

**2003 OVERSEAS LAWYERS
QUALIFICATION EXAMINATION**

**HEAD III: COMMERCIAL
AND COMPANY LAW**

Thursday, 6 November 2003



HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

6 November 2003

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.**

2003 Overseas Lawyers Qualification Examination

Head III: Commercial and Company Law

Question 1 (25 marks)

Hewy, Dewy and Louie Puddles are 3 brothers who are shareholders in a British Virgin Islands company called Duckville Limited ("**Duckville**"). Duckville owns a Hong Kong company called Pond Holdings Limited ("**Pond Holdings**"). Pond Holdings is engaged in computer distribution and other related businesses. Pond Hong Kong Limited ("**Pond HK**") is a wholly-owned subsidiary of Pond Holdings and is engaged in the distributorship business.

Hewy has just identified a US company, Big Texan Inc. ("**Big Texan**"), that wants to buy Pond HK's distributorship business (in other words, the shares of Pond HK), but Big Texan is not familiar with the Asian market, especially the China market. Big Texan has instructed you to act for it in the proposed acquisition. You have attended a few meetings and found out the following 7 points:

- (i) Pond HK has many distributorship contracts in hand from well known computer brand names. These companies are very particular about the people who are appointed distributors and over the years Hewy, Dewy and Louie have built up a rapport and trust with the computer manufacturers. Hewy, Dewy and Louie have indicated that they wish to retain a 20% interest in the business.
- (ii) Pond HK has set up a number of joint ventures in Mainland China with a view to expanding business there. Among these are two 80% interests in each of two joint venture companies, namely JV1 and JV2, which Big Texan insists must be disposed of before they are willing to complete the deal.
- (iii) Pond HK has three wholly-owned subsidiaries: Pond Singapore, Pond Malaysia and Pond Taiwan. Big Texan does not want to purchase any of these companies except for Pond Taiwan. (see point (iv) below)
- (iv) Pond Taiwan has some potential and therefore Big Texan wants to include this subsidiary in the purchase. However, Big Texan is a bit unsure about the performance of Pond Taiwan in the coming 6 months and has told you about such concerns.
- (v) Big Texan wants to pay the purchase price in two tranches. The first will be paid at completion. The second will be payable one year after completion, either in cash or by the issue of Big Texan shares. Hewy and Louie are opposed to this payment method, whereas Dewy says that he will think about it, but insists that the transaction be structured in such a way to ensure that the sellers are protected if the second payment is not made.

(See over the page for a continuation of Question 1)

- (vi) Big Texan is also worried that the possibility of bad debts in some of the accounts receivable may not be sufficiently provided for in the accounts of the Transfer Group.
- (vii) Big Texan is reliant on the Puddles brothers' experience, personal contacts and network in the Asian market, and wants them to use these contacts for the continuing development of Pond HK's business. Big Texan also wants to make sure that there is an incentive for the Puddles brothers to make Pond HK a continuing success.

Questions:

- (a) **Prepare a preliminary due diligence checklist that will be sent to the Puddles brothers requesting them to gather documents and answer questions concerning the Pond group of companies. The checklist should be specific to the facts and the proposed transaction as described above.**
(8 marks)
- (b) **Without drafting any provisions, advise Big Texan on each of the above points (i) to (vii) and what should be included in the documentation that will need to be drafted to address those points and any issues you raise.**
(12 marks)
- (c) **Prepare a list of the relevant documentation that you believe will be necessary to effect the proposed transaction.**
(5 marks)

Question 2 (25 marks)

Trustworthy Investments Limited ("**Trustworthy**") is a Hong Kong incorporated company jointly owned by two very old local companies, Braveheart Company Limited ("**Braveheart**") and Wise Company Limited ("**Wise**"), on a 50:50 basis. The total issued capital of Trustworthy is HK\$1,000,000, but only half of it has been paid up by the shareholders in proportion to their respective shareholdings. Wise and Braveheart have very simple, short standard memoranda and articles of association, commonly used by local companies established in the 1960s.

Tom is a director of both Trustworthy and Wise. There are two other directors of Trustworthy, and the quorum for all directors' meetings is 3. The unanimous consent of all directors is required in order to pass any resolutions. There is also an express provision in the articles of association of Trustworthy that any director interested in any contract with the company must declare his interest before he is allowed to participate in, and vote at, any board meeting pertaining to such contract. Tom is proposing that, in order to take advantage of the anticipated recovery in the local stock market, Trustworthy should borrow a sum of HK\$5,000,000 from Goodwill Company Limited ("**Goodwill**") to get ready for any bargain hunting.

Goodwill is prepared to lend Trustworthy HK\$5,000,000 provided that it is repaid over three years at a monthly interest rate of 2.5 %, and provided further that Trustworthy will:

- (i) execute in Goodwill's favour an equitable charge over all the new shares to be purchased by Trustworthy and a floating charge over all of Trustworthy's goodwill and undertaking. This floating charge is to cover an earlier bridging loan of HK\$500,000 made by Goodwill to Trustworthy for a security deposit and an advance rental payment; and
- (ii) procure from all its shareholders an unlimited guarantee for the repayment of the loan to Goodwill.

Tom has just negotiated the deal successfully and Trustworthy wants to draw down the funds most urgently, preferably by tomorrow.

You are asked by Goodwill to represent it as its solicitor in the above transaction. Your fees of HK\$50,000 will be paid by Trustworthy to be deducted from the loan to be advanced by Goodwill.

Question:

Identify the main corporate law issues and documents that you will need to look at and consider (and explain the legal implications of each of them and the advice you will give) for the above transaction in your capacity as solicitor acting for Goodwill.

In your answer, ignore any possible money lending legal and regulatory issues. You DO NOT need to draft any resolutions or agreements.

(25 marks)

Question 3 (25 marks)

A.I.E. Biotechnology Company Limited ("**Company**") is a Hong Kong incorporated company. The Company was established in early 1998 by three scientists, namely Dr Alan Wong, Dr Ian Cook and Dr Elaine Cook. They are the only directors and shareholders of the Company. During 1998, the Company's development of gene-analysing technology was humming along on schedule. With sufficient cash in the bank, the directors were confident that the Company would be able to weather the poor financing environment, and funded five more years of research and development.

Since early 2002, however, the Company has found itself in an abrupt change of fortune. Even though the Company has been meeting development milestones, the Company reported a significant operating loss in 2002, 45% greater than in 2001. The Company has, over the years, borrowed from the SAR Bank ("**Bank**") to finance its research. Between January 1998 and April 2002, the Bank gave the Company overdraft facilities of up to HK\$3 million on an unsecured basis.

In May 2002, the Company successfully developed and patented a set of biotechnological scans for identifying quirks in the human genome that may be responsible for diseases such as breast cancer. Brian Smith is the Bank's senior manager. Having read the Company's research reports, Mr Smith, who holds a masters degree in Biochemistry, made a decision to grant a further overdraft facility of HK\$2 million to the Company. On 15 May 2002, the further facility of HK\$2 million was drawn down by the Company and at the same time the Company executed an all-money floating charge securing to the Bank the total indebtedness of HK\$5 million, including all interest outstanding to the Bank. The floating charge covers the Company's entire business undertaking.

Although the notion of developing a set of biological scans appeared promising when research on the project first began, it turned out to be far more complicated and far less lucrative than the Company and the Bank expected. The Bank gave notice to the Company crystallising its floating charge on 4 April 2003, and on 9 April 2003 appointed a receiver. A winding up petition was presented against the Company by an unsecured creditor on 22 April 2003, and the winding up order was granted on 19 June 2003.

The liquidator, Eric Leung, has learned the following information:

- (i) The Company owes its employees HK\$300,000 for arrears of wages, and owes the Inland Revenue HK\$100,000 in unpaid profit tax. The Company has 30 other creditors, including Dr Alan Wong himself. They are owed HK\$1 million in total.
- (ii) The Company's main assets are their book debts and registered patents. The book debts now stand at HK\$300,000, and the market value of the patents is HK\$1 million.
- (iii) In May 2000, Dr Alan Wong made a shareholder's loan to the Company in the amount of HK\$800,000. Originally, the loan was repayable in January 2004 and January 2006 by two instalments. However, the Company repaid HK\$200,000 to Dr Wong in March 2001, and another HK\$600,000 to Dr Wong in June 2002. Evidence shows that the Company used part of the Bank's loan to make the second payment to Dr Wong.

(See over the page for a continuation of Question 3)

- (iv) In December 2001, the Company sold its laboratory in Kwun Tong, Hong Kong to Dr Ian Cook's brother, Peter, for HK\$2 million. At the time of sale, the market value of the premises was HK\$3.6 million. Peter now uses this laboratory to run another biotech company with Drs Ian Cook and Elaine Cook, but without Dr Wong's participation.
- (v) On 12 June 2002, the Company received HK\$400,000 from a pharmaceutical company. The Company deposited this amount into the overdraft account with the Bank.

Question:

You act for the liquidator, Eric Leung, who has drawn your attention to all of the above points.

Prepare a letter of advice to the liquidator addressing the issues that you think are relevant. In particular, you should consider providing full reasons as to whether or not the rights of any of the creditors of the Company are protected.

(25 marks)

Question 4 (25 marks)

Answer both Questions 4(a) and 4(b)

Question 4(a):

Clear Diamond Ltd ("**Clear Diamond**") has agreed to sell all the shares in Perfect Jade Ltd ("**Perfect Jade**") to Treasure Hunt Ltd ("**Treasure Hunt**"). Prior to the sale, Perfect Jade transfers certain business assets to its holding company, Clear Diamond, which Clear Diamond is to keep and which do not form part of the sale to Treasure Hunt. These business assets have a combined market value of HK\$8 million, but the transfer of them by Perfect Jade to Clear Diamond is made at HK\$5 million.

- (i) Is the transfer of business assets to Clear Diamond by Perfect Jade caught by Section 47A of the Companies Ordinance?**
(4 marks)
- (ii) Advise the parties what are the consequences of a transaction entered into in breach of Section 47A?**
(6 marks)
- (iii) Are there any alternative strategies that Perfect Jade and/or Clear Diamond could use to transfer the business assets?**
(2 marks)
- (iv) Are there any other corporate issues that could arise as a result of effecting the asset transfer in the manner described above?**
(4 marks)

Question 4(b):

Sapphire Blue Limited ("**Sapphire Blue**"), which is a private company incorporated in Hong Kong with limited liability, proposes to enter into a transaction which will include providing financial assistance for the acquisition of its own shares. Sapphire Blue held a general meeting to pass the relevant "whitewash" special resolution, and 85% of those attending and voting at the meeting voted in favour of the resolution.

- (i) Explain if there are any limitations on the timing of the financial assistance proposed to be given, and if so, what are they?**
(3 marks)
- (ii) Johnny, a friend of yours and a shareholder of Sapphire Blue, asks you what rights he has, having voted against the resolution?**
(3 marks)
- (iii) If the financial assistance were to be given so that a third party can acquire Sapphire Blue's holding company, which is registered in Belgium, do the directors of Sapphire Blue need to worry about the special resolution and, if not, what else do they need to think about?**
(3 marks)

Question 5 (25 marks)

Answer both Questions 5(a) and 5(b)

Question 5(a):

A Market Misconduct Tribunal has been established under the Securities and Futures Ordinance. Please list the types of conduct that fall within the ambit of the tribunal, and then describe any two forms of market misconduct, explaining briefly what needs to be established in order to determine that the relevant conduct constitutes market misconduct under the Ordinance. You should also describe the potential liability imposed under the Ordinance for market misconduct in general.

(15 marks)

Question 5(b):

You are advising a prospective director of an applicant for listing on the Main Board of the Hong Kong Stock Exchange as to his obligations with regard to the listing of the applicant company. He has read in the newspaper that the new Securities and Futures Ordinance imposes stringent obligations in relation to listing matters and is concerned about his potential liability.

Write a letter of advice to the prospective director explaining the following:

- (i) the prospectus obligations under the Companies Ordinance and the potential liability of directors in respect of a prospectus;**
- (ii) the dual filing system introduced under the Securities and Futures Ordinance;
and**
- (iii) any other matters you consider important to draw to your client's attention.**

Your letter should be set out in a style that is appropriate for a lay client.

(10 marks)

END OF TEST PAPER

Question 1

Para (vi) on page 2

'Transfer Group' means
the group of companies
to be transferred
to Big Texan.