CB(1)1653/09-10(01)

HONG KONG BAR ASSOCIATION

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Your Ref: CB1/BC/3/09

15th April 2010

Mr. Fred Pang
for Clerk to Bills Committee
Legislative Council Secretariat
3/F Citibank Tower
3 Garden Road
Hong Kong.

Dear Mr. Pang,

Bills Committee on Companies (Amendment) Bill 2010 and Business Registration (Amendment) Bill 2010

I refer to your letter of 31st March 2010.

Please find herewith a copy of the comments of the Hong Kong Bar Association on Sections 14 to 20 of the Companies (Amendment) Bill 2010 on the proposal on "multiple statutory derivative actions", for your consideration. The same will be placed at the Bar Council Meeting scheduled for 22nd April 2010 for ratification.

Yours sincerely,

Russell Coleman SC
Chairman

Encl.

Hong Kong Bar Association's

Comments on Sections 14-20 of Companies (Amendment) Bill 2020

1. Sections 14-20 of the Companies (Amendment) Bill 2010 propose to extend standing to bring statutory derivative actions to:-

   (1) members of the holding company of the wronged company (category (b) of the proposed definition of "related company") ("**Category 1**");

   (2) members of the subsidiary of the wronged company (category (a) of the proposed definition of "related company") ("**Category 2**"); and

   (3) members of another subsidiary of the holding company of the wronged company (category (c) of the proposed definition of "related company") ("**Category 3**").

2. The Hong Kong Bar Association fully supports the proposal in relation to the Category 1 cases, but not the Category 2 or Category 3 cases. It seems to the Bar that extending standing to the latter cases involves a departure from the rationale of the derivative action, and unless there are independent and cogent reasons to support such an extension, it should not be made without proper study and due consideration of whether it is proportionate to the perceived problem.

3. Derivative action is a procedure devised by the common law to give a remedy to a wrong which would otherwise escape redress: see Wallworth v Holt (1841) My. & Cr. 619 at 635; Burland v Earle [1902] AC 83 at 93; Nurcombe v Nurcombe [1985] 1 WLR 370 at 376A-B and 378F-H. A shareholder, who has neither a legal nor an equitable interest in the assets of the company, is permitted to sue in the name of and for the benefit of the company because the company is in the control of the wrongdoers and the wrong is one which cannot properly be ratified by the majority. The shareholder is given standing to sue because he has a legitimate interest in seeing that the corporate grievance is remedied so that the value of his investment could be protected: see Waddington Ltd v Chan Chun Hoo Thomas (2008) 11 HKCFAR 370 para.74.

4. In Waddington paras.74-75, the Court of Final Appeal held that the same rationale applies in multiple derivative actions (in the Category 1 sense), as such shareholder has a sufficient and legitimate interest in the relief claimed in that any depletion of a subsidiary's assets causes indirect loss to him. For this reason the Court recognized that multiple derivative actions (in the Category 1 sense) can be brought at common law.

5. However, that only deals with the question of standing. The substantive requirements remain that a derivative action is only allowed where there is both a "fraud on the minority" and wrongdoer control: see Waddington para.13. This is clearly correct, for absent these conditions the very basis for invoking the procedure of derivative action will be missing.

6. The Bar does not support extending standing to bring derivative actions to Category 2 and Category 3 cases because that is inconsistent with the rationale for derivative actions set out above.

(1) The economic interest which justifies standing in a multiple derivative action is an interest (albeit indirect) relating to the subsidiary's assets and the shareholder's investment in the parent. A loss in the subsidiary's assets can be reflected as a diminution in value of the shareholding in the parent. However the same cannot be said of Category 2 and Category 3 cases. In Category 2 cases, the shareholder's investment in the company (which is itself a subsidiary) cannot be affected in any way by a depletion in the assets of its co-shareholder (the parent of the subsidiary). Likewise in Category 3 cases, the shareholder's investment in the company cannot be affected by the depletion in the assets of an associate company (another subsidiary of its parent).

(2) It seems to the Bar that the emphasis on "prejudice" in the Administration's Response in LC Paper No. CB(1)1453/09-10(08) Annex D ("**Administration's Response**") shows that the Administration might have misunderstood the meaning of "legitimate interest" expounded in Waddington. The Administration appears to have taken the view that any economic loss which may arise from the depletion of the wronged company's assets would be sufficient. This can be seen from the example given in Administration's Response §7 where it is suggested that minority shareholders of a subsidiary who stands surety for the parent may suffer a loss if the parent defaults on its repayment obligation and the creditor seeks to claim from the surety. On such a view a creditor of the wronged company would arguably have an economic interest sufficient to justify extending standing to him, but this is clearly not the correct legal position: see Mills v Northern Railway (1870) 5 Ch App 621.

(3) Further, it is doubtful whether the Category 2 and Category 3 cases can satisfy the requirements of "fraud on the minority" and wrongdoer control. Again in the example given in Administration's Response §7, it is not clear whether the situation described could amount to a "fraud on the minority", given that the "errant directors" are said to be the only shareholders of the parent.

7. As such, it seems to the Bar that if Category 2 and Category 3 cases are to be justified, that cannot be done on the basis of the derivative action rationale. This is not to say that extension of standing to these cases should never be contemplated – The Bar notes that such an extension has indeed been made in New Zealand, Australia and Canada, although it is not clear what is the basis (which may well be different from the "classical" derivative action rationale) for their respective extension. However if such an extension is to be made in Hong Kong, the Bar would have thought it should only be done after proper empirical study on whether there is a sufficient case to justify it, and if so what is the proper threshold(s) applicable.

Hong Kong Bar Association

Dated this 15th of April 2010.