

CHAPTER 9

COMMON LAW DERIVATIVE ACTION

9.1 We need to consider if the existing right to take a common law derivative action (“CDA”) as preserved under section 168BC(4) of the CO should be abolished in Part 14 of the CB.

Background

Current Position

9.2 Shareholder remedies provisions were substantially revised by the Companies (Amendment) Ordinance 2004 with a view to enhancing legal remedies available to members of a company. One of the significant changes was to provide a new statutory derivative action (SDA) procedure that may be taken on behalf of a company by a member of the company in Part IVAA of the CO. By section 168BC(4), the right to take a CDA was specifically preserved.

9.3 At present, section 168BC(1) only allows a member of a specified corporation (i.e. a Hong Kong or a non-Hong Kong company) to bring or to intervene into an action on behalf of the company in respect of “misfeasance” (i.e. fraud, negligence, default in complying with any statutory provision or rule of law or breach of duty) committed against the company. In response to the comments made by the Court of Final Appeal in *Waddington Limited v Chan Chun Hoo and Others*¹⁰⁷ that the scope of the SDA should be extended to cover “multiple” derivative actions, the Government intends to amend the relevant provisions in the CO through a Companies (Amendment) Bill to allow also a member of an associated company of the specified corporation¹⁰⁸ to take a SDA (see also the Explanatory Notes on Part 14 below).

Concerns

9.4 There had not been major concerns over preserving the right to take a CDA after the introduction of the SDA in the CO. However, in its judgment, the Court of Final Appeal suggested that once the legislation had been extended to cover multiple derivative actions, there seemed no need to retain the CDA. The CDA had been preserved mainly because of concerns that its abolition

¹⁰⁷ (2008) 11 HKCFAR 370.

¹⁰⁸ An “associated company” in relation to a specified corporation means any company that is the specified corporation’s subsidiary or holding company, or a subsidiary of that specified corporation’s holding company.

might deprive shareholders of companies incorporated outside Hong Kong of common law rights which would otherwise be available to them. But the Court of Final Appeal was of the view that such concerns were unfounded because if the question whether a derivative action would be available to such a company was a question of substantive law, then such a question together with the rules of internal management would be governed by the law of the place of incorporation of the company and not by the common law of Hong Kong.

Considerations

9.5 The question of whether the CDA should continue to be preserved after the extension of the SDA to cover multiple derivative actions has been considered by the SCCLR recently. The SCCLR recommended that the public should be consulted before a final view is taken on the issue. The main arguments for and against the abolition of the CDA are set out below for reference:

Arguments for abolishing CDA

9.6 The arguments for abolishing the CDA are:

- (a) it is unusual in an international context for both the SDA and the CDA to co-exist. In Australia, Canada, New Zealand and the UK, the statutory regime has replaced the common law regime; and
- (b) co-existence of the SDA and the CDA is a source of confusion and complication. The continued existence of two parallel regimes will serve no discernible purpose. One of the major reasons given for such an arrangement is to allow members of non-Hong Kong companies to bring a CDA in Hong Kong in circumstances where the rules on standing and internal management in the law of the place of incorporation would allow such members to bring an action. The reason is based on the view that the rules on derivative actions are procedural rules which are governed by the *lex fori* (i.e. Hong Kong law, for present purposes). If the CDA is abolished in Hong Kong, then members of the foreign company would not be able to bring a CDA in Hong Kong even though the law in the place of incorporation would have allowed that. This view is arguable but may not be correct, as suggested in the *Waddington* case.

Arguments for preserving CDA

9.7 The arguments for preserving the CDA are:

- (a) to preserve the ability of members of foreign companies to bring a CDA in Hong Kong, if indeed the correct view is that the rules on derivative actions are procedural rules and are governed by the *lex fori*, while the law of the place of incorporation governs the right of a shareholder to bring a CDA. There are a large number of companies incorporated outside Hong Kong but with Hong Kong resident shareholders, which have no place of business in Hong Kong and therefore are not non-Hong Kong companies within the meaning of Part XI of the CO. These foreign companies are therefore not within the definition of "specified corporation" and not able to bring a SDA. To abolish the common law right for these foreign companies may deprive their shareholders of rights they currently enjoy, because even if the law of incorporation of such companies gives analogous rights to a CDA, they would not be enforceable in the courts of Hong Kong if the CDA were to be abolished. Indeed a CDA may be needed as a fall back position for those non-Hong Kong companies who may bring a SDA pursuant to CO section 168BC, but whose relevant internal management rules do not match the definition of "misfeasance" in CO section 168BB;
- (b) the abolition of the CDA may create unnecessary difficulties for the Hong Kong shareholders of these foreign companies to seek derivative actions in the Hong Kong courts, even though the Hong Kong courts may, under the principle of *forum conveniens*, consider themselves to be the natural and appropriate forum for resolving the issues, as there is nothing in Hong Kong under the Rules of the High Court to regulate such derivative actions;
- (c) the co-existence arrangement has been in place for over four years. It has not caused any major legal problem, notwithstanding the comments made by the Court of Final Appeal in the *Waddington* case. In particular, if not because of the co-existence arrangement, applicants in a case like the *Waddington* case would not have been able to bring a "multiple" derivative action. In any event, there are safeguards in the

CO to prevent duplicative CDA and SDA under CO section 168BE and section 168BC(5) and these safeguards will be preserved in the CB; and

- (d) there are still uncertainties as to what other issues about derivative actions may arise in the future or how some uncertainties of the SDA provision will be resolved. It is therefore safer to keep the CDA at this stage. In any event, it will be safer to maintain the CDA so that members of Hong Kong or non-Hong Kong companies will not be in any way prejudiced or be deprived of any beneficial developments at common law.

Question 7

Do you consider that the common law derivative action currently preserved in section 168BC(4) of the CO should be abolished in the CB?