

**2007 OVERSEAS LAWYERS
QUALIFICATION EXAMINATION**

**HEAD III: COMMERCIAL
AND COMPANY LAW**

Tuesday, 6 November 2007



HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

6 November 2007

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. 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.**

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Head III: Commercial and Company Law

Question 1 (25 marks)

In 2002, Andrew, Billy and Cindy incorporated S.D. Systems Company Limited (“SDS”) in Hong Kong. It is a provider of e-business applications software. Its articles of association comprises Table A under the current edition of the Companies Ordinance.

Andrew, Billy and Cindy each invested HK\$10 in SDS and were issued with 10 ordinary shares, each with a par value of HK\$1. Each of them is a director of SDS. Andrew is Cindy’s brother.

SDS was initially funded by shareholders’ loans in the total sum of HK\$2,400,000 from Andrew, Billy and Cindy in proportion to their initial shareholdings in SDS. Between 2002-2004, its business expanded gradually. In March 2005, SDS acquired, at a huge price, a new set of cutting-edge computer equipment. SDS obtained finance in the form of a HK\$5,000,000 loan and an overdraft facility of HK\$600,000 from SAR Bank Limited (the “Bank”). In return, SDS granted the Bank a mortgage over its office unit in Causeway Bay to secure all monies from time to time owing by it to the Bank under general banking facilities. The mortgage was duly authorised and executed on 2 March 2005, and registered on time with the Hong Kong Companies Registry.

Unfortunately, 2006 was a disastrous year for SDS, and SDS began to experience cash flow problems in October 2006. The Bank requested SDS to provide additional security for the overdraft facility. On 28 December 2006, SDS executed an all-monies floating charge over all of its assets and undertaking in favour of the Bank.

SDS is now also indebted to Gina Company Limited (“GC”) for a total sum of HK\$400,000 for unpaid software products. Mr. Kenny Lam, the manager of GC, told you that SDS has failed to settle any of the invoices issued by GC in the past 4 months despite repeated requests. From Mr. Lam and various sources, you learn that:

- The Causeway Bay office unit is now worth about HK\$5,000,000. Apart from this office unit, SDS’s only valuable assets are some computer equipment and certain consulting fees outstanding from clients. The outstanding consulting fees now stand at HK\$1,550,000 (excluding the amount of HK\$370,000 referred to below), and the market value of the computer equipment is about HK\$950,000.

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

- On 18 March 2007, SDS collected a HK\$370,000 consulting fee from one of its clients. SDS immediately deposited this amount into its overdraft account with the Bank.
- On 14 December 2005, SDS made an early repayment of a HK\$500,000 loan to Johnson Engineering Company Limited (“JEC”), a company incorporated in Hong Kong in June 2002. Cindy and Diana each own 50% of the shares in JEC. Diana is Andrew’s wife. JEC’s directors are Diana and SDS.
- Immediately before the execution of the floating charge on 28 December 2006, the overdraft stood at HK600,000. On 26 February 2007, a cheque was drawn on the overdraft account in the amount of HK\$300,000.
- SDS owes 2 employees HK\$8,000 each for arrears of wages. In addition, SDS has 2 unsecured creditors, namely Charter Renovation Company Limited (for an unpaid plumbing fee of HK\$3,200) and Prompt Finance Ltd (for an unsecured loan of HK\$120,000). Furthermore, SDS has not repaid any part of its shareholders’ loans.
- On 25 January 2007, Emily (the mother of Andrew and Cindy) granted SDS a loan of HK\$600,000 at an annual interest rate of 8% repayable on 25 January 2008. On 1 March 2007, SDS repaid HK\$500,000 to Emily.
- In May 2003, SDS capitalised a profit of HK\$300,000 and, in consequence of this, the shareholders each took 100,000 fully paid-up ordinary shares without advancing any payment for the shares. In July 2004, in consideration of Andrew’s computer programming services provided to SDS for a period of 10 months, he was allotted 200,000 fully paid-up ordinary shares.

Question:

Prepare a letter of advice to Kenny Lam, the Manager of GC, explaining the various choices GC has to recover its outstanding debt from SDS. Your advice should cover the legal position of GC *vis-à-vis* the Bank and any other parties.

(25 marks)

Question 2 (25 marks)

Question 2(a)

Your supervising partner has heard that you have just attended a Continuing Professional Development course on stamp duty and he needs your help on the following questions:

- (i) **Why is proper stamping of documents in a share acquisition and disposal transaction crucial in Hong Kong and, in this context, explain the significance of the process of adjudication?**
(3 marks)
- (ii) **A Limited owns 90% of the issued share capital of B Limited. An individual, X, your firm's client, owns the entire issued share capital of A Limited. Another individual, Y, owns 10% of the issued share capital of B Limited. On the basis of an oral understanding between X and Y, a parcel of Hong Kong non-residential property is to be conveyed from A Limited to B Limited. X cannot immediately recall which company is registered in Hong Kong. X tells your supervising partner that the conveyances are to be financed by certain bank loans. Based on these facts, what are the Hong Kong stamp duty consequences and what can be done to minimize Hong Kong stamp duty?**
(6 marks)

Question 2(b)

Your client is interested in buying a chain of cake shops owned by a company incorporated in Hong Kong. He is not sure whether he should buy the company itself or the company's underlying business.

- (i) **Prepare a memorandum advising the client of the main differences between a share sale and a business sale transaction.**
(6 marks)
- (ii) **Your client tells you that he prefers buying the underlying business and asks you to explain how he may deal with any commercial agreements the vendor company has entered into for the purpose of carrying on the business. Prepare a memorandum explaining to your client how these commercial agreements to which the vendor company is a party may be dealt with as part of the transaction for the sale of the cake shop business to your client.**
(10 marks)

Question 3 (25 marks)

Pearl is a minority shareholder in Cando Ltd (“Cando”), a public company incorporated in Hong Kong and listed on The Stock Exchange of Hong Kong Ltd (“SEHK”). At all relevant times, she held 6.5 % of the issued capital of Cando.

Pearl has always taken a keen interest in the affairs of Cando because her cousin, Con, is a director and he and his immediate family are also its controlling shareholders. Their control is held indirectly through All Invest Ltd (“AIL”). At all relevant times, AIL held about 48% of Cando's shares.

In 2005, Con arranged a series of transactions which resulted in substantial gains for AIL and apparent disadvantageous outcomes for Cando. These transactions invariably involved another company, Monoly Ltd (“Monoly”). In particular, Con arranged for AIL to sell its shareholding in Monoly at a price which was more than four times the price of Monoly shares at the time. He also arranged for Monoly to sell unattractive investment property to Cando at a time when it was short of funds. Cando had to undertake a rights issue to finance the purchase.

Pearl was very suspicious as to the need for a rights issue and now suspects that these transactions are somehow linked. She has also learned that Cando is trying to sell the investment property but has not received a single offer equal to the price it paid in 2005.

In 2006, Pretty Feet Ltd (“Pretty Feet”), a wholly owned subsidiary of Cando, entered into a series of transactions with AIL, including the purchase by Cando of factory premises and an office block. These transactions were approved by Cando in general meeting. Pearl has also recently learned that these purchases were overvalued by between 80 and 100 per cent. Con is the managing director of Pretty Feet.

Pearl believes there was no adequate financial, commercial or other proper reason for these transactions.

Question:

Pearl asks you to prepare a memorandum, citing case authority as appropriate, advising her in respect of the following:

- (a) bringing a common law derivative action; and**
(15 marks)

- (b) bringing an action under sections 168BC – 168BK (Part IVAA) of the Companies Ordinance on Cando’s behalf.**
(10 marks)

Question 4 (25 marks)

Your client, Mr. Alex Chan, consults with you and informs you that he is considering investing HK\$10 million in a new start-up company, TT Limited (the “Company”). The Company is indirectly held by its 2 directors, John and Sam. Each of them owns 1,000 fully paid ordinary shares in A-Team Limited (“Hold Co”), which in turn owns the entire issued share capital of the Company. Both John and Sam have lengthy directors’ service contracts with the Company, with very favourable compensation terms. Betty and Celia, the wives of John and Sam respectively, are the only two directors of Hold Co, and both are paid a handsome annual director’s fee by the Hold Co, which has invariably been paid entirely from the dividends Hold Co receives from the Company.

Mr. Chan has been told that despite the relatively short history of the Company, it has managed to impress various big local companies and has recently secured some lucrative long-term maintenance contracts with these companies that are worth millions of Hong Kong dollars in revenue to the Company. To accommodate its Research and Development Department and growing employee force, the Company is looking to acquire its own premises. The Company plans to use Mr. Chan’s investment towards part of the office acquisition costs, new staff recruitment expenses and as general working capital for the Company. John and Sam tell Mr. Chan that it has been the Company’s practice to pay all net profits as an annual dividend to Hold Co. Hold Co has not, however, made any dividend payments to John and Sam as all dividends are used to pay Betty’s and Celia’s directors’ fees.

Although Mr. Chan is interested in acquiring control of the business, he does not have the time needed to participate in running the company. His wish is to receive a steady and regular return on his HK\$10 million investment and to ensure that his capital is protected. Mr. Chan has toyed with the idea of just lending the money to the Company instead of becoming a shareholder, but he is concerned with the associated credit risk. He also believes that it would be a good idea for him to obtain a security interest over the office premises to be purchased by the Company.

From the perspective of John and Sam, they are keen for Mr. Chan to become a shareholder of Hold Co by issuing to him 10 million new 4% non-cumulative preference shares for his HK\$10 million investment. John and Sam have told Mr. Chan that these new shares will not carry any voting rights and they will also not confer on Mr. Chan any prior or additional rights in respect of a distribution following a winding-up of the Company.

(See the next page for a continuation of Question 4)

Question:

You represent Mr. Chan who asks you to explain the following:

- (i) the main differences between ordinary and preference shares. You should also explain to Mr. Chan what the difference would be between his holding ordinary shares and the non-voting 4% non-cumulative preference shares suggested by John and Sam.**

(6 marks)

- (ii) how should Mr. Chan consider structuring his investment in order to achieve his objectives of receiving a regular and stable return on his HK\$10 million investment, minimizing the risk associated with his investment and his desire to retain some element of control over the company without actually being involved in the day-to-day operations.**

(16 marks)

- (iii) would Mr. Chan be able to obtain a security interest in the office premises to be purchased by the Company if most of the funds for the purchase of the premises will be obtained by way of a bank loan and, if so, what procedural steps should Mr. Chan take to ensure that the security interest is enforceable.**

(3 marks)

Question 5 (25 marks)

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

- (a) **The Securities and Futures Ordinance established the Market Misconduct Tribunal (MMT). Describe and explain the following:**
- (i) **the jurisdiction of the MMT; (5 marks)**
 - (ii) **how and by whom proceedings may be initiated before the MMT; (4 marks)**
 - (iii) **the sanctions the MMT may impose on those it identifies as having engaged in market misconduct. (4 marks)**
- (b) **Your client, Mr. Dim, tells you that he has received the following document from Mr. Sly, in relation to a debt that Mr. Sly’s company, Nil Resources Limited, owes Mr. Dim:**

“To: Mr. Dim,

Date: 1 October 2007

I, the undersigned, James Sly, hereby irrevocably and unconditionally confirm to you that it is my policy to ensure that my company, Nil Resources Limited, is at all times in a position to meet its obligation to you.

SIGNED SEALED AND DELIVERED)

by James Sly)
in the presence of:)”

Assuming Mr. Sly is entirely credit worthy, explain, giving reasons and citing case authority as appropriate, whether the confirmation, which has been properly signed by Mr. Sly, will be enforceable.

(12 marks)

END OF TEST PAPER