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6 May 2004

Secretary for Financial Services and the Treasury
Financial Services Branch
Financial Services and the Treasury Bureau
Government of the Hong Kong SAR
18/F Admiralty Centre Tower 1
18 Harcourt Road
Hong Kong

Attn: Ms. Shirley Lam

Dear Ms. Lam,

Re: Consultation Paper on Statutory Derivative Action in the Companies (Amendment) Bill 2003

I refer to your letter dated 22 April 2004 in connection with the captioned matter and attach the comments of the Law Society's Company and Financial Law Committee, a copy of which has also been sent to the Bills Committee on the Companies (Am) Bill 2003.

Regards,

Joyce Wong
Director of Practitioners Affairs

c.c.: Bills Committee

Encl.

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Comments by the Law Society's Company and Financial Law Committee on the Consultation Paper on Statutory Derivative Action in the Companies (Amendment) Bill 2003 and Proposed Committee Stage Amendments

Concurrent Remedies

1.1 The reason put forward for allowing common law derivative action ("CDA") and statutory derivative action ("SDA") to co-exist is not convincing.

1.2 Paragraph 8 of the Consultation Paper states that in respect of non-Hong Kong companies, shareholders should be given an option to choose between CDA and SDA, or to commence both CDA and SDA. It is said that abolishing CDA "might deprive shareholders of those companies of rights otherwise available to them". It appears that the only reason given is that "there may be different rules of internal management in the law of the place of incorporation compared with those applying to Hong Kong incorporated companies".

1.3 The rationale is unclear bearing in mind the Bill applies to non-Hong Kong companies. Rules about internal management will continue to be governed by the law of the jurisdiction of incorporation of the company, but this does not seem to support the conclusion that an SDA-only approach will prejudice or take away the rights of such shareholders. The SDA is a procedural remedy for corporate wrongs done, and if corporate wrongs (including those about internal management) have been committed, why would an SDA-only approach take away common law rights and prejudice shareholders? Indeed, one would have thought that a SDA would assist by providing the member with a right of redress not otherwise available, as the member is no longer required to prove himself within the exceptions to the rule in *Foss v Harbottle* and ratification will no longer itself be a bar to commencing proceedings (although the court will take that into account in making relevant orders).

1.4 *Konamaeni v Rolls-Royce* referred to in paragraph 8 of the Consultation Paper is not about a SDA. It may perhaps also be relevant to note that the Indian connection in that case (including the bribery charges etc.) were evidently significant as a result of which the proper forum was considered to be India rather than England. In contrast, foreign-incorporated companies that are listed in Hong Kong clearly have a strong Hong Kong connection but have basically no business activities in their place of incorporation. The same comment also applies to foreign companies (such as those incorporated in the BVI) used by private businesses.

1.5 It is important for the Bill to set out clearly how a derivative action should be conducted. Allowing for CDA and SDA to continue concurrently is an unnecessary complication that is likely to result in derivative actions becoming more costly. Paragraph 10 of the Consultation Paper provides an example of an additional complication that should have been avoided.

Threshold for Leave

2.1 Another principal proposal relates to obtaining leave from the court and substituting that in place of the procedure of a striking out.

2.2 We do not object to the requirement to obtaining leave from the court, which also seems to be the position under the UK Rules as a matter of court procedure. However, is the proposed test, namely "a serious question to be tried" (see proposed section 168BB(3)(c)) an appropriate threshold?

2.3 The leading cases on derivative actions, being *Prudential v. Newman* and *Smith v. Croft*, explained why it would be necessary to go above that threshold and require the plaintiff to prove a *prima facie* case (as against simply, "a serious question to be tried"). Why is there a move away from that test?

2.4 There are, almost invariably, serious allegations contained in a derivative action, and the basis for permitting a derivative action to proceed should go beyond having "a serious question to be tried". There are other factors set out in the section, but, on balance, the reference to "a serious question to be tried" sets the threshold too low.

2.5 It is acknowledged there are problems under common law and the decision of *Smith v. Croft* has been heavily criticised, but we are already moving away from the position in *Smith v. Croft* as the Bill provides that ratification is not a bar to proceedings. It also appears, on the face of it, that the court may well have a wider jurisdiction to order an indemnity of costs (as section 168BG(3) refers to a member acting in good faith and having "reasonable grounds" for bringing or intervening in the proceedings or making the application). With those enhanced protection or features, it seems prudent to continue with the requirement that a plaintiff has to prove a *prima facie* case.

Scope of Proceedings

3.1 As the intention is to abolish the requirement that the plaintiff must prove himself within the exceptions of *Foss v Harbottle*, it would seem not necessary to restrict the types of corporate wrongs that may be the subject of a SDA. That said, the emphasis must be on corporate wrongs and a SDA should not be permitted where a member

disagrees with the management's business judgment or decisions provided that such judgments or decisions are made in good faith.

The Law Society of Hong Kong
5 May 2004
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