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By Fax (2877 5029)

17 January 2004

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Hong Kong

Dear Miss Lai,

Companies (Amendment) Bill 2003 ("the Bill")
Schedule 4 – Amendments relating to Shareholders Remedies

I refer to your letter of 29 August 2003 and would like to set out below our responses to your comments on Schedule 4 of the Bill.

Inspection – Proposed section 147

In the context of the Phase I of the Corporate Governance Review, the Standing Committee on Company Law Reform (SCCLR) reviewed and considered the usefulness and adequacy of the unfair prejudice remedies under the existing section 168A, and recommended, among other things, that this section should apply to a non-Hong Kong company in addition to a Hong Kong incorporated company (as defined under existing section 2 of the Companies Ordinance (CO)).

As a related issue, the SCCLR noted that the existing section 147(2)(b) allowed the Financial Secretary to petition for unfair prejudice

remedies under section 168A in respect of a body corporate[1] and thus concluded that there was an inconsistency between sections 147(2)(b) and 168A. On the basis of this conclusion, we propose that section 147(2)(b) should be amended to make it consistent with section 168A (as amended by clause 4 in Schedule 4 of the Bill) to cover a Hong Kong incorporated company as well as a non-Hong Kong company (i.e. a specified corporation).

As the scope of the petition referred to in section 147(2)(b) is governed by section 168A and we have proposed to add "Where the body corporate is a specified corporation" in section 147(2)(b), we do not consider that there is a need to make any corresponding amendment to section 146A and other relevant sections.

Inspection of Specified Corporations' Records by Members – Proposed sections 152FA to 152FE

Paragraph 1(a) – Share qualification of the applicant

There is no specific requirement on the number, volume or particulars of the applicant's shareholding. Insofar as a person is a member of a specified corporation, he may make an application in respect of the specified corporation under the proposed section 152FA.

Paragraph 1(b) – Scope of the records to be inspected

(i) Self-incrimination, interests of third parties and undertaking not to reveal information

(a) Self-incrimination

A specified corporation may claim privilege against self-incrimination under common law and seek to refuse production of documents which are the subject of an application for an inspection order under the proposed section 152FA. It is not our intention to abrogate the privilege against self-incrimination which may be available to a specified corporation. This approach is different from that in existing sections 145(3A) and (3AA) where the privilege against self-incrimination is expressly abrogated to facilitate investigation under those sections.

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[1] This includes a company incorporated outside Hong Kong (but such company may not necessarily be a non-Hong Kong company).

(b) Interests of third parties

The proposed section 152FA(2) provides that the court may only make an order under the proposed section 152FA(1) if it is satisfied that –

(a) the application is made in good faith; and

(b) the inspection applied for is for a proper purpose having regard to the interests of both the relevant specified corporation and the applicant.

Under this section, even if the threshold requirements of good faith and proper interest are satisfied, this does not mean that the court has to grant the inspection order. The court's power is discretionary. While this section does not make any specific reference to the interests of a third party, the court may refuse to make an order if it considers that the third party's interests may be adversely affected.

We are not in favour of adding in the Bill any express provision to require that the court should protect a third party's interests. First, nothing in the proposed section 152FA(2) would prevent the court from considering the relevant facts and circumstances of the application including the interests of a third party. Second, the proposed provisions in the Bill are sufficient for the protection of a third party's interests -

(a) under the proposed section 152FA(1), the court may only authorize inspection of records of a specified corporation, and not the records of other parties;

(b) under the proposed section 152FB(b), the court may specify the records that may be inspected;

(c) under the proposed section 152FA(2), the court shall, after taking into account the facts and circumstances of the application, consider whether it is necessary to make an order limiting the use of the information or documents obtained as a result of the inspection; and

(d) under the proposed section 152FC, the information or document obtained as a result of the inspection shall, subject to certain exceptions, not be disclosed, save with the written consent of the relevant specified corporation.

Third, a similar approach is adopted in the Australian Corporations Act. Lastly, the proposed section 152FA is analogous with an order for discovery in civil proceedings where there is no express rules requiring the court to protect a third party's interests. There is an implied undertaking given by a party and his legal advisers that the documents disclosed on discovery will not be used for any purpose other than the proper conduct of that action. A party can also be required to give an express undertaking not to divulge the contents of such documents to any person otherwise than for the purposes of the litigation[2].

(c) Undertaking not to reveal information

An undertaking not to reveal information per se is not considered as a separate head of privilege unless one can claim public interest immunity e.g. in the case of protection of sources and informants[3]. If the undertaking is given to the court, rather than being contractual in nature, the specified corporation will need to obtain leave of the court or run the risk of being in contempt before making disclosure. Furthermore, to allow the use of such an undertaking as a reason not to produce for inspection records as required under the proposed section 152FA would defeat the purpose of the inspection mechanism.

Generally speaking, a person would not incur liability for breaching a (contractual) undertaking of non-disclosure if the disclosure is made in pursuance of an inspection order since compulsion under the law is usually an exception (either by express provision or in some cases by implication) to the obligation of non-disclosure. That said, if the Bills Committee finds it necessary, we are willing to consider including in the Bill a doubt avoidance provision along the same lines as in existing section 145(3B) of the Companies Ordinance.

(ii) Protection of Personal Data

The proposed section 152FE is added to put beyond doubt that the protection afforded under Data Protection (Privacy) Ordinance (DPPO) in relation to the personal data of individuals would not be prejudiced by the proposed section 152FA, 152FB or 152FC. It is not our policy intent to extend the protection beyond the scope of the DPPO in the Bill to cover a legal entity.

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2 See "Odgers on High Court Pleading and Practice", page 259.

3 See D v NSPCC [1978] AC 171

Paragraph 2 – Interests of third parties

Please see our responses to comments raised in paragraph 1(b) of your letter.

Paragraph 3 - Limiting the use of information

As both an applicant and his representative would have access to the information, we consider it appropriate to provide the court with the power to limit the use of the information by the applicant as well as the representative, even though the representative should not have any independent right to use the information.

Paragraph 4 – Disclosure of information

The proposed section 152FC(1)(a) provides that subject to the proposed section 152FE (relating to protection of personal data), no information or document obtained as a result of the inspection under the proposed section 152FA shall, without the previous consent in writing of the relevant specified corporation, be disclosed to any other person, unless the disclosure is, among other things, required with a view to the institution of, or otherwise for the purposes of any investigation carried out in Hong Kong <u>in accordance with law</u>. The phrase "is required ……. in accordance with law" has the effect of limiting the information disclosable to an investigator who is entitled to obtain the information under the law empowering such an investigation.

As regards the proposed section 152FC(1)(c), its main purpose is to allow the disclosure of the information obtained by means of an inspection order if such disclosure is permitted in accordance with law or a requirement made under law.

Where an authority intends to compel a person to disclose any documents or information, it must always be specifically authorized to do so by some other legal provisions. The proposed section 152FC does not provide for such an authority.

If there is a specific requirement under the law empowering the relevant investigation that interests of the relevant specified corporation, the applicant and other relevant parties ought to be considered, then their interests would need to be considered. It is considered appropriate that the interests of these parties should continue to be considered and be taken care of, where appropriate, by means of the law empowering the relevant investigation.

Bringing or intervening in proceedings on behalf of specified corporation

Paragraph 1 – Bringing proceedings

The proposed section 168BB(1)(a) provides that a member of a specified corporation may without leave of the court bring proceedings before the court on behalf of the specified corporation. This "no leave" arrangement is to implement the SCCLR's recommendation that there should not be "a trial within a trial" for the purpose of determining the standing of an applicant to bring the proceedings. You may wish to note that there is no requirement in Hong Kong for a preliminary hearing to be held to determine the standing of the plaintiff in a derivative action[4].

We note your concerns that under the "no leave" arrangement, a member might bring and continue with a derivative action in bad faith if the concerned company is, for some reasons, unable to file an application for striking out the derivative action under the proposed section 168BD. There are already sufficient safeguards in the Bill, which are no worse than what would have been the case if the derivative action is brought in Hong Kong under common law. First, the proposed section 168BD provides the court with power to strike out a statutory derivative action on application by any party to the action on grounds such as not in good faith, not in the best interests of the company etc. This power is in addition to and does not derogate any power of the court conferred by any enactment or rule of law e.g. the court's existing power to strike out an action under Order 18 rule 19(1) of the Rules of High Court on the ground that it is scandalous, frivolous or vexatious etc. Second, the proposed section 168BG provides that the court may only make an order as to costs in a statutory derivative action in favour of the member if it is satisfied that the member was acting in good faith in, and had reasonable grounds for, bringing the action. With these safeguards, we expect that it is highly unlikely that a reasonable member would bring a statutory derivative action in bad faith.

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4 In Tan Eng Guan v Southland Co Ltd [1996] 2 HKC 100, the court of appeal upheld the defendants' appeal against the summary judgement in respect of a derivative action and granted leave to the defendants to defend the action. One of the grounds for allowing the appeal is that the case was not considered as a suitable case for a summary judgement as days of argument had been spent upon a consideration, aided by copious citation of authorities, of what the circumstances were in which a derivative action could be maintained, and whether such an action could be maintained on the facts of the case. Godfrey JA commented that such questions were best dealt with, as recognized in England and Wales by the trial of a preliminary issue whether the plaintiff ought to be allowed to maintain a derivative action at all. The learned judge further remarked that "We have no such rule, at any rate, not yet, in Hong Kong" (see p.105 at G). As of today's date, there is no such rule in Hong Kong requiring a plaintiff in a derivative action to obtain leave to commence and continue the action.

The proceedings so brought cannot be discontinued or settled without leave of the court. This is to avoid problems like "gold-digging" actions which may be settled on terms which are disadvantageous to the specified corporation. We are not in favour of the suggestion of setting out the grounds for granting the leave in the Bill as it would be much better if the court is given the full discretionary power on whether leave should be granted, having regard to the relevant circumstances of each case. A similar approach is adopted in the statutory derivative action in other common law jurisdictions like Australia.

Paragraph 2 – Intervening in proceedings

(a) Purposes

The purposes listed in the proposed section 168BB(1)(b) are exhaustive. The phrase "continuing the proceedings" should be wide enough to cover "counterclaiming". You may wish to note that the term "counterclaiming" is also not found in similar legislative provisions in other jurisdictions like Australia.

(b)(i) –(iii) Proposed sections 168BB(1)(b) and 168BH

If a member wishes to intervene in any proceedings before the court to which his company is a party only for the purpose of defending those proceedings on behalf of the company under the proposed section 168BB(1)(b), he needs to obtain leave from the court under the proposed section 168BB(3). If he subsequently wants to discontinue the proceedings, he needs to obtain leave from the court under the proposed section 168BH.

If a member applies for leave for a specific purpose e.g. defending the proceedings under section 168BB(3), he may at the same hearing seek leave to take steps to settle the proceedings under section 168BH. However, if a member seeks leave for a purpose which he has no intention to pursue at that stage, it is most unlikely that the court would entertain such an application. It would however be a matter for the court to decide.

If, after the commencement of the proceedings, the concerned applicant wishes to settle them, he needs to obtain leave from the court under section 168BH.

Paragraph 3 – Notice of intention

The objective of the notice requirement is to give the company an opportunity to consider its rights and course of action. The rationale behind the provision is to recognize the cause of action rightly belongs to the company and it should therefore have the first option of pursuing its own rights. Possible consequences from the giving of the notice are: first, the directors may decide that the company should shoulder the responsibility for the action, thus making the derivative action unnecessary; second, the directors may take such steps as to correct or remedy the situation that formed the basis of derivative action; and third, the directors may not respond to or simply ignore the notice. In any event, when the court considers whether leave should be granted, it would need to consider whether the intervention is in the best interest of the company and whether the applicant is acting in good faith. As regards the suggestion of explicitly prescribing in the Bill that the court should consider the company's response to the notice, we are considering whether there is a need to add a new provision along the lines in section 237(2)(a)[5] of the Australian Corporations Act.

Yours sincerely,

(Arthur Au)
for Secretary for Financial Services
and the Treasury

[5] Section 273(2)(a) provides that the court must grant leave for a person to bring or intervene in proceedings if it is satisfied, among other things, that it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them.