated at HK\$6,000,000. In addition:

- the net value of the claims of preferential creditors was estimated at HK\$450,000;
- the total sum due to unsecured creditors was estimated at HK\$2,500,000. One of the creditors has obtained a summary judgment of HK\$370,000 against the Company; and
- on 15 October 2001 and 15 September 2002, the Company repaid respectively HK\$200,000 and HK\$300,000 to Priscilla Chan. She had granted a loan of about HK\$450,000 to the Company on 1 February 1998.

Question:

Prepare a memorandum of advice to SAR Bank which will assist SAR Bank in deciding -

- (i) what options are available to it; and
- (ii) the best way to proceed to collect the debt from the Company.

(25 marks)

Question 4 (25 marks)

Lowly Holdings Limited (“Lowly”), a Hong Kong listed company, is looking for acquisitions outside its main line of business (which is the manufacture and sale of bathroom fittings and accessories) and has identified the business of **Huckle Sportswear Clothing Limited** (“Huckle”) as a possible target.

From its due diligence investigations, Lowly discovers that Huckle is the subject of a major litigation claim in the U.S. The claimant, a U.S. citizen, broke his pelvis when a surfboard bought from Huckle split (surfboards are no longer sold at any retail outlets of Huckle). The claim, for US\$200 million, was filed at Busy Town County Court, California. The Lowly directors are told that actions for excessive damages are often brought in the U.S., but rarely succeed. Nevertheless, if the claim does succeed, it may pave the way for more claims, and so the Lowly directors do not want to risk inheriting an open-ended and sizable liability.

Huckle’s business, which is based in Hong Kong and the U.S., involves the manufacture, distribution and sale of sportswear through its retail outlets. There are currently 52 such outlets, with 2 in the U.S., and all but 5 of these outlets are on leasehold sites (i.e. Huckle rents all the leasehold premises from third parties). Huckle sells both third party products and products that it manufactures. Approximately 10 per cent of Huckle’s turnover, but rather less of its profit, over the last 3 years has been derived from a contract for the manufacture of sportswear for the **Trumble Football Club**. This contract comes up for renewal on 1 January 2003 and the Lowly directors are considering whether the contract is an asset they wish to acquire.

Questions:

Answer questions 4(a), (b) and (c)

- (a) The Lowly directors wish to proceed with the transaction but are not sure if they should proceed by way of a private share acquisition or asset acquisition. They have heard that “sellers often prefer to proceed by way of share sales, whereas purchasers often prefer to proceed by way of asset sales”.

Given the above facts, advise the directors of Lowly and help them analyse the pros and cons of a share sale and asset sale?

(12 marks)

- (b) The Board of Directors of Lowly decides to proceed by way of an asset acquisition and wishes, in particular, to acquire the contract with Trumble. However, it is concerned that consent from the Trumble Football Club to an assignment or novation of the contract cannot be obtained by the completion date.

What will be your advice to the board? In particular, how would you deal with this in the agreement in order to protect Lowly?

(5 marks)

(See over the page for question 4 (c))

- (c) Assume that the acquisition of Huckle takes place as a share acquisition and that the parties have agreed that completion accounts be drawn up shortly following completion of the acquisition to confirm the net asset value of the business being bought and paid for so that an adjustment can be made to the purchase consideration, if necessary. The Chairman of Lowly asks whether Lowly could, instead of going to the trouble of preparing completion accounts, just rely on appropriate warranties in the share sale and purchase agreement and on Huckle's audited accounts for the preceding 3 years?

Draft a memorandum of advice to the Chairman responding to his queries and advising him as appropriate.

(8 marks)

Question 5 (25 marks)

Your brother-in-law, **Cheerful Chan**, is a successful accountant with an international consultancy firm. One of his clients, **Willy Rich**, plans to float his company on the Main Board of the Stock Exchange of Hong Kong and has invited Cheerful Chan to act as a non-executive director of the listed company, while Willy himself would be the chairman. Cheerful Chan would like to accept the appointment, but knowing Willy Rich will rely on him to handle compliance issues, Cheerful Chan would like you to advise him on the obligations of a non-executive director under the law and the Listing Rules in order to assess whether he should accept the appointment or not.

Question:

Prepare a memorandum of advice for Cheerful Chan. The memorandum should contain a description of the requirements under the law and the Listing Rules.

(25 marks)

END OF TEST PAPER