2011 OVERSEAS LAWYERS QUALIFICATION EXAMINATION

HEAD III: COMMERCIAL AND COMPANY LAW

Tuesday, 15 November 2011

THE LAW SOCIETY OF HONG KONG
香港律師會

HEAD III: COMMERCIAL AND COMPANY LAW

TEST PAPER

15 November 2011

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 questions 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.**

2011 Overseas Lawyers Qualification Examination
Head III: Commercial and Company Law

Question 1 (25 marks)

Huge Harvest Investment Ltd. (the "**Company**") is a private company incorporated in Hong Kong in 2008. Its shares are held by 5 shareholders, namely, Peter Wong (60%), Keith Cheung (20%), Eric Au (10%), Wilson Chow (5%) and Frankie Chan (5%). The directors were Peter Wong, Keith Cheung and Wilson Chow. Day-to-day management and important decisions of the Company were carried out by Peter who acted as the managing director of the Company since its incorporation.

Keith played a limited role in the management of the company as he was based in Shanghai and only travelled to Hong Kong occasionally. Eric was a passive investor in the Company and was not involved in the management. Nor had he attended any general meeting of the Company. Wilson is the cousin of Peter and usually agreed with Peter on important issues.

The Company has not made any profit since its incorporation. By October 2010, it had accumulated huge trading losses. Keith and Frankie were not happy with the way that the Company was run by Peter. They were also dissatisfied with the fact that important information concerning the affairs of the Company had not been disclosed to them. Keith wanted the board to take a more active role instead of leaving important decisions to Peter alone.

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

Keith and Frankie also decided to engage a firm of chartered accountants to conduct an independent review of the accounts and books of the Company. In order to have a full picture of the affairs of the Company, the accountants required to see all the relevant documents of the Company (including books of account, minutes of all general meetings and board meetings). As a result, Frankie approached Peter with a formal request to inspect and make copies of those documents. Frankie's request was denied by Peter on the ground that Frankie was not entitled to inspect any documents of the Company. Frankie responded furiously by alleging that Peter's refusal was in "blatant breach" of the Companies Ordinance and threatened to take legal action against Peter.

The Company adopts the current version of Table A as its articles.

Question:

Under the Companies Ordinance and Table A, does Frankie have any legal right to inspect and request copies of any of the documents? You should fully explain your answers (including where applicable reference to relevant legislative provisions and necessary steps involved).

[25 marks in total]

Question 2 (25 marks)

M.S. Company Limited (the "**Company**") is a Hong Kong incorporated company owned by Michael (as to 80%) and Susan (as to 20%), both of whom are also its directors. The Company operates a clothing retail chain, which commenced business in February 2009. Its initial funding was from a HK$1,500,000 shareholder's loan from Michael. Business grew steadily and the Company launched an expansion plan in early 2010 by opening new outlets and even purchased the site for one of the new outlets in Mongkok. The purchase was financed by a HK$7,500,000 mortgage loan from Kowloon Bank ("**KB**"). As security, the Company executed a mortgage in favour of KB on 3 March 2010, under which the Company created in favour of KB a first fixed charge over the premises of the Mongkok outlet to secure all monies from time to time owing to KB under general banking facilities.

Unfortunately, during the last quarter of 2010, the Company was experiencing cashflow problems and could not pay interest on the KB mortgage loan on time. In November 2010, the Company turned to KB again for help. After assessing the situation, KB believed it would be better for them to provide additional funding to the Company to help it turn around, rather than press for immediate repayment of the mortgage loan. So KB agreed to grant a HK$500,000 overdraft facility to the Company, in return for the Company's executing in KB's favour a floating charge over its entire assets and undertaking to secure all monies from time to time owing to KB under general banking facilities. The floating charge was duly executed on 12 December 2010.

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

By March 2011, the Company was again experiencing cashflow problems. Having used up the overdraft, it was unable to obtain more loans from either KB or any other banks. Finally, help came on 15 March 2011 when Alan (Susan's brother-in-law) lent the Company a one-year term loan of HK$800,000 with interest at 10% flat. Both principal and interest are to be repaid by the Company in one lump sum on maturity. Michael caused the Company to use Alan's loan to pay off some arrears owed to its suppliers, and also to reduce his own shareholder loan from HK$1,500,000 to HK$1,000,000.

As at today, the Company's Mongkok premises are worth about HK$7,000,000, but HK$7,300,000 is still outstanding to KB by way of principal and interest under the mortgage loan. The Company's cash in hand is about HK$110,000, whilst a total of HK$80,000 is being owed to some 15 employees in respect of unpaid wages for the past 2 months. The Company's current inventories amount to around HK$400,000. A few weeks ago, Michael finally got tired of Susan's incessant requests that Alan be repaid. So, on 7 October 2011, Michael caused the Company to repay HK$370,000 to Alan, while the Company was in arrears with payments to nearly all its suppliers.

You act for Woo Shi & Co. ("WS"), one of the Company's manufacturers. The Company is indebted to WS for HK$427,000 for garments delivered but unpaid. Peter, the sole proprietor of WS, told you that the Company had been in arrears with payments to both WS and KB for more than 3 months. Peter asks for advice on WS's legal position and the likelihood of recovering its outstanding debt.

Question:

Prepare a written advice to Peter to help him make a decision as to what WS should do in order to recover its outstanding debt. Your advice should cover the legal position of WS *vis-à-vis* KB and all the related parties.

[25 marks in total]

Question 3 (25 marks)

Concept Eateries Limited ("**Concept**") is a company which was incorporated in Hong Kong in November 2006 with an authorised share capital of HK$10,000 divided into 10,000 shares of HK$1.00 par value each, all of which shares have been issued. Natalie and Melinda are both registered in the register of members of Concept as members with each holding 5,000 shares. Natalie is a director and Melinda is a director and the secretary of Concept. Concept owns a chain of high-end restaurants in Hong Kong and is also the distributor of organic meats from Iceland. In addition to Natalie and Melinda, there are another 150 employees working for Concept in the different restaurants. None of the directors or employees has any formal employment contract with Concept. Natalie is overall in charge of managing the operations of all the restaurants and Melinda the organic meat distribution arm of Concept.

Magnus Investments Limited ("**MIL**") wants to enter the high-end retail catering market in Hong Kong and it has decided that the best way to do this is to acquire Concept but MIL has no interest in the distribution of organic meats.

Natalie is prepared to sell all her shares in Concept especially given the fact that recently a major French competitor has been expanding aggressively in Hong Kong and also several employees have taken legal action against Concept on the ground that Concept has not been paying them the legally-prescribed minimum wage. Melinda has just had a baby son and wants to spend more time with her son, therefore she is also happy to sell all her shares in Concept. MIL is happy to purchase all the issued shares of Concept but insists that Concept's meat distribution business not be included in the transaction.

You have been instructed by Natalie and Melinda to act for them in the sale of all the issued shares of Concept and all related matters.

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

Questions:

(a) MIL's solicitor has sent you a request to provide various documents to him so that he can conduct due diligence investigations on Concept. Provide a simple explanation to Natalie and Melinda on the purpose of such due diligence being conducted by MIL's solicitor bearing in mind that Natalie has told you that she has already "told MIL everything".

(4 marks)

(b) (i) Advise Natalie and Melinda the purposes of the representations and warranties to be given by them in the sale and purchase agreement.

(3 marks)

(ii) List out the matters which you would expect to see in the standard warranties of a sale and purchase agreement.

(5 marks)

(c) Explain to Natalie and Melinda the purpose of the disclosure letter that you will be preparing for them in relation to their representations and warranties in the sale and purchase agreement and on the facts, what you might be providing in the letter to protect Natalie and Melinda.

(3 marks)

(d) Advise Natalie and Melinda what actions you will take to assist them to spin off the distribution business. (7 marks)

(e) In addition to the share purchase agreement, what other documents will you need to complete the transfers of the issued shares in Concept from Natalie and Melinda to MIL.

(3 marks)

[25 marks in total]

Question 4 (25 marks)

Mrs. Ko, your neighbour and a housewife, has picked up from her retail bank branch a prospectus of a company ("**Listco**") seeking a listing of its shares on the Hong Kong Stock Exchange. Listco, incorporated in Hong Kong, makes and sells sports shoes throughout the PRC and Hong Kong. Mrs. Ko has read the prospectus and wants to subscribe for shares in Listco. She has heard that you work in a law firm and have experience in company laws and Listing Rules. Mrs. Ko seeks your advice on the following:

Questions:

(a) **Mrs. Ko is planning to use her precious savings to subscribe for shares in Listco. Accordingly, she wants to know what protection there is under common law and all relevant ordinances and regulations in Hong Kong, should the prospectus contain misstatements or misrepresentation or if there is omission of material information about Listco and its businesses in the prospectus. Who can she sue? Who will become liable?**

(10 marks)

(b) **Assuming some or all of the directors of Listco had been negligent in preparing the listing prospectus, can Listco offer them indemnities and/or purchase liability insurance for them?**

(4 marks)

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

(c) The Chairman of Listco owns another company ("Privateco") that makes and sells high-end formal leather shoes but Privateco is neither a subsidiary of Listco nor part of the present listing. This is mentioned in the prospectus. Mrs. Ko wants to know why the Hong Kong Stock Exchange has allowed this to occur and, in so allowing the Chairman to own both companies, what factors may the Hong Kong Stock Exchange have considered and what protection may have been built into the listing process to safeguard the interest of the public investors of Listco?

(7 marks)

(d) Mrs. Ko is worried that the Chairman of Listco may sell his interests in Listco following listing. Can Mrs. Ko rely on any restrictions under the Listing Rules to stop the Chairman from doing that?

(4 marks)

[25 marks in total]

Question 5 (25 marks)

Question 5(a)

Martha is a talented chef who has built a small but successful restaurant in North Point, which simply trades under the name "Martha's" and which is run as a sole proprietorship. It is a relatively high-end restaurant which aims to provide a higher priced dining experience. As well as attracting walk-in customers, Martha's has a loyal following of regular customers, who have previously provided their contact details and these details are captured on a database. Martha's contacts these customers from time to time via e-mail to let them know of promotions at the restaurant and to remind them to book early for various holidays and other special occasions.

Martha's employs 6 people in the kitchen, 10 people in the main restaurant and one accountant. Martha's leases its premises in North Point. The premises next door have become available to rent, and Martha sees an opportunity to expand the business, but she cannot personally make the further investment required to enter into a new lease of the next-door premises, refurbish those premises and finance the increased working capital that will be required to grow the restaurant. Martha has approached her friend Andrew to see if he is interested in investing in the business.

Based on previous net revenue and forecasted future revenue of the expanded operation, Martha is prepared to offer a 40% stake in the business for HK$2,000,000.

Andrew comes to consult you for advice. He does not know much about how businesses are structured but indicates that he has been invited to invest in a partnership. Andrew tells you that given that he is too busy in his own job, he would like to be a purely passive investor. He had thought though that perhaps being a shareholder in a company would be an alternative.

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

Questions:

(i) **Explain to Andrew the fundamental differences between a partnership and a company limited by shares. Give Andrew your opinion as to the preferable structure for Andrew.**

(3 marks)

(ii) **What would need to happen in order for the business of Martha's to be injected into a new company and for each of Martha and Andrew to be issued 60% and 40% of the issued shares respectively?**

(4 marks)

(iii) **Advise Andrew, with brief reasoning, as to what key provisions he should negotiate in a shareholders' agreement to be entered into between them.**

(7 marks)

Question 5(b)

Andrew and Martha incorporate a company called "Martha's Restaurant Limited" (the "**Company**"). Martha owns 60 shares of HK$1 each (being 60% of the total issued shares) and Andrew owns 40 shares of HK$1 each (being 40% of the total issued shares). These shares were subscribed for at a premium to par value. Although Andrew told Martha of the advice he has received about the need to enter into a shareholders' agreement, Martha convinces Andrew that since they have known each other for more than 5 years, they do not need to enter into a shareholders' agreement and that he should be able to trust her. The Company has adopted Table A as its Articles of Association.

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

Four years later, the lease on Martha's is due to expire, and Martha, as the sole director, decides not to seek a renewal. Some of the regular customers do not like the expanded operation and do not come as often, as they prefer the more intimate atmosphere of the restaurant before it expanded. Notwithstanding, Martha's remained relatively profitable and there is an accumulated profit of more than $5,000,000 (no dividend has ever been paid).

Andrew has heard that Martha is planning to resign as an employee of the Company and to open a new restaurant as a sole proprietor, which she also plans to call "Martha's" (i.e. outside of Martha's Restaurant Limited). Andrew also hears that Martha, in connection with her new restaurant, is targeting the customers of Martha's by e-mail and may also be in talks with existing employees and suppliers. Andrew comes to see you for further advice. Before coming to see you, Andrew ran a search against the Company at the Companies Registry and noticed that Martha appears to have had further shares issued to her at par value, which has resulted in her owning 90% of the Company and Andrew owning 10% of the Company. Andrew does not remember signing any paperwork or voting on any resolutions to approve this.

Questions:

(i) **Advise Andrew on the brief details of what procedures should have been followed for the new shares to be issued. Is Martha under any liability for failing to follow these procedures?**

(3 marks)

(ii) **Advise Andrew whether Martha can set up a restaurant which potentially competes. What restrictions if any, is Martha under in this regard, given that she has targeted customers, employees and suppliers in connection with the new restaurant?**

(4 marks)

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

(iii) Advise Andrew as to whether, as a shareholder, he can bring claims against Martha for the grievances he feels he has suffered as a result of the new issue of shares and the proposed competing venture. Advise Andrew if he can look to apply for the Company to be wound up, and if so, on what grounds.

(4 marks)

[25 marks in total]

END OF TEST PAPER