1904 GLOUCESTER TOWER
THE LANDMARK
HONG KONG

TELEPHONE: (852) 2521 7188
FAX: (852) 2810 1823

12 January 2004

Clerk to Bills Committee on
Companies (Amendment) Bill 2003
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Attn: Ms Anita Sit

Dear Madam,

Schedule 4 to the Companies (Amendment) Bill 2003 – amendments to the Companies Ordinance in relation to shareholders' remedies

In response to your two letters addressed to Mr Winston Poon, SC, dated 24 July and 31 December 2003, we (including Mr Poon) set out below our comments on Schedule 4 to the above-mentioned Bill relating to shareholders' remedies.

A. Paragraph 4 of Schedule 4 – Alternative remedy to winding up in cases of unfair prejudice

(1) Extension to "non-Hong Kong companies"

The combined effect of paragraph 1(1) and paragraph 4(1) of the Schedule is to extend the section 168A remedy to any "non-Hong Kong company", which is presently referred to throughout Parts X and XI of the Companies Ordinance as "oversea company". "Oversea companies" are defined in section 332 of the Ordinance as companies incorporated abroad and having a place of business in Hong Kong. Parts I to IX of the Ordinance, with minor exceptions, govern companies incorporated in Hong Kong whereas Parts X and XI cover exclusively unincorporated associations *and foreign corporations*, including oversea (or non-Hong Kong) companies. Thus instead of amending section 168A, which is to be found in Part IV of the Ordinance, it would be more consistent as a matter of format and for ease of reference that a new section making available the section 168A remedy to non-Hong Kong companies should be inserted into those Parts applicable to foreign corporations.

An additional ground for our recommendation is that Part X of the Ordinance (sections 326 to 331A) is dedicated to the winding up of "unregistered companies", the meaning of which, as set out in section 326, embraces oversea (or "non-Hong Kong") companies. Section 327 is the provision for the winding up of unregistered companies. Subject to the qualifications in sub-sections (2) and (3), sub-section (1) of section 327 expressly incorporates all the provisions in Part V

of the Ordinance for the winding up of Hong Kong registered companies. As the present section 168A remedy is an alternative to the compulsory winding up of Hong Kong registered companies under section 177 of the Ordinance, a new provision, possibly similar to section 327(1) by referential incorporation of section 168A (and the proposed amendments in the Bill), should be introduced into the end of Part X of the Ordinance so that this new provision will constitute an alternative remedy to the winding up of unregistered companies under section 327 in so far as oversea or (non-Hong Kong) companies are concerned.

Notwithstanding the recommendation of the Standing Committee on Company Law Reform contained in paragraphs 16.22 and 16.27(d) of its Consultation Paper on proposals made in Phase 1 of the Corporate Governance Review (July 2001) that the members of oversea (or non-Hong Kong) companies be allowed to petition under section 168A, we see no logic in extending the application of this statutory remedy only to oversea (or non-Hong Kong) companies but not to the other forms of entities such as foreign corporations without a local place of business which also fall within the meaning of "unregistered companies" in section 326. Indeed this anomaly was acknowledged by the Standing Committee in paragraph 16.26 of the Consultation Paper when it compared section 168A with section 147(2)(b) of the Ordinance which allows the Financial Secretary to petition for relief under section 168A in respect of a "body corporate", which is defined in section 2(3)

as "including a company incorporated outside Hong Kong." It is common knowledge that there are numerous off-shore asset holding companies held by Hong Kong residents or Hong Kong registered or oversea companies without a place of business in Hong Kong.

Furthermore, the English precedent for section 168A was the result of paragraph 60 of Cohen's Report of the Committee on Company Law Amendment (1945; Cmnd 6659), which recognised that the winding up of a company might not benefit its minority shareholders since the break-up value of the assets might be small or the only available purchasers might be the very majority whose oppression had driven the minority to seek redress. Accordingly, it does not make sense at all for the legislature to provide an aggrieved member with the extreme remedy of destroying an unregistered company by means of section 327 but deny him a less drastic relief which may well be to his and other innocent shareholders' benefit.

(2) <u>"Made" the Petition</u>

The phrase "made the petition" or "making a petition" or "a petition... is made" appearing in sub-paragraph (2)(b), sub-paragraph (3) repeatedly and sub-paragraph (4) of paragraph 4 of the Schedule is, to say the least, awkward. We have never heard of such expressions, nor come across them in any law reports or company law books. Whilst an application may be "made" by someone, a petition, in accordance with legal

usage, should be "presented" by a petitioner (cf. sections 147(2), 179(1), 180(1A), 181, 184 and 329 of the Companies Ordinance, Rule 23 of the Companies (Winding-up) Rules and Order 9 rule 3 of the Rules of the High Court). We therefore suggest that the phrase "made the petition" or "making a petition" or "a petition... is made" should be replaced by "presented the petition" or "presenting a petition" or "a petition... is presented".

(3) Proposed sub-section (2A) of section 168A in paragraph 4(3) of Schedule 4

The amendment, in contradistinction to similar statutory provisions in many other countries, enables the Court to award damages to a member whose interests have been unfairly prejudiced. The most commonly invoked remedy in a section 168A petition is an order to buy out the shares of the oppressed member as empowered by sub-section (2)(c) of section 168A. Once an order to this effect has been implemented, the complainant ceases to be a shareholder of the company.

In the case of an aggrieved member who wishes to retain his interests in the company, it is difficult to envisage any monetary damages sustained by him except the conduct complained of may, indirectly, result in a diminution in the value of his shareholding. If the Court, as mandated by sub-section (2) of section 168A, granted relief thereby "bringing to

an end the matters complained of", that would, in principle, restore the value of his shareholding. Whilst we express no opinion on the propriety of awarding damages under a section 168A petition which seems to go against the authorities (see e.g. Irish Press plc v Ingersoll Irish Publications Ltd [1995] 2 IRLM 279), it is essential, if the proposed sub-section (2A) is to be introduced into the section, that safeguards be written into the sub-section so that when the prejudicial conduct arose as a result of breach of duties owed to the company (see, eg. paragraphs 16.12 and 16.16 of the Consultation Paper of the Standing Committee), the petitioner would not be entitled to recover by way of damages which should properly belong to the company. We can do no better than to reproduce below the authoritative statement of the recent House of Lords decision in Johnson v Gore Wood & Co [2002] 2 AC 1.

> "The position is, however, different where the company suffers loss caused by the breach of a duty owed both to the company and to the shareholder. In such a case the shareholder's loss, in so far as this is measured by the diminution in value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder. These principles have been established in a number of cases, though they have not

always been faithfully observed. The position was explained in a well known passage in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 222-223:

> "But what [the shareholder] cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such as 'loss' is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss. His only 'loss' is through the company, in the diminution of the value of the net assets of the company, in which he has (say) a 3% shareholding. The plaintiff's shares are merely a right of participation in the company on the terms of the articles of association. The shares themselves, his right of participation, are not directly affected by the wrongdoing. The plaintiff still holds all the shares as his own absolutely unencumbered property. The deceit practiced upon the defendant does not affect the shares; it merely enables the defendant to rob the company. A simple illustration will prove the logic of this approach. Suppose that the sole asset of a company is a cash box containing £100,000. The company has an issued share capital of 100 shares, of which 99 are held by the plaintiff. The plaintiff holds the key of the cash box. The defendant by a fraudulent misrepresentation persuades the plaintiff to part with the key. The defendant then robs the company of all its money. The effect of the fraud and the subsequent robbery, assuming that the defendant successfully flees with his plunder, is (i) to denude the company of all its assets; and (ii) to reduce the sale value of the plaintiff's shares from a figure approaching £100,000 to nil. There are two wrongs, the deceit practised on the plaintiff and the robbery of the company. But the deceit on the plaintiff causes the plaintiff no loss which is

> separate and distinct from the loss to the company. The deceit was merely a step in the robbery. The plaintiff obviously cannot recover personally some £100,000 damages in addition to the £100,000 damages recoverable by the company." (at 62D-63C).

If the position is not made clear in the proposed sub-section, it may be construed as having the effect of overriding the common law position in which case there will either be double recovery or the unfairly prejudiced member will benefit at the expense of the creditors of the company.

(4) Proposed sub-section (2B) of section 168A in paragraph 4(3) of Schedule 4

Like other forms of action, we are of the opinion that justice dictates that there should be a limitation period for a past member to seek relief under section 168A. For this purpose, the limitation period may be assimilated to that in respect of breach of trust subject to provisions for latent damage.

(5) Proposed sub-section (2D) of section 168A in paragraph 4(3) of Schedule 4

It is part of our legal system that the Courts always have a discretion to make any order as to costs in any proceedings provided, of course, that the discretion is exercised in accordance with judicial principles. Thus we are unable to

discern any necessity for introducing a new sub-section enabling the Court to award costs in favour of a petitioner. Although this is not so stated in the sub-section, we suspect that the provision is not intended to benefit any petitioner who satisfies the conditions in paragraphs (a) and (b) of the sub-section, but only those whose petitions have been dismissed by the Court. Moreover, the criteria laid down in paragraphs (a) and (b) of the proposed sub-section are lower than the existing threshold for awarding costs in favour of an unsuccessful litigant. The creation of this sub-section may well result in a proliferation of section 168A petitions as a member of the general public reading the sub-section may be misled into believing that once the statutory criteria have been satisfied, he will automatically be entitled to the costs of the proceedings irrespective of the outcome.

(6) <u>Proposed sub-section (5C) of section 168A in paragraph 4(4) of Schedule 4</u>

The definition of 'then members" in the proposed sub-section is, at the very least, ambiguous and, in our view, superfluous. On the basis of the present wording, in order to qualify as a "then member", the period of membership of the claimant in the specified corporation must be *identical* to that of the petitioner who is a past member. We are unable to ascertain the basis for this requirement and particularly in the case of public companies, one rarely finds two shareholders whose dates of commencement and cessation of membership are

exactly the same. On the contrary, the wording of the proposed sub-section (2C) suggests that a *present* member may also obtain damages based on the petition of a past member. Hence on its face, the definition does not make any sense.

In addition, an unfairly prejudicial act may take place at a certain point in time or over any length of period. Provided that the interests of a "then member" were unfairly prejudiced by the act complained of, there is no justification for depriving him of the statutory remedy simply because the span of his membership in the company does not coincide with that of the petitioner. Indeed, the proposed sub-section (2C) in paragraph 4(3) of Schedule 4 expressly states that "the court may, ..., order payment..., to any *then members* (...) of the specified corporation, *whose interests were unfairly prejudiced by the relevant act or conduct*" (our emphasis). Since this proposed sub-section has already set out the criterion for the Court to compensate the "then members", a definition of "then members", whether in the form of the proposed sub-section (5C) or in any other form, is otiose.

B. <u>Paragraph 5 of Schedule 4 – Part IVAA Bringing or Intervening in Proceedings on behalf of Specified Corporation</u>

(1) <u>Sub-sections (1)(a) and (2) of proposed section 168BB in paragraph 5 of Schedule 4</u>

Paragraph 63 of the Explanatory Memorandum of the Bill (page C1669 of L.S. No. 3 to Gazette No. 24/2003) declares that this part of the Bill "adds a new Part IVAA to provide for a statutory derivative action to be taken by a member on behalf of a specified corporation." A derivative action is founded on an exception to the rule in Foss v Harbottle (1843) 2 Hare 461. Before determining what is the exception to the rule, it is essential to understand what is the rule in Foss v Harbottle.

> "A derivative action is an exception to the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested. This is sometimes referred to as the rule in *Foss v Harbottle* (1843) 2 Hare 461 when applied to corporations, but it has a wider scope and is fundamental to any rational system of jurisprudence...
>
> The classic definition of the rule in *Foss v Harbottle* is stated in the judgment of Jenkins L.J. in *Edwards v Halliwell* [1950] 2 All ER 1064 as follows. (1) The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation. (2) Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, *no individual member of the corporation is allowed to maintain an action in respect of that matter* because, if the majority confirms the transaction, cadit quaestio; or, if the majority challenges the transaction, there is no valid reason why the company should not sue..." (Prudential Assurance v Newman Industries (No. 2) [1982] 1 Ch 204 at 210 D-G).

In Johnson v Gore Wood & Co supra, the House of Lords reiterated the rule as follows:-

> "(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss. So much is clear from *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, particularly at pp 222-223,..." (at 35E-G).

In order to redress the injustice caused by this rule in the case when the wrongdoer himself is in control of the company thus preventing it from commencing proceedings against himself, an exception was created under the common law whereby a minority shareholder may commence the action on behalf of the company, which is known as minority shareholders' action or derivative action. The exception is encapsulated once again in Prudential Assurance v Newman Industries (No. 2) supra as follows:-

> "... (5) There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders' action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue." (at 211A-B).

Far from codifying the derivative action as recommended in paragraph 15.25 of the Consultation Paper of the Standing Committee and as purported in the Explanatory Memorandum of the Bill and notwithstanding the requirement in the proposed sub-section (2) that all proceedings must be brought in the name of the company concerned, sub-section (1)(a) of the proposed section 168BB appears to have abolished entirely the Foss v Harbottle rule, let alone its exception on which a derivative action is based, by allowing any member of a company to bring proceedings on its behalf without any qualification or condition whatsoever. The fact that proceedings must be brought in the name of the corporation as stipulated in sub-section (2) is of no assistance either in view of the authoritative pronouncement in Johnson v Gore Wood & Co supra that when a company suffers loss, "only the company may sue in respect of that loss" and not any of its members.

> "A company is a legal entity separate and distinct from its shareholders. It has its own assets and liabilities and its own creditors. The company's property belongs to the company and not to its shareholders. If the company has a cause of action, this is a legal chose in action which represents part of its assets. Accordingly, where a company suffers loss as a result of an actionable wrong done to it, the cause of action is vested in the company and the company alone can sue." (at 61G-H).

In the circumstances, it is our view that unless sub-paragraph (1)(a) of section 168BB is amended to reflect correctly the exception to the Foss v Harbottle rule, the entire Part IVAA

proposed to be introduced into the Ordinance by paragraph 5 of Schedule 4 to the Bill is defective. Accordingly, our comments below on the rest of the provisions in paragraph 5 of Schedule 4 is predicated on such an amendment having taken place.

(2) Sub-section 1(b) of proposed section 168BB in paragraph 5 of Schedule 4

As presently drafted, the sub-section, by employing the words "any proceedings", permits a member to intervene in *any form* of proceedings to which the company is a party. This is clearly absurd. If a company sues its customer for goods sold and delivered or an outsider sues a company for breach of contract, we know of no legal basis, nor is there any proposal or recommendation in the Consultation Paper of the Standing Committee, for any of its shareholders to take over the proceedings, whether for the purpose of their continued prosecution or termination or defence. As stated by the House of Lords, "A company is a legal entity separate and distinct from its shareholders." Not only does the idea offend against the Foss v Harbottle rule, it also undermines the common law rule that a third party has no right to intervene in any proceedings to which he is not a party and in which he has no interest. The requirement of leave from the Court for intervention in the form of the proposed section 168BB(3) is not a mitigating factor in favour of the abrogation of one of the most fundamental principles of common law.

It may well be the case that the intervention in the proposed sub-section was intended to be confined only to the statutory derivative action and no more. If that were the case, however, we see no purpose for a shareholder to intervene for the purpose of "defending" the proceedings on behalf of the company as it is trite law that in such proceedings, the company is only a defendant in name so that any order made may be binding on it. In fact, unless in exceptional circumstances it is an abuse of the powers for the directors to procure the company to take part in such form of proceedings.

(3) Proposed section 168BC in paragraph 5 of Schedule 4

The proposed section 168BB(4), correctly, preserves the common law right of any member to bring a derivative action on behalf of a company. At present, there is no requirement of serving any notice on the company concerned. Not only the requirement imposed by the proposed section 168BC is impractical in urgent cases when an injunction is required to restrain those in control from siphoning off assets of the corporation, it is difficult to ascertain the rationale behind this procedural hurdle, which merely invites the wrongdoers to attempt to strike out or set aside the notice so as to prevent the commencement of a statutory derivative action with the result of creating a trial within a trial. Thus the proposal goes totally against the underlying reason for the recommendation contained in paragraph 15.25(a) of the Consultation Paper of

the Standing Committee that "[t]here will be no 'trial within a trial'...", bearing in mind the time taken and the heavy financial burden in conducting a derivative action. To require a charitable minority who takes up the cause for the company to fight a battle before the war will effectively turn the entire paragraph 5 of Schedule 4 into a dead letter.

(4) Sub-section (1)(b) of proposed section 168BF in paragraph 5 of Schedule 4

Except in matrimonial proceedings involving families or children in which case public policy dictates that litigation should be discouraged, we are not aware of any other form of proceedings, whether under company law or otherwise, in which the Court has a power "requiring" parties to mediate. Whilst the Court may encourage mediation or the parties may choose to do so voluntarily, the proposed power conferred on the Court, which was never considered or proposed by the Standing Committee, will set a precedent which may have the effect of delay and wastage of costs, particularly in the context of a derivative action where the fruit of the litigation goes straight to the coffers of the company and not to the pocket of the shareholder-plaintiff. The mandatory power to mediate, which has extremely wide ramifications, should not be imposed on one form of action without proper consultation and, possibly, consideration by the Law Reform Commission.

(5) Proposed section 168H in paragraph 5 of Schedule 4

The word "settled" is ambiguous. Amongst its many meanings, it may connote the termination of a dispute as a result of an agreement or arrangement or, in its legal sense, the conveyance of a property for the purpose of constituting a trust. Perhaps the word "compromise", which acquires a judicial definition, is more appropriate.

Yours sincerely,

Winston Poon, SC
1904 Gloucester Tower
The Landmark
Central, Hong Kong

Godfrey Lam, Barrister
16/F, One Pacific Place
88 Queensway
Admiralty, Hong Kong

Linda Chan, Barrister
Suite 1501
Two Pacific Place
88 Queensway
Admiralty, Hong Kong