

PCLL Conversion Examination
8th January 2010
Examiner's Comments
Business Associations

Overall Comments

1. In general the candidates did quite well in the exam and showed good understanding of the applicable legal principles in company law and the ability to apply them to the relevant and material facts in the questions. Since the level of legal knowledge and analytical skills manifested by the candidates is comparable to those of the PCLL students, the candidates that received a passing mark are expected to perform equally well in the PCLL Commercial and Company Law course.

2. Questions 1, 2 and 5 were popular choices of the candidates. Question 3, essentially a procedural question, which requires a good understanding of the winding up proceedings, has not been well received by candidates. It shows that the candidates were not as confident in questions which called for the mastery of practical knowledge, compared to questions which required a thorough understanding of substantive legal principles.

Question 1

3. Questions 1(a) and (b) may appear to be overlapping to some extent. However, the candidates are expected to apply their understanding of the various business structures in (b) to the particular facts given in (a).

4. For (a) there are basically only 2 options, partnership or limited company, and the most suitable vehicle under the facts will be a limited company when the following factors are considered:

- (a) financing;
- (b) potential personal liability of lenders to the partnership's debts;
- (c) control by Alice and Roger;
- (d) the nature of the business and the products involved (printer cartridges may potentially bring substantial liability in tort from product liability claim); and
- (e) The risk to Alice's flat and her desire to keep the present job.

5. For (b) the following advantages and disadvantages should be discussed:

- (a) limited liability;
- (b) continuity of the business;
- (c) ease in transferring interests;
- (d) statutory remedies available to shareholders;
- (e) ease in obtaining financing;
- (f) expansion of the business;
- (g) administrative expense (formation and maintaining) and obligations (filing) involved;

- (h) Comparatively more difficult to wind up a company;
 - (i) Withdrawal of capital; and
 - (j) Tax rates.
6. Candidates generally did better in (b) than in (a), showing a strong background knowledge in substantive law. In (a) they seem to neglect to apply their legal knowledge to the facts given.

Question 2

7. This question involves a topic which is supposed to be rather difficult to students in understanding the various available remedies, especially the different requirements in the common law derivative action and its statutory counterpart, i.e. the fraud vs. malfeasance requirements.
8. Surprisingly candidates did not appear to have any problem tackling the various reliefs available. Overall they did reasonably well.
9. For Section 168A relief, the candidates must understand that conduct of majority shareholder complained of must be both unfair and prejudicial. Section 177(1)(f) should be raised. The usual outcome in these cases is a buyout order instead of winding up order. Extra marks will be given if procedural requirements are discussed, and when mediation under the new Practice Directions 3.4 is raised (none of the candidates discussed mediation).
10. A common law derivative action based on fraud on minority came about when decisions are not made in the best interests of the company, and the minority may bring an action on behalf of all shareholders, naming the company as a nominal defendant.

11. Regarding the statutory derivative action, under Companies Ordinance Part IV AA, leave is required to commence. Malfeasance (which although includes fraud in the definition) is a less restrictive requirement than the fraud required in the common law derivative action.
12. Personal action could possibly be instituted against the majority shareholders/directors directly for breach of fiduciary duties.
13. The preferred choices among the remedies expected from candidates should be the relief under Section 168A, followed by the statutory derivative action.

Question 3

14. Least chosen by candidates. The candidates attempted to answer this question generally did not do very well.
15. In (A), a statutory demand in the sum of \$500,000 should first be issued, and strictly following the requirements in Section 178(1) CO. The usefulness of the SD is to render XYZ “deemed to be unable to pay its debts”, i.e. deemed insolvent and give ABC a ground to wind up XYZ. The requirements for SD should be discussed including the offer to compound within 21 days. A Petition and a verifying affirmation are to be filed. Note that there are also the gazetting requirements to be followed, and the obtaining of the Registrar’s Certificate before said return date.
16. The candidates must identify the possible grounds of opposition:
 - (a) defect in form or service of SD and/or Petition;
 - (b) disputed liability;

- (c) challenged quantum;
 - (d) restructuring feasible; and
 - (e) abuse of process (i.e. petition was for some improper or ulterior motives)
17. On the hearing before the company judge, the court will give directions as to how the case is to proceed, and eventually after filing of evidence by the parties, a hearing date will be fixed
18. As with (B), most students missed this question, some completely. The law is that before the making of the winding up order, any creditor such as ABC or contributory (shareholders of XYZ) may apply to stay SC's action against XYZ under Section 181 of CO. This is not an automatic stay under Section 186 of CO that once the winding up order has been made no action or proceedings can continue or be commenced except by the leave of the court.

Question 4

19. Candidates' performance on this question is satisfactory. Most candidates however failed to answer well regarding the 2nd EGM .
20. The candidates must identify the defect in notice in the 1st EGM, which cannot be cured by the shorter notice in Section 114(3) of CO (which requires consent of shareholders holding not less than 95% of the shares, and A and B together only hold 70%), or written resolutions under Section 116B (which requires consent of all shareholders). However, the defect may be rectified easily by A and B re-serving a proper notice, and at that new meeting, the same resolutions can be passed.
21. As for the 2nd EGM, as the quorum of a general meeting is 3, if C refuses to attend, the meeting will be inquorate. Currently there are only 3 shareholders.

As a result, C's absence can block the ordinary resolution by making the meeting inquorate. However, the deadlock on quorum can be resolved if there are more than 3 shareholders in the company. In this connection, either A and/or B can transfer some of their shares to a nominee to allow the nominee to become an additional shareholder.

22. The candidates should mention that the transfer will need to be validly approved by the Board. C cannot block the approval at the board meeting because he will be outvoted. If he chose to attend the board meeting, A and B can still approve the transfer by virtue of Regs. (5) and (6). And since there is no preemption clause, C cannot block the transfer. Alternatively, A and B may apply to the court for a court-ordered meeting under Section 114B CO but the process is too expensive and time-consuming compared to the above mechanism.

Question 5

23. The candidates are generally very familiar with the fundamental fiduciary duties of the directors towards the company. However most candidates did not discuss Section 162 of the Companies Ordinance.
24. Part (B) is very straightforward. Candidates did not answer (c) as well as (a) and (b). Quite a number of them missed the bankruptcy and unsound mind grounds. Most candidates missed the grounds in Table A Reg. 90 and other regulations in the Articles that disqualify directors.