2006 OVERSEAS LAWYERS QUALIFICATION EXAMINATION

HEAD III: COMMERCIAL AND COMPANY LAW

Monday, 6 November 2006

THE LAW SOCIETY OF HONG KONG
香港律師會

HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

6 November 2006

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 <u>FOUR</u> 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 <u>TAKING INTO ACCOUNT THE ANSWERS WITH THE LOWEST SCORES</u>.

5. **Start each question on a separate page of your answer book.**

6. **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.**

7. **An examiner will be present for the first 30 minutes of the examination. Any question relating to the paper must be raised in that period. Questions raised after the first 30 minutes will not be entertained.**

8. **Do not take either this question paper or any answer books with you when you leave the examination room.**

2006 Overseas Lawyers Qualification Examination

Head III: Commercial and Company Law

Question 1 (25 marks)

Yan and Ben started their business in 1992. They thought there may be a demand for European style confectionary in Hong Kong's supermarkets and embarked, in partnership, on finding premises suitable for baking equipment, organizing the importation of ingredients that were not then available in Hong Kong and marketing their initial range of products. They were astonished by their success and by 1994 were employing more than 20 full time staff. Their rate of growth was such that in 1995 their accountant advised them to incorporate.

Yan and Ben applied to register a company in Hong Kong with the name "YB Ltd" by filing a memorandum and a declaration of compliance. They did not file any Articles of Association. The company's certificate of incorporation is dated 1 April 1995.

YB Ltd's Memorandum of Association, which to date has not been altered, contains the following objects clause:

"*(a)* *to acquire and use European style baking equipment for manufacturing all types of European confectionary;*

(b) *to acquire and use any other kitchen equipment for that or similar purposes;*

(c) *to import or otherwise purchase ingredients suitable for making European style confectionary;*

(d) *to sell European style confectionary in both the retail and wholesale market.* "

Yan and Ben continued to run the business much as they had done as partners. Yan and Ben each held 50 percent of YB Ltd's issued share capital and both were named as its directors.

In 2004 Yan and Ben decided the time was right to introduce "new blood" into the company. Alan and Cin were offered positions as directors of finance and marketing respectively subject to their investing in the company. It was finally agreed that Alan and Cin would purchase shares from Yan and Ben such that Yan, Ben, Alan and Cin would each hold 25% of YB Ltd's issued share capital. It was also agreed that Ben would continue to take on the role of company secretary and that Yan would take up the roles of managing director and chairman of YB Ltd.

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

These arrangements worked well until August 2006 when, at the regular monthly meeting of YB Ltd's board of directors, Alan and Cin put forward a proposal to operate a chain of initially 10 coffee shops at various locations across Hong Kong. Yan was totally opposed to the plan and cited the company's objects in support of his argument. Ben was silent on the issue except that he requested further details of the financial implications of the proposal to be prepared for the next board meeting.

Questions:

Advise Ben with respect to the following:

(a) whether operating a chain of coffee shops is within YB Ltd's capacity?
(10 marks)

(b) if Yan continues to oppose the proposal but Ben supports Cin and Alan, whether YB Ltd's objects may be altered and if so, how?
(7 marks)

(c) whether Yan, in his position as a shareholder, managing director or chairman can prevent the coffee shop proposal from going ahead?
(8 marks)

Question 2 (25 marks)

High-Tech Rental Company Limited ("**Company**") maintained a cutting-edge inventory of video, lighting and broadcasting equipment for renting. It had its own engineering departments and a trucking network in Hong Kong.

On 1 November 2005, the Company executed a debenture ("**Debenture**") granting to Kowloon Bank ("**Bank**") a fixed charge over the Company's present and future book debts, and a floating charge over all assets that the Company owned and would own. The Debenture secured: (1) a previously unsecured loan of $600,000 it owed to the Bank; (2) $900,000 advanced to the Company after the execution of the Debenture; and (3) any future amounts to be lent to the Company.

The Debenture, so far as relevant to the Company's book debts, provides as follows:

> *"The Company hereby covenants that, during the continuance of this security, it will pay into the Company's designated account with the Bank [Account No.121-024581] all monies which it may receive in respect of all book debts forthwith on receipt and, pending such payment, to hold such monies on trust for the Bank, and not (without the prior written consent of the Bank) charge, factor, assign or dispose of such monies. In addition, the Company shall, if called upon to do so by the Bank, from time to time, execute legal assignments of such book debts to the Bank."*

The Company's only shareholders were Alan Wong and Benny Smith, who were also the Company's directors. On 25 September 2006, the Company went into liquidation. Having conducted a preliminary investigation, the liquidator learned the following:

- Kowloon Bank appointed a receiver on 4 September 2006. The receiver sold some of the Company's inventory and collected about $450,000 from the sale.
- The Debenture contained a negative pledge clause, but it did not contain any automatic crystallisation clause.
- In the "Form M1 - Mortgage or Charge Details" submitted to the Companies Registry, the Bank's solicitors set out a summary of the terms of the Debenture regarding the charge over book debts and the negative pledge clause under the heading "Description of Property Mortgaged or Charged";
- The Company's balance sheets began to show a net liability from October 2005.
- In 2003, the Company acquired 100,000 shares in Checkland (Holdings) Company Limited ("**Checkland**").

(See the next page for a continuation of Question 2)

- On 18 February 2006, Linda Lee (Alan Wong's sister-in-law) advanced a loan of $600,000 to the Company. In return, the Company granted to Linda an equitable mortgage over 60,000 shares in Checkland. On 14 March 2006, the Company granted Jessica Smith (Benny Smith's wife) an irrevocable option to purchase 40,000 shares in Checkland. Jessica had not exercised the option before the Company's liquidation.
- On 2 February 2006, Anson Company Limited ("**Anson**") advanced a loan of $400,000 to the Company. On 3 March 2006, in discharge of Anson's loan, the Company transferred a motion camera worth $600,000 to Anson only for $200,000. Alan Wong and Benny Smith are the only directors of Anson. The shares of Anson were respectively owned by Linda Lee (10%), Jessica Smith (10%), Benny Smith (10%) and the Company (70%).
- The Debenture was duly authorised, executed and registered with the Companies Registry.
- The Company owed its employees two months' salaries unpaid at liquidation.

Questions:

(a) Advise the Bank of its priority and legal position under the Debenture regarding the Company's various creditors and customers.

(17 marks)

(b) Advise the liquidator as to what avoidance action(s), if any, he may commence and the likelihood of its/their success.

(8 marks)

Question 3 (25 marks)

A client of your firm, Ben Tam, tells you that he met a Hong Kong businessman, Alan Chan, at the recent Shanghai Trade Show. Alan, through a single purpose British Virgin Islands company ("**AC Limited**"), is the sole owner of a wholly foreign-owned enterprise ("**AC Sportswear Company**") in the PRC. AC Sportswear Company manufactures sportswear and distributes the same in North America. Both parties are very excited about the business and think that it can be ready for listing on the Hong Kong Stock Exchange in a few years' time. They drew up the following draft skeleton agreement at the trade show and now Ben instructs your firm to help him to proceed with the proposed transaction.

"Draft Joint Venture Agreement

1. Alan Chan ("**Party A**") agrees to sell 50% of his interest in AC Sportswear Company ("**Company**") to Ben Tam ("**Party B**") and Party B agrees to purchase the same for the sum of $200 million.

2. Party B further agrees to finance an interest bearing operating loan at 6 percent per annum up to $50 million, on an as required basis, for the operation of the Company.

3. This purchase is subject to the renewal of all the relevant permits by PRC government bodies, including but not limited to all associated business registrations, import permits, custom duties and tax registrations and proof of completion of capital investment ($250 million), so that the Company can carry on the business without prolonged interruptions.

4. Party A agrees to pay all expenses related to the operation of the Company in the previous years (including but not limited to all auditing, accounting and Government duties and taxes).

5. Party A further agrees to hold Party B free from any debt and liabilities (including but not limited to any duties and taxes) incurred by the Company prior to the completion of this agreement.

6. Party B further agrees to pay the purchase price in full within fifteen (15) days upon the successful completion of the renewal or extension of the permits.

7. Upon receiving the purchase price in full, Party A shall execute the necessary documents for transfer of the said amount of shares in the Company to Party B. Thereafter, Party B shall be responsible for completing all the necessary procedures for the effective share transfer in the PRC. Party A shall provide reasonable assistance to Party B in the said transfer.

8. This Agreement and the rights and liabilities of the parties hereto shall be governed by the laws of Hong Kong."

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

Questions:

Without drafting any clauses, write a memorandum to Ben explaining:

(a) **what issues he should consider and the questions he should ask Alan <u>before</u> he signs the agreement?**

(10 marks)

(b) **what provisions he should consider adding to the above draft document in order to protect his position as a shareholder in the Company?**

(15 marks)

Question 4 (25 marks)

Kevin and Chris have been good friends since their time at university. They are now directors of a small company "K&C Software Ltd." ("**Company**") that they established 3 years ago after graduating from university. The share capital of the Company is held equally by Kevin and Chris.

Business success has been moderate. It is Chris who is instrumental in running the business, while Kevin devotes much of his time to developing new anti-virus software.

Both Kevin's and Chris' employment contracts with the Company have a clause that states that neither should work in competition with the Company for 2 years after leaving the employ of the Company and any new product or service developed by any of them during their employment belongs exclusively to the Company.

Kevin, who has been developing revolutionary new anti-virus software, has attracted the attention of Caspian, the managing director of a venture capital firm, VC Ltd, that wishes to invest in the Company. Caspian wants to ensure full repayment of VC Ltd's investment no later than 10 years from the date of the initial investment. He also wants VC Ltd to have overall control of the Company in return for it investing $4,000,000 into the Company. Caspian does not want VC Ltd or any of its members to be involved in the daily management and operations of the Company. He also does not want VC Ltd's investment to be made known to anyone outside the Company. Caspian requires VC Ltd to be paid a consistent and regular return on the investment and he wants VC Ltd to have the final say on all management and business decisions. Kevin is very keen for VC Ltd to make the investment but Chris is opposed to the Company receiving finance from a venture capital fund.

Questions:

(a) Advise Caspian on what various alternatives are available to VC Ltd to achieve its investment objectives.

(15 marks)

(b) Assume Chris resigns from the Company and VC Ltd invests in the Company. Would VC Ltd be able to enforce the non-compete clause contained in Chris' employment contract if Chris sets up a business in competition with the Company?

(10 marks)

Question 5 (25 marks)

Questions:

Question 5(a)

(i) **What duties are imposed under the Stamp Duty Ordinance (SDO) and explain the difference between these duties?**

(3 marks)

(ii) **Section 45 of the SDO provides an exemption from stamp duty in certain circumstances. Explain the operation of Section 45 only in connection with a disposal of shares.**

(10 marks)

(iii) **Describe, giving reasons, circumstances other than those contemplated by Section 45 of the SDO when the transfer of shares in a company will not be subject to stamp duty under the SDO.**

(4 marks)

Question 5(b)

(i) **Explain the difference between a warranty and an indemnity.**

(4 marks)

(ii) **Comment on the following clause and explain, giving reasons, whether the clause will succeed in limiting A's maximum potential liability to $1 million:**

> ***"A will indemnify B against A's breach of contract up to a maximum amount of $1 million."***

(4 marks)

END OF TEST PAPER