Bills Committee on
Companies (Amendment) Bill 2003

Follow-up actions arising from the discussion
at the meetings on 20 and 28 February 2004, and 11 March 2004

Introduction

This paper sets out the outcome of the follow-up actions arising from the discussion at the meetings on 20 and 28 February 2004, and 11 March 2004.

Meeting on 20 February 2004

Procedural issues relating to a statutory derivative action (SDA)

2. Our counterparts in Australia advise us that a company is named as a plaintiff in an SDA brought by its member under the Australian Corporations Act 2001 mainly because the action is brought on behalf of the company (possibly) with company funds, and it is the company which will benefit from any successful action. The exact way the member requests discovery from the company is most likely determined by the Supreme Court Rules for each State jurisdiction given that the action will be brought on behalf of the company itself. Each State's Rules are generally very similar, and are amended from time to time although as far as they know there is no special set of rules introduced to deal specifically with an SDA. General discovery requires a court order. Whilst they are not sure of the exact method, in the case of an SDA, the court has wide powers to make orders and directions (section 241 of the Act) which could include the discovery of certain documents. They do not think that the court would regard the named plaintiff being the company itself as a hurdle to granting an order for discovery, and that the court would tailor an order for discovery as it thinks fit.

3. More generally, the Australian Corporations Act 2001 provides that a member may obtain information from his company under section 247A(1) of the Act, which permits the member to apply to the court for an order authorising him to inspect books of the company, or authorizing another person (whether a member or not) to inspect books of the company on his behalf. In relation to an SDA, section 247A(3) of the Act gives a comparable right to a person who is granted, or applies for, or is eligible to

apply for, leave under section 237 of the Act to bring or intervene in proceedings in the company's name. As in the case of an application by a member under section 247A(1), the court may make an order authorising inspection by the applicant or by someone on the applicant's behalf under section 247A(4) of the Act only if it is satisfied that the applicant is acting in good faith and the inspection is made for a purpose connected with applying for leave under section 237, or connected with bringing or intervening in proceedings with leave under section 237.

4. Similar to the situation in Australia, we do not think that the court in Hong Kong would regard the named plaintiff being the company itself as a hurdle to granting an order for discovery. As explained before, there are a number of channels for facilitating discovery including the Rules of High Court, the proposed section 168BF and section 152FA.

Meeting on 28 February 2004

Undertaking as to damages

5. The proposed sections 350B(1) and (3) provide that the court may, on the application of the Financial Secretary or an affected person, grant an injunction order, on such terms as the court considers appropriate, restraining a person from engaging in the relevant conduct or requiring that person to do certain act or thing. The proposed section 350B(5) further provides that where the court considers appropriate, it may grant an interim injunction pending the determination of an application for an injunction under the proposed section 350B(1) or (3). We believe that the phrase "on such terms as the court considers appropriate" should be wide enough to allow the court to require an undertaking as to damages by the Financial Secretary or the affected person as it considers appropriate when it grants an injunction or an interim injunction.

Meeting on 11 March 2004

(i) Derivative action in the UK and Hong Kong

6. We have not been able to locate any specific information about the usage of the derivative action in the UK and Hong Kong. Members may wish to note that in the UK, the Rules of the Supreme Court were amended in 1994 so as to introduce a special new procedure for a derivative action, which, in effect, is a preliminary screening process which reinforces

the ruling in Prudential Assurance Co. Ltd v Newman Industries Ltd. (no. 2) [1982] 1 ALL ER 354 that the question of the plaintiff's standing should be settled before the substantive issue is heard. These provisions, were then reproduced in the Civil Procedure Rules in 1998, which requires the claimant to obtain the permission of the court to continue the case once the claim has been issued and served. A passage in the UK Law Commission Report No. 246 on Shareholder Remedies [1997] suggests that notwithstanding the intention of the Court of Appeal in Prudential Assurance Co. Ltd v Newman Industries Ltd. (no. 2) [1982] 1 ALL ER 354 that the preliminary hearing in a derivative action should be relatively short, the actual situation has turned out to be different. Paragraph 6.6 of the Report reads as follows -

> "The Court of Appeal no doubt envisaged that the determination of this preliminary issue should involve a relatively short hearing. However, the hearing of Smith v Croft (No. 2) [1988] Ch 114, lasted 18 days. In that case, complicated questions of law arose. Difficult questions of fact can also arise at this stage as the case of Trusthouse Forte plc v Savoy Hotel plc illustrates.".

It is worth noting that the threshold for granting leave under the common law derivative action in the UK is different from that in our proposed statutory derivative action under the Bill. The former is "fraud on the minority" and "wrongdoers in control of the company" whereas the latter is "good faith of the member", "best interests of the company", "serious question to be tried" and "concerned company will not itself bring the proceedings or properly take responsibility for them".

(ii) Best interests of the company

7. The "best interests of the company" criterion recognises that a company may have sound business reasons for not pursuing a legal action open to it and that its directors might legitimately have decided that the best interests of the company would be served by not taking the legal action. According to the court in Swansson v R.A. Pratt Properties Pty Ltd. [2002] 42 ACSR 313, for an applicant to establish that it is in the interests of the company that he be granted leave, the applicant must normally produce evidence at least to the following matters -

> (a) evidence as to the character of the company (different considerations may apply depending on whether the company is a small private company whose few

shareholders are the members of a family or whether it is a large publicly listed company. If the company is a small family company, it may be relevant to take into account the effect of the proposed litigation on the purpose for which the company was established and on the family members who are the shareholders. Such consideration will be irrelevant if the company is a publicly listed company);

(b) evidence of the business, if any, of the company so that the effects of the proposed litigation on its business may be considered;

(c) evidence enabling the court to form a conclusion whether the substance of the redress which the applicant seeks to achieve is available by means other than a derivative action; and

(d) evidence as to the ability of the defendant to meet at least a substantial part of any judgement in favour of the company in the proposed derivative action so that the court may ascertain whether the action would be of any practical benefit to the company.

8. In the absence of a rebuttable presumption along the lines in section 237(3) of the Australian Corporations Act 2001 (Annex) in the Companies (Amendment) Bill 2003, which deals with proceedings involving a third party, there will be no presumption to be displaced by an applicant for leave and the burden remains (albeit easier) on the applicant to show that the derivative action is in the best interest of the company. That said, given that there will now be a leave requirement for commencing an SDA under the Bill and that the application for leave is not to be made on an ex parte basis, the company should be able to make a representation before the court as to whether the action is in the best interests of the company. Hence, we believe that lawful and reasonable commercial transactions of a company per se should normally be excluded from the scope of the SDA as it is difficult to establish that it would be in the best interests of the company to commence an SDA involving such commercial transactions.

Financial Services Branch
Financial Services and the Treasury Bureau
March 2004

Annex

AUSTRALIAN CORPORATIONS ACT 2001
- SECTION 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.

AUSTRALIAN CORPORATIONS ACT 2001 - SECTION 228

Related parties

Controlling entities

(1) An entity that controls a public company is a related party of the public company.

Directors and their spouses

(2) The following persons are related parties of a public company –

(a) directors of the public company;
(b) directors (if any) of an entity that controls the public company;
(c) if the public company is controlled by an entity that is not a body corporate—each of the persons making up the controlling entity;
(d) spouses and de facto spouses of the persons referred to in paragraphs (a), (b) and (c).

Relatives of directors and spouses

(3) The following relatives of persons referred to in subsection (2) are related parties of the public company –

(a) parents;
(b) children.

Entities controlled by other related parties

(4) An entity controlled by a related party referred to in subsection (1), (2) or (3) is a related party of the public company unless the entity is also controlled by the public company.

Related party in previous 6 months

(5) An entity is a related party of a public company at a particular time if the entity was a related party of the public company of a kind referred to in subsection (1), (2), (3) or (4) at any time within the previous 6 months.

Entity has reasonable grounds to believe it will become related party in future

(6) An entity is a related party of a public company at a particular time if the entity believes or has reasonable grounds to believe that it is likely to become a related party of the public company of a kind referred to in

subsection (1), (2), (3) or (4) at any time in the future.

Acting in concert with related party

(7) An entity is a related party of a public company if the entity acts in concert with a related party of the public company on the understanding that the related party will receive a financial benefit if the public company gives the entity a financial benefit.