PCLL Conversion Examination
June 2019
Examiner's Comments
Business Associations

General comments

The standard of papers in this sitting of the Business Associations Conversion Examination was, overall, average, with some candidates capable of providing coherent legal analysis. As examiners, we expect candidates to be able to identify the legal issues in questions. Then they should identify the law that is relevant to the issues. They should also ask what the law means for their clients or advisees base on the facts as set out in the questions. The examination questions are designed to resemble as closely as possible what candidates may come across in practice. Majority of the candidates finished the paper. Here are the comments on how candidates answered each question.

Question 1

The candidates who did well for this question discussed the contractual effect of the articles under s.86. Good students will mention that Keith as a member of the company can, prima facie, sue to enforce the articles, for a breach of the notice requirement for meetings.

Candidates who did well were able to discuss the irregularity principle. The extent of a member's right to enforce the s.86 company contract is subject to the "irregularity principle". Under the rule in Foss v Harbottle [1843] 2 Hare 461, if an ordinary majority of members can ratify an act the minority cannot sue. It follows that the minority cannot normally challenge 'mere irregularities" or "mere breaches of the articles" which can be so ratified. Such irregularities are said to be wrongs to the company for which it alone can sue: MacDougall v Gardiner [1875] 1 ChD 13, 23.

The difficulty is illustrated by two "ultimately irreconcilable" cases MacDougall v Gardiner [1875] 1 Ch D 13 and Pender v Lushington [1877] 6 Ch D 70. In the former the chairman's wrongful refusal to call for a poll in breach of the articles was held to be a mere "internal irregularity" for which no personal action would lie; whereas in the latter the chairman's refusal to recognize votes attached to shares held by nominee shareholders was held to infringe a member's "personal rights": Gower's Principles of Modern Company Law (10 edn, Sweet & Maxwell 2016) [3-27].

Better candidates were able to apply the facts: Anthony may rely on the "irregularity principle", and argues that the procedural failure in convening a meeting could be ratified: Kwok Ping Sheung Walter v Sun Hung Kai Properties Ltd [2009] 2 HKLRD 11; Lim Jonathan v She Wai Hung [2011] 1 HKLRD 305; Re Green Valley Investment [2003]; Re Hong Kong Sailing Federation [2010] 1 HKLRD 801.

On the other hand, Keith may rely on the Pender doctrine and argues that a member has a personal right to sue to enforce the articles. In Re Dalny Estates Ltd [2018] 1 HKLRD 409, the

Court of Appeal accepted that the Court may refuse to "intervene in internal disputes" because of an irregularity), but allowed the plaintiff to challenge the notice and meetings. It is clear law that a written resolution required unanimous consent of all members under ss.556(1) and 561(3). A simple majority is not sufficient. Anthony's assertion of written resolutions is open to question.

However, those who did relatively poorly simply mentioned that this was in relation to irregularity principle but did not go on to elaborate their answers with reference to cases and statutory provision or apply the facts to the case.

Question 2

B Ltd may rely on the statutory presumptions, embodied in ss.117 to 119 of the Companies Ordinance, which provides protection for a third party dealing with a company.

Good students will discuss the objective of the section is to free an external party from making inquiries as to the limitations on directors' powers and the internal regularity of corporate acts. And a failure to make such enquiries will not amount to bad faith. The effect is that an outsider dealing with the company could still be regarded as acting in good faith, notwithstanding some procedural irregularity, where the directors were not acting in breach of fiduciary duties. But where a director was acting in breach of fiduciary duties, an outsider who is aware of the breach (or who is put on enquiry) could be regarded as acting in bad faith: Wrexham Association Football Club Ltd v Crucialmove Ltd [2006] EWCA Civ 237 where an outsider was held to have acted in bad faith when he had knowledge of the director's conflict of interest, had acted closely with the defaulting director, and made no enquiries whether the transaction had been authorised by the board.

The best students will mention that B Ltd can rely on s.117 to argue that, it is not obliged to inspect the company's articles, and that Chris's powers to bind the company is deemed to be 'free of any limitation' of the company's articles that the use of company seal requires a board authorisation. Notwithstanding that the mortgage was unrelated to the company's business, and that the company did not benefit from the loan, B Ltd is not bound to enquire as to the limitations on Chris's powers, unless B Ltd has actual knowledge of Chris's breach of duty, and had acted closely with the defaulting director.

Some students who did poorly completely missed s.117.

Question 2b

Answer 2(b) Some candidates were able to identify that this is in relation to transaction between the company and corporate insider. The statutory protection afforded to an external party will not apply where he is an 'insider' - a director of the company or its holding company; or an entity connected with such a director: s.118(2). If B Ltd is a company connected with a company director, it cannot rely on s.117. Rather, s.118 allows the company (granting a mortgage of its land) to rescind the transaction. However the transaction ceases to be voidable in certain circumstances laid down in s.118(3).

The best students will mention that irrespective of whether the transaction is avoided, any party to the transaction and the person who authorised the transaction (here, Chris) are liable to account to the company for any gain he has made as a result of the transaction (s.118(4)(a)), and to indemnify the company for its loss or damage (s.118(4)(b)).

Question 3

Most candidates mentioned the contractual effect of the articles. The articles constitute a contract between the company and its members and between the members inter se. Good students mention the extent of a member's right to enforce the s.86 company contract has been subject to 'outsider right' restriction. The traditional view is that the articles only confer rights on a member qua member, but not in an 'outsider' capacity, for instance, as a director, solicitor, or other official: Eley v Positive Life Assurance Co Ltd [1876] 1 Ex D 88.

Exceptional students were able to apply the facts of the case and discuss the following: Michael may rely on the second line of authorities headed by Quin & Axtens Ltd v Salmon [1909] 1 Ch 311; affd [1909] AC 442 which supports the proposition that a member can require the company to observe the contract with him under the articles, even this would result in an indirect enforcement of 'outsider' rights. In Salmon, the company's articles delegated general powers of management to the board; but Article 80 provided that no board decision on the relevant issue should be valid if either of two managing directors dissented. Salmon, one of the managing directors, had duly indicated his dissent from such a decision of the directors; but subsequently an ordinary resolution was passed at the general meeting confirming that decision. The Court of Appeal and the House of Lords allowed Salmon, the managing director, suing as a member, to obtain an injunction restraining the company from completing the transaction in breach of the articles, and thereby indirectly enforcing a veto given to him by the articles in a capacity otherwise than qua member. The Salmon principle has been justified to protect a shareholder director's rights to hold office, to participate in management, or to commence litigation.

Here, Michael may rely on s.86 of the Companies Ordinance and the Salmon doctrine to obtain an injunction to restrain the company from completing the transaction in breach of article 24. It is arguable that if Michael sued qua member (and not qua solicitor), he would probably succeed in his action to restrain the company from removing him as their solicitor. However, this conclusion conflicts with the Hickman principle, and is difficult to reconcile with the Eley line of cases, and other decisions which have pronounced against outsider rights. Some students struggled with this question.

Question 4

Most students who attempted this question were about to point out this is in relation to statutory unfair prejudice remedy. Some students went in more detail than others to examine what is the statutory unfair prejudice remedy and how it entitles a member of a company to petition to the court where his interests have been 'unfairly prejudiced': Pt. 14, Div. 2 (ss.723 – 727). Its underlying premises is the member's personal right to be treated fairly. First, the conduct complained of must be both unfair and prejudicial to members' interests, not merely unfair, nor merely prejudicial. The key phrase in the section, 'unfairly prejudicial', comprises two elements,

unfairness and prejudice: Re Tobian Properties Limited [2013] 2 BCLC 567 [21]; Re ATV [2015] HKLRD 607 [52]. Good students would examine the elements in detail and application of s.725 – that even if unfair prejudice is established, the court 'may make such other order as it thinks fit': s.725(1).

Some candidates who gave relatively poor answers simply cited the relevant statutory provisions and cases without further elaborating on the legal analysis and what the courts would consider.

Only very few students also mention that the Companies Ordinance introduces a significant change to the law on ratification of conduct by adding a disinterested shareholders' approval requirement. Shareholder ratification now requires an ordinary resolution (as in the old law) and is subject to disinterested shareholder approval. S.473 provides for ratification of directors' conduct by disinterested shareholders' approval (or by unanimous shareholders consent) to prevent conflicts of interest and possible abuse of power by interested majority shareholders in ratifying the unauthorized conduct of directors. S.473 permits ratification of directors' duties by disinterested members, and the votes of the director in question (and persons connected with him) are to be disregarded: s.473(3). The law on unanimous consent remains unchanged, so that the restrictions imposed by s.473 will not apply when every member approves the ratification: s.473(6). Further, the new law does not alter the common law on non-ratifiable acts (such as misappropriation of corporate assets and fraud): s.473(7). S.473(b) preserves existing common law rules which restrict ratification, so that ratification is valid only if the company is solvent as at the date of the passing of the resolution ratifying the act, or that certain breaches are not ratifiable. Here, the improper share allotment is ratifiable.