
2008 OVERSEAS LAWYERS QUALIFICATION EXAMINATION

HEAD III: COMMERCIAL AND COMPANY LAW

Tuesday, 4 November 2008



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TEST PAPER

4 November 2008

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.**

2008 Overseas Lawyers Qualification Examination

Head III: Commercial and Company Law

Question 1 (25 marks)

Titanica Limited (“Titanica”) is a Hong Kong incorporated company which operates a retail computer hardware business in Hong Kong. The shareholders and directors, Moby, Nimo and Poppy, have been friends for more than 10 years. The daily operations of the business are undertaken and conducted by Nimo and Poppy, who are a married couple. Titanica was incorporated in 2005 with an authorized share capital of HK\$10,000 divided into 10,000 shares of HK\$1.00 each. In January 2006, Dick, a friend of Moby, was appointed a non-executive director of Titanica.

The friends had ambitious plans for Titanica, genuinely believing that the business had great potential. However, their hopes were shortlived and Titanica’s business never took off. By July 2008, Titanica experienced serious cash flow difficulties. A meeting of the directors was held on 11 July 2008 to consider whether further funds should be injected into the business. The directors were, however, unable to reach a decision on this issue and so adjourned the meeting for one week. Immediately after the directors’ meeting, Nimo and Poppy, who were also in personal financial difficulty themselves, moved quickly and procured Titanica to enter into an agreement with Fox Limited without the knowledge of Moby or Dick. The directors and shareholders of Fox Limited are Nimo, Poppy and Totem Tam. The terms of the agreement provide that (i) loans amounting to \$2 million, previously advanced to Nimo and Poppy by Titanica, would be assigned to Fox Limited; (ii) Titanica’s principal assets, a shop in Pokfulam and all its inventory, valued at \$1 million, would be transferred to Fox Limited; (iii) Fox Limited would be required to discharge the consideration for the loan assignment and asset transfer on 8 July 2009. Upon discovering the transaction, Moby reported the matter to the police and applied to have Titanica wound up.

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

Question:

Moby consults you to ascertain the following:

- (i) Explain, giving reasons and citing case authority, as appropriate, whether the transaction that Nimo and Poppy caused to be concluded with Fox Limited is liable to be set aside.**

(7 marks)

- (ii) Explain what is meant by tracing and whether the assets disposed of to Fox Limited may be traced.**

(10 marks)

- (iii) Moby discovered that Nimo and Poppy have never prepared audited financial statements or filed any annual returns for Titanica. What, if any, liability are Moby and Dick exposed to?**

(8 marks)

Question 2 (25 marks)

ABB Co. Ltd (“ABB”) is a very successful and well known family business manufacturing and trading in electronic goods. The founder of the business, Bunn, died in 1999 and, since that time, ABB’s board of directors comprised of Bunn’s three sons, namely Alan, Bill and Ben, and Rawson, who is a qualified professional accountant. Alan, Bill and Ben and their step-mother, Annie, each hold 25 per cent of ABB’s issued share capital.

In mid 2007, Rawson came across some paperwork which suggested that some of the hi-fi systems manufactured at ABB’s factory in Guangdong were being delivered to a company called MacS Ltd (“MacS”). Ordinarily the hi-fi systems would either be transported to ABB’s godown in Hong Kong and then distributed to retailers here or sold to wholesalers in the USA. Rawson noticed that MacS’s premises were also in Hong Kong and it thus appeared that ABB was competing with MacS for customers. Rawson then tried to discover the price at which ABB was selling the hi-fi system to MacS but could not find any relevant paperwork or evidence of payment.

Rawson was reluctant to question either Alan, Bill or Ben because he was very well paid and did not want to lose his position as finance director. But he felt uneasy about his findings and sought to discover the scale of the deliveries to MacS and the impact of these activities on ABB’s profits and dividends.

At about the same time Alan, who is the eldest of the three brothers and took on the roles of CEO and chairman of ABB, proposed a massive expansion of ABB’s manufacturing plant in Guangdong. The proposal required ABB to raise more than \$50 million. The board of directors supported the proposal and Rawson was given the task of finding ways to raise the required funds.

Negotiations with various banks, all of which asked for a copy of ABB’s latest audited accounts, resulted in ABB creating a fixed charge over its godown and a floating

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

charge over the stock of electrical goods stored at its godown as security for loans amounting to \$30 million. When Rawson next saw Alan he explained that the banks appeared to be reluctant to lend additional funds largely because of the economic slowdown in the USA. Alan's response was "try asking my step-mother to make up the difference".

Reference to Alan's step-mother, Annie, prompted Rawson to recall his earlier concerns about ABB's relationship with MacS – and the suspicion that Alan, and perhaps his brothers, were diverting ABB's business to another company. Before consulting with Annie, Rawson conducted a search at the Company's Registry, which revealed that the only shareholder of MacS was a company called Scam Ltd ("Scam") and that Alan was the founding member and only shareholder of Scam.

Rawson was so alarmed by this revelation that he arranged a meeting with Annie and explained his concerns. Annie then consulted her lawyer with a view to "stopping the cheating". She had suspected that her step-sons had been cheating her ever since Bunn's death, when the brothers removed her as a director of ABB, but previously she had no evidence.

Question:

You are Annie's lawyer and she asks you to advise on the following:

- (i) whether she has any grounds to petition for ABB Co. Ltd to be wound up by the court and the likelihood of her petition succeeding. (7 marks)**

- (ii) whether her step-sons are in breach of their duties as directors, and the powers of the court / liquidator in respect of investigating their activities. (12 marks)**

- (iii) the laws, if any, for ensuring that her step-sons cannot be appointed as directors of a company. (6 marks)**

Question 3 (25 marks)

Hydro Company Limited (“Company”) was incorporated in Hong Kong in January 1993. For more than 15 years, the Company has built a reputation for advanced water purification systems. Its customers include major hotels in Hong Kong, Macau and Shenzhen. The Company has only two directors, Peter Yim and his wife, Susan Yim, who are also the Company’s shareholders.

The Company’s business has been expanding ever since the Macau Government encouraged foreign investors to construct up to 25,000 new hotel rooms to meet the growing demand from the city’s booming tourism industry. During the three years ended 2005, the Company’s turnover and net profit achieved a double-digit annual growth rate.

Impressed by the Company’s performance, the Company’s banker, SAR Bank (“Bank”) invited the Company to join its “Premier Overdraft Protection Scheme” in January 2005. Being one of the Bank’s “Preferential Customers”, the Company was granted a pre-approved standby credit limit of up to \$800,000. The interest rate on the amount drawn under this facility is 1% above HSBC’s prime lending rate, with a monthly minimum repayment of 5% of the amount drawn. The Company duly executed the overdraft facility letter on 26 January 2005.

Unfortunately, in June 2006, the Company experienced some serious bad debts when it failed to collect approximately \$5,000,000 from a Shenzhen developer. The combination of bad debts and a previous bad investment in early 2006 produced enormous difficulties for the Company. After prolonged negotiations, the Bank agreed to lend an additional \$1,000,000 to the Company. On 2 January 2008, the Company granted an “all-monies” floating charge over all of its assets, book debts and undertaking in favour of the Bank (“Debenture”). The Debenture secured (1) the

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

previously unsecured loan of \$800,000, being the amount overdrawn on the current account; and (2) a new \$1,000,000 overdraft facility (at 1.75% above HSBC's prime lending rate) established for the Company at the same time as the execution of the Debenture.

Unfortunately, by 31 October 2008, the Company was unable to repay any part of its debts despite repeated written demands. According to a report prepared by the Bank's credit department, the Company's main assets are its book debts, which are estimated to be worth about \$1,100,000. Other pertinent information includes the following:

- The Company's balance sheets began to show a net liability from December 2007;
- The total amount due to unsecured creditors is estimated to be \$700,000. One of the unsecured creditors, Bravo Marble Company Limited ("Bravo"), obtained a summary judgment order against the Company in the amount of \$276,355.
- Desperately trying to help her husband, Susan Yim sold all her diamond rings and gold necklaces in July 2006 and granted an interest-free loan of \$500,000 to the Company. The loan is repayable on 1 July 2009. Susan Yim's sister, Mary Wong, sold her portfolio of shares in July 2006 and granted an interest-free loan of \$300,000 to the Company. This loan is repayable on 1 April 2009.
- On 24 December 2006, the Company made an early loan repayment of \$300,000 to Susan Yim. On 27 June 2008, the Company made an early loan repayment of \$250,000 to Mary Wong.
- The net value of the claims of preferential creditors against the Company is estimated to be \$280,000.

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

- The table below shows recent movements of funds in the Company's overdraft ("OD") facility account with the Bank:

Date	Deposit (\$)	Withdrawals (\$)	Balance (\$)
3 January 2008			800,000 OD
12 January 2008		410,000	1,210,000 OD
15 February 2008	285,000		925,000 OD
28 March 2008		315,000	1,240,000 OD
4 April 2008	337,000		903,000 OD
27 April 2008	178,000		725,000 OD
31 October 2008		275,000	1,000,000 OD

- Bravo issued a statutory demand yesterday threatening to wind up the Company unless the judgment debt (together with interest) is discharged in full within 21 days.

Question:

You are consulted by Mr. Richard Jones, senior manager of the Bank, to advise him of the various scenarios available to the Bank to recover its debt. Prepare a letter of advice to Mr. Jones analyzing the various options (including their advantages and disadvantages) available to the Bank with a view to recommending the most effective option to recover its debt. Your letter of advice should conclude with an outline of a strategic plan for Mr. Jones to consider.

Question 4 (25 marks)

Question 4(a)

- (i) Explain briefly why it is important that the issued share capital of a company is maintained. (2 marks)**
- (ii) Apart from restrictions against financial assistance under the Companies Ordinance, name 4 other means of protection provided under the same Ordinance for the maintenance of capital. (2 marks)**

Jade Limited (“Jade”) agrees to sell all the shares in its wholly-owned subsidiary, Pearl Limited (“Pearl”) to Diamond Limited (“Diamond”). Prior to the sale, Pearl transfers, with the knowledge and agreement of Diamond, certain business assets to Jade, which Jade is to retain and which will not form part of the sale to Diamond. The transfer of these business assets by Pearl is made at below market value.

- (iii) Giving reasons, explain whether the transfer by Pearl is caught by section 47A of the Companies Ordinance. (4 marks)**
- (iv) Are there any alternative strategies which Pearl or Jade could use to transfer the business assets? (2 marks)**

Question 4(b)

John, a colleague in your solicitors’ firm, has been asked by an old client to serve as an independent non-executive director (“INED”) of a company that is listed on the Hong Kong Stock Exchange. John loves the sound systems made by this company and has shares in the company. John is a property lawyer and does not know much about manufacturing. John is not sure if he can accept the appointment. If John accepts the appointment as an INED, he wants to know more about his responsibilities and liabilities. He has heard that the job of an INED is an onerous one and an INED has to serve on different committees.

Prepare a written memorandum of advice for John, dealing with the queries and issues he has raised. (15 marks)

Question 5 (25 marks)

You are consulted by Mr. Lo, who is a director and 40% shareholder of a Hong Kong incorporated company, Xanadu Limited (“Xanadu”), a furniture manufacturer. The remaining shares are held by Mr. Lo’s 3 brothers in equal shares. Mr. Lo tells you that Xanadu has for the past 6 months been experiencing financial difficulty. The company’s main asset is its premises from which it operates in Hong Kong. The value of the property, which is unencumbered, is \$5 million. It is not possible to sell the property as Xanadu’s business is operated from the premises and moving to new leased premises would result in the company incurring significant additional expenditure. Mr. Lo is concerned that Xanadu will, from the end of the current month, not be able to service all its debts, the vast majority of which are debts due to trade creditors. Mr. Lo has calculated that Xanadu will have cash of \$150,000 at the end of the month from which it will need to pay \$500,000 in debts to various trade and other creditors. Although Xanadu has various bank loans, none of them is secured. Xanadu’s total liabilities are \$3 million.

Mr. Lo does not believe Xanadu’s cash-flow will improve and estimates that the company will not have sufficient funds to pay its current liabilities for the foreseeable future. He tells you that he is physically and emotionally exhausted and just wants to cease operations as soon as possible although his fellow directors and shareholders want to continue operations for as long as possible without changing the way they operate the business. They are also averse to borrowing further funds from the bank.

Question:

Prepare a detailed letter of advice to Mr. Lo in which you explain the following:-

- (i) whether it is possible to liquidate Xanadu and, if so, what would be the appropriate method(s) of liquidation available to the board to consider? You should also highlight the main differences between the methods of liquidation you outline for Mr. Lo. (10 marks)**

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

(ii) the procedures (including time periods) that will need to be followed in order to appoint a liquidator by way of a creditors' voluntary liquidation. (8 marks)

(iii) are there any potential liabilities Mr. Lo and others would be exposed to if the remaining directors refuse to wind-up Xanadu and it continues operating in its current financial predicament? (7 marks)

END OF TEST PAPER