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HONG KONG BAR ASSOCIATION

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24th May 2004

Ms. Shirley Lam
 for Secretary for Financial Services
 and the Treasury
 Financial Services and the Treasury Bureau
 18/F Admiralty Centre, Tower 1
 18 Harcourt Road, Hong Kong

Dear Ms. Lam,

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

I thank you for your letter dated 22nd April 2004 and apologise for the delay in replying to the same. I enclose the written comments of the Hong Kong Bar Association on the Consultation Paper on Statutory Derivative Action in the Companies (Amendment) Bill 2003 for your consideration.

Yours sincerely,

Jennie Wang
 Administrator

Encl.
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HONG KONG BAR ASSOCIATION
COMMENTS ON THE CONSULTATION PAPER
OF APRIL 2004 ON COMMITTEE STAGE AMENDMENTS
TO THE COMPANIES (AMENDMENT) BILL 2003

1. As a general comment on Part IVAA proposed by the Bill, we note that although the legislative purpose of introducing Part IVAA is to introduce a statutory *derivative* action, the provisions under sections 168BA to 186BI seem to suggest that they apply to *all civil proceedings* (see the definition of "proceedings" in s.168BA). There is no basis to expand the scope of the provisions to any proceedings other than derivative actions. In terms of drafting, the administration may consider expressly clarifying the limited scope of these provisions by adopting a similar form of wording as in RSC O.15 r.12A in the UK which provided as follows: "*(1) This rule applies to every action begun by writ by one or more shareholders of a company where the cause of action is vested in the company and relief is accordingly sought on its behalf (referred to in this rule as a 'derivative action').*"
2. The principal committee stage amendment to the Bill is the introduction of a regime requiring leave of the court before a member can bring a statutory derivative action. The procedures for bringing such an action, as envisaged by the Bill as amended, are as follows:
 - (a) The member gives 14 days' notice to the company of his intention to bring a statutory derivative action on its behalf; alternatively, the member applies to the court for leave to dispense with the service of such notice. See s.168BC(1) & (4).
 - (b) The member then applies to the court under s.168BB(3) for leave to bring the statutory derivative action.

(c) It is only after the court has given leave that the member may then bring a statutory derivative action under s.168BB(1).

3. In contrast to the position in the UK, under the procedure for common law derivative action, it is unnecessary for a shareholder plaintiff to apply to the court for leave to continue the action in Hong Kong, as is required in the UK (RSC O.15 r.12A). Despite the absence of such requirement, there do not appear to have been major difficulties caused by lengthy arguments on the standing of the plaintiff in derivative actions. As practitioners with experience of acting in derivative actions, we do not agree with the FSB's observation that: "In practice, it would normally be difficult to show that there are controlling or ill-motivated shareholders who are preventing litigation from taking place". Indeed, in their Consultation Paper on Phase I of the Corporate Governance Review issued in July 2001, the SCCLR expressly noted with apparent approval that it was not the practice in Hong Kong to determine the standing of the plaintiff at a preliminary stage (despite suggestion to the contrary in Tan Eng Guan v Southland Co Ltd [1996] 2 HKC 100).
4. Any requirement for leave is likely to deter minority shareholders from bringing derivative actions. There are already considerable disincentives for shareholders to bring such actions. To start with, any damages recovered in such actions will enure to the benefit of the company, not to the minority shareholder himself. Yet the minority shareholder is potentially liable for his own costs as well as the costs of the defence if he is unsuccessful (subject to obtaining a Wallersteiner v Moir (No. 2) order).
5. Requiring leave will mean creating an additional procedural obstacle. This will simply mean greater costs and further delay before the substantive complaints can be determined by the court. Given the sometimes lackadaisical approach to litigation in Hong Kong and the time often taken up in interlocutory

proceedings, an additional interlocutory hearing will probably set back the progress of an action by at least a few months.

6. The Bill expressly preserves the right to bring a common law derivative action: sec s.168BB(4). As far as the common law derivative action is concerned, the Bill does not seek to change the current position where leave is not required. The introduction of the requirement for leave for the statutory derivative action is likely to make this parallel procedure a much less attractive option by contrast. Even before the minority shareholder can so much as issue a writ in a statutory derivative action, he will first have to apply for leave, which is likely to result in an *inter partes* battle since notice has to be served on the company of the shareholder's intention to make that application.
7. In addition, the open-textured criteria proposed in the Bill for the granting of leave are likely to cause difficulties. It may require lengthy arguments on a wide range of considerations, both legal and commercial, for the court to decide whether "it is satisfied that it is in the best interests" of the company for leave to be granted (as is required under s.168BB(3)(a)). We query whether it is appropriate to ask the court to decide what is "in the best interests" of the company in view of the long established principle of judicial non-interference with *bona fide* management decisions (see Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 at 832 and Kwok Shun On v Wong Sai Wing [2001] 3 HKLRD 811 at para.73). Further, we note that the condition "serious question to be tried" is often used in the context where an interlocutory injunction is being sought and it is unclear whether it is appropriate to borrow the phrase for the purposes of commencing a derivative action.
8. More generally, as these amendments are committee stage amendments, none of the conditions proposed in s.168BB(3), viz., "good faith of the shareholder", "best interests of the company" and "serious question to be tried" has been seriously considered by the SCCLR prior to their Consultation Paper in July 2001.

9. It may be questioned whether these procedural complications are consistent with the purpose of making derivative actions a more readily available remedy to minority shareholders. All these conditions will have to be established by and at the expense of a shareholder who, at the stage of asking for leave at any rate, is likely to have little access to the relevant information. In fact, the SCCLR recognized the undesirability of having a preliminary inquiry of the right to bring a derivative action and expressly stated in their Consultation Paper on Phase I of the Corporate Governance Review issued in July 2001 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"* (see paragraph 15.25(a)) and that: *"These proposals (taken together with the proposals with regard to the unfair prejudice remedy, below) are intended to remove any uncertainties or procedural obstacles and facilitate derivative actions"* (see paragraph 15.29). The present proposal in the committee stage amendments to the Bill is likely to lead to a "trial before a trial" to determine whether the shareholder should have leave to commence a derivative action, contrary to the recommendation in the SCCLR's Consultation Paper.
10. Moreover, if (as the FSB has suggested though we disagree with the observation), there is difficulty under the existing law for shareholders to show that the wrongdoers are in control, such difficulty will not be reduced, and may be exacerbated, by the conditions specified in s.168BB(3), in particular, paragraphs (c) and (d), requiring the shareholder-plaintiff to show it is "probable" that the company will not itself bring proceedings or that the company will not itself "properly take responsibility" for the proceedings.

11. The consultation paper on the committee stage amendments to the Bill dated April 2004 stated *"it is believed that a shareholder would generally opt for taking a SDA and refrain from taking a CDA"* (paragraph 11). Given the above, one may think that that belief is no more than wishful thinking.

12. Paragraph 12 of the consultation paper on the committee stage amendments to the Bill concerns the co-existence of statutory and common law derivative actions. If an applicant chooses to commence two actions, one as an SDA and the other a CDA, in respect of the same subject matter, it is always open to the defendant to apply under general principles to strike out or stay one of the actions. The principle has been stated thus:

"If a plaintiff brings two actions in the High Court in respect of the same cause of action the Court will generally regard it as an abuse of the process of the Court and vexatious [and will] put the plaintiff to his election as to which action he will continue, and will stay one of the actions".

(See Atkin's Court Forms, Vol. 37, p. 204; McHenry v Lewis (1882) 22 Ch D 397 and O.15 r. 5(1) & (2)).

13. There is no reason to believe that the concerns expressed by the FSB could not be dealt with under these well established common law principles. In the light of the problems associated with the statutory derivative action, no provision should be inserted to deal with its co-existence with the common law derivative action, other than s.168BB(4) which expressly preserves the common law remedy.

22nd May 2004

Hong Kong Bar Association