Submission from Mr David M. WEBB

Multiple statutory derivative actions

18th April 2010

CB(1)1653/09-10(02)

Submission to the Legislative Council
Bills Committee on Companies (Amendment) Bill 2010

Honourable Members,

Thank you for your e-mail of 8-Apr-2010 inviting me to give views specifically on Clauses 14-20 of the Companies (Amendment) Bill 2010 (the **Bill**), to enable a member of a related company of a specified corporation to bring or intervene in proceedings against a specified corporation as defined in section 2 of the Companies Ordinance. This I now do, and apologise for it being 1 business day late. I hope that you can still incorporate my views into your deliberations on 20-Apr-2010.

Most importantly, the Bill will allow registered shareholders (members) of a holding company to bring a statutory derivative action on behalf of its direct or indirect subsidiary. As the Administration notes, this is already a common law right, as affirmed by the decision in Waddington Ltd v Thomas Chan Chun Hoo, Court of Final Appeal, 8-Sep-2008. Holding companies are just one category of related companies in the Bill, the others being subsidiaries or fellow subsidiaries of the specified corporation. The CFA did not deal with the question of minority shareholders in a subsidiary company bringing a derivative action on behalf of a holding company or on behalf of a fellow subsidiary.

Whilst the proposed amendments to the Ordinance will certainly be of use to registered shareholders in private holding companies and their subsidiaries, they are not, in their present form, of much use to the public shareowners of listed companies, for reasons which I will explain. You can rectify this by amending the Bill.

The Financial Services and Treasury Bureau (**FSTB**) in Annex D of its follow-up to issues raised at the first meeting on 23-Feb-2010 (pages 30-34 of the PDF), provides a helpful review of the legislation in Australia, New Zealand, Canada, the UK and Singapore. In three of those places (Australia, New Zealand and Canada), there is now a statutory right of derivative action for all related companies. Furthermore, in Canada and Singapore, any other person who, in the discretion of the court, is a "proper person", may seek to bring a derivative action. Presumably, in determining whether a person is a proper person, the issue to be considered is whether the person has suffered a loss from the wrong done to the specified corporation and will have a sufficient economic interest in the relief claimed in the proceedings.

Include all proper persons

Now this brings me to the key gap in the Administration's proposal. The vast majority of shares beneficially owned by the public in HK-listed corporations are not in fact held by them, but by a bare nominee. In most cases, the registered shareholder is HKSCC Nominees Ltd (**HKSCCN**), the *de facto* central depository of the Central Clearing and Automated Settlement System (**CCASS**) operated by Hong Kong Securities Clearing Co Ltd, a wholly-owned subsidiary of Hong Kong Exchanges and Clearing Ltd. In order to settle a transaction on the stock exchange, the shares must have been deposited into CCASS. HKSCCN in turn holds the shares for more nominees, owned by banks, brokers and custodians, who in turn hold shares for beneficial owners.

There is no realistic possibility of HKSCCN bringing derivative actions on behalf of beneficial owners, because it has no economic interest in the shares it holds, and because it is part of a bureaucratic public body which I doubt would entertain the idea of conducting the litigation on behalf of a beneficial owner even if it was remunerated and under a collateralised indemnity for costs. Even under scrip-less registration proposals (if we ever get them implemented), it is likely that most beneficial owners would still not be legal shareholders.

It might be possible for a prospective applicant to withdraw shares from CCASS and register them in its own name, but this would inevitably occur after the alleged wrongdoing to the specified corporation, and it could be open to the defendant to argue that the applicant was not a legal shareholder at the time of the alleged wrongdoing. Furthermore, if a holding company has put itself, or been put, into provisional liquidation, then under s182 the register of members is automatically frozen and transfers are prohibited without the consent of the court, so taking legal ownership of the holding would not be an option.

Incidentally, the freezing of the share register is another area of the Companies Ordinance that needs reform, since it makes it impossible for most public shareowners, not being registered holders, to oppose a petition by a company to put itself into provisional liquidation. That process is something which several apparently solvent companies used in the last 2 years to run away from minority shareholders.

So, for the current proposals to have any real benefit to public shareholders of listed companies, it is

important that you amend the Bill to broaden the class of applicants to include not just related companies but all beneficial shareowners. I suggest you include "proper persons", preferably to be defined as:

> "any person who, to the satisfaction of the court, has an interest in the relief claimed in the proceedings, whether legal or equitable".

This would still be subject to the safeguard requirement in s168BC(3) that the court is satisfied that it appears to be prima facie in the interest of the specified corporation that leave be granted to the applicant and that there is a "serious question to be tried". As a second-best alternative, the law should state that a person who is a member of a company (or its related company) has the same rights to apply to bring the derivative action regardless of whether he was a member at the time of the alleged wrongdoing to the company.

Parallel regimes

While writing, I note that the CFA in *Waddington* urged the Administration and the Legislature to remove the duplication of common law rights and statutory rights. This has not been done, and the Administration has not explained why not. Ribeiro PJ wrote (para. 32):

> "The co-existence of both the statutory and common law regimes is unusual in an international context and is a source of confusion and complication. It would appear to be appropriate for the statutory regime to replace the common law derivative action altogether. This question deserves to be addressed by the Administration and the Legislature as soon as possible."

While Lord Millett NPJ wrote (para. 80):

> "We have no power to extend the provisions of s.168BC to multiple derivative actions by analogy. We must leave such actions to continue to be governed by the common law, while expressing the hope that the legislature may in due course extend the section to cover them, and perhaps at the same time take the opportunity to consider whether it is really sensible to maintain two parallel regimes with different threshold tests, one requiring leave and the other not."

The statutory regime requires that there is a "serious question to be tried", while the common law regime sets the higher hurdle of requiring that a prima facie case be shown. However, the statutory regime requires leave of the court to bring the action, while the common law does not. In my view, the statutory regime is more efficient, as it is less likely to require a "trial before a trial".

Access to Justice

I cannot conclude without mentioning the economic reality. While such statutory rights as are proposed are important to have, they are of little value if they are prohibitively expensive to enforce. While the court has discretion under s168BI at any time during the case to make an order for costs to be paid by the specified corporation, there is no certainty for a potential applicant as to whether and when this order will be forthcoming, and if it is, then whether the specified corporation, having been the subject of the alleged abuse by the defendants, will have the means to pay any costs if ordered to do so. A court will only make an award for costs if it is satisfied that the member was acting in good faith and had reasonable grounds for making the application for the derivative action.

Furthermore, even if a derivative action is successful, the award will be made to the specified corporation, not its members (or its parent's members), and the abused company will likely still be controlled by the defendants, since otherwise, it could have sued them on its own. So the money may promptly be siphoned off again, and the value of the recovery may never be realised by the shareholders.

So these are significant deterrents to bringing a derivative action, which is why so few have been brought since 2004. It is not as if HK is such a bastion of good governance that few cases warranted the action. There have also been very few shareholder legal actions of any other kind, including s168A (unfair prejudice), because the potential costs for any one shareholder on its own far outweigh the size of its claim.

To address this issue:

1. the Administration and Legislators should give full support to the proposals of the Law Reform Commission to introduce class action rights;
2. lawyers must be allowed to work for contingent legal fees;
3. litigation finance companies must be permitted to finance litigation; and
4. to make points (2) and (3) possible, the laws against champerty and maintenance must be abolished.

I wrote extensively about all these issues on Webb-site.com in the article Class actions for HK (17-Mar-10)

which I attach. The 4 points above were also the subject of an opinion poll which indicated strong public support. I attach the results. The Administration has no excuse for inaction, if it wishes to enhance and protect HK's position as an international financial centre.

Finally, I note that a Legislator has expressed concerns that increasing shareholder rights will increase the amount of litigation "thereby subjecting the operation of listed companies to higher risks of legal challenges" (Panel on Financial Affairs, 11-Jun-2009). Of course it would. The point of these proposals is to increase the risk that abuse of a company will be challenged, and thereby to deter it. That is the whole point - you cannot have a fair society if people do not have laws to ensure fair play and the means to enforce them through litigation when all else fails. Honest management should have nothing to fear. Justice is the friend of fair societies, not its enemy. Our loser-pays costs system will ensure that frivolous or vexatious actions will be kept to a minimum and will remain the domain of those for whom money is no object.

Yours sincerely

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Class actions for HK

17th March 2010

On 5-Nov-2009, Hong Kong's Law Reform Commission published a consultation paper proposing the introduction of a mechanism for "multi-party litigation" in HK, or class actions. If implemented, this will be a huge step forward for facilitating access to justice and introducing a financial deterrent to wrong-doing. Much of our common law and statute provides theoretical remedies for cheated consumers or investors, but these remedies remain impractical so long as we lack two things: a legal right to represent plaintiffs with a common interest as a "class", and mechanisms for funding the litigation.

Without a class action system and a litigation funding system:

- hundreds or thousands of potential litigants may each have a claim which is too small to justify the millions of HK$ that it may take to bring a case against a defendant with deep pockets who may go all the way to the Court of Final Appeal;
- any plaintiff who brings a case will be giving a "free ride" to all the other potential litigants. If the plaintiff proves his case, then the others will find it much easier to reach individual settlements or recycle the evidence in their own cases; and
- any plaintiff who brings a case risks paying the defendant's costs if the case fails.

Court clearance

The paper proposes, correctly in our view, that an action can only become a class action if the court allows it. The key test should be whether the court can identify a claim which is substantially the same for all potential claimants.

Loser pays

Opponents of class actions like to scaremonger, saying that HK would end up like the USA with a lot of "nuisance" litigation. Our "loser-pays" system ensures that would not happen. It deters frivolous, meritless or vexatious actions, but it does mean that any class action system will be useless without a mechanism for funding the downside risk of paying the defendants' costs. Nobody is going to take the risk of being the representative plaintiff in a class action unless his potential costs are covered by a funding mechanism. His upside might only be a few thousand dollars, but the downside could amount to millions.

Opt out

A key provision of any class action system is the mechanism for determining who participates in any result. The consultation in our view correctly proposes an "opt-out" rather than "opt-in" system. In an opt-out system, once a court agrees to hear a case as a class action, the case would be advertised, and any potential claimant would have a fixed amount of time to opt out (in order to preserve his rights), failing which, he would be bound by the outcome. Very few claimants would opt out, because each would have to believe that he had some claim which was worth bringing individually, despite the costs, or as a member of a different class action. A court will normally unify competing class actions if they represent substantially the same claims.

The opt-out system ensures two things:

- That the action will represent the vast majority of potential claimants, increasing the economic viability of the case. The downside risk of the litigation is relatively fixed, being the costs on both sides, whereas the upside is determined by the size of the potential damages. If you are only representing a small subset of potential claimants under opt-in, then many cases will not be viable; and
- For the defendant, it increases the certainty that they will not face substantial follow-on litigation from other potential claimants. They know exactly who has opted out, and any award or settlement will be binding on all the other members of the class, bringing finality to a case.

However, we think the consultation is wrong to suggest that cases should default to "opt-in" if they involve parties from outside HK, particularly claimants. We are an international city serving global markets, both financial markets and those in real goods and services. Almost any shareholder action, and most consumer actions, would involve potential claimants from overseas. For example, even a defective product sold in HK can be bought by tourists. Any shareholder action involving a listed company would certainly include beneficial shareholders who are overseas. If these cases default to "opt in" for a large portion of the potential claimants, then it raises a significant barrier to the viability of the case. Put simply, if large parts of the claimant base have to opt in, then it becomes more of a joint action than a true class action system, and we already have a joint action system. It doesn't work.

So if there is a clear connection with HK, such as a defective product sold here, a service provided here (including to visitors), or a stock acquired on our stock exchange, then the members of that class, wherever they are, should have to opt out if they want to preserve separate rights of action here.

We should note that to be viable, class action rights must include any beneficial owner, not just registered nominee shareholders who have no economic interest in the case. This is an ongoing issue for shareholder litigation generally, not just class actions.

Funding

It is this crucial part of the proposal where the consultation paper goes wrong. It proposes fattening up and "expanding the scope" of an existing Consumer Legal Action Fund (**CLAF**), which sits under the Consumer Council and until now has been a bit of a joke. It was set up on 30-Nov-1994 with a grant of only HK$10m and by May-2005 it had spent HK$2.39m. The latest Consumer Council annual report shows that the CLAF had net assets of HK$14.4m at 31-Mar-09 and by then had considered 118 groups of cases (a "group" comprising applications with common background and interests) of which only 32 were funded, or about 2 per year. It is overseen by the Consumer Legal Action Fund Management Committee.

The consultation paper (para 8.156) says:

> "Our general intention is to take a step by step approach, leading to the establishment of a general class actions fund in the long term."

This conjures up the image of a government-appointed gatekeeper committee which has the (possibly exclusive) right to decide which cases can be submitted to court, and then to fund them from a fund which is presumably established using taxpayers' money. Hong Kong's rule of law is often cited by Government as one of our competitive advantages. It can only be an advantage if there is affordable access to justice. We cannot afford to take a "step by step" approach to removing these barriers, imposing new ones (a gatekeeper committee) in their place. Even if it is not exclusive, and private sector entities are allowed to fund litigation, a government-run body would be interventionist and distort the market.

It would be rather like setting up a government body to decide which companies can get venture capital funding or which movies get funded. These are real-life examples of government intervention in HK's economy in the form of the Applied Research Council (and its successors) and the Film Development Council with its Film Development Fund. Then there's the Hong Kong Mortgage Corporation, which crowds out the mortgage insurance market, and the Urban Renewal Authority, which throws its weight around in the form of statutory compulsory purchase powers in the redevelopment market. We don't need another interventionist monster. We need a competitive, efficient, free-market solution.

There is no need for a public fund to finance class actions. The private sector should be allowed to assess cases on their merits and decide whether to finance them, covering the costs (including the defendant's costs on the downside) in return for an agreed share of any winnings. The courts should have discretion to require security from the plaintiff to cover the defendant's costs, which would be financed by whoever is funding the case.

And who should be allowed to fund a case? In our view, anyone, including the law firm, third parties, or a wealthy lead plaintiff, in each case for a share of the potential award. Large law firms may choose to self-finance a case from their own capital, or they may choose to outsource the risk to a litigation funding company (**LFC**), which in effect is "insuring" the downside of the case. If an LFC is funding a case, then they in turn will employ legal experts to assess the case, just as a fund manager employs experts to pick stocks. And if a wealthy plaintiff is willing to self-fund a case in return for a share of the class winnings, then he should be free to do so, for that is no different to him owning an LFC.

If a court faces applications from competing class actions with the same underlying claim, then all other things being equal (or *ceteris paribus*, as a judge would say), he should pick the one which offers the lowest share of any winnings to funders and the highest share to class members. In effect, a tender would be held for the

right to conduct the litigation. This would help to keep down the costs.

There is no point in pretending that LFCs or other third parties are not already funding court actions here - it is an open secret in several cases, such as the now-settled case of Akai Holdings against Ernst & Young. Yet the consultation paper balks at the notion of a free market, and says (p224):

> "if LFCs were to be allowed in Hong Kong , legislation would be necessary to recognise and regulate LFCs, as well as to clarify what activities are approved in commercial third party funding of litigation."

In our view, there is no obvious need to legislate for LFCs or other third parties who may fund cases, including self-funding law firms and wealthy plaintiffs. If the concern is about their credit worthiness, then that can be dealt with by a judge's discretion to require security for costs. Optionally, LFCs may be insurance companies, in which case their capital adequacy is regulated by the Commissioner of Insurance. Rather than create a regulatory framework for LFCs, with the implication that everyone else would be prohibited from funding a case, we need to legislate to remove barriers that stand in their way, which brings us neatly on to...

Champerty and maintenance

There are still archaic laws in HK against champerty (profiting from someone else's litigation) and maintenance (funding someone else's litigation). These laws were devised in medieval England to counter the risk of corruption of the courts - where a nobleman could lend their name to a case in return for a piece of the winnings and influence the judge (either by threat or incentive) in return. Even the word "champerty" derives from Middle French *champart*, meaning a feudal lord's share of his tenant's crop. Hong Kong is one of the last places where champerty and maintenance is still a crime. Those laws should be consigned to history. Our Judiciary is widely seen as independent and not corrupt. We pay judges well enough, and the penalties for corruption are high enough, to minimise that risk.

However, instead of making those laws history, HK has, for the first time since 1897, used them in prosecutions. The case involved a recovery agent and a solicitor, and a 25% share of the damages in a traffic injury. If there is a problem with fair disclosure or the practices used by "ambulance-chasing" recovery agents, then it should be dealt with by setting up an agent-licensing body and establishing standards rather than outlawing them. As far as we know, these were the only prosecutions after 21 people were arrested "throughout the territory" in a blitz on 3-Jul-2008 (you will note the fictitious spokesman in that press release telling us all about it).

It is a highly unlikely coincidence that only 5 days after the arrests, the Government launched a TV advertising campaign, at public expense, warning people that champerty and maintenance is a crime. It takes more than 5 days to script, cast and edit such commercials. At the very least, they prepared the commercial and then held it until the arrests, which to us smacks of an abuse of process. Watch the ad at the link. Now if the guy in the hospital bed had been a cheated shareholder in a potential class action case, would the agents and lawyers also be accused of champerty and maintenance?

Contingent legal fees

Those best placed to asses the merits of a case and whether to fund it are often the lawyers acting on it. Section 64 of the Legal Practitioners Ordinance (LPO) and paragraph 4.1.16 of the Hong Kong Solicitors' Guide to Professional Conduct respectively outlaw and prohibit contingent legal fees on contentious cases. These should be scrapped. They represent an artificial constraint on the terms of contract between a customer and a supplier of legal services. Customers and suppliers should be free to negotiate any fee basis in the free market.

Some have raised the possible conflict of interest in acting on a contingent or "no win, no fee" basis. The argument goes that if a lawyer is contracted for a share of the winnings and liable for costs, then he might push his client to settle a case quickly, for a lower outcome than might be achieved if he pursues the case to completion. We would counter that with the argument that if a lawyer is on a fixed hourly rate, then he might push his client into prolonged litigation, resulting in higher fees for the lawyer and a lower net recovery for the client than if the case had been settled quickly. The truth is that neither fixed fee rates nor contingent legal fees can completely avoid conflicts of interest. It is inherent in any supplier-customer relationship that the supplier will seek to maximise his expected profit. However, that includes the prospect of repeat business or referral business versus loss of business and reputational damage, so this does tend to offset the incentive for the supplier to screw the customer.

Take doctors, for example - they could just charge you a fixed annual fee for "all you can eat", including drugs and tests, but then they would have an incentive to kick you out of their clinics as fast as possible. Alternatively, they could charge you for each and every procedure, and charge mark-ups on medical tests and drugs, in which case, they have an incentive to do more work and tests than necessary. Neither basis is

devoid of conflict. The latter basis prevails in HK.

Barristers, with their age-old traditions and anti-competitive practices, are a conservative lot, and many of them are horrified by the prospect that they may be asked by solicitors and clients to act on anything other than an hourly or daily rate. On 6-Nov-2009 your editor went on local radio with the Chairman of the Bar Association and the President of the Law Society of HK to discuss this.

Barristers should get used to the real world, a world in which travel agents, estate agents, stockbrokers and shop assistants work on a partly or fully commissioned basis, for a percentage of any deal they complete. Barristers who win more cases than average should have nothing to fear from this, for they will be competitive against their peers. Change is coming to the bar, including the new rights of audience for experienced solicitors in the High Court and Court of Final Appeal. Get used to it. Nobody is going to force barristers or solicitors to work on a contingency basis, but it should not be illegal to charge that way.

In any event, the advent of class actions would certainly provide more business for both barristers and solicitors, because when united in classes, more cases will find viable access to justice than before. Class actions will support jobs in the legal sector, which is an important limb of our service-based economy.

HAMS

It is worth mentioning that the consultation paper devotes several pages (210-213) to a discussion of our 2001 proposals to establish HAMS (Hongkong Association of Minority Shareholders). In brief, the proposal was to legislate a 0.005% levy on stock-market transactions to fund a body to represent investors and catalyse reform. A board of non-executive governors would oversee it, half elected by individuals and half by institutions, with nominal membership fees to cover communication costs. It would be open to all, and accountable to the Legislative Council for the use of the levy. HAMS would have three divisions: a policy division, for advocacy and engagement in the legislative, regulatory and standards-setting process; a ratings division, for comprehensive corporate governance ratings and proxy voting recommendations; and an enforcement division, for quasi-class actions. As we said at the time, in the absence of a legal framework for real class actions, and with barriers to contingent legal fees, HAMS could synthesize class actions by acting for hundreds or thousands of members in joint actions, using part of its levy to finance the cases.

However, quasi-class actions were always our second-best option, the first-choice being a real class action system, which is now proposed by the Law Reform Commission. As we noted above, in a real class-action system, there is no need for a central funding body, whether funded by investor levies or government grants, because the free market will take care of it and finance viable cases if allowed to do so.

Class actions and competition

The HAMS proposal received widespread market endorsement, but was left on the shelf in Apr-2002 when the Government refused to contemplate a levy, alleging that HAMS would "lack accountability" - which is ironic coming from an unelected government. The real issue, and the likely source of opposition to the current class action proposals, is that the tycoons, who pull the strings of government, don't want to face meaningful empowerment of consumers and investors in the courts. It's the same reason why the Government is dragging its feet on a multitude of issues, including the introduction of a competition law. Just take a look at the LegCo database on competition policy - there has been no update on the proposed law since 30-Mar-2009, although in his 14-Oct-2009 policy address, the Chief Executive said that the Government hoped to introduce the bill in the 2009-10 legislative session. After all, it's only been 14 years since the Consumer Council first recommended one and the government said no, thanks.

Class actions would be a key tool for seeking compensation for anti-competitive behaviour such as price-fixing, if that were illegal. Take, for example, the class action settlement with British Airways and Virgin Atlantic, who allegedly conspired to fix prices for fuel surcharges between 2004 and 2006. Note that it only applies if you bought your ticket in the UK or US, even if you were flying to HK. Although both airlines fly to HK, price fixing is perfectly legal here, so customers who bought tickets in HK were not part of the claim.

What do you think?

Should consumers and investors have class action rights in HK courts? Should they be free to negotiate contingent fees with lawyers? Should third parties be allowed to finance and insure legal costs? Tell us your views in our class actions opinion poll. We will forward this paper as our (belated) submission on class actions, and follow up by submitting the poll results. Unlike the proposed class action system, you have to opt-in to count, so vote now!

What do you think? Take our Opinion Poll!

Your name will not be disclosed, but the aggregate results will be sent to the Law Reform Commission

Poll results: Class actions

Current time:	01:43:59 19-Apr-2010
Closing time:	18:00:00 9-Apr-2010
Time remaining:	**Poll closed**

Introduction

Please read our article and then answer these questions.

Questions

1. Should class actions be allowed in Hong Kong?

Answer	Responses	Share
Yes	243	94.2%
No	14	5.4%
Undecided	1	0.4%
Total	258	100.0%

2. Should lawyers be allowed to charge fees on a contingent basis?

Answer	Responses	Share
Yes	191	74.0%
No	40	15.5%
Undecided	27	10.5%
Total	258	100.0%

3. Should third parties be allowed to provide litigation funding?

Answer	Responses	Share
Yes	194	75.5%
No	41	16.0%
Undecided	22	8.6%
Total	257	100.0%

4. Should the laws against champerty and maintenance be abolished?

Answer	Responses	Share
Yes	172	68.3%
No	27	10.7%
Undecided	53	21.0%
Total	252	100.0%