Examiner's report

F4 Corporate and Business Law (CHN)
December 2012

Specific Comments

Question One

This question required candidates to state the procedural ways to deal with the various situations when an assignment of contract takes place and a dispute, between the assignee and the other party to a contract, is brought to the court under the Judicial Interpretation on Contract Law by the Supreme People's Court.

Some key issues should be taken into consideration when candidates answer this question:

This question is nothing to do with the conditions for a party to assign his rights (obligations) or both rights and obligations under a contract to a third party. Therefore, it is irrelevant to this question as to the notification requirement by the party who wants to assign his contractual rights to a third party or the consent of the other party when a party who wants to assign his contractual obligations to a third party. These conditions to assign his rights and obligations to a third party are ***substantive matters***, not the ***procedural ways*** to be dealt by a court when a dispute is brought to the court.

According to the relevant provisions of the Judicial Interpretation on Contract Law, where a party assigns his rights or obligations to a third party and a dispute is brought, between the third party and the another party to the contract, the court may add the original party (assignor) of the contract as the ***Third Party in civil procedure*** to join the litigation. This way would be helpful for a court to determine the effectiveness of the assignment, no matter that the dispute arose out of the assignment of the contractual rights or obligations.

Most of candidates were unable to give a satisfactory answer to this question, since they failed to understand the requirement of this question being relevant to the procedural ways. Another major reason why they could not give a satisfactory answer was the misunderstanding of procedural ways to handle the case involving the assignment of rights or obligations with the jurisdiction of court. Although the jurisdiction constitutes a kind of procedural matters in civil litigation, the Judicial Interpretation on Contract Law by the Supreme People's Court does not deal with this matter.

Question Two

This question required candidates to explain the term *non-competition clause*, and state the persons who are subject to *non-competition* obligations and conditions for a labour contract to include a *non-competition clause*. Performance in this question was satisfactory.

The term *non-competition clause* refers to a clause contained in a labour contract, or a confidentiality agreement between an employee and employer, under which the employee agrees to maintain the trade secret of the employer, or the confidentiality of matters relating to the industrial properties of the employer for a period of time after the termination or dissolution of a labour contract. Under the relevant provisions of the Labour Contract Law, the persons who are subject to *non-competition* obligations include the employer's senior executives, senior technicians and other personnel with confidentiality obligations. Where a labour contract contains a *non-competition* clause, the same contract shall also stipulate that the employer pays monetary compensation to the employee on a monthly basis after the termination or dissolution of the labour contract. The term shall not exceed two years.

The common errors of this question include:

- Failing to state the persons who are subject to *non-competition* obligations;
- Failing to state that the labour contract shall also stipulate that the employer pays monetary compensation to the employee on a monthly basis during the term of *non-competition* after the termination or dissolution of the labour contact and the term of such a *non-competition* shall not exceed two years.

Question Three

This question required candidates to explain a *pre-contractual liability*, and state the conducts of a party that will result in pre-contractual liability and to distinguish between a *pre-contractual liability* and the liability for breach of contract.

Pre-contractual liability refers to the liability caused by a party's conduct, as prescribed in the Contract Law, which cause a loss or damages to the another party during the process of negotiating a contract but the contract is finally not concluded. However, some candidates did not understand the meaning of the *pre-contractual liability*, holding incorrectly that this was a rule of law contained in the Labour Contract Law. Actually, there is no such a rule of *pre-contractual liability* in the Labour Contract Law. Therefore, the performance on this part was unsatisfactory.

Since most of candidates failed to explain the term *pre-contractual liability*, it is natural that they were unable to distinguish between *pre-contractual liability* and the liability for breach of contract. The major difference between them stands for: with respect to the *pre-contractual liability* there is no contract between the parties even though they have negotiated to conclude a contract; while under the liability for breach of contract an effective contract has been concluded but one of parties breaches it. The performance on part (b) was also unsatisfactory.

In part (c) candidates were required to state the conducts of a party, in the process of negotiating a contract that may cause a pre-contractual liability. In accordance with Article 42 of the Contract Law, the following conducts may give rise to such a *pre-contractual liability*: under the pretext of concluding a contract to negotiate in bad faith; deliberate concealment of the important facts relating to conclude a contract or providing false information; other conducts in violation of the principle of good faith. Since the basis of the *pre-contractual liability* depends on the non-existence of a contract, the conducts that may give rise to the *pre-contractual liability* shall be prescribed by law. While the liability for breach of contract may provide for in the contract or prescribed by law. Most of candidates were unable to state these conducts.

Question Four

This question required candidates to state the composition of the board of directors in different forms of limited liability companies, and the ways to deal with the situation where the number of directors is less than quorum., Performance for this question was not good as expected.

Part (a) required candidates to state the composition of the board of directors of a limited liability company. According to Article 45 of the Company Law, such a company shall set up a board of directors composed of 3 to 13 members, unless otherwise stipulated by the law. The method of the creation of the chairman and vice chairman of the board of directors shall be stipulated in the articles of association of the company. Most of candidates did not correctly state the number of the board of directors and the method of the creation of the chairman and vice chairman. Some candidates stated the number of shareholders for a limited liability company, instead of the number of the board of directors.

Under the requirement of part (b), where a limited liability company is invested and established by two or more state-owned enterprises, its board of directors shall include representatives of the employees of the company.

Part (c) required candidates to state the ways to deal with the situation where the number of directors is less than quorum. According to Article 46 of the Company Law, where the members of the board of directors are less than the quorum due re-election is not conducted upon expiry of the term of office of a director or a director resigns during his term of office, the said director shall still perform his functions as a director.

Common errors for this question include:

- Failing to understand the meaning of the composition of the board of directors by stating the number of shareholders of a limited liability company;
- Failing to understand the requirement of part (a) by stating the statutory capital for a limited liability company that is invested by two or more state-owned enterprises;
- Failing to understand the requirement of part (c) by stating the functions of the board of directors of a limited liability company.

Question Five

This question required candidates to explain the term *rectification*, and state the legal effect of *rectification* on the right of guarantee during the period of *rectification*.

This question required candidates to make a summary from the relevant provision of the Enterprise Bankruptcy Law. As a whole, candidates were unable to answer this question satisfactorily due to the misunderstanding of the system as to *rectification.*

The term *rectification* refers to such a system under which a debtor or an investor whose investment accounts for 10% of the registered capital of the debtor, after the application for bankruptcy has been accepted and before the declaration of bankruptcy of the debtor by the court, may apply to the court to rectify debts of the debtor, under the conditions of acceptance of such application by the court and the suspension of the bankruptcy procedures. The debtor may continue its business operations, so as to avoid bankruptcy of the debtor and resume its ability of normal business operations.

Based on the above understanding of the system of rectification, any party who intends to apply for *rectification* shall meet several strict conditions: the applicant shall be the debtor itself or a shareholder whose investment accounts for 10% of the registered capital of the debtor; the time for application shall be within the period after the application for bankruptcy having been accepted but before the declaration of the bankruptcy by the court; the debtor may continue to operate its business where the application is approved by the court. Candidates were required to describe many points to give a full and correct explanation on part (a) of this question. However, most of candidates were not familiarised with this system under the Enterprise Bankruptcy Law and were able to describe very limited points to this term.

Part (b) of this question required candidates to state the legal effect of *rectification* on the right of guarantee during the period of *rectification*. According to the law, in the period of rectification, the guarantee's right on the particular property of the debtor shall be suspended. However, if there is a possibility for the secured property to suffer from damages or significant depreciation of value so that the guarantee's rights are endangered, the guarantee may apply with the court for recovering the right to guarantee. A bankruptcy administrator may also set a guarantee for a new loan for the purpose of continuing the debtor's business operations. Most of candidates were unable to state any content in part (b).

Many candidates confused the system of rectification with the priority of settlement of assets after the completion of the liquidation.

Question Six

This question required candidates to explain a *takeover by offer* of a listed company, state the ways to deal with the shares of a listed company purchased after the expiration of the duration of takeover and the ways to deal with the legal status of the listed company purchased after the completion of takeover.

With respect to part (a) *takeover by offer* refers to the form of taking over a listed company where the investor comes to hold or jointly hold with others, through a stock exchange, 30% of the issued shares of a listed company and continues to purchase such shares, the investor shall comply with to issue to all the shareholders of the listed company a takeover offer for buying the whole or part of the shares of the listed company. In terms

of *takeover by offer* as a form of taking over a listed company it is not unfamiliar to candidates since it has been tested for several times. However, only limited numbers of candidates could give satisfactory answers to this part of question. Some of them were confused with the form of corporate financing--initial public offerings.

With respect to the requirement in part (b), the trading of shares of a listed company under takeover shall be terminated where the distribution of shares does not meet the requirements for listing. The purchaser is also under an obligation to purchase the remaining shares of the target company from the holders on the same condition. Moreover, the target company shall change its enterprise form where it no longer meets the requirement for a joint stock company after the completion of the takeover. Obviously, the answer to this part of the question covered three points: to terminate the trading of shares of the target company; to purchase the remaining shares of the target company where the holders of such shares intend to sell their shares to the purchaser, and to change the enterprise form where necessary. As a whole, very few candidates were able to pick up two points of the answer to this part. Some candidates, however, stated the report requirements to the relevant government authority as well as the stock exchange. They failed to correctly understand the requirement of this question.

Question Seven

This question required candidates to describe various activities relating to the capital of a company that shall be regarded as fraudulent corporate behaviour, and state the reasons why such activities will be regarded as fraudulent corporate behaviour.

This question required candidates to understand clearly the meaning of this question and analyse the reasons. As a whole, the performance for this question was not satisfactory.

Part (a) required candidates to describe various activities, in relation to the capital of a company, which shall be regarded as fraudulent behaviour. According to law, the following activities, in relation to the capital of a company, shall be regarded as fraudulent corporate behaviour: providing a false statement of the registered capital during the process of establishing a company; making false capital contributions and withdrawing the capital after the establishment of the company.

It should be noted that this part required candidates to describe various activities that shall be regarded as fraudulent behaviour, *in terms of the capital of a company*, not the activities that shall be regarded as fraudulent behaviour in the general sense. Some candidates described several activities that should be considered to be the fraudulent behaviour in the general sense; however, they failed to describe any illegal activities *in relation to the capital of a company*. Of course, they did not answer the question to the point.

Part (b) required candidates to state the reasons why such activities will be regarded fraudulent corporate behaviour. The essential reason stands for that such activities would endanger the capital of a company and reduce the capacity of the company to settle its debts with its own assets. With respect to this part, almost all candidates were unable to give a satisfactory answer.

Question Eight

This question was to test candidates of the knowledge with respect to the transfer of the rights and obligations and the formation of a contract.

The performance for this question was quite satisfactory, as most of candidates were able to give the correct conclusions and also provide adequate reasons to support their conclusions. However, some candidates still failed to give a correct conclusion as to the formation of the contract.

Part (a) required candidates to determine whether there was a contract between Aishen Garment Co and Conka Sales. According to the relevant provisions of the Contract Law, a party may transfer his contractual rights to a

third party where he notifies the other party to the contract; a party may also transfer his contractual obligations to a third party where he obtains the consent from the other party to the contract. In this case, Bulinger Store's transfer of contractual rights has satisfied the condition as prescribed in the Contract Law, since it sent a written notice to Aishen Garment Co. On the other side, Aishen Garment Co did not give a consent to Bulinger Store Co concerning the transfer of the contractual obligations. However, though Aishen Garment Co kept silence as to whether or not agreeing the transfer of obligations by Bulinger Store to Conka Sales, it has delivered the goods and received the payment by Conka Sales. It is obvious that Aishen Garment Co acknowledged, with its acts, the transfer of contractual obligations by Bulinger Store to Conka Sales. The conclusion should naturally be that there was a contract between Aishen Garment Co and Conka Sales.

Some candidates failed to give a correct conclusion as to the formation of the contract, by focusing their attention on the fact that Aishen Garment did not give a consent to Bulinger Store's transfer of the contractual obligations. These candidates paid no or less attention to the fact that Aishen Garment has sent a fax to Conka Sales advising it to take delivery and later actually delivered the goods to Conka Sales. According to the Contract Law, the formation of a contract may be adopted by written, oral or other forms. In business operations people often take an oral expression or acts to show their intention to enter into a contract. Therefore, although Aishen Garment did not express its consent in a written form, it did so with its acts indicating that Conka Sales was its counterpart in the said transaction.

Part (b) required candidates to state the accessory right along with the transfer of rights. Where a party transfers his rights, the transferee shall acquire right accessory to the essential rights, unless the accessory right is exclusive for the transferor himself. Therefore, Conka Sales as a transferee acquired the accessory right when it acquired the right to the goods, including the right to claim for damages in the court. It was entitled to claim damages against Aishen Garment Co for the defects of the goods. Most of candidates were able to answer this part correctly, but few of them made the point as to the accessory right.

Question Nine

This question was to test candidates of knowledge with respect to the rule of derivative litigation.

Candidates were required to determine whether Ms E was, as one of the shareholders of Tenda Co Ltd, entitled to bring a lawsuit against Mr A, and what conditions shall be satisfied if she wanted to bring such a lawsuit as well as the beneficiary of such a litigation.

With respect to part (a), the correct answer was that Ms E should be entitled to bring a lawsuit against Mr A. Under the Company Law the controlling shareholders, actual controllers or directors of a company shall not, by taking advantage of their affiliate relationship, damage the interests of the company. Where any one of these persons violates laws or articles of association and causes damages to the company, such person shall be liable for the damage. Under such a circumstance any shareholder may directly bring a lawsuit against the person concerned subject to the conditions as prescribed by the law. This means that the lawsuit was not unconditional. Most of candidates were able to give a correct conclusion, even though some of them did not state the legal basis of such a litigation and the litigation being subject to the conditions as prescribed by the Company Law. A few candidates held that Ms E was not entitled to file a lawsuit against Mr A, on the ground that Ms E was not a party who suffered from Mr A's conduct. Obviously, they failed to understand the derivative litigation under the Company Law.

Part (b) required candidates to state the conditions to be met where a shareholder intends to bring a lawsuit against the relevant persons as above-mentioned. First, Ms E should request the supervisory board to bring the relevant person who causes the damage; second, the supervisory board should file the lawsuit within 30 days upon receipt of Ms E's request but failed to do so; third, Ms E then should be entitled to file a lawsuit, in her own name, against Mr A for the interests of the company. Although many candidates were able to give a correct answer to part (a) with respect to the possibility for Ms E's lawsuit, most of them failed to state these conditions.

Part (c) required candidates to state who should be the beneficiary where Ms E was granted a favourable judgement by the court. In this regard, the answers were varied. Some candidates held that Tenda Co should be the only beneficiary; but others held that all the shareholders, except Mr A, should be the beneficiaries. Some candidates, who stated that Ms E was not entitled to bring a lawsuit against Mr A, held Tenda Co or Ms E to be the beneficiary.

The correct answer to this part is Tenda Co should be the only beneficiary where the court granted a favourable judgement. Since Ms E's lawsuit was for the interests of the company the result of such a legal action should be attributed to the company, even though she brought the lawsuit in her own name. This is a basic principle of derivative litigation under the Company Law. It should be noted that where any one considers that Ms E was not entitled to bring a lawsuit, for the interests of the company, against Mr A in part (a), the natural answer to part (c) should be that the court would not grant a favourable judgement to Ms E. Obviously, their answers to part (a) and (c) were conflict logically.

Question Ten

This question required candidates to deal with the legal issues relevant to the declaration of credits and the legal effect of bankruptcy procedure on pending cases.

Part (a) of this question required candidates to state how to deal with the pending cases after the court accepts an application for bankruptcy. According to Article 20 of the Enterprise Bankruptcy Law, any pending cases involving the debtor against whom an application for bankruptcy has been accepted by the court shall been suspended. Hence, the pending case between Construction Bank and Dalie Co should be suspended. Performance for this part was satisfactory.

In part (b) candidates were required to deal with the legal matters concerning the secured debts. Industry Bank's total credit was RMB 20 million yuan, among which RMB 12 million yuan was mortgaged by the building. Therefore, after the completion of the liquidation procedure, Industry Bank should have a general credit for RMB 8 million yuan. Some candidates merely described the order of distribution of the liquidation assets, and failed to give a specific amount of general credit that could be declared by Industry Bank.

Part (c) required candidates to determine whether Merchant Bank was entitled to declare its credit and join the bankruptcy procedure. According to the Enterprise Bankruptcy Law, the joint and several creditors may choose one from among them to declare the creditor's right or may jointly declare the creditor's right together. In this case Dalie Co provided guarantee for a loan to Merchant Bank, but the principal Jiqing Company failed to settle the debt. Hence Merchant Bank, as a creditor and guarantee, was entitled to choose Dalie to declare its credit. Most of candidates gave a correct conclusion to this part of the question, but were unable to give detailed reasons to support their conclusion.