2018 OVERSEAS LAWYERS QUALIFICATION EXAMINATION

HEAD III: COMMERCIAL AND COMPANY LAW

Friday, 16 November 2018

THE LAW SOCIETY OF HONG KONG
香港律師會

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Question 1 (25 marks)

Great Expectations Property Development Limited ("GEPCo") is a company whose shares are listed on the Hong Kong Stock Exchange. Together with its subsidiaries, it is principally engaged in property development, investment and convenience store operations. Kent Enterprises Limited ("Kentco") is a wholly owned subsidiary of GEPCo.

The board of directors of GEPCo (the "Board") is contemplating entering into the transactions set out below and has consulted you on whether those transactions constitute connected transactions as defined under Chapter 14A of the Listing Rules. Mr. Magwitch is one of the directors on the Board.

Questions:

(a) **Advise on the purpose of the so-called connected transaction rules.**

(2 marks)

(b) **In respect of each of the transactions below being contemplated, advise (and give reasons) whether it is a connected transaction or not:**

(i) **A rights issue to its shareholders and Ms. Havisham, a substantial shareholder of GEPCo, intends to subscribe for the rights issue;**

(2 marks)

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

(ii) **A share option scheme for the benefit of its staff (including Mr. Magwitch);**

(2 marks)

(iii) **Appointment of a new executive director, Mr. Jaggars, and entering into a directors' service contract with him;**

(2 marks)

(iv) **Purchases from convenience stores owned by GEPCo by Mr. Magwitch who tells you he regularly buys groceries there;**

(2 marks)

(v) **A transfer of a parcel of land to Kentco;**

(2 marks)

(vi) **Leasing of premises from Ms. Havisham to be used as one of GEPCo's new convenience stores.**

(2 marks)

(c) **If GEPCo were to proceed with leasing premises from Ms. Havisham to be used as one of GEPCo's new convenience stores, advise what procedural requirements under the Listing Rules GEPCo needs to follow.**

(11 marks)

[25 marks in total]

Question 2 (25 marks)

Microchip Manufacturing Expert Limited ("Company"), a Hong Kong private company, manufactures microchips for sale in the Asia-Pacific Region.

On 4 May 2017, the Company entered into a four-year term loan facility (HK$6,000,000) with Goodwill Bank secured by a floating charge over all assets, book debts and undertakings of the Company ("Goodwill Bank Debenture"). The Goodwill Bank Debenture was duly registered under the Companies Ordinance, Cap. 622. The Company also borrowed HK$5,000,000 from one of its shareholders, Mr. George Wong ("George"). George is also a director of the Company.

Due to the Sino-US trade war, the Company's sales have dropped significantly since June 2018. The Company needed more cash to deal with its financial situation. On 21 June 2018, Rigid Bank provided a HK$5,000,000 2-year term loan facility to the Company secured by a charge over the Company's book debts ("Rigid Bank Debenture"), which was duly registered under the Companies Ordinance, Cap. 622. According to the terms of the Rigid Bank Debenture, any assignment or disposal of the book debts requires Rigid Bank's consent, and the proceeds of the collected book debts must be paid into a designated account maintained with Rigid Bank. On 30 June 2018, the Company borrowed HK$3,000,000 (a five-year term loan facility) from Wealthy Bank secured by a fixed charge over all machinery owned by the Company ("Wealthy Bank Fixed Charge"). Due to an administrative oversight, the Wealthy Bank Fixed Charge was not registered under the Companies Ordinance, Cap. 622. Nothing was done to rectify the error.

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

On 12 July 2018, the Company granted an "all-monies" floating charge over all of its assets, book debts and undertakings in favour of George to secure all personal loans provided by George to the Company.

On 28 July 2018, in need of some quick cash, the Company sold its office building in Central ("Central Office") to Mrs. Anita Wong, the wife of George. The consideration was HK$5,000,000, which was HK$2,000,000 lower than the market value of the Central Office (as valued by an independent valuation in June 2018). George explained that this is a "good bargain" for the Company, as the Company needed the cash quickly and the market was "sluggish" at the time.

The finances of the Company deteriorated further in August 2018. On 6 August 2018, Goodwill Bank appointed a receiver upon an event of default, which is also an event that crystallized the floating charge pursuant to the terms of the Goodwill Bank Debenture. On 13 August 2018, an unsecured creditor presented a winding-up petition against the Company.

The liquidator, Randy Yip, has learned the following information:

(i) The Company's main assets are its book debts (HK$5,000,000), inventory (HK$500,000) and machinery (HK$4,000,000).

(ii) The Company owes 30 of its employees a total of HK$500,000 wages in arrears. It was also revealed that the Company has failed to pay profits tax (HK$150,000) in the immediate previous year.

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

(iii) A trading partner of the Company, Neutron Max Limited ("NML"), initiated proceedings against the Company for breach of contract resulting in the loss of profits (amounting to HK$3,000,000). The Court of First Instance gave judgment in favour of NML to the full extent of the claim. NML commenced enforcement actions on 16 August 2018.

(iv) The Company has 6 unsecured trade creditors, who are owed HK$3,000,000 in total.

(v) On 2 August 2018, the Company used the proceeds of sale of the Central Office to fully discharge the shareholder's loan (with interest) owed to George.

(vi) Evidence shows that the Company has been insolvent since July 2018.

The Company made no early repayment to Goodwill Bank, Rigid Bank and Wealthy Bank in connection with the term loan facilities.

For the purpose of this question, assume that there is no negative pledge clause in any of the debentures or charges.

Question:

You act for the Company's liquidator, Randy Yip, who has drawn your attention to all of the above points. **Prepare a letter of advice to the liquidator, addressing the rights and priorities of all the creditors of the Company.**

(25 marks)

[25 marks in total]

Question 3 (25 marks)

Super Energy Company Ltd. (the "Company") is a private company incorporated in Hong Kong in 2006 by Mr. and Mrs. Chow. Initially the couple were the only shareholders and directors of the Company which is engaged in the business of providing shipping and associated services between Hong Kong and Mainland China. The initial share capital of the Company was HK$2,000,000. The total number of issued shares was 20,000 (Mr. and Mrs. Chow subscribed 10,000 shares each at $100 per share). All issued shares were fully paid up.

In 2013, the Company underwent some structural changes. Mr. and Mrs. Chow invited their twin sons, Jimmy and Peter (who returned to Hong Kong after completing their MBAs in the United States), to join the Company. The parents transferred some shares to their sons as a gift and invited the twins to join the board as directors. By the end of 2013, there were 4 shareholders and 4 directors in the Company:

Mr. Chow	6,000 shares (30%), a director
Mrs. Chow	6,000 shares (30%), a director
Jimmy	4,000 shares (20%), a director
Peter	4,000 shares (20%), a director

To the disappointment of his parents, Jimmy was not interested in the business and management of the Company. He never attended any shareholders' meetings or board meetings although he received dividend (on his 20% shareholding) and director's fee each year since he had joined the Company.

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

The following are the relevant provisions of the articles of association of the Company (which does not adopt the Model Articles) in respect of appointment of directors:

Article 16: .... a person who is willing to act as a director.... may be appointed to be a director by ordinary resolution in an annual general meeting ("AGM").

Article 17: .... all directors must retire from office at the next AGM and shall be eligible for reappointment to the office in accordance with Article 16.

Throughout the years, AGMs of the Company were held on 31 December each year, at which all directors retired and were reappointed for the ensuing year. Following the usual practice, an AGM was convened on 31 December 2017 at which all directors (including Jimmy) retired. The shareholders present at this meeting (namely the parents and Peter) duly passed an ordinary resolution to reappoint themselves as directors of the Company. However, Jimmy was not reappointed. As a result, Jimmy is no longer entitled to receive a director's fee although he has been assured that he would continue to receive a dividend (on his 20% shareholding).

Jimmy is upset about the outcome of the 2017 AGM and suspects that he has been unfairly treated by other members/directors of the Company. He is eager to find out what has happened to the Company. Jimmy believes that as a director of the Company, he would have been entitled to inspect corporate documents of the Company and investigate the affairs of the Company.

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

Question:

(a) Advise Jimmy whether a director has the right to inspect corporate documents. If so, can such right be restricted?

(12 marks)

In September 2018, to save the family from financial disputes, the parents conceded to offer (they have no legal obligation to do so) Jimmy a lump sum of HK$6,000,000 (being 20% of the Company's net assets according to the audited accounts for the year ended 31 December 2017) to buy out Jimmy's shares in the Company. Jimmy rejected this offer. He believes that the fair market value of his shares should be at least HK$12,000,000 although he has no evidence to support this valuation.

In order to prove the true value of his 20% shareholding in the Company, Jimmy plans to engage a firm of chartered accountants to conduct an independent review on the financial position of the Company. To have a full picture of the affairs of the Company, the accountants required to see all the relevant documents of the Company. These include books of account, audited accounts, bank statements, minutes of all general meetings and board meetings, all written contracts and all annual tax returns (the "Relevant Documents").

Jimmy approached the Company last week with a formal request to inspect and make copies of the Relevant Documents. Jimmy's request was declined on the ground that he was no longer a director and thus not entitled to inspect any documents of the Company. Jimmy believes that he has the legitimate right to inspect the Relevant Documents. He is now considering taking legal action against the Company.

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

Question:

(b) **Does Jimmy have any legal right to inspect and request copies of any of the Relevant Documents under the Companies Ordinance, Cap. 622 in his capacity as a shareholder of the Company?**

(13 marks)

[25 marks in total]

Question 4 (25 marks)

Part A

Michael is the husband of Carrie. Michael is a senior finance manager of ABC Ltd. ABC Ltd. intends to acquire a controlling stake of XYZ Limited, a famous wine distributor in Asia. Michael will be involved in this acquisition. He informed his wife, Carrie of this. Carrie subsequently informed this confidential information to her sister, Minnie. Minnie and Carrie then each acquired shares of ABC Ltd. The share price of ABC Ltd. rose by about 15% on the day that the transaction was announced. At the instruction of Carrie, Minnie sold the shares of ABC Ltd. and obtained some profit.

Question:

(a) **Are Michael, Carrie and Minnie liable under Part XIII of the Securities and Futures Ordinance, Cap. 571?**

(13 marks)

Part B

Billy and William are university classmates and worked in different fund houses. Recently, they quit their own jobs and planned to set up a new company (the "Company") in Hong Kong to carry out the business of asset management. Billy and William will be the directors and shareholders of the Company. They will be involved in the day-to-day management of the Company. The Company intends to serve professional clients in and outside Hong Kong.

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

Billy and William come to meet you and want you to advise them on the legislation, procedure and licensing requirements.

Question:

(b) Prepare a memorandum of advice for Billy and William to advise on the regulatory procedures involved.

(12 marks)

[25 marks in total]

Question 5 (25 marks)

Part A

NL Retail BV ("Seller") is a company incorporated in The Netherlands. It has one wholly-owned subsidiary called CSH Retail and Distribution Limited ("CSH") which is a company incorporated in Hong Kong. In turn, CSH owns 100% of the shares in a People's Republic of China ("PRC") incorporated Wholly Foreign Owned Enterprise ("WFOE"). The WFOE is engaged in the business of retail and wholesale distribution of "Cape Street" branded apparel and accessories. The WFOE has five stores in shopping malls in selected cities in the PRC and one flagship store in Shanghai. All of these stores are leased, and each lease contains a change of control clause to the effect that the landlord may terminate the relevant lease if the direct or indirect ownership of the WFOE changes without the consent of the landlord. In total, the WFOE employs around 35 staff based in the PRC. The WFOE distributes the "Cape Street" branded apparel and accessories pursuant to a retail distribution agreement ("Distribution Agreement") entered into between the Seller and Cape Street (UK) Limited, which is a company incorporated in England and Wales and which owns the "Cape Street" brand. The Distribution Agreement was signed in 2015, and provides that the Seller and its subsidiaries can distribute "Cape Street" apparel and accessories in the PRC territory. The Distribution Agreement is for an initial period of 10 years, but is renewable, at the option of the Seller, for a further period of 10 years provided that certain conditions in the Distribution Agreement have been met.

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

CSH also has a head office in Hong Kong and employs 10 staff. The management team comprises three people based in Hong Kong and is critical to the ongoing operations of the business. Each member of the management team has an employment contract which states that either CSH or the relevant employee can terminate it on one month's notice. CSH owns its premises in an office development in Kwun Tong, which is free of any mortgage.

NW Holdings Limited ("Buyer") is a Hong Kong incorporated company. The Buyer is also involved in retail and wholesale distribution of apparel and accessories and has a number of other brands in its portfolio. It distributes branded apparel and accessories throughout the Asia Pacific region through various subsidiaries.

The latest audited accounts of CSH are for the financial year ended 31 December 2017 and show that CSH made a small loss in that year. However, the Buyer believes that CSH has many synergies with the Buyer's existing portfolio of brands, and that the Buyer can return CSH to profit in the short term.

The Buyer has approached you to act in connection with the acquisition of the entire issued share capital of CSH.

The Seller and the Buyer have entered into a non-binding Memorandum of Understanding ("MOU").

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

The MOU includes the following provisions:

- The Seller and the Buyer will sign a binding sale and purchase agreement following completion of the Buyer's due diligence exercise and within six weeks following the date of the MOU.

- Completion of the sale and purchase of shares ("Completion") will take place within four weeks following satisfaction of conditions precedent. If Completion has not taken place within four weeks following the signing of the sale and purchase agreement, the sale and purchase agreement will terminate.

- The consideration for the transfer of shares is HK$230,000,000, of which HK$180,000,000 is payable on Completion and HK$50,000,000 is payable three months after Completion.

- If net current assets are more than HK$10,000,000 at Completion, then the Buyer will pay an amount equal to the excess, as verified by completion accounts. However, if net current assets are less than HK$10,000,000 at completion, then the Seller will pay an amount equal to the shortfall.

- It is anticipated that the net current assets position at completion will be approximately HK$12,500,000. As such, it is agreed that the Seller is able to extract a pre-Completion dividend of HK$2,500,000.

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

In accordance with the Buyer's instructions, you are preparing the sale and purchase agreement, assisting in negotiations, undertaking legal due diligence in respect of the Hong Kong company and its head office operations and liaising with PRC lawyers in connection with the due diligence in respect of the WFOE and its operations.

Questions:

(a) **Explain how the maximum amount of dividend is calculated and procedure for CSH to pay the pre-Completion dividend to the Seller.**

(6 marks)

(b) **Based on the facts outlined above, identify the three main conditions precedent that the Buyer should insist on to ensure that it can continue to run the operations of CSH and the WFOE.**

(3 marks)

(c) **Identify the documents that the Seller should provide to the Buyer at Completion.**

(6 marks)

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

Part B

The Buyer has an existing loan facility of HK$20,000,000 from its bank. The facility is currently unsecured. The Buyer has spoken with its bank to borrow a further HK$50,000,000 in order to fund the second tranche of the consideration. The bank has agreed to provide the further finance in principle, but subject to CSH guaranteeing repayment of the full amount of US$70,000,000 plus interest, to be secured by way of a mortgage of CSH's premises in Kwun Tong.

Question:

(d) **Explain with reasoning whether or not the guarantee and security can be given. Explain the procedure that CSH and its directors must go through in order for the guarantee to be given and for the security to be approved. What are the consequences if the procedures are not followed?**

(10 marks)

[25 marks in total]

END OF TEST PAPER