
Welcome to CFRED
Chinese University of
Hong Kong

Faculty of Law

18th February 2011

Anne Carver

A brief introduction on how to be good

AKA Shareholder's expectations, director's duties and the new law

- Definitions of Mismanagement , Misconduct and "Affairs of the Company"
- The blurring at some of the edges
- Public policy
- The *Duomatic* principle
- Waiting for Part 2 Phase 2 Co Bill

The Companies Bill Part 1

- ❑ **Clause 456 Directors' Duty of Care, Skill and Diligence (Part 10 Division 2)**
- ❑ **Clauses 712 -716 Remedies for Unfair Prejudice to Members' Interests**
- ❑ **Clauses 717- 719 remedies for Others' conduct in relation to Companies etc**
- ❑ **Clauses 720 -727 Derivative Action for Misconduct against Companies**

Putting it in the context of the common law

Foss v Harbottle

Ebrahimi v Westbourne Gallery

Re City Equitable

Percival v Wright

Mismanagement and Misconduct

Is there a difference?

5 possible approaches for minority



- 1. Is there a section 23 rights to enforce the articles of association? Often described as a “ statutory contract”**
- 2. Is there a shareholders’ agreement? It may provide for arbitration but it is not for the court to make a new shareholders’ agreement and it cannot restrict the statutory powers of the company**
- 3. Is there a right to a derivative action under exception to *Foss v Harbottle*?**
- 4. Section 168A [Cos Bill Clause 712]**
- 5. Section 177(1)(f) [Part 2 Phase 2 NOT Gazetted]**

See also the firm guidance on being good provided by:

- **Securities and Futures Ordinance**

- section 37A
- the SFC can bring an action for unfair prejudice

- **Companies Ordinance**

- section 147(2)(b)
- the Financial Secretary can present a petition for winding up on **the basis of unfair prejudice**
- New Co Bill Clauses 713(2) and 867(3)

The rule in *Foss v Harbottle* - public policy

Only the company may bring an action for a wrong done to the company

- See, for example, ***Waddington Ltd v Chan*** [2008] HKCFA 63 at 47 per Lord Millett on the consequences of *Salomon*

“The company’s property belongs to the company and not to its shareholders. If the company has a cause of action, this represents a legal chose in action which represents part of its assets”, per Lord Millett at p47

The rule in *Foss v Harbottle* in the structure and objectives

- 2 fundamentals
 - (i) The company is a separate legal entity (*Salomon*)
 - (ii) Majority rule prevails
- The Rule is therefore the proper plaintiff for a wrong done TO the company (misconduct) is the company
- The exception to the rule is where there is a fraud on the minority – the common law and statutory derivative action where the purpose is to obtain a remedy for the company for misconduct [NOT for the individual plaintiffs]

The 5 exceptions to the Rule in *Foss v Harbottle*

- ❑ **Illegality/ ultra vires (section 5A/ Co Bill Clause 110)**
- ❑ **Act needed sanction by some special majority of members (section 23, Co Bill Clause 81))**
- ❑ **Personal right of member (section 23, Co Bill Clause 81)**
- ❑ **Fraud on minority [the most important common law exception to *Foss v Harbottle*]**
- ❑ **Common law and statutory derivative action by minority claiming a wrong done to the company (section 168BC and Co Bill Clauses 720 -727)**

The facts of *Foss v Harbottle* revisited

- Two shareholders brought action against the company's 5 directors alleging property misapplied; wasted funds; and certain mortgages improperly given
- Plaintiffs asked the court to declare that the directors were accountable for the company's loss and sought the appointment of a receiver
- (closer to misconduct – derivative action)

How would *Foss v Harbottle* be litigated today ?

- Under the section 168A Companies Ordinance “unfair prejudice” remedy
[The modern “unfair prejudice” company law remedy since 1978]

And/Or

- As an alternative remedy under section 177(1)(f)
[The just and equitable ground]
- Or
- Or a commonlaw/statutory derivative action
Misconduct under section 168BC

The modern approach

- Almost inevitably the plaintiff joins the two actions for a section 177(1) (f) (the “just and equitable” winding up provision) and 168A the “unfair prejudice” order.
- **Note that the court is obliged to consider whether a petitioner has acted unreasonably in failing to pursue alternative remedies when asking for a winding up petition under section 177(1) (f)**

If the respondent to the petition agrees to buy the shares of the Petitioner, the Court will normally strike out the winding up petition

Typical unfair prejudice categories

Dilution of shares or voting rights
Diversion of corporate opportunity
Excessive payment of directors' salaries
Failure to declare dividends
Failure to provide information
Exclusion from management
Lack of access to information
Negligence
Mismanagement of company's internal affairs
Expropriation of property

**section 168A examples of
“mismanagement”**

Section 168A

- ❑ Mismanagement by a director – Petitioner does NOT have to come to court with clean hands
- ❑ Conduct complained of must be BOTH unfair and prejudicial

Section 177(1)f (in Part 2 Phase 2 Co Bill)

- **Section 177(1) (f) is based on:**
 - section 37(f) *Partnership Ord* (cap38) winding up is a remedy of last resort**
- **Section 180(1A) –has company followed its own internal company procedures before coming to court?**

The leading case on unfair prejudice– Taiwa Land Investment [1981] HKLR 297

- Note that it is not necessary for the court to decide that it would be just and equitable to wind up company before making an unfair prejudice order and **that the act complained of can be an isolated act**
- Note also wording of section 168A - **members can have different interests** and even if not all of them are seriously affected, it is the interests of the seriously affected minority that will be considered
- Note also Co Bill clause 714(5) **reflective loss principle**

Unfairly prejudicial conduct

Taiwa Land [1981]

- ❑ For conduct to be unfairly prejudicial it had to contain elements of BOTH unfairness AND prejudice
- ❑ Court must take an **objective view of the facts including the nature of the company and the relationship of the parties**
- ❑ Here the company was a small operation with only 4 directors who had personal relationships and all participated **in the affairs of the company with close mutual trust and confidence**
- ❑ The association was formed on a basis of mutual trust From the beginning they had all run the cinema together as a business - Plaintiff was **"locked in" on sale of his shares**

Analogies to the just and equitable grounds in *Ebrahimi v Westbourne Galleries Ltd*

The difference between “oppression” and “unfair prejudice”?

“Oppressive” was thought to mean tyrannical conduct or tyrannical abuse of power whereas **unfair prejudice is a less stringent test. It is a visible departure from the standards of fair play expected on which every shareholder who entrusts his money to a company is entitled to rely**

AND

Fuad J applied Lord Wilberforce’s 3 factors in

Ebrahimi v Westbourne Galleries Ltd [1973] AC 369 i.e. the analogy of the just and equitable principle in company law for the purposes of a section 177 (1)(f) Petition

The decision – harsh but just?

- **No basic understanding could be proved to have existed**
- **Petitioner did not discharge the burden of proof that there were valid grounds for intervening in the affairs of the company or decisions taken bona fide by the board**
- **The blurring of the principles by Fuad J – a good thing to bring equity into it but what about clean hands of Petitioner?**

Relevant cases

1. *Re Golden Bright Ltd* [2004] HKEC 265,
Re Golden Bright Ltd [2006] HKEC1774,
Re Golden Bright Ltd [2008] HKEC 1922 CA
2. *Taiwa Land Investment Co Ltd* [1981] HKLR 297
3. *Re Chime Corp Ltd* [2004] HKLRD 922
4. *Re Sun Hung International Ltd* [2009] 2 HKLRD 418
5. *Tsui Wai Kuen v Cheung King Chung Ray and Others* [2007] HKEC 2151,
Tsui Wai Kuen v Cheung King Chung Ray and Others [2007] HKEC 2152
6. *Re Wing Kai Investment Co Ltd*[2010]HKEC 1722

Re Chime Corp Ltd (2004) HKLRD

922

- An order for damages / restitution under section 168A?
- Petitioners issued a protective writ for a derivative action AND petition under section 168A

Re Chime Corp Ltd (2004) (CFA)

- The question of law for the CFA was whether on a section 168A petition the court could make an order for payment of damages or compensation or for the grant of restitution for the company.
- Court agreed that petitioners would also be able to mount a common law derivative action of the kind exemplified by *Wallersteiner v Moir* [1974] 1 WLR 991 –but not convenient as subject matter would,

" Substantially overlap, if not duplicate.....It would then be necessary for both sets of proceedings to be heard together..... If ,as seems to be the case, the courts are committed to the principles underlying the rule in Foss v Harbottle, then it is not to be expected that they would wish to undermine those principles by permitting minority shareholders routinely to obtain by petition that which is not available to them in an action begun by writ." (The Hon Mr Justice Bokhary p 935 et seq.)

Lord Scott's goose and golden eggs

See Lord Scott's judgment at p 949

"[T]he goose who lays the golden eggs – this dispute is about who owns the goose and the golden eggs, not the management of the goose"

So is this case about mismanagement or misconduct ?

Re Sun Hung International Ltd [2009] 2 HKLRD 418

- ❑ New developments on the “affairs of a company”
- ❑ Directions for Petitioner to file and serve a summons to amend the petition
 - (1) inconsistent with the documents exhibited
 - (2) scandalous
 - (3) relate to the “affairs of the company’s subsidiaries” and are NOT the “affairs of the Company”
- ❑ (Amendments related to false accounting and manipulation of accounts at the factories)

Re Sun Hung International Ltd [2009] 2

HKLRD 418

□ Held:

- Amendments to a Petition should in general be allowed if they were necessary to enable real questions and controversy between the parties, **provided they did not prejudice the other party and if any prejudice could not be compensated by an appropriate costs order**
- **Affairs of the company should be interpreted extremely widely and liberally**
- **Affairs of the company encompass all matters which may come before the Board**

Re Sun Hung International Ltd [2009] 2 HKLRD 418

□ Held (cont'd):

- Conduct of the affairs of a company includes refraining from procuring a subsidiary from doing something or condoning by inaction the subsidiary, particularly when the directors of parent and subsidiary are the same
- The way in which the affairs of a subsidiary is conducted can constitute unfairly prejudicial conduct in respect of parent's affairs (citing *Waddington*)

Re Wing Kai Investment Co Ltd [2010] HKEC 1722

- The ***Duomatic*** principle at work
Re Duomatic Ltd [1962] 2 Ch 365

" a doctrine that formalities may be disregarded if they have been waived by ALL shareholders acting in concert who want the same substantial result. "

Can be characterized as estoppel /
ratification/ waiver/ agreement to a
breach of fiduciary duty

Re Wing Kai Investment Co Ltd[2010]

1972- August 1989 Father in control/ assisted by Elder Son
Mr Bo Kin

Father died intestate 24th August 1989

Younger son Mr Po Kei alleges

- ❑ \$12million dividends declared but never paid
- ❑ Withdrawals of almost \$28 million
- ❑ Loans of almost \$9 million to Bo Kin
- ❑ Directors' emoluments of almost \$6million to Bo Kin
- ❑ Denial of access to company documents
- ❑ Attempt to put company into liquidation under section 177(1)(a) made in bad faith /improper purpose
- ❑ 13 years of arguing and ex post facto allegations – almost impossible to prove

Who has to prove what ?

- ❑ Burden on Petitioner to prove misapplication of company assets that occurred over 20 years ago
- ❑ Elder Brother to prove propriety of his actions as director in control
- ❑ Apply *Duomatic* principle

Conclusion

- ❑ Reflective loss principle
- ❑ Problems of agency
- ❑ Problems of definitions
- ❑ Problems of shareholder agreements and *Re Mediavision Ltd* [1993] 2 HKC 629
- ❑ Equity and company law
- ❑ Relationship with section 177(1)(f)
- ❑ Await Part 2 Phase 2 to fill in this picture

Anne Carver

Faculty of Law

CUHK

CFRED Colloquium