

**2004 OVERSEAS LAWYERS
QUALIFICATION EXAMINATION**

**HEAD III: COMMERCIAL
AND COMPANY LAW**

Monday, 15 November 2004



HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

15 November 2004

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.

2004 Overseas Lawyers Qualification Examination

Head III: Commercial and Company Law

Question 1 (25 marks)

Lee Hung Company Limited (“LHCL”) is a company incorporated in Hong Kong. It carries on business manufacturing colour screens for 3G mobile phones. The directors of LHCL are Peter Wong, Michael Smith and Susan Smith, who are also the shareholders. Over the years, the SAR Bank (“Bank”) lent money to LHCL on an unsecured basis by means of overdraft facilities. However, due to severe competition from Korean rivals, which offered much cheaper prices, LHCL began suffering from cash flow problems from November 2003. The Bank became worried about LHCL’s ability to repay the outstanding debt, which stood at \$1,250,000 as at December 2003.

By a debenture dated 7 January 2004 (“Debenture”), LHCL, as beneficial owner, charged to the Bank:

- (i) by way of legal mortgage, a property (Flat 3, 15/F, Renee Garden, Kowloon Bay, Hong Kong) specified in the schedule to the Debenture; and
- (ii) by way of first floating charge, all the undertaking, property and assets of LHCL, both present and future, which were not subject to the fixed charge.

The Debenture covered the previous debt of \$1,250,000 as well as a further amount of \$1,000,000 advanced on 7 January 2004, together with any future amounts to be advanced by the Bank to LHCL. The Debenture was properly authorised, executed and registered at the Companies Registry and Land Registry in Hong Kong.

In March 2004, LHCL repaid \$250,000 to the Bank but, in May 2004, LHCL borrowed a further amount of \$450,000 from the Bank through the overdraft facilities.

Currently, LHCL owes about \$2,300,000 to unsecured creditors. One of these creditors is Fat Hop Finance Company Limited, which provided an unsecured loan of \$700,000 to LHCL at a rate of interest of 49% per annum. LHCL’s 25 employees are owed a total amount of \$650,000 in unpaid salaries for September and October 2004.

On 12 December 2003, LHCL repaid to Peter Wong a shareholder’s loan in the amount of \$150,000. On 21 January 2004, LHCL also made an early repayment to Joe Chan of a \$250,000 loan. Joe Chan is Susan Smith’s son from her first marriage.

The current market value of the property in Kowloon Bay is approximately \$850,000. The inventory and machinery of LHCL should realise about \$1,450,000 at current market values.

Question:

The Bank now seeks your advice on how best to proceed to collect its debt from LHCL. Prepare a memorandum of advice to the Bank which analyses the various options available to the Bank and then, giving reasons, recommend the most effective option available to the Bank.

(25 marks)

Question 2 (25 marks)

Jet Foods Ltd. (“JFL”) owns and operates a chain of fast food outlets in Hong Kong. During the SARS outbreak, JFL was close to being insolvent but over the last 12 months, profits have exceeded expectations and the board of directors, which presently comprises 4 individuals, Peter, Paul, Mary and Song, are looking to expand JFL’s business. Presently, Peter, Paul, Mary and Song each holds 22 per cent of JFL’s shares. The remaining 12 per cent is held by family and friends. At the last JFL board meeting, the main items for discussion and resolution were (i) which of three designers would JFL engage to design a ‘new look’ for its fast food outlets and (ii) the appointment of two additional directors. Slim and Bar, who are friends of Paul, have both indicated that they would be willing to invest capital in JFL if appointed as non-executive directors. At the board meeting, the board of directors resolved to engage Aero Décor Ltd (“ADL”) as the designer and to appoint Slim and Bar as non-executive directors. Peter said very little during the board meeting in part because, unbeknown to the board, his wife works for ADL and he did not want to disclose his personal bias in favour of ADL. The board was also unaware that:-

- (i) Mary is a substantial shareholder of ADL (Mary’s shares are registered in the name of a company, which she and her husband own);
- (ii) Bar was previously a director and major shareholder of Wheels-meals Ltd (“WML”), a company which supplied meals to schools in the New Territories and went into insolvent liquidation during the SARS crisis. There was also a rumour circulating before the SARS outbreak that WML was employing illegal immigrants;
- (iii) Slim had recently been charged under s 121 of the Companies Ordinance for failing to keep books of account in respect of a family catering business which appointed him as a non-executive director because of his experience as a chef.

Question:

The above matters have now been drawn to Song’s attention and he seeks your advice as to their effect, if any, on the resolutions passed at the JFL board meeting. Advise Song.

(25 marks)

Question 3 (25 marks)

Answer both Questions 3(a) and 3(b)

Question 3(a):

What is the distinction between a fixed charge and a floating charge? Why is the distinction important?

(10 marks)

Question 3(b):

Hook Capital Inc., an international venture capital fund, has established a private limited company, Pirate Limited, as a vehicle to acquire the entire issued share capital of Peter Pan Limited, which is a wholly owned subsidiary of Press Gang Limited. Parrot Bank plc will make a loan to Pirate Limited to allow it to fund the acquisition of Peter Pan Limited. One of the conditions precedent to the loan is that Peter Pan Limited and Tinker Limited, a wholly owned subsidiary of Peter Pan, give a composite debenture and guarantee to the bank to secure the bank's loan to Pirate Limited. All the companies mentioned above, except for Hook Capital Inc. and Parrot Bank plc, are private companies incorporated in Hong Kong.

Questions:

(i) Explain why the giving of the composite debenture and guarantee to Parrot Bank plc by Peter Pan Limited and Tinker Limited will constitute unlawful financial assistance under Hong Kong law?

(5 marks)

(ii) What procedures need to be taken and documents completed in order to ensure that the financial assistance is not prohibited?

(10 marks)

Question 4 (25 marks)

The Companies (Amendment) Ordinance 2003 (“**Ordinance**”) was passed on 2 July 2003 and came into operation on 13 February 2004 except for clause 67 (as relating to sections 158C(1)(a) and (b)).

Question:

You have been asked by Audrey Hepburn, the in-house lawyer of your client, My Fair Lady Inc., a large business conglomerate, to explain to her what changes the Ordinance has introduced with regard to the following topics:

- (i) the minimum number of directors/shareholders permitted for private companies and issues introduced or amended by the Ordinance that relate directly to companies that have the minimum number of directors and/or shareholders (10 marks)**
- (ii) removal of directors (2 marks)**
- (iii) alternate directors (3 marks)**
- (iv) shadow directors (2 marks)**
- (v) indemnification/insurance of/for officers and auditors (4 marks)**
- (vi) presentation of statutory demands; and (2 marks)**
- (vii) statutory declarations (2 marks)**

Question 5 (25 marks)

Starry Night Limited (“SNL”) is an Australian company which is interested in buying a financial services company in Hong Kong as a platform for entering into the financial services industry. For this purpose, SNL intends to buy all the shares of King Pin Limited (“KPL”).

KPL’s operations comprise a brokerage business operated through Mickey Limited and an investment advisory services business operated by Minnie Limited. Both Mickey Limited and Minnie Limited are wholly owned subsidiaries of KPL. Minnie Limited has a number of client investment advisory mandates in hand.

KPL is owned as to 50% by Slippery Co. and as to 25% by Slide Co. Slide Co is a 100% subsidiary of Slippery Co. The remaining 25% of KPL is held by a few founding shareholders.

SNL has instructed you to act for it on the proposed acquisition. The proposed acquisition is to include the following terms:

- (i) The purchase consideration will be the aggregate of the Warranted NAV (see paragraph (ii) below) and US\$5,000,000.
- (ii) The Vendors are to jointly and severally warrant that the audited consolidated net asset value of KPL, as at the date of completion of the sale and purchase agreement (“**S&P Agreement**”) will be not less than US\$20,000,000 (“**Warranted NAV**”).
- (iii) Financial due diligence is to be carried out by a firm of auditors, Additup & Partners who have been selected by SNL. The existing auditors of KPL are Greatmaths & Partners. The purchase consideration will be subject to adjustment. In this regard, a completion audit will be carried out by Priceright & Partners on the consolidated accounts of KPL as at the date of completion of the S&P Agreement.
- (iv) Payment for the purchase consideration will be made as follows:-
 - US\$1,000,000 will be payable as a deposit upon signing the S&P Agreement;
 - 50% of the total purchase consideration (less the deposit) will be payable on completion of the S&P Agreement; and
 - the remaining 50% of the total purchase consideration (“**Deferred Payment**”) will be payable one year after completion of the S&P Agreement.
- (v) SNL will not acquire the brokerage business and will also not acquire any of the employees of Minnie Limited.
- (vi) KPL has a valuable employee, Victor Value, and SNL wants to keep him in the company. SNL also wants KPL to be able to carry on “business as usual” and does not want Slippery and Slide to divert the existing client investment advisory mandates to their own businesses.

(See over the page for a continuation of Question 5)

Questions:

- (a) List the typical informational documents that you will request to review regarding KPL and its subsidiaries for the purposes of legal due diligence. (7 marks)
- (b) What would you suggest as being some of the conditions to the completion of the S&P Agreement? (5 marks)
- (c) KPL's counsel has asked that the Deferred Payment be secured and asks you to propose the form of such security. Give 3 examples of how the Deferred Payment might be secured. (3 marks)
- (d) What would you suggest should be the correct adjustment formula in the event that the Warranted NAV is less than the actual net asset value of KPL? (3 marks)
- (e) You envisage that Priceright & Partners will have some difficulty in performing the completion audit. What might this difficulty be and what would you suggest to overcome this difficulty? (2 marks)
- (f) What means would you advise to prevent the existing mandates from being diverted by Slippery and Slide? (5 marks)

END OF TEST PAPER