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9 March 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

Also on behalf of my colleagues, Mr Godfrey Lam and Ms Linda Chan, I am enclosing herewith a copy of our comments on the Responses of the Financial Services Branch to our submissions to the Bills Committee dated 12 January 2004 and 5 February 2004. I would be grateful if you could pass the document to the Chairman of the Committee for consideration.

Yours sincerely,

Winston Poon, SC

WP/dc

Encl.

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Ms. Shirley Lam
Principal Assistant Secretary for
Financial Services and the Treasury
(Financial Services)
Financial Services and the Treasury Bureau
Government of the Hong Kong
Special Administrative Region
18/F, Tower 1, Admiralty Centre
18 Harcourt Road
Hong Kong

BY FAX & LETTER

Dear Ms Lam,

Comments on Schedule 4 to the Companies (Amendment) Bill 2003 and on the Financial Services Branch's Responses to our submissions dated 12 January 2004 and 5 February 2004 respectively

Thank you for your two letters addressed to Mr. Winston Poon SC dated respectively 11 and 19 February 2004. We have, however, learnt with dismay that the Bills Committee proposes to impose a leave requirement for commencing a statutory derivative action. Due to its cardinal importance, we shall comment first on this issue.

Leave requirement for commencement of statutory derivative action

As you are aware, the SCCLR is composed of a wide spectrum of representatives drawn from the various sectors of the public having frequent

interactions with company law. Apart from the ex officio members, it includes representatives from the financial services, accountancy and legal profession and was, at the relevant time, chaired by a Court of Appeal Judge who was well respected and widely experienced in company law. It was the considered opinion of the SCCLR based on the experience of its many members that, unlike the United Kingdom, minority shareholders in Hong Kong, far from abusing the process as feared by the Bills Committee, had been inhibited from bringing derivative actions due to the prohibitive costs and length of time involved (see para. 15.14 of the Consultation Paper on proposals made in Phase I of the Corporate Governance Review (July 2001) ("Consultation Paper")). As we have mentioned earlier, it requires a charitable minority at the risk of paying substantial costs out of his own pocket to take up the case for the company.

Seeing the proliferation of litigation in the United Kingdom as a result of imposing the leave requirement, the immediate reaction of the SCCLR was to recommend that it be specified in the codified derivative action that "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 the company" (para 15.25(a) of the Consultation Paper). The recommendations of the SCCLR was "intended to remove any .... procedural obstacles and facilitate derivative actions" (para. 15.29 of the Consultation Paper).

Thus the proposal of the Bills Committee defeats wholly the object of the recommendation of the SCCLR. Instead of removing the hurdles for the commencement of derivative actions, it places additional obstacles before minority shareholders by requiring them to fight two battles rather than one all at their own risks! There is no evidence whatsoever that derivative actions are consistently abused by minority shareholders in Hong Kong. If the recommendations of Bills Committee is adopted, we have grave doubts if the legislation will ever be invoked.

We now express our view on the Financial Services Branch's responses to our submissions dated 12 January 2004 and 5 February 2004 as enclosed in your two letters. Since our views have already been stated in those submissions and nothing since has altered them, we therefore set out below only such further comments as appear necessary by reference to the paragraph numbers of the Financial Services Branch's responses.

The 11 February 2004 Financial Services Branch's Responses to our submissions dated 12 January 2004

§2

We would point out that the position in the UK is that while the unfair prejudice remedy (s.459 of the Companies Act 1985) does not apply to unregistered companies, it does not apply to oversea companies either. The proposed extension of the unfair prejudice remedy in Hong Kong to oversea companies but not to unregistered companies (whatever the rationale may be) cannot therefore be justified by reference to the UK situation.

§§3-4

The response betrays a lack of understanding of the format or structure of the Companies Ordinance, particularly the genesis of its various parts which were derived from their counterparts in the Companies Acts of the United Kingdom. Our suggestion is made on the basis that the winding up provisions for Hong Kong companies and oversea companies are already currently contained in widely separate parts of the Ordinance. Inserting a provision in the Parts applicable to unregistered or oversea companies to make the unfair prejudice remedy available in respect of those companies simply follows the same logic and, in our view, renders the Ordinance more user-friendly rather than less since one can see at a glance (at those Parts) which provisions in the Ordinance are applicable to foreign (i.e. unregistered or oversea) companies.

§§6-7 - Proposed subsection (2A) of section 168A in paragraph 4(3) of Schedule 4

There is a statutory requirement for relief under section 168A, viz., "with a view to bringing to an end the matters complained of". We have reviewed the SCCLR's recommendation and have not been able to find any discussion, let alone recommendation, for the abolition of this requirement. Accordingly, we query whether there is any basis to suggest that the words "whether or not" should be added before the phrase "with a view to bringing to an end the matters complained of".

Further, since we submitted our comments, the Court of Appeal in Hong Kong has handed down a decision on the question whether section 168A(2)(d) authorized the court to make an order for damages to members: see Re Chime Corporation Limited, CACV 124 of 2003, unreported, 20 February 2004, paras. 14 to 36. In particular, in para. 26(1), the Court of Appeal stated:-

> "[p]urely as a matter of construction, the width of the words in section 168A(2) are such as to include the award of financial compensation as being a possible remedy ... but as a matter of principle I fail to see why an award of financial compensation should automatically be excluded".

On the Court of Appeal's reasoning, the words "whether or not" are not necessary since the existing words "with a view to bringing to an end the matters complained of" do not preclude the remedy of damages.

However, we should point out that the Court of Appeal's decision appears to be inconsistent with the view expressed by the SCCLR on the question of the width of the section 168A(2). In para. 16.24 of the Consultation Paper, the SCCLR stated that "despite the width of [section 168A(2)], it is not clear if this would allow the court to make an order for damages to be awarded to members". Further, the Decision of the Honourable Madam Justice Kwan in the same case at first instance on 6 May 2003 was to the opposite effect. We understand that an application is being made in that case for leave to appeal to the Court of Final Appeal.

§9 - Proposed subsection (2B) of section 168A in paragraph 4(3) of Schedule 4

The position of a present member should not be equated with the position of a past member as the latter has, by his own choice, ceased to have any interest whatsoever in the company. That being the case, unless the Companies Ordinance so provides, the past member would have no standing to complain about the affairs of the company in particular how its affairs ought to be conducted in the future (which, as discussed above, is the object of the section 168A remedy). It is for this reason that we suggest that "justice dictates that there should be a limitation period for a past member to seek relief under section 168A".

§§12-15 - Paragraph 5 of Schedule 4 – Part IVAA Bringing or Intervening in Proceedings on behalf of Specified Corporation

The sole aim of codifying derivative action is to clarify and to "remove uncertainties and provide a more effective means of enforcing directors' and other wrongdoing committed in relation to the company" (para. 15.27 of the Consultation Paper). Since the Financial Services Branch has acknowledged that "such exceptions [to the Foss v. Harbottle rule] are difficult, if not impossible, to be codified" (§14), the administration should consider, irrespective of the recommendations of the SCCLR, whether any useful purpose may be served by introducing a statutory derivative action.

In our view, to have peripheral "guiding principles" as in Australia and Singapore or, as presently envisaged in the Bill, to allow the commencement of an action, leaving the Court to determine later whether it falls within the exceptions to the Foss v Harbottle rule is unacceptable. Far from shedding any light on the principles of derivative action as suggested by the SCCLR, the wording of section 168BB would create much more uncertainties to this branch of the law and muddle the entire situation. We wonder how this type of legislation can be described as user-friendly at all.

The 19 February 2004 Financial Services Branch's Responses to our submissions dated 5 February 2004

Subsection (2) of proposed section 168BB in paragraph 5 of Schedule 4 – Discovery of documents

The response does not address our concern about the inability of the Court to award costs in favour of or against a minority shareholder. However, it highlights the anomalous situation where the person who has the conduct of the proceedings (the member) is not the person who has the right to or control over the company's documents (the Board of Directors). At present, there is no problem with discovery as the company is always joined as a nominal defendant in the derivative action so that while the member is responsible for conducting the action (in his own name), the company, often represented by an independent firm of solicitors, is responsible for making discovery in respect of the documents in question.

While it is easy to say that "the persons who do have control of the company's documents should cause the company to comply with the discovery obligation", these persons are often the very defendants themselves. So under the proposed section it appears that the defendant will be in charge of the plaintiff's discovery as well (for the company is the plaintiff).

If the company is the plaintiff (since the action is brought in its name), it is doubtful that the member in question has any standing to apply to the Court for any order under Order 24, rules 7, 12 and 16 of the Rules of High Court to direct the company or an officer of the company to do or not to do any act. Equally, the officer may not be a party to the cause or matter, and the Court does not have jurisdiction over him.

Yours sincerely,

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