Abolition of Nominal or Authorised Capital and Par Value

2.002 Until the commencement of the current CO,[6] the previous and former Companies Ordinances had required a company having a share capital, unless the company was an unlimited company, to state in its memorandum of association the amount of share capital with which the company proposed to be registered and the division thereof into shares of a fixed amount.[7]

On incorporation the founder members needed to consider how much money they would need for the start up of the business of the company. They might be taking over an existing business from a sole trader or a partnership, in which case, particularly if they were not intending to borrow immediately, the buy out price for the business plus a sum for immediate cash needs may be the appropriate amount to take as the nominal or authorised capital of the company. But for many companies, particularly those incorporated to hold a flat or other single asset already acquired and not intending to trade actively, the nominal / authorised capital might indeed be nominal, e.g., HK$2.[8] The nominal capital of a company represented the amount of share capital which might be issued without an alteration to the capital clause in the memorandum of association of a company. But it was easy enough to increase the capital.[9] When a company has been trading for some time its nominal capital, even if fully paid-up, might bear little relation to the assets or value of the company. The 1932 Companies Ordinance, based on the companies legislation developed in the United Kingdom in the latter part of the nineteenth century, was premised on a public company[10] making a public offering to raise funds which would be expended in some substantial development, such as, in the UK nineteenth century context, a railway, canal or factory. In those circumstances, it was understandable that the law should require that some sum should be put forward as the capital required for the initial project, so that investors would have some idea of what they were investing in. But, as will be shown below, that sum may not accurately reflect the amount actually invested in the company.

Originally, under the early English companies legislation, companies were required to have a minimum authorised capital.[11] A stated amount of authorised capital was seen as a protection for shareholders and creditors, and even today in Europe and elsewhere a compulsory minimum capital is still a requirement, at least for public companies. There is no requirement for a minimum authorised capital in the companies legislation in Hong Kong, but the Stock Exchange Listing Rules require a minimum capitalisation for listing, unless the issuer satisfies the profit test.[12]

[6] On 3 March 2014; see Companies Ordinance (Commencement) Notice 2013, LN 163 of 2013.

[7] predecessor CO, s.5(4) and First Schedule Table B.

[8] About a quarter of Hong Kong incorporated companies had a nominal capital of HK$2 or less.

[9] Companies Ordinance 1865, s.12; see also Companies Ordinance 1932, s.53(a), at para 2.013.

[10] That was, a company which was not a private company within the predecessor CO s.29. CO, s.12 has a definition of a public company: as a company that: (a) is not a private company; and (b) is not a company limited by guarantee.

[11] The UK Limited Liability Act 1855 required that not less than three quarters of the authorised capital had been subscribed and a company was required to be wound up if it lost three quarters of its capital. These requirements did not survive the Joint Stock Companies Act 1856.

[12] For a main board listing a capitalization of at least HK$4,000,000,000, subject to waiver under Stock Exchange Listing Rules r 8.05A (under the market capitalisation / revenue test; see also Stock Exchange Listing Rules r 8.05(3)(d)).

A remaining relic of a minimum capital can be found in the provision in the companies legislation,[13] which prohibits an allotment of shares which have been offered to the public for subscription unless the amount specified in the prospectus as the minimum subscription is achieved.

As we have seen above, the company's nominal share capital had to be divided into shares of a fixed amount. This fixed amount was the nominal or par value of the shares. Generally, the company could not issue its shares for less than the par value.[14]

If it transpired at a later date that the par value was too high, e.g., in the case of a listed company, its shares was trading at less than the par value, then this might be an appropriate time to consider a reduction of capital by re-designating the nominal value of the shares at a lower amount.[15]

The rationale of requiring a nominal capital amount and par value for shares was to protect shareholders and creditors. Nominal capital was said to provide protection to prospective subscribers and creditors by indicating the amount of the capital of the company. In the past, the nominal capital was often stated at a high amount in order to impress prospective investors and creditors, but it was the amount of the shares that had been issued (rather than the maximum amount that might be issued without an increase in capital) that more accurately reflected the amount invested by subscribers. However, even that could be misleading. In the past it was common for shares to be issued only partly paid-up, the balance to be "called up" later. It was the paid-up share capital which most accurately reflected what subscribers had invested. In more recent times nominal capital usually bore some relation to the likely needs of the company[16] and shares were generally payable in full on issue. Since 1972 the false impression that might be caused by partly paid shares was dealt with by the provision in the predecessor CO whereby, if a company made a statement as to its authorised or issued capital in any document of the company issued in Hong Kong, it had to also issue a statement in the document of the paid-up capital of the company no less prominently.[17] In reality, nominal/authorised capital was not usually relied upon by investors, creditors or others when making decisions concerning companies. Since companies often did not issue shares up to the amount of the authorised capital limit and, in any event, loss of capital may result from trading, prudent creditors did not place much, if any, reliance on the amount of the authorised capital.

Par value was said to protect existing shareholders by preventing companies from issuing shares for less than par value and thus diluting the proportions of the respective shareholders, but it is easy enough for a company to increase its capital and thereby dilute the shareholding proportions. In any event, par values were arbitrary

[13] Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap.32)("CWUO"), s.42, as amended by Schedule 9 s.13(3) of the CO, but otherwise unaffected by the CO.

[14] See *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL). There were some exceptions in ss.50(1) and 50(2) of the predecessor CO.

[15] For reduction of capital, see para 2.016 *et seq*.

[16] Formerly a so-called "capital duty", in effect a charge, was payable upon incorporation of a company at the rate of HK$1 for every HK$1,000 or part of HK$1,000 of the nominal share capital of the company, subject to a maximum of HK$30,000; see predecessor CO, 8th Schedule, Part I, para (a). But this charge seems to have had little influence on the choice of the amount of nominal capital. It was abolished as from 1 April 2012 by the Companies Ordinance (Amendment of Eight Schedule) Order 2012, LN 39 of 2012.

[17] Predecessor CO s.350A; now see CO, s.202. As stated by Betty M. Ho in *Public Companies and their Equity Securities: Principles of Regulation under Hong Kong Law* (The Hague: Kluwer Law International, 1998) p 39: "To those unfamiliar with Anglo-Hong Kong law, a statement of the share capital of the company other than of paid-up capital is extremely misleading".

and misleading. A real value of a share, market or otherwise, might be worth more or less than the par value, depending on how the company's business was doing. A share is simply a proportionate interest in the net worth of a business. Par values obscured this reality.[18]

Many Common Law jurisdictions had migrated to a no par system in the last decade or so. In some cases the change has been mandatory (e.g., Australia, New Zealand and Singapore); in other cases optional (e.g., some Channel Islands (Jersey and Guernsey), the British Virgin Islands, the Cayman Islands and British Columbia). Under no par systems authorised capital, in the sense of a stated monetary value, can no longer exist, but it is possible to retain a form of authorised capital stated in a number of shares.[19] It is also possible to retain partly paid shares under a mandatory no par system. The United Kingdom abolished authorised share capital in the Companies Act 2006,[20] but retained the nominal value of shares.[21] The Companies Ordinance Rewrite conducted by the Hong Kong Government commenced work in the latter part of 2006 and authorised capital and par value shares were amongst the items considered in the first year. Recommendations as to the migration to a no par system, the abolition of authorised share capital and retention of partly paid shares were published in a Consultation Paper in June 2008 and the provisions in the White Bill were explained in a Consultation Paper published in May 2010 and were set out in Part 4 Share Capital of the Blue Bill published on 14 January 2011. The provisions were not controversial and are now to be found in Part 4 of the CO.[22]

Issued and Unissued Capital

2.003 The issued share capital of a company is the amount of the total price paid for shares which a company has issued.

Unissued share capital is the value of the shares of the company which have yet to be paid for or agreed to be taken. The share capital of a company is upon incorporation unissued capital, with the exception of the shares subscribed for by the founder members.[23]

Issue and Allotment

2.004 Neither "issue" nor "allotment" is defined in the CO. They are not the same thing. Allotment is when a person acquires the unconditional right to be included in the

[18] See the extract from the Canadian Dickerson Report 1971 referred to in Ho (n 17 above), p 39, n 58.
[19] CO, s.85(2).
[20] It is now concerned mostly with called-up share capital; see Companies Act 2006, s.547.
[21] See Companies Act 2006, s.542 (as it was required to do by the Second European Company Law Directive).
[22] The Consultation Papers and Conclusions, the Consultation Study by Freshfields Final Report and the Blue Bill can be found on the CO Rewrite website (fstb.gov.hk/fsb/co_rewrite/).
[23] A founder member: (a) in relation to a company formed and registered under the CO, means a person who signs on the company's articles for the purposes of the formation of the company; or (b) in relation to a company formed and registered under a former Companies Ordinance, means a person who subscribed to or signed on the company's memorandum of association; see CO, s.2(1). A founding member is to be regarded as having agreed to become a member of the company; see CO, s.112(1). On the registration of a company, a founder member of the company must be entered, as a member, in the company's register of members; see CO, s.112. Hong Kong has permitted one person companies since the Companies (Amendment) Ordinance 2003 came into force on 13 February 2004; see CO, s.4(1).

company's register of members in respect of the shares he or she has agreed to take from the company.[24] Issue imports some subsequent act has been done whereby the title of the allottee has been completed. The shares are issued when an application to the company for shares has resulted in allotment and notification thereof to the purchaser and completed by entry on the register of members.[25]

Paid-up Capital and other Types of Capital

2.005 The price of shares is nowadays usually paid up in full upon the allotment of the shares.[26] Often in the past shares would be only partially paid up and the company might subsequently make a call for the balance or part of the balance.[27] This is not the same as payment of shares by installments, which is not uncommon nowadays.[28] For partly-paid shares nothing further is due from the purchaser until a call has been made. In the case of purchase of shares payable by installments the installments are due on the agreed dates.[29]

In both cases of partially paid shares and shares being paid for by installments, the shares will have been issued and registered in the name of the purchaser. In default of payment on a call or of an installment the company may exercise its lien over the shares[30] or start the process of forfeiture of the shares.[31]

Paid-up capital is the amount of capital contributed to the company for its issued shares, where the shares are fully paid up. Shares can be issued as fully paid for a consideration other than cash.[32]

Partly paid capital is the amount contributed where the shares are partly paid.

Uncalled capital is the amount unpaid on shares where a balance is due on the shares issued before a call has been made for the payment of the whole or part of the balance.[33]

Called-up capital is the amount actually contributed to the share capital of a company, including what is presently due to be paid or provided by members, i.e. the amounts called for or other consideration due from the members.

[24] See UK Companies Act 2006, s.558. There was no equivalent section under the predecessor CO nor is there under the current CO.
[25] *National Westminster Bank plc v IRC* [1995] 1 AC 119 (HL).
[26] The Model Articles for private companies provide that no share is to be issued unless the share is fully paid; see Companies (Model Articles) Notice (Cap.622H), Sch 2 art.56.
[27] See para 2.002. For articles on calls regarding public companies, see Companies (Model Articles) Notice (Cap.622H), Sch 1 arts. 70 to 79 (public company). For private company, see Companies (Model Articles) Notice (Cap.622H), Sch 2 art.56. All shares to be fully paid up; see n 26 above.
[28] Installments due, but not paid, on the issue price of shares, may now be the subject of a registrable charge; see CO, s.334(1)(f).
[29] See Companies (Model Articles) Notice (Cap.622H) Sch 1 art. 73(1). A call notice need not be issued in respect of sums that are specified, in the terms on which a share is issued, as being payable to the company in respect of that share —(a) on allotment; (b) on the occurrence of a particular event; or (c) on a date fixed by or in accordance with the terms of the issue; (2) But if the due date for payment of such sum has passed and it has not been paid, the holder of the share concerned is —(a) treated in all respects as having failed to comply with a call notice in respect of that sum; and (b) liable to the same consequences as regards the payment of interest and forfeiture.
[30] For lien, see Companies (Model Articles) Notice (Cap.622H), Sch 1 arts. 68, 69 (public companies).
[31] For forfeiture, see Companies (Model Articles) Notice (Cap.622H), Sch 1 arts. 75 to 78 (public companies).
[32] See para 2.008.
[33] For charges on uncalled capital, see Part 12.

Classes of Shares

2.006 Shares may be issued with different rights attached. Any share in the company may be issued with such preferred, deferred or other special rights or such restrictions, whether in regard to dividend, voting, return of capital or otherwise as the company may from time to time determine. Classes of shares are discussed in Part 3.

II. PAYMENT FOR SHARES

Introduction

2.007 It will be shown later[34] that the doctrine of capital maintenance was a fundamental principle of company law from the early days. A company's capital was sacrosanct and not allowed to be returned to shareholders. The capital was a source to which creditors could resort in the event of the liquidation of the company. The fact that the capital might have been lost through trading did not deter the courts nor the legislature from establishing detailed rules as to maintenance of capital and one aspect of that doctrine was that the company must receive at least the nominal value of the shares. This rule does not survive the abolition of nominal value. But it is still necessary that a proper price be paid for shares (otherwise the directors may be liable for breach of fiduciary duty) and the prohibition against issuing shares at a discount still applies.[35]

Payment in Cash or Non-cash Consideration

2.008 Shares may be issued at any price which the directors decide may be obtained for them.[36] With the abolition of par value, the concept of issuing shares at a premium is no longer applicable. If the company receives less than the price fixed for shares, then it has issued shares at a discount, which is prohibited.

Cash means actual cash or a cheque or the release of a liability of the company for a liquidated sum.[37]

The payment for the shares must be cash or non-cash consideration. Non-cash consideration means consideration in strict contract principles, so past services is not good consideration for the allotment of shares.[38] An allotment of shares on consideration of the debt due to the founding members for pre-incorporation expenses is good consideration,[39] as is allotment of shares in consideration of a retainer of the allottee for future services at a fixed sum.[40]

[34] See para 2.029.
[35] See para 2.012.
[36] See *Hilder v Dexter* [1902] AC 474 (HL); see also *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd* [1904] AC 648 (HL). In determining the price the directors must act in the best interests of the company. The issue of undervaluing the shares sometimes arises in the context of initial public offering, where the over subscription may suggest that the price was too low. But it is difficult to prove.
[37] See *Re Jones Lloyd & Co Ltd* (1889) 41 Ch D 159; see also *Park Business Interiors Ltd v Park* [1992] BCLC 1034. There was no equivalent in any of the former COs nor is there in the current CO of the definition of "cash consideration" in the UK legislation (See CA 1985, s.738(2); CA 2006, s.583(3)).
[38] *Re Eddystone Marine Insurance Co* [1893] 3 Ch 9 (CA Eng).
[39] *Park Business Interiors Ltd v Park* [1992] BCLC 1034.
[40] *Gardner v Iredale* [1912] 1 Ch 700.

Valuation of Non-cash Consideration

2.009 Where the company accepts non-cash consideration, such as a factory and equipment of a business formerly run as a partnership, it may not be easy to determine whether a proper price has been paid for the shares.

Fortunately, the courts rarely interfere. They will not inquire into the value of the non-cash consideration so long as the company honestly regards the consideration given as fairly representing the price of the shares.[41] However, it sometimes may be apparent from the terms of a contract that the value put on the non-cash consideration is extravagant, in which case the court will treat the transaction as an issue of shares at a discount[42] and require the shareholders to pay the balance of the full price of the shares[43] or treat the shares as only partly paid.

Return of Allotment

2.010 When a company limited by shares makes any allotment of shares, it must within one month thereafter deliver to the Registrar of Companies a return of allotment in the specified form,[44] i.e. Form NSC1. Where shares are allotted for a non-cash consideration, the return must state the particulars of the contract for sale or for services or other consideration for the allotment.[45] On default in complying with these requirements the company and every responsible person of the company who is in default will be liable to a default fine and, for continued default, to a daily default fine.[46]

Registration of Allotment

2.011 A company must register an allotment of shares as soon as practicable and in any event within 2 months after the date of the allotment, by entering in the register of its members the information referred to in ss.627(2) and 627(3) of the CO.[47]

Shares Issued at a Discount

2.012 At common law, issuing shares at a discount, i.e. at less than their nominal value, was prohibited.[48] The predecessor CO permitted issue at a discount subject to certain restrictions and with the sanction of the court where shares of the same class have already been issued and the company was entitled to commence business at least one year before the issue.[49]

[41] See *Re Ooregum Gold Mining Co of India v Roper* [1892] AC 125, 137 (HL); see also *Re Wragg Ltd* [1897] 1 Ch 796, 830–831 (CA Eng); *Re Innes & Co Ltd* [1903] 2 Ch 254 (CA Eng); *Re White Star Line Ltd* [1938] Ch 458 (CA Eng).
[42] For issue of shares at a discount, see para 2.012. Issue of shares at a discount is still generally prohibited under CO, s.147.
[43] *Hong Kong and China Gas Co Ltd v Glen* [1914] 1 Ch 527.
[44] CO, s.142(2)(a). The return must include a statement of capital (CO, s.201) as at the date of the allotment.
[45] CO, s.142(2)(b). See also ss.142(2)(c),142(2)(d), and 142(2)(e) of the CO. For extension of time for delivery of the return, see CO, ss.142(4) to 142(7). See also *Re China Unicom (Hong Kong) Ltd* ([2016] 2 HKC 343, unrep., HCMP 2106/2015, 22 September 2015); *Re Poly Property Group Co Ltd* (unrep., HCMP 3154/2015, 15 December 2015, [2016] 4 HKC 169); *Re Hong Wei (Asia) Co Ltd* ([2016] HKCU 1741(unrep., HCMP 1418/2016, 13 July 2016) (relevance of issue of default summons).
[46] CO, s.142(3). For responsible person, see CO, s.3 and n 47 below.
[47] CO, s.143(1). For contravention see CO, s.143(2). CO, s.3 (Responsible person) makes an officer and shadow director liable if he or she authorizes or permits or participates in a contravention or failure.
[48] *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL).
[49] CO, ss.50(1) and 50(2).

The Ordinance has a general prohibition of commissions, discounts and allowances.[50] Section 148 of the CO provides for permitted commissions and subsequent s.149 of allows capital to be applied in writing off certain expenses and commissions.

III. INCREASE OF CAPITAL

Power of Company to Alter Share Capital

2.013 A limited company may alter its share capital in any one or more of the following ways.[51]

The company may: (a) increase its share capital by allotting and issuing new shares in accordance with Part 4; (b) increase its share capital without allotting and issuing new shares, if the funds or other assets for the increase are provided by the members of the company; (c) capitalize its profits, with or without allotting and issuing new shares; (d) allot and issue bonus shares with or without increasing its share capital; (e) convert all or any of its shares into a larger or smaller number of shares; and (f) cancel shares –(i) that, at the date the resolution for cancellation is passed, have not been taken or agreed to be taken by any person; or (ii) that have been forfeited.[52]

A limited company may alter its share capital as referred to in paras (e) or (f) only by resolution of the company.[53] Such resolution may authorize the company to exercise the power: (a) on more than one occasion; and (b) at a specified time or in specified circumstances.[54] If shares are cancelled under para (f) above, the company must reduce its share capital by the amount of the shares cancelled.[55] For the purposes of Part 5 (Transactions in relation to Share Capital) of the CO, a cancellation of shares under s.170 of the CO is not a reduction of share capital.[56] A limited company's articles may exclude or restrict the exercise of a power as conferred by s.170 of the CO.[57]

Exercise of the Power

2.014 These powers may be exercised in general meetings[58] or, where appropriate, using the written resolution procedure.[59] Generally, under express regulations the appropriate resolution is an ordinary resolution.[60] If the articles do not provide for increase of capital, it will be necessary to amend the articles to so provide.[61] The notice convening a meeting to consider a resolution to increase the capital should state the amount of

[50] CO, s.147.
[51] CO, s.170(1).
[52] CO, s.170(2).
[53] CO, s.170(3). CO, ss.140 and 141 contain provisions requiring a resolution of the company for an allotment of shares. Those sections may be relevant to an alteration of share capital referred to in paras (a), (c), (d), above. In any conversion under CO, s.170(2)(e) the proportion between the amount paid and the amount, if any, unpaid on each reduced share must be the same as it was in the case of the share from which the reduced share is derived; see also CO, s.170(5).
[54] CO, s.170(4).
[55] CO, s.170(6).
[56] CO, s.170(7). For reduction of capital see s.2.016 *et seq.*
[57] CO, s.170(8).
[58] See Part 5 paras 5.019, *et seq.*
[59] CO, s.548.
[60] And for Model Articles, see Companies (Model Articles) Notice (Cap.622H) (public companies), Sch 1 art. 87 and (private companies) Sch 2 art. 69.
[61] CO, s.87. For amendment of articles see Part 1, para 1.016 *et seq.*

the proposed increase.[62] The currency of the increase need not be the same as that of the original capital.[63]

Where the articles provide for increase of capital etc those provisions must be observed if the increase is to be valid and effective.[64]

Notice of the alteration of capital (other than for an increase of capital) must be given to the Registrar of Companies in the specified form NSC11 within one month of the alteration.[65]

Fettering the Company's Power to Increase the Capital

The power to increase capital can be abused. In private companies where there is conflict between members, capital is often increased and an issue of new shares made, in order to cause a dilution in the shareholding of the opposition. Dilution is a common complaint in unfair prejudice cases.[66] 2.015

So it is not uncommon in private companies, and joint venture companies in particular, for the articles or a separate shareholder agreement to provide for unanimous approval for an increase of capital.[67] A company cannot fetter its statutory powers, so if such a restriction appears in the articles[68] or in a separate shareholder agreement to which the company is a party, the restriction will not be binding on the company. However, the restriction may be binding on those shareholders party to the agreement (but not shareholders not party to the agreement, unless they adhere to the agreement in some manner),[69] so that, for example, it might be possible to obtain an injunction against a shareholder who was intending to vote contrary to what had been agreed or even damages for breach of contract, if loss could be proved. The Hong Kong courts seem to have gone further in deciding that not only can the company not fetter its statutory rights, but neither can members fetter their statutory powers.[70]

IV. REDUCTION OF CAPITAL

Maintenance of Capital Doctrine

This doctrine of the maintenance of the capital of a company has already been mentioned[71] and more will be said about it later.[72] A company's capital was sacrosanct and not allowed to be returned to members. The reduction of the capital of a company falls within this principle, but, in order to contrast the topic of reduction with the topic of increase of capital just discussed, reduction of capital will be dealt with now. 2.016

[62] CO, s.171(2)(b); see also *MacConnell v E Prill & Co Ltd* [1916] 2 Ch 57.
[63] CO, s.172(1); see also *Re Scandinavian Bank Group plc* [1988] Ch 87.
[64] See *Tsao Chin Lan v Tin Ka Kung* [1995] 2 HKC 671 (CA).
[65] CO, s.171(1). The notice must include a statement of capital; see CO, ss.171(2)(c) and 201. For non-compliance under ss.171 and 171(4) of the CO.
[66] See *Tseng Yueh Lee Irene v Metrobilt Enterprise Ltd* [1994] 2 HKC 684; see also *Ng Yat Chi v Max Share Ltd* [2001] 1 HKLRD 561 (CA), affirmed [2001] 3 HKLRD 299 (CFA).
[67] *Russell v Northern Bank Development Corp Ltd* [1992] 1 WLR 588 (HL).
[68] For the contractual effect of the articles, see CO, s.86.
[69] *Russell v Northern Bank Development Corp Ltd*, n 67 above.
[70] See *Re Greater Beijing Region Expressways Ltd* [1999] 4 HKC 807; see also *Muir v Lampl* [2005] 1 HKLRD 338.
[71] See para 2.007.
[72] See para 2.029.

Reasons for Reduction

2.017 A company may wish to reduce its capital for a variety of reasons, but the most common situation in the past was where the company had suffered a permanent loss of capital through trading losses and the market value of its shares was less than their par value, so that the company could not raise further capital.[73]

The reverse situation is where a company has an excess of capital. This may happen where there is legislation applicable to the company's business requiring a certain capital ratio[74] and the company is giving up that part of its business where a minimum capital is required.[75]

With the comparative relaxation of the rules relating to purchase of own shares by a private company,[76] in many instances a private company will prefer to purchase its own shares, rather than go the reduction route.

Prohibition, Subject to Ordinance

2.018 Except as provided in the CO, no company limited by shares or limited by guarantee and having a share capital[77] shall reduce its share capital in any way.[78] This reflects the capital maintenance principle expounded in the case of *Trevor v Whitworth*.[79]

However, subject to any provision of the company articles that prohibits or restricts the reduction of the company's share capital,[80] a company limited by shares,[81] may reduce its share capital under Division 3 of Part 5 of the CO in any way,[82] by one or other of the two procedures specified in the Ordinance. But a company may not reduce its share capital, if, as a result of the reduction, there would no longer be any member of the company holding shares other than redeemable shares.[83]

Section 210 (Permitted reductions of share capital) of the CO provides some examples of the types of reduction, as follows: (1) A company may extinguish or reduce the liability on any of its shares in respect of share capital not paid up;[84] and (2) A company may, either with or without extinguishing or reducing liability on any of its shares: (a) cancel any paid-up share capital that is lost or unrepresented by available assets;[85] or (b) repay any paid-up capital in excess of the company's wants.[86]

[73] Not being able to issue shares at a discount (see para 2.012), or pay dividends (dividends are only payable out of profits available for distribution, see CO, s.297. A distribution by way of reduction of capital is an exception; see also CO, s.290. See also para 2.018 for the types of reduction referred to in CO, s.210.

[74] As in the securities industry, see Securities and Futures Ordinance (Cap.571) ("SFO"); see also SFO, s. 145 and Securities and Futures (Financial Resources) Rules (Cap.571N).

[75] Note that there is no minimum capital required under the Money Lenders Ordinance (Cap.163): see *Re Shun Sing Finance Co Ltd* (unrep., HCMP 2518/2006, [2007] HKEC 699), where the company was giving up lending on unsecured loans and therefore needed less capital.

[76] See para 2.031 below.

[77] Since 13 February 2004, a company cannot be formed as, or become, a company limited by guarantee with a share capital as prescribed in CO, ss.9 and 66.

[78] See generally on the prohibition *Hill v Permanent Trustee Co of New South Wales Ltd* [1930] AC 720 (PC).

[79] (1887) 12 App Cas 409 (HL).

[80] CO, s.210(3).

[81] And guarantee companies with a share capital incorporated before 13 February 2004 (see n 77 above).

[82] CO, s.210(1); see also *ex parte Westburn Sugar Refineries Ltd* [1951] AC 625 at 629 (HL). Note that CO, s.211, adds a new procedure of special resolution supported by a solvency statement.

[83] CO, s.210(2).

[84] Since most shares are nowadays fully paid up on issue (see para 2.005 above) this situation is not common.

[85] As indicated in para 2.017 above this is a common situation.

[86] The examples are based on the methods approved in *Poole v National Bank of China Ltd* [1907] AC 229 (PC).

The three specified methods of reduction are without prejudice to the expressed power to reduce capital "in any way". A combination of two or more of the specified ways may be used.

Permitted Reduction of Share Capital

2.019 The two procedures for a company to reduce its share capital are: (a) by special resolution supported by a solvency statement; or (b) by special resolution confirmed by the court.[87]

Procedure (a) above was introduced by the CO, ss.215 *et seq* and is based on the UK Companies Act 2006, ss.642 to 644. Since this new procedure is likely to reduce the number of applications to the court to confirm a reduction,[88] it will be dealt with first of all. The concept of a solvency statement made by director as an alternative to a court application for confirmation of a transaction by the company is not new to the CO. It existed under the predecessor CO in s.47F in the context of the giving of financial assistance and in s.49K of the predecessor CO in the context of redemption or purchase of own shares of a private company out of capital. The concept has been extended in CO to other situations.[89]

Solvency Test

2.020 A company satisfies the solvency test in relation to a transaction if: (a) immediately after the transaction there will be no ground on which the company could be found liable to be found to be unable to pay its debts; and (b) either (i) if it is intended to commence the winding up of the company within 12 months after the date of the transaction, the company will be able to pay its debts in full within 12 months after the commencement of the winding up; or (ii) in any other case, the company will be able to pay its debts as they become due during the period of 12 months immediately following the date of the transaction.[90]

Solvency Statement

2.021 A solvency statement in relation to a transaction is a statement that each of the directors making it has formed the opinion that the company satisfies the solvency test in relation to the transaction.[91] In forming an opinion for the purpose of making a solvency statement, a director must: (a) inquire into the company's state of affairs and prospects; and (b) take into account all the liabilities of the company (including contingent and prospective liabilities).[92]

A solvency statement must be in the specified form (Form NSC17); must state: (i) the date on which it is made; (ii) the name of each director making it; and (c) must be signed by each director making it.[93]

[87] CO, s.211.

[88] See Companies Registry Annual Report 2014-15 p 28,133 out of 141 reductions were by the new out–of-court procedure.

[89] CO, s.204.

[90] CO, s.205.

[91] CO, s.206(1).

[92] CO, s.206(2).

[93] CO, s.206(3).

Reduction of Share Capital by Special Resolution Supported by Solvency statement

2.022 All directors of the company must make the solvency statement.[94]

The special resolution for reduction of share capital must be passed within 15 days after the date of the solvency statement.[95]

If the special resolution is proposed as a written resolution,[96] a copy of the solvency statement must be sent to every member of the company at or before the time when the proposed resolution is sent to them.[97] If the special resolution is proposed at a meeting, a copy of the solvency statement must be made available for inspection by members at the meeting.[98]

As regards a written resolution, a member of the company holding shares to which the resolution relates, is not an eligible person for the purpose of voting on the resolution.[99] Where the resolution is proposed at a meeting, the resolution is not effective, if any member holding shares to which the resolution relates exercises the voting rights carried by any of those and the resolution would not have been passed if the member had not done so.[100] These restrictions do not apply in the case of a reduction that applies equally to all issued shares in the company.[101]

Publication of Notice

2.023 If the special resolution for reduction of share capital is passed, the company must publish a notice in the Gazette stating that the company has approved a reduction and other information set out in s.218 of the CO including that a dissentient member or a creditor of the company can within 5 weeks of the date of the resolution apply to the court to cancel the resolution.[102] The company must also publish a notice to the same effect in at least one specified Chinese language newspaper and one specified English language newspaper or give written notice to that effect to each of its creditors.[103] There is also provision for inspection of the resolution and the solvency statements.[104]

[94] CO, s.216(1).

[95] CO, s.216(2). For precedents of such resolution, see John Brewer, *The Law of Hong Kong Companies* (Sweet & Maxwell, 3rd edn, 2017) p 162; *The Encyclopaedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Form 213 *et seq*. *Palmer's Company Precedents* (17th edn, 1956) is still very useful in Hong Kong, because, despite the current CO and Civil Justice Reform, this text is closer to Hong Kong's current position, Part I, Form 519. For where a company's powers are fettered, e.g. unanimity is required for a reduction of capital, see para 2.015 above.

[96] For written resolutions signed by all members see Part 5, para 5.131 *et seq* of this text.

[97] CO, s.216(3). For a precedent, see *The Encyclopedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Form 211.

[98] CO, s.216(4). For form of notice to general meeting see *The Encyclopedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Form 212.

[99] CO, s.217(1).

[100] CO, ss.217(2) and 217(3).

[101] CO, s.217(5). For offence if share capital is reduced in contravention of the Ordinance, see CO, s.212. For liability of members following reduction of share capital, see CO, s.213. A reserve arising from a reduction of share capital is to be regarded for the purposes of Part 6 of the Ordinance as realized profit; see also, CO, s.214.

[102] CO, s.218.

[103] CO, s.218(3).

[104] CO, s.219.

Application to Court for Cancellation by Members or Creditors

2.024 Application for cancellation of the special resolution to the Court of First Instance is made by originating summons in the expedited form.[105] A member, who has not consented to or voted in favour of the special resolution, or a creditor of the company may apply.[106] The application must be made within 5 weeks of the date of the special resolution.[107] The company must give notice to the Registrar of Companies in the specified form (Form NSC18) within 7 days after the application is served on the company.[108] If no application is made to the Court, the company must deliver a return in specified form (Form NSC19) to the Registrar of Companies no earlier than 5 weeks nor later than 7 weeks after the date of the resolution.[109] If the Court confirms or cancels the special resolution,[110] the company must deliver to the Registrar of Companies a return in the specified form (Form NSC19) and the Registrar must register the return.[111]

The reduction takes effect when the return under either s.224 or s.225 of the CO is registered.[112]

Reduction of Share Capital Confirmed by Court

2.025 The alternative to reduction of share capital by special resolution supported by solvency statement is reduction by special resolution confirmed by order of the Court of First Instance confirming the reduction.

Application to the Court

2.026 Application to the court for an order confirming a reduction is made by petition presented by the company.[113] The petition will set out, amongst other things, the history of the company, the initial or current capital, the distribution of the shares, the company's creditors, the regulation in the articles authorising the reduction, the convening of the meeting to pass the resolution, the explanation of the proposed reduction to the shareholders, the nature and effect of the reduction, how any creditors are to be protected and the voting on the resolution.[114]

As is usual in most situations where the originating process is by petition, the petition must set out all the relevant facts. The supporting affidavit/affirmation cannot be used to make good deficiencies in the petition itself. The supporting affidavit/affirmation will have exhibited to it all the relevant documents relating to the company and

[105] Rules of the High Court (Cap.4A), O 102 r 2; see also CO, s.58(1). For a useful Procedural Table see *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(4), pp 303–309.

[106] CO, s.220(1) to 220(3).

[107] CO, s.220(1).

[108] CO, s.220(4)(b).

[109] CO, s.224.

[110] CO, s.222.

[111] CO, s.225.

[112] CO, s.215(2).

[113] CO, ss.226. The petition is listed under High Court Miscellaneous Proceedings ("HCMP").

[114] For precedents see *Brewer* pp 167-168; *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(5), Form 104 *et seq* (the Claim Form in *Atkin* will need adaptation to petition form); see also *Palmer's Company Precedents* (17th edn) Part I, Form 520. If the balance sheet of the company recorded an accumulated loss which reduced available capital, this was the amount of share capital for the purposes of the reduction, so the reduction should have been structured in two parts. See *Re Fok Ying Tung Ming Yuan Development Co Ltd* [2016] 2 HKLRD 292.

the background and terms of the proposed reduction, including the notice to creditors of the proposed reduction and consents to the reduction.[115]

Where the reduction requires confirmation by the court and involves a diminution of members' liability in respect of unpaid share capital or where paid-up capital is returned to members and in any other case if the court so directs, any creditor may object to the reduction, and the court shall settle a list of creditors so entitled; but may dispense with the consent of any creditor entered on the list on the company securing payment as the court may direct;[116] or, if having regard to the special circumstances of the case, the court thinks proper so to do, may direct that the above protection for creditors' interests shall not apply.[117]

The substantive hearing of the petition is preceded by a case management summons.[118] On the summons appropriate orders will be made, e.g. dispensing with a list of creditors, directions for the advertisement giving notice of the presentation of the petition.[119]

Factors Relevant to the Court's Jurisdiction

2.027 The court, if satisfied, with respect to every creditor of the company who is entitled to object to the reduction, that either consent to the reduction has been obtained or that the debt or claim has been discharged or has determined, may make an order confirming the reduction on such terms and conditions as it thinks fit.[120]

To settle a full list of creditors can be quite a task and the court may dispense with this requirement and direct the company to advertise the petition instead. The primary concern of the court is to be assured that the interests of the creditors are protected and that the procedures by which the reduction of capital is carried out are formally correct.[121]

The principles upon which the court will act in the hearing of the confirmation of a reduction of capital are well established by the cases. In addition to the formal requirements, eg of a special resolution and settlement of the list of creditors (or the dispensation of the list) the company must satisfy the following four conditions if it is to obtain confirmation of the proposed reduction from the court:

(1) The shareholders must be treated equitably, eg as between shareholders of the same class;[122]

[115] For precedents see *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(5), Form 108 et seq; for notice to creditors see *Brewer* p 163. These witness statements in *Atkin* will need adaptation to affidavit/affirmation form. Prior to the abolition of nominal value (see para 2.002 above), it was usual for the company to offer an undertaking that any bad debts recovered would be paid into a share premium account. Under the CO, the equivalent undertaking is not to treat debts recovered as realized profits distributable as dividends until all the creditors have been paid; see also *Re CNT Security Group Ltd* [2014] 4 HKLRD 659.

[116] CO, s.226(2).

[117] CO, ss.226(3) and 226(4). The above protection of creditors measures strictly only apply to the two instances of reduction referred to in CO s.226(2); see also *Re Meux's Brewery Co Ltd* [1919] 1 Ch 28 at p 36.

[118] For case management summons, see Rules of the High Court (Cap.4A) ("RHC"), O 5 and Practice Direction 5.2.

[119] See e.g. *Re Hong Kong Construction (Holdings) Ltd* [2007] 1 HKLRD 190 at para 24; see also *Re Lai Sun Development Co Ltd* [2006] 4 HKLRD 573. For advertisements see *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(5), Forms 122 and 123; *Palmer,* Forms 527 and 528.

[120] CO, s.229(1). For orders see *Atkin's Court Forms*, n 119 above, and Form 124; see also *Palmer,* Form 529.

[121] *Scottish Insurance Corp Ltd v Wilson & Clyde Coal Co Ltd* [1949] AC 462 at 486 (HL). For the penalty for concealing the name of a creditor, see CO, s.226.

[122] See *Re Fortune Dragon Motors Ltd* (unrep., HCMP 1219/2002, 3 September 2002, [2002] HKEC 1156).

(2) The shareholders must have had the proposal properly explained to them, so that they can exercise an informed judgment when voting at the general meeting on the resolution for the reduction;

(3) The interests of the creditors must be safe guarded; and

(4) The reduction must be for a discernible purpose.[123]

Creditors' interests are protected either by their consent to the reduction[124] or an appropriate undertaking by the company[125] or a bank guarantee[126] or the creation of a special capital reserve.[127] An undertaking known as a *Grosvenor Press*[128] undertaking is particularly appropriate where the losses are not permanent in nature, i.e. there is some prospect of recovery and is to the effect that any subsequent recoveries will be paid into a special capital reserve.[129] A similar form of undertaking, to credit an amount equal to the credit arising from the cancellation, is given where it is proposed to write off goodwill.[130]

Whether losses are permanent or not is for the court to decide.[131]

The purpose of the reduction must not be to circumvent any statutory provision, e.g. the provisions governing the issue of shares at a discount.[132]

Purchase of own shares[133] is an alternative to a reduction.[134]

Registration of Order and Minute of Reduction

2.028 Where the reduction is by special resolution and application to the court for the confirmation of the court, the order of the court confirming the reduction and a copy thereof together with a copy of the minute approved by the court showing with respect to the share capital of the company, as altered by the court, the amount of the share capital, the number of issued shares, the amount of each share and the amount, if any, deemed

[123] See *Re South China Strategic Ltd* [1997] HKLRD 131; see also *Re Lippo China Resources Ltd* [1998] 1 HKLRD 20; *Re Tian An China Investments Ltd* [1998] 2 HKLRD 474; *Re Cheuk Nang Technologies (Holdings) Ltd* [2001] 4 HKC 571; *Re China Strategic Holdings Ltd* [2006] 4 HKLRD 273; *Re Lai Sun Development Co Ltd* [2006] 4 HKLRD 573; *Re Fok Ying Tung Ming Yuan Development Ltd* [2016] 2 HKLRD 292.

[124] For form of consent, see *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(5), Form 116. Not only should the creditors consent, but they should also indicate their willingness to postpone their claims to those of non-consenting creditors. See also *Re South China Strategic Ltd* [1996] 4 HKC 182 at 186 (where the company had offered to provide a guarantee to cover the non-consenting creditors); *Re Capital Asia Ltd* [1999] 2 HKC 854 (unrep., HCMP 5475/1998, 22 January 1999).

[125] For a precedent of undertaking see *Atkin's Court Forms* (2nd edn, 2010 Issue) vol 8(5), Form 109; and see note 115, above.

[126] See *Atkin's Court Forms*, Form 114.

[127] See the form of undertaking set out in a Schedule to the report of the *Re Poly Investments Holdings Ltd* [2007] 2 HKLRD 10; see also the scheduled undertaking in *Re Worldco International Ltd* (unrep., HCMP 382/2007, 17 September 2007, [2007] HKEC 1710).

[128] *Re Grosvenor Press plc* [1985] 1 WLR 980.

[129] See *Re Mizuno Corp of Hong Kong Ltd* [2007] HKEC 2274 (unrep., HCMP 2108/ 2007, 14 December 2007).

[130] See *Re Lippo China Resources Ltd* [1998] 1 HKLRD 20.

[131] See *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 WLR 975; see also *Re Capital Asia Ltd*, above.

[132] *Re Tian An China Investments Co Ltd* [1998] 2 HKLRD 474.

[133] See para 2.031 below.

[134] If the company has capital in excess of its requirements, a repurchase is simpler than a reduction.

to be paid up on each share[135] must be produced to the Registrar of Companies and the Registrar must register the order and minute.[136]

The resolution to reduce the capital takes effect on the registration of the order and minute.[137] Notice of the registration must be published in such manner as the court may direct.[138] The Registrar of Companies must issue a certificate certifying the registration of the order and minute and the certificate will be conclusive evidence that all the statutory requirements with respect to the reduction have been complied with.[139]

V. MAINTENANCE OF CAPITAL

Introduction

2.029 In order to protect creditors the courts developed the capital maintenance doctrine, i.e. that the capital of a company should be applied only for the purposes of the business and should not be returned to the shareholders.[140]

The courts also recognised that the company's capital might be diminished or lost in the course of the company's trading,[141] so that there was no guarantee that the capital fund would still be there when the creditors tried to resort to it. Despite that, the courts developed rules to protect the capital. It has already been shown that on the issue of shares there were rules to ensure that the full value of the shares was obtained[142] and the restriction on the reduction of capital,[143] and the next sections will cover the special rules (so far as they still exist) preventing a return of capital to shareholders in relation to redemption of redeemable shares, repurchase of shares, financial assistance for purchase of the company's own shares and payment of dividends out of distributable profits.

In addition, some general rules may prevent the repayment of capital. For example, directors' remuneration may be paid out of capital, if there are no profits.[144] But excessive remuneration (not uncommon in small family companies) may be treated by the court as a repayment of capital.[145] There is also a general rule that gifts can only be

[135] The court may require additional matters to be mentioned in the minute, see *Re Harrods (Buenos Aires) Ltd* [1936] 2 All ER 165; see also *Re Paringa Mining and Exploration Co Ltd* [1957] 3 All ER 424. For precedents of Minutes see *Brewer* p 168; *Palmer's Company Precedents* (17th edn) Part I, Forms 532–540.

[136] CO, s.230(1). The order and minute cannot be produced to the Registrar until the minute is completed, see *Re Hong Kong Construction (Holdings) Ltd* [2007] 1 HKLRD 190 paras 30 and 31, where the company through its leading counsel undertook to file an affidavit as to the exact number of shares when that had been determined. For consultation with the Registrar as to the terms of the order and minute, see *Re BOCI Research Ltd* [2000] 1 HKLRD 194; see also *Re Henderson Investment Ltd* (unrep., HCMP 917/2007, 5 June 2007, [2007] HKEC 1025).

[137] CO, s.230(4).

[138] CO, s.230(5).

[139] CO, s.231. So anyone wishing to challenge the resolution to reduce the capital or raise any irregularity in the procedure must do so before the Registrar's certificate is issued. For the liability of members in respect of reduced shares; see CO, s.232(2). For offence if share capital reduced in contravention of Division 3 of Part 5 of the CO, liability of members following reduction of share capital and treatment of reserves arising from reduction of share capital, see note 101 above.

[140] *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519 at 533; see also *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 at 133 (HL).

[141] *Trevor v Whitworth* (1887)12 App Cas 409 at 423–424 (HL).

[142] See para 2.008 above.

[143] See para 2.018 et seq above.

[144] See *Re Lundy Granite Co Ltd* (1872) 26 LT 673.

[145] *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016; *MacPherson v European Strategic Bureau Ltd* [2000] 2 BCLC 683 (CA Eng).

made by a company out of distributable profits or in furtherance of its objects. They cannot be made out of capital or out of money borrowed by the company and, if so made, the money must be returned.[146]

Attitudes have changed over the years and a more realistic view taken of the protection, or rather lack of it, that the maintenance of capital doctrine, as expounded at common law, provided to creditors. Legislation now permits the return of capital subject to specified conditions. These provisions tend to be complicated. The recent trend overseas has been to replace these conditions by a solvency test, i.e. capital may be returned, so long as the company is solvent and can meet the claims against it. Hong Kong has gone in this direction in the current Companies Ordinance.

Redemption of Shares

The companies legislation has permitted redeemable preference shares since 1 July 1933.[147] The issue of redeemable preference shares is a useful source of fundraising by private companies where the family or other founder members do not wish to lose long-term control of the company. Such shares can be issued in the knowledge that, if the company is profitable, sooner or later the shares can be redeemed. 2.030

The power to issue redeemable shares was extended beyond preference shares to any type of shares.[148] The current legislation provides that subject to the relevant provisions of the CO[149] a company limited by shares[150] may, if not prohibited to do or restricted in so doing by its articles,[151] issue shares which are to be redeemed or are liable to be redeemed at the option of the company or the shareholder.[152] Note that the shares may be redeemed by either the company or the holder of the shares.

No redeemable shares may be issued at a time when there are no issued shares of the company which are not redeemable.[153] Redeemable shares may not be redeemed unless they are fully paid;[154] and the terms of redemption must provide for payment on redemption.[155]

[146] See *Re Newman (George) & Co* [1895] 1 Ch 674 (CA Eng).

[147] The English Companies Act 1929 s.46 was the source of the original Hong Kong provision, i.e. s.49 of the current CO. That was the first statutory breach in the capital maintenance doctrine. Before that the English Companies Act 1908 s.40 authorised a company by special resolution to return accumulated profits to its shareholders in reduction of capital paid up on their shares. That was a statutory recognition of another Common Law rule, linked to capital maintenance, that dividends could only be paid out of profits; see *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 ChD 519 (CA Eng); and para 2.034.

[148] See Companies (Amendment) Ordinance 1991.

[149] That is, CO, s.233 et seq.

[150] And a company limited by guarantee and having a share capital incorporated before 13 February 2004, see CO s.233(b) and n 78 above.

[151] See CO, s.234(2). See the Companies (Model Articles) Notice (Cap.622H) Sch 1 art 89 and Sch 2 art 71, for articles permitting buy-backs (including redeemable shares). For an example of resolution to authorize issue of redeemable shares see *The Encyclopaedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Form 241.

[152] CO, s.234(1). For payment for redemption and solvency statement for payment out of capital with special resolution and solvency statement see Part 5 Div 4 Subdiv 6 of the CO.

[153] CO, s.234(3). There must be some non-redeemable, ie ordinary shares, issued before redeemable shares can be issued. Subscriber founder member shares are inevitably non-redeemable.

[154] CO, s.268.

[155] CO, s.268(1). On terms of redemption see CO, s.235(3). The terms of redemption should make it clear whether or not payment in full upon redemption is required, see *Peña v Dale* [2004] 2 BCLC 508.

Shares may only be redeemed out of distributable profits[156] of the company or the proceeds of a fresh issue of shares made for the purpose of redemption or subject to satisfaction of the solvency test, out of capital.[157]

Shares which have been redeemed are treated as cancelled[158] and on redemption a company must: (a) reduce the amount of its share capital if the shares were redeemed or bought back out of capital; (b) reduce the amount of its profits if the shares were redeemed or bought back out of profits; or (c) reduce the amount of its share capital and profits proportionately if the shares were redeemed or bought back out of both capital and profits, by the total amount of the price paid by the company for the shares.[159]

Redemption is triggered by notice to redeem.[160]

Where a company passes a special resolution approving any payment out of capital for the redemption of its shares any member of the company who had not consented to or voted in favour of the resolution and any creditor of the company may within 5 weeks of the passing of the resolution apply to the court for cancellation of the resolution.[161]

Purchase of Own Shares –Share Buy-backs

2.031 At Common Law, a company could not purchase its own shares.[162] The rationale for this principle was to protect creditors from a return of capital to a company's members[163] without the sanction of the court.[164] Purchase of own shares, subject to conditions, has been possible in Hong Kong since 1991, when the predecessors to the current provisions were added to the CO.[165] Section 236 of the CO now provides the general power of a company to buy back its own shares. A company's articles may prohibit or restrict a buy-back.[166] A company must not buy back its own shares if, as a result of the buy-back, there would no longer be any member of the company holding shares other than redeemable shares.[167]

[156] See para 2.033 below.

[157] CO, s.257(2). For payment out of capital a special resolution is required (CO, s.258) and the directors must make a statement of solvency under CO, s.259 in Form NSC 17; see also 2.033 below.

[158] CO, s.269(1).

[159] CO, s.269(2).

[160] For forms see *Brewer* p 176; *The Encyclopaedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Forms 242 and 243.

[161] CO, s.263. And see CO, s.265 for the powers of the court on such application.

[162] *Trevor v Whitworth* (1887) 12 App Cas 409 (HL). The prohibition of the payment of a dividend out of capital was another aspect of this principle; see also *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519 (CA Eng); and para 2.033 below.

[163] *Trevor v Whitworth* (1887) 12 App Cas 409 (HL at p 419 per Lord Herschell: "…whatever has been paid by a member cannot be returned to him".

[164] For reduction of capital with confirmation by the court see now para 2.025 *et seq*.

[165] i.e., ss.49 to 49S of the predecessor CO. Predecessor CO, s.58(1A), added in 1984, stated the general principle that, except as provided in the CO, no company limited by shares or limited by guarantee and having a share capital should purchase or subscribe for shares in the company. Section 49B of the predecessor CO referred to "purchase" only. This did not include subscription; see *Re VGM Holdings Ltd* [1942] Ch 235 (CA Eng). The replacement under the current CO for this s.58(1A), i.e. s.267(1), uses the word "acquire".

[166] CO, s.236(2). For precedent of regulation in articles of association authorising purchase of own shares see the Companies (Model Articles) Notice (Cap 622 H) Sch 1 art 61(2) (public company) and Sch 2 art 57(2) (private company).

[167] CO, s.236(3). CO, s.257 provides that as a general rule purchase of own shares must be financed out of distributable profits or the proceeds of a fresh issue of shares made for the purposes of the purchase or out of capital by special resolution and solvency statement.

Procedure for Purchase of Own Shares

2.032 The CO draws a distinction for the purposes of purchase of own shares between listed companies[168] and unlisted companies. The provisions relating to listed companies are generally more detailed than those for unlisted companies.

A listed company may purchase its own shares:

(a) under a "general offer", to all members or all members holding a particular class of shares;[169] or

(b) on the Stock Exchange of Hong Kong or other recognised stock exchange ("market purchase");[170] or

(c) in some other manner.[171]

There are provisions for the authorisation of the purchase by the company in general meeting and in the case of a purchase under method: (a) for there to be included with the notice of the meeting a copy of the document containing the proposed general offer and a statement signed by the directors (containing such particulars as would enable a reasonable person to form a valid and justifiable opinion as to the merits of the proposed offer); or, in the case of a purchase under method; (b) for there to be included with the notice of meeting of the terms the proposed purchase.

If a general offer may result in a member being compelled to dispose of his shares under CO, s.712[172] the company must, *inter alia*, appoint an independent investment adviser to advise members who may be affected by the compulsory disposal on the merits of the proposed offer.[173]

In addition to the provisions under the CO, where a listed company purchases its own shares attention must also be given to the Codes on Takeovers and Mergers and Share Buy-backs.

An unlisted company may only purchase its own shares under a contract approved in advance in accordance with the relevant provisions.[174] The terms of contract must be authorised by a special resolution before the contract is entered into.[175]

Provision is made for disclosure by the company of a purchase of its own shares. It must deliver to the Registrar of Companies for registration a return in the specified form, i.e. Form NSC 2, stating with respect to shares of each class purchased

[168] The term "listed company" is defined in CO, s.2(1) to mean a company which has any of its shares listed on a reconised stock market (as defined in s.1 of Part 1 of Schedule 1 to the SFO as a stock market operated by a recognised exchange company). A recognised exchange company means a company recognised as an exchange company under s.19(2) of the SFO.

[169] CO, s.238. For "general offer" see ss.238(6) and 270. For precedents of resolutions of general meeting authorising purchase see *Brewer* p 170; *The Encyclopaedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Form 245.

[170] CO, s.239.

[171] CO, s.240, where the contract for the buy-back is authorized in advance by special resolution. A contract may take the form of a contingent buy-back contract.

[172] Under the CO.

[173] CO, ss.238(3)(a) and 238(4).

[174] CO, ss.244 to 256.

[175] CO, ss.244 and 245. For authority (of both listed and unlisted companies) to enter into a contingent purchase contract, see CO, ss.240 and 244. For form of contract and other relevant precedents, see *The Encyclopaedia of Forms and Precedents* (5th edn, 2011 Reissue) vol 10(1), Forms 249 and 250. For assignment or release of company's right to purchase own shares, see CO, ss.242, 243, 250, and 251.

the number of those shares and the date on which they were delivered to the company.[176] Copies of certain approved contracts in writing or, if not in writing, a memorandum of the contract terms, must be kept in the company's registered office for inspection by members of the company and, in the case of listed companies, the public.[177]

Shares purchased under the statutory provisions are treated as cancelled[178] on buy-back and the company must: (a) reduce the amount of its share capital if the shares were redeemed or bought back out of capital; (b) reduce the amount of its profits if the shares were redeemed or bought back out of profits; or (c) reduce the amount of its share capital and profits proportionately if the shares were redeemed or bought back out of both capital and profits, by the total amount of the price paid by the company for the shares.[179]

Distribution of Profits and Assets

2.033 A company may only make a distribution out of profits available for distribution.[180] Distribution is defined to mean every description of distribution of a company's assets to its members, whether in cash or otherwise.[181] Exception is made for:

(a) an issue of shares as fully or partly paid bonus shares;

(b) a redemption or buy-back of any shares in the company out of capital (including the proceeds of any fresh issue of shares), or out of unrealised profits in accordance with the relevant provisions of the CO;[182]

(c) the reduction of share capital by extinguishing or reducing any member's liability on any of the company's shares in respect of capital not paid up, or by repaying paid up share capital;[183]

(d) a distribution of assets to the members on the company's winding up;

[176] CO, s.270(2). There are additional requirements for listed companies; see CO, s.270(2)(d). For default in delivery, see CO, s.270(4).

[177] CO, s.237. There are sanctions for non-compliance (CO, s.237(6)) and in the case of refusal of inspection the court may (but need not) compel performance (CO, s.237(7)). It appears that the right to inspect is not absolute. To seek to inspect for purposes not contemplated by the CO would amount to an abuse; see *Democratic Party v Secretary for Justice* [2007] 2 HKLRD 804.

[178] CO, s.269(1).

[179] CO, s.269(2).

[180] CO, s.297(1). Part IIA of the predecessor CO was added in 1991. Prior to that the law as to the payment of dividends and the making of other distributions was governed by the Common Law. So, for example, the original reg 117 of Table A provided that dividends could only be paid out of profits. But "profits" were not defined and some of the decided cases had been inconsistent with the basic principle. So that, for example, dividends could be paid from an unrealised capital gain on a revaluation of fixed assets (*Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353) or from current trading profits without making good losses in fixed capital (*Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1 (CA Eng)). The reg 117, as amended in 1993, current in the predecessor CO prior to its repeal by the CO, provided that no dividends should be paid otherwise than out of profits in accordance with Part IIA of the CO. The equivalent articles in the Companies (Model Articles) Notice (Cap.622H) provide that a dividend may only be paid out of the profits in accordance with Part 6 of CO: see also Sch 1 (public companies) art 91(3), Sch 2 (private companies) art 73(3) of Cap.622H.

[181] CO, s.290(1). Whether a distribution may be made is determined by reference to the company's accounts, see CO, ss.302 and 304 to 306; see also *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 (CA Eng).

[182] CO, s.233 and see paras 2.030, 2.031 and 2.032 above.

[183] See para 2.018 *et seq* above.

(e) financial assistance given by the company to a member under ss.283, 284 or 285 of the CO.[184]

Profits available for distribution are its accumulated, realized profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganisation of capital duly made.[185]

A distribution made in breach of the general prohibition is unlawful and *ultra vires*.[186] Where a member is aware of a proposed improper distribution he or she could apply to the court for an injunction to restrain the distribution pursuant to the CO s.729,[187] the fraud on the minority exception to the rule in *Foss v Harbottle*[188] and, where appropriate, possibly under CO, s.86.[189] Where a distribution is made to a member who knows or has reasonable grounds for believing that it contravenes Part 6 of the CO,[190] he or she is liable to repay it to the company or in the case of a non-cash distribution he or she is liable to pay the company a sum equal to the value of the distribution.[191]

A director who has authorised an unlawful distribution will be liable to repay the money (or equivalent money's worth for a non-monetary distribution) to the company.[192] It is not a defence that the members had approved the distribution.[193] But directors may be relieved of liability pursuant to the CO, ss.903 and 904[194] where they have exercised reasonable care in relation to the company's accounts being properly prepared.[195]

Financial Assistance Generally Prohibited

Financial assistance is usually dealt with in the context of the capital maintenance doctrine, as is done here, but the rationale for the prohibition against the provision of financial assistance is more to prevent asset stripping (or "looting" to use the US expression).[196] **2.034**

[184] CO, s.290, in definition of "distribution".

[185] CO, s.297(2). The requirement that the profit be realised reverses the decision in the *Dimbula Valley* case referred to in n 179 above. For the special case of insurance companies, see CO, s.293.

[186] See *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1986] Ch 447 (CA Eng).

[187] See Part 8 para 8.135 *et seq* of this text.

[188] See Part 8 para 8.069 of this text.

[189] See Part 8 para 8.065 of this text.

[190] *It's a Wrap (UK) Ltd v Gula* [2006] 1 BCLC 143, [2006] 2 BCLC 634 (CA Eng).

[191] CO, s.301. This is without prejudice to any other obligation on the member (but it does not apply to financial assistance in contravention of CO, s.275 or any payment made by the company in respect of the redemption or buy-back by the company of shares in itself); see also CO, s.301(5).

[192] *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 (CA Eng).

[193] See *Re Aveling Barford Ltd v Perion Ltd* [1989] BCLC 626.

[194] See Part 11 para 11.075 of this text.

[195] See *Dovey v Cory* [1901] AC 477 (HL).

[196] See Betty M. Ho, *Public Companies and their Equity Securities: Principles of Regulation under Hong Kong Law*, Kluwer Law International 1998, pp 528 *et seq*. The original legislation in the UK Companies Act 1929 s.45 was a result of recommendations of the Greene Committee (see Company Law Amendment Committee 1925–1926 Report 1927 Cmnd 2657, para 30). The Greene Committee saw the giving of financial assistance to purchase a company's own shares as offending the spirit of *Trevor v Whitworth* (1887) 12 App Cas 409 (HL), which prohibited a company from trafficking in its own shares. The Jenkins Committee (Company Law Committee) in its Report 1962 Cmnd 1749, paras 171–176 reviewed the rationale and noted that the provision of financial assistance by a company did not involve any movement of the company's share capital. The Hong Kong Companies Law Revision Committee in its Second Report 1973 commenting on CO s.48 (which was the then Hong Kong version of the original UK s.45–subsequently Companies Act 1948 s.54) referred to the abuses

For a variety of reasons then, members may be prejudiced by the conduct of the directors or the majority members. The law on members' remedies seeks to provide an avenue for members to protect their rights and interests in the company against such improper conduct. Yet while the various remedies discussed in this chapter are intended to alleviate some of the injustices that might occur under the doctrine of majority rule, there is always tension in the law in this area, as it needs to strike a balance between the interests of the majority members and that of the minority. Just as the majority might oppress the minority, so too can the minority oppress the majority if too much power is conferred on the minority under the law.

General Law Restrictions on Minority Remedies: Foss v Harbottle

Introduction

8.003 The rights of minority members to seek a remedy under the general law[5] are restricted by the rule in *Foss v Harbottle*.[6]

Proper Plaintiff Principle

8.004 Where directors have breached their duties owed to the company, or where any person has infringed any rights of the company,[7] then pursuant to the proper plaintiff principle in *Foss v Harbottle*, the right to seek a remedy against the wrongdoer resides in the company.[8] In that case, the court held that two individual shareholders did not have standing to bring an action against directors who had breached their duties owed to the company, as the proper plaintiff was the company itself. The proper plaintiff principle is generally regarded as the first limb of the rule in *Foss v Harbottle*.

Irregularity Principle

8.005 In relation to disputes between members, the doctrine of majority rule applies such that the decision of the majority in a general meeting is binding on the company. This doctrine of majority rule is reflected in what is regarded as the second limb of *Foss v Harbottle*, as explained in *Burland v Earle*,[9] namely the internal management or irregularity principle which provides that a member is not entitled to sue to complain of a mere informality or irregularity where the irregularity is one which can be cured

[5] Common law and equity.

[6] (1843) 2 Hare 461, 67 ER 189. On *Foss v Harbottle* generally, see K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 *Cambridge Law Journal* 194, (1958) 16 *Cambridge Law Journal* 93 S. M. Beck, "The Shareholders' Derivative Action" (1974) 52 *Canadian Bar Review* 159. On the historical origins of the rule, see B. S. Prunty, "The Shareholders' Derivative Suit: Note on its Derivation" (1957) 32 *New York University Law Review* 980 A. J. Boyle, "The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History" (1965) 28 *Modern Law Review* 317. For a theoretical analysis, see R. R. Drury, "The Relative Nature of a Shareholder's Right to Enforce the Company Contract" 45 (1986) *Cambridge Law Journal* 219.

[7] As to corporate rights, see para 8.011 below.

[8] *Re Chime Corp Ltd* [2004] 3 HKLRD 922 at 934 (CFA); see also *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370 at 390; *Anglo-Eastern (1985) Ltd v Knutz* [1988] 1 HKLR 322 at 326 (CA); *Tang Eng Guan v Southland Co Ltd* [1996] 2 HKLR 117 at 105 (CA); *Richcombe Investment Ltd v Tin Fung* [2001] 2 HKC 115; *Samuel Tak Lee v Chou Wen Hsien* [1984] 1 WLR 1202 (PC); *Johnson v Gore Wood and Co (a firm)* [2001] 2 WLR 72.

[9] [1902] AC 83 at 93–94 (PC); see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 210; *King Pacific International Holdings Ltd v Chun Kam Chiu* [2002] 3 HKLRD 49 at 55; *Re Hong Kong Sailing Federation* [2010] 1 HKLRD 801; *Re Dalny Estates Ltd* [2018] 1 HKLRD 409 (CA).

by a vote of the company in general meeting and where the intention of the majority members is clear.

Rationale for the Rule in Foss v Harbottle

8.006 The first limb of the rule in *Foss v Harbottle*, namely the proper plaintiff principle, follows logically from the doctrine of separate legal entity.[10] Additionally, both limbs have been justified from a policy perspective on various grounds:

(i) Firstly, the rule in *Foss v Harbottle* avoids a multiplicity of actions by a number of shareholders over the same issue[11] (though it has also been said that this problem could simply be avoided by the courts exercising its powers to consolidate proceedings).[12]

(ii) Secondly, the company is in a better position to judge whether to institute proceedings than an individual shareholder.[13]

(iii) Thirdly, where the dispute involves persons internal to the company (i.e. shareholders or directors), it might be appropriate for the company itself rather than the courts to decide, as a business or management matter, whether or not to take legal action.[14]

(iv) Fourthly, the courts should not intervene where a majority of the shareholders do not support the commencement of legal proceedings. This is the majority rule doctrine, discussed above in paragraph 8.001. Related to this idea is the perceived need to avoid excessive litigation which might otherwise arise if there is a particularly litigious or cantankerous shareholder who wishes to complain of every minor irregularity even though the majority feels that litigation is unnecessary.[15]

One Rule or Two?

8.007 The interpretation of *Foss v Harbottle* above is that it contains two rules or two limbs – namely the: (i) proper plaintiff and (ii) the irregularity principles. A different view is that the two rules are essentially one. This might be argued on the basis that the two aspects of the rule are simply manifestations of the one principle of majority rule.

The irregularity principle clearly reflects the doctrine of majority rule since the views of the majority prevent a minority from instituting action in relation to the irregularity. The proper plaintiff principle is also said to be a principle of majority rule, since where a wrong is one done to the company, the majority of the members can decide whether or not to pursue the litigation.[16] Certainly, majority rule is one of the

[10] *Foss v Harbottle* (1843) 2 Hare 461 at 490–491, 67 ER 189; see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 224.

[11] *Gray v Lewis* (1872–73) LR 8 Ch App 1035 at 1051.

[12] A. J. Boyle, *Minority Shareholders' Remedies* (Cambridge: Cambridge University Press, 2002), p 7.

[13] R. P. Austin and I. M. Ramsay, *Ford's Principles of Corporations Law* (Sydney, LexisNexis Butterworths, loose-leaf edn), para 11.240.

[14] *Shuttleworth v Cox Brothers and Co (Maidenhead) Ltd* [1927] 2 KB 9 at 22–24; see also *Carlen v Drury* (181 2) 1 Ves & B 154 at 158.

[15] *MacDougall v Gardiner* (1875–76) LR 1 Ch D 13 at 25 *per* Mellish LJ.

[16] K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 *Cambridge Law Journal* 194 at 198.

justifications given for the proper plaintiff principle. However, as discussed below,[17] if the articles confer on the board the power to authorise proceedings in the name of the company, the views of the majority members *prima facie* cannot prevail over the views of the board. Thus it would seem that the proper plaintiff principle operates independently of the doctrine of majority rule.

Another argument that there is only in essence one rule in *Foss v Harbottle* is on the grounds that the irregularity principle can be subsumed under the proper plaintiff principle. Two justifications might be given for this approach.

Firstly, it could be thought that where an irregularity has occurred (such as some procedural irregularity contravening the articles), a wrong has been occasioned to the company, so that the company is the proper plaintiff to commence proceedings. The company may decide, through a decision of a majority of the members, to ratify the wrong, with the effect that no complaint can subsequently be made over the irregularity.

However the difficulty with this approach is that it overlooks the fact that the company's constitution operates as a statutory contract between the company and its members, as well as between members *inter se*,[18] and so contraventions of the constitution infringe on the rights of members. The wrong then is not simply to the company but also directly to the members as well.

Nonetheless, it could be argued that the courts draw a distinction between provisions in the articles which confer personal rights on members and those which do not[19]–and it is the latter which come within the proper plaintiff principle.[20]

The view that there is in essence only one rule in *Foss v Harbottle*, consisting of the proper plaintiff principle, is supported by the judgments in *McDougall v Gardiner*[21] and *Edwards v Halliwell*.[22] However, other cases have suggested that the irregularity principle is a principle separate to the proper plaintiff principle, including *Browne v La Trinidad*[23] and *Prudential Assurance Co Ltd v Newman Industries Ltd*,[24] and academic commentators generally discuss the two principles on the basis that they are separate.[25] There has now been explicit acceptance by the Court of First Instance in Hong Kong that the irregularity principle is separate to the proper plaintiff principle.[26]

[17] See para 8.013 below.

[18] CO, s.86.

[19] See para 8.066 below.

[20] This approach could well be criticised as being artificial though in the sense that it is not really the company which is injured or wronged when there is some procedural irregularity that contravenes the articles: see, e.g., S. M. Beck, "The Shareholders' Derivative Action" (1974) 52 *Canadian Bar Review* 159 at 187 C. Baxter, "The Role of the Judge in Enforcing Shareholder Rights" (1983) 42 *Cambridge Law Journal* 96 at 104.

[21] (1875–76) LR 1 Ch D 13 at 22–23 *per* James LJ, at 24–25 *per* Mellish LJ, at 27 *per* Baggallay JA (Eng CA).

[22] [1950] 2 All ER 1064 at 1066 *per* Jenkins LJ (with whom Sir Raymond Evershed MR agreed) (Eng CA).

[23] (1887) 37 Ch D 1 at 10 *per* Cotton LJ, at 17 *per* Lindley LJ (Lopes LJ concurring) (Eng CA).

[24] [1982] Ch 204 at 210 (Eng CA) see also *Link Agricultural Pty Ltd v Shanahan* [1999] 1 VR 466 at 473 (CA, Victoria); *Papaioannoy v Greek Orthodox Community of Melbourne* (1978) 3 ACLR 801 at 805 (SC, Victoria).

[25] See R. R. Pennington, *Pennington's Company Law* (London: Butterworths LexisNexis, 8th edn, 2001), pp 792–793 P. L. Davies, *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 7th edn, 2003), pp 449–450 V. Joffe, *Minority Shareholders: Law, Practice and Procedure* (London: Butterworths, 2000), pp 2–3 S. M. Beck, "The Shareholders' Derivative Action" (1974) 52 *Canadian Bar Review* 159 at 165, 189 S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong: LexisNexis Butterworths, 2003), pp 1242–1247. *Cf* S. W. Mayson, D. French and C. L. Ryan, *Mason, French and Ryan on Company Law* (London: Blackstone, 22nd edn, 2005), para 18.3.1.

[26] *Re Hong Kong Sailing Federation* [2010] 1 HKLRD 801 at [50].

Whether there is one rule or two can have implications in relation to the enforcement of individual rights of members in a personal action.[27]

General Law and Statutory Minority Remedies

Introduction

8.008 Although there are difficulties posed for minority members under the rule in *Foss v Harbottle*, there are various remedies under the general law and the CO which are intended to mitigate some of the harshness of the common law rule.

Firstly, in relation to breaches of directors' duties or other wrongs committed against the company, if the proper corporate organ for making the decision to institute action against the directors declines to do so, members who wish to commence litigation in the name of the company might be able to do so through a derivative action as an exception to the rule in *Foss v Harbottle* under the general law. Uncertainties and limitations in the scope of the general law exceptions have led to the legislature enacting a statutory derivative action (now contained in CO, Part 14, Division 4) as well, discussed further at paras 8.031-8.032 below.

The common law action however has not been abrogated (CO, s.732(6)), and members can potentially choose between the statutory or common law derivative action. It should also be noted that in situations where the company's rights have been infringed, although members can only resort to the derivative action in order to remedy the company's loss, the same conduct giving rise to the company's cause of action might on the particular facts also give rise to other (personal) remedies for members.[28]

Secondly, in relation to conduct of the majority members which infringes on the personal rights of members, the members may have personal rights of action against the company or the persons engaged in the wrongdoing. Situations giving rise to a personal right of action of members under the general law are outside the scope of the proper plaintiff principle in *Foss v Harbottle* because it is not the company's right which is infringed but the member's personal right.[29] The proceedings brought by the member in these situations is a personal action of the member (as opposed to an action on behalf of the company). The precise cause of action will depend further on the source of the particular right that has been infringed. For rights conferred by the company's constitution, members might be able to seek to enforce the constitution pursuant to s.86 of the CO. Where personal rights are conferred by a separate contract between the parties (e.g. in a shareholders' agreement), then the right to sue is a contractual one derived from that agreement. The general law also recognises that members have personal rights in particular situations, and so members can enforce their rights pursuant to the general law principles (see paragraph 8.068 below).

There are also statutory remedies. Such as:

(i) The CO Part 14 Division 2 (which reproduces the predecessor CO, s.168A) allows members to seek certain personal remedies in relation to unfairly prejudicial conduct (see paragraph 8.073 below);

[27] See paras 8.066–8.067 below.

[28] See para 8.068 below in relation to personal rights under the general law, and note also statutory remedies such as CO, Pt 14, Div 2.

[29] *Edwards v Halliwell* [1950] 2 All ER 1064 at 1067.

(ii) Section 177(1)(f) of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32) ("CWUO") allows members the remedy of winding-up the company on the grounds that it is just and equitable (see paragraphs 8.128-8.129 below);

(iii) Members are also given standing to enforce compliance with requirements of the CO (see paragraph 8.135); and

(iv) Members satisfying the relevant statutory thresholds may apply to the court for an order to inspect the company's records (see paragraph 8.139).

In addition, Part 5 Division 7 of the CO (derived from ss.63A and 64 of the predecessor CO) impose restrictions on the ability of a company to alter special rights attached to shares of members (i.e. class rights), and minority shareholders have certain rights to seek the court's declaration to invalidate variations.[30]

Distinction Between Corporate Rights and Personal Rights

8.009 It should be apparent from the preceding discussion that the remedies that would be available depends firstly on whether the wrong has been done to the company or the members personally. If the personal rights of members have been infringed, then the proper plaintiff principle in *Foss v Harbottle* does not prevent the members from bringing an action in their own name.[31] The distinction between corporate rights and personal rights is also significant for various other reasons. For example, where it is the company's right which is infringed and a derivative action is brought on behalf of the company, any remedy that is obtained in the action would be for the company's benefit, with the judgment being given in favour of the company.[32] In addition, there are implications as to costs.[33] The scope of corporate rights is discussed at paragraph 8.011 below, and personal rights at paragraph 8.059 below.

II. ENFORCEMENT OF DIRECTORS' DUTIES AND CORPORATE RIGHTS

Introduction

8.010 The proper plaintiff for commencing proceedings to enforce the company's rights or to seek a remedy in relation to the company – including a breach of directors' duties owed to the company – is the company itself.[34] Where the proper organ for commencing legal proceedings in the name of the company has not done so, a member of the company can in some circumstances bring an action on behalf of the company *via* a derivative action.[35]

[30] See Part 3 of this text on Shares and Transfer of Shares.

[31] However there is still the question of whether the irregularity principle might still constrain the enforcement of personal rights of members, see paras 8.066–8.067 below.

[32] *Spokes v Grosvenor Hotel Co* [1897] 2 QB 124; see also *Maxgood International Ltd v Hyran Holdings Ltd* (unrep., HCCL 286/1998, [2000] HKEC 1354), as per Stone J: action was not a derivative action in circumstances where the remedies sought were personal remedies for the plaintiff shareholder and not remedies for the company.

[33] See paras 8.030 and 8.049 below.

[34] See para 8.004 above.

[35] See para 8.014 below.

Corporate Rights

The situations that involve infringements of the company's rights can be grouped into various categories: **8.011**

(i) The first is in relation to the duties of directors (including fiduciary duties) which are owed to the company.[36] A breach of such duties gives the company a right of action;[37]

(ii) A second situation is where members engage in conduct that infringes on the company's rights. This includes misappropriation of the company's assets, such as a decision of the majority in a general meeting to give or sell to themselves at an undervalue the assets of the company;[38]

(iii) A third situation involving infringement of the company's rights is where a third party commits a wrong against the company giving the company a cause of action, such as breach of a contract entered into with the company, or a misrepresentation made to the directors of the company who were acting in their capacity as directors;[39] and

(iv) Finally, there is a fourth category relating to infringements of the company's articles by members. It is well established that the company has a right to enforce the company's constitution against members as a statutory contract.[40]

In some situations, the same conduct amounting to an infringement of the company's rights could also amount to an infringement of the rights of members.

Enforcement of Directors' Duties

Where directors breach their duties to the company, then primarily it is for the company[41] itself to take civil proceedings[42] against the directors. Apart from the company's right to pursue the directors under the general law, there may be other consequences of directors' breach of duties. For instance, conduct involving breaches of duties might be grounds for the seeking of a disqualification order against the director under Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32) ("CWUO"), Part IVA. Pursuant to the CWUO, s.168P, applications for a disqualification order under s.168F (breaches of the CWUO or CO) may be made by the Companies Registrar, and applications for disqualification orders under the other provisions (CWUO, ss.168E to 168G) may be made by the Official Receiver, the Financial Secretary, a provisional **8.012**

[36] *Percival v Wright* [1902] 2 Ch D 421; see also *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd* [1983] 3 WLR 492.

[37] See *Re Chime Corp Ltd* [2004] 3 HKLRD 922 at 937.

[38] See *Menier v Hooper's Telegragh Works* (1874) LR 9 Ch App 350 at 350; see also *Cook v Deeks* [1916] 1 AC 554; *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 445.

[39] *Ellis v Property Leeds (UK) Ltd* [2002] EWCA Civ 32 (Eng CA).

[40] CO, s.86; see also *Hickman v Kent or Romney Marsh Sheep-Breeder's Association* [1915] 1 Ch 881.

[41] The position in Hong Kong can be contrasted with, for example, the position in Australia, where the corporations regulator (Australian Securities and Investments Commission) has powers to seek civil penalty orders and declarations in relation to breaches of fiduciary duties: see Corporations Act 2001 (Aust) Part 9.4B.

[42] The mere breach of a fiduciary duty does not lead to criminal liability. This can be contrasted, for example, with criminal provisions for reckless or dishonest breaches of certain fiduciary duties in Australia, see Corporations Act 2001 (Aust) s.184.

liquidator or liquidator of the company, or any past or present member or creditor of the company. In the case of listed companies, the Securities and Futures Commission also has a right to seek disqualification orders under Securities and Futures Ordinance (Cap.571), s.214. Where the director's breach of duty involves the commission of a criminal offence (such as fraud or theft), then there may be investigations and prosecutions brought by the Commercial Crime Bureau of the Hong Kong police, the Independent Commission Against Corruption, or the Department of Justice.

Proper Corporate Organ for Commencing Litigation

8.013 Where the company is the proper plaintiff to enforce the company's rights, the question arises as to who is entitled to take action in the name of the company. This will depend on the articles of association, and the courts have accepted that the conferral of general management powers on a corporate organ (usually the board) means that the particular organ also has powers to institute legal proceedings for the company.[43]

Irrespective of whether the articles vest management powers exclusively in the board, there is a suggestion that there is a special principle in relation to commencement of litigation whereby the general meeting has a concurrent power to institute legal proceedings.[44] Under this principle, even if the articles do not allow the general meeting to override a decision of the board to bring proceedings,[45] the general meeting still has power to pass an ordinary resolution to institute proceedings if the board has not done so. This view is supported by a number of early English cases,[46] including the English Court of Appeal decisions in *Harben v Phillips*[47] and *MacDougall v Gardiner*,[48] where it had been accepted that the general meeting could always authorise proceedings in the company's name. Neville J's decision in *Marshall's Valve Gear Company Ltd v Manning Wardle & Co Ltd*[49] might also be understood on the basis of such a rule allowing the general meeting to commence proceedings in the name of the company,[50] and in addition there are some *obiter* comments of the House of Lords

[43] *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* [1989] BCLC 100; see also *Mitchell & Hobbs (UK) Ltd v Mill* [1996] 2 BCLC 102; *Broadview Commodities Pte Ltd v Broadview Financial Ltd* [1983] HKLR 384. As to whether the management powers of the board are subject to the directions of the general meeting under articles in the form of Table A, art.82 of the predecessor CO (prior to the amendments in 2004); see also *Automatic Self-Cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34; *Marshall's Valve Gear Co Ltd v Manning Wardle & Co Ltd* [1909] 1 Ch 627; *Salmon v Quinn and Axtens Ltd* [1909] 1 Ch 311; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; and *Tang Kam Yip v Yau Kung School* [1986] HKLR 448.

[44] See K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 *Cambridge Law Journal* 194 at pp 201–202 R. R. Pennington, *Company Law* (London, Butterworths, 8th edn, 2001), p 793; P. L. Davies, *Gower and Davies' Principles of Modern Company Law* (London, Sweet and Maxwell, 8th edn, 2008), para 17–3.

[45] *John Shaw and Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 (Eng CA).

[46] *Mozley v Alston* (1847) 1 Ph 789; *Exeter and Crediton Railway Company v Buller* (1847) 16 LJ Ch 449 at 452; *Pender v Lushington* (1877) 6 Ch D 70 at 79.

[47] (1883) LR 23 D 14.

[48] (1875) LR 1 Ch D 13 at 22.

[49] [1909] 1 Ch 267.

[50] Neville J had held that the general meeting could commence proceedings in the name of the company, however, the decision appears to be on the basis of the wider principle that the management powers of the board are subject to direction by the general meeting via ordinary resolution under articles similar to the former version of Table A art.82 of the predecessor CO (prior to those 2004 amendments to the predecessor CO). Whether that wider principle is correct is the subject of debate. However, even if the wider principle in *Marshall's Valve Gear* is wrong, it might be argued that the outcome in the case can be supported on the narrower basis of the particular rule allowing the general meeting to institute proceedings.

in support of this position in *Alexander Ward & Co Ltd v Samyang Navigation Co Ltd*.[51] More recently though, Harman J in *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd*[52] rejected this principle. Australian cases have also held that where the articles confer general management powers exclusively on the board, there is no room for allowing the general meeting a concurrent power to commence proceedings.[53]

As a matter of principle, if the board does possess exclusive management powers pursuant to the articles, it is not entirely clear why an exception should be made in relation to the decision to institute legal proceedings compared with other matters of management.[54] One basis for a concurrent power of the general meeting to commence litigation might be the rule in *Foss v Harbottle* itself. It has been said that an important assumption behind *Foss v Harbottle*, derived from the majority rule doctrine, is that majority shareholders can decide to commence proceedings,[55] and that rejection of the view that the general meeting can bring an action in the company's name would lead the rule in *Foss v Harbottle* to: "…utter destruction by this sidewind".[56]

However it is arguably incorrect to say that *Foss v Harbottle* would have no operation if that assumption was rejected. There is no inconsistency between the proper plaintiff principle and a principle allowing only the board to commence litigation in the name of the company. Moreover the doctrine of majority rule would still have effect, since even if the majority cannot commence proceedings in the company's name, the majority could replace the recalcitrant directors from office with new directors who are willing to commence litigation.[57]

Whether or not the general meeting has a special power to commence litigation, the general meeting has residual powers of management where the board is unable to act, for example due to deadlock in the board or where it is not possible for the board to form a quorum.[58] This principle has been adopted in relation to commencement of proceedings. In *Alexander Ward and Co Ltd v Samyang Navigation Co Ltd*,[59] two individuals had commenced proceedings purportedly for the company at a time when there were no appointed directors and where no general meetings had been held. The House of Lords held that although the proceedings were not properly commenced in the name of the company, it was possible for the liquidator of the company to subsequently ratify the decision to commence proceedings. The argument that the liquidator could not ratify due to the company not having the capacity to commence the proceedings in the first place (when there were no directors and no general meeting held)

[51] [1975] 1 WLR 673 at 679.

[52] [1989] BCLC 100 at 104.

[53] *Kraus v J G Lloyd Pty Ltd* [1965] VR 232 *Massey v Wales* (2003) 57 NSWLR 718.

[54] See D. L. Larson, "Control of Corporate Litigation in the Light of the Doctrine of Constitutional Contract and *Bamford v Bamford*" (1970) 5 *University of British Columbia Law Review* 363 at 367–368. Ford, Austin and Ramsay also reject the view that the general meeting has a concurrent power to institute legal proceedings: see R. P. Austin, I. M. Ramsay, *Ford's Principles of Corporations Law* (Sydney: LexisNexis Butterworths, looseleaf edn), para 7.140.

[55] See K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 *Cambridge Law Journal* 194 at pp 201–202.

[56] K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 *Cambridge Law Journal* 194 at p 202.

[57] On the power of the general meeting to remove directors from office, see CO, s.462.

[58] *Barron v Potter* [1914] 1 Ch 895.

[59] [1975] 1 WLR 673.

was rejected, on the basis that the company *was* competent to commence proceedings either:

> "…by appointing directors or … by authorising proceedings in general meeting which, in the absence of an effective board, has a residual authority to use the company's powers".[60]

This approach was applied in *Miracle Chance Ltd v Ho Yuk Wah David*[61] where the Hong Kong Court of Appeal held that, in circumstances where one of the two directors refused to attend board meetings such that there was insufficient quorum, the majority shareholder could authorise proceedings in the company's name through a general meeting resolution. By contrast, a narrower approach has been adopted in Australia, with the New South Wales Court of Appeal holding that although the general meeting has residual powers where the board is unable or unwilling to act, that power is not engaged where a deadlock can be resolved by the general meeting exercising power to appoint additional directors.[62] On this view then, the general meeting could not commence proceedings for the company if the members could appoint new directors to enable the board to act.

Under the Model Articles (as set out in the Companies (Model Articles) Notice (Cap.622H)), the members in general meeting have a power to give directions to the board by passing a special resolution. (Sched.2, art.4 (private companies) and Sched.1, art.3 (public companies) of this Cap.622H). For companies which adopt these Model Articles, the general meeting would accordingly have a power to require the board to commence legal proceedings in the name of the company. These provisions in the Cap.622H Model Articles are derived from the version of Table A, art.82 of the predecessor CO that was introduced in 2004.

III. DERIVATIVE ACTIONS

8.014 Where the proper organ for commencing legal proceedings in the name of the company has not done so, a member of the company can in some circumstances bring[63] an action on behalf of the company, ie a derivative action. Derivative actions are possible under the common law by way of exceptions to the proper plaintiff principle in *Foss v Harbottle*. Members may also seek leave from the court to bring a statutory derivative action on behalf of the company pursuant to CO, Part 14 Division 4. Despite the introduction of the statutory action, the right to bring a derivative action under the common law is preserved.[64]

Prima facie, the question of whether a member of a company incorporated outside of Hong Kong can bring a derivative action in Hong Kong on behalf of the company depends on the law of the place of incorporation.[65] However, pursuant to the provisions in CO, Part 14 Division 4, a statutory derivative action can be brought in Hong Kong on behalf of a non-Hong Kong company.[66]

[60] [1975] 2 All ER 424 at 428–429.

[61] [1999] 3 HKC 811. See also *Cheung Tse Ming v Cheung Yuk May* (unrep, HCA 9995/1995, [1996] HKLY 199), Rogers J.

[62] *Massey v Wales* (2003) 57 NSWLR 718.

[63] The District Court has also accepted that under the common law a member could intervene in proceedings to defend an action on behalf of the company, though there does not appear to be any precedent on the point: *Myers Management Consulting v Topmix (International) Co Ltd* [2015] 4 HKC 422.

[64] CO, s.732(6).

IV. COMMON LAW DERIVATIVE ACTION

Grounds for a Derivative Action

8.015 The bringing of a derivative action by a member in relation to a wrong done to the company is allowed under the common law pursuant to the exceptions to the proper plaintiff principle in *Foss v Harbottle*. The judgment of Jenkins LJ in *Edwards v Halliwell*[67] is often cited as setting out the exceptions:

(i) *ultra vires* or illegal conduct

(ii) where the general meeting decides via an ordinary resolution in situations where a special majority is required;

(iii) where members have a personal right of action; and

(iv) fraud on the company.

In categories (i) and (ii) above, members have a personal right of action to restrain the impugned conduct. Thus in that respect, the situations in those categories, along with other situations of personal rights in category (iii), do not come within the proper plaintiff principle of *Foss v Harbottle*, and so are not actually exceptions to the principle. In those cases, members can bring a personal action in their own name rather than a derivative action to restrain the conduct.[68] However, where members wish to seek compensation or recovery of property for the company resulting from some *ultra vires* or illegal or unlawful act, then the proper action is via a derivative action on behalf of the company.[69] Such a situation, and the situations of fraud on the company[70] in category (iv) are true exceptions to the proper plaintiff principle where a member could seek a remedy (for the company) only *via* a derivative action. There are also suggestions from Jenkins LJ's judgment that there is a further exception to the proper plaintiff principle where a derivative action would be allowed in any other case where that would be in the interests of the justice. There are uncertainties though as to whether this exception actually exists under the common law.[71]

Ultra Vires or Illegal Conduct

8.016 Conduct is regarded as being *ultra vires* a company, firstly in a narrow sense, in that the conduct is beyond the capacity of the company,[72] and secondly, in a wider sense

[65] *East Asia Satellite Television (Holdings) Ltd v New Cotai LLC* [2011] 3 HKLRD 734 *Wong Ming Bun v Wang Ming Fan* [2014] 1 HKLRD 1108.

[66] CO, s.722.

[67] [1950] 2 All ER 1064 at 1067.

[68] See para 8.059 below as to the scope of members' personal rights.

[69] See paras 8.015-8.016 below.

[70] See para 8.017 below.

[71] See para 8.020 below.

[72] The common law *ultra vires* doctrine in this narrower sense has been abolished, as companies now have full capacity as that of a natural person see CO, ss.115, 116.

of being illegal or unlawful, being in contravention of the companies' legislation or general law. Examples of the latter include an unlawful payment of dividends or other unlawful return of capital,[73] or unlawful financial assistance for the acquisition of the company's shares.[74] An individual member has a personal right of action to restrain a company from engaging in *ultra vires* conduct,[75] but where the remedy sought is to rescind the impugned transaction or to seek compensation or recovery of property that the company has lost as a result of the unlawful transaction, the action must be an action in the name of the company.[76] Where the proper organ for commencing the action in the name of the company does not do so, a member would *prima facie* have a right to bring a derivative action on behalf of the company to seek a remedy for the company (and it is not necessary to establish that the wrongdoers are in control of the company – which is required in the fraud on the company exception to the proper plaintiff principle).[77] However the court may decline to allow the member to bring the derivative action if a majority of independent members chooses not to have the company proceed.[78]

Fraud on the Company

8.017 It is well established that where wrongdoers commit a fraud on the company[79] and are in control of the general meeting, then a minority member can bring a derivative action as an exception to the proper plaintiff principle in *Foss v Harbottle*.[80] The courts adopted this principle to ensure that the wrongdoers could not prevent the company from bringing proceedings against themselves in circumstances where no remedy would be available if individual members were unable to bring an action.[81] Both elements of fraud and control need to be established in order to rely on the fraud on the company exception.

Fraud

8.018 The concept of fraud under the fraud on the company doctrine is equitable fraud, being based on the equitable notion of fraud on a power.[82] This concept of fraud is wider

[73] CO, s.212; see also *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474; *Devlin v Slough Estates Ltd* [1983] BCLC 497 at 503.

[74] CO, s.275; see also *Smith v Croft (No 2)* [1987] 3 WLR 405.

[75] See para 8.068 below.

[76] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474 at 479; *Smith v Croft (No 2)* [1987] 3 WLR 405; *Nankivell v Benjamin* (1892) 18 VLR 543; *Hawkesbury Development Co Ltd v Landmark Finance Pty Ltd* (1969) 92 WN (NSW) 199.

[77] *Smith v Croft (No 2)* [1987] 3 WLR 405 at 177.

[78] *Smith v Croft (No 2)* [1987] 3 WLR 405.

[79] The doctrine is sometimes referred to as "fraud on the minority". However, where a derivative action is brought as an exception to the proper plaintiff principle, then the action is in relation to a wrong to the company, and strictly speaking the fraud has been perpetrated on the company. Accordingly, the term "fraud on a company" should be used in relation to situations coming within the fraud exception to the proper plaintiff principle: see K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle* (continued)" (1958) 16 *Cambridge Law Journal* 93 at 93–94. The phrase "fraud on the minority" should be used for situations where the majority members commit a wrong that infringes on the personal rights of minority members: see para 8.069 below.

[80] *Burland v Earle* [1902] AC 83 at 93 (HL); see also *Edwards v Halliwell* [1950] 2 All ER 1064 at 1067.

[81] See *Foss v Harbottle* (1843) 2 Hare 461 at 490, 67 ER 189; see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 211.

[82] *Anglo-Eastern (1985) Ltd v Knutz* [1988] 1 HKLR 322; see also *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 12.

than common law fraud (which requires dishonest or deceitful conduct), and in general covers conduct where a power has been exercised for a purpose beyond the scope of or not justified by the instrument creating the power.[83] This includes breaches of fiduciary duties by directors,[84] such as: (i) diverting business opportunities for the directors' own benefit (corporate opportunity doctrine) [85](iii) obtaining secret profits and commissions[86] or otherwise obtaining a profit by reason of their position as directors or by reason of an opportunity or knowledge arising from such position;[87] (iii) transacting with the company in breach of the rule against conflict of interest;[88] and (iv) misappropriation of company property.[89] Conduct involving breaches of fiduciary duty can come within the notion of equitable fraud even though the directors have acted in good faith.[90]

In *Alexander v Automatic Telephone Co*,[91] the directors caused the company to issue shares to themselves without the need for them to make payments on the shares while other allottees of shares were required to pay. The court held that the conduct came within the notion of fraud so as to ground a derivative action even though the directors were acting "in the belief that they were doing nothing wrong".[92]

Where directors have breached their duty to act with care, skill and diligence, their negligent conduct will not of itself amount to equitable fraud.[93] However, where the directors have benefited from their own negligence, then the conduct will come within the doctrine of fraud on the company.

In *Daniels v Daniels*,[94] a derivative action was allowed in circumstances where the directors negligently caused the company to sell land belonging to the company to one of the directors at a gross undervalue and where the director profited from a resale of the land. Templeman J stated that:

> "...the broad principle that a derivative action on the basis of fraud on the company could be available where directors use their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company".[95]

[83] *Vatcher v Paull* [1915] AC 372 at 378 (HL); see also *Shears v Chisolm* (1992) 9 ACSR 691 at 790 (concept of fraud on a power includes "an exercise of power for an ulterior purpose, an exercise of power otherwise than for the purposes for which the power was conferred, [and] an exercise of power otherwise than *bona fide* in the interests of the company as a whole").

[84] *Kim Sie Joong v Ng Cheuk Ngon* (unrep, HCA 552/2002, [2002] HKEC 1056); see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 316 *per* Vinelott J. Note that Vinelott J's judgment was reversed in part on appeal (see [1982] Ch 204), but the appeal court did not deal with Vinelott J's analysis of the fraud on the company exception to *Foss v Harbottle*. See also *King Pacific International Holdings Ltd v Chun Kam Chiu* [2002] 3 HKLRD 49 at 55–56 *Liu Hsiao Cheng v Wong Shu Wai* [2015] 4 HKLRD 766 at 773.

[85] *Cook v Deeks* [1916] 1 AC 554; see also *Kim Sie Joong v Ng Cheuk Ngon* (unrep, HCA 552/2002, [2002] HKEC 1056).

[86] *Anglo-Eastern (1985) Ltd v Knutz* [1988] 1 HKLR 322.

[87] *Ronald Li-Kai Chu v Deacon Te-Ken Chiu* [1986] HKLR 1011.

[88] *Atwool v Merryweather* (1867) LR 5 Eq 464; see also *Mason v Harris* (1879) LR 11 Ch D 97.

[89] *Spokes v Grosvenor Hotel Co* [1897] 2 QB 124.

[90] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 316 *per* Vinelott J.

[91] [1900] 2 Ch 56 (Eng CA).

[92] [1900] 2 Ch 56 at 65.

[93] *Pavlides v Jensen* [1956] Ch 565.

[94] [1978] Ch 406.

[95] [1978] Ch 406 at 413; see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 316 *per* Vinelott J; *Anglo-Eastern (1985) Ltd v Knutz* [1988] 1 HKLR 322 (CA); *Kim Sie Joong v Ng Cheuk Ngon* (unrep., HCA 552/2002, [2002] HKEC 1056).

The English Court of Appeal has held that, except for cases of actual fraud in the sense of there being deliberate and dishonest breaches of duty, the *fraud exception* to the proper plaintiff rule only applies if: (i) the wrongdoing has caused loss to the company and (ii) the wrongdoer has personally benefitted from the breaches of duty.[96]

The position under the common law in Hong Kong is not settled. In *Liu Hsiao Cheng v Wong Shu Wai*,[97] an application was made to strike out the action on the basis that there was no plea that the wrongdoer has received some personal benefit by reason of the acts complained of. The Court of First Instance declined to strike out the claim, accepting that it remained arguable in Hong Kong that the requirement for personal benefit to the wrongdoer is confined to cases of negligence such as in *Daniels v Daniels*, above.

Conduct within the notion of fraud includes not only conduct of the directors, but conduct of the majority members which amounts to a wrong to the company. Thus derivative actions have been allowed where the majority shareholders have passed a resolution effectively misappropriating the company's assets to themselves[98] and where they have passed a resolution directing the company to discontinue legal proceedings brought against the controlling shareholder for breach of a contract made with the company.[99]

Control

8.019 The second element that needs to be established under the *fraud exception* to the proper plaintiff principle is control of the company by the wrongdoers.[100] The element of control is often stated to be control of voting power in the general meeting.[101] This might generally be the case. However, the critical issue in relation to control must be whether the wrongdoers control either or both the board and the general meeting so as to prevent the company from bringing the action (since the mischief to which the

[96] *Harris v Microfusion 2003–2 LLP* [2017] 1 BCLC 305, approving *Abouraya v Sigmund* [2014] EWHC 277 (Ch).

[97] [2015] 4 HKLRD 766.

[98] *Menier v Hooper's Telegraph Works* (1873–74) LR 9 Ch App 350.

[99] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

[100] The view that control is a necessary ingredient for the fraud on the company exception is generally accepted today (see the cases cited in this section and see also, e.g., I. J. Dawson and I. S. Stephenson, *The Protection of Minority Shareholders* (Croydon: Tolley, 1993), pp 42–46 E. J. Boros, *Minority Shareholders' Remedies* (Oxford: Clarendon Press, 1995), pp 192–193 V. Joffe, *Minority Shareholders: Law, Practice and Procedure* (London: Butterworths, 2000), p 14; S. W. Mayson, D. French and C. L. Ryan, *Mason, French and Ryan on Company Law* (London: Blackstone, 22nd edn, 2005), para 18.4.3; S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong, LexisNexis Butterworths, 2003), p 1256). However, some earlier cases indicated that the derivative action could still be available even where an independent majority has approved of the fraud or had otherwise allowed the company not to sue. See the case of *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474 at 482; and see also K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle* (continued)" (1958) 16 *Cambridge Law Journal* 93 at 95 R. R. Pennington, *Pennington's Company Law* (London: Butterworths LexisNexis, 8th edn, 2001), pp 810–812. In *Tam Lai King v Incorporated Owners of Malahon Apartments* [2010] 5 HKLRD 63, the Court of First Instance affirmed the need to plead or prove control by the wrongdoers, but accepted that when the matter has been allowed to proceed to completion at trial, it might not be desirable to rule the matter purely on procedural objection to the failure to plead control when there is already proof or disproof of the underlying allegation of wrongdoing and the validity of any condoning of the wrongdoing by the board or a meeting of the company.

[101] See *Burland v Earle* [1902] AC 83 at 93–94; see also *Eromanga Hydrocarbons NL v Australia Mining NL* (1988) 14 ACLR 486 at 489.

derivative action is directed is the possibility of the wrongdoers preventing the company from suing themselves).[102]

Where the wrongdoers control both the board and more than 50 percent of the voting power in the general meeting, then clearly the element of control would be established.[103] Where the wrongdoers control the board but not the general meeting, the requisite element of control would not be established at least where the general meeting has the power to commence proceedings in the name of the company.[104] If the general meeting does not have such a power, it may be that the wrongdoers' control of the board would be sufficient to allow the derivative action.[105] Where the wrongdoers do not control the board but have a majority of the votes in the general meeting, it may be that a derivative action should not be available since the independent directors on the board could commence proceedings in the name of the company. That is, the company is not prevented by the wrongdoer from suing, and hence a derivative action under the fraud exception should not be available.[106] Even if the wrongdoer uses his or her voting power at a general meeting to ratify the conduct, the better view is that the ratification would not be effective to prevent the board from instituting action (on the grounds that the ratification of the fraud is itself a further fraud and wrong perpetrated on the company)[107] and hence the wrongdoer's control of the general meeting is not relevant.[108]

In situations of deadlock where the company is prevented from taking any action by reason of the wrongdoer's 50 percent control, the fraud on the company exception

[102] *Burland v Earle* [1902] AC 83 at 93–94; see also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 211; *Farrow v Registrar of Building Societies* [1991] 2 VR 589 at 594.

[103] See *Birch v Sullivan* [1957] 1 WLR 1247 at 58.

[104] *Smith v Croft (No 3)* [1987] BCLC 355 (derivative action would not be allowed where a majority of the independent members decide not to sue).

[105] See *Foss v Harbottle* (1843) 2 Hare 461 at 494, 67 ER 189; R. R. Pennington, *Pennington's Company Law* (London: Butterworths LexisNexis, 8th edn, 2001), p 809 S. W. Mayson, D. French and C. L. Ryan, *Mason, French and Ryan on Company Law* (London: 22nd edn, Blackstone, 2005), para 18.4.3. On the other hand, it might be argued that even in this situation, the company is not prevented from suing if independent members have sufficient voting power to replace the wrongdoing directors from the board or to appoint additional directors who are willing to sue (see CO s.462 which allows removal by an ordinary resolution and the Model Articles (Cap.622H), Sched.2, art.22 (private companies), and Sched.1, art.23 (public companies) where an ordinary resolution is sufficient for appointment of new directors). But see the comments of Vinelott J in *Prudential Assurance Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 324, 327, where his Lordship noted that such a course of action might be impractical or unrealistic in particular circumstances and so might not be sufficient reason to deny a derivative action. Also, in *World One Investments Ltd v Chow Cheuk Lap* [2013] 3 HKLRD 701, Chan J took the view that even though in principle independent shareholders could change the board members, it is possible to control the outcome of a shareholders' meeting in a public company without controlling the majority shareholding because of lack of attendance by some of the "public shareholders". Chan J accordingly considered that control of the board without control of the majority shareholding could be sufficient to amount to control by the wrongdoer in the case of public companies. Cf S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong, LexisNexis Butterworths, 2003), p 1256.

[106] See *Smith v Croft (No 2)* [1987] 3 WLR 405 at 184–185; see also *Prudential Assurance Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 221 (Eng CA); *Konamaneni v Rolls-Royce Industrial Power Plant (India) Ltd* [2002] 1 BCLC 336; S. W. Mayson, D. French and C. L. Ryan, *Mason, French and Ryan on Company Law* (London, 22nd edn, Blackstone, 2005), at para 18.4.3. It may be otherwise though if the independent board members are unable to provide valid reasons not to sue, in which case it could be said that those independent directors themselves have also breached duties to the company (eg in negligence), and such a breach of duty combined with the wrongdoing director's fraud have prevented the company from suing the wrongdoer. In such a situation, arguably the derivative action should be available. See also K. W. Wedderburn, "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1958) 16 *Cambridge Law Journal* 93 at 95–96.

[107] See para 8.021 below.

[108] But *cf* S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong, LexisNexis Butterworths, 2003), p 1256.

can still be relied upon to support a derivative action. In *Anglo-Eastern (1985) Ltd v Knutz*,[109] a shareholder seeking to bring a derivative action alleged that Knutz, who was a director and a 50 percent beneficial holder in the company, had breached his fiduciary duties by causing profits and commissions to be secretly diverted to another company in which he had controlling interests. The Court of Appeal noted that the plaintiff shareholder was not strictly speaking a minority, but accepted that a derivative action should be allowed, otherwise there was no other way for the company to sue Knutz and the other wrongdoers.[110]

There is no legal requirement for the aggrieved member to try to procure the company to sue in its own name against the wrongdoer by convening a meeting first before commencing the derivative action.[111] Where it is clear that the wrongdoer is in control or there is deadlock, any such attempt would be futile.

Where the wrongdoers do not control a majority of the votes, but where a resolution has been passed ratifying the conduct or to the effect that no proceedings should be brought, it appears that the derivative action under the fraud exception could still be available if the resolution would not have been passed but for the wrongdoers' votes[112] (at least where a majority of the independent members are not against commencing proceedings).[113]

If control is via beneficial holdings, the element of control would still be satisfied for the purposes of allowing a derivative action, as illustrated by the *Anglo-Eastern (1985) Ltd v Knutz* decision, above.[114] Furthermore, it appears that control can be established where the wrongdoers are able to exercise effective (or de facto) control by, for example, offering inducements to controlling shareholders to vote in favour of the wrongdoers,[115] or by the use of proxy votes, or otherwise by any means of manipulation of their position in the company.[116] In *Waddington Ltd v Chan Chun Hoo*,[117]

[109] [1988] 1 HKLR 322 (CA); see also *Ingre v Maxwell* (1964) 44 DLR (2d) 764; *Glass v Atkin* (1967) 65 DLR (2d) 501; *Fargro Ltd v Godfrey* [1986] 1 WLR 1134; *Barrett v Duckett* [1995] BCC 362; *Liu Hsiao Cheng v Wong Shu Wai* [2015] 4 HKLRD 766 at 772.

[110] [1988] 1 HKLR 322 at 329.

[111] See *Liu Hsiao Cheng v Wong Shu Wai* [2015] 4 HKLRD 766 at 772.

[112] See *Prudential Assurance Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 323–324 *per* Vinelott J. On appeal, the Court of Appeal had left open the question of the meaning of "control", see [1982] 2 WLR 31 at 219–220.

[113] *Smith v Croft (No 2)* [1987] 3 WLR. 405.

[114] See also *Pavlides v Jensen* [1956] 3 WLR. 224. But where a trustee, which owns the legal title to the majority shares, was appointed by the alleged wrongdoer, it might not necessarily follow that the trustee would be acting under the directions of the wrongdoer. Note also the case of *Lim Jonathan v She Wai Hung* [2011] 1 HKLRD 305, where the court accepted that there was a triable dispute as to the plaintiff's entitlement to bring the derivative action where the majority shares were held by a trustee and not the alleged wrongdoer.

[115] Where the members effectively act in collusion with the wrongdoing directors, an alternative basis for finding that there is fraud on the company is to say that the members (in control) are themselves involved in wrongdoing if, for example, they are voting in favour of the directors due to some collateral benefit or inducement given by the wrongdoers see also para 8.021 below.

[116] *Prudential Assurance Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 324–325 *per* Vinelott J (note that on appeal, the Court of Appeal had left open the question of the meaning of "control": see [1982] Ch 204 at 219.) It is possible however to interpret Vinelott J's decision as being based on a separate "justice" exception to the proper plaintiff principle (as to which, see para 8.020 below) rather than an extension of the fraud on the company exception to cover situations where the wrongdoers do not have *de jure* control of more than 50% of the voting power see also *Ruralcorp Consulting Pty Ltd v Pynery Pty Ltd* (1996) 21 ACSR 161.

[117] [2006] 2 HKLRD 896 at 905. The extension of the notion of control is also supported in the following judgments. See the cases of: *Farrow v Registrar of Building Societies* [1991] 2 VR 589; *Tan Guan Eng v Ng Kweng Hee* [1992] 1 MLJ 487; *Smith v Croft (No 2)* [1987] 3 WLR 405 at 184–185.

the Court of Appeal, in rejecting the view that it is always necessary to establish that the wrongdoers have at least 50 percent of the voting rights, stated that control is a practical matter and what would amount to control would vary with the circumstances of each company.

The time for assessment of control is *prima facie* at the time the action is filed, however where the wrongdoers no longer have control after that time, it may be possible for defendants to amend their pleadings (pursuant to the ordinary principles of whether amendments are to be permitted), and where that has been done, the court should assess the element of control as at the time of the trial.[118]

Interests of Justice

There is a suggestion that apart from the above exceptions to the proper plaintiff principle, there is a further exception where a derivative action would be allowed in the interests of justice. Dicta in early cases in England indicated the possibility of this exception existing. In *Foss v Harbottle*[119] itself, Sir James Wigram had stated that: **8.020**

> "…the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue".

In *Prudential Assurance Ltd v Newman Industries Ltd (No 2)*,[120] Vinelott J at first instance had allowed a derivative action on this basis in circumstances where two directors had intentionally defrauded the company in causing the company to acquire assets at an excessive price and where, although they did not have *de jure* control of the company, their actions had deceived all but one director that they had adequate independent advice on the propriety of the acquisition, the result being that there was no real prospect that the question whether proceedings should be brought would ever be put to the shareholders in a way that would enable them to exercise proper judgment.

The decision was appealed on other grounds, but in its judgment the English Court of Appeal expressed doubt as to whether there is a "justice" exception to *Foss v Harbottle* due to the uncertainties and difficulties in applying such a test.[121] One explanation given for the earlier decisions referring to "justice" is that justice is not so much a separate exception to the proper plaintiff principle but simply the rationale for the established exceptions.[122]

In Australia however, there have been a number of decisions accepting that justice is anindependent exception. In *Biala Pty Ltd v Mallina Holdings Ltd (No 2)*,[123] Ipp J held that

> "a derivative action can be allowed whenever the justice of the case so requires."

[118] *Biala Pty Ltd v Mallina Holdings Ltd (No 2)* (1993) 11 ACSR 785 at 839.

[119] (1843) 2 Hare 461 at 492, 67 ER 189; see also *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474 at 480–482 *Baillie v Oriental Telephone & Electric Co Ltd* [1915] 1 Ch 503 at 518; *Cotter v National Union of Seamen* [1929] 2 Ch 58 at 69; *Heyting v Dupont* [1964] 1 WLR 843 at 850–851, 854.

[120] [1981] 1 Ch 257.

[121] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 221.

[122] See *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 444 *Edwards v Halliwell* [1950] 2 All ER 1064 at 1067.

[123] (1993) 11 ACSR 785. On appeal, there was no discussion of Ipp J's approach in relation to the justice exception: *Dempster v Malliner Holdings Ltd* (1994) 13 WAR 124.

In that case, the plaintiff was unable to establish the fraud on the company exception as, on the evidence, the Court could not be satisfied that the wrongdoers were in control of the company (after they had sold their shares following the issue of the writ). The Court, however, accepted that the *justice exception* could be relied upon in the: (i) circumstances of the case where serious breaches of fiduciary duties had been committed; (ii) where the company could receive a substantial amount of compensation were the proceedings allowed; (iii) where the disposal of shares by the wrongdoers following the issue of the writ had been effected through some unusual transactions and where such a disposal was the only reason that the plaintiffs did not come within the fraud exception to *Foss v Harbottle*; (iv) where no explanation had been made as to why the new shareholders had acquired the shares knowing that there was pending litigation and why they did nothing to attempt to bring it to an end until a late stage immediately before the commencement of the trial; and (v) where the prospect of the company itself commencing the proceedings was remote.

In *Cope v Butcher*,[124] the Court also accepted that the *justice exception* existed, however a derivative action was not allowed in that case in circumstances where the pleadings were silent on the question of what steps had been taken to invoke the normal company procedures in bringing an action.[125]

Such a flexible approach in allowing a derivative action in the interests of justice appears to be supported in Hong Kong by the Court of Appeal's decision in *Waddington Ltd v Chan Chun Hoo*.[126] One issue in that case was whether a double derivative action could be maintained,[127] and in resolving this point, Rogers V-P (with whom Le Pichon JA agreed) cited with approval the *dicta* of Sir James Wigram in *Foss v Harbottle* noted above, and further cited the comments of Lord Cottenham in *Wallworth v Holt*[128] that:

> "…it is the duty of this Court to adapt its practice and course of proceeding to the existing state of society, and not by too strict an adherence to forms and rules, established under different circumstances, to decline to administer justice, and to enforce rights for which there is no other remedy".

Rogers V-P held that a double derivative action could be pursued and that, quite apart from the authorities supporting this, the court should be prepared to allow such an action:

> "…in order to open the door of justice in this Court to those who cannot obtain it elsewhere".[129]

[124] (1996) 20 ACSR 37.

[125] See *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1995) 19 ACSR 483; see also *Ruralcorp Consulting Pty Ltd v Pynery Pty Ltd* (1996) 21 ACSR 161; *Hurley v BGH Nominees Pty Ltd* (1982) 6 ACLR 791. See also generally R. Baxt, "What is the Real Fuss about *Foss v Harbottle*" (1994) 12 *Company and Securities Law Journal* 178 R. Teele, "A Fifth Exception to the Rule in *Foss v Harbottle*?" (1995) 13 *Company and Securities Law Journal* 329 Justice Ipp, "Problems with 'Control' in Fraud on the Minority Actions" (1997) 18 *Company Lawyer* 88 S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong: LexisNexis Butterworths, 2003), pp 1263–1269.

[126] [2006] 2 HKLRD 896 at 908–909.

[127] See para 8.026 below.

[128] (1841) 4 MY & CR 621 at 635, 42 ER 238 at 244.

[129] [2006] 2 HKLRD 896 at 909. The Court of Final Appeal affirmed the Court of Appeal's decision on the issue of double derivative actions, but the reasoning differed somewhat, see *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370.

Effect of Ratification

Common law

The company in general meeting can, *prima facie*, ratify directors' breaches of fiduciary duties so as to relieve the directors from any liability and to affirm any transaction entered into in breach of duty.[130] Members are not fiduciaries and can *prima facie* exercise their proprietary right to vote as they please, including in their own interests.[131] Under the common law, this principle applies equally to directors who are voting in their capacity as members in relation to some transaction in which they have personal interests, and so *prima facie*, ratification of a breach of fiduciary duty could be effective even though the ratification is achieved through the wrongdoing directors' votes.[132] **8.021**

There are restrictions though on ratification. The general meeting cannot ratify breaches of duties relating to actions which the general meeting would not have power to authorise under the articles, the CO or the general law. Thus it has been held that the general meeting cannot ratify an act which is *ultra vires* the company (in the narrow sense of being beyond the capacity of the company),[133] nor an act which is illegal.[134] Also it is not possible for the general meeting to ratify an infringement of the personal rights of members,[135] nor a breach of the duty to take into account the interests of creditors.[136]

Subject to the above restrictions, ratification achieved through a unanimous decision of the members would be effective.[137]

Ratification by an ordinary resolution can also be effective, however not where such ratification itself amounts to a fraud on the company, thereby giving rise to the possibility of bringing a derivative action.[138] This concept of fraud perpetrated by

[130] *Bamford v Bamford* [1969] 2 WLR 1107. As to the distinction between ratification of a transaction entered into by a director for the company in breach of duty such that the company adopts the transaction and ratification to relieve the director from liability for breach of duty; see *Lam Kin Chung v Soka Gakkai International of Hong Kong Ltd* [2018] HKCFI 747, [2018] 2 HKLRD 769.

[131] *Pender v Lushington* (1877) LR 6 Ch D 70 at 75; see also *Peter's American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 504 *Hiew Fook Siong v Fung Tak Keung* [2006] 3 HKLRD 762.

[132] *North-West Transportation Co Ltd v Beatty* [1887] 12 App Cas 589. This is now altered under the CO; see para 8.022 below.

[133] See para 8.016 above.

[134] *Re Exchange Banking Co* (1882) 21 Ch D 519; *Smith v Croft (No 2)* [1987] 3 WLR 405; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 307. See also para 8.016 above.

[135] See para 8.068 below.

[136] *Re Horsley & Weight Ltd* [1982] 3 WLR 431; *Nicholson v Permakraft (NZ)* [1985] 1 NZLR 242 at 254; *Chingtung Futures Ltd (in liquidation) v Lai Cheuk Kwan Arthur* [1994] 1 HKLR 95; *Tradepower (Holdings) Ltd v Tradepower (HK) Ltd* (2009) 12 HKCFAR 417.

[137] See *Salomon & Co Ltd v Salomon* [1897] AC 22 at 57; *Re Express Engineering Works Ltd* [1920] 1 Ch 466; *Parker & Cooper Ltd v Reading* [1926] Ch 975; *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 3 WLR 492; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1982] 3 WLR 715; *Re Horsley & Weight Ltd* [1982] 3 WLR 431; *New Zealand Netherlands Society "Oranje" v Kuys* [1973] 1 WLR 1126 *Queensland Mines Ltd v Hudson* [1978] 18 ALR 1; *Re D'Jan of London Ltd* [1994] 1 BCLC 561.

[138] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 543 at 307, 316 *per* Vinelott J. Note that Vinelott J's judgment was reversed in part on appeal (see [1982] Ch 204), but this aspect of Vinelott J's was not discussed by the appeal court. Note also that there is an alternative analysis of the cases involving ratification, on the basis that there are certain breaches of duty which are unratifiable in principle, and it is for this reason that ratification could not be effective in preventing a derivative action see, e.g., K. W. Wedderburn, "Derivative Actions and *Foss v Harbottle*" (1981) 44 *Modern Law Review* 202. It is submitted though that there

the majority is based on the concept of fraud on a power, preventing the majority from securing some personal gain which does not fairly arise out of the subjects dealt with by the power and is outside or inconsistent with the contemplated objects of the power.[139]

Where directors have engaged in fraud (within the concept of equitable fraud)[140] in breach of their duties, and the company has suffered loss or damage as a result of the breach, an act of ratification by a majority of the members in general meeting would itself be a fraud on the company if the resolution is passed through the strength of the votes of the wrongdoing directors.[141]

This is illustrated by the cases where the breach of duty involves misappropriation of corporate property[142] deprivation of assets to which the company is entitled;[143] or negligence causing the company loss (where the directors have themselves benefited from the negligence).[144] Where the company has suffered loss as a result of the directors' fraud, the majority would also be engaging in a fraud on the company where, although they were not originally themselves party to the breach of fiduciary duty, they are acting for a collateral purpose in supporting the wrongdoing directors rather than acting to secure the benefit[145] of the company[146] (such as where the majority members vote in support of the wrongdoers because of inducements given to them by the wrongdoers).[147] In these situations where the ratification can be regarded as itself amounting to a fraud on the company, a derivative action would not be barred.

There would not be fraud on the company and ratification can be effective to prevent a derivative action being brought where the majority members are acting independently of the wrongdoers and not for any collateral purpose, even though the company has suffered loss. In addition, a derivative action will not be available

is greater coherency as a matter of principle in viewing the situation as one where all breaches of fiduciary duty are potentially ratifiable, but that ratification may be ineffective where the ratification itself amounts to a fraud on the company see S. Lo, "The Continuing Role of Equity in Restraining Majority Shareholder Power" (2004) 16 *Australian Journal of Corporate Law* 96 at 107–112 see also S. W. Mayson, D. French and C. L. Ryan, *Mason, French and Ryan on Company Law* (London: Blackstone, 22nd edn, 2005) at para 18.4.5. Note also S. C. Loh and W. M. F. Wong, *Company Law: Powers and Accountability* (Hong Kong: LexisNexis Butterworths, 2003), pp 1297–1299. In practice however, whichever view is adopted, there might not be a difference in outcome if the same boundary is drawn as to when ratification will be regarded as being effective to bar a derivative action. Cf B. Hannigan, "Limitations on a Shareholder's Right to Vote –Effective Ratification Revisited" [2000] *Journal of Business Law* 493.

[139] See *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671; *British Equitable Assurance Co Ltd v Baily* [1906] AC 35 at 42 *per* Lord Lindley (HL); *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2; *Peter's American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 511–512 *per* Dixon J (HC of Aust) *Ngurli Ltd v McCann* (1953) 90 CLR 425 (HC of Aust). See further P. G. Xuereb, "The Limitation on the Exercise of Majority Power" (1985) 6 *Company Lawyer* 199 at 202–206 G. R. Sullivan, "Restating the Scope of the Derivative Action" (1985) 44 *Cambridge Law Journal* 236 at 253–254 S. Lo, "The Continuing Role of Equity in Restraining Majority Shareholder Power" (2004) 16 *Australian Journal of Corporate Law* 96 at 105–112.

[140] See para 8.018 above.

[141] See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 307 *per* Vinelott J *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 445; see also CO, s.473, discussed at para 8.022 below.

[142] *Cook v Deeks* [1916] 1 AC 554.

[143] *Alexander v Automatic Telephone Co* [1900] 2 Ch 56.

[144] *Daniels v Daniels* [1978] 2 WLR 73.

[145] If there are commercial reasons justifying the decision to ratify the conduct, then the members could be regarded as acting for the benefit of the company.

[146] Cf *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 307; *Smith v Croft (No 2)* [1987] 3 WLR 405 at 186; *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237 at 255.

[147] Cf *Prudential Assurance Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 324–325.

whenever a majority of independent members are against the bringing of the action.[148] Members would not be regarded as independent if they are casting their votes with a view of supporting the wrongdoing directors instead of securing the benefit of the company, or if their situation is such that there is a substantial risk of that happening.[149]

Also where the breach of fiduciary duty does not result in loss or damage to the company, ratification by a majority of members will be effective even though the wrongdoing directors are in control of the general meeting and have themselves voted in favour of the ratification. Thus ratification would be effective in cases where directors were in breach of the conflict rule in a transaction with the company but where the transaction was fair to the company[150] where directors have profited from their position in circumstances where the company could not have obtained the profit for itself;[151] or where the only complaint against the directors is that they have issued shares for improper purposes.[152]

Statutory restrictions on ratification

8.022 Under s. 473 of the CO, where there is a proposed ratification by a company of conduct[153] by a director involving negligence, default, breach of duty or breach of trust in relation to the company, any vote in favour of the resolution by that director[154] must be disregarded. The votes of any member who is an "entity connected" [155]with the director or who holds any shares in the company on trust for the director or a connected entity must also be disregarded.

Section 473 of the CO accordingly provides a more direct manner of preventing ratification on the strength of the votes of the wrongdoing director and his or her associates compared with the common law. However s.473 only applies where there is a ratification of a breach that has already occurred. It does not apply to a resolution that purports to authorise, in advance, conduct that would otherwise amount to a breach of duty. Here, it would be necessary to rely on the common law principles, discussed at para 8.021 above, to argue that the ratification is ineffective.

Section 473 of the CO also does not apply where the ratification is achieved by unanimous consent of the members of the company.[156]

Standing

8.023 Registered members have standing to bring a derivative action,[157] even in relation to conduct that occurred prior to them becoming members.[158] However former members would not be able to sue nor continue a derivative action upon ceasing to be a

[148] *Smith v Croft (No 2)* [1987] 3 WLR 405; *Burrows v Becker* (1968) 70 DLR (2d) 433.

[149] *Smith v Croft (No 2)* [1987] 3 WLR 405 at 404.

[150] *North-West Transportation Co Ltd v Beatty* [1887] 12 App Cas 589.

[151] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 389.

[152] *Hogg v Cramphorn Ltd* [1966] 3 WLR 995; *Bamford v Bamford* [1969] 2 WLR 1107. But note that a member whose holdings have been diluted from the share issue would be able to bring a personal action to restrain the issue.

[153] Conduct includes both acts and omissions; see CO, s.473(5)(a).

[154] Director includes former directors and also shadow directors; see CO, s.473(5)(b), (c).

[155] For the meaning of entity connected with a director, see CO, s.486.

[156] CO, s.473(6)(a).

[157] *Junestar Investment Corp v Boldwin Construction Co Ltd* [2003] 3 HKLRD 618 at 626 (so long as the person bringing the action is a registered member, the court is not concerned with the beneficial ownership of the shares).

[158] *Seaton v Grant* [1867] LR 2 Ch App 459.

member.[159] Equitable or beneficial owners of shares do not have standing to commence derivative actions.[160] However, a person not on the company's register of members may be entitled to bring a derivative action in exceptional circumstances such as where those controlling the company wrongfully refuse to register a share transfer and thus the company's register does not list the transferee as a member.[161]

There is no requirement that the wrong complained of must negatively impact on the economic interests of a member in order for the member to have standing to bring a derivative action; see *Lam Kin Chung v Soka Gakkai International of Hong Kong Ltd* (unrep., HCMP 1002/2017, [2017] HKEC 2603)) at [15]. A member of a charitable company limited by guarantee has an interest in the proper administration of the company arising from his membership which is distinct from the general public's interest in the proper administration of charities generally. Accordingly it can be justifiable to allow such a member to bring a derivative action even though there might be an alternative remedy available through intervention by the Secretary for Justice, as *parens patriae*, for protection of charitable interests; see *Lam Kin Chung v Soka Gakkai International of Hong Kong Ltd* (unrep., HCMP 1002/2017, [2017] HKEC 2603)) at [14], [22].

Inequitable Conduct of Member

8.024 The derivative action is an equitable remedy and thus where the member seeking to bring a derivative action has him or herself engaged in conduct which is inequitable or unjust in the eyes of equity, then the court may bar the claim.[162] This will be the case, for example, where the member does not come to the court with "clean hands" or has been guilty of delay[163] where the member seeks to bring the action for an ulterior motive;[164] or where the member has received the benefits from the wrongdoing with knowledge of the relevant facts.[165]

Companies in Liquidation

8.025 The courts have held that a member cannot commence a derivative action pursuant to the exceptions to *Foss v Harbottle* where the company has already entered into liquidation, for the reason that the wrongdoers are no longer in control and the liquidator has the power[166] to commence proceedings.[167] If a member is dissatisfied with the liquidator's decision not to sue, then the member could apply to the court for an order

[159] See *Clarkson v Davies* [1923] AC 100; *Fulloon v Radley* [1992] 2 Qd R 290.

[160] *Guildford Investment Co Ltd v Tak Wo Finance and Investment Ltd* (unrep, HCA A1610, [1987] HKLY 100); see also *Tsang Yue Joyce v Standard Chartered Bank (Hong Kong) Ltd* [2010] 5 HKLRD 628; *Maas v McIntosh* (1928) 28 SR (NSW) 441; *Hooker Investments Pty Ltd v Email Ltd* (1986) 10 ACLR 443; *Fulloon v Radley* [1992] 2 Qd R 290. See further J. Payne, "Derivative Actions by Beneficial Shareholders" (1997) 18 *Company Lawyer* 212. But generally under trust law, a beneficiary may be entitled to bring proceedings on behalf of the trustee in special circumstances: see *El Sayed v El Hawach* (2015) 317 ALR 771.

[161] *Zabusky v Virgtel Ltd* [2013] 1 Qd R 285.

[162] *Nurcombe v Nurcombe* [1985] 1 WLR 370 (Eng CA).

[163] *Nurcombe v Nurcombe* [1985] 1 WLR 370 at 376, 377.

[164] *Barrett v Duckett* [1995] BCC 362.

[165] *Towers v African Tug Co* [1904] 1 Ch 558 *Nurcombe v Nurcombe* [1985] 1 WLR 370; *Knight v Frost* [1999] 1 BCLC 364.

[166] CWUO, s.199(1)(a).

[167] *Ferguson v Wallbridge* [1935] 3 DLR 66 (PC); see also *Fargro Ltd v Godfroy* [1986] 1 WLR 1134; *Scarel Pty Ltd v City Loan & Credit Corporation Pty Ltd* (1988) 12 ACLR 730; *Zempilas v JN Taylor Holdings Ltd (in liq) (No 6)* (1991) 5 ACSR 28; *Junestar Investment Corp v Boldwin Construction Co Ltd* [2003] 3 HKLRD 618 at 622.

compelling the liquidator to do so, pursuant to s.200(5) of the CWUO (which gives the court control over the liquidator's powers).[168]

Alternatively a member could seek to rely on the misfeasance proceedings provision in s.276 of the CWUO.[169] In overseas cases, it has also been held that a member could apply to the court for permission to sue on behalf of the company, pursuant to the inherent powers of the court to order that a contributory (or a creditor) of a company in liquidation be authorised to use the company's name as a plaintiff.[170] If the proceedings would involve a drain on the company's assets, then the court must be satisfied as to their probability of success before authorising the proceedings, but where there is no such risk (for example, because the member agrees to provide an indemnity for the costs and expenses of the litigation) then the court can authorise the proceedings so long as they are not vexatious or oppressive.[171]

Where the derivative action was commenced before liquidation, the action is not stayed under s.186 of the CWUO[172] upon winding-up, as the action is not "against" the company within the provision.[173] However, upon the commencement of winding up, both the directors and the members cease to have authority over the company's business and assets,[174] including the right to litigate on the company's behalf, with the liquidator acquiring such powers.[175] On the basis of this general principle then, it appears that the court would have power to stay the derivative action upon winding up even though the action is not automatically stayed under section 186.[176] The liquidator could decide to continue the action,[177] or if not, the member could seek orders as noted above for continuation of the proceedings either by the liquidator or by the member him or herself. Apart from staying the proceedings, the court also has power to strike out the derivative action after the company has entered liquidation.[178]

[168] See *Fargro Ltd v Godfroy* [1986] 1 WLR 1134; *Revelry Gains Ltd v Joy Rich Development Ltd* [2017] 1 HKLRD 769; *Chen Muhua v Joint and Several Liquidators of Joy Rich Development Ltd* (unrep., HCCW 146A/2013, HCCW 146/2013, [2017] HKEC 1101).

[169] *Re Shun Kai Finance Co Ltd* [2015] 2 HKLRD 264 at [22] (CA).

[170] See *Re Bank of Gibraltar and Malta* (1865) LR 1 Ch App 69; see also *Re Imperial Bank of China India and Japan* (1866) LR 1 Ch App 339; *Cape Breton Co v Fenn* (1881) LR 17 Ch D 198 (Eng CA); *Lloyd-Owen v Bull* (1936) 4 DLR 273 (PC); *Fargro Ltd v Godfroy* [1986] 1 WLR 1134; *Aliprandi v Griffith Vintners Pty Ltd (in liq)* (1991) 6 ACSR 250; *Eros Cinema Pty Ltd v Nassar* (1996) 14 ACLC 1374; *Re Colorado Products Pty Ltd (in prov liq)* (2014) 97 ACSR 581; *Re Colorado Products Pty Ltd (in prov liq)* (2014) 97 ACSR 581.

[171] *Lloyd-Owen v Bull* (1936) 4 DLR 273 (PC); *Aliprandi v Griffith Vintners Pty Ltd (in liq)* (1991) 6 ACSR 250; *Eros Cinema Pty Ltd v Nassar* (1996) 14 ACLC 1374.

[172] CWUO, s.186 provides that when a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company except by leave of the court.

[173] *Junestar Investment Corp v Boldwin Construction Co Ltd* [2003] 3 HKLRD 618 (derivative action which commenced before the appointment of a provisional liquidator was not stayed under that CWUO, s.186 following such appointment).

[174] See Chapter 1, para 1.001 in *Company Law in Hong Kong –Insolvency*.

[175] See CWUO, s.199.

[176] *Ever Joint (Holdings) Ltd v Nice Theme Ltd* [2006] 4 HKLRD 516 (stay ordered so that the liquidator could decide whether to continue with the claim) *Mehta v Mehta* [2007] 2 HKLRD 520 at 526; see also *Scarel Pty Ltd v City Loan and Credit Corp Pty Ltd* (1988) 79 ALR 483 at 490; A. R. Keay, *McPherson's Law of Company Liquidation* (London: Sweet and Maxwell, 2001), para 7.63.

[177] Pursuant to CWUO, s.199(1)(a). The reference to bringing an action within the provision includes the continuation of an action commenced before winding-up see *Akira Sugiyama v Kosei Securities Co (Asia) Ltd* [1992] 1 HKC 261.

[178] *Mehta v Mehta* [2007] 2 HKLRD 520 (action stayed where the substratum of the plaintiff's claim is gone following the appointment of the liquidator, such as in the present case where the plaintiff's action was to prevent a director from exercising control over the company).

Double or Multiple Derivative Actions

8.026 A double derivative action refers to the situation where a member of Company A, which in turn is a member of Company B, seeks to bring a derivative action on behalf of Company B. Where for example, Company B is a wholly-owned subsidiary of Company A (the parent company), and the controllers of the parent company perpetrate a wrong on the subsidiary, then *prima facie* the controllers could prevent the subsidiary from taking action against themselves, and moreover there would not be any minority member in the subsidiary to bring a derivative action on its behalf.

The term "multiple derivative action" is used to describe the derivative action brought by a member of a parent company on behalf of a sub-subsidiary, though the term is also used to include double derivative actions as well. In *Waddington Ltd v Chan Chun Hoo*,[179] the Court of Final Appeal held that multiple derivative actions can be brought under the common law in Hong Kong. Lord Millett NPJ noted that the justification for an ordinary derivative action applies as well to the case where the wrongdoers, who through their control of the parent company also control its subsidiaries, defraud a subsidiary or sub-subsidiary as it is to the case where they defraud the parent company itself.[180]

In either case, wrongdoer control precludes action by the company in which the cause of action is vested. His Lordship emphasized that the question of whether a derivative action can be brought is simply a question of the plaintiff's standing to sue, and stated further:

> "On a question of standing, the court must ask itself whether the plaintiff has a legitimate interest in the relief claimed sufficient to justify him in bringing proceedings to obtain it. The answer in the case of a person wishing to bring a multiple derivative action is plainly 'yes'. Any depletion of a subsidiary's assets causes indirect loss to its parent company and its shareholders".[181]

The Court of Appeal has held that whether a derivative action can be brought is a matter of substantive law, determined by the law of the place of incorporation, and accordingly a multiple derivative action cannot be brought in Hong Kong on behalf of a foreign company if the law of the place of incorporation of that company does not allow multiple derivative actions to be brought.[182]

Procedure

Form of Pleadings

8.027 The form of the writ in a derivative action has traditionally been in the terms, for example:

> "[name of plaintiff] suing on behalf of himself and all other shareholders in the Third Defendant other than the First and Second Defendants (where the third defendant is the company and the first and second defendants are the wrongdoers)."

[179] (2008) 11 HKCFAR 370. See also *Universal Project Management Services Ltd v Fort Gilkicker Ltd* [2013] Ch 551.
[180] (2008) 11 HKCFAR 370 at 395.
[181] (2008) 11 HKCFAR 370 at 398.
[182] *East Asia Satellite Television (Holdings) Ltd v New Cotai LLC* [2011] 3 HKLRD 734.

While the action is in substance an action on behalf of the company, the plaintiff sues in his or her own name, and the company is joined as a defendant so that the company would be bound by the judgment and could take the benefit of any remedy ordered in its favour by the court.[183] Since the plaintiff is suing on behalf of the company, strictly speaking it is not necessary for the pleadings to state that the plaintiff is suing on behalf of the other shareholders.[184]

Establishing Standing

8.028 The member seeking to bring the derivative action must plead both the cause of the action being pursued on behalf of the company as well as the grounds for coming within the exceptions to the proper plaintiff principle giving the member standing to sue, otherwise the claim may be struck out on the basis that the pleadings disclose no reasonable cause of action.[185]

Under court rules in England, it had been necessary for the member to apply to the court for leave to continue a derivative action under the common law.[186] There is no comparable requirement under the Hong Kong court rules. However, even prior to the introduction of the leave requirement in the English court rules in 1994, the courts in England had held that the member's standing should be determined as a preliminary issue,[187] with the member needing to prove a *prima facie* case that the company is entitled to the relief sought and that the action comes within the proper boundaries of the exceptions to the proper plaintiff principle.[188]

In determining this preliminary issue, the courts were not to proceed on the basis that the allegations in the plaintiff's pleadings are facts as they would be on the trial of a preliminary point of law,[189] and so it would be necessary for the plaintiff to provide sufficient evidence for the court to be satisfied that there is a *prima facie* case.

Also, it had been held that it may be appropriate for the court to grant a sufficient adjournment for the members to consider in general meeting whether the proceedings

[183] *Spokes v Grosvenor & West End Railway Terminus Hotel Co Ltd* [1897] 2 QB 124 at 126, 128; see also *Greenberg v Rund* (unrep, HCA A6953/1988, 2 Dec 1988). As the company is joined as a defendant, the name of the plaintiff in the pleadings should not actually refer to the plaintiff as suing "on behalf of [name of company]"; see *Kwong Ian (Hong Kong) Construction and Real Estate Development Co Ltd v Glorious Sun (Highway Development) Ltd* (unrep, HCA 260/2006, [2006] HKEC 1493).
[184] *Wallersteiner v Moir (No 2)* [1975] QB 373 at 390–391.
[185] Rules of the High Court, (Cap.4H) ("RHC") O 18, r 19(1)(a). For an example of a case where the court considered an application to strike out the claim, see *Kim Sie Joong v Ng Cheuk Ngon* (unrep, HCA 552/2002, [2002] HKEC 1056). In that case, the court noted that in an application under O 18, r 19(1)(a), evidence is inadmissible and the court must have regard only to the pleadings. In the circumstances of that case, the court declined to strike out the plaintiff's claim on the basis that it is only in plain and obvious cases that the court should strike out pleadings and in the present situation it was by no means obvious that the plaintiff had no reasonable cause of action.
[186] Civil Procedure Rules 1998, r 19.9(3).
[187] In Hong Kong, the court can determine matters as a preliminary issue under RHC, O 33 rr 3, 7.
[188] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 221–222 (Eng CA) *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 14–15 *Barrett v Duckett* [1995] 1 BCLC 243 at 250. The rationale is that it would be undesirable to subject the company to a full trial in circumstances where the plaintiff should not have been allowed to bring the action in the first place due to a lack of standing (ie, because the exceptions to the proper plaintiff principle are not established).
[189] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 221.

should continue[190]–this would be important where the action should be debarred because of the views of an independent majority,[191] but it appears that the conduct of, and proceedings at, the meeting could also give an indication to the court in relation to whether there is "fraud" or "control" for the purposes of the fraud on the company exception to *Foss v Harbottle*.[192]

Earlier cases in Hong Kong had indicated that it was necessary for the member to establish a *prima facie* case in accordance with the above principles,[193] however the Court of Appeal in *Waddington Ltd v Chan Chun Hoo*[194] took the view that there is no requirement in respect of a common law derivative action that the plaintiff must show that it has a *prima facie* case prior to being allowed to proceed with the action. This point was not in issue when the case went on appeal to the Court of Final Appeal, but Ribeiro PJ rejected the Court of Appeal's view in stating that as a matter of both principle and authority, the common law does require the plaintiff to show the requisite prima facie case when his standing to bring a derivative action is challenged.[195]

In Australia, the courts had declined to apply the English requirements to prove a *prima facie* case as an inflexible rule applicable in all situations. Rather the courts took the view that the issue of standing should be determined in each case according to what appears to be just and convenient in the circumstances,[196] and that it would be inappropriate to determine the matter as a preliminary issue where a hearing to determine the issue would take as long as a full trial itself[197] or where the issue can only be properly dealt with upon a consideration of all the evidence at a full trial.[198]

Whether Plaintiff is Entitled to Summary Judgment

8.029 In *Tang Eng Guan v Southland Co Ltd,*[199] the Court of Appeal held that only in the most rare circumstances can it be appropriate for the court to make an order for summary judgment in favour of a plaintiff in a derivative action. The reason is that issues in relation to whether the derivative action can be maintained (ie whether the plaintiff has standing to sue) can only be properly dealt with either as a preliminary issue or at a full trial.[200]

[190] See *Hogg v Cramphorn Ltd* [1966] 3 WLR 995; *Bamford v Bamford* [1969] 2 WLR 1107; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666; *Condraulics Pty Ltd v Barry & Roberts Ltd* (1984) 8 ACLR 915; *Hooker Investments Pty Ltd v Email Ltd* (1986) 10 ACLR 443; *Residues Treatment & Trading Company Ltd v Southern Resources Ltd (No 4)* (1988) 14 ACLR 569. It would not be necessary to call a meeting though where the result is a foregone conclusion: *Marshall's Valve Gear Company Ltd v Manning Wardle & Co Ltd* [1909] 1 Ch 267 at 272.

[191] See *Smith v Croft (No 2)* [1987] 3 WLR 405, see also para 8.021 above.

[192] See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 222.

[193] See *Tang Eng Guan v Southland Co Ltd* [1996] 2 HKLRD 117 at 105–106 (CA) *DEG Holdings Pty Ltd v Golden Harvest Entertainment (Holdings) Ltd* (unrep, A10087/1998, [1998] HKEC 3); *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 415–416.

[194] [2006] 2 HKLRD 896 at 905.

[195] *Waddington Ltd v Chan Chun Hoo* (2008) 11 HKCFAR 370 at 379–383. Ribeiro PJ's comments were also endorsed by Li CJ, and Bokhary and Chan PJJ. As to what is required to show a *prima facie* case, see *Melvin Waxman v Li Fei Yu* (unrep., HCA 1973/2012, [2013] HKEC 1341), [20]– [27].

[196] *Hurley v BGH Nominees Pty Ltd* (1982) 6 ACLR 791 at 794–795.

[197] *Hurley v BGH Nominees Pty Ltd* (1982) 6 ACLR 791 at 794–795.

[198] *Eromanga Hydrocarbons NL v Australis Mining NL* (1988) 14 ACLR 486 *Dempster v Biala Pty Ltd* (1989) 15 ACLR 191 at 193.

[199] [1996] 2 HKLRD 117.

[200] [1996] 2 HKLRD 117 at 105–106.

Costs

8.030 In *Wallersteiner v Moir (No 2)*,[201] the English Court of Appeal made it clear that the court has power to order the company to pay the costs of a member bringing a derivative action both:

(i) where the action against the defendant is successful (in which case, the company would be liable for the costs if they are not recovered from the defendant, and the company would also be liable for the additional costs (over and above party and party costs) taxed on a common fund basis); and

(ii) where the action against the defendant is unsuccessful (in which case, the company would be liable to pay both the costs ordered in favour of the defendant, as well as the minority member's own costs taxed on a common fund basis).

The above case suggests that the court's jurisdiction to make an indemnity order lies in equity. However, in *Waddington Ltd v Chan Chun Hoo Thomas*,[202] Chow J considered, in *obiter*, that the better view is that the jurisdiction should, strictly speaking, be regarded as being based on s.52A(1) of the High Court Ordinance (Cap.4) ("HCO"), though his Lordship accepted that equitable principles govern the exercise of such jurisdiction by the court.

The court has a discretion whether to grant an order, and it would be appropriate to allow an order for a full indemnity of the member's costs down to judgment if the member had been acting in good faith and had sought recovery for the company on reasonable grounds.[203] Whether the member can be regarded as having acted reasonably in bringing the action depends on a test of whether a hypothetical independent board, exercising the standard of care which a prudent businessman would exercise in his own affairs, would have decided to bring the action.[204]

Thus in *Chung Sau Ling v Asia Women's League Ltd*,[205] Chu J declined to order indemnity costs, in circumstances where the plaintiff failed to plead any loss or damage suffered by the company, on the grounds that a prudent businessman would not ordinarily incur expenses in litigating a dispute when there is no apparent pecuniary or other advantage to be gained from such a course, having regard to the inherent risks in and the high costs of litigation.[206]

For an example of where the court granted an indemnity as to costs in favour of the minority shareholder, see *Melvin Waxman v Li Fei Yu.*[207]

[201] [1975] QB 373 at 391–392, 403–404. See also *Farrow v Registrar of Building Societies* [1991] 2 VR 589.

[202] [2015] 3 HKLRD 471.

[203] *Wallersteiner v Moir (No 2)* [1975] QB 373 at 403–404.

[204] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 415 *per* Chu J, citing *Wallersteiner v Moir (No 2)* [1975] QB 373 at 404 *Re Shun Tak Holdings Ltd* [2009] 5 HKLRD 743 at 757; *Smith v Croft* [1986] 2 All ER 551; *Jaybird Group Ltd v Greenwood* [1986] BCLC 319.

[205] [2001] 3 HKC 410.

[206] In *Wallersteiner v Moir (No 2)* [1975] QB 373 itself, an order was made for the company to indemnify the plaintiff's costs up to and including discovery, after which time the plaintiff would be required to obtain further directions from the court. A similar order was made in *Jaybird Group Ltd v Greenwood* [1986] BCLC 319. Costs indemnity orders were declined though in *Smith v Croft* [1986] 2 All ER 551 and *Halle v Trax* [2000] BCC 1020. See also *Parker v NRMA* (1993) 11 ACSR 370.

[207] (unrep., HCA 1973/2012, [2017] HKEC 561).

Generally, in deciding whether or not to grant an order, the court may take into account factors including the merits of the case, the wishes of the genuinely independent shareholders, whether the action is for the benefit of the shareholders, and the impecuniosity or the financial strength of the plaintiff.[208] In relation to the latter point, while the impecuniosity of the plaintiff is one relevant factor for the court to consider, the fact that the plaintiff does not demonstrate that the indemnity is genuinely needed is not a bar to an indemnity order being granted.[209] It may however be necessary for the plaintiff to show that he or she does not have sufficient resources to finance the action if the plaintiff is effectively seeking early payment from the company via an order for the company to pay costs as they are taxed while the action is still proceeding.[210]

An application for a costs indemnity should be made by way of a summons pursuant to the inherent jurisdiction of the court.[211] The application can be made after the issuing of the writ, and it does not matter that the application is made before discovery.[212]

In *Melvin Waxman v Li Fei Yu*,[213] the court stated that:

> "If the application is made at an early stage of the proceedings, the minority shareholder is normally expected to provide an estimate of the likely costs to be incurred in prosecuting the action. Having regard to the estimate of costs provided by the minority shareholder and such other factors as the court may consider to be relevant, the court will exercise its discretion on whether to grant to the minority shareholder an indemnity as to costs, and if so whether the indemnity should in the first instance be limited to a particular stage of the proceedings (e.g., discovery, exchange of witness statements, advice on evidence, etc). The estimated costs to be incurred and the size of the claim are matters plainly relevant to the court's exercise of discretion in this regard."

It is also well established that the application may be made at a later stage, even after the conclusion of the action. In *Melvin Waxman*, above,[214] the court also noted that if the application is made after the conclusion of the action, in principle the minority shareholder should inform the court of the costs that he has actually incurred in the action. The proportionality between the costs incurred and the amount of recovery is a factor relevant to the court's exercise of discretion whether to grant an indemnity in favour of the minority shareholder and the extent of the indemnity to be granted.

In *Wallersteiner v Moir (No 2)*,[215] the English Court of Appeal noted that the application could be *ex parte*, though the court could give directions as to whether the company or the defendants or anyone else should be made respondents. Buckley LJ also stated in that case that the evidence of the plaintiff and other parties given in relation to the application would not be disclosed to the defendants unless the court so directed and the defendants, if made respondents to the summons, would not be permitted to be present when the merits of the application was discussed.[216]

However Walton J in *Smith v Croft*[217] took the view that the company should be joined to the application (rather than the application being made *ex parte*), and further that all of the applicant's evidence should be disclosed to the company, except where the evidence is covered by legal professional privilege or where there is some other justification for withholding the evidence. In an application for an indemnity costs order, the desired practice is to place before the court a counsel opinion or evidence of some independent investigation or assessment of the case, but the non-availability of such material is not necessarily fatal to the application.[218]

Relationship with Other Remedies

There is a suggestion that a derivative action will not be allowed if there is an alternative remedy which would be adequate,[219] on the basis that the derivative action is a procedural device to be used only if there is otherwise no possibility of recovery for the company. However the same facts may give rise to both a claim by the company and a personal claim by members in relation to their personal rights, and there is no bar to a derivative action being brought at the same time as a personal action (with the proceedings joined as appropriate) where separate remedies are genuinely sought.[220] This is because the nature of the proceedings are different, with the derivative action seeking a remedy for the company's loss and the personal action a remedy in relation to the personal rights of the member.[221] **8.031**

V. STATUTORY DERIVATIVE ACTION

Introduction

The difficulties confronting minority members in bringing a derivative action under the common law, in relation to issues involving standing, costs, ratification and other disincentives, have led to the enactment of a statutory derivative action.[222] The provisions were originally introduced in Part IVAA of the predecessor CO, (by the Companies (Amendment) Ordinance 2004 (No 30 of 2004), effective 15 July 2005) and are now **8.032**

[208] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 415 *per* Chu J, citing *Wallersteiner v Moir (No 2)* [1975] QB 373 *Smith v Croft* [1986] 1 WLR 580; *McDonald v Horn* [1995] 1 All ER 961. See also *Watts v Midland Bank plc* [1986] BCLC 15.

[209] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 417; *Jaybird Group Ltd v Greenwood* [1986] BCLC 319.

[210] *Smith v Croft* [1987] 3 WLR 405 at 565; *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 417.

[211] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 414. *Cf Waddington Ltd v Chan Chun Hoo Thomas* [2015] 3 HKLRD 471, where it is suggested that the basis of the court's jurisdiction to make an indemnity order is High Court Ordinance (Cap 4) ("HCO"), s.52A(1).

[212] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 417, *cf Smith v Croft* [1986] 1 WLR 580.

[213] (unrep., HCA 1973/2012, [2017] HKEC 561), [31].

[214] (unrep., HCA 1973/2012, [2017] HKEC 561), [32].

[215] [1975] QB 373 at 391–392, 403–404.

[216] *Wallersteiner v Moir (No 2)* [1975] 2 WLR 389 at 404–405.

[217] [1986] 2 All ER 551 at 558. See also *McDonald v Horn* [1995] 1 All ER 961 at 974–975 where the Court of Appeal appears to give support to this approach.

[218] *Chung Sau Ling v Asia Women's League Ltd* [2001] 3 HKC 410 at 416.

[219] *Barrett v Duckett* [1995] 1 BCLC 243; *Cooke v Cooke* [1997] 2 BCLC 28; *Portfolios of Distinction Ltd v Laird* [2004] 2 BCLC 741.

[220] See *Koy Holdings Corporation v Spider Knitters Ltd* [1998] 1 HKLRD 788; *Re Prudential Enterprise Ltd* [2002] 1 HKLRD 267 (CA); *Re Chime Corp Ltd* [2004] 3 HKLRD 922 at 935 (CFA); see also V. Joffe, *Minority Shareholders: Law, Practice and Procedure* (London: Butterworths, 2000), pp 36–37.

[221] *Koy Holdings Corporation v Spider Knitters Ltd* [1998] 1 HKLRD 788 at 790; *Re Prudential Enterprise Ltd* [2002] 1 HKLRD 267 at 276–277.

[222] See Standing Committee on Company Law Reform, *Corporate Governance Review: Consultation Paper on Proposals Made in Phase I of the Review*, July 2001, paras 15.14–15.29.

contained in the CO, Part 14 Division 4. These provisions were modelled in part on provisions in other jurisdictions,[223] however, there are differences in the provisions in the various jurisdictions.

Where the CO, Part 14, Division 4 applies, a member may bring a derivative action or intervene in proceedings to which the company is a party if the court grants leave.[224] In relation to whether a derivative action can be brought under the statutory provisions, it is no longer necessary to examine the common law exceptions and the principles relevant thereto, such as fraud and control, with the court broadly looking at the interests of the company when deciding whether or not to grant leave.

Application of Companies Ordinance (Cap.622) ("CO") Part 14 Division 4

8.033 Section 732 of the CO sets out the circumstances when Part 14 Division 4 is applicable, namely where a member seeks to:

(i) bring proceedings in respect of misconduct committed against a company

(ii) bring proceedings in respect of any matter where a company fails to bring proceedings in respect of such matter by reason of misconduct committed against the company; or

(iii) intervene in proceedings in respect of any matter where a company fails to diligently continue, discontinue or defend the proceedings in respect of such matter by reason of misconduct committed against the company,

where the cause of action in relation to the proceedings is vested in the company and relief is sought on behalf of the company.[225]

[223] Canada: Canada Business Corporations Act 1974–1976 ss.239–242, implemented following the Dickerson Report (R. V. W. Dickerson, J. L. Howard, L. Getz, *Proposals for a New Business Corporations Law for Canada*, Information Canada, Ottawa, 1971) New Zealand: Companies Act 1993 ss.165–168, enacted with effect in July 1994; Australia: Corporations Act 2001 ss.236–242, originally introduced into the Corporations Law by the "CLERP" reforms (Corporate Law Economic Reform Program Act 1999) with effect from 13 March Singapore Companies Act ss.216A, 216B. See also the UK Companies Act 2006, ss.260–264, and the recommendations of the Law Commission, *Shareholder Remedies*, Law Commission Report No 246, Cm 3769, Oct 1997, paras 6.1–6.114, and the Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, paras 5.82–5.90. On the overseas provisions, see also, for Australia and New Zealand: P. Fitzsimons, "Statutory Derivative Actions in New Zealand" (1996) *Company and Securities Law Journal* 184 M. Berkhan, "The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights?" (1998) 10 *Bond Law Review* 74 S. Watson and O. Morgan, "A Matter of Balance: the Statutory Derivative Action in New Zealand" (1998) 19 *The Company Lawyer* 236 P. Prince, "Australia's Statutory Derivative Action: Using the New Zealand Experience" (2000) 18 *Company and Securities Law Journal* 493 L. Thai, "How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand" (2002) 30 *Australian Business Law Review* 118 I. M. Ramsay and B. B. 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. Canada: M. S. Baxter, "The Derivative Action Under the Ontario Business Corporations Act: A Review of Section 97" (1982) 27 *McGill Law Journal* 452 B. Cheffins and J. Dine, "Shareholder Remedies: Lessons from Canada" (1992) 13 *The Company Lawyer* 89 W. Kaplan and B. Elwood, "The Derivative Action: A Shareholder's 'Bleak House'?" (2003) 36 *University of British Columbia Law Review* 443. Singapore: P. K. M. Choo, "The Statutory Derivative Action in Singapore: A Critical and Comparative Examination" (2001) 13 *Bond Law Review* 64.

[224] CO, s.732.

[225] CO, s.732.

Commencing or Intervening in Proceedings on Behalf of Company

CO, Part 14 Division 4 can be relied upon both where a member seeks to commence a derivative action and where a member wishes to intervene in proceedings already commenced where those within the company in control of the litigation have not diligently continued or defended the action for the company.[226] The provisions are limited to civil proceedings within the jurisdiction of the court.[227] 8.034

Companies within CO Part 14 Division 4

A statutory derivative action can be brought on behalf of both companies incorporated under the CO (or its predecessors) and non-Hong Kong companies.[228] A non-Hong Kong company is a company incorporated outside Hong Kong that: (i) has established a place of business in Hong Kong on or after the commencement of CO, Part 16 (i.e. 3 April 2014); or (ii) has established a place of business in Hong Kong before that date and continues to have a place of business as at that date.[229] 8.035

Misconduct

Leave can be sought for a derivative action under the CO, Part 14, Division 4 in relation to "misconduct", which means "fraud, negligence, breach of duty, or default in compliance with any Ordinance or rule of law".[230] This covers, for example: (i) breaches of fiduciary duties; (ii) situations falling within the notion of common law fraud (actual deceit); (iii) cases of pure negligence; (iv) breaches of statutory duties; and (v)situations where the conduct has caused the company to act illegally or unlawfully in contravention of either the companies legislation or other laws in general. 8.036

The concept of misconduct is clearly wider than the concept of fraud under the common law doctrine of fraud on a company, and thus there is a greater scope for a derivative action to be brought under the statute compared with the common law in this regard. A statutory derivative action can be brought not only where the directors have committed misconduct, but in relation to any proceeding where any person has committed misconduct against the company as defined under s.732(1) of the CO.

In addition, a statutory derivative action can be commenced in respect of any matter where a company fails to bring proceedings in respect of such matter by reason of misconduct committed against the company as so prescribed under s.732(2) of the CO. This provision was interpreted in *Re Myway Ltd*[231] as making it clear that the statutory provisions can be relied upon to institute proceedings against third parties. The conduct of persons within the company preventing the company from taking legal

[226] CO, s.732.

[227] CO, s.731. However, the application for leave is brought in the Court of First Instance: see s.732 and the definition of "Court" in s.2.

[228] CO, s.722(1).

[229] CO, s.2(1). For the concept of 'establishing a place of business in Hong Kong', see *Kam Leung Sui Kwan v Kam Kwan Lai* (2015) 18 HKCFAR 501, sub nom *Re Yung Kee Holdings Ltd* [2015] 6 HKC 644. As to whether a company which previously established a place of business in Hong Kong but no longer has such a place of business is still a non-Hong Kong company, cf *Re Gen2 Partners Inc* [2012] 4 HKLRD 511.

[230] CO, s.731.

[231] [2008] 3 HKLRD 614 at 621–622.

investment as desired to capture the growth of the share value of the company. On the other hand, a company that pays out high dividends would retain and reinvest less of the earnings in the business and in theory this reduces the future earnings and dividends payout. The reason given is that if the company wanted to increase dividend payout without changing their investment plans and borrowing, it may issue more shares but there must necessarily be a transfer of value from the old to the new shareholders. The capital loss borne by the shareholders sets off the increased dividend they receive. Hence advocates of the dividend irrelevance theory argue that investors will not place a higher value on companies with high dividend payout. Therefore, companies ought to let dividends fluctuate according to the manager's investment and financing decisions and not be influenced by investor preference for dividends.

Signalling Effect of Dividend Payments

11.004 But how do proponents of the dividend irrelevance theory explain the commonplace phenomenon that an increase in dividend is often accompanied by an increase in the price of the shares whilst a dividend cut lead to the fall of the share price? They do so by the theory that there is a *signalling effect* when dividends are declared. By reason of the information asymmetry between those managing the business and the general shareholders, the former obviously with better information about the business and its prospects, higher dividends signal to shareholders that the managers forecast good prospects of higher future earnings. The assumption made however is that directors cannot lie to seek to boost the value of the companies' shares by declaring high dividends notwithstanding the prospects of business is not good as the company does not have the future cash-generating power to maintain any inflated dividends.[2] However, one empirical study shows that the signalling effect of dividend may be less prominent in Hong Kong than in the United States. It has been reported that in Hong Kong dividend payout ratio varies a lot more than in the United States and there is no significant underperformance or out performance whether one year before, during or after dividend cuts or dividend increases respectively.[3]

Criticisms of the Dividend Irrelevance Theory

11.005 The dividend irrelevance theory is now believed to be correct only in an efficient capital market and where one excludes the effect of tax and transaction costs. Even in the absence of any withholding tax on the dividends or capital gains tax in Hong Kong, there will be transaction costs such as brokerage fees and other levies incurred as well as the inconvenience to shareholders in realizing shares in the market for cash. Hence shareholders may prefer dividend payments. Furthermore, the model assumes that all shares are readily realizable in the market at a price which reflects the true value of the business of the company. It does not take into account market irrationality. Moreover, in the case of shares of small or private companies, shares are highly illiquid and shareholders who want cash would rely heavily on the payment of dividends.

[2] For more on the signalling hypothesis see Brigham and Houston, *Fundamentals of Financial Management*, (Mason, OH: South-Western/Cengage Learning, 12th edn, 2009), pp 460–461.

[3] See Thomas J. Chemmanur and Y. Helen Liu, "Dividend Policy: New Insights from a Comparative Study of Hong Kong and the United States", a paper presented at the Third Annual Conference of the Chinese Finance Association, September 1996, New York (http:/www.aimhi.com/VC/tcfa/conference/archives/cfa_work.html).

An Alternative Theory

11.006 An alternative theory that has been advanced by academics such as Myron Gordon[4] and John Lintner[5] is that investors value current dividends more highly than any future capital growth. The reason being is that there is an uncertainty that shareholders will receive capital gain in the future even where profits are retained and reinvested in the business. It also assumes that shareholders can trust the managers of the company to properly employ the retained earnings in pursuing profitable business opportunities or not otherwise enriching themselves through acquisition of assets which cannot be justified or paying huge salary and emoluments to themselves. However, this alternative theory is not without criticisms. For example, Professors Merton Miller and Franco Modigliani argue that investors often reinvest their dividends in companies of similar type rather than to pocket the immediate gain. Furthermore they argue that often the riskiness of future returns to shareholder is not determined by dividend payout policy but the riskiness of operating cash flows.[6]

A Different Phenomenon for Hong Kong Companies

11.007 The interest and preference of shareholders and managers may more be aligned where shares of the company are closely held or family-owned, as is characteristic of many companies in Hong Kong and other South-East Asian economies. An empirical study of Hong Kong listed companies shows that there is no statistically significant relationship between family ownership and dividend policy for all companies sampled generally and for large market capitalization firms. For small market capitalization firms, there is a negative relationship between dividend yield (dividend per share divided by share price) and family ownership (percentage of shares held by controlling family) up to 10 percent of the company's stock but a positive relationship for firms with greater family ownership between 10 to 35 percent.[7] The positive relationship in small firms has been explained as being due to investors demanding a higher dividend payout from companies with potentially the highest risk of expropriation of minority shareholders or alternatively, the larger payouts representing the extraction of company resources by the controlling family shareholders who empirically receive a large amount of dividend income.

Legal Rationale for the Regulation of Distribution

Capital Maintenance

11.008 If, as some economic theories suggest and empirical data shows, shareholders like dividends, one would have thought that the question of whether profits are distributed and the amount to be distributed is best left to the better judgment of those charged with running the business. Yet it is not a purely commercial decision as the law regulates the distribution of profits by companies to their shareholders by restricting the funds

[4] Myron J. Gordon, "Optimal Investment and Financing Policy", (May 1963) *Journal of Finance*, 264–272.

[5] John Lintner, "Dividends, Earnings, Leverage, Stock Prices, and the Supply of Capital to Corporations", *Review of* (Aug 1962), *Economics and Statistics*, 243–269.

[6] See Brigham & Houston, *Fundamentals of Financial Management*, (Mason, OH: South-Western/Cengage Learning, 12th edn, 2009), p 459.

[7] Zhilan Chen, Yan-Leung Cheung, Aris Stouraitis, Anita W.S. Wong, "Ownership Concentration, firm performance and dividend policy in Hong Kong", (2005) 13 *Pacific-Basin Finance Journal* pp 431–449. See in particular pp 443–447.

out of which the distribution may lawfully be made. In effect, this restricts the level of dividends that may be declared by the company. The need for the law to regulate distributions by companies stems from a fundamental principle of company law that capital must be maintained. It is often said the principle of capital maintenance is the price to be paid for limited liability by choosing to incorporate a company for the carrying of business activities. The capital maintenance principle[8] as traditionally understood restricted: (a) the use of capital otherwise than for properly pursuing the objects of the company; and (b) the return of capital to shareholders unless with the sanction of the court. An often cited passage explaining the rationale for the need to maintain capital is that of Lord Watson in *Trevor v Whitworth*:[9]

> "One of the main objects contemplated by the legislature, in restricting the power of limited companies to reduce the amount of their capital as set forth in the memorandum, is to protect the interests of the outside public who may become their creditors. In my opinion, the effect of these statutory restrictions is to prohibit every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the Court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of business."

The Implied Contract

11.009 Before express statutory regulations were introduced into this area of the law, the courts resorted to the notion of an implied contract between the company and its creditors to justify the protection afforded to creditors in prohibiting payment of dividends out of capital. It is said that creditors dealing with the company or otherwise advance money to companies with limited liability are entitled to rely on the faith of an implied representation by the company that capital is only applied for the purposes of the business and not returned to its shareholders. As explained by Jessel MR in *Re Exchange Banking Co, Flitcroft's Case*:[10]

> "A limited company by its memorandum of association declares that its capital is to be applied for the purposes of the business. It cannot reduce its capital except in the manner and with the safeguards provided by statute, and looking at the Act 40 and 41 Vict c 26, it clearly is against the intention of the Legislature that any portion of the capital should be returned to the shareholders without the statutory conditions being complied with. A limited company cannot in any other way make a return of capital, the sanction of a general meeting can give no validity to such a proceeding, and even the sanction of every shareholder cannot

[8] For further discussion on capital maintenance, see Part 2 of this text on Capital.
[9] (1887) 12 App Cas 409 at 423–424.
[10] (1882) 21 Ch D 519 at 533–534.

> bring within the powers of the company an act which is not within its powers. If, therefore, the shareholders had all been present at the meetings, and had all known the facts, and had all concurred in declaring the dividends, the payment of the dividends would not be effectually sanctioned. One reason is this - there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement, which is sometimes said to be an implied contract with creditors, people dealing with the company give it credit. The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders…"

II. THE REGULATION OF DISTRIBUTION BY COMPANIES

The Common Law

General Rule

11.010 Before statutory provisions were introduced to regulate the distribution of profits by a company, the general principle at common law was that dividends must not be paid out of capital.[11] This prohibition was said to be implicit even where the memorandum and articles of association of the company do not expressly prohibit the payment of dividends out of capital.[12] Even where the articles of the company purport to allow payment of dividend out of capital, such an article would be invalid.[13] Nor can shareholders sanction the payment of dividends out of capital.[14] Before the introduction of statutory rules expressly governing the distribution of profits, the prohibition against the payment of dividend out of capital was held to be implicit. The courts have explained that it would be contrary to the legislative provisions against the return of capital to shareholders to allow the distribution otherwise than out of profits.[15]

The Distinction Between Profits and Capital

11.011 Although at common law the distinction was often drawn between profits and capital, it is probably more correct to say, the prohibition was that dividends cannot be paid out of capital and not that it must only be paid out of profits, though the latter requirement was commonly found in the articles of association of companies. As was pointed out by Farwell J in *Bond v Barrow Haematite Steel Co*:[16]

> "…the law (1) that dividends must not be paid out of capital, and (2) that dividends may only be paid out of profits - are not identical, but diverse. The first

[11] See *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519 at 533–534.
[12] *Guinness v Land Corporation of Ireland* (1883) 22 Ch D 349.
[13] *Verner v General and Commercial Investment Trust* [1894] 2 Ch 239.
[14] *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519 at 533.
[15] *Verner v General And Commercial Investment Trust* [1894] 2 Ch 239 at 264.
[16] [1902] 1 Ch 353 at 365.

> is the requirement of the statutes, and cannot be dispensed with; the latter is in Table A or the articles of the particular company, and is one of the regulations of this company which has to be construed. A company which has a balance to the credit of its profit and loss account is not bound at once to apply that sum in making good an estimated deficiency in value of its capital assets. It may carry it to a suspense account or to reserve, and if the assets subsequently increase in value the amount neither has been nor will be part of the capital. If, therefore, a part of that balance is used in paying a dividend, that dividend is not paid out of capital, because the sum has never become capital, although it still remains a question whether it has been paid out of profits or not. It has been pointed out by Lindley LJ in *Lee v Neuchatel Asphalte Co*[17] that there is nothing in the statutes requiring a company to keep up the value of its capital assets to the level of its nominal capital. The requirement is merely negative, that dividends shall not be paid out of capital, and the balance to the credit of profit and loss account does not automatically become part of the capital assets because the value of the actual capital assets has depreciated to an amount equal to or exceeding that balance."

Accordingly, at common law, the payment of dividend out of share premium account was held not to be capital and could be lawfully made.[18]

Non-Cumulative

11.012 Another matter to note about the common law rule is that there was no requirement that trading losses made in the previous years had to be taken into account in determining whether there were profits available for distribution.[19] The financial position of the company was therefore looked at in isolation each year. Notwithstanding huge losses may have been incurred in the past, so long as there were profits for the year in which dividends are proposed, such profits could be properly distributable.

No Requirement to take into account Losses

11.013 At common law, there was no rule which required any loss in capital to be made good before profits could be distributed unless the articles so required[20] so long as there were profits to distribute when the whole of the accounts were fairly taken into account.[21] On the other hand, though profits could be distributed notwithstanding a loss in capital, any loss in revenues could not be made good by any appreciation in capital and used for distribution.[22] This follows from the strict segregation between the capital and revenue accounts maintained by the court in previous cases.

No Distinction Between Realized and Unrealized Profits and Losses

11.014 There was also no requirement at common law to distinguish between realized and unrealized profits for the purposes of determining what profits were distributable, which as will be seen later is no longer the case by reason of the distinction now

[17] (1889) 41 Ch D 1.
[18] *Drown v Gaumont-British Picture Corp Ltd* [1937] Ch 402.
[19] *Ammonia Soda v Chamberlain* [1918] 1 Ch 266 at 289.
[20] *Verner v General Investment Trust* [1894] 2 Ch 239.
[21] *Foster v New Trinidad Lake Asphalt Co Ltd* [1910] 1 Ch 208.
[22] *Wall v London & Provincial Trust Ltd* [1920] 1 Ch 45.

introduced by statute. At common law, any increase in the value of capital could be realized and distributed as it is treated as profits and not capital.[23] Even unrealized profit was said to be properly distributable.[24]

The Problem with the Common Law Rule

11.015 As already has been mentioned, the distinction between capital and profits was thus important in previous cases in determining whether a distribution can be made. However, courts often lamented on the difficulty of such a distinction and emphasized that cases were decided on the specific facts of each case such that no easy rule can be drawn from previous cases. In *Dovey v Cory*,[25] Earl of Halsbury LC thus remarked:

> "It is easy to lay down as an abstract proposition that you must not pay dividends out of capital; but the application of that very plain proposition may raise questions of the utmost difficulty in their solution."

Fortunately, the previous case law and the distinction between capital and revenue can now happily be disregarded with the introduction of statutory provisions in the current Companies Ordinance (Cap.622) ("CO") which now governs the distribution of profits by a company.

The Companies Ordinance (Cap.622)

Legislative History

11.016 The regulation of distribution of profits by companies by legislation was first introduced when the former Part IIA (ss.79A to 79P) of the predecessor CO was added by Companies (Amendment) Ordinance 1991, which was passed on 4 July 1991 and became effective as of 1 September 1991. Part IIA more or less replicated Part VIII of the UK Companies Act 1985, as amended by the Companies Act 1989. The statutory provisions which provides for the restriction on a company making a distribution to its shareholders and a statutory definition of what are distributable profits are now to be found in Part 6 of the CO.

General Rule Applicable to all Companies

11.017 The primary statutory provision is found in s.297(1) of the CO. It prohibits a company from making a distribution except out of profits available for distribution. It applies to all companies, public or private.

The Articles of Association (Table A or the "Model Articles")

11.018 When the former Part IIA of the predecessor CO was introduced, Article 117 of the Table A was amended to expressly require payment of distributions to be in accordance with the provisions of Part IIA. Article 117 provides:

[23] *Wall v London & Provincial Trust Ltd* [1920] 1 Ch 45, citing *Lubbock v British Bank of South America* [1892] 2 Ch 198 in approval. See also *Cross v Imperial Continental Gas Association* [1923] 2 Ch 553.
[24] *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] 2 WLR 253.
[25] [1901] AC 477 at 487.

> "No dividend shall be paid otherwise than out of profits in accordance with the provisions of Part IIA of the Ordinance".

Formerly, art.117 of Table A of that predecessor CO only stated that dividends could only be paid out of profits. For existing companies that have already adopted Table A as their articles of association, that art.117 shall continue to apply. For companies incorporated after the commencement of the current CO, the new model articles of association in the CO subsidiary legislation of the Companies (Model Articles) Notice (Cap.622H) ("Model Articles") will apply in so far as the articles of a company do not exclude or modify them (CO, s.80). The Model Articles provides:

> "A dividend may only be paid out of the profits in accordance with Part 6 of the Ordinance".[26]

Minimum Threshold

11.019 As s.296 of the CO[27] provides, that Part 6 does not affect any provision of a company's articles restricting the sums out of which or the cases in which a distribution may be made, it will always be necessary to examine carefully and properly construe the articles of each company on what restrictions are imposed above and beyond that of Part 6.

The Prohibition on Certain "Distributions"

Definition of "Distribution"

11.020 Section 297 of the CO prohibits the making of certain distributions. "Distribution" is statutorily defined in s.290(1) of the CO to mean every description of distribution of a company's assets to its members whether in cash or otherwise, except distribution by way of:

(a) an issue of shares as fully or partly paid bonus shares;

(b) a redemption or buy-back of any shares in the company out of capital (including the proceeds of any fresh issue of shares), or out of unrealized profits, in accordance with Division 4 of Part 5;

(c) a reduction of share capital by extinguishing or reducing any member's liability on any of the company's shares in respect of share capital not paid up, or by repaying paid up share capital;

(d) a distribution of assets to members of the company on its winding-up; or

(e) financial assistance given by the company to a member under ss. 283, 284 or 285 of the CO.[28]

[26] See art. 91(3) of the Model Articles for Public Companies Limited by Shares ("Model Articles for public companies") in Schedule 1 to Cap.622H and Article 73(3) for Model Articles for Private Companies Limited by Shares ("Model Articles for private companies") in Schedule 2 to Cap.622H.

[27] Formerly, s.79P of the predecessor CO was based on s.281 of the Companies Act 1984 (UK).

[28] Formerly, s.79A(1) of the predecessor CO save that (e) was only added in the current Ordinance.

Types of Distributions that are Restricted

11.021 Although not limited to such, the most obvious type of distribution caught by the provisions of Part 6 of the CO is the payment of dividends. Other distributions in the form of cash, assets, debentures or shares would all *prima facie* fall within the definition unless specifically exempted by the definition. Given the breadth and generality of "every description of distribution of a company's assets", it would be prudent to assume that unless otherwise falling within the five instances which are specifically excluded in the definition, it will be caught by the provisions of Part 6 of the CO.

Distribution "to its Members"

11.022 On the other hand, not every payment out of assets to shareholders would be caught by the provisions of Part 6 of the CO. The definition is qualified by the words "to its members" which would suggest that the distribution would have be made to members *qua* shareholders.[29] For example, as is common in small private companies, where all the shareholders are also directors of the company, the issue arises whether payments as a form of reward or remuneration are caught by the provision. If the true intention of the payment was a reward for past or future services provided to the company, the mere fact that payment is made out of assets of the company to shareholders or former shareholders in proportion to their shareholding may not necessarily be considered a "distribution".[30] However, the burden would be on the company to satisfy the court any payment, which otherwise is plainly a distribution of the company's assets to its members, and falling within the definition of distribution, is a genuine reward for past services to its directors.[31]

Reform in the UK

11.023 In the UK, the Steering Group to the Company Law Reform 2000, originally proposed to insert into the definition that a distribution for the purpose of that section is distribution of assets to members "in their capacity as members" but the responses received was not in favour of the proposal and this was abandoned.[32]

Types of Distributions that are Excluded: Issue of Bonus Shares

Capitalization of Profits for the Issuance of Bonus Shares

11.024 Often a company may choose to capitalize any surplus of profits (whether being a credit standing in the profit and loss account or its reserves) by converting them into shares or debentures and issuing them to shareholders proportionate to their shareholding in the company instead of paying cash dividends. The power to do so must

[29] *Cf* the equivalent provisions in New Zealand where "distribution" is defined to mean: (a) the direct or indirect transfer of money or property, other than the company's own shares, to or for the benefit of the shareholder; or (b) the incurring of a debt to or for the benefit of the shareholder –*in relation to shares held by that shareholder*, and whether by means of a purchase of property, the redemption or other acquisition of shares, a distribution of indebtedness, or by some other means. It was held in *Re DML Resources Ltd (In Liquidation)* [2004] 3 NZLR 490 that a distribution involved the direct or indirect transfer of money or property by a company to or for the benefit of a shareholder in its capacity as shareholder.

[30] *MacPherson v European Strategic Bureau* [1999] 2 BCLC 203 at 213c–d, on appeal [2000] 2 BCLC 683 at 702, para 52.

[31] See *MacPherson v European Strategic Bureau*, on appeal [2000] 2 BCLC 683, per Buxton LJ at 704, para 59.

[32] *Modern Company Law For A Competitive Economy, Capital Maintenance: Other Issues* (June 2000), paras 35–36.

be found in the company's articles.[33] The Model Articles provide that the company may upon the recommendation of directors resolve to capitalize profits and where the capitalization is accompanied by the issue of shares or debentures, apply the sum capitalized in the proportions in which the members would be entitled if the sum was distributed by way of dividend.[34]

Exempted Distribution under s.290(1) of the CO: issue of bonus shares

11.025 The definition of distribution specifically excludes the issue of bonus shares.[35] Prior to the introduction of legislative provisions, the common law regarded the issue of bonus shares[36] or debenture stock[37] out of profits not in the nature of payment of profit (and hence properly taxable as income in the hands of the recipient under the relevant UK tax regulations). In the case of *Blott* and *Greenwood*,[38] Lord Haldane made it abundantly plain that the matter as to whether the distribution is in the nature of making a payment out of capital must be looked at from what is the intention of the company, expressed and to be found in the terms of the resolution at their extraordinary general meeting.[39] He then further held in that case, the issue of bonus shares did not involve any payment of profits out of the company:

> "For the reasons I have given I think that it is, as matter of principle, within the power of an ordinary joint stock company with articles such as those in the case before us to determine conclusively against the whole world whether it will withhold profits it has accumulated from distribution to its shareholders as income, and as an alternative not distribute them at all, but apply them in paying up the capital sums which shareholders electing to take up unissued shares would otherwise have to contribute. If this is done the money so applied is capital and never becomes profits in the hands of the shareholder at all".[40]

Issue of Debentures

11.026 Similarly, in the case of the issue of debenture stock to shareholders at common law it has been held that this did not involve any payment of assets out of the company. Hence in *Commissioners of Inland Revenue v Fisher's Executors*,[41] Viscount Cave LC held:

> "No doubt, the shareholders got debenture stock which, like the shares in *Blott's* case, was a valuable thing; but they had no power to call in the stock, which gave them no present right to receive any part of the company's assets either in money or in money's worth, but only entitled them to a sum to be carved out of those assets if and when the stock was paid off. It is true that debenture stock, unlike shares, creates a debt; but the debt in this case was not presently payable and may never become payable while the company is in existence. The whole transaction was 'bare machinery' for capitalizing profits and involved no release of assets either as income or as capital".[42]

[33] *Wood v Odessa Waterworks Co Ltd* (1889) 42 Ch D 636.
[34] See art.99 of Schedule 1 of the Model Articles for public companies and art.79 Schedule 2 of the Model Articles for private companies.
[35] See definition of "distribution" in CO, s.290(1) (formerly, s.79A of the predecessor CO).
[36] *Commissioners of Inland Revenue v Blott*; *Commissioners of Inland Revenue v Greenwood* [1921] 2 AC 171.
[37] *Commissioners of Inland Revenue v Fisher's Executors* [1926] AC 395.
[38] [1921] 2 AC 171.
[39] See *Re Blott and Greenwood*, [1921] 2 AC 171 at 182, where Lord Haldane held: "But if, acting within its powers, it disposes of these profits by converting them into capital instead of paying them over to the shareholders, that, as I conceive it, is conclusive as against all the outside world".
[40] See *Re Blott and Greenwood*, [1921] 2 AC 171 at 184.
[41] [1926] AC 395.

Rationale for the Exemption

11.027 As already mentioned, the rationale for the regulation of distribution by company is the concern for the maintenance of capital. The issue of bonus shares and debenture properly understood does not involve any distribution of assets as the fund necessary to pay up the shares remains with the company. As explained by Scott J in *Re Cleveland Trust plc*[43] in relation to the equivalent UK provision:

> "Section 263 of the 1985 Act does not apply to the issue of shares as fully-paid or partly-paid bonus shares. The reason for the lack of legislative concern is that the fund necessary to pay up the shares remains with the company. There is no distribution of company assets to shareholders and creditors' interests are not therefore at risk".[44]

Accounting Treatment

11.028 In accounting terms, it has been explained that there is no reduction in the company's assets where bonus shares are issued since the assets and liabilities side of the balance sheet remains unchanged but the capital and reserves side of the balance sheet is rearranged with a reduction in the amount of the profits or other relevant reserves and an equal increase in the amount of the paid up share capital reflecting the increase in the issued share capital. What is involved is the capitalization of undivided profits of the company (or of the sum standing to the credit of the company's share premium account or capital redemption reserve, if available) and appropriating to the member in question out of the profits so to be capitalized what is needed in paying up in full the unissued shares which are to be allotted to him as fully paid up bonus shares.[45]

Issue of Debenture Shares should also be Exempted

11.029 It is therefore explicable that the definition of "distribution" for the purposes of Part 6 of the CO expressly excludes the issue of bonus shares.[46] However, it should be noted that there is no specific exemption for the issue of debenture shares financed out of distributable profits though it is submitted that there is no reason why they ought not be also exempted for like the issue of shares, as explained by the foregoing, they involve no payment of capital out of the company.

[42] See *Commissioners of Inland Revenue v Fisher's Executors* [1926] AC 395 at 403–404. See also *Re Outen Will's Trusts* [1962] 3 WLR 1084.
[43] [1991] BCLC 424.
[44] See *Re Cleveland Trust plc* [1991] BCLC 424 at 432c–d.
[45] See Blackburn J in *Topham v Charles Topham Group Ltd* [2003] 1 BCLC 123 at 139e–f.
[46] CO, s.290(1).

Unlawful Profits Capitalized

11.030 However, where the profits which purportedly is capitalized is unlawful, ie on the false premise that there were profits available for distribution, the issue of bonus shares may be *ultra vires* and void.[47]

Other Exempted Distributions under s.290(1) of the CO

11.031 The redemption or buying back of the company's own shares as well as the reduction of capital by extinguishing or reducing unpaid capital or by paying off share capital are transactions expressly excluded from the definition of "distribution". These transactions are already strictly regulated by the relevant sections of the CO.[48] Upon liquidation of the company, there is no power for the company or the liquidator to declare and pay as dividends out of surplus assets to shareholders.[49] These surplus assets would have to be distributed in the course of winding up in accordance with the retitled Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap.32) and is therefore also expressly exempted from the definition of "distribution" for the purposes of Part 6 of the CO. Financial assistance (within the meaning of CO, s.274(1)) given by the company to a member under ss.283, 284 or 285 of the CO, is also now exempted under Part 6 of the CO.

Section 297(1): The General Rule

Distribution may only be made out of "Profits Available for Distribution"

11.032 Where the purported distribution falls within Part 6 of the CO, companies may only make such distribution out of "*profits available for distribution*".[50] Unlike previously under the common law, there is now a statutory provision stipulating what are profits available for distribution. There is no longer a distinction drawn between capital and profits for the purposes of determine what may be distributed by the company.[51] Rather, s.297(2) of the CO provides that what is distributable is to be mathematically calculated by taking the company's accumulated, realized profits, so far as not previously utilized by distribution or capitalization, subtracting it with its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital[52] (i.e. accumulated realized profits –accumulated realized losses).

Distribution out of Realized Profits Only

11.033 Only realized profits can be used for the distribution.

[47] *Re Cleveland Trust plc* [1991] BCLC 424.

[48] The redemption or purchase of the company's own shares out of capital or out of unrealized profits must be in accordance with Division 4 of Part 5 of the Ordinance. For the reduction of share capital, see Division 3 of Part 5 of the CO which lays down stringent criteria to safeguard the interests of the creditors of the company.

[49] See *Re Catalinas Warehouses and Mole Co Ltd* [1947] 1 All ER 51; see also *Re Syston & Thurmaston Gas Co* [1937] 2 All ER 322; *Re Crichton's Oil Co* [1902] 2 Ch 86; *Re TXU Europe Group Plc (in admin and VCA)* [2011] EWHC 2072 (Ch).

[50] CO, s.297(1) (formerly s.79B(1) of the predecessor CO.).

[51] See *Lee v Neuchatel Asphalte Co* (1889) 41 Ch D 1; see also *Ammonia Soda Co Ltd v Chamberlain* [1916–1917] All ER Rep 708.

[52] CO, s.297(2). See the equivalent definition in s.263(3) of the Companies Act 1985 (UK).

Meaning of "Profits" and "Losses"

11.034 "Profits" and "losses" are not defined but clearly would include gains or losses incurred from trading and sale of capital made by the company at any time.

Cumulative

11.035 The requirement for "accumulated" profits or losses in s.297(2) of the CO also makes clear that the position of the company is viewed cumulatively and not just for a particular year.[53] Thus the balance of any profit or loss from previous years has to be taken into account for the calculation of distributable profits of the current year.

"Realized Profits" and "Realized Losses"

Statutory Definition of "Realized Profits" and "Realized Losses" under s.291 of the CO

11.036 The distinction is between realized and unrealized profits is important for the purpose of determining what profits are properly distributable. A company's realized profits is defined under s.291 of the CO as those regarded as realized profits for the purpose of any financial statements prepared by the directors in accordance with principles generally accepted at the time when those accounts are prepared, with respect to the determination for accounting purposes of realized profits.[54] Accordingly, legislature has deferred to the accounting profession as to what is regarded as realized or unrealized profits. The main guidance on the accounting standards in Hong Kong are collectively known as the *Hong Kong Financial Reporting Standards* ("HKFRS") which includes all HKFRS, Hong Kong Accounting Standards ("HKAS"), Statements of Standard Accounting Practice ("SSAP"), and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which was formerly the Hong Kong Society of Accountants ("HKSA"). Departure from SSAPs is allowed only where the Standard is clearly inappropriate and a true and fair view cannot be give by applying it.[55]

Accounting Guidance Issued by HKICPA for Hong Kong

11.037 In May 2010, the HKICPA issued under Accounting Bulletin 4, *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance* ("the Guidance"). It is closely based on the Technical Release (TECH 01/09), *Guidance on the determination of realized profits and losses in the context of distributions under the Companies Act 2006* issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland but adopted by HKICPA to the Hong Kong context. Its declared purpose is to identify, interpret and apply the principles relating to the determination of realized profits and losses for the purposes of making distributions under the former ss. 79A to 79P of the predecessor CO. However, it is expressly

[53] The UK equivalent provisions first found in s.39 of the Companies Act 1980 and then ss.263 and 275 of the Companies Act 1985 to include the requirement for profits and losses to be "accumulated" was as a result of the recommendation of the *Jenkins Committee Report* (1962) Cnmd 1749, para 341 that revenue account should be seen as a continuous account.

[54] CO, s.291(1) (formerly s.79A(3) of the predecessor CO).

[55] HKAS1, paras 15 and 17.

stated to be for general guidance only.[56] It was issued in response to concerns over the lack of clarity over the meaning of "realized profits" expressed during a consultation exercise carried out in June 2006 in respect of the predecessor CO and the Companies Ordinance re-writing exercise.[57]

Guidance on "Realized Profit" and "Realized Loss"

11.038 Generally, profits are treated as realized only when realized in the form of cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty and that realized profits may also encompass profits relating to assets that are readily realizable".[58] As a matter of generally accepted accounting practice, a profit is realized where it arises from:

(a) a transaction where the consideration received by the company is "qualifying consideration";

(b) an event which results in "qualifying consideration" being received by the company in circumstances where no consideration is being given by the company;

(c) the recognition in the financial statements of a change in fair value, in those cases where fair value has been determined in accordance with measurement guidance in the relevant accounting standards or company law, and to the extent that the change recognized is readily convertible to cash;

(d) the translation of:

  (i) a monetary asset which comprises "qualifying consideration"; or

  (ii) liability;

(e) the reversal of a loss previously regarded as realized; or

(f) a profit previously regarded as unrealized (such as amounts taken to a revaluation reserve, merger reserve or other similar reserve) becoming realized as a result of:

  (i) consideration previously received by the company becoming "qualifying consideration";

  (ii) the related asset being disposed of in a transaction where the consideration received by the company is "qualifying consideration";

  (iii) a realized loss being recognized on the scrapping or disposal of the related asset;

  (iv) a realized loss being recognized on the write-down for depreciation, amortization, diminution in value or impairment of the related asset;

  (v) the distribution in specie of the asset to which the unrealized profit relates; or

[56] See Accounting Bulletin 4, para 1.1.
[57] See Accounting Bulletin 4, para 1.7.
[58] See Accounting Bulletin 4, para 3.3.

  (vi) the receipt of a dividend in the form of qualifying consideration where no profit is recognized because the dividend is deducted from the book value of the investment to which the profit relates.[59]

The most common form of "qualifying consideration" is cash but also includes:

(a) an asset that is "readily convertible to cash";

(b) the release, or the settlement or assumption by another party, of all or part of a liability of the company;

(c) an amount receivable in any of the above forms of consideration where:

  (i) the debtor is capable of settling the receivable within a reasonable time;

  (ii) there is a reasonable certainty that the debtor will be capable of settling when called upon; and

  (iii) there is an expectation that the receivable will be settled.[60]

An asset, or a change in the fair value of an asset or liability, is considered as "readily convertible to cash" if:

(a) a value can be determined at which a transaction in the asset or liability could occur, at the date of determination, without negotiation and/or marketing, to convert the asset, liability or change in fair value into cash or to close it out;

(b) in determining the value, information such as prices, rates or other factors that market participants would consider in settling a price is observable; and

(c) the company's circumstances must not prevent immediate conversion to cash or close out of the asset, liability or change in fair value; for example, in disposing of the item there would not be any intention or need to liquidate or curtail materially the scale of the company's operations, or to undertake a transaction on adverse terms.[61]

Other instances which would constitute realized profits are also set out.[62] The Guidance further provides that losses should be regarded as realized losses except to the extent that the law, accounting standards or the Guidance provide otherwise.[63]

Concept of Realized Profit is Flexible and Changing

11.039 The concept of "realized profits" is recognized to be a dynamic and complex accounting concept.[64] It is apparent from the words "regarded as realized profits … at the time when the financial statements are prepared" [65]that the concept of "realized profits" is

[59] See Accounting Bulletin, para 3.9.
[60] See Accounting Bulletin 4, para 3.11.
[61] See Accounting Bulletin 4, para 3.12.
[62] See Accounting Bulletin 4, para 3.14.
[63] See Accounting Bulletin 4, para 3.10.
[64] See *Consultation Conclusions on the Companies Ordinance Rewrite Consultation Paper* entitled "*Share capital, the capital maintenance regime and statutory amalgamation procedure*" published by the Financial Services and Treasury Bureau in February 2009 at para 33.
[65] CO, s.291(1).

intended to be dynamic and changing with the development of generally accepted accounting principles. A profit which previously was regarded as unrealized may become realized when the relevant criteria set out in the Guidance are met. Conversely, a profit previously regarded as realized may become unrealized when the criteria in the Guidance cease to be met.[66]

The Commercial Effect of the Transaction

11.040 Furthermore, the Guidance recognizes that for the purposes of determining whether a company has a realized profit, transactions and arrangements should not be looked at in isolation and the overall commercial effect of the company (and not of the group) has to be considered as to whether it satisfies the definition of realized profits set out in the Guidance. This presumably targets intra-group or tax-driven transactions and stress the need to look behind any such transaction (almost like an accountancy way to pierce the corporate veil) particularly if a transaction is artificial, linked, or circular.[67]

Specific Instances Where Profits or Losses are treated as Realized

11.041 Other than the general provision in s.291 of the CO, which is expressly stated to be without prejudice to any specific provision for the treatment of profits of any description as realized,[68] s.292 of the CO also provides specifically for a number of instances where for the purposes of Part 6 of the CO, a certain amount is to be regarded as a realized profit or realized loss.

Revaluation of a Fixed Asset

11.042 Where a fixed asset has been revalued and an unrealized profit is made, and a sum is written off or retained for depreciation of that asset over a period, then there is a deemed realized profit of the amount by which that sum exceeds the projected sum[69] in relation to the depreciation of that asset over the period.[70] In calculating whether there has been a profit made in respect of that asset, where there is no record of the original cost of the asset, or a record cannot be obtained without unreasonable expense or delay, the value ascribed to it in the earliest available record of its value made on or after its acquisition may be used.[71] For the purposes of s.292 of the CO, an asset is a "fixed asset" if it is intended to be used or otherwise held on a continuing basis in the company's activities.[72] This definition is in line with the definition at common law as explained in *Ammonia Soda Co Ltd v Chamberlain*[73] by Swinfen Eady LJ:

> "What is fixed capital? That which a company retains in the shape of assets upon which the subscribed capital has been expended, which assets either themselves produce income independently of any further action by the company, or, being retained by the company are made use of to reproduce income or gain profits. A trust company, founded to acquire and hold stocks, shares, and securities, and from time to time to divide the dividends and income arising therefrom, is an instance of the former. A manufacturing company, acquiring or erecting works with machinery or plant, is an instance of the latter. In these cases the capital is fixed in the sense of being invested in assets intended to be retained by the company more or less permanently and used in producing an income. What is circulating capital? It is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business in the form of money, goods, or other assets, and which or the proceeds of which are intended to return to the company with an increment and are intended to be used again end again and to always return with some accretion".

[66] See Accounting Bulletin 4, para 3.6.
[67] See Accounting Bulletin 4, para 3.5.
[68] CO, s.291(2).
[69] "Projected sum" is defined in CO, s.295(7) to mean a sum that would have been written off or retained for depreciation if the revaluation of the asset had not been made.
[70] CO, s.292(5).
[71] CO, s.292(6).
[72] CO, s.292(8).
[73] [1918] 1 Ch 266 at 286–287.

However, the line between fixed and circulating asset has been frequently said to be a fine and difficult one to draw.[74] It depends not so much on the nature of the asset concerned but the nature of the trade to which the asset is employed.[75] In case of doubt, accounting practice again would become very relevant in this regard.

Distribution in Kind

11.043 Another instance where an amount is regarded as a "realized profit" is where a company makes a distribution consisting of or including a non-cash asset, and any part of the amount at which that asset is stated in the referential financial statements[76] represents an unrealized profit, that part of the amount is regarded as a realized profit.[77]

Provisions for Depreciation Treated as a "Realized Loss"

11.044 Except for a provision for the depreciation of fixed assets resulting from a revaluation of all of the company's fixed assets or all of the company's fixed assets other than goodwill, all provisions are treated as "realized losses".[78] Formerly, this section only applied to those provisions set out in paragraph 30(1) of the Tenth Schedule of the predecessor CO but now there is no such limit in the current CO.[79]

No Need for Actual Revaluation

11.045 For the purpose of the above exception, it is not necessary to carry out any actual revaluation. Any consideration by the directors of the value at a particular time of a fixed asset is treated as a revaluation.[80] However, a number of requirements have to

[74] See per Viscount Haldane in *John Smith and Son v Moore* [1921] 2 AC 13 at 19–20: "My Lords, it is not necessary to draw an exact line of demarcation between fixed and circulating capital. Since Adam Smith drew the distinction in the Second Book of his 'Wealth of Nations', which appears in the chapter on the Division of Stock, a distinction which has since become classical, economists have never been able to define much more precisely what the line of demarcation is. Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters".
[75] *Davies (HM Inspector of Taxes) v The Shell Company of China Ltd* (1950–1952) 32 Tax Cas 133.
[76] See further below at para 11.049.
[77] CO, s.294 (formerly s.79L of the predecessor CO); see also UK Companies Act 1985, s.296. However, there is no definition of "non-cash asset".
[78] CO, ss.292(1) and 292(2).
[79] See predecessor CO, s.79K(1).
[80] CO, s.292(3).

be satisfied. In the case of listed companies or private companies where the annual financial statements of the previous years as specified in s.304 of the CO are used to justify any distribution:

(a) the directors have to be satisfied that the aggregate value of the company's fixed assets at the time is not less that the aggregate amount at which they are for the time being stated in the financial statement; and

(b) there must be stated in a note to those financial statements that:

(i) the directors have considered the value of the company's fixed assets without actually revaluing those assets;

(ii) they are satisfied that the aggregate value of those assets at the time of consideration of those assets is or was not less than the aggregate amount at which they are or were for the time being stated in the financial statements; and

(iii) accordingly, by virtue of s.292(4) of the CO, amounts are stated in the financial statements on the basis that a revaluation of the company's fixed assets is to be regarded as having taken place at that time.[81]

In the case of a private company where the financial statements are those specified in ss. 305 or 306 of the CO are used to justify any distribution then only condition (a) above needs to be satisfied.[82]

Profits and Losses before 1 September 1991[83]

11.046 Where having made all reasonable enquiries, the directors of a company are unable to determine whether a particular profit or loss made before 1 September 1991 is realized, they may treat such profit as realized or such loss as unrealized as the case may be.[84] In effect, the benefit of the doubt is given in favour of the company in increasing the fund out of which it can lawfully make distributions.

Special Rules for Insurance Companies

11.047 For a company that is an insurer and carries on long term business as defined in ss.2 and 2(1) of the Insurance Companies Ordinance (Cap.41), a special provision applies as to what may be regarded as realized profit or loss for the purposes of Part 6 of the CO. Any amount properly transferred to the statement of comprehensive income of the company from a surplus in the fund maintained by it in respect of the long term business is to be regarded as a realized profit and a deficit in that fund is to be regarded as a realized loss.[85] Subject to the foregoing, s.293(3) of the CO provides that any profit or loss arising in the company's long term business is to be disregarded.

[81] CO, ss.292(3)(a) and 292(3)(b)(i).
[82] CO, s.292(3)(b)(ii).
[83] The commencement date of former Part IIA of the predecessor CO.
[84] CO, s.291(3); see also UK Companies Act 1985, s.263(5).
[85] CO, s.293(4) (predecessor CO, s.79E(2); see also UK Companies Act 1985, s.268).

Meaning of Surplus or Deficit in Fund

11.048 A surplus and deficit in any fund maintained by an insurance company is defined respectively to mean any excess of the assets representing that fund over the liabilities of the company; and any excess of those liabilities over the assets attributable to its long term business[86] as shown by an actuarial investigation.[87]

The Justification of the Distribution

By Reference to Specified Financial Statements in Division 4 of Part 6 of the CO

11.049 The amount of a distribution which may be lawfully made by a company must be determined by reference to financial items (defined in CO, s.290(1) as meaning profits, losses, assets and liabilities, provisions and share capital and reserves, including undistributable reserves) as stated in the financial statements specified in Division 4 of Part 6 of the CO.[88] In the majority of the cases, the relevant financial statements will be the company's last annual financial statements.

Requirements for Last Annual Financial Statements

11.050 The financial statement must have been: (a) laid before the company in general meeting in accordance with s.429(1) of the CO or sent to every member under s.430(3) of the CO;[89] and (b) properly prepared in accordance with Subdivision 3 of Division 4 of Part 9 of the CO or so prepared save in relation to matters that are not material for the purpose of determining whether the distribution would be prohibited by those ss. 297, 298, 299 or 300 of the CO.[90]

Requirement for Auditor's Report

11.051 There also must be an auditor's report prepared under s.405 of the CO with an unqualified opinion to the effect that the financial statements have been properly prepared in compliance with the CO or otherwise with a written statement as to whether the matter in respect of which the report is qualified is material for the purpose of determining whether the distribution would be prohibited by ss.297, 298, 299, or 300 of the CO.[91] A written statement may be made at the time of the report or subsequently but must be laid before the company in general meeting or sent to every member to whom the auditor's report is sent under s.430(3) of the CO (where a company is not required to hold a general meeting).[92]

Interim Financial Statements

11.052 Exceptionally, where a proposed distribution would contravene ss.297, 298, 299 or 300 of the CO if determined by reference to the financial items as stated in the last

[86] CO, s.293(4) (formerly predecessor CO, s.79E(1)).
[87] "Actuarial investigation" is defined in s.293(5) to mean an investigation made under s.18 of the Insurance Companies Ordinance (Cap.41) (periodic actuarial investigation at least once every 12 months required in that section) or pursuant to a requirement imposed by s.32 of that Cap.41 (required by the Insurance Authority to cause an actuary to investigate the financial condition of the business).
[88] CO, s.304.
[89] CO, s.304(2).
[90] CO, s.304(3).
[91] CO, ss.304(4) and 304(5).
[92] CO, s.304(6).

annual financial statements, interim financial statements may be used to justify the making of distribution by the company.[93] In other words, where the last annual financial statements do not disclose sufficient profits to make the proposed distribution, the company is given a second chance by the preparation and use of interim accounts for the purposes of showing that there are distributable profits.

Requirement in Relation to Interim Financial Statements for Listed Companies

11.053 For listed companies,[94] the interim financial statements must enable a reasonable judgement to be made as to the amounts of the financial items.[95] They must also have been: (a) properly prepared in accordance with Subdivision 3 of Division 4 of Part 9 the CO or so prepared save in relation to the matters that are not material for the purposes of determining whether the distribution would be made in contravention of those ss.297, 298, 299, or 300 of the CO;[96] (b) contain a statement of financial position that is approved by the directors and signed by 2 directors on the directors' behalf whose name must be stated;[97] and (c) delivered to the Registrar for registration.[98]

Interim Financial Statements for Private Companies

11.054 For private companies, the interim financial statements are that which is necessary to enable a reasonable judgement to be made as to the amounts of the financial items.[99] No other statutory requirements in terms of form, content or service are imposed.

Initial Financial Statements

11.055 Where the distribution is proposed to be declared before any financial statements are laid before the company in general meeting under s.429(1) of the CO or sent to every member under s.430(3) of the CO, then the financial statements for the purposes for justification are the company's financial statement that are necessary to enable a reasonable judgement to be made as to the amount of the financial items.[100] For listed companies, there are additional requirements that:

(a) the financial statements must have been properly prepared in accordance with Subdivision 3 of Division 4 of Part 9 of the CO or so prepared save in relation to the matters that are not material for the purposes of determining whether the distribution would be made in contravention of ss.297, 298, 299 or 300 of the CO;[101]

(b) contain a statement of financial position that is approved by the directors and signed by 2 directors on the directors' behalf whose name must be stated;[102]

[93] CO, s.305(1).
[94] "Listed company" is defined in CO, s.2 to mean a company that has any of its shares listed on a recognized stock market.
[95] CO, s.305(2).
[96] CO, s.305(3).
[97] CO, s.305(5).
[98] CO, s.305(6).
[99] CO, s.305(2)(b).
[100] CO, s.306(1).
[101] CO, s.306(2).
[102] CO, s.306(4).

(c) the company's auditor must have prepared a report on the financial statements stating whether in his/her opinion the financial statements satisfy (a) above,[103] or if not so satisfied the auditor must have given a written statement as to whether, in his/her opinion, the matter in respect of which the report is qualified is material for the purpose of determining whether the distribution would be made in contravention of ss.297, 298, 299 or 300 of the CO;[104] and

(d) a copy of the financial statements, auditor's report and any written statement must have been delivered to the Registrar for registration.[105]

Successive Distributions

Where Prior Distributions have been made

11.056 Where the company wishes to justify payment of distributions by reference to financial statements and the company has either made one or more prior distributions by reference to those same financial statements, the proposed distribution is increased by the amount of the prior distributions.[106]

Giving of Financial Assistance or other Payments made since the Financial Statements were Prepared

11.057 In the case where since the financial statements were prepared, financial assistance has been given by the company out of its distributable profits or given in contravention of Division 5 of Part 5 of the CO and the giving of that financial assistance reduces the company's net assets or increases its net liabilities, the proposed distribution is increased by the amount of that financial assistance.[107] Furthermore, where since the financial statements were prepared the company has made a payment in respect of the buy-back by the company of its own shares or a payment of any description specified in s.257(5) of the CO, except a payment lawfully made otherwise than out of distributable profits, the proposed distribution has to be increased by the amount of that payment.[108] The net effect is that any previous distributions or payment or assistance given by the company which has in fact reduced the company's net assets or increased its liabilities must be deducted from the distributable profits as shown in the financial statements relied upon by the company to justify the proposed distribution.

Additional Requirement for Listed Companies

Section 298 of the CO

11.058 There is an additional restriction imposed on the ability of listed companies to make distribution. Even where under s.297 of the CO, it would have profits available for

[103] CO, s.306(5).
[104] CO, s.306(6).
[105] CO, s.306(7).
[106] CO, ss.303(1) and 303(2).
[107] CO, ss.303(1) and 303(2). "Net assets" and "net liabilities" are defined terms under CO, s.303(5).
[108] CO, ss.303(1), 303(2), and 303(4).

distribution, a listed company has to further satisfy the requirement that at the time of distribution: (a) the amount of its net assets is not less than the aggregate of its called up share capital and undistributable reserves;[109] and (b) if and to the extent that the distribution does not reduce the amount of those assets to less than that aggregate.[110]

Meaning of "Net Assets"

11.059 "Net assets" is defined to mean the aggregate of the company's assets less the aggregate of its liabilities.[111]

"Uncalled Share Capital" not an Asset

11.060 For the purposes of s.298 of the CO, a listed company cannot include any uncalled share capital as an asset for the purposes of determining the amount of the net assets of the company.[112]

Meaning of the Company's "Undistributable Reserves"

11.061 This is defined to mean: (a) the company's accumulated unrealized profits (so far as not previously utilized by a capitalization but does not include a transfer of profits to its capital redemption reserve on or after 1 September 1991) less its accumulated unrealized losses (so far as not previously written off in reduction or reorganization of capital); or (b) any other reserve that the company is otherwise prohibited from distributing by the CO (apart from Part 6 of the CO) or its articles.[113] As unrealized losses are excluded from the undistributable reserves, in effect, listed companies are required to take into account unrealized losses when deciding whether it may make distributions.

Investment Companies

Modification of or Exemption from the General Restrictions

11.062 The restrictions imposed on all companies generally by s.297 and the additional requirement on listed companies by subsequent s.298 of the CO may be modified or exemption given by the Financial Secretary for any listed company whose principal business consists of investing its funds in securities, land or other assets with the aim of spreading investment risk and giving its members the benefit of the results of the management of the assets subject to any such terms and conditions as he may consider appropriate.[114]

[109] CO, s.298(1)(a).
[110] CO, s.298(1)(b).
[111] CO, s.290(1).
[112] CO, s.298(2).
[113] See definition of "undistributable reserves" in CO, s.290(1).
[114] CO, s.300. *cf* the more elaborate provisions in s.267 of the UK Companies Act 1985 which provides for the making of regulations to provide an altogether different set of rules for the calculation of distributable profits for investment companies.

III. CONSEQUENCES OF AN UNLAWFUL DISTRIBUTION

Status of the Distribution Made in Contravention of Part 6 of the CO

Effect of Contravention of Part 6 of the CO

11.063 The requirements laid down by Part 6 of the CO are strict and mandatory.[115] Even where the company can show it could have lawfully paid out the distribution in question, this is not a defence.[116] Accordingly, the failure to comply with the statutory requirements laid down for the preparation of the accounts to justify payment of the distribution is not a mere technicality but renders the distribution unlawful and payment by directors of such *ultra vires*. Instances where the court has held there has been a breach of the accounting provisions of the statute include: the accounts failed to present a true and fair view by inflating the profits,[117] failing to make provision for tax liabilities,[118] failure of the auditor to make the statement required under s. 406 of the CO where the accounts are qualified[119] or there was no such statement at the time of the distribution,[120] and inclusion of an unlawful dividend in the profit and loss accounts.[121] Even where the directors can show the level of profit available would have remained the same, the adoption of an accounting practice otherwise than that stated in the relevant accounts contained a material misrepresentation as to the basis upon which they were created such that they were not true or fair would render the distribution unlawful.[122] The requirements laid down by ss. 302, 304, 305, and 306 of the CO have to be complied with at the time of making the distribution.[123]

Shareholders Cannot Ratify Breach

11.064 Moreover, shareholders cannot confirm or ratify the distribution rendered unlawful by the provisions of Part 6 of the CO and any such resolution passed is ineffective.[124] The reason given being is that the accounting sections afford a major protection for creditors of the company and not just the members.[125]

[115] The English Court of Appeal has said that the provisions of the UK equivalent provision (UK Companies Act 1985, s.270) are of a "strict and mandatory character" in *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 544i. See also *Revenue and Customs Commissioners v Holland* [2010] 1 WLR 2793 at paras 46 and 47.
[116] See *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 545a–b.
[117] See *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 535h–536a, the reference to the trial judge's finding that instead of the published pre-tax profits of some £90 million, a true and fair view ought to have limited profits to £32 million for the year 1991 and instead of profits of £80–85 million in truth the profits ought to have been close to zero.
[118] *Re Loquitur Ltd, Inland Revenue Commissioners v Richmond* [2003] 2 BCLC 442 at 471d–e, paras 133–134.
[119] *BDG Roof-Bond Ltd v Douglas* [2000] 1 BCLC 401.
[120] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] 3 WLR 812.
[121] *Re Cleveland Trust* [1991] BCLC 424 at 431e–431g.
[122] *Allied Carpets Group plc v Nethercott* [2001] BCC 81.
[123] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] 3 WLR 812.
[124] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] 3 WLR 812 at 816F-H. See also *Allied Carpets Group plc v Nethercott* [2001] BCC 81, *Progress Property Co Ltd v Moorgarth* [2010] 1 BCLC 1 (CA), [2011] 1 WLR 1 (SC) and *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd* (2009) 12 HKCFAR 417 at 466D–E. This is consistent with the common law position before the coming into operation of the legislative provisions: see e.g. *Re Exchange Banking Co, Flitcroft's Case* (1882) 21 Ch D 519.
[125] *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] 3 WLR 812 at 817B-C. See also *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 546h–i.

Liability of Recipient Shareholders

Liability to Repay

11.065 A member of a company is liable to repay to the company any distribution (or its value if it was distribution in kind) received by him or her which was made in contravention to ss. 297, 298, 299, or 300 of the CO where he knows or has reasonable grounds for believing that it is so made.[126] A shareholder will be liable if he knew or ought to have reasonably known of the facts constituting the contravention whether or not he knew that the CO has been contravened. Hence, ignorance of the law is no defence.[127] Where only part of the distribution is unlawful, only that part which is unlawful needs to be paid back.[128]

Objective Statutory Test

11.066 Section 301(1)(b) of the CO provides that the provision *applies only* where a member "knows or has reasonable grounds for believing" that the distribution convenes that the relevant section. Hence the test is an objective one.

Liability Under the Common Law

11.067 However, s.301(4) expressly provides that s.301 the CO as a whole is without prejudice to any obligation otherwise imposed on a member of a company to repay a distribution unlawfully made and therefore preserves the common law position.[129] In the case of *Precision Dippings Ltd v Precision Dippings Marketing Ltd*,[130] the company had paid a dividend of £60,000 to its parent company and within a year the company went into creditors' voluntary liquidation. The relevant accounts were qualified but the auditors did not make a statement on the materiality of the qualification before the dividend was paid. It was accepted that the recipient directors of the parent company were unaware of the relevant requirements of the UK Companies Act 1985 and were advised by the company's auditors that they could lawfully make those distributions. The English Court of Appeal relied upon the saving provisions and held it was not necessary to examine the wordings of those provisions. The Court of Appeal instead turned to consider the common law position and having held the payment was *ultra vires*, held the recipient directors were liable to repay the sum as constructive trustee. Accordingly, there was no consideration of whether the directors had reasonable grounds for believing the distribution was unlawfully made.

Liability under Constructive Trust

11.068 Similarly, shareholders who receive payment of dividends unlawfully declared may be liable as constructive trustee to repay the money to the company if he or she would have been held so liable at common law. In order for a constructive trust to arise at common law, there must be established breach of fiduciary duty on the part of the

[126] CO, ss.301(1)–301(3).

[127] See *It's a Wrap (UK) Ltd v Gula* [2006] EWCA Civ 544 on the UK equivalent s.277(1) of the Companies Act 1985. The English Court of Appeal held that since the respondent directors and shareholders of the company knew that the company had no profits, they knew that the distributions had been made in contravention of the Act and the dividends had to be repaid.

[128] See reference to "or that part of the distribution" in the CO, ss.301(1)–301(3).

[129] See *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd* (2009) 12 HKCFAR 417 at para 125.

[130] [1985] 3 WLR 812.

directors and the recipient has the requisite level of knowledge about the factual circumstances giving rise to the breach of trust so as to require him or her to account for payment of those distributions. As to the different levels of knowledge, in the case of *Baden, Delvaux and Lecuit v Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France SA*,[131] Peter Gibson J identified five categories of knowledge:

> "(i) actual knowledge; (ii) wilfully shutting one's eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; and (v) knowledge of circumstances which would put an honest and reasonable man on inquiry".

Those persons in the first three categories are said to have actual knowledge and the latter two categories have constructive knowledge only. Actual knowledge would lead to the imposition of liability on the recipient[132] although there is some uncertainty as to whether constructive knowledge suffices.[133]

Proof of Knowledge

11.069 However, as a matter of practical reality, save in the case of small private companies, shareholders who are not directors or involved in the management of the company would unlikely to have requisite knowledge be it actual or constructive to be fixed with a constructive trust.

Liability of Directors and Auditors

No Express Statutory Liability in Part 6 of CO

11.070 Section 301 of the CO does not expressly impose liability upon directors for making unlawful distribution but the position at common law is clear. A director who causes the company to enter into an *ultra vires* transaction will be liable for breach of his fiduciary duty to the company.[134]

Liability of Director as Fiduciary or Trustee and for Breach of Duty of Care under the Common Law

11.071 By reason of their fiduciary position,[135] directors who cause their company to make *ultra vires* payments are in the same position as trustees who make payments in

[131] [1993] 1 WLR 509 at 575–576.

[132] See *Barnes v Addy* (1874) 9 Ch App 244; see also *Belmont Finance Corp v Williams Furniture* [1979] Ch 250 at 267; *Selangor United Rubber Estates v Cradock (No 3)* [1968] 1 WLR 1555 at 1590 (per Buckley LJ).

[133] *Selangor United Rubber Estates v Cradock (No 3)* [1968] 1 WLR 1555; see also *Baden v Société Générale* [1993] 1 WLR 509N at 573. However, the favoured approach is a single test of unconscionability and to ask whether in the words of Buckley LJ in *Belmont Finance (No 2)* [1980] 1 All ER 393 at 405, the recipient can "conscientiously retain [the] funds against the company" or, in the words of Sir Robert Megarry VC in *In re Montagu's Settlement Trusts* [1987] Ch 264, 273: "[the recipient's] conscience is sufficiently affected for it to be right to bind him by the obligations of a constructive trustee". See Nourse LJ in *Bank of Credit and Commerce International (Overseas) Ltd (in liq) v Akindele* [2000] 4 All ER 221 at 235–236.

[134] See *Re Sharpe* [1892] 1 Ch 154.

[135] See Lord Porter in *Regal (Hastings) Ltd v Gulliver* [1742] 1 All ER 378 at 395, [1967] 2 AC 134 at 159: "Directors, no doubt, are not trustees, but they occupy a fiduciary position towards the company

breach of trust, and are liable to make good to the company the money so misapplied.[136] Some older cases suggest that there is liability on the part of directors even where they acted *bona fide* and honestly where payment to shareholders was *ultra vires*.[137] However, the preferred view is that directors will not be held liable where they took reasonable care to prepare the accounts or reasonably relied on other officers or accountants to prepare the same and on that basis honestly and reasonably relieved that payment could be justified.[138] In *Bairstow v Queens Moat Houses plc*[139] where a claim against directors for unlawful distribution of dividends was brought on the basis of breach of trust and breach of contract held that a director who authorizes the payment of an unlawful dividend in breach of his duty as quasi trustee, will be liable to repay such dividends if:

(a) he knows that the dividends were unlawful, whether or not that actual knowledge amounts to fraud;

(b) he knows the facts that established the impropriety of the payments, even though he was unaware that such impropriety rendered the payment unlawful; (c) he must be taken in all the circumstances to know all the facts which render the payments unlawful; or

(d) he ought to have known, as a reasonably competent and diligent director, that the payments were unlawful.

Partial Repayment

11.072 However, a constructive trust is only imposed on that part of the distribution which is unlawful and the directors only need to account for the partial *ultra vires* payment.[140]

whose board they form". See also *J Harrison (Properties) Ltd v Harrison* [2002] 1 BCLC 162 at 173, para [25] where Chadwick LJ stated the following propositions: "... (i) that a company incorporated under the Companies Acts is not trustee of its own property; it is both legal and beneficial owner of that property; (ii) that the property of a company so incorporated cannot lawfully be disposed of other than in accordance with the provisions of its memorandum and articles of association; (iii) that the powers to dispose of the company's property, conferred upon the directors by the articles of association, must be exercised by the directors for the purposes, and in the interests of, the company; and (iv) that, in that sense, the directors owe fiduciary duties to the company in relation to those powers and a breach of those duties is treated as a breach of trust".

[136] *Re Exchange Banking Co, Flitcroft's case* [1882] 21 Ch D 519; see also *Re Sharpe* [1892] 1 Ch 154; *Precision Dippings Ltd v Precision Dippings Marketing Ltd* [1985] 3 WLR 812; *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 545b–c.; *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd* (2009) 12 HKCFAR 417 at 466C-D.

[137] *Re Sharpe* [1892] 1 Ch 154.

[138] See *Leeds Estate Building and Investment Company v Shepherd* (1887) 36 ChD 787 at 801 cited with approval in *Dovey v Cory* [1901] AC 477 at 490 and also *Re Kingston Cotton Mill Co (No 2)* [1896] 1 Ch 331, where Vaughan Williams J held at 348 that the directors were not liable in paying dividends where they honestly and reasonably believed there were profits out of which to pay them and had no reason not to believe the statements of the managers (which turned out to be false) upon which their belief was based. The auditors who were found to have relied honestly and reasonably on the statement of the manager in the preparation of the accounts were found not to be negligent also by the Court of Appeal, at [1896] 2 Ch 279.

[139] [2000] 1 BLCL 549 at 559h–560b (Nelson J) whose judgment on directors' liability for paying unlawful dividends was upheld by the Court of Appeal at [2001] 2 BCLC 531.

[140] *Re Cleveland Trust* [1991] BCLC 424 at 429i.

Solvency of Company is Irrelevant

11.073 The fact that the company is solvent is not a defence to the claim against the directors to make good the unlawful distribution.[141] Directors may however seek an indemnity from shareholders who knowingly received the unlawful dividends.[142]

Liability of Auditors

11.074 Contribution proceedings against the auditors may also be appropriate where they are liable to make good the unlawful dividends paid on the recommendations of the directors of the bank based on balance sheets prepared and certified by the auditors which did not truly represent the financial position of the company.[143]

Relief under s.903 of the CO

11.075 Relief may be available to a director or an auditor under the CO where it can be shown that he or she acted honestly and reasonably and that having regard to all the circumstances of the case he or she ought fairly be excused from his liability.[144] However, it is unlikely where there has been a finding that the directors were guilty for dishonestly preparing accounts for the purposes of justifying the payment of distribution which otherwise would be unlawful could successfully resort to this exemption.[145] Furthermore, directors cannot hide behind the company's accountants where there is a duty to take reasonable steps to ascertain the financial position of a company before declaring a dividend.[146]

Right of action by Shareholder Against Director for Unlawful Distribution?

The No Reflective Loss Principle

11.076 Where directors of a company make an unlawful distribution the question arises whether shareholders have any right of action against them. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,[147] it was said that it is an:

> "... elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C".

The court further referred to what is known as the rule in *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189 in saying:

> "But what [a shareholder] cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum

[141] *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 at 546h–i.

[142] *Moxham v Grant* [1900] 1 QB 88.

[143] *Re London & General Bank (No 2)* [1895] 2 Ch 673.

[144] See CO, s.903(1).

[145] The Court of Appeal in *Bairstow v Queens Moat Houses plc* [2001] 2 BCLC 531 also considered the question of relief under s.727 of the UK Companies Act 1985. It was held that given the finding by the trial judge that there was dishonesty in the preparing of false accounts, it was not open to find the paying of dividends on the strength of those accounts to be honest and reasonable. Hence relief was not allowed, at 552f–h and 553e–h.

[146] *Hilton International Ltd v Hilton* [1989] 1 NZLR 442.

[147] [1982] 1 All ER 354 at 357, [1982] Ch 204 at 210.