The most striking innovation of the Companies (Amendment) Ordinance 2004 is the creation of a new statutory derivative action.[6] The Companies Ordinance Part IVAA (sections 168BA–BK) came into operation on 15 July 2005, introducing for the first time into Hong Kong company law a new statutory derivative action.

The new remedy is based on models provided by existing Commonwealth legislation. It creates a statutory right for members to apply for leave of the court, to bring or intervene in proceedings on behalf of the 'specified corporation'[7] (including both a Hong Kong company and a non-Hong Kong company), for 'misfeasance'[8] (broadly defined to encompass fraud and negligence) committed against the specified corporation: Companies Ordinance sections 168BB and 168BC.

The new statutory action, which is potentially wider than the common law action, has introduced a welcome liberalisation of the rules by (a) extending derivative actions to 'negligence', and (b) replacing the 'fraud and control' tests with the statutory leave mechanism and thresholds laid down in the legislation. The statutory derivative action is designed to address the inadequacies of the common law derivative action[9] and to provide an effective mechanism by which shareholders could protect themselves.[10] It is intended that statutory clarification of the derivative action would remove uncertainties, and would create a valuable tool to enhance corporate governance and maintain investor confidence.[11]

This chapter examines the new statutory derivative action as contained in Part IVAA (sections 168BA–BK) of the Companies Ordinance. Part 1 of this chapter provides a brief overview of the operation of Part IVAA. Part 2 examines the new statutory regime for derivative actions, and the approach taken by the Hong Kong courts in interpreting and applying this new remedy.

6 The Companies (Amendment) Ordinance 2004 took effect on 15 July 2005. See Companies Registry, *Implementation of Shareholder Remedies-Related Provisions of the Companies (Amendment) Ordinance 2004* (Companies Registry External Circular No 6/2005) [3].

7 A flexible concept of 'specified corporation' has been defined to include both a 'Hong Kong company' and a 'non-Hong Kong company' for the purposes of ss 168BA–BK: Companies Ordinance ss 2(1), 2(12).

8 'Misfeasance' is defined as 'fraud, negligence, default in compliance with any enactment or rule of law or breach of duty': Companies Ordinance s 168BB(2).

9 Financial Services and the Treasury Bureau, *Consultation Paper on Statutory Derivative Action in the Companies (Amendment) Bill 2003* (April 2004).

10 Standing Committee on Company Law Reform, *Corporate Governance Review by the SCCLR: A Consultation Paper on Proposals made in Phase I of the Review* (July 2001) [15.27] (hereinafter the 'SCCLR's Corporate Governance Review Phase I').

11 SCCLR's Corporate Governance Review Phase I [15.27].



# 1 Companies Ordinance, Part IVAA

Part IVAA (sections 168BA–BK) of the Companies Ordinance, which came into force on 15 July 2005, sets out a new statutory regime for derivative actions. It creates a statutory right for members to apply for leave of the court, to bring or intervene in proceedings on behalf of the specified corporation[12] for 'misfeasance' committed against the specified corporation.[13] Two points are worth noting:

(a) 'Misfeasance' is defined as 'fraud, negligence, default in compliance with any enactment or rule of law or breach of duty';[14]

(b) An important innovation introduced by the Companies (Amendment) Ordinance 2004 is that a flexible concept of 'specified corporation'[15] has been defined to include both a 'Hong Kong company' and a 'non-Hong Kong company' for the purposes of sections 168BA–BK. The expanded definition enables overseas companies to be brought within the ambit of the new remedy.

## (a) The law

The new statutory derivative action is contained in Part IVAA of the Companies Ordinance. Section 168BB sets out the statutory basis for the derivative remedy:

**'CO s 168BB Application**

(1) This Part [IVAA] applies to—

(a) the bringing of proceedings in respect of misfeasance committed against a specified corporation;

(b) the bringing of proceedings in respect of any matter where a specified corporation fails to bring proceedings in respect of such matter by reason of misfeasance committed against the specified corporation; and

(c) the intervention in proceedings in respect of any matter where a specified corporation fails to diligently continue, discontinue or defend the proceedings in respect of such matter by reason of misfeasance committed against the specified corporation,

where in relation to the proceedings brought or intervened in, the cause of action or right to continue, discontinue or defend those proceedings, as the case may be, is vested in the specified corporation and relief, if any, is sought on behalf of the specified corporation.

12 Companies Ordinance ss 168BB–BC.

13 Companies Ordinance s 168BB (1).

14 Companies Ordinance s 168BB (2).

15 See Companies (Amendment) Ordinance 2004, Sch 2, s 1(1), which added the definition of 'specified corporation' into the Companies Ordinance. 'Specified corporation' is defined as 'a Hong Kong company or a non-Hong Kong company': Companies Ordinance s 2(1). 'Non-Hong Kong company' is defined in s 2(12) as follows: 'The reference to a non-Hong Kong company in the definition of "specified corporation" in subsection (1) shall, before the commencement of section 1(1) of Schedule 2 to the Companies (Amendment) Ordinance 2004 (30 of 2004), be deemed to be a reference to an overseas company as is for the time being defined under this Ordinance.'

(2) In this section, "misfeasance"... means fraud, negligence, default in compliance with any enactment or rule of law, or breach of duty.'

Sections 168BC and 168BD lay down the statutory leave criteria:

**'CO s 168BC Members may bring or intervene in proceedings**

(1) A member of a specified corporation may, with the leave of the court granted under subsection (3)
   (a) bring proceedings before the court on behalf of the specified corporation; or
   (b) intervene in any proceedings before the court to which the specified corporation is a party for the purposes of continuing, discontinuing or defending those proceedings on behalf of the specified corporation.'

(2) Any proceedings brought under subsection (1)(a) on behalf of a specified corporation shall be brought in the name of the specified corporation.

(3) The court may, on the application of a member of a specified corporation, grant leave for the purpose of subsection (1) if the court is satisfied that—
   (a) it appears to be prima facie in the interest of the specified corporation that leave be granted to the applicant;
   (b) if the applicant is applying for leave to bring proceedings under subsection (1)(a), there is a serious question to be tried and the specified corporation has not itself brought the proceedings;
   (c) if the applicant is applying for leave to intervene in proceedings under subsection (1)(b), the specified corporation has not diligently continued, discontinued or defended those proceedings; and
   (d) except where leave is granted by the court under section 168BD(4), the member has served a written notice on the specified corporation in accordance with section 168BD.

(4) Subject to other provisions in this Part, this Part shall not affect any common law right of a member of a specified corporation to bring proceedings on behalf of the specified corporation, or intervene in any proceedings to which the specified corporation is a party.'

**'CO s 168BD Service of written notice**

(1) Subject to subsection (4), a member of a specified corporation shall serve a written notice on the specified corporation at least 14 days before he applies for leave under section 168BC(3) in respect of the specified corporation.

(2) Service of a written notice under this section shall be effected by leaving it at—
   (a) in the case of a company, its registered office;
   (b) in the case of a non-Hong Kong company, the address of its authorized representative that is registered under section 333.

(3) A written notice under this section shall state—
   (a) the intention of the member to apply for leave under section 168BC(3) in respect of the specified corporation; and
   (b) the reasons for his intention.

(4) The court may grant leave to dispense with the service of a written notice required by this section.'



### (b) Key features

Central elements of the new statutory derivative action are as follows:

***(i) Statutory leave requirement.*** Shareholders are required to apply for leave before bringing a derivative suit. Section 168BC(3) contains the criteria to be applied in deciding whether the court should, in the exercise of its discretion, permit the claim to proceed. The court may, on the application of a member of a specified corporation, grant leave if it is satisfied that:

*(1)* it appears to be prima facie in the interests of the specified corporation to grant leave;[16]

*(2)* there is a serious question to be tried and the specified corporation has not itself brought the proceedings (if the application is for leave to bring proceedings);[17]

*(3)* the specified corporation has not diligently continued, discontinued or defended those proceedings (if the application is for leave to intervene in proceedings);[18] and

*(4)* unless dispensed with by the court, the member has served a 14 days' written notice on the specified corporation setting out his intention to apply to the Court and the reasons for his intention in accordance with section 168BD.[19]

***(ii) Ratification.*** In relation to ratification, there has been a significant tightening of the current law. Approval or ratification by the company of the conduct that is the subject matter of the action will not be a bar to the action.[20] While ratification will not prevent the bringing of a statutory derivative action, the court may nonetheless take shareholder ratification into account (including the extent to which ratifying members were well-informed about the relevant conduct and were acting for proper purposes).[21]

***(iii) The co-existence of statutory and common law derivative actions.*** Section 168BC(4) permits the co-existence of the statutory and common law derivative actions.

Hong Kong introduced its statutory derivative action in 2005, and since then there have been seven cases[22] in which the action was invoked. The following sections will discuss the new statutory derivative action and the approaches taken by the Hong Kong courts in interpreting and applying this new remedy.

16 Companies Ordinance s 168BC(3)(a).
17 Companies Ordinance s 168BC(3)(b).
18 Companies Ordinance s 168BC(3)(c).
19 Companies Ordinance s 168BC(3)(d).
20 Companies Ordinance s 168BF(1).
21 Companies Ordinance s 168BF(2)(a)–(c).
22 *Re F & S Express Ltd* [2005] 4 HKLRD 743 (CFI); *Re Lucky Money Ltd & Others* (unreported, HCMP 505/2006, 18 July 2006); *Re Kammy Town Limited* (unreported, HCMP 874/2007, 1 June 2007); *Re Nice & Well Ltd* (unreported, HCMP 2148/2008, 11 December 2008); *Re MyWay Ltd* [2008] 3 HKLRD 614; *Re Grand Field Group Holdings* [2009] 3 HKC 81; *Re Wong Heng Investment Co Ltd* (unreported, HCMP 1302/2009, 19 August 2009).

# 2 THE NEW STATUTORY REGIME FOR DERIVATIVE ACTIONS

## 2.1 THE SCOPE OF PROCEEDINGS

Sections 168BB and 168BC of the Companies Ordinance permit shareholders to pursue a statutory derivative action for 'misfeasance'[23]committed against the 'specified corporation.'[24] 'Misfeasance' is defined as 'fraud, negligence, default in compliance with any enactment or rule of law or breach of duty.'[25] 'Specified corporation' has been broadly defined to include both a 'Hong Kong company' and a 'non-Hong Kong company' for the purposes of the statutory derivative action: Companies Ordinance, sections 2(1) and 2(12).

The scope of the statutory derivative action is potentially wider than the common law action and has taken constructive strides in two aspects:

(a) First, the non-inclusion of the 'fraud and control' tests in the new statutory remedy represents a radical departure from the previous thresholds to a member making a common law derivative claim.
(b) Secondly, a mere allegation of negligence by directors, without any allegation of lack of good faith or benefit to the directors, can prima facie be the subject of a derivative action.[26]

In defining what wrongs to the company would be the subject of a derivative claim, perhaps the most striking difference between the UK and Hong Kong approaches is that the UK remedy is confined to dealing with breaches of directors' duties;[27] whereas the Hong Kong remedy is slightly broader since it is potentially available to be used against non-directors such as managers and senior officers as well as controlling shareholders. In this respect, the protection afforded to shareholders under Hong Kong law appears to be more extensive than its UK equivalent.

A broad approach to the scope of the remedy was taken by Barma J in the recent important case of *Re MyWay Ltd* [2008] 3 HKLRD 614 where it was held that the new statutory remedy can be used against third parties who were outsiders to the company. In that case, the plaintiff and the defendant were equal shareholders in, and sole directors of, a company providing online education services. The plaintiff alleged that the defendant and two former employees had diverted business from the company to their own private business, KEA EdTech Company Ltd (KEA) by offering identical educational programs. An action for passing-

23 Companies Ordinance s 168BB (2).
24 Companies Ordinance ss 2(1), 2(12).
25 Companies Ordinance s 168BB (2).
26 Cf *Pavlides v Jensen* [1956] Ch 565.
27 In the UK, the new Companies Act 2006 gives shareholders a new statutory right to sue directors (Companies Act s 260(5)(a) and (b)) for negligence, default, breach of duty or breach of trust (Companies Act s 260(3), subject to the court allowing the action to proceed (Companies Act ss 261–263).



off was brought by the plaintiff against KEA and the two former employees.[28] The defendant countered by presenting an unfair prejudice petition seeking a share purchase order, and applying to have the plaintiff's action struck out. The plaintiff sought leave under section 168BC(1)(b) of the Companies Ordinance to intervene in proceedings to continue the legal action on behalf of the company. In granting leave to the plaintiff to continue the proceedings, Barma J took the view that the scope of the Hong Kong statutory remedy is not confined to dealing with breaches of duty by directors or officers, and that the new remedy can also be used where the claim involves 'outsiders' who are alleged to have been guilty of some breach of duty owed to the company. In the words of Barma J (at [25]):

> 'It is not correct to seek to limit the scope of sections 168BB and 168BC to what might be termed the classic derivative action by a shareholder against wrongdoers who are officers or insiders so far as the company is concerned. The terms of section 168BB(b) and (c) make it clear that the statutory derivative action created by Part IVAA of the Ordinance is not so limited. I therefore do not think that the court should be predisposed against the grant of leave in cases in which the claim involves outsiders, rather than directors or officers of the company who are alleged to have been guilty of some breach of duty owed to the company.'

## 2.2 PLAINTIFFS IN DERIVATIVE ACTIONS

Section 168BC(1) confers standing on 'shareholders' of a 'specified corporation'.[29] Two points are material:

(a) 'Shareholders' means present members (excluding former members) of the company.[30] This follows the common law position in which former members (including those who were members at the time a wrong was done to the company) cannot bring derivative proceedings. Current members, even if they were not members at the time the corporate

28 [2008] 3 HKLRD 614 [12].
29 Companies Ordinance s 168BC(1) provides that a 'member' of a 'specified corporation' may, with the leave of the court: (a) to bring an action on behalf of the specified corporation, or (b) to intervene in existing proceedings to which the specified corporation is a party. *Cf* The statutory provisions in Canada confer standing on a catchall 'proper person' categories of applicants. Apart from a catchall 'proper person' category, past and present shareholders, past and present directors or officers and security holders are expressly included in the pool of potential applicants: see Canada Business Corporations Act s 238. In Australia, eligible persons include members, former members, those entitled to be registered as members of the company or a related company, as well as officers or former officers of the company: see Australian Corporations Act 2001 s 236. The UK provision confers standing only on existing members: UK Companies Act 2006 s 260(1).
30 Noting that the SCCLR, in its corporate governance review project on shareholders' remedies, had recommended that the pool of potential derivative applicants should be widened to include shareholders at the time of the relevant wrongdoing, present shareholders and directors of the company, but that recommendation was not taken up: see SCCLR's Corporate Governance Review Phase I [8.02], [15.26].

cause of action arose, are the only plaintiffs entitled to bring such proceedings.

(b) The main gain of this provision is that a flexible concept of 'specified corporation' has been defined to include both a 'Hong Kong company' and a 'non-Hong Kong company': see Companies Ordinance, sections 2(1) and 2(12). The latter term enables overseas company to be brought within the ambit of the new remedy.[31] The expanded definition is a welcome development and could assist minority shareholders in overseas companies to bring derivative suits in appropriate cases.

## 2.3 Statutory leave requirement

The Hong Kong legislation[32] lays down a number of preconditions which *must be satisfied* for a court to grant leave. Section 168BC(3) provides that the court may, on the application of a member of a specified corporation, grant leave if it is satisfied that:

(a) it appears to be prima facie in the interests of the specified corporation to grant leave;[33]

(b) there is a serious question to be tried and the specified corporation has not itself brought the proceedings (if the application is for leave to bring proceedings);[34]

(c) the specified corporation has not diligently continued, discontinued or defended those proceedings (if the application is for leave to intervene in proceedings);[35] and

(d) unless dispensed with by the court, the member has served a 14 days' written notice on the specified corporation setting out his intention to apply to the Court and the reasons for his intention in accordance with section 168BD.[36]

In this section, the statutory leave criteria will be examined separately.

### (a) Interests of the company

Before seeking the leave of the court to bring a derivative suit, the plaintiff shareholder must, as a precondition, establish that the action 'appears to be *prima facie*' in the interests of the company. A similar precondition for granting leave exists in New Zealand,[37] Canada,[38] the UK[39] and Australia.[40]

31 The expanded definition is in line with proposals made by the SCCLR which sought to bring overseas companies within the subject of Hong Kong corporate governance: see SCCLR's Corporate Governance Review Phase I [15.28].

32 Companies Ordinance s 168BC(3).

33 Companies Ordinance s 168BC(3)(a).

34 Companies Ordinance s 168BC(3)(b).

35 Companies Ordinance s 168BC(3)(c).

36 Companies Ordinance s 168BC(3)(d).



Interestingly the Australian legislation[41] requires the court to be satisfied that the proposed derivative action may be, appears to be, or is likely to be, in the 'best interests' of the company. This is a higher threshold than that of the Canadian[42] and New Zealand[43] legislation, which only require that the action be in the 'interests' of the company. The leading discussion of the 'best interests' criterion is Palmer J's widely followed approach in *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313, (2002) 20 ACLC 1549 [55], [56]:

> 'The language "best interests" does not require evidence of "some absolute or superlative" interest for the company although it is not sufficient to show that the application "*appears to be*" or "*is likely to be*" in the company's best interests.'[44]

In several cases the Australian courts have come to defining the best interests of the company as parallel to the welfare of the company.[45] It was held in *Swansson*[46] that in considering the best interests of the company, the court will take into account the character of the company, evidence of the business of the company, whether redress is available through other means, and the ability of the defendant to meet the judgement. Continuing to trade profitably is obviously in the best interests of the company.[47] The strength of the case, at a prima facie level, is also directly relevant to the question of the best interests of the company.[48]

37 New Zealand Companies Act s 165(2)(d).

38 Canada Business Corporations Act s 239(2)(c).

39 In the UK, first, a derivative action will be barred absolutely if the court is satisfied that a person acting in accordance with the duty to promote the success of the company for the benefit of its members would not seek to continue the claim: UK Companies Act 2006 s 263(2)(a). Second, the court has a discretion as to whether to permit a claim to proceed by considering a range of factors, including the importance of the claim to a director acting to promote the success of the company: UK Companies Act 2006 s 263(3)(b).

40 Australian Corporations Act 2001 s 237(2)(c).

41 Australian Corporations Act 2001 s 237(2)(c).

42 The Canadian legislation requires the court to assess whether the action 'appears to be in the interests of the corporation': Canada Business Corporations Act s 239(2)(c).

43 New Zealand Companies Act s 165(2)(d). In New Zealand, the court shall have regard to, inter alia, the company's interests in the proceedings: New Zealand Companies Act s 165(2)(d). However in relation to the issue of granting of leave, the court must be satisfied that the action is 'in the interests of the company': New Zealand Companies Act s 165(3)(b).

44 *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313 [55]–[56] (Palmer J): 'The requirement that the action is 'in the best interests' of the company 'sets a far higher threshold for an applicant to cross' when compared to the requirement that the action merely "appears to be" in the interests of the company.' This interpretation has subsequently received strong judicial support: see *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 51 ACSR 299.

45 *Charlton v Baber* (2003) 47 ACSR 31, (2003) 21 ACLC 1671; *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040.

46 (2002) 42 ACSR 313, (2002) 20 ACLC 1549.

47 *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 ALR 451, (2002) 42 ACSR 534.

48 *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457, (2004) 51 ACSR 299, (2004) 23 ACLC 93.

> the legislative requirement in Australia, or that it is acting in good faith, unlike the legislative requirement in Australia, Canada and Singapore.'

These remarks were echoed by Barma J in *Re MyWay Ltd* [2008] 3 HKLRD 614, a case of an application for leave under section 168BC(1)(b) to intervene in proceedings. The judge took the view that the company's interest requirement has a rather low threshold and could be satisfied if it could be show on a *prima facie* basis that the grant of leave would be in the interests of the company. Barma J, after referring to *Re F & S Express Ltd* and *Re Lucky Money Ltd*, stated (at [28]):

> 'In my view, having regard to the terms of section 168BC, which make it clear that all that is required for the grant of leave is that it should be shown on a *prima facie* basis that the grant of leave would be in the interests of the Company, it is neither appropriate nor necessary to establish this element to a particularly high standard. This accords with the approach of Kwan J in two recent decisions on section 168BC, namely *Re F & S Express Ltd* [2005] 4 HKLRD 743, and *Re Lucky Money Ltd* (unreported, HCMP 505/2006, 18 July 2006).'

As pointed out by Barma J, the derivative applicant is only required to establish on a '*prima facie*' basis that the proposed action, or his proposed intervention, is in the interests of the company concerned.[55] The *prima facie* test was expressly approved by the court as being applicable to both an application for leave to bring proceedings (under section 168BC(1)(a)) and an application for leave to intervene in proceedings (under section 168BC(1)(b)). Barma J concluded (at [32]):

> 'I have come to the conclusion that this question should be approached in much the same way. If the court is satisfied that it is, *prima facie*, in the interests of the company for leave to be granted, it would appear to follow that it would correspondingly involve a failure to act in the best interests of the company not to take the steps for which leave is to be granted.'

To the same effect was the decision in *Re Grand Field Group Holdings Ltd* [2009] 3 HKC 81. Kwan J remarked in her usual trenchant manner: 'For the first requirement, it is only necessary to establish it appears to be prima facie in the interest of the Company to sue. It is not necessary or appropriate to establish this to a particularly high standard and the court should not attempt to resolve the underlying dispute.'[56] Kwan J then added: 'It would suffice if an arguable case is disclosed and, on the face of it, it would be in the interest of the Company to bring proceedings.'[57]

In *Re Wong Heng Investment Co Ltd* (unreported, HCMP 1302/2009, 19 August 2009), the minority shareholders sought leave to bring a statutory derivative action against the majority shareholders. The majority

55 [2008] 3 HKLRD 614 [31].
56 [2009] 3 HKC 81 [21].
57 [2009] 3 HKC 81 [21].



shareholders' application seeking security for costs from the minority (the derivative applicant) in the proposed statutory derivative proceedings was refused by the court. Kwan J held (at [6]):

> 'It is well established in an application for leave to bring a statutory derivative action, it is only necessary to show it appears prima facie in the interest of the company to bring the proposed action. *There is no need and it is not appropriate to establish this to a particularly high standard.* I am inclined to think on the available evidence, the applicants have good prospects of meeting the relatively low threshold laid down by statute and would succeed in obtaining leave to bring a statutory derivative action.' (emphasis added).

There is presently a relative paucity of cases on section 168BC from which to conclude how the Hong Kong courts will approach the company's interest criterion. Given that the statutory derivative action is designed to overcome the problems with the common law derivative action, it should be approached as a measure of reform designed to improve the restrictive standing requirements confronting shareholders. Hence the company's interest criterion should be accorded a liberal interpretation so as not to place a novel obstacle to derivative proceedings.

### (b) Serious question to be tried

A further precondition to bringing a statutory derivative suit is that the alleged misconduct was, in all respects, the product of a serious question to be tried.[58] The Hong Kong provision is modelled on the Australian legislation,[59] which puts 'serious question to be tried' as an independent condition to be satisfied for granting leave (if the application is for leave to bring proceedings under section 168BC(1)(a)).

In Australia, in seeking to determine whether the derivative claim raises a serious question to be tried, it was held in *Swansson* that the court would not normally go into the merits of the claim to avoid turning it into a mini-trial of the issues.[60] Palmer J's discussion in *Swansson* would seem to suggest that this criterion could be satisfied on very low evidence, and that the applicant has the same relatively low threshold to surmount as in the case of an application for an interlocutory injunction.

Although described as 'a low threshold', this criterion seems to have put a critical hurdle in the path of leave applications in Australia. It was held in *Charlton v Baber* (2003) 47 ACSR 31 that the applicant must 'show sufficient colour of

58 Companies Ordinance s 168BC(3)(b).
59 Australian Corporations Act 2001 s 237(2)(d). *Cf* The Canadian legislation contains no express threshold test: Canada Business Corporations Act s 239; whereas in New Zealand the court must have regard to the 'likelihood of the proceedings succeeding,' which is a relevant criterion but is not strictly a precondition for granting leave: New Zealand Companies Act 1993 s 165(2)(a).
60 *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313.

right to final relief.'[61] Other cases indicate that a reasonable body of evidence is required to satisfy the court that there is a serious question to be tried.[62] The discussion in *Charlton* and the approach in other cases,[63] would seem to suggest that a reasonable degree of assurance, based on reliable evidence, is required to satisfy the court that there is a serious issue to be tried.

**HK cases**

Although section 168BC(3)(c) requires some consideration of the merits of the case, the approach taken by the Hong Kong courts would seem to suggest that this criterion has a low threshold and that the merits of the claim should not be discussed in great detail.

In *Re F & S Express Limited* [2005] 4 HKLRD 743, Kwan J pointed out that the court 'will not normally enter into the merits of the proposed derivative action to any great degree', and the applicant has 'the same relatively low threshold to surmount as in the case of an application for an interlocutory injunction.'[64] In so ruling, the Australian authority of *Swansson* was cited in support of the approach taken. Kwan J stated (at [21]):

> 'To ascertain if there is a serious question to be tried, the court "will not normally enter into the merits of the proposed derivative action to any great degree", and the applicant has "the same relatively low threshold to surmount as in the case of an application for an interlocutory injunction": *Swansson v RA Pratt Properties Pty Ltd & Another* (2002) 42 ACSR 313, 318 [25]).'

A similarly robust approach to the serious question criterion was taken by Kwan J in her subsequent decision in *Re Lucky Money Ltd* (unreported, HCMP 505/2006, 18 July 2006). In her judgment, Kwan J stressed that 'the good faith requirement was removed in an earlier version of the bill considered by the Bills Committee of Legislative Council. The idea is that there should not be a trial within a trial and the court should not be forced to enter into the merits of claims where there are serious disputes.'[65] This is an eminently pragmatic conclusion and may well prove its worth in future cases.

In *Re Grand Field Group Holdings* [2009] 3 HKC 81, Kwan J advanced similar views by holding that the serious question criterion 'has a relatively low threshold' and could be satisfied by establishing that there is 'an arguable case.'[66] The case concerned a public listed company carrying

61 (2003) 47 ACSR 31.
62 *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457.
63 *Resource Equities Ltd v Western Ventures Pty Ltd* (2004) 51 ACSR 436; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457.
64 [2005] 4 HKLRD 743 [21].
65 Unreported, HCMP 505/2006, 18 July 2006 [40].
66 [2009] 3 HKC 81 [30], [35], [41] (Kwan J).



on, through its subsidiaries, a property development business in Mainland China. The company was founded by the derivative applicant, Mr Tsang, a former director who held nearly 22 per cent of the shares. Mr Tsang brought a statutory derivative action on behalf of the company against its controlling directors, alleging that they had, in breach of fiduciary duties, misappropriated corporate assets by diverting corporate funds to other companies in which they had a substantial interest through various related party transactions.[67] Kwan J was plainly of the view that 'there is a serious question to be tried if the directors had acted in breach of their fiduciary duties to the company,'[68] and that this criterion could be satisfied if there was a finding for 'an arguable case.'[69]

The discussion in *Re F & S Express*, and the approach in *Re Grand Field* would seem to suggest that the serious question criterion has a rather low threshold and would not present an insuperable barrier for a derivative applicant to overcome as the courts are keen to avoid turning the derivative application into a mini-trial. Such a pragmatic approach is consistent with the objective of introducing the statutory derivative action as an effective remedy to protect shareholders while maintaining appropriate checks and balances to avoid unmeritorious claims.

**(c) Inaction of the company**

Under section 168BC(3) of the Companies Ordinance, the court must be satisfied that it is probable that:

(i) the company has not itself brought the proceedings (if the application is for leave to bring proceedings);[70] or
(ii) the company has not diligently continued, discontinued or defended those proceedings (if the application is for leave to intervene in proceedings).[71]

A similar precondition to leave exists in Australia[72] and the UK.[73] In Australia, this criterion seems to have a low threshold. In most cases, it will be readily apparent whether this requirement is satisfied;[74] all that is required is some evidence establishing the unlikelihood of action, for example, where the board

67 [2009] 3 HKC 81 [17].
68 [2009] 3 HKC 81 [26].
69 [2009] 3 HKC 81 [30], [35], [41].
70 Companies Ordinance s 168BC(3)(b).
71 Companies Ordinance s 168BC(3)(c).
72 Australian Corporations Act 2001 s 237(2)(a).
73 UK Companies Act 2006 s 263(3)(e).
74 *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104.

is deadlocked, or the alleged wrongdoer controls the board,[75] or there is a lack of funding on the part of the company to commence litigation.[76] These are clear inferences that the proceedings will not be brought.

The situation is similar in Hong Kong. Case law shows that it will be relatively easy for the applicant to demonstrate inaction by the company. In *Re F & S Express Limited*,[77] a case of an application for leave to bring proceedings under section 168BC(1)(a), Kwan J only required grounds for finding that it was probable that the company had not brought any recovery proceedings against the alleged wrongdoers.

In *Re Lucky Money Ltd*,[78] a case of an application for leave to intervene in proceedings under section 168BC(1)(b), the company's failure to file an acknowledgment of service was held to be sufficient evidence that the company would not itself defend the action. A similar decision was reached in *Re Nice & Well Ltd*[79] where the derivative applicant and the defendant were two equal shareholder-directors of the company. Kwan J only required some evidence establishing that the company was unable to bring an action against the defendant as a result of the deadlock between the two equal partners.

### (d) Notice requirement

The requirement to give a fourteen days' written notice is a precondition for a plaintiff shareholder to bring a statutory derivative suit.[80] The notice requirement can be waived if the court dispenses with the service of a written notice.[81] This flexible approach could assist the minority shareholder to pursue a derivative suit where there is a need for urgent litigation especially where the wrongdoers are in control of the board of directors.

75 *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104, 145; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888; *Reale v Duncan Reale Pty Ltd* [2005] NSWSC 174; *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435; *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* (2002) 42 ACSR 398; *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170.

76 *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 51 ACSR 299.

77 [2005] 4 HKLRD 743.

78 Unreported, HCMP 505/2006, 18 July 2006.

79 Unreported, HCMP 2148/2008, 11 December 2008.

80 Companies Ordinance s 168BC(3)(d).

81 Companies Ordinance s 168BD(3). See also *Re Lucky Money Ltd & Others* (unreported, HCMP 505/2006, 18 July 2006) where Kwan J made an order dispensing with the notice requirement for the derivative applicant to serve written notice on each of the companies under section 168BD(4) on the ground of the urgency of the matter. A similar provision to dispense with the notice requirement exists in Canada: Canada Business Corporations Act s 239(2)(a).



The notice requirement, which is common in existing Commonwealth legislation,[82] is an obvious necessity to provide the company with the opportunity, through the board of directors, either to take its own remedial action or to prepare a proper response to the plaintiff shareholders' application.[83] The justification for a notice requirement is the recognition of the principle that the company is the proper plaintiff in an action to enforce its rights as the cause of action rightly belongs to the company, and it should have the option of pursuing its own rights.

### Conclusions on leave criteria

There are certain conclusions which, however tentatively, can be drawn from a comparison of some of the main common law jurisdictions where the statutory derivative action has been adopted.

In Canada, despite the proactive approach of the legislature, it has been observed that there are unnecessary complications and difficulties in the derivative leave application proceedings. As Kaplan and Edwood remark, 'the merits of the lawsuit have become a significant, costly and time-consuming battleground in leave proceedings, enormous amount of time and money are expended in pursuing the factual minutia.'[84]

This has not occurred in Australia. A recent empirical study of the Australian derivative action[85] indicates that the leave applications are not turning into expensive and lengthy 'mini-trials'. Rather, the length of the hearings and the judicial scrutiny of the proposed actions reflect the complexity of the cases.

Of derivative action in the UK, the new regime governing derivative claims procedure under the Companies Act 2006, while expanding the scope of the remedy, is keen to avoid unmeritorious shareholders' claims. It appears that a derivative claim will rarely be subject to an absolute bar, and the focus will be on the courts' discretion in deciding whether leave should be granted. Lowry has argued that 'this is throwing quite a burden on the court, particularly as the competing factors are unlikely, at least on all occasions, to be satisfactorily

82 Canada Business Corporations Act s 239(2)(a); New Zealand Companies Act 1993 s 165(3)(4); Australian Corporations Act 2001 s 237(2). Noting that in the UK, the Law Commission had recommended that a shareholder wishing to bring a derivative action be required to serve a notice on the company at least 28 days before the commencement of the proceedings, but that recommendation was not taken up: see HC Official Report, SC D (Company Law Reform Bill) 13 July 2006, cols 660, 672.

83 Boyle, *Minority Shareholders' Remedies* (CUP, Cambridge 2002) 71.

84 Kaplan and Elwood, 'The Derivative Action: A Shareholder's "Bleak House"?' (2003) 36 UBCLR 443, 460.

85 Ramsay and Saunders, *Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action* (Centre for Corporate Law and Securities Regulation, University of Melbourne, 2006) 48.