**Responses to the submission of 12 January 2004 from Mr Winston Poon, SC, Mr Godfrey Lam and Ms Linda Chan**

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

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

The Standing Committee on Company Law Reform (SCCLR) makes a number of proposals to enhance shareholder remedies in its Consultation Paper on Proposals made in Phase I of the Corporate Governance Review (CGR). One of these proposals is to allow members of oversea companies to seek unfair prejudice remedy under the existing section 168A of the Companies Ordinance (CO) and submissions received during the consultation indicate support for such a proposal. On the basis of the SCCLR's recommendation, we propose to expand the scope of section 168A to cover oversea companies.

2. We agree that it appears logical to dovetail the scope of sections 168A and 327 in view of their connection and thus, extend the application of section 168A further to unregistered companies. We are, however, mindful of the situation in the UK where it has been the case since 1980 that while the winding up provisions apply to unregistered companies, the unfair prejudice remedy provisions do not. We are uncertain about the rationale behind this arrangement. Given the lack of practical experience about the possible implications of extending the unfair prejudice provisions to unregistered companies, we suggest consulting the SCCLR and relevant stakeholders before taking a decision and that this issue should preferably be dealt with in the next exercise of amending the CO.

3. It is suggested in the submission that instead of amending existing section 168A, a new section making available the unfair prejudice remedy to oversea companies should be inserted into those Parts applicable to foreign corporations (i.e. Parts X and XI) since these two parts cover exclusively unincorporated associations and foreign corporations, including oversea companies. While this suggestion is merely a matter of format and does not change the legal effect of the proposed amendments, we wonder whether the approach of scattering the proposed amendments in different Parts of the CO is user-friendly, particularly because Part X is applicable to unregistered companies which

cover other types of associations (such as partnerships) as well. Readers may be misled in believing that the unfair prejudice remedy is also available to those associations (assuming that section 168A is not amended in the context of the Bill to extend its application to unregistered companies). Furthermore, since the existing section 168A is well known to the practitioners as being the provision for an alternative remedy to winding up in cases of unfair prejudice, readers may find it more convenient if we put all amendments in section 168A as they could have a full picture of the scope of application of the provision by reading one provision.

4. We consider that providing in Parts X and XI cross-references to the unfair prejudice remedy would not be user-friendly as it will require a reader to flip back more than a hundred sections to find out the details of the remedy.

*(2) "Made" the Petition*

5. For the sake of consistency with the wording in the existing provisions of the CO, we agree 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 subsection (2A) of section 168A in paragraph 4(3) of Schedule 4*

6. In the context of the Phase I of the CGR, the SCCLR recommends that existing section 168A should be amended to make it clear that the court has power to award damages by way of a remedy to members in circumstances of unfair prejudice. The rationale behind this recommendation is that despite the width of existing section 168A(2), it is not clear if this section would allow the court to make an order for damages to be awarded to members and that in relation to listed companies, it is not clear that the remedies available under this section are necessarily adequate since it may not be practicable in all circumstances, for instance, for the court to require a buy-out of minority shareholders.

7. On the basis of the SCCLR's recommendation, we propose to add sections 168A(2A) and 168A(2C) to make it clear that the court <u>may</u> award damages by way of a remedy, in addition to other remedies, to members in circumstances of unfair prejudice. The proposal on its own

would not result in a violation of the common law principle that a member cannot sue for a loss which is merely reflective of the company's loss as it would not vary the nature of the claim, create new cause of action, or confuse the distinction between personal claim and derivative claim.

8. That said, we are considering if there is a need to add a doubt avoidance provision to make it clear that the proposed sections 168A(2A) and 168A(2C) shall not have the effect of entitling a member to damages when the company itself has a claim for damages in respect of the same matter.

*(4) Proposed subsection (2B) of section 168A in paragraph 4(3) of Schedule 4*

9. At present, there is no limitation period for a present member seeking relief under existing section 168A. That said, matters such as long delay in bringing proceedings, change of position in the meantime and injustice in seeking to remedy matters which occurred long ago are matters which the court could take into account in proceedings brought under section 168A. We consider that the same treatment should be accorded to a past member seeking relief under section 168A.

*(5) Proposed subsection (2D) of section 168A in paragraph 4(3) of Schedule 4*

10. We are now looking into the matters further and will let you have our substantive response later on.

*(6) Proposed subsection (5C) of section 168A in paragraph 4(4) of Schedule 4*

11. We agree that this section should be deleted.

***B. Paragraph 5 of Schedule 4 – Part IVAA Bringing or Intervening in Proceedings on behalf of Specified Corporation***

*(1) Subsections (1)(a) and (2) of proposed section 168BB in paragraph 5 of Schedule 4*

*(2) Subsection (1)(b)of proposed section 168BB in paragraph 5 of Schedule 4*

12. In the context of the Phase I of the CGR, the SCCLR recognizes

the difficulties associated with the application of the major exception to the rule in Foss v. Harbottle (i.e. "fraud on the minority" and "the wrongdoers in control of the company") e.g. difficulty in discerning from the case law clear principles under which a wrongdoing may be ratified by the majority shareholders and circumstances under which they may not. There are some other practical difficulties with, and disincentive to members commencing a derivative action in Hong Kong e.g. a member bringing the action is potentially liable for the costs of the action even though he has no corresponding right to the potential damages.

13. In view of the above difficulties, the SCCLR recommends that a statutory derivative action should be introduced whereby there will be no "trial within a trial" for the purpose of determining the standing of an applicant to commence a derivative action on behalf of a company, and ratification by general meeting would not be a bar to the commencement of the action.

14. On the basis of the SCCLR's recommendation and having due regard to the law providing for statutory derivative action in comparable jurisdictions like Australia, Singapore, sections 168BA to 168BI in the Bill are proposed. As in the law of the comparable jurisdictions, no reference is made to exceptions to the rule in Foss v Harbottle in the proposed sections as such exceptions are difficult, if not impossible, to be codified. In fact, it is precisely because of the difficulties and uncertainties of the exceptions that it was considered necessary to have statutory derivative action in those jurisdictions. That said, certain guiding principles like good faith, best interests of the company, effect of approval or ratification by members are proposed for the court to consider (either under the striking out mechanism in the proposed section 168BD or the leave mechanism under the proposed section 168BB(3)) when processing a statutory derivative action.

15. To address the concerns about the scope of the statutory derivative action and lack of sufficient safeguards therein, we are considering whether there is a need to -

(a) make it explicit in the proposed section 168BB(1) that the subject proceedings should be confined to those for the recovery of damages for fraud, negligence, default, breach of duty, or other misconduct, committed by a person who is or has been a director of the company (c.f. section 50 of the Australian Securities and Investments Commission Act 2001 at Annex A); and

(b) add a new provision along the lines in section 237(3) of the Australian Corporation Act 2001 at Annex B to "define" the scope of "best interests" in the proposed sections 168BD and 168BB(3) whereby proceedings between a company and a third party would normally be excluded from the statutory derivative action.

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

16. To facilitate a member to commence a derivative action, we agree with the SCCLR's recommendation that there should be no "trial within trial" for the purpose of determining the standing of an applicant to commence the action (i.e. no leave is required for bringing a statutory derivative action). That said, there should also be sufficient safeguards to avoid any frivolous claims. The objective of the notice requirement is to give the concerned company an opportunity to consider its rights and course of action. For example, it may apply to the court under the proposed section 168BD to strike out the intended statutory derivative action if it considers that the action is brought in bad faith or not in the best interest of the company. Unlike the requirement of obtaining leave for commencing a derivative action, this striking out mechanism is only a safeguard which could be deployed when necessary. It is worth noting that this notice requirement in also found in the law providing for statutory derivative action in other comparable jurisdictions like Australia, Singapore.

17. To cater for urgent cases where, for example, an injunction is needed to restrain those in control from siphoning off assets of a company, we have also proposed a new provision i.e. proposed section 168BC(4) whereby the court may grant leave to dispense with the notice requirement.

*(4) Subsection (1)(b) of proposed section 168BF in paragraph 5 of Schedule 4*

18. In the light of the comments made in the submission and for the sake of consistency with the approach adopted in other proceedings under the CO, we agree to delete the reference to "mediation" in the proposed section 168BF.

*(5) Proposed section 168BH in paragraph 5 of Schedule 4*

19. From the drafting point of view, the use of "settle" in relation to legal proceedings is proper (see Order 34 rule 8(2) of the Rules of High Court).

**Financial Services Branch**
**Financial Services and the Treasury Bureau**
**February 2004**

Annex A

**AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION ACT 2001 - SECT 50**
**ASIC may cause civil proceeding to be begun**

Where, as a result of an investigation or from a record of an examination (being an investigation or examination conducted under this Part), it appears to ASIC to be in the public interest for a person to begin and carry on a proceeding for:

(a) the recovery of damages for fraud, negligence, default, breach of duty, or other misconduct, committed in connection with a matter to which the investigation or examination related; or
(b) recovery of property of the person;

ASIC:

(c) if the person is a company—may cause; or
(d) otherwise—may, with the person's written consent, cause;

such a proceeding to be begun and carried on in the person's name.

**CORPORATIONS ACT 2001**
**- SECT 237**
**Applying for and granting leave**

(1) A person referred to in paragraph 236(1)(a) may apply to the Court for leave to bring, or to intervene in, proceedings.

(2) The Court must grant the application if it is satisfied that:

(a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and
(b) the applicant is acting in good faith; and
(c) it is in the best interests of the company that the applicant be granted leave; and
(d) if the applicant is applying for leave to bring proceedings—there is a serious question to be tried; and
(e) either:
(i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
(ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

(3) A rebuttable presumption that granting leave is not in the best interests of the company arises if it is established that:

(a) the proceedings are:
(i) by the company against a third party; or
(ii) by a third party against the company; and
(b) the company has decided:
(i) not to bring the proceedings; or
(ii) not to defend the proceedings; or
(iii) to discontinue, settle or compromise the proceedings; and
(c) all of the directors who participated in that decision:
(i) acted in good faith for a proper purpose; and
(ii) did not have a material personal interest in the decision; and
(iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
(iv) rationally believed that the decision was in the best interests of the company.

The director's belief that the decision was in the best interests of the company is a rational one unless the belief is one that no reasonable person in their position would hold.

(4) For the purposes of subsection (3):

(a) a person is a third party if:
(i) the company is a public company and the person is not a related party of the company; or
(ii) the company is not a public company and the person would not be a related party of the company if the company were a public company; and
(b) proceedings by or against the company include any appeal from a decision made in proceedings by or against the company.

Note: *Related party* is defined in section 228.