

PCLL CONVERSION EXAMINATION JUNE 2011

Title of Paper : Business Associations
Date : 24 June 2011
Time : 9:30 a.m. – 9.45 a.m. (Reading Time)
9:45 a.m. – 12:45 p.m.

Instructions

1. Write your **candidate number** on the cover of each answer book. Do **NOT** write your name in the answer book.
2. Start each answer on a separate page of the answer book.
3. Write your answers only in the answer books provided.
4. This is a three-hour examination.
5. This is an open book examination.
6. Reading time for this paper is 15 minutes. Do **NOT** begin writing in your answer books during this period until you are instructed to do so.
7. This paper consists of 5 pages, including four questions. Candidates are required to answer **THREE** questions out of four. A total of 300 marks may be awarded.
8. Each question is worth 100 marks.
9. The passing mark for this paper is 150 marks.

**DO NOT OPEN THIS QUESTION BOOK
UNTIL YOU ARE TOLD TO DO SO**

PCLL Conversion Examination June 2011

Business Associations

Question 1 (100 marks)

Tim and John wish to set up a business in manufacturing and supplying special light bulbs for use in saltwater aquariums for exotic fish. Tim, who has just graduated from university, is the one who designs the light bulbs. Besides his designs, he does not have the financial means to contribute any cash to the business. However, he would allow the business to be conducted at his home inherited from his parents, and the light bulbs could be stored at the covered rooftop of his home as well. John has a full time job as the manager of a Hong Kong company (which he intends to keep) which requires him to do quite a lot of sourcing for suppliers in China. John can contribute to the business by finding factories in China which could manufacture and supply the light bulbs. Although they anticipate that the business venture would be risky, it would be quite profitable in the long term.

Bob, their mutual friend, agrees to contribute most of the initial capital to the new business, in the sum of about HK\$200,000.

- (a) Advise Tim and John as to the different forms of business organizations that they could consider adopting for the new venture. Discuss the specific advantages and disadvantages of each in light of the facts given. (50 marks)

- (b) If the business is to be conducted as a partnership by Tim and John, advise Bob as to how he might contribute the HK\$200,000 to the business. Also advise Tim as to any issues arising from his agreeing to allow his own home to be used for the business. Are there any additional facts you would need to know before fully advising Tim? (20 marks)

- (c) Assuming that Tim and John then decided to conduct their business in the form of a partnership, but because of the time required for the light bulbs to be delivered to Hong Kong, Tim and John agreed that John would first order the light bulbs from a factory in China, XYZ, before the parties enter into a partnership agreement. However, it turned out eventually that the business was never established, and XYZ was never paid. Advise XYZ. (30 marks)

Question 2 (100 marks)

Horace is an experienced qualified accountant and one of the four shareholders in ABC

Limited, a company set up a year ago which provides cleaning services to offices, shopping centers and housing estates. There are four directors. Clause 7 of the company's articles provides:

"7. Horace shall be employed as the company's accountant and shall not be removed from office except for misconduct."

Meanwhile Clause 8 provides:

"8. Where a shareholder intends to sell her shareholding in the company, the shareholder must inform the directors, who must acquire the shares in equal proportions at a fair price."

Horace has since worked as the accountant of the company. Due to his negligence however, there were some major errors in the books of the company. However the auditor is of the opinion, which is supported by expert evidence, that Horace has not engaged in any misconduct.

The Board of Directors then relieved Horace from his position as the company's accountant upon discovery of the major errors in the books of the company. Horace, who is unhappy, wants to sell his shares. However, the other directors, who are the majority shareholders, passed a special resolution in a recent General Meeting to alter Clause 8, which now reads:

"8. Where a shareholder intends to sell her shareholding in the company, the shareholder must inform the directors, who must acquire the shares in equal proportions at a price to be determined by the directors in their absolute discretion."

Advise Horace on:

- (a) Whether the Board is bound by Clause 7. (50 marks); and
- (b) Whether Horace can challenge the alteration of Clause 8 under the common law? (50 marks)

Question 3 (100 marks)

(A) Yellow Cabs Limited provides taxi services on Lantau Island. It was established about 3 years ago and presently owns 10 taxis. Three months ago, one of its drivers/employees, Danny, hit and seriously injured a man who was crossing the road under broad daylight. Investigation showed that the accident was due solely to the negligence of Danny, who was reading a newspaper at the same time he was driving.

Yellow Cabs Limited had received a letter of demand last week from Leung and Lee, a solicitors firm, which acts for the victim. It is anticipated that the damages to be claimed eventually by the victim would be in the vicinity of HK\$10m. The sole shareholder of Yellow Cabs Limited, Peter, had come to you for legal advice. He had informed you that Yellow Cabs Limited had transferred 8 of the 10 taxis to a newly established company, Blue Taxi Limited, two months ago. When asked by you, Peter's explanation was that Blue Taxi Limited's only shareholder is his son Tom and he had wanted (due to his age) to transfer his business to Tom.

Advise Peter as to whether the victim could recover his damages against the assets of Blue Taxi Limited. (60 marks)

- (B) "As fiduciaries, directors must not place themselves in a position in which there is a conflict between their duties to the company and their personal interests or duties to others."

Do you agree? Discuss the various aspects of this "no-conflict rule" at common law and under statute. (40 marks)

Question 4 (100 marks)

A is a contributory of KWL Investment Ltd ("KWL"). The sole object in establishing KWL is to own and develop certain commercial/residential/office complex in Guangzhou PRC ("the GZ Project").

KWL has 4 shareholders, A, B, C and D, since its inception. Each of the shareholders owns 25% shareholding in KWL. All the shareholders had been appointed, and remain the only 4 directors of KWL. B, who is the eldest of the 4 and a Justice of the Peace in Hong Kong, had been highly respected by the other 3 shareholders and was elected Chairman of the Board.

The 4 shareholders had been close personal and family friends for years as well as business associates (in other companies or projects). Each of the shareholders has contributed capital to KWL in the sum of \$5m and made unsecured loans to KWL of another \$5m.

All KWL's bank accounts require the signatures of 2 of the 4 shareholders for withdrawals and issuance of cheques. It has been the agreement and understanding of the shareholders since the establishment of KWL that they would have joint management of KWL in its operations and affairs.

Since 2010, B had increasingly begun to assume complete control in the affairs of KWL and frequently made decisions for KWL without consulting the other 3 shareholders/directors. A, in several informal meetings with the other 3, had voiced his concerns of B's lack of transparency and "dictatorship" in running KWL, and certain questionable expenses incurred by B in relation to the GZ Project. Each time A was bluntly silenced by B and when it was his turn to speak, B would announce that the meeting was over.

Whenever he was confronted by A, B became very upset and lost his temper. A, who was concerned with B's age and health, decided to back down and adopted the decisions of B and the other shareholders/directors.

In January 2011, as A was then in financial difficulties, the other 3 shareholders each contributed an additional sum of \$1m as further loans to KWL to pay consultant fees in relation to the GZ Project. B then suggested that since A could no longer contribute to KWL financially, A should not be allowed to execute any document on behalf of KWL. C and D supported B's suggestion and A was removed as signatory to KWL's bank accounts, besides not being allowed to execute any KWL's documents. A's repeated demands for the repayment of his loans to KWL (which were agreed to be repayable on demand by the 4 shareholders) were refused.

A Board meeting was convened subsequently without notice being given to A, and he was removed as a director in the said meeting by the other 3 directors. B, C and D further resolved to raise the capital of KWL by \$20m, to be contributed equally by KWL's 4 shareholders. The said resolution to increase the capital was passed subsequently in a shareholders' meeting held 3 weeks later, which meeting was also attended by A. As A, due to the short notice and lack of cash, was unable to contribute his share of \$5m. A's shareholding was therefore diluted to 12.5%.

After being removed as director of KWL, A has demanded repeatedly to see the financial accounts of KWL. His requests were ignored by B.

Advise A as to what, if any, legal remedies he may have under the circumstances.

~ End of Examination Paper ~